Institute and Faculty of Actuaries

Investment Strategy for Defined Benefit and Defined Contribution Pension Funds

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Direct Lending: A Viable and Sustainable Investment Sector or a Cyclical Phenomenon?

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Private Debt and Direct Lending
A Permanent Fixture for Pension Schemes?

Defining **Private Debt** and **Direct Lending**

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Private Debt is the provision of credit finance to company owners by institutions and funds without the intermediation of banks

Direct Lending is the provision of credit finance to owner-managed companies by funds and institutions without the intermediation of banks, and excluding credit for private equity fund buyouts

Bank Funding Now the Minority Portion in US and UK

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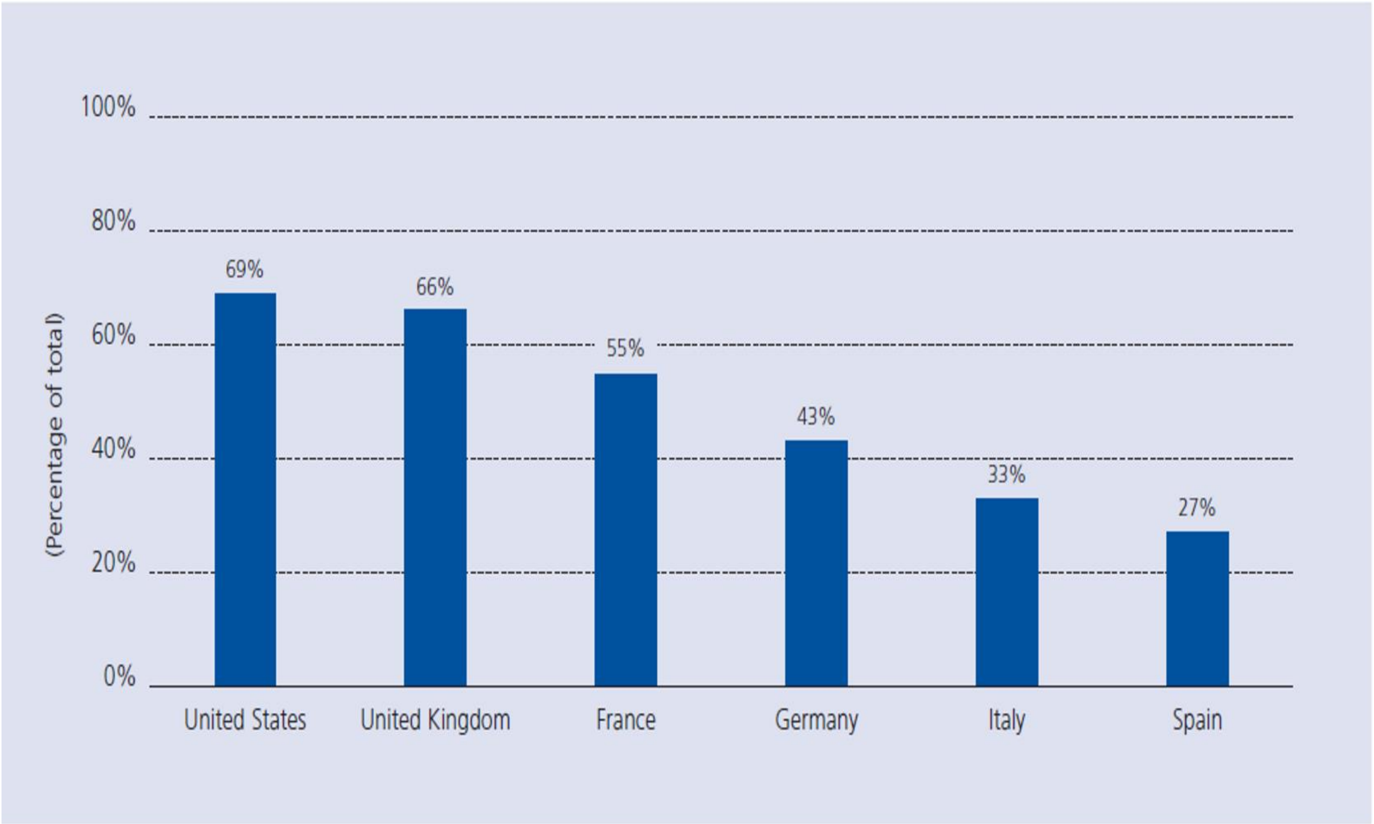

