

Private Equity Strategy

1. Overview of the Current Private Equity Portfolio and how it is Managed

1.1 Overview of Current Portfolio

The LCPF private equity (PE) fund has NAV (net asset value) of approximately £250m, which equates to 5% of the total £5bn pension fund, as at June 2013. This is invested across 28 different managers, in 69 funds and gives exposure to over 1000 underlying companies. The capital has been committed with the support of Capital Dynamics:

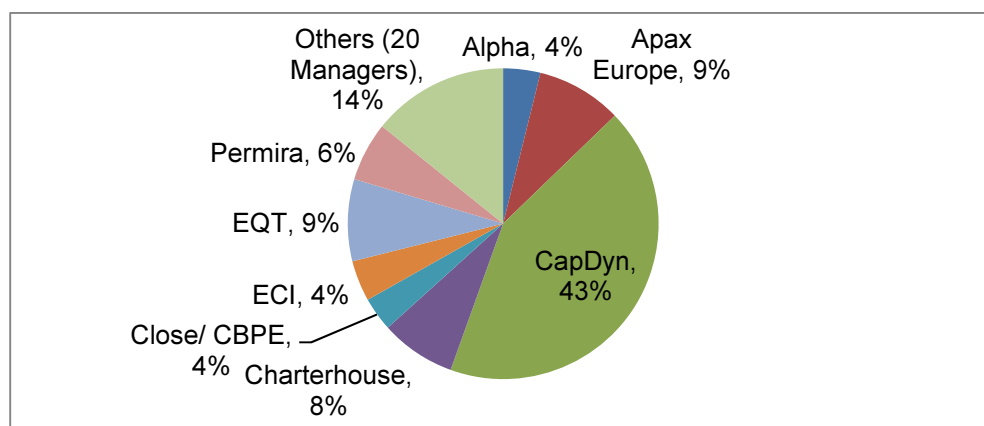
How LCPF Has Invested its Assets

NAV (at 31 August 2013)	No. of Managers	No. of Funds	Comments
Primary Funds New funds with no investments at the time of being committed to	27	57	Funds Identified by Capital Dynamics
Primary Funds of Funds FoF manager identifies new funds with no investments at the time of being committed to	1	9	Funds Managed by Capital Dynamics
Co-Investment Fund Manager invests alongside PE managers	1	1	Managed by Capital Dynamics
Secondary Fund Manager buys older Primary funds, from current investors, which are >50% already invested	1	1	Managed by Capital Dynamics
Direct Investment Red Rose		1	Identified by Capital Dynamics
Total	28	69	

The vast majority of LCPF's exposure is to buyouts of companies located in developed western markets. This is the main arena for global private equity. It also has some exposure to venture capital, to Asian funds and to non-primary funds.

85% of the current NAV exposure is concentrated in 25% of the managers, though this does not fully consider the diversification from funds of funds (see chart, below):

LCPF Exposure by PE Manager (Net Asset Value, 31 Aug 2013)



The chart above classifies all Capital Dynamics funds together. This includes CD funds of funds, which are diversified across many underlying managers. The risk relating to Capital Dynamics is diversified across more managers than it might initially appear.

1.2 Fund Types in the PE Portfolio

Individual Primary Funds

LCPF's individual primary funds are identified by Capital Dynamics, with a one-off finder's fee paid. Fees are also paid to the primary fund managers, typically 2% p.a. and 20% of profits ('carry'). The finder's fee is relatively inexpensive, compared to funds of funds and allows LCPF to leverage off Capital Dynamics' research.

Primary Funds of Funds

LCPF has committed to 8 primary funds of funds (FoF), covering USA, Asia and Europe; in buyouts and venture capital. The FoF manager then commits to around 15 primary PE funds. The advantage is greater diversification and also devolution of investment decisions to a third party. The main risks are an additional layer of fees (approximately 1% p.a. mgt/ 0%-10% carry) in addition to primary manager fees.

Co-Investment Fund

LCPF has committed to one co-investment fund, managed by Capital Dynamics. This invests in around 15 companies, alongside private equity managers. An attraction for LCPF is lower fees than a primary fund (approximately 1% p.a./ 12.5% carry). Return potential appears broadly comparable to a primary fund. Risks include reduced access to the many investments that PE managers choose not to co-invest; and a risk of negative selection bias (PE funds offering co-investments in companies that they perceive as less attractive)

Secondary Fund

LCPF has committed to one secondary fund, managed by Capital Dynamics. This invests in PE funds that are at least 50% already invested. Attractions of a secondary fund for LCPF include the greater certainty of the funds' final performance; diversification; secondary funds are often bought at a discount to NAV; and avoidance of early years' annual management fees. The negatives are a double fee layer (approximately 2% p.a./ 20% to the PE manager and 1% p.a./ 10% to the secondary manager). The net result is expected to be moderately lower risk and (sometimes) lower return when compared to primary fund investing, with an attractive risk-adjusted return.

