HYMANS ROBERTSON

Leicestershire County Council Pension Fund

Private Debt review

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Overview

Purpose

This paper is addressed to the Pension Fund Committee (the "Committee") of the Leicestershire County Council Pension Fund (the "Fund"). It provides a review of the Fund's strategic allocation private debt assets. It sets out the expected run-off profile of the Fund's existing private debt assets based on decisions agreed to date, and our views on the options for maintaining the strategic allocation to these assets over the long term.

Background

The Fund's Private Debt allocation was previously reviewed in depth in October 2022 and the target allocation was slightly revised down from 10.5% to 9.5%, with agreement to this change at the January 2025 Committee meeting. This change reflected wider strategic considerations as well as Pool offerings; the Pool are revisiting the fund offerings but currently it will not be possible to maintain the existing strategic allocation – nor the current level of target return – for the private debt class using the Pool's offerings alone. This has prompted a wider strategic review of the Fund's private debt allocations, the results of which are set out in the remainder of this paper. 34

Key questions to be addressed in this paper

- What does the current private debt portfolio look like, and what is the expected run-off profile?
- What are our current views on the Fund's private debt managers and implications for the existing portfolio?
- When do further commitments to private debt need to made to maintain the target allocation?
- What are the options available to meet the target allocation? Can this be done effectively with the Fund's existing managers?

General risk warning

Please note the value of investments, and income from them, may fall as well as rise. You should not make any assumptions about the future performance of your investments based on information contained in this document. This includes equities, government or corporate bonds, currency, derivatives, property and other alternative investments, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the full amount originally invested. Past performance is not necessarily a guide to future performance.

Executive Summary

The Fund has a well-developed private debt portfolio that has contributed positively to the Fund's investment strategy through strong returns and diversification. We believe it still has an important role in the investment strategy. The Fund had 7.0% of total assets invested in private debt as at 31 December 2024, a 2.5% underweight of the target allocation as at that date.

We intend to address the underweight allocation to private debt over the next three years through commitments to closed-end vintages that provide diversification and a defined return profile. The investment period is structured this way because there is typically a delay between when the Fund commits capital and when it is drawn down by the manager; capital is only called as suitable investment opportunities become available, so it will take time for the Fund's investment managers to deploy the commitments made today.

When recommending a breakdown of the proposed commitments, we have taken the following factors into consideration:

- The Fund potentially transitioning all assets to LGPS Central.
- The preference to allocate capital to existing managers and, thereby, limit any additional governance burden.
- Our views on the private debt market, the appropriate composition of the Fund's private debt portfolio once fully invested.
- Concentration risks, and expected speed of deployment of any new commitments.

We outlined several approaches the Fund could take to meet the target allocation, given the Fit for Future consultation, we have considered a blended approach to be the most feasible with only £120m to be committed in 2025 and the remainder to be split between IG corporates and cash.

- We recommend the Fund top up an additional £120m to the 2024 LGPSC sleeves (£90m to LGPSC Direct Lending and £30m Real Assets). This allows the private debt exposure to get closer to target, whilst being mindful of concentration risks associated with further allocation to 2024 LGPSC vintage investments.
- Of the remaining £180m, we recommend £90m to be invested in the Aegon Short Dated IG corporate bond investment. These assets are more liquid in nature but will provide investment returns correlated (to a degree) to that of private credit mandates. It's important to note that this is no substitute for genuine private market investments but in our view this 'holding place' is preferable to cash, over a 1-3 year period.
- This will be an initial investment of £90m to the Aegon Short-Dated IG corporate bond product as soon as possible, with this expected to be drawn down over time as Private Credit commitments are called. The remaining £90m will be managed in line with the Fund's cash management strategy to service the Fund's wider private market commitments.
- We recommend engaging with Central in the following areas: new opportunistic fund, expanding the asset classes within future Direct Lending vintages to include Asset Backed Lending and / or Credit Secondaries, private debt opportunities they see in Developed Asia, creation of a hedged share class to eliminate currency risk and following best practice frameworks.