Source: IEB (Instituto de estudios bursátiles)

Typical Investment Vehicles in **Private Debt**

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Private Debt Funds and **Direct Lending Funds:**

Typically use **GP / LP structures** like private equity funds

Target annual returns between **5% and 20%** depending on investment strategy

Pay **interest** on their lending through to investors

Make 5-7 year loans and have an **8-10-year life**

Are between **100m and 5bn in size**

Are managed by **expert lenders** who may have banking backgrounds

What is the Take-up of **Private Debt**?

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Total Global AUM:	$523bn (2015)
Largest Investor:	Private Sector Pensions (17%)
# of New PD Funds:	120 (2015)
% to Private Equity:	71% (2015)

Source: **Preqin**

The Friendly **Regulator**

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"The approach to reform recognises that an effective financial system needs intermediation outside the traditional banking sector. When conducted appropriately, it can be a valuable alternative to, and provide competition for, banks in funding the real economy."

– Mark Carney , Bank of England Governor

The Supportive **Inter-governmental Administrator**

The imperative is.. “Further developing and integrating capital markets” and “reducing the dependence on bank funding.’

- ‘European Commission President Jean-Claude Juncker:

The Encouraged **Business Leader**

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“We need to nurture the UK’s vibrant alternative finance market and encourage even more competition in banking so that businesses can get growth capital.”

- John Cridland, Then Director General of the CBI

The Enthusiastic **Fund Manager**

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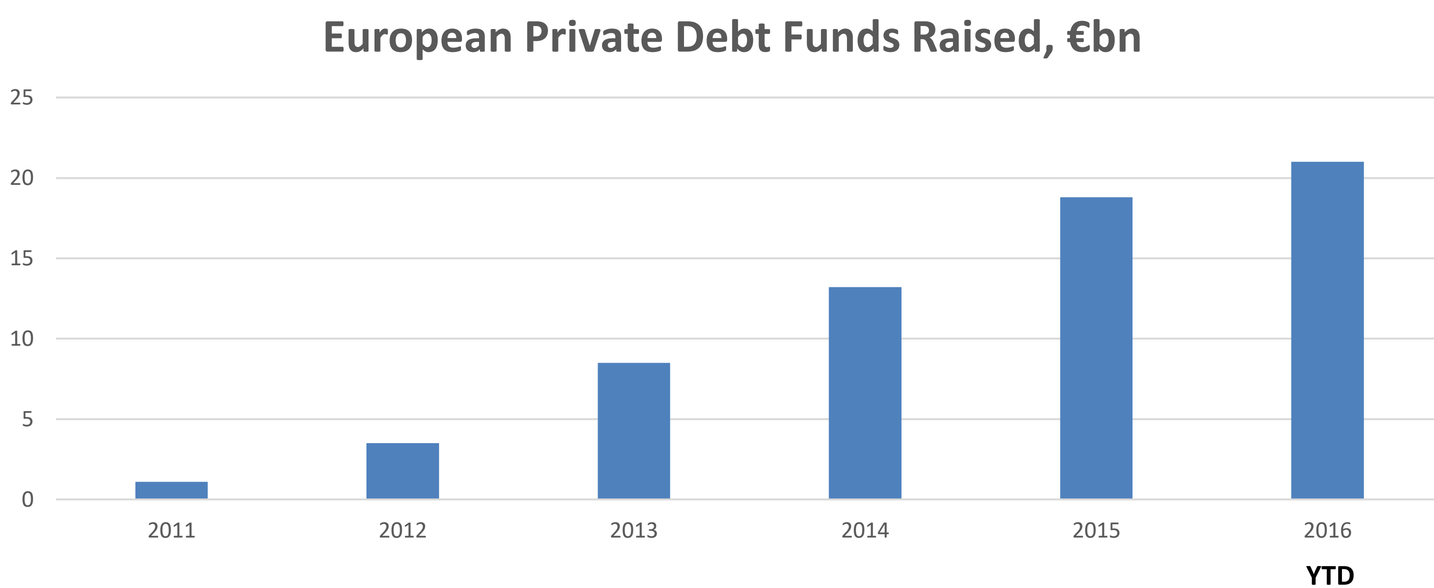
"Market-based financing has fueled the creation of companies … market-based financing has built warehouses, manufacturing plants and hotels…, when traditional banks could not, or would not, provide capital."