Direct Investment

LCPF has invested in one company directly, Red Rose. This was originated by Capital Dynamics. Red Rose is lower risk quasi-infrastructure, without the gearing typical in PE.

A summary of the typical industry fees paid for different fund types is below. Actual fund fees vary by provider and date (sometimes at half these official rates):

LCPF Current PE Portfolio Exposure by Investment Structure

Data at 31 August 2013	One-Off Fees	Annual Fees		Carry		Funds Held est.	Underlying Cos Invested In est.	% of NAV + Undrawn Commitments	Comments
		PE Mgr	FoF Mgr	PE Mgr	FoF Mgr				
Primary Funds	0.50%	2%		20%		1	15	66%	
Primary Fund of Fund		2%	1%	20%	0% to 5%	10 to 20	150	18%	
Co-Investment Fund		1%		12%		1	10 to 20	4%	
Secondary Fund		2%	1%	20%	10%	10 to 20	150	5%	Shorter life, less mgt fees
Direct Investment		n/a		n/a		n/a	Red Rose	7%	

Fees are approximation of industry averages, not actual fees paid by LCPF

1.3 The Nature of LCPF's Relationship with Capital Dynamics

LCPF established a private equity business relationship with Crossroads Ltd in September 1998. The relationship was governed by a broadly worded contract that defined Crossroads similarly to a discretionary fund manager, setting strategy and managing daily operations.

When Crossroads was acquired by Capital Dynamics, in 2004, the relationship was maintained, with the original contract not revised.

In practice, Capital Dynamics recommends funds for LCPF to invest in, with LCPF investing in all funds recommended to date.

1.4 PE Portfolio Performance

The benchmark used to evaluate the PE portfolio is FTSE All Share (Total Return). In addition, an informal comparison is made to the British Venture Capital Association (BVCA) PE benchmark top quartile fund average return.

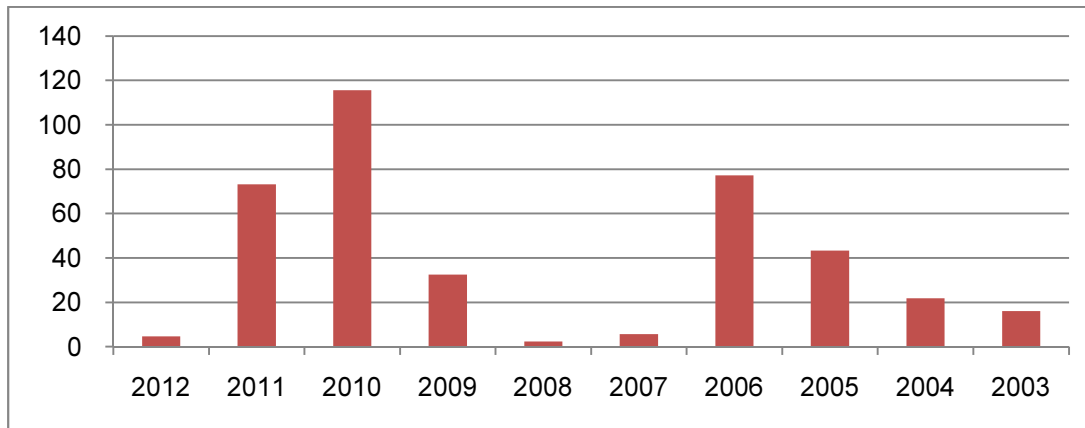
Since inception the reported PE portfolio net IRR is approximately 13%, which represents a 3% premium to the FTSE All Share. For comparison, this equates to an average return of 1.5x capital invested (i.e. a 150% return achieved over a 10-13 year fund life).

Asset Allocation and Risk Management

Since 1998, LCPF has committed to 54 funds through 18 managers. However, a small number of these managers are disproportionately large. 80% of capital was committed to half the managers; 35% to one (Capital Dynamics; though this includes funds of funds that are then invested in many fund managers).

In addition, capital was not committed in equal amounts every year. The largest committed in any year was £115m and the smallest £3m. This might imply some manager specific risk and market timing risk.

