City of Westminster Pension Fund

ESG Private Equity – Review and Considerations

November 2023

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Introduction and Background

Introduction

- This paper has been prepared for the Pension Fund Committee (the "Committee") of the City of Westminster Pension Fund (the "Fund"). The purpose of this paper is to provide:
    - An overview of Private Equity at an asset class level including the investment characteristics;
    - A summary of how ESG can be implemented in Private Equity and how this compares to other asset classes;
    - A view on how Private Equity might fit into the Fund's strategic target asset allocation and anticipated direction of travel for investments going forward;
    - An overview of market conditions and our views on the current attractiveness of Private Equity relative to other private market asset classes; and
    - Our views and anticipated impact of the ongoing LGPS consultation.

Background

- We presented our investment strategy review to the Committee at the 9 March 2023 Pension Fund Committee Meeting. At the meeting the Committee discussed the merits of moving 5% of the public equity allocation to fixed income, as well as a wider rebalance of the total portfolio.
- While the premise of this asset allocation change was to reduce the overall investment risk profile (and expected return) of the Fund, the Committee also discussed the merits of moving some of the listed public equity mandate to private equity over the near term to act as a balance, This would be a new area of investment for the Fund and the Committee.

Background (cont.)

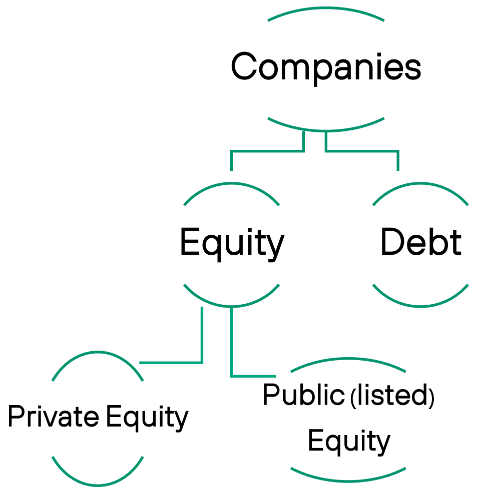
- The reasoning behind this consideration by the Committee was the opposing view that the strong funding position achieved by the Fund, and the surplus built up, represented an opportunity to take on a higher level of investment risk (via asset classes such as Private Equity) and further drive returns.
- Subsequently, at the 29 June 2023 Pension Fund Committee Meeting , the Committee considered the merits of Renewable Energy Infrastructure as a "compromise" between the relatively lower risk profile of fixed income and relative higher return profile of Private Equity, with strong impact characteristics and strong cashflows and agreed to invest an additional 5% to the existing Renewable Energy Infrastructure mandate held with Quinbrook.
- At the time, it was highlighted that our recommendations were not a "set and forget" strategy, rather the Fund's strategic allocations can and should be considered on a relatively ongoing basis.
- The Committee agreed they would still like to consider the merits of Private Equity on a standalone basis further, which is the purpose of this paper.

Private Equity – Asset Class Overview

What is Private Equity?

Private Equity As An Asset Class

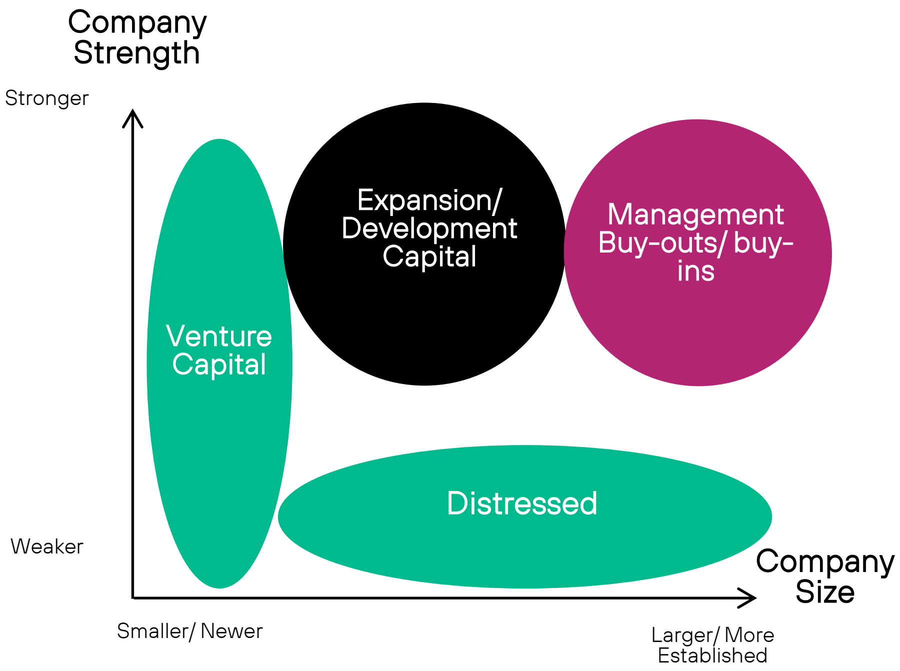
- Companies are funded by debt and equity. Profit generated by the company is first used to pay back debt, with residual profits flowing to equity holders. As such, equity returns are more variable and are considered higher risk (and have higher expected returns) when compared to debt.
- Equity can be traded on a public market, such as the London Stock Exchange, in which case the equity is 'public' (or 'listed'). If the equity of a particular company is not listed on a stock exchange, it is considered 'private' equity.
- As private equity is not frequently traded, special expertise is needed to access the equity of these private companies.
- Private equity funds will generally specialise in purchasing the equity of a particular type of private company, with different drivers of returns. These styles include:
    - Venture capital/ early stage
    - Distressed
    - Expansion/ Development Capital
    - Management buy-outs/ buy-ins
- Further information in relation to these styles is given on the next page.