Proposed Structure

- The current portfolio is diversified by manager and vintage, and largely focussed on the lower-risk, senior end of the private debt market along with allocations to more opportunistic areas such as distressed debt and special situations.
- We believe the Fund should continue to diversify the private debt portfolio across different areas of the market. The tables to the right sets out the market segment and regional allocations for the Fund's private debt portfolio. We remain comfortable that the ranges reflect the current market appetite and will provide the Fund an appropriate amount of diversification.
- The attractiveness of special situations and distressed debt continues to vary over the credit cycle. We therefore recommend the Fund retains the flexibility to vary the level of exposure to these market segments.
- The actual allocations for distressed debt will fall to the lower range in 2025, similarly special situations will start to fall post 2027, without further commitments. Given the lack of available opportunities via the pool and the strong funding position, we do not at this stage recommend increasing the allocation to opportunistic areas. Given the volatility associated with opportunistic debt and attractive opportunities elsewhere in the private debt universe means we are comfortable that the private debt portfolio is positioned towards the lower end of the opportunistic debt range
- However, we recommend engaging with Central to understand the appetite of other Partner Funds for an opportunistic fund.
- We recommend that the regional targets and ranges remain unchanged. However, we recommend the Fund continues to reduce its geographic exposure to Europe towards current targets, in favour of North America and Developed Asia. Current exposure is added to the portfolio through funds with a global remit, which we remain supportive of.

Market segment definitions (current)	Market segment definitions (revised)	Current Target (%)	Proposed revised target (%)	Range (%)	
				Current	Proposed
Senior corporate debt	Senior corporate debt	65	70	40-90	40-90
Real asset-linked debt	Real asset-linked debt	20	20	10-30	10-30
Special situations debt	Opportunistic debt	10	10	0-20	0-20
Distressed debt		5		0-10	

Region (no changes recommended)	Target (%)	Range (%)
Europe	45	30-60
North America	45	30-60
Developed Asia & Rest of World	10	0-20

Engagement with Central

Given the limited opportunities currently available via the Pool, we recommend engaging with Central on the following areas. This could be done alongside other Partner Funds, where there is interest – we would be happy to help in that respect.

Areas to Engage with Central	Rationale
Opportunistic funds: appetite from other Partner Funds and opportunities on the horizon,	The Fund's exposure to opportunistic areas falls away in the next few years. There is currently no new vintage offered by Central that replicates the risk return profile currently being targeted within the Fund's opportunistic debt bucket.
Inclusion of asset backed lending and credit secondaries within future vintages, likely Direct Lending	Asset backed lending and credit secondaries are attractive opportunities for the Fund that will diversify the portfolio and complement the current holdings.
Region Exposure to include Developed Asia	We believe that Developed Asia continues to present an attractive opportunity to diversify some of the exposure away from Europe and North America. Engaging with LGPS Central on the private debt opportunities they see in Developed Asia, and whether they expect future vintages to include allocations to this geography or whether global exposure will have a higher weight to developed Asia.
GBP hedged share class	The Fund is exposed to currency risk as Central only offer an unhedged share class. The creation of a hedged share class can eliminate the currency risk the Fund is exposed to in future sleeves. (Noting that if this is not possible, an alternative is to allow for this more approximately by adjusting the allocation to the currency hedge programme with Aegon to offset exposures).
Responsible Investment - climate targets for individual portfolio companies in new vintages	Given the Fund's climate ambitions, and we have seen private debt managers set strategies focusing on aligning the individual portfolio companies to the Fund's climate goals. We recommend Officers engage with Central to follow best practice frameworks.

Current asset allocation

The Fund invests in private debt to provide a high-income yield and to diversify the risks associated with the Fund's allocation to growth assets.

In the January 2025 strategy review, the Committee agreed to reduce the target allocation from 10.5% to 9.5%. The Fund had 7.0% of total assets invested in private debt, a 2.5% underweight to the new target allocation.

The Fund has significant uncalled commitments which will increase exposure as they are drawn, however exposure elsewhere will fall as underlying assets are realised.

- Of the current mandates, c. £180m remains committed but undrawn – the majority of which (c.£133m) is within the LGPS Central 2021 Private Debt mandates. This is forecast to be drawn over the period to the end of 2028.
- The Fund has also committed a further £280m across two 2024 LGSPC sleeves - £180m to the Direct Lending fund and £100m to the Real Assets fund.
- Given the relatively small exposure to the Partner Group MAC IV fund, the Fund has opted to take the discount to NAV and exit from this position.

