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BOARD AGENDA LETTER

DATE: September 16, 2020

TO: Board of Retirement

FROM: Donald C. Kendig, CPA, Retirement Administrator

Staff Contact: Douglas Kidd, Investment Officer

SUBJECT: Consideration of Private Credit Program Options– APPROPRIATE ACTION

Recommended Action

1. Direct Staff and Verus to compile a short list of Private Credit Advisors which can provide deal sourcing and due diligence for private credit investments to be made over the next three years;

Alternative Action

2. Or, Staff to develop pacing plan with Verus to maintain private credit allocation at existing level and coordinate through the next three calendar years to fund new Private Credit commitments, including deal sourcing and fund due diligence;
3. Or, Begin discussions with Carlyle to re-commit to existing private credit relationship.

Fiscal and Financial Impacts

The biggest unknown of course is future returns, which are likely to vary by the approach chosen. Each approach will add new fund commitments and to the workload on the FCERA Accounting Services Unit. Fees may range from 0.5% on called capital. Option #2 would entail much more Staff time, as well as Verus time, but would not carry a separate fee. Carlyle currently charges fees of 1.25% management fee, and 15% carried interest on the BDC portion of our investment with them but does not charge for the similarly sized separate account. Those underlying fund fees would be similar with all options, although an advisor will argue that they can help us to realize "volume discounts" by pooling client commitments and bringing scale to General Partners raising Funds.

Background and Discussion

FCERA contracted with Carlyle in 2017 to provide advice and management of the FCERA private credit program. The program consists of three segments. The first is investment in a private Business Development Company, the second is a similar in structure, but a separate account format for FCERA. Those two investments have targeted private equity sponsored direct lending. The third is a Fund of Funds targeting mezzanine debt. The investment period was intended to be 3 years, followed by the wind down period. Carlyle expects to call the last of our capital by Q1 of 2021. In order to maintain the targeted 8% allocation and maintain a consistent investment pace, it is now time to consider the necessary follow-on investment program to the current Carlyle arrangement.

The Carlyle program is focused on providing credit for private equity sponsored deals, (i.e. buyout or leveraged buyout transactions.) The AlpInvest Fund of Funds program is strictly mezzanine debt, (lower quality, higher returning, often shorter term in nature.) As mentioned in prior Board meetings in 2020, Staff believes now is the time to consider a follow-on to the Carlyle program, and that there are essentially three good options. The first is the easiest, which would be a continuation of the existing Carlyle program. Because of their origin and history as a private equity shop, the focus will continue to be on sponsored deals, although the AlpInvest mezzanine program adds a different dimension with higher potential returns and higher credit risk.

Second, Staff can work with Verus to establish a reasonable pacing plan for the next few years, which will likely be around $125mil in commitments to maintain the 8% target. Staff and Verus can evaluate and recommend 2-3 new fund commitments in each of the next three years to reach the $125mil annual pace. This will entail continuing research, meetings, due diligence and coordination, and is certainly within our capabilities. What is difficult to gauge with this approach is whether the combination of Staff and Verus can differentiate between the best funds and the also-rans, and having done that, whether FCERA can gain access to those top funds. There will of course be relevant legal reviews.

The third approach is to contract with an external advisor, such as Aksia, to provide deal sourcing and due diligence. The primary reason for this choice would be to increase the diversification within the private credit program, since these advisors tout their familiarity and expertise in all types of credit, or by “collateral type,” as they explain it. Another advantage to this approach is that the Advisors are equipped to review many more funds in any given year, and they will also have better visibility into upcoming funds being raised, as well as having experience and data from prior funds in order to predict fund performance. Although they may not know or negotiate any FCERA side-letter provisions, they do legal reviews on every recommended fund.

An enticing feature of the external advisor approach is the prospect of creating a Fund of One. In this structure, FCERA and the Advisor are the only two Partners in the Fund. FCERA retains beneficial ownership of the underlying Fund investments. FCERA will also retain the right to veto any recommended fund investments and will retain the right to cease making new Fund commitments at any time. The drawback is of course that the Advisor will charge fees for their services, on top of the fees being charged by the underlying fund investments. The Board is asked

to consider those fees in the context of prospective net returns to FCERA, and not solely in absolute terms. Staff believes that the breadth of coverage and the depth of research will enable FCERA to realize better returns and better private credit diversification with an Advisory relationship than with the other alternatives. It is important to remind Trustees that diversification is desirable, even within the Private Credit allocation.

Attachments

1. Aksia Presentation July 2020

(Aksia has provided permission to post this attachment and to provide it upon request.)