Investment Styles

Investment Styles

- The indicative 'type' of company these different styles of private equity firms invest in (by size and strength) is shown in the chart and description below:
- Venture capital/early stage – venture capital/early-stage companies are usually formed around one concept which remains to be proven. They often operate in high-tech industries, and by their nature are the most risky form of private equity.
- Distressed – a broad category referring to investments in equity or debt securities of financially stressed companies. It could be an investor acquiring debt securities with a view to gaining control of the company's equity following a corporate restructuring or equally the provision of debt and equity investments to companies undergoing financial or operational challenges.
- Expansion/development capital - expansion/development capital is provided to existing private companies to help them grow. They are often family-owned businesses that are not yet ready for flotation and cannot raise the necessary funds from their bankers. They are less risky than venture capital because they have a trading history.
- Management buy-outs/buy-ins - management buy-outs/buy-ins (MBOs/MBIs) usually involve separating an existing business unit away from a larger parent company. When the existing management of the company remains in place, the deal is called an MBO. An MBI involves outsiders being imported to replace the old management. MBOs and MBIs are usually the least risky type of private equity as they involve existing businesses, and often the main change is simply restructuring the ownership of the business.



Investment Characteristics

Investment Characteristics

- Generally, asset classes with a higher level of risk are expected to outperform safer asset classes over the long run, compensating investors for bearing this risk.
- Private equity is considered a high risk / high return asset class and is therefore a good fit to form part of a high growth-orientated, long term investment strategy for investors able to tolerate the illiquidity and volatility..
- We have outlined the key investment characteristics and key risks associated with the asset class below:
    - Illiquidity risk – given private equity is rarely traded, it is difficult to move out of a private equity investment quickly without selling at a substantial discount. In comparison to other market participants, the Fund is well placed to take illiquidity risk as it is immature and has a significant active membership, giving it a long term time horizon.
    - Small company risk – private companies are often smaller or less developed than their listed counterparts, particularly in the case of venture capital. Smaller companies tend to have more volatile earnings and a higher risk of bankruptcy than more established companies, and as a result of this higher risk these companies are expected to deliver higher returns in the long run (the private market counterpart to the 'small cap premium' seen in listed equity).
    - Equity risk – although private equity is not listed and, as such, is not directly exposed to market movements, the underlying companies will be operating in the same economic conditions and industries as their listed counterparts. Additionally, given the equity of these companies will receive profits only after debtholders have been repaid, returns to equity holders will be volatile. As a result, over the long run equity returns are expected to be higher than the less variable debt returns to compensate for this risk.

Investment Characteristics (cont.)

- Active management opportunities – private equity funds have experience in working with private companies, and in some cases look to generate value by restructuring poorly performing companies to improve their efficiency.
- Aligned incentives – private companies avoid public shareholder pressure, which could lead to principal-agent problems and a focus on quarterly performance over long term sustainable growth.

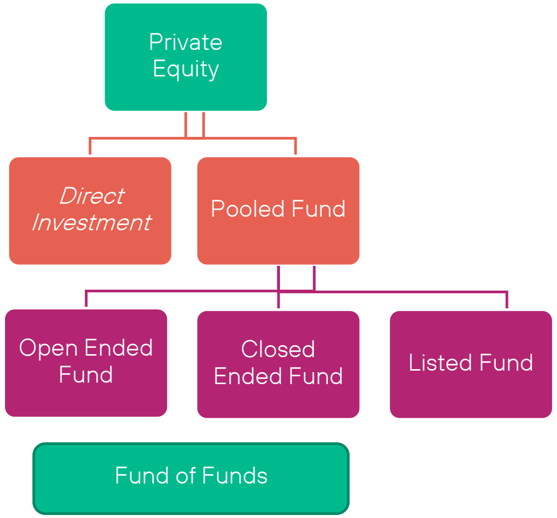
Further Considerations

- Leverage – private companies typically rely more heavily on debt financing, increasing the variability of private equity returns and the potential for bankruptcy. Symmetrically, this use of leverage will magnify equity returns when the underlying company performs strongly.
- Investability – there is significant variation between the performance of private equity funds set up in different years (different 'vintages') and within the same year. As such, it is very important to pick the right manager, and conversely, choosing a weak manager will have a long-term detrimental impact on returns even if private equity performs well as a whole.
- Equity correlation – historically, private equity has been strongly correlated with listed equity. As such, they should not be considered a diversifying asset within a portfolio containing listed equity.
- Pricing – given there is no listed market price for private equity, pricing will be less reliable and more subjective in comparison to listed companies.

Asset Class Access (1)

Accessing Private Equity

- Investing in private equity can either be as a direct investment, or through a pooled fund, as shown in the chart below. The Fund (as with the vast majority of pension schemes) does not have the scale or governance budget to meaningfully invest directly. As such, we will focus on the different types of pooled investments the Fund could utilise.