The Fund currently invests across a combination of Pool and third-party managers. The table to the right provides a summary of the existing investments.

Fund	Vintage	Fund Stage	Commitment	Current NAV (£)	Total Fund Assets
CRC CRF III	2017	Harvest period	£43.9m ($55m)	£4.4m ($5.5m)	0.1%
CRC CRF V	2021	Harvest period	£52m	£51.3m	0.8%
CRC CRF VI	2024	Investment period	£40m	0*	0.0%
M&G DOF II	2014	Harvest period	£40m	£0.4m	0.0%
M&G DOF III	2015	Harvest period	£40m	£9.8m	0.1%
M&G DOF IV	2017	Harvest period	£40m	£31.6m	0.5%
Partners Group MAC I	2014	Harvest period	£100m	£5.2m	0.1%
Partners Group MAC III	2016	Harvest period	£70m	£2.1m	0.0%
Partners Group MAC IV	2017	Harvest period	£120m	£14.1m	0.2%
Partners Group MAC V	2019	Harvest period	£100m	£51.6m	0.8%
Partners Group MAC VI	2020	Harvest period	£60m	£42.9m	0.6%
Partners Group MAC VII	2023	Investment period	£19m	£13.9m	0.2%
LGPS Central Credit Partnership I (High return) *	2021	Investment period	£60m	£32.7m	0.5%
LGPS Central Credit Partnership II (Low return) **	2021	Investment period	£240m	£146.8m	2.2%
LGPSC Credit Partnership IV (Real asset return)*	2022	Investment period	£117m	£56.6m	0.9%
TOTAL			**£1,141.9m**	**£463.5m**	**7.0%**

Source: Respective managers and client's capital statements, as of 31 December 2024

** CRC VI made their first capital draw down in March 2025 **LGPSC values as of 30 September 2024*

GBP to USD = 1.2524

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Cashflow projection

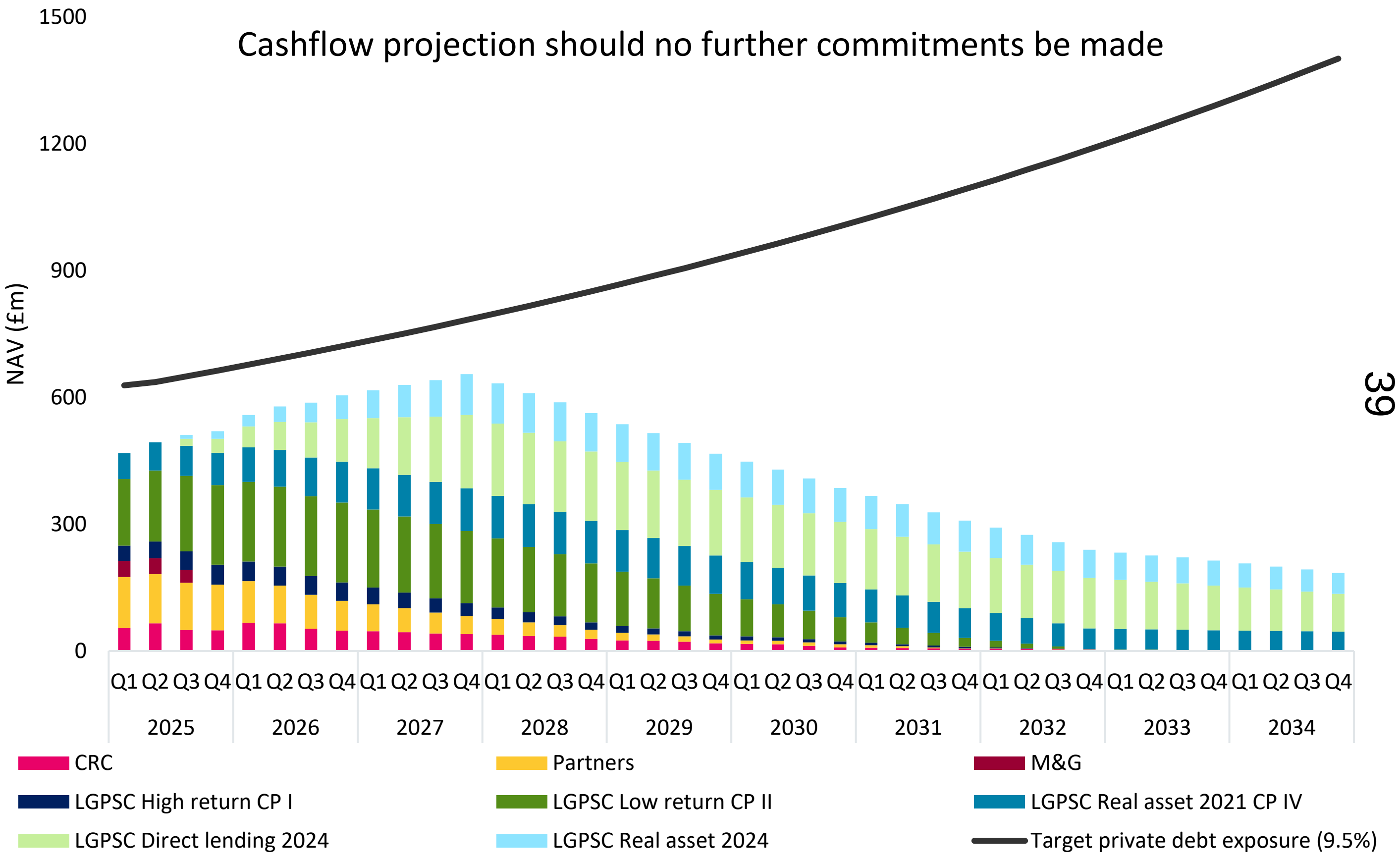
Using data provided from the Fund's managers and our own assumptions where necessary, we have produced an estimate of the private debt run-off profile as set out in the chart to the right. Note market conditions or manager actions may impact these estimates.

