



City of Westminster

Committee Report

Decision Maker:	PENSION FUND COMMITTEE
Date:	29 November 2023
Classification:	General Release
Title:	ESG Private Equity
Wards Affected:	All
Policy Context:	Effective control over council activities
Financial Summary:	There are no immediate financial implications arising from this report, although investment performance has an impact on the Council's employer contribution to the Pension Fund (the Fund) and this is a charge to the General Fund.
Report of:	Phil Triggs <i>Tri-Borough Director of Treasury and Pensions</i> ptrigs@westminster.gov.uk 020 7641 4136

1. EXECUTIVE SUMMARY

- 1.1 This paper summarises the attached Isio paper, shown in Appendix 1, on the ESG private equity asset class, including investment characteristics, an overview of market conditions and its suitability within the City of Westminster Pension Fund strategic asset allocation.

2. RECOMMENDATIONS

- 2.1 That the Pension Fund Committee:
- note the assessment, observations and recommendations in relation to ESG Private Equity as set out by Isio at Appendix 1.

3. BACKGROUND

- 3.1 Following the Pension Fund's investment strategy review at the 9 March 2023 committee meeting, the committee requested consideration of the ESG Private Equity asset class for the Fund's strategic asset allocation. This paper includes an overview of the Private Equity asset class, key investment characteristics and risks, an overview of market conditions and Isio's views on the attractiveness of private equity.
- 3.2 Private Equity is classified as ownership of a company that is not publicly listed or traded on a public stock exchange. In comparison to debt financing, equity returns are more variable, with profits generated used to repay debtholders first and residual profits flowing to equity holders. As private equity is traded infrequently, specialised expertise is needed to access this market, with generally four areas of investment: venture capital, distressed, development capital and management buy-outs or buy-ins.
- 3.3 Generally, private equity can be accessed either as a direct investment or through a pooled fund, with the following pooled investment types:
- **Open-ended:** the fund manager will create or redeem units in a private equity fund as demand to buy or sell units fluctuates.
 - **Closed-ended:** the fund will raise commitments from investors for the entire duration of the fund cycle, and cash will be redistributed to investors as the fund matures.
 - **Listed Fund:** investment via publicly listed companies that invest in private companies.
 - **Fund of Funds:** diversifying across a range of private equity asset managers.
- 3.4 Generally the asset class carries a higher level of risk than traditional asset classes. However, private equity is expected to provide additional returns to compensate for bearing this risk. The key investment characteristics and risks of the asset class are set out as follows:
- **Illiquidity risk:** as private equity is infrequently traded, it is difficult to move out of without selling at a significant discount.
 - **Small Company risk:** private companies are generally smaller or less developed than those listed on an exchange. Therefore, they tend to have more volatile returns and a higher risk of bankruptcy.
 - **Equity risk:** private companies are exposed to the same economic conditions as their listed counterparts, and only receive profits after debtholders have been repaid.

- **Active Management opportunities:** opportunity to generate value in poorly performing companies by improving their efficiency.
- **Aligned Incentives:** private companies avoid the public shareholder pressure.
- **Leverage:** private companies typically rely more heavily on debt financing.
- **Investability:** there can be significant variation between performance of private equity funds, thus manager selection is key.
- **Equity Correlation:** historically the asset class is strongly correlated to listed equity, thus shouldn't be considered as a diversifying asset.
- **Pricing:** this is less reliable as there is no listed market price for comparison.

3.5 Within Appendix 1, Isio sets out how ESG can be integrated into the private equity asset class, with a particular focus on impact investment. Investments are typically aligned with UN Sustainable Development Goals (SDGs), and have focus on stewardship priorities and Key Performance Indicators (KPIs) linked to ESG objectives. However, the number of propositions available in the market is fairly restricted, with Isio believing more attractive ESG investment opportunities are available elsewhere.

