Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND INVESTMENT PANEL**	
MEETING DATE:	**27 February 2019**	**AGENDA ITEM NUMBER**
TITLE:	**Private Debt – Asset Class Update**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
Appendix 1 – Mercer Paper: Private Debt Asset Class Update Exempt Appendix 2 – Brunel Private Debt Portfolio Specification		

1 THE ISSUE

1.1 Opportunities to invest in Private Debt (PD) were recommended as a long term objective of the 2017 investment strategy review. As an asset class, PD is expected to generate attractive risk adjusted returns, earning an illiquidity premium and credit spread, that outstrips its publically traded equivalent, high yield debt. It is envisaged that PD may form one of the recommendations of the 2019 strategic review and this paper serves to provide Panel with an introduction to the asset class ahead of that review.

1.2 Increasing regulation and more stringent capital requirements following the global financial crisis have led to a retraction in bank loans to middle market companies. This has created an opportunity for unconventional lenders, namely institutional investors, to fill the void and, in many cases, negotiate terms with borrowers directly. The increasing opportunity set is not without its risks, which are discussed in more detail below and in the Mercer Asset Class Update Paper at Appendix 1.

1.3 Brunel will be developing a dedicated Private Debt portfolio. The specification for this portfolio is included at Exempt Appendix 2.

2 RECOMMENDATION

That the Panel:

2.1 **Notes the information contained in the Report and Appendices**

3 FINANCIAL IMPLICATIONS

3.1 Costs associated with PD investing are typically higher than investing in liquid public debt markets given the extra due diligence that is required of managers. A managers ability to negotiate favourable loan terms or ‘covenants’ is a critical part of the investment process but adds a layer of complexity that increases fees.

3.2 As PD continues to attract investors there is evidence of downward pressure on management fees as funds compete for capital. Research by PREQIN in 2017 cites a record high of 324 PD funds (a 12% year-on-year increase) in the market seeking a combined $153bn in capital commitments, which is indicative of both the demand in this asset class as well as the breadth of the opportunity set.

3.3 Average management fees for PD funds are at their lowest point across the last 10 years (PREQIN, 2017), with the average at 1.50%, compared to 1.75% the prior year. Management fees for PD funds have traditionally ranged from 1% to >2%, depending on level of risk and complexity of the underlying loans, where high levels of complexity can command a premium for management.

3.4 As competition for institutional capital remains high among PD funds, further fee contraction is not totally unexpected. That said, certain funds that specialise by industry or region for instance, are likely to continue to demand a relatively high premium.

4 PRIVATE DEBT – ASSET CLASS OVERVIEW

4.1 In its simplest form PD involves non-bank lenders (typically institutional investors) extending credit to unlisted middle-market companies. Middle market companies are defined as having earnings broadly in the range of $20m-$60m. In most cases the borrower will be owned by a private equity firm (sponsored) but could also be family- or management-owned (non-sponsored).

4.2 The return profile of PD funds varies widely as managers can invest across the whole capital structure. Senior debt represents the lowest risk as it is first to be repaid on default. Junior is moderately risky and is subordinate to senior debt, meaning it has a secondary claim on default of the borrower. Mezzanine[1] and distressed financing represents the highest risk/return profile.

4.2 Returns from PD assets are made up of exposure to credit risk and an 'illiquidity premium'. The illiquidity premium means an investment cannot easily be realised and, when subscribing to a fund, can often be subject to a lock-up period as fund managers look to deploy committed capital. In PD this premium is expected to add between 1.0%-1.5%% to returns. Additionally, PD is perceived as offering investors superior protections compared to traditional bonds. Managers can often customise loan terms with a borrower, building in strong covenants designed to minimise the risk of a company suffering a credit event.

5 PRIVATE DEBT – FURTHER CONSIDERATIONS

5.1 **Concentration risk**: Many PD strategies will be concentrated in a niche area, are less diversified and significantly smaller than traditional debt funds. Any allocation to this asset class should be well diversified across sector and region.

5.2 **Credit risk:** Given credit risk is a primary driver of returns in PD thorough due diligence needs to be undertaken both at an underlying loan level by the manager and at a fund selection level to identify the extent to which leverage is used for instance. Higher risk PD funds tend to be more exposed to any cyclical downturn in the market where default rates increase chance of loss.

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[1] Mezzanine debt is a hybrid of debt and equity and falls between senior secured debt and equity in a company's capital structure. Mezzanine debt structures are customised and negotiated between lenders and borrowers, making them considerably more illiquid than high-yield bonds and unsecured loans available to larger companies.

5.3 **Capacity:** With an increased level of demand from investors to access specialist PD funds, capacity constraints should be a consideration, where a large allocation may not be deployed immediately.

6 RISK MANAGEMENT

6.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

7 EQUALITIES

10.1 An equalities impact assessment is not necessary.

8 ISSUES TO CONSIDER IN REACHING THE DECISION

8.1 Report is for information only.

9 ADVICE SOUGHT

9.1 The Council's Section 151 Officer has had the opportunity to input to this report and have cleared it for publication.

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Background papers	Mercer Paper to Officers December 2018
Please contact the report author if you need to access this report in an alternative format	