LGPS Next Step on Investments: a focus on private equity

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In this article we will look at five questions LGPS funds may want to consider as they evaluate private equity and discuss how it might help them deliver both their return and impact ambitions.

The recent Government Consultation, LGPS: Next steps on investments[1], set out a proposal that Local Government Pension Schemes (LGPS) adopt an ambition to invest 10% of their assets in private equity in order to accelerate investment in UK growth. The ambition received a mixed response. This was not necessarily to do with whether private equity was an appropriate asset class to deliver UK growth, or whether it is an asset class to deliver appropriate risk-adjusted returns for LGPS funds. Rather, it was in large part to do with whether it was appropriate for the government to be setting what could be seen as an arbitrary asset allocation ambition for LGPS funds at all.

We set out a series of questions on LGPS funds and private equity and discuss how it could help them deliver both their return and impact ambitions.

1. Is private equity the most appropriate asset class to invest in high-growth companies?

Private equity as an asset class is an ideal way for LGPS to invest in the UK's emerging group of high-growth companies with products and services delivering positive impacts.

There is a large and growing pool of high-growth small- and medium-sized businesses that cannot be accessed through public equity markets. This is increasingly the case as the most disruptive and highest growth companies choose to stay private for longer than they used to. Quite simply, it has become hard to invest in these businesses through public markets.

Additionally, a large number of purpose-led businesses have been set up to tackle inequality and the key challenges of our time. These businesses tend to be private and so can only be accessed through private markets.

Good private equity managers take a long-term, very active approach that supports the creation of real sustainable value without the distraction of quarterly earnings. They provide a powerful combination of financial capital and human expertise to accelerate the growth of a business. For instance, private equity managers often invest in growing family businesses and then strengthen the senior management team to drive the next stage of growth. The involvement of private equity helps these businesses to attract senior and highly experienced professionals to serve on the management team, such as chief financial officers and chief operating officers.

Additionally, private equity managers conduct a significant amount of due diligence, often over many months, ahead of the acquisition of a business. They have access to confidential information, can question management on all parts of the business, and can commission extensive impact due diligence. Compared to public equity market investors, private equity has a much greater ability to assess not only a company's future growth prospects but also its likely positive impact.

Another strength of private equity is the strong alignment of interest between company management, private equity general partners and investors in growing and improving the business. That provides a strong incentive for all stakeholders to

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maximise investment returns and deliver positive impact.

2. Can private equity deliver on levelling up?

Private equity is well placed to deliver on the levelling up agenda as it can channel investment into UK companies that provide local jobs through the growth and improvement of those companies. Private equity investment is a form of investment that is well able, and has proven its ability, to successfully invest in many of the small- and medium-sized high-growth businesses that are the backbone of local and regional economies. It can and has supported purpose-led private businesses that are typically not available through public equity markets.

It is also important to differentiate between the levelling-up benefits that come from a local approach as opposed to a global approach. There are certain targets that can be met by local investment, such as creating good local jobs, but other objectives are naturally global. For instance, climate change is a global challenge that requires a global approach. Similarly, improving health and well-being also takes a global approach, for example through the development and distribution of vaccines and other important life changing healthcare solutions. Furthermore, goals such as improving education or transport across the UK require a national approach.

3. What opportunities currently exist to contribute to UK growth capital?

There is a large and growing opportunity set among middle-sized companies that are rapidly growing at a time of great change. These companies are often disrupting their sectors and choosing not to raise capital on public equity markets. Instead they prefer to do this through private markets where they gain from the twin benefits of financial capital and private equity firms' expertise in how to scale, improve and exit businesses.

Generally, the private equity environment has changed in the past two years due to macro-economic headwinds, but we do not believe this has harmed the prospects for long-term UK growth capital investing. As inflation increased on both sides of the Atlantic, central banks and in-turn commercial banks have lifted interest rates and tightened the availability of credit. This has led to reduced levels of bank credit, tighter covenants, an increase in defaults, a disconnect between buyer and seller deal pricing expectations, and challenging fundraising. The large private equity managers that have relied chiefly on financial engineering to drive returns are particularly vulnerable. Moreover, we believe the "buy-and-build" strategy of using debt-fuelled acquisitions is challenged right now.