– Tony James, President & COO of Blackstone

European Private Debt **Fundraising**



Source: **Private Debt Investor and Preqin**

Some 2014-2016 Tenders: **UK Pensions**

North Yorkshire	£100m
Strathclyde	£250m
John Lewis	£100m
Lancashire	£100m (CRED)

Some Key Players: **Fund Managers**

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Ares Management	Private Debt (1997)
ICG	Private Debt (1995)
GSO Capital	Private Debt (2005)
Beechbrook Capital	Direct Lending & PD (2008)
Park Square	Private Debt (2004)
Haymarket Financial	Private Debt (2009)

BEECHBROOKcapital

Direct Lending

Jon Herbert

Credit – The Investment

- Loans
- Medium term (4-6 years)
- Repayment – typically bullet and end of term
- Use – for strategic purpose (acquisitions; buyouts; shareholder realignment; growth capital; refinancing)
- Security – either first ranking (senior loans) or second ranking (mezzanine or second lien loans)
- Documentation – loan agreement; security documents (guarantees & debentures); intercreditor agreement

Credit – The Investment (continued)

- Interest – Either cash pay or PIK, typically quarterly in arears
- Interest – Typically floating rate
- Interest rates – LIBOR + 4% to 12% (depending on markets, risk, subordination, liquidity)
- Fees – Arrangement fees; Monitoring fees; Agency fees
- Equity kickers – Warrants or bought equity
- Covenants – Monitor the performance of the borrower; Leverage; Interest Cover; Cashflow; Capex; Loan To Value; Covenant Lite

Risks Investing in Credit

- Credit Risk – Probability of Default; Loss Given Default; Cyclicality
- Portfolio Risk – Concentration
- Deployment Risk – Origination capability
- HR Risk – Loss of key executives
- Liquidity Risk – Medium term investment vehicle; medium term assets; Limited depth in secondary markets
- Currency Risk – Mismatch of cashflows between borrowers, the fund and the investors

Cyclical Phenomena or Sustainable Asset Class

- The role of banks is changing fundamentally
  - Matching of assets with liabilities
  - Protection of depositors
  - Higher capital ratios and lower leverage
  - More focus on ROCE
  - Focus on shorter term and lower risk lending products
  - Lower volatility business model
  - Partner with other capital providers like funds – RCF facilities; 1st loss, 2nd loss deal structures
- The US market has changed
- In the European Buyout market fund penetration >50%
- Pull from investors for the asset class
  - Diversification from equities / fixed income
  - Floating rate with good cash yield paid quarterly

Strategy of a Current UK SME Credit Fund

- Target market
  - High growth UK SMEs, EV £10m - £50m
  - Not owned by Private Equity (so families, entrepreneurs, HNWs, AIM quoted, family offices)
  - An under served market
  - Opportunity to deliver strong returns for investors (net 8%-10%) with low volatility
- Fund raising
  - First close Dec 2015 £103m, Final close Dec 2016 expected £200m
  - 8 investors including BBB, EIF, local authority pension fund, European pension funds

Strategy of a Current UK SME Credit Fund (Continued…)

- Deployment
  - 20-25 assets, average loan £8m-£10m
  - Diversified by sector, borrower, location, purpose
- Gross returns 11-13%, made up of;
  - Cash interest margin 10%+ (small amounts of PIK)
  - Arrangement fees 3%+
  - Warrants/Small minority equity stakes 2%
  - Make Whole 3 years – realise minimum multiple of 1.3x
- 8 year fund, typical GP/LP structure
- Management fees; 50bps on commitment + 75bps on utilised capital + carried interest

Examples of Direct Lending Investments

- Example borrowers:
- Oxygen Freejumping
    - Trampoline park owner and operator
    - Capital to roll out new sites
    - Owned by Management and HNW investors
- MCM Expo
    - Operator of exhibitions in niche market
    - Capital to allow founder to buyout his original co-founder