Open-Ended Fund

- The equity fund manager will create or redeem units in a private equity fund as demand to buy or sell units fluctuates. These units are then bought or sold at the unit price (offer for purchasers or bid for sellers) at the time of the transaction. This allows investors to enter and exit the fund over the course of the fund cycle, although this process can take a number of months, this delay would become more pronounced in periods of market stress.

Closed-Ended Fund

- Initially, this fund will raise commitments from investors for the entire duration of the fund cycle, and will then draw down on these commitments over time to purchase assets. As the fund matures, cash will be redistributed to the original investors.
- This approach avoids dilution of the returns of profitable investments, but commits investors to the full lifecycle of the fund (typically c. 10 years). Additionally, commitments will only be invested for a portion of the time capital is committed due to the delay in drawing down funds.

Listed Fund

- Listed private equity funds are publicly owned companies that invest in private ones – they are a subset of closed ended funds. It is therefore possible for schemes to invest in these listed companies to gain exposure to the private equity market.
- The key drawback of this approach is that by being listed on the stock markets, the market value of such funds tend to take on an even greater correlation to other listed equities than is already the case for private equity. This can make such funds far less attractive as an investment to sit alongside a traditional equity investment portfolio.

Fund of Funds

- This approach will look to circumvent the risk of picking a weak private equity manager by diversifying across a range of different funds. This has the advantage of delegating fund selection choice to a manager with specific expertise in the sector, which can lead to a better overall exposure. The key drawback of the approach is the multiple layer of fees, paid first to the underlying private equity managers and then to the fund-of-funds manager.

Asset Class Access (2)

- In the table below we provide a comparison of the key benefits and drawbacks of the various access routes for the asset class.

Access	Key benefits	Key drawbacks
Open-ended Fund	Better liquidity Faster route to investment	Portfolio diluted as more units created Potential for other investors to exit early
Closed-ended Fund	Exposure to PE lifecycle Other investors can't leave early	Less liquid Not fully invested throughout cycle
Listed Private Equity	Potential better liquidity Regulation	Higher costs Equity correlation
Fund of Funds	Diversifies the risk of poor investment management choices Usually open ended	Additional layer of fees

ESG Implementation in Private Equity

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What does 'good in ESG' look like across Equity Investment?

Asset Class	Investment Approach/Framework	Risk Management	Voting & Engagement	Reporting	Collaboration
Private Equity	– As is the case for other actively managed asset classes, ESG integration into the investment approach of private equity managers is crucial. – Positive traits would typically include: use of an ESG scorecard, integrating quantitative KPIs and objectives, integration into due diligence; and clear evidence of ESG factors directly impacting decision making.	– Integration of strong ESG processes into risk management is as important in private as in public markets. – Positive characteristics include: use of multiple data providers with raw data that feeds into scoring and risk management; and using scenario analysis as part of a risk management framework (including climate)	– Voting is typically not applicable (unlike public equity). – Active ownership is crucial to managing ESG risks; managers will often own a majority stake in the firm (with control of the board) and are very well placed to drive positive change, relative to public asset holders (who are typically minority shareholders).	– Private equity firms are not mandated to report; as a result data quality and transparency is expected to be lower than public markets. – Active ownership required to fully understand ESG risks within the portfolio and encourage reporting where possible, while using multiple data providers and proxies to fill gaps.	– Similar to other asset classes; we believe managers should demonstrate collaboration with industry bodies and initiatives specifically focussed on alternative asset classes (including private equity).
Impact Private Equity	– Typically, investments are aligned to UN SDGs or impact objectives (for example Net Zero) – such as investing directly in solution providers. – Quantitative KPIs are generally set at deal level.	– Same as above	– Same as above, however there is more focus on alignment of impact objectives with stewardship priorities.	– Reporting is against set objectives and KPIs. – Investor fees can be linked to impact KPIs, to generate incentives which are aligned to funds' ESG objectives.	– Same as above
Active Public Equity	– We look for similar integration into the investment process; however, there is expected to be more reliance on publicly reported data and information.	– There is less need for multiple data providers as data is publicly available and provided from source (albeit divergence between providers remains common).	- Managers can influence companies via voting and engagement; albeit the scope for change is smaller than in private markets. - Managers should utilise proxy voting providers, and should engage with firms on their stewardship priorities.	– There is typically higher data quality / transparency given firms are required to publicly disclose more information.	- Same as above

Key Characteristics of Impact Private Equity

Summary

- Private Equity is well placed to generate 'impact', given its detailed active approach to bottom-up deal due diligence, as well as the ownership structure of most PE investments (i.e., funds will typically hold majority stakes in underlying companies, with control of the board allowing significant influence over the direction of the underlying business including decisions in relation to ESG). Majority stakes are much less common in earlier stage PE (i.e., Venture or Growth investing); however, ownership share remains significantly higher than what is typical in public markets. Furthermore, PE funds are typically smaller than public market equivalents, allowing managers the scope to be truly 'active owners'.
- There are different approaches to Impact PE: some managers have a clear focus on climate or Net Zero; whereas others have adopted a broader impact approach (typically using the UN SDGs as a framework). Typically, managers can categorise an impact-suitable firm using proportion of revenue attributed to providing a solution or product that achieves a particular goal/s (see below).
- These approaches integrate specific environmental and/or social impact objectives alongside more traditional financial (risk/return) objectives, in equal importance, with quantitative KPIs set and monitored against at fund and deal levels. We have also seen a number of managers link a portion of incentive fee to meeting impact-based KPIs.