Modelling suggests that the allocation, allowing for the LGPSC 2024 vintage commitments, the Fund's exposure to private debt remains below the 9.5% of total Fund target.

While future projections can vary depending on asset repayments and market conditions, we can see that using managers' current estimations and our own assumptions above, **the Fund's overall private debt weighting increases but remains underweight over 2025-2027, and then begins to fall materially underweight post-2027, should no further commitments be made beyond the ones already made to CRC VI and LGPSC 2024 vintages.**

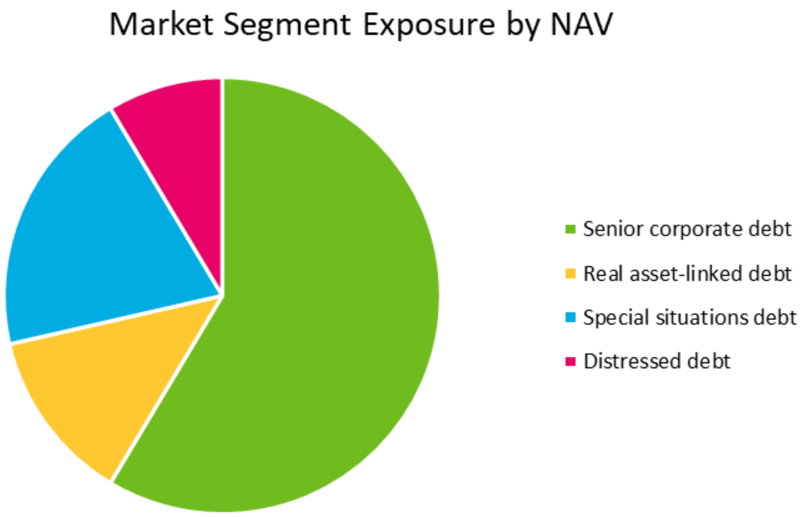
Allowing for all agreed commitments, we estimate that by 2027 c.86% of the private debt asset allocation will be pooled. The market segment exposure is expected to be predominantly senior corporate debt (c.57%) and real asset-linked debt (c.29%). Opportunistic areas such as distressed debt and bank relief will be a significantly lower proportion, due to maturing of funds (and no further commitments assumed beyond CRF VI).

