Private Debt Commitments 2023

Addressee and purpose

This paper is addressed to the Officers and Investment Sub-Committee ("ISC") of Leicestershire County Council Pension Fund ("the Fund"). The purpose of this paper is to update our recommendations on the Fund's private debt commitments for 2023.

This paper should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing. We provide comment from an investment but not a legal or tax perspective.

Please note that Hymans Robertson LLP and our group companies have a wide range of clients some of which are fund managers who may be included in and/or recommended to you as part of this exercise. We have a research team that advises on shortlisting fund managers in manager selection exercises, which is separate from our client and other relationships with fund managers and therefore we do not believe there will be a conflict that would influence the advice given. We would be happy to discuss this and provide further information if required.

Background

In 2022, we undertook a comprehensive review of the Fund's private debt portfolio, including proposed commitments to the asset class in 2023-24. In **2023**, we recommended that the Fund commit £180m to the next vintage of the LGPS Central Private Debt (Low Return) sub-fund and £100m to the Private Debt (Real Asset) sub-fund. We recommended further commitments of £280m in **2024**, ideally to the Fund's existing private debt managers, but with the allocation between them to be determined at the time. All commitments were subject to the Fund representing no more than 20% of total assets in each underlying fund.

Setting limits on ownership is common practice when investing in pooled funds and is designed to protect investors from investing in sub-scale funds. The 20% limit on the Fund's share of each LGPSC sub-fund was proposed for three specific reasons:

- It was intended to ensure that the sub-funds were large enough to invest effectively and, in particular, to enable LGPSC to achieve a greater level of portfolio/manager diversification than the Fund could achieve acting independently (thereby addressing concentration risk)[1];
- It would also increase the likelihood of securing savings on investment management fees;
- It meant that the Fund would likely not be the largest investor in either sub-fund and therefore less at risk of having to take responsibility for managing them, if LGPSC became unable to meets its obligations (so addressing operational risk).

It is important that the Fund continues to make regular commitments of similar size to the asset class, so that the target allocation is achieved and thereafter maintained in steady state. Regular commitments also ensure good diversification across the different vintages of each underlying fund series. It is possible to adjust the level of commitments in any one year to reflect the short-term outlook for private lending, but we recommend this is done only when the outlook is particularly strong (or weak).

Our outlook for private debt at the end of Q2 2023 was neutral. We considered the increased risk of default as economic growth decelerates in developed markets to be largely offset by the expectations that most major

[1] We acknowledge that the 20% limit could have unintended consequences if the Fund applied the limit and reduced the size of its investment as this could reduce the level of portfolio/manager diversification and cost savings achievable by LGPSC.

economies would escape recession and the significant higher yields being generated on private debt today. We therefore see no argument for tactical changes to the planned level of commitments.

Please note that we have not revisited our commitment sizing calculations to confirm whether or not the level of commitments remains appropriate given changes in the size of the Fund and the pace of drawdowns and distributions by underlying managers. However, the size of the Fund has not changed materially since last year, and Officers have confirmed with the Fund's private debt managers that net cashflows (drawdowns minus distributions) are broadly unchanged. This would suggest the planned commitment amounts remain appropriate.

LGPSC Private Debt funds – 2023 vintage

LGPSC has indicated that it plans new vintages of both the Low Return and Real Asset sub-funds in Q3 2023. Soft commitments at first close from partner funds (including the Fund) are currently £265m and £150m for the Low Return and Real Asset sub-funds respectively[2]. This means the Fund's initial share of the two sub-funds would be 68% and 67% respectively.

Both sub-funds will remain open until September 2024, giving all partner funds the opportunity to make additional commitments in 2024. Both are therefore expected to be larger than indicated above by final close.

For the Fund to commit to these sub-funds, at the planned levels or anywhere close to them, the 20% limit would need to waived on this occasion. Discussions have taken place with LGPSC regarding the provisions that are, or could be, put in place to protect the Fund to allow this to happen. These are detailed below.

Managing concentration risk

To address our concerns, LGPSC has proposed the following minimum levels of portfolio/manager diversification:

- Low Return sub-fund (in the event that total commitments are £200-400m): at least 3 underlying managers will be appointed, and each will be expected to make at least 50 loans
- Real Assets sub-fund (in the event that total commitments are £100-200m): at least 2 underlying managers will be appointed, and each will be expected to make at least 10 loans.

Higher minimum levels will apply if total commitments exceed these bands, as it is hoped they will by the final close of each sub-fund. LGPSC provided the following guidance on the impact of higher commitments on the average size of each loan made (the "loan concentration")[3].

Loan concentration of Low Return sub-fund

Total Commitments, £m		#Managers	#Underlying Loans	Ave. Loan Concentration, %
Lower	Upper			
>200	<400	3	150	0.67%
>400	<600	4	200	0.50%
>600	-	5	250	0.40%

[2] Source: LGPSC
[3] Source: LGPSC

Loan concentration of Real Assets sub-fund

Total Commitments, £m		#Managers	#Underlying Loans	Ave. Loan Concentration, %
Lower	Upper			
>100	<200	2	20	5.00%
>200	<400	3	30	3.33%
>400	-	4	40	2.50%

We are comfortable that these provisions will ensure adequate diversification of both the Low Return and Real Asset sub-funds. The different threshold number of loans reflects the nature of each asset class; loans secured against real assets tend to be significantly larger, but typically lower risk due to their security interest in tangible assets, than those made to mid-market corporate borrowers which is the focus of the Low Return sub-fund.

LGPSC has indicated that the commitments to be made to underlying managers will be sufficiently large to secure meaningful fee savings (relative to what the Fund could achieve acting independently). We are reassured by this guidance.

Addressing operational risk

Mitigating operational risk is a significant issue for funds handled by a single third-party manager. In this case, we believe the risk is limited for three reasons:

- These are multi-manager funds; if for any reason LGPSC became unable to manage them, responsibility for management of the underlying loan portfolios and any credit issues that had arisen within them would remain with the underlying managers.
- LGPSC and partner funds have agreed key person provisions whereby if they experience changes in staffing which in LGPSC's view could have a material impact on the management of the sub-funds, LGPSC are required to consult the Advisory Committee on the actions to be taken. The Fund is represented on the Advisory Committee which provides an opportunity to influence, though not to direct, the actions taken by LGPSC in response to the staffing issues. These are significantly weaker than the key person provisions offered by third-party managers, which typically include the suspension of new investments pending the replacement of the key persons. But given the nature of the relationship between the Fund and LGPSC, we are fairly comfortable with the arrangements in place.
- As a LGPSC partner fund and shareholder, the Fund would have significantly more influence over ongoing management arrangements than it would with a third-party manager.

Support for pooling

We believe there is one further argument for proceeding with the commitments as planned. It is likely they are necessary for LGPSC to launch the next vintages of both sub-funds in a timely manner, each with sufficient capital to build effective portfolios. We believe it is in the long-term best interests of the Fund for LGPSC to make available a regular series of new sub-funds given the importance of making regular commitments to closed-end, private markets funds.

Recommendation

Given the arguments outlined above, we recommend the Fund drops the 20% limit and proceeds with the planned commitments. Limits on commitments to future LGPSC products should be considered on a case-by-case basis, taking into account the provisions in place to mitigate concentration and operational risks. We recommend the 20% limit is retained for commitment to third-party managed products.

Prepared by:-

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For and on behalf of Hymans Robertson LLP