Broad Impact Private Equity Approach

- This approach looks to identify businesses which provide products and / or solutions which are aligned (from a revenue perspective) to a number of UN SDGs (both social and environmental) which are key priority areas for the fund, with the objective of aiding in achieving one or more of these global goals. For example, social housing, infrastructure, healthcare and financial inclusion.

Net Zero / Climate Transition Private Equity Approach

- We have seen a few impact private equity approaches with a specific focus on climate transition; these funds invest in firms providing solutions to the climate emergency (including technologies and projects) and which aid in the Net Zero transition, across both mitigation and adaptation. For example, renewables, afforestation projects, and climate technologies.

Sustainable Development Goals ('SDGs')

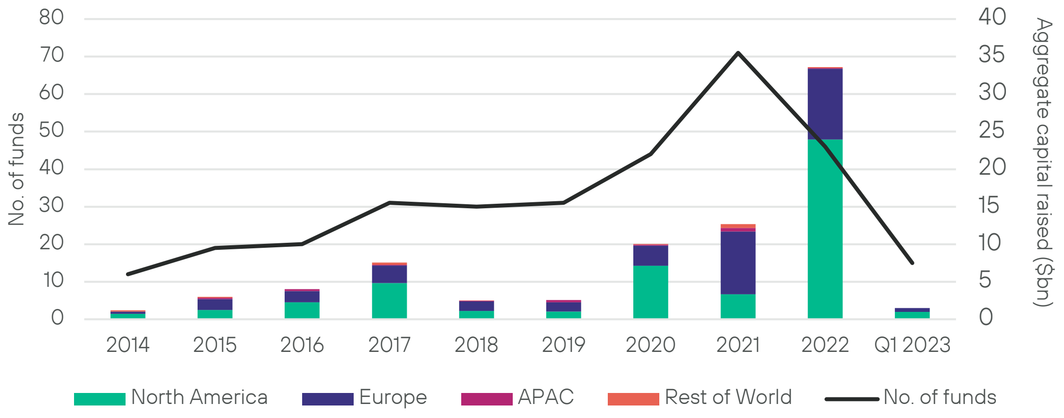
Investing in private firms that provide solutions to one or several of the United Nations' SDGs.

Net Zero

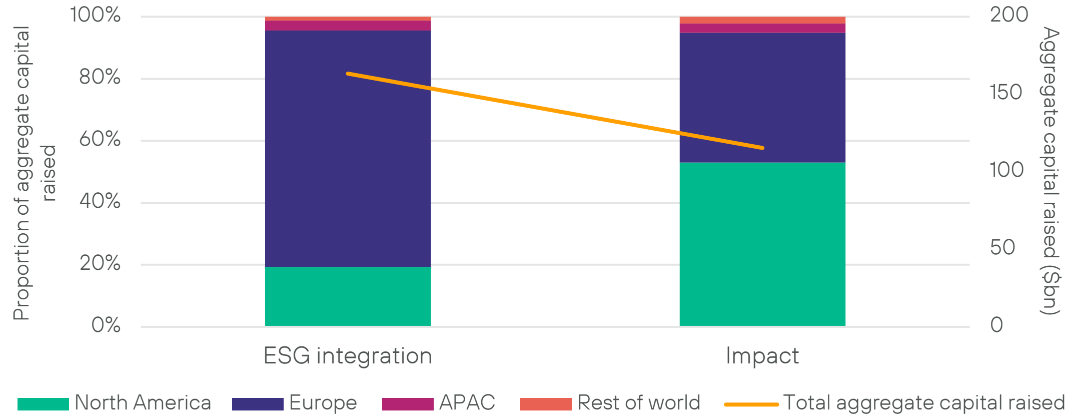
Investing in private firms that provide products and solutions (e.g. technology) which aid in the Net Zero transition (mitigation as well as adaptation).

