# BCPP Joint Committee

**Date of Meeting:** **1 October 2020**

**Report Title:** **Annual review of Alternatives (for information and discussion)**

**Report Sponsor:** **Border to Coast CIO – Daniel Booth**

## 1 Executive Summary

1.1 The first annual review of the Alternatives structure has been performed in line with the Border to Coast Product Development and Review Policy.

1.2 The review has covered the appropriateness of the structure; the suitability of the investment process (including incorporation of Responsible Investment); relationships with external service providers; the level of commitments and capital deployment in line with risk parameters; an assessment of the benefits of pooling; future product developments; and whether customer requirements are being met.

1.3 The key points to note are:

- Commitments from Partner Funds higher than expected (£3bn v. £2bn).
- Capital has been deployed in line with expected timeframes (56% of commitments, of which 13% has been called) and within risk parameters.
- Benefits include cost savings versus industry average (we are developing Partner Fund specific MI), development of industry partnerships, and improving access to investments for Partner Funds.
- The costs of the structure are broadly in line with original expectations.
- Partner Funds have been very supportive both during the design stage and the first year of operation. Customer feedback has been taken into consideration and issues have been dealt with in a timely manner.
- There are a number of future product developments that are currently in the planning stage and will be progressed further where there is sufficient demand.
- The structure will be reviewed to determine whether additional flexibility is required from a tax perspective, particularly with regards to US investments.

## 2 Recommendations

2.1 That the report is noted.

## 3 Alternatives structure

### *Structure*

3.1 A brief overview of the structure is as follows:

- There are ten corporate entities wholly owned by Border to Coast[1]. These are the General Partner (GP) for each Scottish Limited Partnership (SLP), and Border to Coast is appointed as the operator.
- A separate structure for each Partner Fund and each SLP is a separate limited partner in any underlying investment i.e. no co-mingling.
- Investments are made on a pro-rata basis in relation in relation to each Partner Fund's commitment to the relevant offering.

3.2 The original rationale for this structure was as follows:

- It enabled the benefit of economies of scale whilst maintaining segregation of assets across Partner Funds.
- It enabled the potential transfer of legacy assets without valuation, performance dilution, or cross-contamination issues across Partner Funds.
- It provided the flexibility for Partner Funds to make annual commitments without a proliferation of legal structures increasing costs and complexity. The number of separate SLPs would be capped at 11 (one for each Partner Fund) as opposed to one per asset class per annum.

3.3 The structure does result in an increase in administration requirements and associated costs but reduces complexity. As investments are not co-mingled individual Partner Fund cash flows do not need to be tracked in the same way as would be the case if a single commitment was made by Border to Coast, reducing the risk of error.

### *Process*

3.4 The Alternatives team utilises a detailed and robust due diligence process in selecting suitable investments. This focuses on the following key areas:

- Investment – including ESG and responsible investment;
- Operational – including operational processes;
- Compliance – including financial crime risks, PEPs and sanctions screening;
- Legal; and
- Tax.

3.5 ESG factors and Responsible Investment have been incorporated into the process. This includes a specific ESG questionnaire which is circulated to prospective managers with additional review by the RI team. There will be enhancements in respect of ESG reporting and the team is working with Albourne to further develop ESG due diligence. It should be noted that Private Markets managers tend to be behind Public Markets managers in their integration of ESG and RI.

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[1] At the present time Lincolnshire has not made a commitment to Alternatives

3.6 There is a robust governance process with peer review across the Alternatives team and additionally a Compliance review. There is also a review by the Alternatives Investment Strategy Committee (AISC), which is chaired by the CIO, and final approval by either the CIO or CEO depending on the size of the commitment. Potential investments that are considered to have higher non-investment risks are escalated to the CEO who may refer them to the Board's Private Markets Committee for review.

### *Service providers*

3.7 The Alternatives structure utilises four key external service providers:

- Administration services – provided by Northern Trust since launch in May 2019 as part of the wider Third Party Administration contract. Services include cash flow processing, accounting and performance reporting.
- Due Diligence support and Administration oversight – provided by Albourne since March 2020 and includes both IDD and ODD support as well as facilitating oversight of Northern Trust through Investment Book of Record reconciliation.
- Legal services – provided by Cleveland since April 2019 as part of an 18 month contract. Services include reviewing legal documentation and negotiating side letters. It should be noted that an OJEU procurement for a longer term contract for Legal services has recently been launched.
- Tax services – provided by Deloitte since April 2018 as part of the wider Tax Services contract. Services include reviewing legal documentation to ensure tax issues are understood and negotiating any tax points in the side letters.

