Review of investment proposals

Addressee

This paper is addressed to the Committee and Officers of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund ("the Fund"). It relates to the recent proposals from KKR and M&G regarding potential commitments to new funds that they are launching.

KKR Infrastructure II

The Fund currently has an investment in the KKR Infrastructure Fund I. This is a direct fund investing in global infrastructure. Fund II is to be structured on a similar basis to Fund I and is effectively a continuation of Fund I which closed to commitments in 2012. Fund II will target low teens returns gross of fees, focussing on brownfield investments; restructuring and developing assets to generate a strong and stable income stream over the lifetime of the Fund (12 years plus some extension clauses).

There are a number of different factors to consider when looking at this opportunity.

View on infrastructure

We believe infrastructure can be a highly attractive investment opportunity, particularly for LGPS funds like Suffolk. It should provide a strong, partly inflation linked, income based return and diversification from equities. It requires a longer term investment horizon which is in line with Suffolk's objectives and allows the Fund to benefit from this illiquidity premium. There is usually a high fee hurdle (typically 1% on committed plus a performance element) but the levels of return net of fees are still sufficient to meet the Fund's requirements if they are delivered.

There is evidence of a market opportunity in infrastructure given the level of demand versus current supply of capital to be invested. However, the challenge is in sourcing and structuring the investments to deliver the desired returns at an acceptable level of risk, which requires a skilled manager. There are also some key risks that need to be accounted for such as political and regulatory risk around the infrastructure assets and interest rate risk, given that there is often a high degree of leverage supporting some of the investments. We believe that if suitably managed the expected returns compensate for these risks. While there is evidence that pricing of core operating infrastructure assets is looking rich, especially in the UK, we believe that a manager with the ability to source value-add type assets globally should still be able to find attractive opportunities.

View on KKR and Fund II

KKR have shown a strong track record to date in being able to find infrastructure opportunities and get money invested. This has been demonstrated by Fund I which as at 31/12/13 had drawn down around 70% of the $1bn committed to the fund and generated a net IRR of 10.6%, albeit it is too early to place much emphasis on this. We continue to rate KKR as a firm and they have a strong and experienced team. They have also demonstrated the strength and depth of their network in sourcing proprietary investments in a range of regions and industry sectors to date. Proposed fees are in line with Fund I and we believe are fairly competitive for a direct fund investment such as this. We therefore believe KKR's Fund II is an interesting investment opportunity.

Fit with overall investment strategy

Suffolk currently have a long term target of 5% to infrastructure. This is split evenly between Partners Group and KKR. To date KKR have drawn down a significant proportion of their original commitment and now represent 1.3% of Fund assets while Partners Group have been slower to draw down funds and sit at 0.5%. It should also be noted that the asset value of the overall fund has grown over the last few years and therefore the even once the two managers have fully drawn down the capital, the actual allocation may not meet the 5% target. It therefore seems likely that further commitments would be required to meet the 5% target.

I believe the Committee needs to consider a number of factors before making any new commitments.

- is a 5% target to infrastructure still appropriate?
- how should the target be split across the infrastructure mandates?
- how do we review the commitment programme over time to ensure we are achieving the desired exposure?

Once we have clarity on these points it is then possible to make a more informed decision on the KKR proposal. While we rate KKR and believe Fund II looks attractive we believe there is time to take a step back and review the decision making process. KKR have confirmed that the initial target for first close on Fund II is end July but there is a possibility this may be pushed back. If Suffolk were not to commit before first close there is a slightly higher performance fee that would apply but we believe a decision should not be rushed to ensure a slightly lower fee.

M&G Debt Opportunities Fund (II)

M&G are currently launching a new fund; Debt Opportunities Fund (II) (DOF2). This follows the success of the first Debt Opportunities fund, (DOF1) in which Suffolk are currently invested. The first fund closed in June 2012 with €280m of commitments and is now fully drawn down. The fund's current performance, based on two realised investments and the expected return on current portfolio holdings, is in excess of the 15% p.a. return target.

DOF2 will follow the same investment philosophy as DOF1, investing in a concentrated portfolio of European distressed debt opportunities. It is anticipated that the second fund will close to new capital before the end of the second quarter 2014 and given M&G's current pipeline of deals, they foresee that the first capital call for the fund will be on or close to day one of the investment period. This fund will also be targeting a return in excess of 15% p.a.

View on distressed debt

Distressed debt managers target bonds, loans and other financial claims which offer high levels of yield (>10%), often trading at a meaningful discount to their par value (>40%). The current technical factors remain supportive of distressed debt investing, the most notable being:

Supply - in contrast to most risk asset classes and strategies, distressed debt managers can find that difficult financial and economic conditions act in their favour, through increasing the supply and breadth of potential investments (of which only a very small proportion will ever be attractive) and the likelihood that current owners of this debt are willing to sell at heavily discounted prices. This potential for counter cyclicality is one of the most attractive aspects of the asset class.