Impact Private Markets

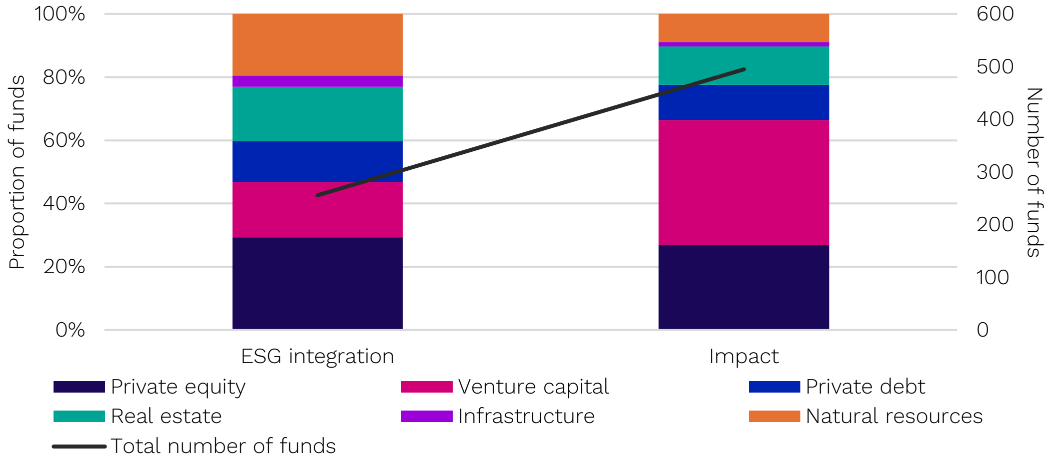
Impact fundraising by region and year



Impact vs ESG funds closed by region, vintages 2013-2023



Impact vs ESG funds closed by asset class, vintages 2013-23



- Private market impact fund volume has trended upwards over recent years, with capital raised spiking in 2022, as several large funds closed. Private market impact investing remains North America and Europe-centric.
- Impact funds skew to venture capital (and private equity), while funds with broader and less stringent ESG integration are more dispersed across alternatives. Venture Capital lends itself well to impact investing, given its focus on small, fast-growing companies, which often offer a new or innovative product or service relative to the market.
- The impact market remains very small compared to the private market universe, with global PE fundraising alone topping $625bn in 2022. The opportunity set for impact investing is clearly much smaller than that of traditional PE funds; however, this is also reflected in fewer managers competing for deals. Whilst still early days, and current options remain limited, we expect that the scale of private market impact investing will continue to grow, with tailwinds from institutional investors and regulation.

Data source: Preqin; data as of May 2023

Strategic Asset Allocation

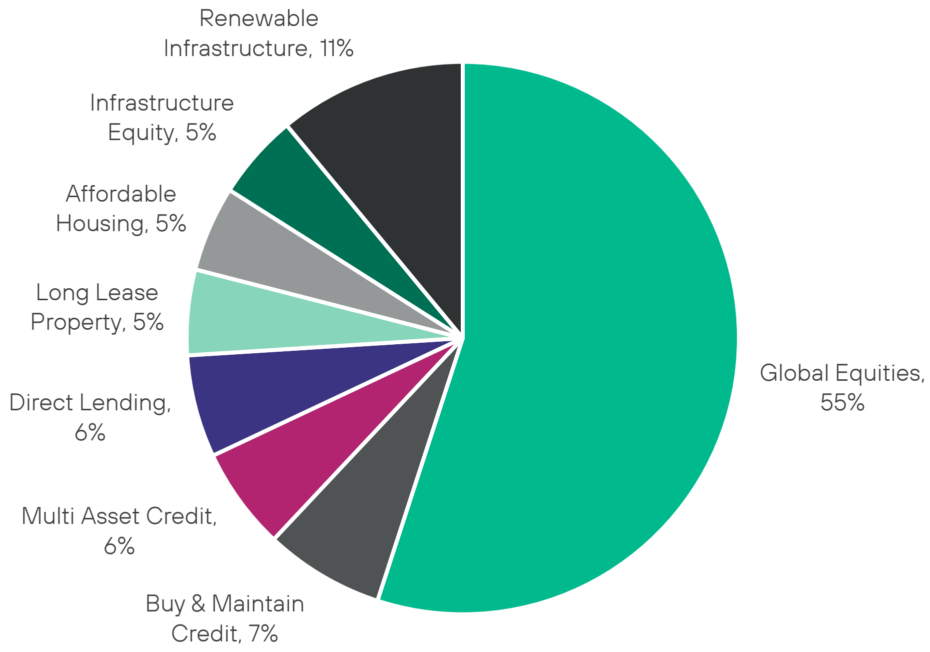
Strategic Asset Allocation (1)

Funding Position

- The Fund recently undertook a formal investment strategy review. This was concluded in March 2023 following the results of the actuarial valuation, which indicated a very strong funding position of c. 144% had been achieved as at 31 March 2023. Given market conditions since then we anticipate that the funding position will have improved further, standing at c. 161% as at 30 June 2023.

Results of Investment Strategy Review

- In the context of this strong funding position, the results of the investment strategy indicated there was scope to reduce the risk profile of the Fund whilst still targeting sufficient return to satisfy the actuarial basis set at the 2022 valuation point. As such, we presented and discussed with the Committee a range of investment strategies which slightly reduced investment risk. These options were cognisant of the fact the Fund remains open to accrual and new members, operates with a long-term investment horizon, and is looking to balance the ongoing costs of the Fund with investment returns.
- The Committee discussed the investment strategy analysis and agreed to target an updated asset allocation which, compared to the current target, reduced the equity allocation by 5% and increased the allocation to renewable energy infrastructure by 5%. The target strategy also required an additional 2.5% deployment into UK Residential Housing to bring this allocation up to target.
- Our analysis showed that the impact of these strategic changes would maintain the overall return of the Fund's portfolio (estimated to be 6.8% p.a. at the time of the analysis) whilst lowering the investment risk profile of the assets by c. 7% (based on expected volatility of returns).
- The agreed target asset allocation is shown to the right.



Strategic Asset Allocation (2)

Current and Agreed Strategic Allocation to Private Equity

- Neither the current asset allocation, nor the agreed target have an allocation to Private Equity as an asset class. An investment strategy with an allocation to Private Equity was considered at the time of the review, but was discounted primarily as it was shown to increase overall investment risk and therefore does not align with the primary objective of reducing projected funding level volatility. As such the Fund does not currently have a target allocation to the asset class.