Annual Commitments to Private Equity by LCPF (£m)



1.5 External Consultant's Opinion

LCPF commissioned a review of its portfolio at June 2011 by consultant BFinance. Key conclusions included:

- LCPF is overdiversified. 30 funds is sufficient;
- There is a large number of recent fund of funds, which leads to higher fees and a delay in return generation. This is regarded as unusual as investors often use FoFs as a first step before investing directly. LCPF has 'regressed' in the opposite direction;
- Reliance on a few well known brand name PE managers, possibly missing out on less well known names;
- A focus on European buyouts, possibly missing opportunities elsewhere;
- More resources should be used to find better funds and negotiate better terms;
- LCPF could find ways to lower fees, such as through direct co-investments.

2. Future Private Equity Strategy

2.1 Target PE fund Size

NAV as % of Pension Fund	7.50%
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It is recommended that LCPF targets a private equity portfolio NAV equal to 7.5% of the pension fund, up from 5%. Long term PE investing is well suited to a long term pension fund that can accept the illiquidity.

Due to time delays between capital being committed (by LCPF) and invested (by the PE manager) of up to 5 years, commitments have to be around 2x to 2.5x the target NAV. There is a risk that commitments will be drawn by PE managers faster than forecast, or current investments will be exited slower than forecast. In both situations, cash flow will be negative and the fund NAV will rise more than forecast.

Capital Dynamics has suggested annual commitments of between £100-120m p.a., of which around two-thirds will sustain the historic 5% commitment and a further third to grow this to 7.5% of the Pension Fund.

2.2 Target Return

LCPF expects a private equity return in excess of the U.K. stock market, as compensation for the greater illiquidity and potential volatility.

- Formally target annualised return ('Net IRR') of FTSE All Share + 3%
 - 3% is a minimum risk premium, with 6%-8% an achievable 'stretch' target;
 - This is expected to equate to a net IRR of 10% to 15%;
 - A PE fund is considered successful if it is rated in the top quartile of funds with a similar vintage and strategy;
 - Use alternative fund benchmarks, as appropriate, for funds that can be shown to warrant this.

2.3 Risk Management

Key risk drivers have been identified in the table below. These were considered in setting the Strategy Limits.

Risk Driver	Importance	Risk Management Solution	Return Consideration
Market direction	High	Invest equally on a three year rolling basis, to avoid market timing	Avoids buying at the top and selling at the bottom
Fund strategy risk	High	Focusing on lower risk/ higher return developed market buyouts. Limit exposure to higher risk/ (sometimes) lower return venture capital	Risk and return are aligned, but good funds can still be found in strategies with poor average returns. No strategy is off-limits.
Company specific risk	High	Diversify across 40-80 funds, resulting in exposure to c.400-1200 underlying companies. Implies 5-10 new funds per year.	Need to avoid over diversification reducing returns. Marginal risk/return benefit falls as diversification increases (is your tenth choice fund as good as your first?)
Manager risk	High	High Risk: Favour managers with strong records, as evidence of persistence. Medium Risk: Be wary of relying too much on a single manager, especially for primary funds.	Risk and return is aligned. LCPF manager also has autonomy to commit to younger managers if returns warrant additional risk
Sector risk	Medium	Diversification across multiple generalist funds creates a sector diversified portfolio. Exposures should be monitored	Sector diversification helps reduce volatility. Do not expect this to reduce returns.
Country or region risk	Medium/ Low	Focus on developed markets, where returns are less variable than emerging markets. Prefer U.K. liabilities to be matched by U.K. assets if returns are equal.	Good companies in a weak or volatile region should still perform strongly. No region or country is off-limits to fund manager.

2.4 PE Strategy Limits

We set strategy limits that reflect the market and also give LCPF the opportunity to be over/ under weight the market (see table, below). In addition to formal limits, informal guidance is given, to aid risk management.

A. PE Strategy Limits (by Fund Type and Geography)

	Assume Pension Fund Value (£m) 5,000	% of PE Allocation		% of Pension Fund		Example for £5bn Pension Fund (£m)	
		Min	Max	Min	Max	Min	Max
	Fund Type		100%		7.5%		375
1	Buyouts (LBOs)	70%	100%	5.25%	7.50%	263	375
2	Venture Capital (VC)	0%	10%	0%	0.8%	0	38
3	Other PE Sub-Classes	0%	20%	0%	1.5%	0	75
3.1	Max in Any Single Sub-Class	0%	10%	0%	0.8%	0	38
	Geography						
	Europe (incl. U.K.)	50%	75%	3.8%	5.6%	188	281
	Non-Europe	25%	50%	1.9%	3.8%	94	188
	Developed Markets	90%	100%	6.8%	7.5%	84	188
	Emerging Markets	0%	10%	0%	0.8%	0	38

"Emerging Markets" are as defined by MSCI or FTSE listed indices

Primarily, the best and most consistent returns have been in developed market buyouts. There are periods when this has not been the case and the allocation limits enable the LCPF to adapt to market changes.

