4Q2013 IAC Meeting Materials

IAC Meeting – February 18, 2014

Private Debt/Direct Lending Presentation

The Asset Class, The Opportunity Set and The MSBI Portfolio

PRIVATE DEBT / DIRECT LENDING

AGENDA

- What is Private Debt
  - Three strategies
- Direct Lending
- The Alternative Investments View & Live Opportunities
- The Fixed Income View & Live Opportunities
- What are other Institutional Investors doing in this space?
- Conclusions
- Guest Speaker

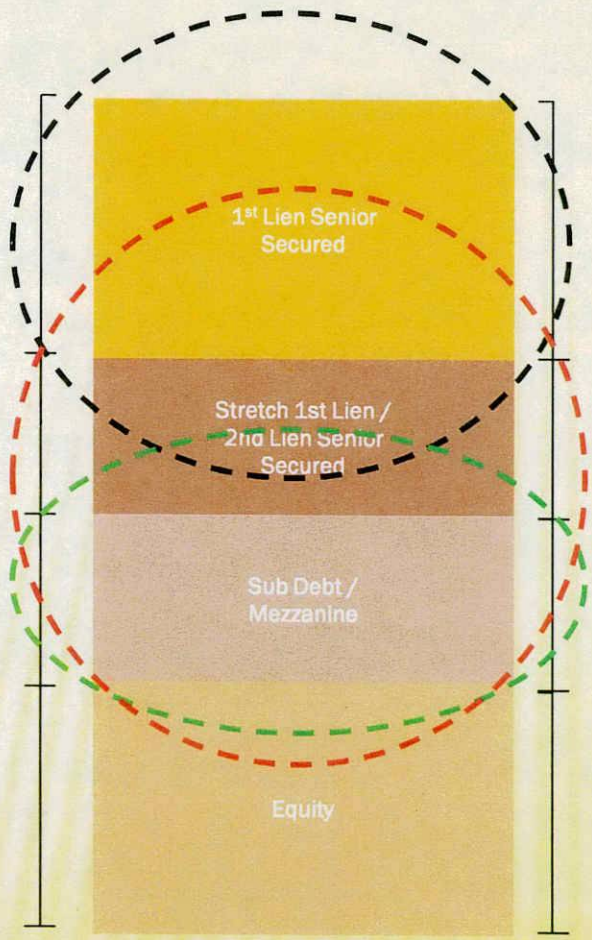
WHAT IS PRIVATE DEBT?

- Private Debt strategies are pools of capital that are organized with the intent of acquiring debt securities or originating loans to corporate entities or real estate properties
  - Three basic strategies:
    - Direct Senior Lending
    - Mezzanine Lending/Subordinated Debt
    - Distressed Debt

CAPITAL STRUCTURE EXAMPLE

Three Private Debt Strategies Target Different Parts of the Corporate Capital Structure

•**Mezzanine Lending/Subordinated Debt** strategies target the middle (mezzanine) of the capital structure
•Fund manager seeks a diversified portfolio of 10-20 mezzanine loans
•These loans are subordinate to the senior loans and are often unsecured by any of the company's assets
•These loans are often accompanied by "equity kickers" consisting of warrants or options on the company's equity
•Due to the unsecured and subordinated nature of the loans, combined with equity upside, these strategies target returns net to the investor of 10-12%



•**Direct Lending** strategies target the top of the Capital Structure
•Target returns net to the investor of 8-10%

•**Distressed Debt** strategies target all parts of the capital structure
•Fund manager seeks to acquire the debt of companies that are financially distressed, often at discounts to par value
•This debt can be publicly traded or private
•The fund manager may seek to acquire control of the company through conversion of debt to equity
•Targeted returns net to the investor of 12%+