3.8 The relationships with the service providers have been effective since launch and has enabled Border to Coast to leverage its internal resources. There are regular service reviews to ensure that any issues are resolved and to enable best practice to be shared. It should be noted that the operating model will evolve as volumes of cash flow processing increase.

### *Capital commitments and deployment*

3.9 Border to Coast currently has £3bn of commitments from Partner Funds in the Alternatives structure, of which c. 56% has been deployed and c. 13% of capital deployed has been called:

| | Launch date | Commitment (£m) | Deployment[1] (£m) | Capital called (£m) |
|---|---|---|---|---|
| Private Equity 1A | May-19 | 500 | 498.7 | 60.0 |
| Infrastructure 1A | Jul-19 | 675 | 666.0 | 127.9 |
| Private Credit 1A/B | Oct-19 | 581 | 292.6 | 27.6 |
| Private Equity 1B | Apr-20 | 485 | 153.5 | - |
| Infrastructure 1B | Apr-20 | 760 | 81.8 | 0.9 |
| **Total** | | **3,001** | **1,692.6** | **217.2** |

As at 31 July 2020

[1] Including investments that have been approved and are awaiting the completion of subscription documents and acceptance from the investment manager

3.10 Capital Deployment by Border to Coast is on track. The investment periods for Private Equity 1A and Infrastructure 1A have ended and Partner Funds have been released from their residual commitments. The investment periods for the other portfolios are scheduled to end on 31 March 2021.

3.11 The level of capital called by external managers is modestly lower than expected due to greater commitments being made toward the end of the investment period for Series 1A; making first close commitments before investment activity has commenced; an increasing trend of managers fundraising for subsequent funds before completing the deployment of capital in the predecessor fund; and the impact of Covid-19 on transaction activity.

*Portfolio construction*

3.12 Each portfolio has sector and geographic parameters which were agreed with Partner Funds in the initial design phase. A workshop was held with Partner Funds prior to the launch of Series 1B to ensure that these parameters remained suitable. The parameters are assessed over the three years of a Series (1A, 1B and 1C) rather than in individual years to avoid overdiversification.

3.13 Risk parameters and current exposures for each sleeve are shown in **Appendix 1**.

3.14 There are a number of investment themes in each portfolio, which are summarised in **Appendix 2**, where the team believe there will be attractive investment opportunities. The portfolios will be tilted towards these themes but no one theme will dominate portfolio construction. Commitments made to date are summarised in **Appendix 3**.

*Assessment of the benefits of pooling*

3.15 The key aims of the Alternatives structure were to:

- Facilitate Partner Funds asset allocation to Alternatives;
- Generate attractive net of fees, risk-adjusted returns through robust due diligence and economies of scale; and
- Provide access to managers, strategies and investments that Partner Funds may not be able to access individually.

3.16 The benefits achieved since launch to date are:

- Cost savings through economies of scale, first close discounts and a change in mix from higher cost (e.g. fund of funds) to lower cost (e.g. co-investment funds) investments. To date, this has resulted in estimated annualised cost savings (relative to industry standard fees and before Border to Coast costs), of **c. £5m p.a.**, equivalent to **33bps**[2]. It is recognised that some Partner Funds would have historically had lower fees than the industry standard. It is not possible to determine the cost savings for each Partner Fund at the current time due to lack of information on historic costs.
- Access to niche strategies (e.g. Blackstone Life Sciences) and capacity constrained managers (e.g. GPV) through early engagement and leveraging the scale and long-term nature of the Border to Coast programme.

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[2] For reference, the original Government submission suggested cost savings from Alternatives of 25 – 50bps p.a. calculated on the same basis (i.e. not including Border to Coast costs).

3.17 It is expected that additional cost savings can be generated in the future through direct co-investments (which are typically lower or zero fees). Although no co-investments have been made to date a number of Infrastructure co-investments are currently being reviewed.