3.6 During July 2023, the LGPS Consultation was released by the Department for Levelling Up, Housing and Communities (DLUHC), seeking views on proposals relating to the investments of the LGPS. This included a proposal to allocate 10% of assets into high growth private equity schemes. There is expected to be some delay until the results of the consultation are known, and it is anticipated that there will be significant pushback against some of those proposals, including mandating a 10% private equity allocation.

4. STRATEGIC ASSET ALLOCATION AND MARKET CONDITIONS

4.1 The Pension Fund's latest actuarial valuation took place on 31 March 2022, with the funding level rising to 128% from 75% at 31 March 2013. Much of this increase in funding level has been as a result of excellent investment returns, alongside very significant deficit recovery payments made by the Council, as set out in the following table. Westminster City Council paid off its employer deficit during the financial year 2021/22, with circa £200m committed in deficit payments in the previous nine years.

4.2 Any further investment risk taken could erode into this surplus position that the Council has generated over recent years with its own cash reserves.

Date	Amount (£m)
2014/15	6.0
2015/16	7.5
2016/17	9.0
2017/18	20.5
2018/19	24.5
2019/20	28.5
2020/21	22.7
2021/22	80.0
Total	198.7

- 4.3 The Fund's most recent investment strategy review was undertaken during March 2023, with the funding level at 144% and rising to 160% at 30 September 2023. Given this strong funding position, the Fund took steps to reduce the overall risk profile of the Pension Fund, while still achieving a return in excess of the actuarial discount rate. It was agreed by the Committee to reduce the equity allocation by 5% with a 5% increase in renewable energy infrastructure, as well as appoint a UK residential housing manager to deploy the remaining 2.5% allocation to affordable housing.
- 4.4 At the time of the investment review, private equity was considered. However, as it did not meet the key objective of reducing investment risk and volatility, it was not included within the strategic asset allocation. It should be noted that the underlying objective of the Fund is to ensure member benefits are paid as they fall due, with this key objective forming the basis of the fiduciary duty of the Pension Fund Committee. The updated investment strategy takes these key investment principles into consideration with the aim of protecting the Fund's ability to meet member benefits going forward.
- 4.5 Under current market conditions, capital raised within the private equity asset class has continued to soften over the previous 12 months, with investor interest cooling. In addition, pricing within the buy-out market remains elevated, and private equity buyout deal pricing has steadily drifted upwards over the last seven years. The deal volume and value has continued to trend downwards, with smaller add on deals making up an increasing proportion of the market. The exit market also remains relatively subdued, with holding periods continuing to trend upwards.
- 4.6 Private equity faces a more uncertain environment, with fast paced changes in interest rates having made a significant impact on the sector, with a higher cost of debt financing. Therefore, the short to medium outlook for the asset class is uncertain, with a number of challenges to navigate in generating future returns. Although private equity funds have performed well in past years, Isio does not anticipate future performance to be as strong under current market conditions.

5. RECOMMENDATIONS AND NEXT STEPS

5.1 Following this evaluation of ESG Private Equity, Isio have set out the following views and recommendations for the Committee to consider:

- Given the strong funding level of the Pension Fund, Isio does not believe the Committee needs to generate investment returns above the position formally agreed at the investment strategy review.
- Under the current market conditions and, given the limited ESG opportunities within the private equity asset class, Isio does not believe an allocation to private equity is aligned to the direction of travel of the Fund's investment strategy.
- Until there is greater clarity on the LGPS consultation outcomes, Isio would not encourage a new allocation into private equity. Any retrospective changes to the asset class may result in costly restructuring further down the line, if the Fund were to be over/under exposed.

5.2 The Committee is recommended to revisit the ESG private equity asset class, once there has been formal communication from the DLUHC on the LGPS consultation and the level of ESG integration within the market is sufficiently developed.

If you have any questions about this report, or wish to inspect one of the background papers, please contact the report author:

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BACKGROUND PAPERS: None

APPENDICES:

Appendix 1: Isio ESG Private Equity Review and Considerations