Private Credit – Overvalued or value creator?

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EY

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Introduction
Long term yields fall further and credit spreads stay low...

BoE Gilt Curve (Dec 15 to June 18)

Markit Corporate Bond Spreads (Dec 11 to Dec 17)

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…so pension providers broaden their horizons

Source: Aviva Alternative Income Study 2018
The scale of the illiquid asset opportunity..

Suffolk Pension Scheme invests £60m in greenfield infrastructure.

The M&S Scheme, British Coal Staff Superannuation Scheme and the Mineworkers Pension Scheme have each invested in solar assets via Greencoat.

CoE Pensions Scheme has said it plans to invest 20% of it’s £2bn return-seeking pool in infrastructure assets.

Lambeth Council Pension Scheme has invested £42m in build-to-rent projects.

NEST is challenging the asset management industry to innovate in order improve DC schemes’ access to private credit.
The flood of capital into private credit has driven down returns

Source: Preqin

Private debt assets under management

Investor views of key issues in 2018

Source: Preqin
But are they diving in too fast?

“Pension trustees may have different reasons to want to gain exposure to illiquid assets.”

“Where trustees [are considering] changing their scheme’s investment strategy to include assets with less liquidity, [trustees should] make sure they have the necessary skills, expertise and appropriate governance arrangements for the complexity of their scheme’s investments, so the risks are properly managed.”

tPR has also committed to provide further guidance on..

“how trustees’ investment strategy can include assets with long-term investment horizons, such as venture capital, infrastructure and other illiquid assets in a diverse portfolio.”

[Source – “Pension funds and liquidity” – The Pensions Regulator blog]
Potential opportunities
What might be considered alternative?

<table>
<thead>
<tr>
<th>Type of investment</th>
<th>Examples</th>
<th>Key features</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>Social infrastructure, economic infrastructure, energy (including renewables)</td>
<td>Loan to a project; no security; highly illiquid</td>
</tr>
<tr>
<td>Real estate backed</td>
<td>Residential &amp; commercial lending, social housing, student accommodation, equity release, ground rent</td>
<td>Formally secured on a property; highly illiquid</td>
</tr>
<tr>
<td>Other asset backed</td>
<td>Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing</td>
<td>Formally secured on real assets; often highly structured</td>
</tr>
<tr>
<td>Other unsecured</td>
<td>Private placements, SME lending, high yield, overseas (including emerging market) debt</td>
<td>Unsecured; most closely related to corporate bonds</td>
</tr>
<tr>
<td>Other</td>
<td>Private equity, hedge funds, insurance linked securities</td>
<td>Various risk / return profiles</td>
</tr>
</tbody>
</table>
Returns

Indicative Modified Duration

Equity release mortgage loan
CRE loan
Infrastructure Loan
Student housing loan
Social housing loan
Ground Rent

Infrastructure loans
Real estate backed loans
Other asset backed securities
Other unsecured assets

0%
1%
2%
3%
4%
5%

0 5 10 15 20 25 30 35

Gilt curve
Swap curve

AAA corporate bond
AA corporate bond
A corporate bond
BBB corporate bond

0%
5%
10%
15%
20%
25%
30%
35%
Challenges and constraints
Challenge 1 – how do I get hold of one?

• Unlike corporate bonds or equities, a pension scheme generally can’t buy non-traditional assets easily. It could buy one through:
  – Pooled fund
  – Securitisation

• If I find one, can I price it?
• And perform a credit assessment?
Challenge 2 – Do I need to retain liquidity?

- Liquidity requirements need to allow for:
  - Benefit payments
  - Collateral requirements
  - De-risking strategies

- 56% of UK pension schemes are cash flow negative¹

- Increased uncertainty around cash flows as a result of pensions freedoms

- Private credit funds offer increased liquidity compared to directly holding assets

¹ Source – Mercer’s European Asset Allocation Report 2017

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Challenge 3 – How do I manage when things change?

• As the pension scheme has a relationship with the borrower (potentially through an intermediary), terms can be changed either contractually or on a discretionary basis through:
  – Changes in borrower circumstances
  – Borrower optionality
  – Variations (or changes to loan terms)

• As such, pension schemes may wish to:
  – Hire expertise in house
  – Utilise investment management (or credit insurance) expertise
  – Outsource all management
## Summary of challenges

<table>
<thead>
<tr>
<th>Type of investment</th>
<th>Examples</th>
<th>Pricing Transparency</th>
<th>CF certainty</th>
<th>Ability to source</th>
<th>Ongoing management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infra-structure</td>
<td>Social infrastructure, economic infrastructure, energy (including renewables)</td>
<td>Low</td>
<td>High</td>
<td>Medium</td>
<td>Complex</td>
</tr>
<tr>
<td>Real estate backed</td>
<td>Residential &amp; commercial lending, social housing, student accommodation, equity release, ground rent</td>
<td>Low</td>
<td>Medium</td>
<td>Medium – difficult</td>
<td>Complex</td>
</tr>
<tr>
<td>Other asset backed</td>
<td>Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing</td>
<td>Medium - High</td>
<td>Medium</td>
<td>Easy</td>
<td>Simple</td>
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<td>Private placements, SME lending, high yield, overseas (including emerging market) debt</td>
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</tbody>
</table>

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Final thoughts
Final thoughts

• Consideration of alternative assets will be key in meeting funding targets and long-term aspirations

• Pension Schemes should continue to evaluate non-traditional opportunities, being aware of the potential benefits as well as the challenges

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• The views expressed in this presentation are those of the presenter.