Further capital commitments are therefore needed to achieve the 9.5% target allocation to private debt.



Source: investment managers, Hymans Robertson as of Q4 2024. Summary of assumptions used to carry out cashflow modelling are available upon request.

Market segment exposure



Target allocation by market segment

Market segment	Current Target (%)	Range (%)	Current (%)
Senior corporate debt	65	40-90	58.6
Real asset-linked debt	20	10-30	12.9
Special situations debt	10	0-20	20.0
Distressed debt	5	0-10	8.6

The Fund's current target has a bias towards senior corporate loans, with smaller allocations to more opportunistic areas such as distressed debt and bank risk sharing transactions, in a bid to improve returns and diversification of the portfolio.

The current allocation to senior corporate debt is broadly in line with the agreed target level, albeit continued commitments will be necessary to maintain this level of exposure.

As a reminder real asset-linked debt exposure funds the development of real assets, such as infrastructure and real estate projects. This segment provides access to a different set of borrowers and the income streams used to service the debt are derived from different sources, thus providing diversification. The loans typically benefit from security over tangible assets which improves their downside protection.

The Fund has committed capital to special situations debt, through the LGPS Central High Return 2021 sleeve and CRC Capital Relief Fund V. A further commitment was made to CRC Capital Relief Fund VI.

The allocation to distressed debt is within the target allocation range. Exposure to this asset class provides diversification as the risks are largely driven by the individual deals rather than the overall market. It should be noted that distressed debt is a higher risk asset class, at a level akin to private equity; the returns potential however is typically higher to compensate for this.

Source: NAVs provided by respective managers as at 31 December 2024, LGPS Central data as of 30 September 2024 and M&G DOF III is as of 31 October 2024.

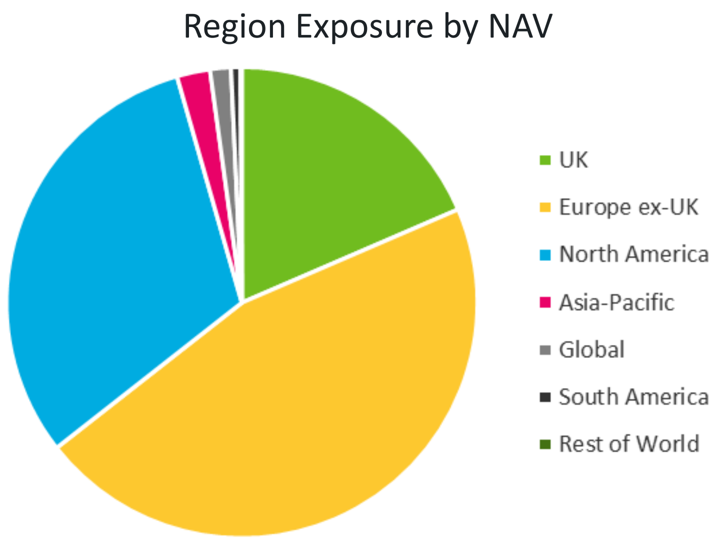
Region exposure

The portfolio's regional allocation is almost entirely focussed on Europe and the US, with Europe by far the largest regional exposure. The opportunity to invest in other regions is a fairly new phenomenon, and some small allocations have been made elsewhere within the global funds, but these will not have large impacts on the portfolio performance.

The table to the right sets out the agreed regional allocations for the Fund's private debt portfolio. Given opportunities are largely focused in Europe and North America we remain comfortable with the ranges in the current framework.

The current allocation remains skewed towards Europe. This is expected to reduce with a proportional increase in the North America exposure by the end of 2025, as a result of capital deployments to North America focussed managers within the LGPS Central and maturing of existing, European focused, strategies. The 2024 direct lending sleeve will have 2 European focused managers and 2 North America focused managers.

We believe that Developed Asia continues to present an attractive opportunity to diversify some of the exposure away from Europe and North America. Current exposure is added to the portfolio through funds with a global remit. We remain comfortable that the Fund is currently towards the lower end of the target range given the current lack of options available via the Pool, but **we recommend engaging with LGPS Central on the private debt opportunities they see in Developed Asia, and whether they expect future vintages to include allocations to this geography**.