3.18 Border to Coast costs are expected to be slightly higher in absolute terms than the original business case (£4.1m v. £3.9m in 2020 – 21), but lower as a percentage of commitments (0.14% v. 0.19%). If the estimated cost savings highlighted in **3.16** above are taken into account, the Alternatives structure has broadly reached break-even.

3.19 Although absolute costs in future years are likely to be marginally higher than in the original business case, the higher than expected level of commitments should result in the overall costs of the structure being broadly similar at 0.1% of commitments p.a. once £5bn of commitments has been reached.

*Future product developments*

3.20 There are a number of new product developments that are currently in the early stages of development.

- Listed Alternatives – investments held within listed structures and expected to operate in a similar manner to the ACS equity sub-funds. Indicative customer demand is considered to be sufficient to consider launch with timing of launch to be confirmed. Customer appetite for this product is driven either by existing allocations to listed or a desire to achieve faster capital deployment than can be achieved through private market investments.
- Legacy Alternatives – a high level business case has been prepared and a workshop has been held with Partner Funds. Two funds (Lincolnshire and Surrey) have expressed an interest in the formal transfer of legacy investments into their SLP. Some other Partner Funds have expressed an interest in an advisory service to monitor legacy investments without a transfer.
- Annual subscription programmes for existing asset classes with the investment period for the next subscription due to commence in April 2021.
- Asset allocation – Partner Funds would make a commitment to Alternatives, with a defined risk and return objective, and the asset allocation decision would be delegated to Border to Coast. Lincolnshire have expressed an interest in this offering. Other funds may also be interested but may wait until they see how it operates in practice before committing.
- Cash flow management – this includes cash flow modelling to assist Partner Funds with their asset allocation; and liquidity management by processing cash flows to reduce the administrative burden on Partner Funds, thereby making the process more efficient for Border to Coast and Northern Trust. This project has wide Partner Fund initial support.

These projects will be progressed further over the next year.

*Customer requirements*

3.21 Feedback has been received from Partner Funds since launch, with the majority of the comments being supportive. The key issues that have been raised are:

- *Individual investment commitment sizes are lower than expected.* The programme was structured to provide each Partner Fund with a diversified portfolio whilst capturing the benefits of scale and maintaining a simple operating model. Partner Funds that already have a mature Alternatives programme do not necessarily require this level of diversification, but other Partner Funds do. Nevertheless, the feedback has been taken on board and average investment sizes are likely to increase from c. £65m in Series 1A to c. £100m+ in Series 1B and beyond. As the Border to Coast programme matures there may be less need for diversification within each Series and individual commitment levels may increase further.

- *Pace of deployment is slower than expected.* This is a function of the timescales for fund closings with some extensions to fundraising periods which are not necessarily within Border to Coast's control. Deployment of capital for the rest of Series 1 is expected to be more evenly spread.

- *Border to Coast does not necessarily provide the level of exposure to certain strategies or sectors that some Partner Funds would like, resulting in allocations outside of Border to Coast*. It is difficult to satisfy all Partner Fund requirements whilst trying to maintain a relatively simple and low cost operating model. However, all Partner Funds were involved in the design of the structure and various offerings, and these are revisited on an annual basis prior to the launch of the next Series or sub-Series. There may be a possibility to consider more bespoke portfolios for individual Partner Funds, but this could increase the cost and complexity of the structure whilst losing some of the benefits of pooling.

- *Call and distribution process is increasing workloads due to volume of relatively small payments.* The initial operating model involves a straight pass through of call instructions from the investment manager to the Partner Funds. During the design phase of the structure it was not possible to achieve consensus on a more efficient process. This is now being considered as part of the cash flow management product development outlined in **3.20** above.

- *Client reporting documents were difficult to understand.* We have worked with Northern Trust to provide greater clarity in reports and have also held a workshop with Partner Funds to review the reports. In addition, we hold quarterly workshops with Partner Funds to provide a regular update on investment activity and market conditions.

- *Initial issues for some Partner Funds in making call payments.* There have been relatively few issues but where they have occurred, we have worked with the Partner Fund in question and Northern Trust to understand the issue, attempt to resolve it, and learn any lessons for improvements. We have also communicated with the underlying investment managers to ensure that they are aware of any potential delays in payment so that it does not have a reputational impact.

## 4 Conclusion

4.1 The annual review of the Alternatives structure has been completed. The key points to highlight are:

- There is a robust due diligence and governance process in place ensuring appropriate investment decision making.