DIRECT LENDING

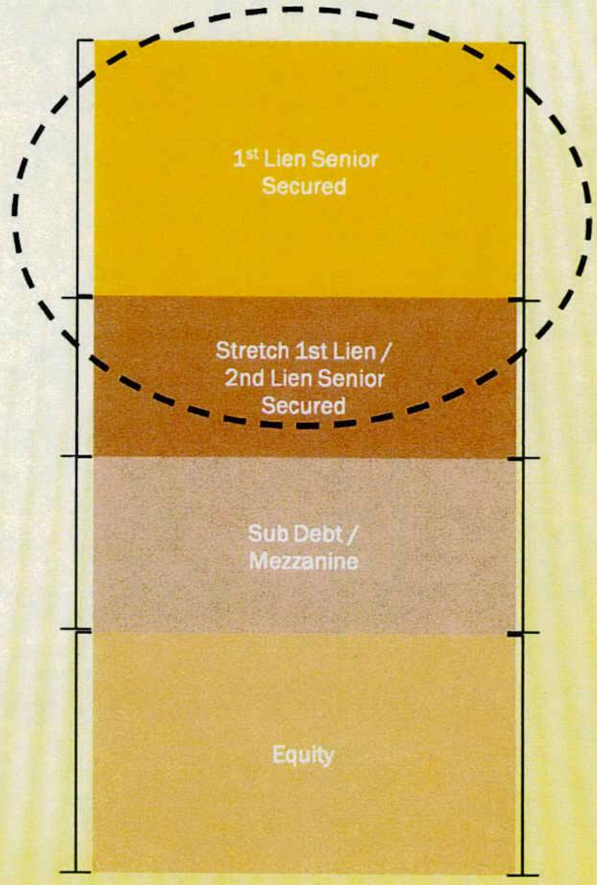
- What is Direct Lending?
  - Originated financings to middle-market companies ($50 million of EBITDA or less)
  - Historically regional banks and finance companies have been primary providers of direct lending capital
- Loan Characteristics
  - Loans are typically senior and secured by 1st and/or 2nd liens on company assets
  - Loans tend to have 5-7 year maturities
  - Loans are often non-callable for 2-3 years
  - Loans have limited liquidity given smaller and narrow investor base
  - Terms are negotiated and highly customized
  - Yields are generally higher than syndicated loan market
    - Recently, middle market senior secured loans have generated unlevered yields ranging from LIBOR plus 4.5% to LIBOR plus 6.5% with a LIBOR floor of 1.5% to 2.5%. The floor protects investors from LIBOR rates that dip below it by providing a minimum base yield in a low interest rate environment.
    - Spread between middle market loans and large corporate loans is wider than historical standards

Sources: KKR Asset Management, Barclays

DIRECT LENDING (CONT.)

Targets the Top of the Corporate Capital Structure

- Senior Debt/Direct Lending Strategies seek to originate senior secured loans to middle-market companies (EBITDA of $50 million or less)
- Fund managers executing this strategy seek a diversified portfolio of 10-20 loans
- The seniority of these investments in the capital structure reduces their risk, since they are in position to be repaid first in the event of bankruptcy. However, this position also reduces the total return expectations of the investment
- May have low correlation to traditional asset classes
- May provide an interest rate hedge



•Rate of Return Objective: 8-10%

•Interest Rates on Senior Loans are often floating

•Subordinated Loans are often Fixed Rate

DIRECT LENDING (CONT.)

What is the Opportunity Set?

- Traditional sources of capital (regional banks, finance companies) have reduced the amount they lend to middle market companies
  - BASEL III capital requirements forcing banks to hold more capital in reserve against these types of loans
  - Lack of shadow banking market with hedge funds, CLOs, others focused on liquid credit
- This has caused a funding gap for middle market companies
  - Mid-market private equity sponsors have become more active
  - Private debt funds have attempted to fill this funding gap
- Direct Lending strategies may provide an interest rate hedge when interest rates rise
- These characteristics can make Direct Lending attractive to some investors from an overall portfolio perspective

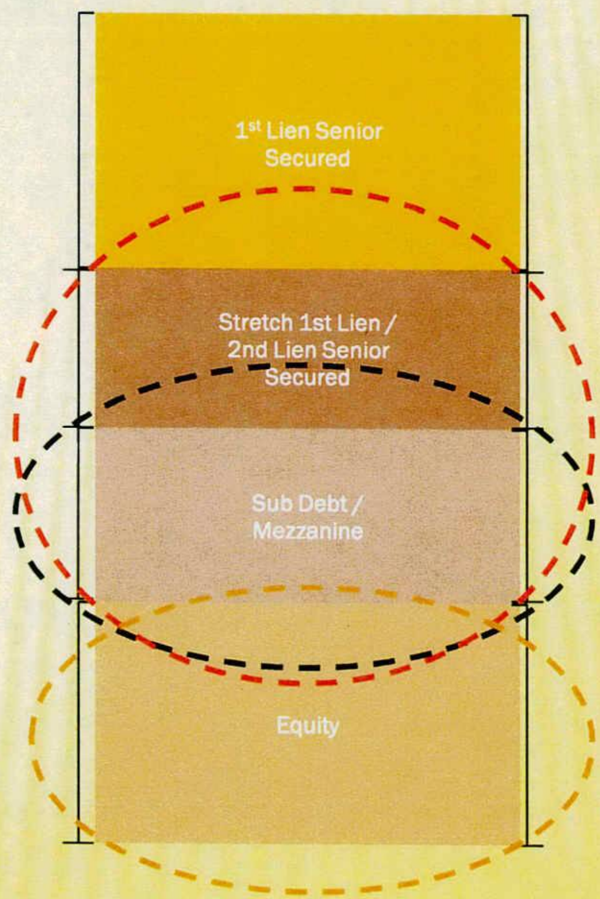
THE ALTERNATIVE INVESTMENTS VIEW

- What CAN go in the Alternatives Portfolio?
  - Commingled Funds where our participation is limited to 20% and there are at least 4 other investors and where our liability is limited to our capital commitment
    - Typically Limited Partnerships
- What HAS gone into the Alternatives Portfolio?
  - Commingled Funds focused on Private Equity, Real Estate, Equity Resources, and Yield-Oriented
  - The Yield-Oriented component has provided current income to the Alternatives portfolio in different ways
    - Corporate mezzanine/sub. debt strategies
    - Producing Properties contractual dividends (Merit Energy)
    - Real Estate Debt strategies (Capital Trust, Carbon Capital)

