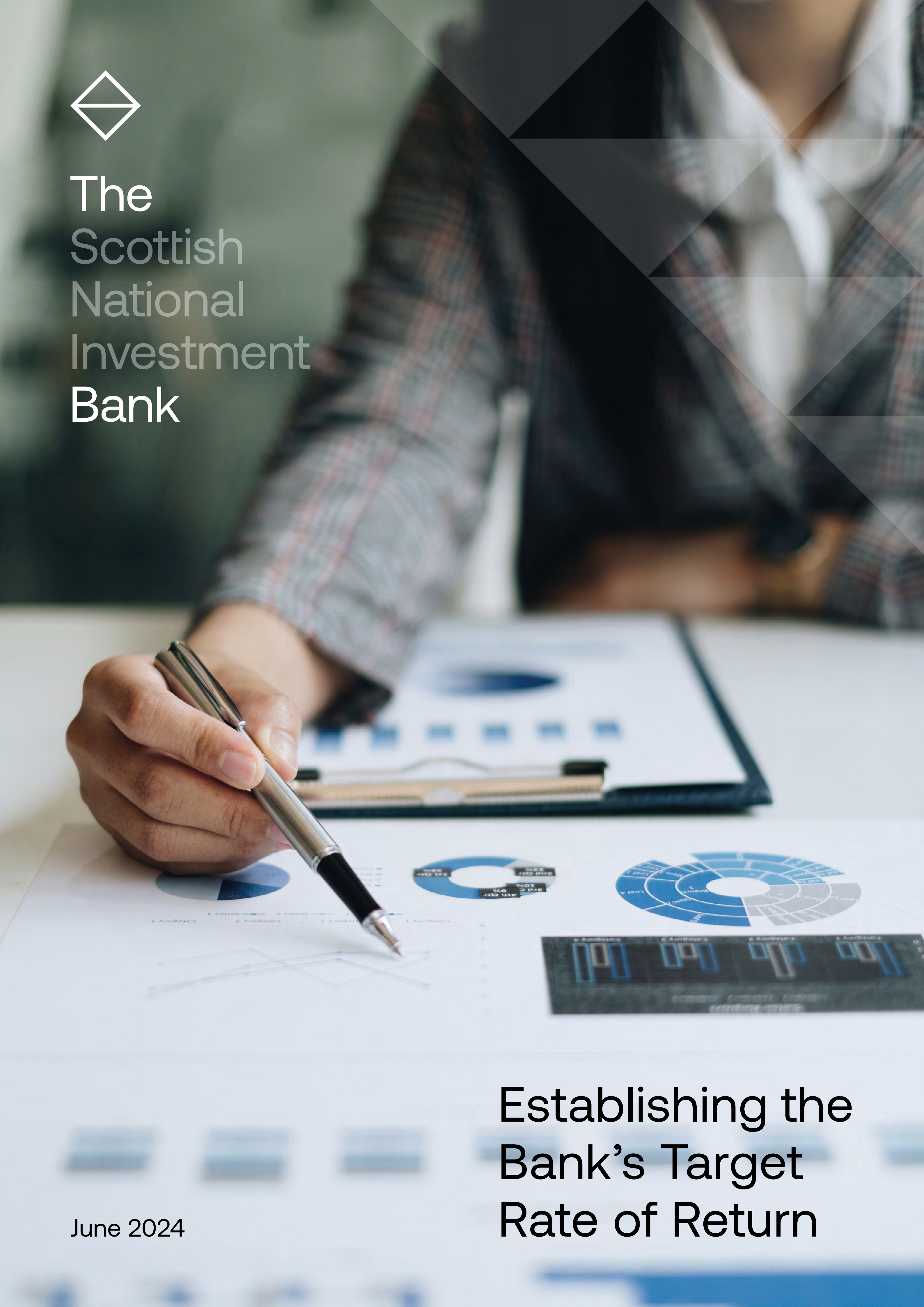

The Scottish National Investment Bank

Establishing the Bank's Target Rate of Return

June 2024

Introduction

The Scottish National Investment Bank was established in November 2020 to focus on three grand challenges that Scotland faces:

- The climate emergency.
- Place-based inequality.
- The need to drive innovation.

As a young and ambitious organisation, we are addressing these challenges by making long term investments in businesses and projects which confront these issues. We refer to this as our mission-impact investment approach[1]. Our three missions, which directly reflect the challenges above, are:

The Bank's Missions

Net Zero	Place	Innovation
Address the climate crisis, through growing a fair and sustainable economy.	Transform communities, making them places where everyone thrives.	Scale up innovation and technology, for a more competitive and productive economy.