Strategic Characteristics of Private Equity

- While the Fund's current public equity allocation invests in a portfolio of listed exchange-traded companies, as noted earlier in this report, private equity funds invest in private or unquoted companies that are not subject to the same rigorous rules and regulations of an exchange. Private equity funds are therefore expected to deliver returns that are relatively uncorrelated with traditional equity markets (although have similar underlying return drivers but are valued differently and so the return profiles of the two asset classes differ).
- **However, private equity managers are actively taking on increased investment risk in search of higher investment returns, relative to public markets. This is contrary to the agreed direction of travel of the investment strategy review, whereby it was agreed to seek a reduced level of expected investment return in return for a reduction in the investment portfolio's risk position and, correspondingly, a reduction in projected funding level volatility.**
- Finally, our approach to investment philosophy places an emphasis of asset classes which have increased certainty and stability in their return profile (for example asset classes which offer contractual income over appreciation). **This would lead us to prefer asset classes such as infrastructure equity or private debt ahead of private equity given the investment characteristics they offer. We believe the current market environment dynamics are also supportive of our philosophy with attractive risk adjusted returns currently available in these asset classes. These views are aligned to the recent allocations made by the Fund.**

Reminder: Why De-Risk?

- The ultimate objective of the Fund is to ensure all members' benefits are secure and can be met as they fall due. This forms the basis of the fiduciary duty of the Pension Fund Committee.
- Typically, in the case where a pension fund is not fully funded, this requires an investment strategy to take sufficient risk in order to target an investment return to help repair the deficit. As the funding position improves, pension funds will typically reduce risk from the investment strategy by reducing the allocation to volatile asset classes to increase the security of the funding position and reduce the likelihood of a deficit opening up again via adverse market conditions.
- For pension funds that are still open to new members such as the Fund, there needs to be a certain level of return (and therefore risk) maintained to align with the newer active members' accrual, while still being conscious of maintaining a positive funding position as this is effectively the measure that shows the Fund is able to meet members' benefits. This can be achieved by ensuring that the investment portfolio targets an expected return with a suitable margin over the Actuary's required return, but with investment risk managed to reduce the funding level volatility. Seeking to increase overall investment risk at this stage would run counter to this approach and act to increase the likelihood that the funding gains and corresponding surplus achieved over recent years could be wiped out should investment markets move against the Fund.
- The updated strategic asset allocation following our investment strategy review took into account these key investment principles and is expected to act to protect the Fund and its ability to meet members' benefits going forward.

Current Market Environment

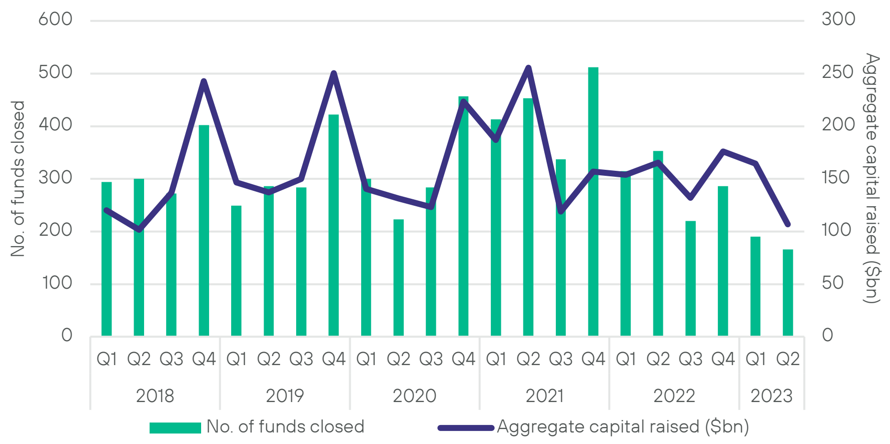
Current Market Conditions (1)

In this section we discuss the current Private Equity market environment.

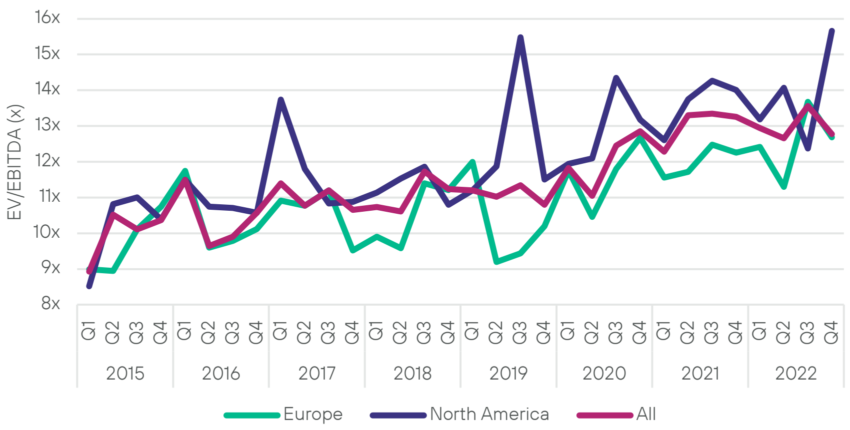
Capital raised has continued to fall over recent quarters, with LP interest in the asset class cooling.

Buyout deal pricing remains elevated relative to historical data, particularly in North America.

PE Fundraising[1]



PE Buyout Deal Multiples[1]



Fundraising

- PE fundraising has softened over the last 12 months, with $107bn raised and 166 funds closed in Q2, down from $165bn and 353 respectively a year earlier. The fundraising decline has been particularly prevalent in North America, with $72bn raised in Q2, a fall from $133bn in Q2 2022; as a result, Europe ($29bn) and APAC ($6bn) fundraising proportionally rose to c. 33% of the global market [1].
- We believe investor decisions continue to be driven by the 'denominator effect', with equity markets languishing below their 2022 highs and rising gilt yields continuing to push fixed income values down. Additionally, concerns appear to be growing around the short to medium term prospects for PE, with GPs having to deal with a high interest rate environment which is very different from the post-financial crisis era. With that in mind, investors may be increasingly pausing to observe how the market develops in the short term.