- Border to Coast has effective working relationships with all of its external service providers and no major issues have arisen since launch.

- Capital commitments from Partner Funds have been significantly higher than originally expected and have been deployed in line with expected timeframes and risk parameters.
- The structure has yielded material benefits since launch including significant cost savings versus market benchmarks (with further work ongoing to assess individual Partner Fund savings) and improved access to investments for Partner Funds.
- There are a number of potential product developments that are currently being considered in order to develop the Alternatives structure further and in response to Partner Funds' requirements.
- Feedback from Partner Funds has generally been positive, and issues have been dealt with in a timely manner.

## 5 Author

Mark Lyon, Head of Internal Management

mark.lyon@bordertocoast.org.uk

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## 6 Supporting Documentation

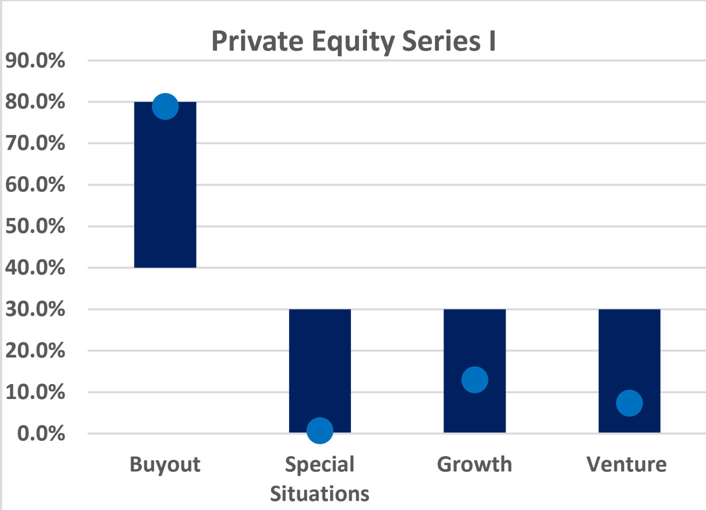
Appendix 1: Risk parameters and current exposure

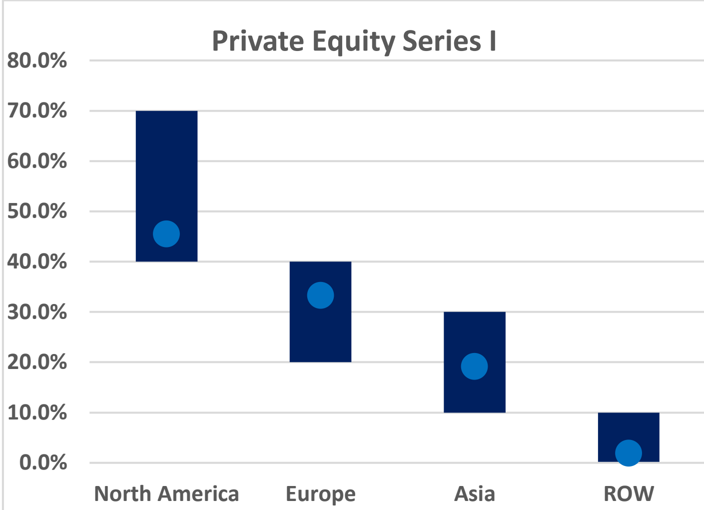
Appendix 2: Key investment themes

Appendix 3: Commitments made to date

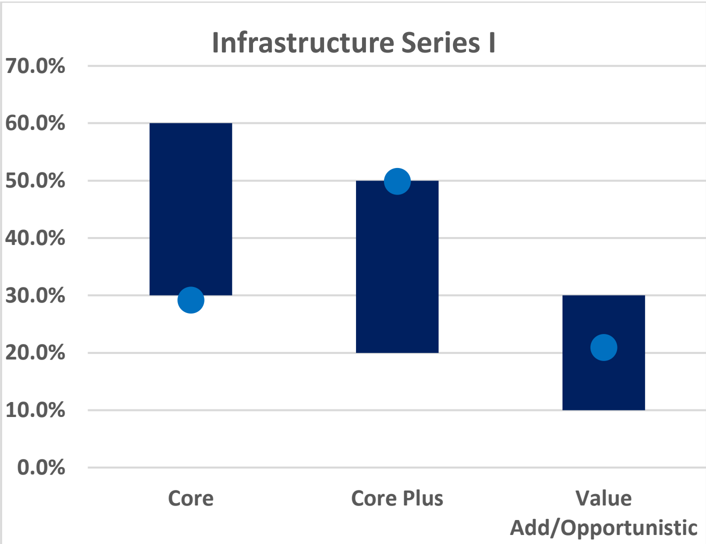
## Appendix 1: Risk parameters and current exposure