Target allocation by region

Region	Target (%)	Range (%)	Current (%)
Europe	45	30-60	64
North America	45	30-60	31
Developed Asia & Rest of World	10	0-20	4

Source: NAVs provided by respective managers as at 31 December 2024, LGPS Central data as of 30 September 2024 and M&G DOF III is as of 31 October 2024. "Global" in the chart represents exposures where the manager has not provided a more granular breakdown.

Private Debt: Sub-Asset Classes

Direct lending has grown into a dominant strategy within private debt, offering attractive returns and steady income. However, to build more resilient and well-balanced portfolios, investors should consider diversifying beyond core direct lending by incorporating strategies with differentiated risk-return characteristics.

Lower risk / lower return — Higher risk / higher return

Trade Finance
1. Base rate + 2%
2. Cash plus or collateral waterfall
3. Relatively liquid / open ended

Fund Finance
1. 6-8% net IRR
2. Uplift versus IG credit
3. Closed-ended funds

Tangible Assets

Infra Debt
1. 7-10% net IRR
2. Historically better risk profile than equivalent-rated corporate credit
3. Closed-ended funds

Real Estate Debt
1. 5-10% net IRR
2. Diversify property, new allocations on lower valuations.
3. Mostly closed-ended

Core Allocation

Direct Lending
1. 8-10% net IRR (senior)
2. Illiquidity premium over liquid fixed income
3. Evergreen or closed-ended

Bank Risk Share (RegCap)
1. 10-14% net IRR
2. Diversification (SME) or premium over IG (large cap)
3. Closed-ended

Opportunistic
1. 13-20% net IRR
2. Return enhancement
3. Mostly closed-ended

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Venture Debt
1. 12-20% net IRR
2. Return enhancement /potential for productive finance
3. Closed-ended

Asset Backed Lending
1. 8-14% net IRR
2. Diversification from corporate risk (like ABS versus corporate FI). Could be lower risk than direct lending due to security & amortising loan profile
3. Typically closed-ended

1. Expected returns
2. Typical rationale for investment
3. Implementation

Private Debt: Market Developments

- The sub-classes below are relevant to the Fund, given the current investment approach.

Direct corporate lending
(Current investment, available via the Pool)

- The sharp rise in base rates, persistent economic uncertainty, and inactive broadly syndicated loan (BSL) market over the last few years have opened the door for direct lenders to gain market share, often collaborating in club deals to fund larger loans traditionally handled by the BSL market.
- However, this trend began to shift in 2024. With inflation easing, major central banks started cutting rates, and BSL activity picked up.
- Recently, margins have tightened toward long-term averages in both Europe and the US, especially in the upper-mid and large-cap segments, as refinancing activity picked up in the BSL market. At the same time, rising effective rates have pressured companies, particularly in consumer-facing sectors, manufacturing, and real estate. This has led to a notable increase in covenant waivers, amendments, and instances of non-accruals across portfolios. While expected returns will come down as rates are cut, they remain compelling on a risk-adjusted basis.
- That said, market turbulence linked to US tariffs has created refinancing challenges for deals in the BSL market, potentially shifting momentum back to direct lenders.

Infrastructure debt
(Current investment, available via the Pool)

- Infrastructure debt continues to benefit from high demand, particularly for cross-over or sub-investment grade rated assets. Assets pertaining to the energy transition remain in high demand.
- The higher interest rate environment has seen the asset class become a more compelling opportunity on a relative value basis, both in comparison to core infrastructure equity and other private debt (where infrastructure debt has traditionally lagged returns). Infrastructure assets have generally demonstrated resilient valuations, unlike property.

Real estate debt
(Current investment, available via the Pool)

- 2023 was a troubled year for transaction and financing volumes in the UK real estate market. Pricing, demand, and rents were polarised to specific sectors as well as those assets with attractive ESG credentials, a trend which has continued into 2024.
- Transactional activity (and valuation) may be positively impacted as interest rates come down and inflation settles. In the UK, whole loans are more attractive in terms of deployment opportunities and overall returns.