Pricing

- As shown above, PE buyout deal pricing has steadily drifted upwards over the last 7 years, albeit having remained broadly flat over the last 12 months; while quarter-on-quarter spikes should be ignored, given the outsized impact of particularly large mega deals on average, it is possible that the ongoing significant supply of private capital has underpinned the medium term upward trend [1] (though it should be noted that public market valuations have also trended upwards over the last decade). Deals in North America continue to command a premium relative to those in Europe, primarily due to the higher proportion of fast-growing technology firms in the region [1].
- As dry powder starts to tick down, and private markets begin to adjust to the new interest rate environment, we might expect to see multiples moderate over the short to medium term.

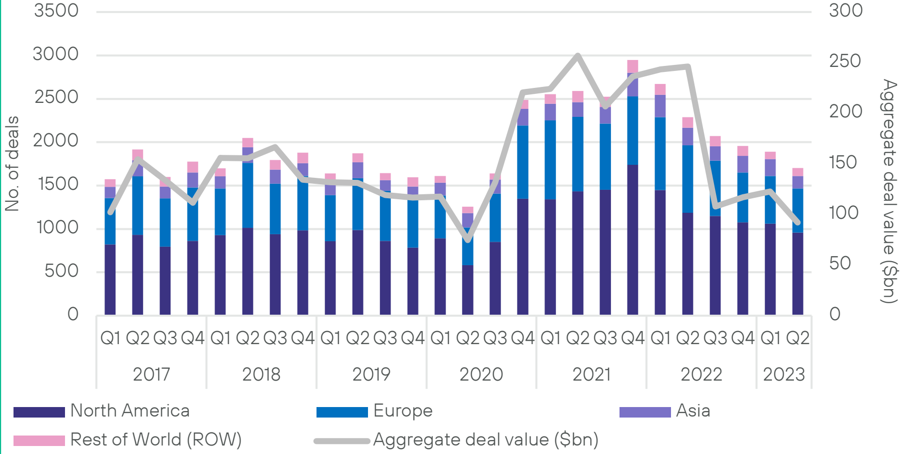
Source 1: Preqin

Current Market Conditions (2)

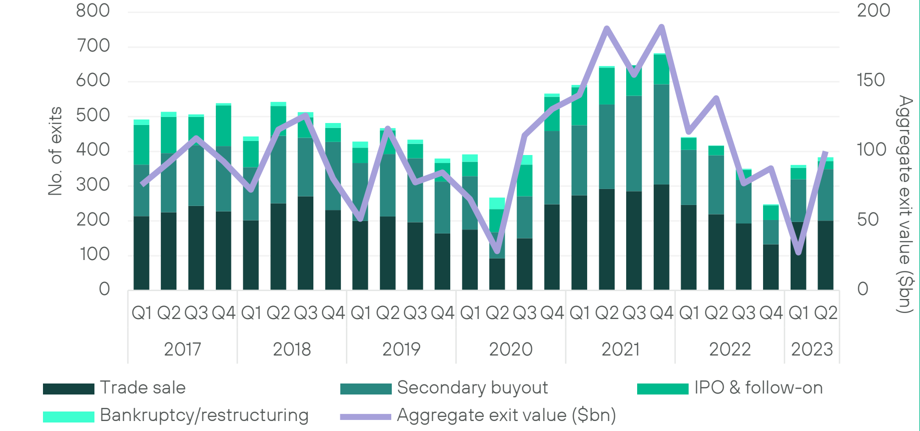
Deal activity continued to trend downwards, with smaller add-on deals making up an increasing proportion of the market.

Exit activity remains extremely subdued relative to history, as holding periods continue to tick upwards.

Number and value of Buyout Deals[1]



Exit activity by type of sale[1]



Deal activity

- Deal volume and value has continued to trend downwards, in what has been a consistent theme across all regions, as inflation remains entrenched, monetary conditions remain tight relative to recent history, and the immediate prospects for PE continue to be uncertain.
- Pitchbook note that the average debt to enterprise value ratio on US leveraged buyout deals was 43% through the first half of 2023; this compares to 51% in 2022, and a five-year average of 52%. With dealmakers increasingly focussed on interest coverage ratios, in a high-rate environment, it is unsurprising that headline level leverage levels have begun to fall [2].
- In what is a difficult environment, GPs have increasingly turned to smaller 'add-on' deals, which can often be financed using old credit facilities and / or Net Asset Value financing. The proportion of add-ons grew to nearly 80% of all US buyouts over the period [2].

Exits

- The exit market activity remains muted, with six consecutive quarters of volume and value below 2021's equivalent figures; however, Q2 saw initial signs of an uptick, with the $100bn in exit value up significantly from Q1's $27bn. This may be partly driven by the impact of the public markets which, while still below highs, have stabilised in 2023.
- The US exit / investment ratio fell to 0.32x in Q2 2023 [2]; this compares to a relatively steady ratio of between 0.50x and 0.55x between 2013 and 2018. Average holding periods continue to grow, with GPs unable or unwilling to sell holdings at current exit market valuations.
- US exits to corporate buyers accounted for a record 65% of exit value in Q2, and are on track for an all-time high annual proportion [2]. There was particularly notable activity in the energy sector, with industry participants pushing consolidation, and continuing drive towards the green energy transition [2].