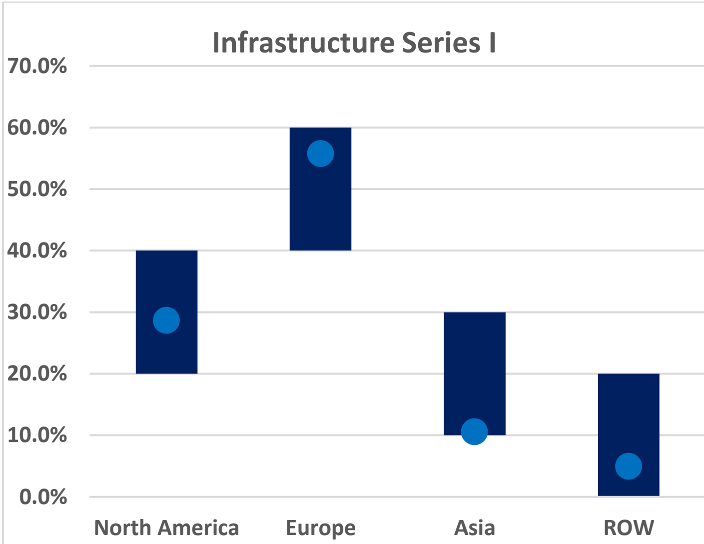
### Private Equity



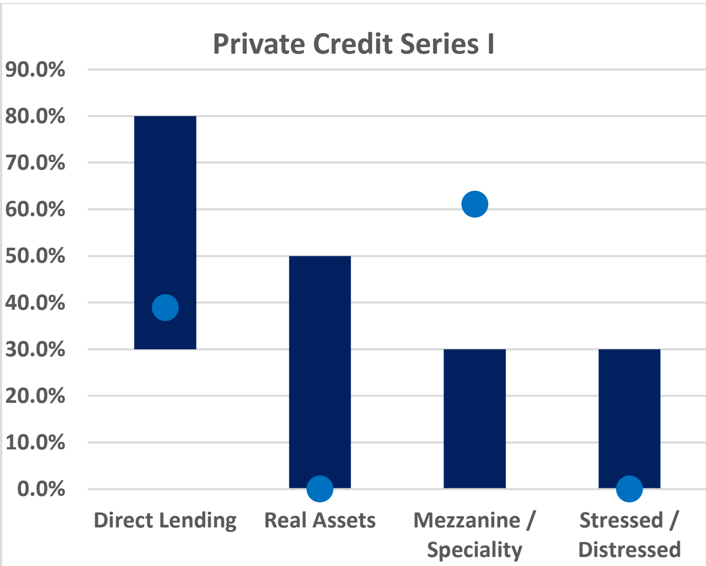



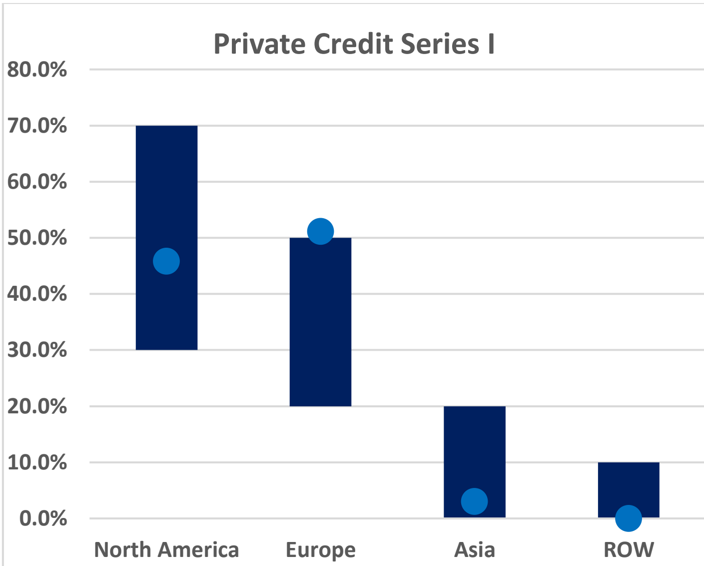

### Infrastructure




### Private Credit



## Appendix 2: Key investment themes

### Private Equity

**Operational Value Add** – deliver enhanced returns through operational improvements and expansion opportunities rather than being reliant on leverage.