As a mission-led impact investor, our investment decisions go beyond just commercial returns. Every pound we invest needs to deliver long-term social, environmental, or economic benefits across Scotland through innovative businesses and projects that work in support of our three core missions. We publish details of each investment we make and how they align to our missions on our website[2].

Beyond this, we typically seek to invest in projects or businesses requiring up to £50 million to support their growth or development. The investment we make can take the form of debt, equity or third party fund investment. We are a 'patient' investor which can invest over longer time periods than are typical with other investors.

As a development bank, we also have a role as a catalyst for private capital, encouraging investment that might be challenging to achieve without our support. To enable this, the Scottish Government has committed to capitalise us with £2 billion over a ten-year period.

Finally, we have also been established as a commercial investor and we seek to make a commercial return on each of our investments, demonstrating the value our investment returns on the public capital we have been allocated.

1. More detail about how we seek to support these missions, our approach as an impact investor, and the investments we have made so far can be found on our website (www.thebank.scot).
2. https://www.thebank.scot/portfolio

Introduction continued

A commercial return is also a critical element of our remit and supports our ambition to both crowd private capital into opportunities by demonstrating a commercial rate of return is achievable, and to make a return to firstly cover our operating costs and, in time, to reinvest in the next generation of businesses and projects. Making a re-investible return on our current and future portfolio is an essential step towards realising our ambition to become a perpetual investment fund for Scotland.

Setting a Target Rate of Return (TRR) for the Bank at this stage therefore provides clarity to our Shareholder on the level of anticipated returns, supports our engagement and position in the market as a commercial investor, and contributes to our ambition to crowd in private capital.

This paper covers the context for setting our TRR at the portfolio level, the approach we took to establish it, and how we will monitor and review it. Our TRR is a long-term measure of the financial returns we aim to make from our portfolio of investments. This complements our non-financial benefits which we describe in our Impact Report, published on our website.

In considering our portfolio TRR, it is worth noting some of the distinct attributes of the Bank. We are Scotland's only national development bank, and as such we comply with requirements around Subsidy Control (for clarity, the Subsidy Control regime replaces the requirements previously articulated under "State Aid" legislation). This means that:

- We are designed not to compete with other sources of investment, but to act as a catalyst for them, actively seeking to work with other investors.
- We invest on a commercial basis in all cases, with pricing and investment structures reflecting the commercial risk we take.

This commercial risk is, in many instances, likely to be higher than many private sector investors. We acknowledge that our higher risk profile, and the range and number of investments we commit to, will increase the likelihood of volatility within our portfolio compared with the private market.

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Context

During the set-up of the Scottish National Investment Bank, it was intended that the Bank be established with a target rate of return, measured over the long-term (e.g. a 10-year or greater horizon) and applied across its portfolio. Once established, the Bank and the Scottish Government subsequently agreed that it would be for the Scottish Government – as our sole Shareholder – to *"set a target rate of return for the Bank… at an appropriate time, taking into account a written recommendation as to that Target Rate of Return from the Bank Board"*[3].

That process has now concluded, with the Scottish Government accepting the recommendation provided by the Bank's Board. This paper sets out the process we followed to identify our proposed TRR, the final TRR agreed with the Scottish Government, and how we will implement and report on it going forward.

We commenced work to identify an appropriate TRR once the initial start-up phase of the Bank had been completed. This timing was in line with the views of the Scottish Government and parliamentary committees, which had shared that *"a Target Rate of Return not be set or applied for the Bank in the short term"*[4].

Approaching this TRR-setting exercise with the benefit of an initial two years' operational data allowed us to capture our early investment experiences and engagement with the market.

Our TRR is also not the only metric against which we will judge our performance. As an impact investor the financial returns we seek must also be viewed alongside the economic, social, and environmental benefits that our investments deliver. We continue to monitor and report our portfolio's impact performance to reflect this.

"Approaching this TRR-setting exercise with the benefit of an initial two years' operational data allowed us to capture our early experiences of engagement with the market."

We concluded that any TRR should be measured and reported over the long term – it is not a single point in time measure. This approach is consistent with the Bank's role as a provider of long-term, patient capital. It should also be set incorporating actual, historic performance to the point of calculation, and forecast performance for the remaining period of measurement. The final agreed TRR will therefore be monitored and periodically reviewed as our investment portfolio grows and develops.