The central expectation is to commit the vast majority of capital between Europe and North America, with a bias to buyouts.

Supporting Guidance on Private Equity Strategy Limits

- Venture capital is expected to be not more than 10% of the PE fund
 - Average returns are mostly poor and volatile, but there are periods of strong performance, as well as individually strong managers.
- Emerging market funds are expected to be not more than 10% of the PE fund
 - Emerging market returns in this area have not been sufficient to warrant the risks, though this may change.

B. Concentration Limits (by Fund Structure)

Limits on the concentration by fund structure are proposed (see table, below), with the aim of ensuring a minimum level of diversification, but discouraging over diversification. These limits reflect the different risk profiles of the different forms of investment and are set in two dimensions, the first in relation to limits on the new commitment that can be made each year (thus the maximum that could be committed to new primary funds in a year is 25% of the total new commitments). The second dimension is limits within the total PE portfolio where for example no more than 50% of the total portfolio should be in secondary funds.

Concentration Limits by PE Fund Structure

Commitment Limits per <u>individual</u> PE Fund (as a % of annual PE commitment target)	Target	Min.	Max.	Total PE Portfolio Limit (% of NAV)
Primary Fund	15%	7%	25%	100%
Co-Investment Fund	15%	7%	25%	40% incl Direct
Primary Fund of Fund	20%	10%	30%	50%
Secondary Fund	20%	10%	40%	50%
<u>Direct</u> Co-Investments by LCPF in individual companies (as % of the original fund's investment)		20%	100%	40% incl Co- Investment Funds

The central expectation is to commit to 4-6 funds per year, mostly primary, allowing for larger commitments to more diversified funds of funds. In addition to initial commitments to funds, direct co-investments are allowed in individual companies that are held by LCPF's funds.

3. Transition from Current Private Equity Portfolio to Future Portfolio

The transition to the new strategy will take place gradually by investing future commitments in line with the proposed new strategy.

It is not intended to make a single bulk commitment to increase PE exposure from 5% of pension fund NAV to 7.5% but instead increase annual commitments to achieve an equal exposure to all future vintages.

We may support this by purchasing funds in the secondary market to gain greater exposure to past vintages ('back filling'). This enables a faster move from 5% NAV to 7.5%. This will depend upon both the price and performance of the relevant funds.

Commitments will be made with the aim of improving returns or lowering costs. This may include:

- Avoid primary funds of funds and instead commit directly
 - This confirms the way most capital is already invested;
 - A fund of fund might be acceptable as a way to gain access to a fund manager's research, or in a niche that LCPF can not easily access through direct primary funds;
- Conviction investing rather than a diversified market proxy
 - More actively engage with all LCPF's advisers to source best ideas;
 - Moving to a more concentrated portfolio will be gradual;
 - Decision on size of individual fund commitments is with the LCPF.
- Source investments from a broader range of fund managers and advisers
 - Reduces concentration risk of current limited relationships;
 - Investments not originated by Capital Dynamics are unlikely to be monitored by them and will therefore require closer monitoring by LCPF.
- Increase exposure to co-investment funds
 - This is a continuation of the existing co-investment strategy;

- Can offer a similar return to primary funds, at a lower cost.
- Make co-investments directly alongside LCPF's external co-investment funds
 - Where available, LCPF may directly invest in the same co-investments as its external co-investment fund. The timeliness of co-investing does not allow for external consultant advice, so reliance is placed in the co-investment manager.
- Make co-investments directly in existing LCPF primary or secondary funds, without an adviser;
 - The underlying fund would have already been evaluated by an adviser.
- Increase investments in secondary funds, where appropriate
 - This is a continuation of the existing secondary strategy;
 - Where available, LCPF may directly invest in the same underlying funds as its external secondary manager, without seeking external consultant advice placing reliance on the manager's research.
- Make direct investments in companies, where available (longer term goal).

Request for Authorisation

To achieve the stated aims, the following is requested:

- Confirmation of the PE allocation at 7.5% NAV (not commitments) as a percentage of the pension fund;
- Formally target PE net IRR of FTSE All Share + 3% (with informal use of additional or alternative benchmarks where appropriate, as stated in section 2.2);
- Confirmation of the PE Strategy Limits (set out in section 2.4A);
- Confirmation of the Concentration Limits (set out in section 2.4B);
- Authority to purchase individual funds in the secondary market, subject to external advice;
- Authority to invest in co-investment funds, subject to external advice;
- Authority to invest in secondary funds, subject to external advice;
- Authority to make co-investments that replicate those made by co-investment funds that LCPF has committed to;
- Authority to make co-investments offered by LCPF's primary or secondary PE funds, without external advice, but subject to due diligence from the PE manager offering the co-investment.