Aksia LLC

Private Credit Investor Trends
FCERA
July 2020

www.aksia.com

Private Credit: Overview and Update on Investor Trends

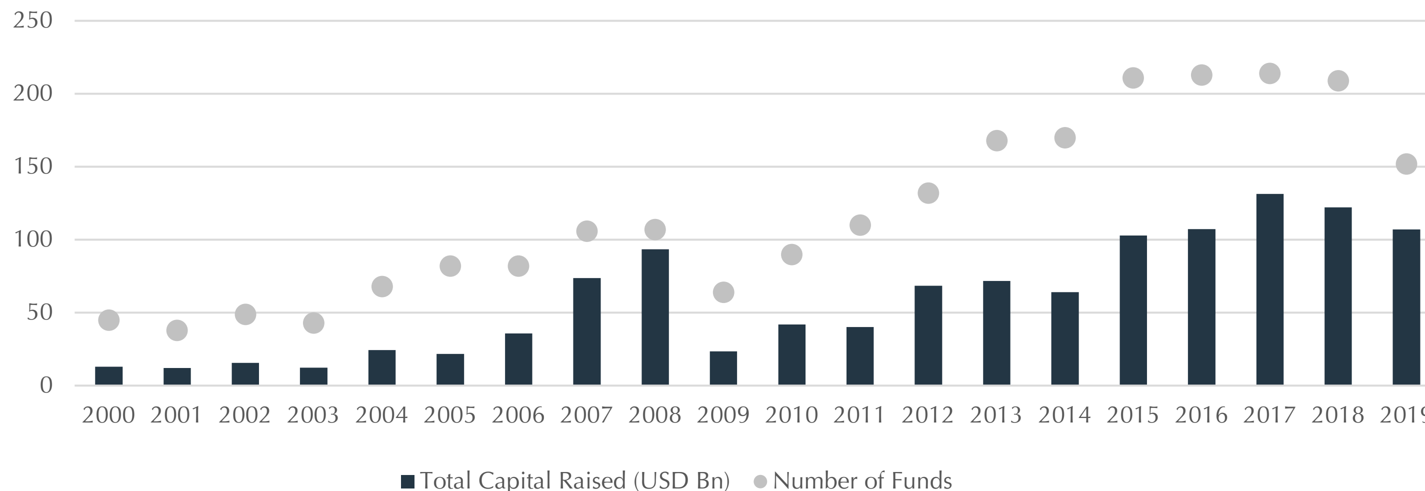
Private Credit: Primary Motivations

Primary motivations:

- Potential enhanced yields over public credit due to illiquidity and complexity premium
- Exposure to strategy "diversifiers" via wide spectrum of underlying collateral types
- Potential income generation through contractual yield, usually floating rate based

At the same time, capital inflows remain strong:

- Annual fundraising across private debt funds averaged $114 billion from 2015 – 2019, double the average over the prior five year period[1]
- However, private credit is not without its issues. Investors cite the top 3 issues as: rising interest rates, pricing / valuations, and competition for assets[2]



Source: Preqin Data, as of February 3, 2020

1. *Preqin Data, as of February 3, 2020*
2. *2019 Preqin Global Private Debt Report*

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What is PC? How do you define Private Credit?

Direct Lending

U.S. Direct Lending
- Senior
- Opportunistic
- LMM (sponsored)
- LMM (non-sponsored)
- Private BDCs
- Industry Focused
- SBIC
- Revolvers

European Direct Lending
- Senior
- Opportunistic
- Lower Middle Market
- Country-Specific Funds

Emerging Markets Lending
- Asian
- African
- CEE/Middle East
- Latin American
- Pan-EM

Global Direct Lending
- Global

Mezzanine

U.S. Mezzanine
- Upper Middle Market
- Middle Market
- Lower Middle Market

European Mezzanine
- European Mezzanine

Structured Equity
- Structured Equity

Distressed & Special Situations

Corporate Distressed
- U.S.
- European
- Emerging Markets
- Global
- Single Trade