**Buy and build** – adding value through developing a platform and taking advantage of higher multiples for scale businesses.

**Mid-market focus –** lower valuation multiples and leverage levels, and greater opportunities for operational value add and buy and build strategies.

**Asia** – expected growth in economic activity, demographics, and wealth creation as well as the development of the private equity market.

**Sector Specialists** – industry expertise brought by sector specialists can be a real differentiator both in terms of value creation and deal sourcing.

**Sector Themes** – industries that are expected to benefit from long term structural drivers – e.g. Technology (Artificial Intelligence ("AI"), the Internet of Things ("IoT"), cloud computing etc.) and Healthcare (long term demographic trends and increased healthcare spending).

### Infrastructure

**Emerging Markets** – Demographics and economic activity have generated significant demand for new infrastructure investments. Where a suitable risk premium is available this can present an attractive opportunity compared to developed market infrastructure, but underlying risks need careful consideration.

**Operational Value Add** – Strategies seeking to deliver enhanced returns through operational value add versus a buy and hold mentality.

**Greenfield** – Strategies that seek to capture additional investor returns whilst demonstrating strong risk mitigation techniques.

**Energy Transition** – Tilt towards investments that are enabling or benefiting from the move to a lower carbon economy (e.g. renewable energy, battery technology etc.)

**Digital Revolution –** Investments which benefit from the growing demand for data and access to digital communication networks e.g. data centres, fibre networks etc.

### Private Credit

**Senior Debt –** a more defensive approach at this point in the credit cycle with a focus on quality credits and depth of underwriting.

**Track record** – managers with experience of investing through the cycle, and sufficient resources with a robust process for dealing with problem credits including workout experience.

**Stressed/Distressed –** potential for attractive opportunities given position in economic cycle, extended leverage levels and current structuring solutions, such as lack of covenants and upward adjustments to EBITDA.

**Real Assets** – focus on quality collateral from real assets with a current preference for infrastructure over real estate due to lower valuation volatility.

## Appendix 3: Commitments made to date

### Private Equity

| Fund | Description | Commitment (LC) |
|---|---|---|
| **Series 1A** | | |
| GreatPoint Ventures II | US early stage venture | $40m |
| Palatine IV | UK lower mid-market buyout | £40m |
| Baring Asia VII | Pan-Asia buyout | $60m |
| NB Co-Investment IV | Global buyout | $100m |
| Greenspring Opportunities VI | US late stage venture | $60m |
| StepStone Secondaries IV | Global secondaries | $75m |
| Hg Saturn II | European upper mid-market (technology) | $90m |
| Hg Genesis IX | European mid-market (technology) | €35m |
| Blackstone Life Sciences V | Global growth (healthcare) | $70m |
| Digital Alpha II | Global growth (technology) | $50m |
| **Series 1B** | | |
| KKR Asian IV | Pan-Asia buyout | $94m |
| Thoma Bravo XIV | Global buyout (technology) | $100m |

### Infrastructure

| Fund | Description | Commitment (LC) |
|---|---|---|
| **Series 1A** | | |
| Brookfield IV | Global core/core plus | $125m |
| GIP IV | Global core/core plus | $60m |
| AMP II | Global core/core plus | $100m |
| Infracapital Greenfield II | European core plus | £100m |
| iCON V | European core/core plus | $100m |
| Arcus European II | European core plus/value add | €90m |
| Macquarie GIG II | Global renewables | €101m |
| Stonepeak | Global renewables | $100m |
| **Series 1B** | | |
| Patria IV | Latin America core/core plus | $100m |

### Private Credit

| Fund | Description | Commitment (LC) |
|---|---|---|
| **Series 1A/B** | | |
| HPS Mezzanine 2019 | Global mezzanine | $104m |
| GSO IV | Global mezzanine | $125m |
| Ares V | European direct lending | £115m |