Basel III implementation - the key impacts of this regulation is an increase in capital requirements for banks, changes to the way counterparty risk is assessed and the re-rating of certain risk assets. All of these have put further pressure on European banks that have been deleveraging since the 2008 financial crisis. One of the resulting opportunities is the ability to purchase non-performing loans and other assets from banks at heavily discounted prices (although this has been much slower to transpire than many initially thought at the end of the financial crisis). It has also led to tighter credit conditions making it harder for companies to access financing which can lead to financial difficulties and as such investment opportunities.

Corporate balance sheet and working capital efficiency - this has a much wider impact on corporates at this stage of the credit cycle compared to 2008-2009, when distressed opportunities where largely driven by overleveraged LBO companies.

We note that success in security selection is not necessarily dependent on the overall macro-economic environment, good or bad. However, we expect that widespread recovery in the coming years would act as a tailwind to the strategy (to the extent that this had not reduced prospective returns through occurring during and / or prior to the investment period).

View on M&G and DOF2

In terms of its competitors, M&G's position as a leading debt investor (both for external investors and its own Life Fund) provides it with a competitive edge in this area. This is for a number of reasons:

- Firstly, the exposure and information gained on underlying borrowers by M&G through its current debt and/or equity investments (e.g. within its Life Funds) will be critical in identifying opportunities.
- Secondly, M&G's debt ownership outside of the Debt Opportunity Fund's assets (in many instances, M&G will, in aggregate, own 25% or more of the debt capital / instrument involved) is important in establishing control during any restructuring.

Finally, subject to appropriate arrangements as to equal treatment of the different investors, we regard the common ownership of M&G with the Fund as being attractive in terms of aligning interests.

On a standalone basis, the team has provided evidence of demonstrable experience and track record in dealing with similar investments in the past, initially investing for its own Life book of assets, before launching DOF1. It has also shown sufficient due diligence resource, with a team of credible restructuring specialists and large private and public credit research teams. In terms of the Fund itself we consider DOF2 as an attractive diversifying growth strategy for the Fund (the returns of distressed debt portfolios will be extremely security specific). We also believe there is a valid investment thesis due to increasingly stringent regulatory requirements continuing to place pressure on banks to delever combined with difficult economic conditions.

M&G will charge an investment management fee of 1.5% p.a. (on drawn capital) and a performance fee of 20% above 8% compound return to investors. These fees, whilst high, are broadly in-line with those being charged by competitor managers for distressed debt funds, which can charge performance fees based on returns over LIBOR (rather than returns above 8% p.a. as is the case here). The fees are also lower than other 'alternative' investments targeting similar returns (for example, a successful hedge fund targeting 15% continues to gather assets while charging 2% base fees and a 20% participation in returns over LIBOR).

Fit with overall strategy

The Fund currently has a 2% long term target for the initial distressed debt investment with DOF1. This was very much an opportunistic investment providing strong potential returns and diversification from equities. The DOF1 commitment is now fully drawn down and represents 1.5% of fund assets, given the growth in asset value. The expectation is for capital to be returned from DOF1 in around 2 years, therefore depending on the rate at which DOF2 invests money any allocation to DOF2 would likely increase the total allocation to distressed debt at the overall Fund level (depending on the commitment size).

As with infrastructure we would ideally like to be able to review the purpose of each part of the investment structure before deciding whether to make a commitment. However, we see DOF2 as being a much more opportunistic investment with a limited time window to consider any investment. In our view we see this as an attractive investment opportunity which could be accommodated as a further opportunistic investment particularly given the position relative to target on other less liquid asset classes such as private equity which we expect to reduce over time.

M&G has a proven track-record investing in this market, illustrated by the success of DOF1. We are confident that they will continue to find attractive investment opportunities for the DOF2, given the firm's extensive knowledge of the market and its reputations of being one of the largest credit managers for both its internal and external client base. They currently have a large pipeline of deals which they are looking at for DOF2.

Summary

We appreciate that the investment strategy has grown more complex in recent years and that there is a need for greater clarity on what the strategy and structure is trying to achieve and that this should be the immediate focus of the Committee. However, we believe the M&G DOF2 is an exciting opportunistic investment which the Committee should consider further as was the case with the original DOF1.

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April 2014

For and on behalf of Hymans Robertson LLP

Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

All derivatives involve risk including (amongst others) the risk of adverse or unanticipated developments of a market, financial or political risk and the risk of counter-party default. In addition, you may be subject to operational risks in the event that your manager(s) does not have in place appropriate legal documentation or internal systems and controls to monitor exposures of this nature.