3. https://www.thebank.scot/sites/default/files/2022-11/shareholder-relationship-framework_25-november-2020.pdf
4. https://sp-bpr-en-prod-cdnep.azureedge.net/published/EEFW/2019/7/4/Scottish-National-Investment-Bank-Stage-1-Report/EEFWS052019R09.pdf

Our Approach

In developing our recommendation for a TRR, we identified two key phases in our growth. The first is the medium-term period from the Bank's inception to 31 March 2026 ('FY26'). The second phase will be the period beyond this, when the portfolio continues to mature in the lead-up to deployment of the full £2 billion of initial budgeted capital.

Our recommendation proposed an initial TRR to 2026, set as a range to account for the emergent nature of our early portfolio in this first phase, where portfolio development will primarily be concerned with capital deployment and relatively low generation of returns. This approach also recognises the macroeconomic uncertainty that has been evident since we commenced development of the TRR.

After 2026, in the second phase, the Bank's portfolio will be driven to a greater extent by capital growth, with new capital deployment representing a lower proportion of the portfolio construction. Returns will primarily be driven by existing investments on a more consistent basis. The intention is that a longer-term TRR is then set, in line with our role as a patient investor and as envisaged prior to the Bank's establishment.

To reach a TRR recommendation for the initial period from inception to FY26 we constructed a model portfolio to project a level of return from the Bank's investments. We also conducted research across a number of key areas to inform and cross-check our projections, including:

- **Identifying the key influences** on target rates of return, for example, investor return and performance expectations, risk appetite, the nature of their target investment opportunities etc., which are adopted and differ across different types of investors.
- **Assessing historic market returns** for assets of various classes which are relevant to the Bank's investment activity.
- **Liaising with other market participants** to gain their insights on setting and adopting TRRs for their investment activities.

Our Approach continued

Model portfolio

Our model portfolio was constructed using a forecast mix of debt, equity, and fund investments. This was based on an assessment of market-level returns across relevant asset types, and across a range of industry sectors reflective of the mission-related activity across which we invest (across Net Zero, Place and Innovation).

We also recognise that, in this early stage of our development, much of the return to FY26 will result from income on our debt investments as these typically start providing income and returns from the point of investment.

The return and appreciation profile of equity investments can take longer to become established, making their performance more relevant over the longer term. These returns are driven substantially by exits. In effect, the returns from deployment of capital into equity investments will be longer term, with investments taking several years to reach a point of exit, in line with our role as a patient investor.

Potential returns have been modelled on a commercial basis, reflecting the need to crowd in, make a positive financial return, and our obligations to meet Subsidy Control requirements. There are, however, two key differentiators that influence our forecast returns.

The first of these is our **risk appetite**, which as a development bank may lead to higher losses in our portfolio than private capital providers. While we act commercially in our investment decision-making, and will seek to make appropriately benchmarked financial returns through each of our investments, we also recognise that the risk appetite necessary in our role may result in a higher loss rate with respect to company failures and therefore an overall downwards effect on returns at a portfolio level.

The second is the **long-term, patient capital approach** which we typically take, which means the hold period or debt duration of our investments may be longer than for a typical investor with a resultant reduction in internal rates of return.

Despite the potential impact these factors may have on the potential returns to be realised across our investment portfolio, compared to a typical private investor, we would consider both of these factors to be reflective of, and inherent to, our role as a development bank. Failure to take an appropriate level of risk, or to take a strategic view in the provision of patient capital, would inhibit delivery of our missions and the crowding in of private capital into these key challenges.

As a time-weighted measure, the TRR we recommended also takes into account the comparatively long investment hold time mentioned above as a feature of long-term patient capital.

In order to measure the actual performance of our investment activities against the target set for us, we will use the Internal Rate of Return (‘IRR’) methodology. This is due to IRR being a widely used metric for investment funds, useful for reflecting the return on investments in illiquid assets that are not regularly traded, such as unlisted equities.

> “Potential returns have been modelled on a commercial basis, reflecting the need to crowd in, make a positive financial return, and our obligations to meet Subsidy Control requirements.”

Our Approach continued

The impact of macroeconomic conditions

The TRRs set for other market participants typically take into account cost of capital assumptions. These are driven to a significant extent by gilt prices. Cost of capital assumptions factor into projecting portfolio performance, particularly when calculating prospective returns on debt investments. To crowd in private capital we will therefore need to demonstrate that we can deliver net value through our investments.