Real Estate Distressed
- U.S.
- European
- Global

Special Situations
- U.S.
- European
- Emerging Markets
- Global

Specialty Finance

Consumer & SME Lending
- Marketplace Finance
- Lender/Platform Finance

Factoring & Receivables
- Factoring & Receivables

Regulatory Capital Relief
- Regulatory Capital Relief

Royalties
- Healthcare
- Music/Film/Media
- Energy & Minerals
- Royalties

Healthcare Lending
- Healthcare Lending

Venture Lending
- Venture Lending

Insurance Linked
- Diversified
- Life
- Non-Life

Litigation Finance
- Litigation Finance

Merger Appraisal Rights
- Merger Appraisal Rights

PE Portfolio Finance
- PE Portfolio Finance

Structured Credit

CLO
- CLO Debt
- CLO Multi
- Captive CLO Equity
- 3rd Party CLO Equity

CRE
- Non-Agency CRE B-Piece
- Agency CRE B-Piece
- CMBS/CRE

RMBS
- RMBS

Consumer ABS
- Consumer ABS

Esoteric ABS
- Esoteric ABS

Europe Structured Credit
- European Structured Credit

Structured Credit Multi-Sector
- Structured Credit Multi-Sector

Real Estate Credit

U.S. CRE Core Lending
- U.S. CRE Core Lending

U.S. CRE Transitional Lending
- Large Loan
- Middle Market
- Small Balance
- Opportunistic

U.S. CRE Bridge Lending
- Large Loan
- Middle Market
- Small Balance

European CRE Lending
- Bridge
- Transitional
- Core

EM CRE Lending
- EM CRE Lending

Residential Mortgages
- Residential NPLs
- Single Family Rental
- Mortgage Servicing Rights
- Residential Origination

Real Assets Credit

Infrastructure Lending
- Senior Focus
- Sub-IG Focus
- Mezz Focus

Energy Credit
- Energy Lending
- Energy Mezzanine Lending
- Opportunistic

Trade Finance
- Trade Finance

Metals & Mining Finance
- Metals & Mining Finance

Agricultural Credit
- Agricultural Credit

Transportation
- Aviation Lending
- Maritime Lending
- Road & Rail Lending
- Diversified Transportation Lending

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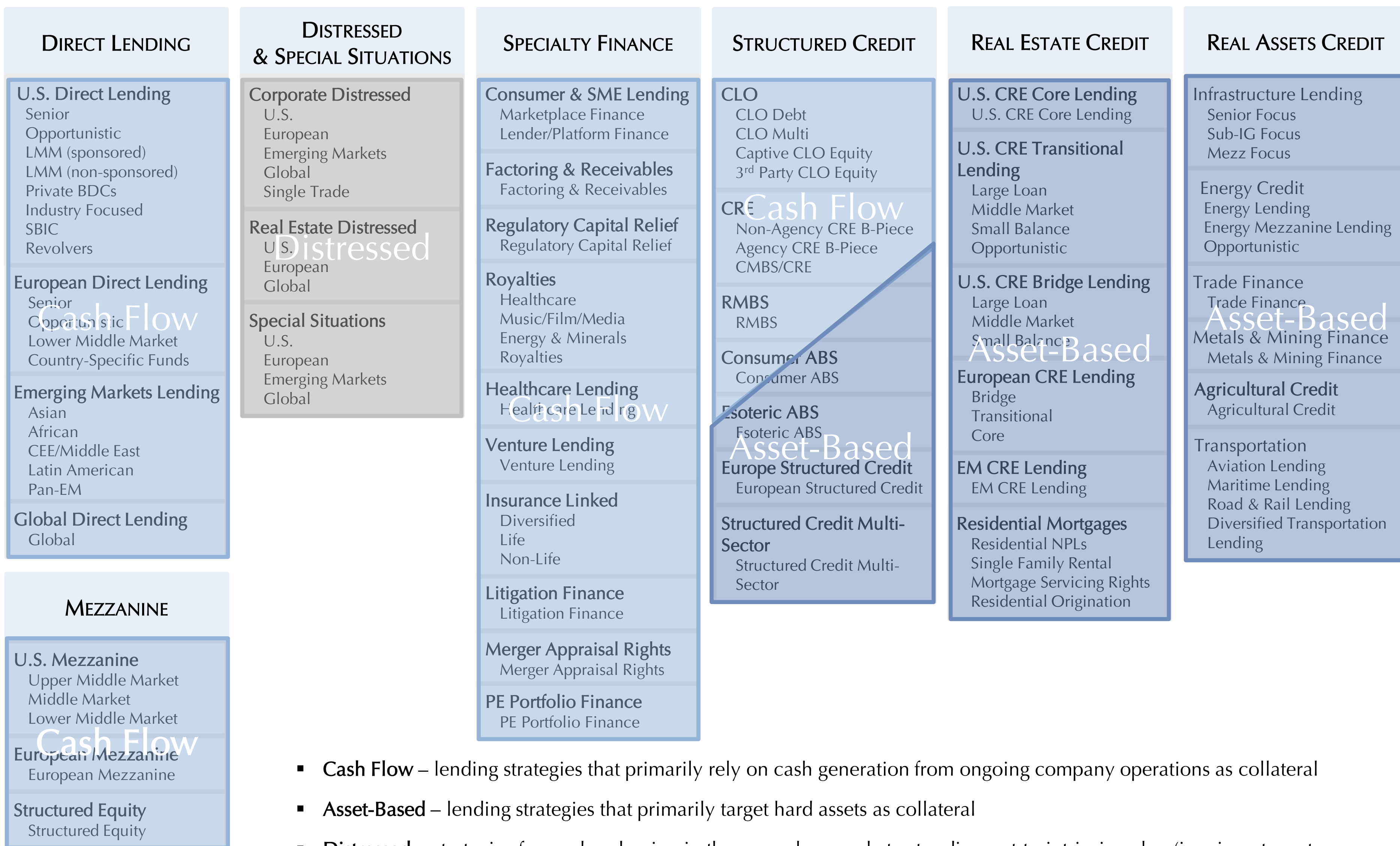
90+ Strategies → 3 Key Categories