THE ALTERNATIVE INVESTMENTS VIEW

Have Targeted Middle and Lower Parts of the Corporate Capital Structure

- The Alternative Investments Portfolio has a high rate of return, long-term investment strategy
- Private Debt has materialized in the Alternatives Portfolio in the form of the higher returning strategies like Mezzanine/Sub. Debt and Distressed Debt
  - Examples:
    - Yield-Oriented Portfolio: Prudential Capital Partners, Audax, Summit Subordinated Debt Funds, Goldman Sachs Mezzanine Partners
    - Private Equity Portfolio: Wayzata Investment Partners (distressed debt-for-control), Varde and CarVal (whole loans, distressed securities, special situations) and Blackstone Real Estate Partners (distressed and opportunistic real estate investments)
- Through 12/31/13, the Yield-Oriented portion of the Alternatives Portfolio has returned 13.1% over the last 10 years



- Private Equity funds invest in the equity portion of a typical capital structure
- Through 12/31/13, the Private Equity portion of the Alternatives Portfolio has returned 16.5% over the last 10 years

THE ALTERNATIVE INVESTMENTS VIEW

Live Opportunities in Direct Lending

- Summit Credit Partners
  - Senior Secured 1st and 2nd lien loans proprietarily sourced
  - Will often acquire “equity kickers” to enhance the return
- Permira Debt Managers
  - Senior Secured loans to European mid-market businesses
  - Take advantage of a much wider funding gap in Europe caused by a structurally weaker banking system relative to the U.S.

THE FIXED INCOME VIEW

- Separate account structure
- Eight investment managers
  - Five portfolios managed using Active strategy
  - Three portfolios managed using Semi-Passive strategy
- Individual portfolio sizes $1.0 - $2.4 billion
- Fixed income portfolio = $13.5 billion

THE FIXED INCOME VIEW

- Eligible investments
  - U.S. and Canadian Government bonds, notes, bills, and mortgages
  - Corporate bonds (including high-yield)
  - MBS, ABS, and CMBS
  - Non-USD and emerging market bonds (IG only; must be in index)
  - Yankee and Eurodollar bonds

THE FIXED INCOME VIEW

Bank Loans

- Floating rate
- Below-investment-grade quality
- Secured by assets of the borrower
- Most senior source of capital in capital structure
- Interest rate paid on loan based on index, plus spread

THE FIXED INCOME VIEW

Bank Loans (cont.)

- Benefits
  - Historically have had low to negative correlation to investment-grade bonds
  - Historically have performed well during periods of rising rates
  - Generally most senior source of capital
  - Very little duration risk
  - Low price volatility

THE FIXED INCOME VIEW

Bank Loans (cont.)

- Risks
  - Credit quality of borrower
  - Technical factors (e.g. market's appetite for risk, liquidity, default environment, etc.)
  - Historically have had a higher correlation to equities than investment-grade and government bonds
  - Less liquid than investment-grade bonds
  - Prepayment risk

THE FIXED INCOME VIEW

Example: BlackRock Bank Loan Portfolio

- Duration = 0.25 years
- YTM = 4.7%
- Average credit quality = B1/B+
- 9% Technology / 7% Healthcare / 6% Gaming / 5% Chemicals / 4% Metals & Mining
- 97% bank loans / 2% high-yield corporates / 1% corporates, CLOs, and cash

WHAT ARE OTHER PUBLIC PENSION FUNDS DOING IN THIS SPACE?

- Staff had conversations with five large public pension plans (Virginia RS, Oregon SIC, MassPRIM, Florida SBA and Washington SIB)
- Each invest in a variety of private debt strategies, including Bank Loans and Direct Lending
- They all account for these strategies differently, but most consider these "Opportunistic" investments

CONCLUSIONS

- Direct Lending and more liquid debt strategies like Bank Loans have attractive risk/return characteristics when viewed as stand-alone investments
- The Direct Lending opportunity is real and likely to persist due to regulatory changes and a persistent spread in the interest rates of private senior secured loans to more liquid, publicly traded debt
- Further investigation by Staff is warranted

GUEST SPEAKER

- Lou Salvatore – GSO Capital Partners (Blackstone)