Source 1: Q2 2023 Preqin Private Equity Update;
Source 2: Q2 2023 PitchBook US PE Breakdown

Current Market Conditions (3)

Outlook

- Having enjoyed a buoyant environment for fundraising, dealmaking and fund returns through the post-financial crisis decade, PE now faces a more uncertain environment. Rising short and long-term interest rates have had a significant impact on the industry, with higher cost of debt financing eroding the financial positions of existing portfolio companies, and also reducing prospective fund-level returns looking forward.
- In light of the 2022 sell-off in public markets, PE firms have increasingly struggled to raise capital, with LPs continuing to be impacted by the 'denominator effect'. This has been compounded by a fall in distributions from existing holdings, as General partners ('GPs') are either unable or unwilling to realise investments at current market valuations. As such, availability of capital for GPs has fallen, and is expected to continue to do so in the near future.
- To combat this environment, we have seen GPs adopt several relatively alternative tactics. These include: turning to NAV financing to support or grow portfolios; having portfolio companies increasingly utilise 'payment-in-kind' debt which defers interest payments into the future; and using 'continuation funds' to maintain ownership of strongly performing assets.
- **Against this backdrop, the short to medium term outlook for the asset class is uncertain, with GPs having to navigate a number of potential headwinds to future returns. In this environment, we believe that GPs who have abundant access to capital, are selective with deals, and have the expertise to generate operational improvements, are well placed to outperform in this market.**

DLUCH LGPS Consultation – Next Steps on Investment

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DLUCH Consultation Considerations

DLUCH LGPS Consultation

- In July 2023, via the Mansion House speech, the UK government indicated its intention to implement a series of reforms targeted at the LGPS and also the broader pensions market. Subsequently, a consultation was launched by DLUCH to gather the views of key stakeholders who would be impacted by the proposed changes. This consultation period is now closed and we are awaiting the results.
- The consultation sought views in five key areas:
    - Proposals to accelerate and expand asset pooling;
    - An allocation of 5% of assets to support levelling up in the UK;
    - **An allocation of 10% of assets into high growth private equity companies in the UK;**
    - An amendment to the LGPS regulations to implement a requirement for pension funds to assess their investment consultants as laid out by the Competition and Markets Authority order; and
    - A technical change to the definitions of investment in the LGPS regulations.
- This introduces significant uncertainty to the regulatory environment the Fund could soon be operating in.

Private Equity in the Consultation

- As noted above the allocation to private equity is a key aspect of the ongoing consultation. We expect there to be some delay until the results of the consultation are known and significant push back on certain aspects of the consultation can be expected, including the UK Private Equity allocation given the strong overall funding position of LGPS funds and current market dynamics.
- If the government proposals are legislated, LGPS funds will be required to allocate 10% of total assets to private equity, and within that, a subset of the market with a significant bias to the UK. It remains unclear exactly what the outcome and impact of this will be.
- **As such, all else being equal, we would not advocate any new allocations to private equity until there is greater clarity on the regulatory environment. This would avoid any duplication of exposure, over exposure, or the need for potentially costly restructuring further down the line.**

Summary and Next Steps

Summary, Isio View and Next Steps

Summary

- This paper provides an overview of Private Equity, its investment and ESG characteristics, and a summary of where it could fit in the portfolio. The key elements of this overview show:
    - Private Equity can be expected to be a high return and high risk allocation;
    - Implementation routes are typically more expensive and opaque compared to other asset classes the Fund invests in – this is reflective of the higher expected return profile but also the underlying structure of the market;
    - Although there are a number of "ESG Impact" Private Equity propositions available in the market, with an expectation more will develop in the coming years, we believe a focus on ESG implementation in the asset class could overly restrict implementation, and more attractive ESG characteristics are currently available elsewhere e.g. Renewable Energy Infrastructure and UK Affordable Housing.
    - Private Equity funds have performed very strongly in recent years, in tandem with strong returns of public market equities. We do not anticipate future performance to be as strong, given current macroeconomic and fund raising conditions, and we also believe current market dynamics favour other areas of private market investments e.g. infrastructure and private credit.
    - The live DLUCH LGPS Consultation has increased uncertainty surrounding the future investment environment for LGPS, with Private Equity specifically addressed in the consultation, with the potential for LGPS to be required to allocate 10% of their total assets in UK Private Equity at some point in the future.

Isio View

- Given the strong Funding position of the Fund we do not believe the Committee needs to drive investment returns beyond the position agreed upon earlier this year when the investment strategy was formally reviewed, and updated strategic asset allocation agreed.
- This, combined with the specific investment characteristics of Private Equity, limited ESG impact of the asset class and current market conditions means we do not see an allocation to Private Equity naturally aligned to the "direction of travel" of the investment strategy.
- The DLUCH LGPS Consultation may mandate an allocation to the asset class in future but to what extent and the timing of any required allocation is unclear. We believe it would be sensible to observe how this develops ahead of making any allocations to the asset class at this time.
- **On balance, we do not believe this should be a priority for the Committee now, but propose a further assessment of the suitability of an allocation once there is further clarity on the consultation and once the level of ESG integration in the market has developed further.**

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