- **Cash Flow** – lending strategies that primarily rely on cash generation from ongoing company operations as collateral
- **Asset-Based** – lending strategies that primarily target hard assets as collateral
- **Distressed** – strategies focused on buying in the secondary markets at a discount to intrinsic value (i.e., investor returns driven by capital gains rather than yield)

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Private Credit – Complementary to other Asset Classes

Private Credit	vs. Private Equity	vs. High Yield Bonds	vs. Hedge Funds
Typical Benefits	- Typically lower fees / often paid on invested capital - J-Curve mitigation - Current yield - Shorter fund duration - Capital structure seniority - Less dispersion of returns / narrower range of outcomes	- Benefit from rising rates (floating rate) - Senior vs. subordinated - Yield pick-up from illiquidity premium - Less price volatility / technical-driven selling - Lower EBITDA leverage - Covenant protection	- Suitable structure for less liquid assets - Preferred return or hard hurdle - Improved transparency - Reduced investor adjacency risk - Reduced cash performance drag - Less whipsaw risk
Typical Drawbacks	- Lower expected returns / upside is capped - GP track record duration often limited - Less operational control	- Less liquidity - Slower capital deployment - Less market transparency - Smaller issuers - Higher fees	- Less liquidity - No ability to short - Less able to pivot with opportunity

Approaches to Portfolio Construction: Yield Generator vs Diversifier

Fixed Income Substitute:

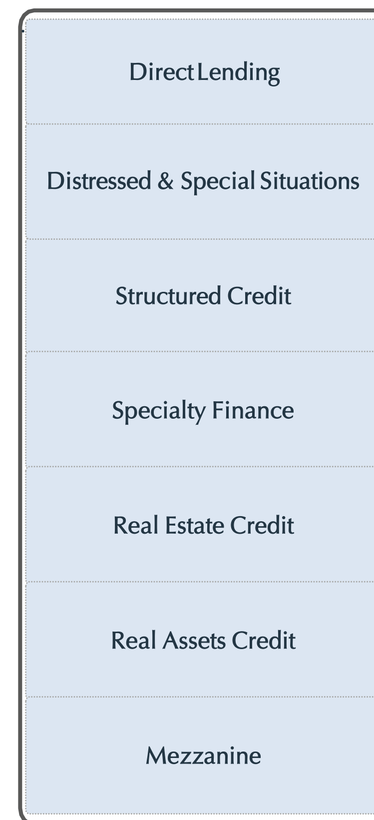
Diversified positions in senior lending strategies - often a combination of corporate and real estate debt GPs

Core + Satellite:

Concentrated positions in direct lending and/or cross asset complemented with smaller holdings in specialized GPs

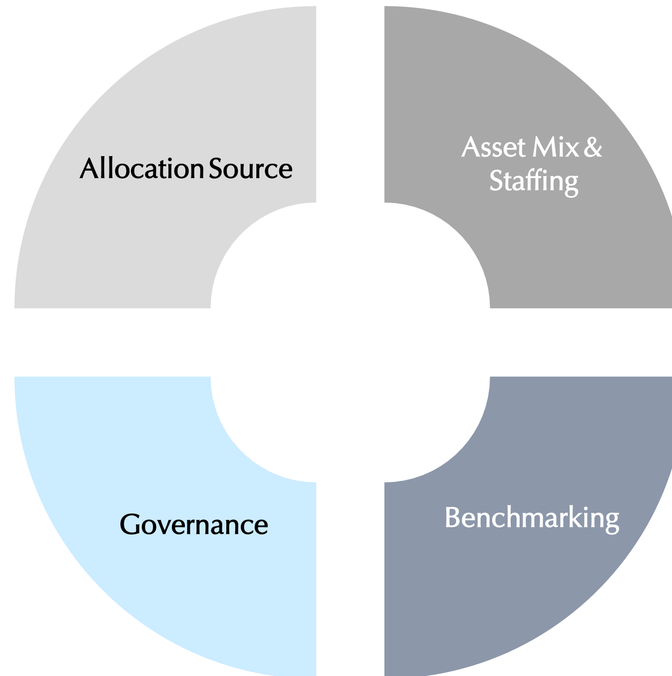
Opportunistic:

Diversified across various collateral types with a bias towards niche opportunities



Current Hot Topics of Discussion: Implementation Considerations

- Where should the source of allocation come from (e.g., high yield, private equity, hedge funds, other)?



- What asset types will it include? (e.g., real estate, corporate, real assets?)
- Who at the organization should manage it (i.e., Fixed Income, PE, Absolute Return, Team effort)?

- How are investment decisions made?
- Who has the ultimate sign off?

- How should it be measured/ benchmarked (i.e., high yield index, levered loan index, LIBOR + spread, custom mix)?

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Allocation Source – Benefits & Challenges of Investors' Different Approaches

	Benefits	Challenges
① Dedicated Allocation *IPS establishes target allocation ('bucket') and segregates assets for investing in PC*	▪ Dedicated resources – both assets for investment and internal staff to cover the space ▪ Clearly established mandate with goals and objectives	▪ Need to go through governance process to revise IPS (most likely) ▪ Define who would internally be responsible for the allocation (new hire?)
② Investments within Other Asset Allocations *PC investments are either housed in an assigned asset class (e.g., PE) or opportunistically allocated within related asset classes (e.g., RE debt fund within RE bucket)*	▪ Can allocate opportunistically, over/under-weighting specific asset classes ▪ PC can serve different purposes or goals, depending on bucket (e.g., FI vs. PE)	▪ Can be challenging for PC to meet a different asset class's established constraints or objectives ▪ E.g., PE return objectives or HF liquidity constraints

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Aksia's 2020 Private Credit Themes[1]

1. **Build your house of bricks**
   - Within "on-the-run" strategies such as upper middle market corporate credit and large loan CRE lending, focus on identifying solid credits by partnering with established GPs
   - Emphasize sourcing channels, strong underwriting standards and sufficient resources
2. **Spread out**
   - Focus on capacity-constrained, niche strategies that rely on a GP's effort to unlock value
   - Find strategies and regions where GPs can extract illiquidity and complexity premiums
3. **Tiptoe into distressed**
   - "Tiptoe" into stressed debt, distressed debt, rescue finance, and private credit secondaries
   - Build positions across the distressed landscape so capital can be invested over the next 2-3 years

[1] Based on Aksia's opinion and not intended as personalized investment advice.

Current Risks[1]

1. **Valuation of legacy portfolios**
    - Public market assets have repriced broadly, but private market valuations will (predictably) lag
    - Be hyper-vigilant about the risks of investing into legacy portfolios with NAVs that may be inflated
2. **Revolvers are being drawn**
    - Many sponsors pushing portfolio companies to draw their RCFs to lock in liquidity
    - Lenders have told us that they were surprised at how aggressively borrowers called down their revolving credit facilities in response to or anticipation of liquidity needs
3. **Margin calls may lead to forced selling of illiquid assets**
    - Sub lines and NAV-based facilities (together "Fund Leverage") are governed by complex agreements
    - Clauses may give lenders rights and covenants that allow them to call the facility into "technical default" even if the underlying loans are performing; Portfolio valuation is a key control item

[1] Based on Aksia's opinion and not intended as personalized investment advice.

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Taking Advantage of the Credit Opportunity - Post COVID

1. Liquid Credit Dislocation
   - Pronounced widening of investment grade credit spreads from liquidity-driven selling creating asymmetric returns in high-quality companies.
   - Senior securities with significant equity cushion trading at discounts to par.
2. Rescue Finance
   - Many levered companies (both good quality and bad) in both the U.S. and Europe likely to face severe liquidity issues resulting from COVID-19 related financial stress.
   - Opening for capital providers with the ability to structure rescue finance or recapitalization deals across the capital structure; Weaker senior loan docs utilized in recent past may allow new capital to dictate favorable terms.
3. Deep Distressed
   - Current economic and financial contraction likely to lead to a broad-based wave of defaults, restructurings, bankruptcies, liquidations, and distressed asset sales.
   - Seasoned distressed investors may gain access to high-quality businesses and assets at depressed valuations.

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