However, areas of UK growth capital are less vulnerable and could actually benefit from the current situation. In particular, the lower mid-market – in other words investing in small- to medium-sized growth companies – uses conservative levels of debt in financial structures and principally relies on a company's revenue and profit growth to drive returns for investors. We also think the macro-economic headwinds will be less of an issue for private equity funds making co-investments and investing in the secondary private equity market.

It is also worth noting that the trajectory of inflation is now downwards in the UK – as it is in the US and continental Europe – which in time should lead to lower interest rates, more plentiful credit and greater consumer confidence. This will, in due course, provide the significant number of UK growth companies with a positive macro-economic tailwind.

4. How can LGPS funds approach impact measurement in private equity?

As more capital has been allocated to impact investing through private equity, so robust frameworks for measuring the delivery of impact have been developed. There have been various initiatives to codify the measurement and reporting of impact, such as the Global Impact Investing Network's IRIS metrics[2]. Notably, the Impact Measurement Project (IMP) is a global initiative to find a common consensus on how to measure, manage and report on impact across asset classes. The IMP starts from the premise

that everything we do has an impact on people and the planet – impact management is the practice of understanding these impacts with a view to increasing the positive and decreasing the negative.

At Columbia Threadneedle Investments we have built impact measurement into the private equity investment process. Before investing in a company we perform an impact assessment whereby we score the company out of 15 in terms of impact. For each company, we analyse "what" the intended positive impact of the company's product or service is, and the risk of any negative impact; "who" is impacted, including underserved populations; "how much" impact (scale, depth and duration) will happen; and the "additionality", ie positive impact contribution versus what would happen anyway.

These questions help us to build an impact thesis. For it to qualify as a private equity impact investment a company must:

a) score at least 10 out of 15 under our Impact Assessment Methodology

b) have more than 90% of the revenues it generates aligned to one or more of the 169 targets that underly the United Nations Sustainable Development Goals

On the basis the company qualifies, we then develop company-specific impact Key Performance Indicators (KPIs) to measure the company's positive impact over our investment holding period. The KPIs are developed in collaboration with the companies' management teams, so ensuring buy-in. They are articulated to all stakeholders – which could include the LGPS funds – and help to drive company returns. For our private equity impact products, we only invest in companies where management actions will simultaneously drive both financial returns and a positive impact – there is no compromise on either target.

It is important to note the difference between metrics measuring impact on the one hand and environmental, social and governance (ESG) progress on the other. Impact metrics are specific to individual companies, whereas ESG metrics tend to be more universal. Furthermore, only a sub-set of companies deliver products or services with positive impact at their core. By contrast, every company needs to optimise its ESG performance.

5. Can LGPS funds access superior financial returns while driving growth and impact?

Private equity is the ideal asset class for investing in companies that can have the largest positive impact and deliver the strongest financial returns. The LGPSs can select managers whose values and investment objectives are aligned with their own, emphasising long-term sustainable growth and impact.

There is strong non-cyclical demand for products and services addressing key human and planetary needs. Three prime examples of this are as follows: firstly, there is a range of "environmental sustainability" businesses in areas such as climate change mitigation, pollution reduction and clean energy. Secondly, "health and well-being" is a growth area – specifically, well-being and prevention, curative medicine, rehabilitation and palliative care. Finally, we would highlight "diversity and inclusion", where there is demand for products and services that promote equal access to finance and technology, a safe working environment, quality education, affordable housing and cyber security.

In summary, we believe this is the right time for the LGPSs to invest with impact, as young businesses are both delivering positive impact and growing quickly. Such is the interest from investors in these businesses that there are ample opportunities for exit, underpinning the likely strong financial returns. allocations.

1. Gov.uk, Local Government Pension Scheme (England and Wales): Next steps on investments, 22 November 2023

2. IRIS+, https://iris.thegiin.org/

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