Opportunistic credit
(Current investment, not currently available via the Pool)

- Despite continued low corporate default rates relative to history, there are pockets of stress in the market. Challenges (and hence opportunities in this space) relate to cashflows where companies are paying floating rate debt in a higher for longer interest rate environment, and where companies are approaching refinancings.
- Tariffs are creating uncertainty and volatility in the credit markets which is creating opportunities for opportunistic credit investors to deploy selectively.

Regulatory Capital Relief
(Current investment, not currently available via the Pool)

- The RegCap market continues to be active, mostly in Europe but with increased issuance in the US. European banks are exploring more programmatic issuance with different collateral types.
- With the regulatory changes, the RegCap market has seen new entrants, particularly those transacting on a tactical basis and in the US, translating to tighter spreads in the more widely syndicated deals.

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Other Opportunities

Asset backed lending

Private loans which provide financing to counterparties secured on a pool of assets. The pool is typically composed of performing assets that generate contractual cash flows. Loans are typically amortising.

Consumer assets
Backed by consumer loans e.g. residential mortgages, auto loans, credit card loans

Real assets
Backed by tangible, real assets e.g. buildings, equipment, aviation

Intangibles
Generally backed by intangible or unconventional assets, e.g. royalties, IP, fund finance

Offers diversification of corporate risk within most private debt portfolios (direct lending and opportunistic)

Credit secondaries

Funds buying secondary stakes of private credit funds. Potential to take advantage of other investors' liquidity needs. Credit secondaries are still a maturing market with a lot more supply than demand, meaning secondary GPs can be selective.

Benefits
- Mitigation of blind pool risk
- Seasoned loans
- Quick deployment
- Diversification

Drawbacks
- Similar multiples vs primary investment
- Limited influence in underlying origination, workouts and ESG
- 2 layers of fees

Buying funds at a discount equates to accretive IRR returns on a similar risk profile (corporate risk of direct lending).

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Asset backed lending and credit secondaries are attractive opportunities for the Fund that would diversify the portfolio and compliment the current holdings

Responsible investment considerations

As with all debt, it is more difficult to enact change as the debtholder than it is as the equity owner, but private debt has markedly lagged other private markets asset classes in terms of ESG reporting and data gathering, and managers must rely on engagement to enact change. This becomes more difficult with some forms of structured credit where managers don't have access to the underlying loans or assets. Integration of ESG considerations within the investment process is now the bare minimum threshold when assessing managers; within debt assets, ESG risk factors are ultimately credit factors that can impact the credit worthiness of any issuer. Governance therefore has been integral to credit analysis for many years with environmental and social considerations now gaining more importance.

Direct Lending / special situations

- Sustainability linked loans, commonly referred to as an ESG margin ratchet, have now become more commonplace in direct corporate lending in Europe, a trend which has transferred from the syndicated leveraged loan market. A sustainability linked loan, will grant the borrower a small reduction in interest margin if it can meet certain ESG KPIs. In some instances, the interest margin may increase if the borrower fails to meet ESG KPIs (ie a 2-way ratchet).
- The KPIs can vary depending on the company but can include reduction of carbon emissions and increasing the diversity of the company's board or employee base. However, it is difficult to analyse the ambition of the KPIs without knowing the company details. As the market develops, we see the use of a 2-way ratchet becoming standard although more often in the larger part of the direct lending market.

Real estate debt

- Real estate lenders have also started to link the spread of the lending to ESG improvements although this is not nearly as widespread as in the direct lending market. Given there is strong demand for new buildings to meet high environmental and social impact standards, we expect further adoption on new loans going forwards.
- Within real estate however, we are seeing higher levels of stranded asset risk where sponsors are left with buildings that don't meet these high standards and which cannot be subsequently sold. Transitional strategies focusing on extensive refurbishment for these buildings is potentially an opportunity set for LGPS Central Real Asset fund although committing capital to such products may not improve the Fund's climate risk metrics in the short-term but would certainly contribute to improving them over time and support more impactful and value add real-world emissions reductions.

Distressed debt

- Responsible investment in distressed debt relies very much on the investment manager's ESG practices and integration into the investment process. There is certainly the extra risk of predatory lending in a "loan-to-own" strategy so this must be mitigated.

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Thank you

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