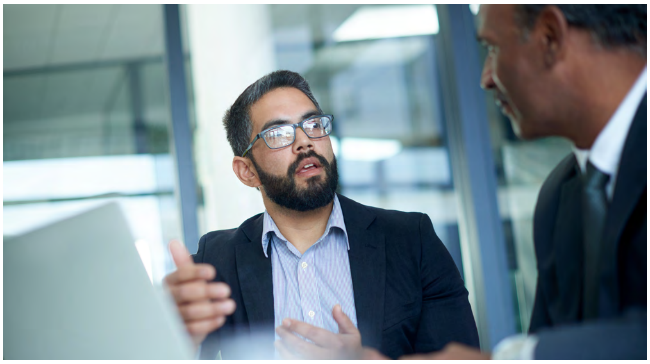
We also recognise the importance of demonstrating a financial return commensurate with the value of the public capital we are allocated.

Following COVID-related economic disruption, we also saw additional significant macroeconomic volatility from the second half of 2022 over the period of the TRR being set, with potential for future economic disruption resulting from macroeconomic or geopolitical volatility. The initial TRR set should reflect this and have a degree of additional uncertainty in market forecasting.

As a result of the prevailing uncertainty, we concluded that providing a range for the initial TRR would be appropriate, and would cater for both:

(i) **a target at the lower end,** should market pricing on debt drop back towards their 2019-21 levels, or

(ii) **a target at the higher end**, in case debt pricing remains elevated for longer.



Comparator institutions

During our research on a prospective TRR we also spoke with a range of investors – both private investors as well as a number of other development banks from across the UK, Europe and North America to understand their approach to calculating and then implementing a TRR. We recognise that development banks are a small subset of investors and are typically tailored in their approach according to their individual operating environment and institutional maturity.

The TRRs set for development banks vary according to the organisation's remit, approach to investment, and economic context. Looking at our development bank peers, however, we do see similar approaches being taken both to the timing of implementation of a TRR – with the measure first being taken after several years of operations, with potential subsequent revision to reflect market experience – and in the final TRR set[5].

5. For example, the UK Infrastructure Bank has been set a return on equity target of 2.5-4.0%. The Australian Clean Energy Fund must target an average return of at least the five-year Australian Government bond rate plus 2-3% per annum over the medium to long term. The British Business Bank's target rate of return adjusted over time relative to the capital deployed and the medium-term cost of capital, typically ranging from 1.2-3.2%.

Conclusions

Based on the above factors, and a result of the research and market engagement we undertook, we recommended a 3%-4% gross IRR as an appropriate medium term TRR for our portfolio.

Recommended medium term TRR for our portfolio

3%-4% gross IRR

This range has been identified based on the findings of the model portfolio, and with reference to the uncertainty around the cost of debt as impacted by current macroeconomic volatility. The Scottish Government has accepted this recommendation.

This TRR represents the rate of financial return the Bank will seek to deliver over time across its portfolio. It will first be formally tested at the end of FY26, at which point the intention is that a longer-term TRR is set.

The level at which that longer-term TRR is set will similarly take account of the factors set out in this paper. We expect that by 2026 the Bank's portfolio will also be more established, particularly for our equity investments, with sufficient hold periods on investments in the portfolio to better project a return and appreciation profile going forward.

For clarity, the IRR of individual investments will be determined by a range of factors, including instrument type, risk profile, impact and cost of capital. The recommended 3-4% TRR is set at the portfolio level.

This reflects the risk profile associated with our investments as a development bank, and its associated potential higher loss rate with respect to company failures.

Implementation and our role as a mission-led development bank

In implementing our TRR we recognise that there is risk in measuring an inappropriate TRR too early in the Bank's portfolio lifetime. In particular the risk to our role as a long-term, strategic investment institution seeking to deliver complex medium- to longer-term financial performance goals. These goals include securing an appropriately balanced portfolio and targeting and supporting the right businesses and projects in line with our investment remit.

We therefore remain committed to ensuring that we avoid the unintended consequence that establishing a TRR drives short-term decision making and detracts from the long-term patient capital approach which the Bank has been mandated to deliver. The research and market engagement we have undertaken will support us in achieving this.

Finally, the financial TRR has also been assessed independently of impact-focused returns which our investments may also achieve. As a development bank, a key demonstration of our performance is the impact we have made and the change we have driven. Our investments deliver a wide range of positive environmental, social and economic impacts against our missions – including renewable energy generation, emissions avoided, jobs created, patents supported, and affordable housing delivered – and we will report on those through our annual Impact Reports, as well as against our TRR going forward.

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