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Private debt Q&A

New mallowstreet and M&G report reveals UK pensions industry views

M&G INVESTMENTS

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Jo Waldron, director of private credit

Demand for private debt among pension schemes continues to grow substantially. At the same time, the reasons for investing vary considerably, due to the diverse nature of outcomes sought by schemes and the heterogeneity of the investment universe itself. To gain deeper insight into schemes' current views on private debt, M&G recently collaborated with the research and insights arm of mallowstreet – an online community within the UK pensions industry – to survey and interview 100 leading industry professionals. Here, we discuss some of the key findings with Jo Waldron, director of private credit at M&G.

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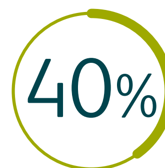
What did the survey tell us about pension scheme allocations in the UK?

We know from our ongoing engagement with our UK pension scheme clients that they have been steadily increasing their allocations to private debt, so the survey has allowed us to gain further insight into the extent to which this is happening at an industry level. Over three quarters of survey respondents representing over £850 billion in pensions assets, currently invest in private debt. Of those existing private debt investors, half expect to increase their allocations over the next 1-2 years. Meanwhile, a quarter of those not currently invested are planning to make an allocation.

The amount pension schemes invest varies according to their size, funding levels and time to end game. Around two out of five schemes larger than £3 billon are most likely to allocate 5-10% of their portfolios to private debt, while a slightly lower number of schemes have target allocations of 1-5%. 'Mid-sized' schemes between £1 billion and £3 billion in size are more likely to have allocations of 1-5% or no allocation.



of schemes larger than £3 billion allocate 5-10% of their portfolios to private debt

Nine out of ten schemes that are less than 85% funded invest in private debt, compared to around eight out of ten schemes with higher funding levels. Schemes allocating for the first time are most likely to be 7-10 years from their end game, reflecting the increasingly important role private debt could play in meeting longer-term objectives. Additionally, two out of five schemes and consultants would like to see private debt included in defined contribution (DC) schemes' default options, self-select investment offerings, or both which was particularly interesting as historically we have found that private debt is mainly accessed by defined benefit (DB) schemes.

What are the main investment outcomes sought by pension schemes?

Private debt represents a broad and diverse investment universe, which extends far beyond mid-market direct corporate lending. This means investors are looking to use private debt to provide a large variety of outcomes. Almost nine out of ten respondents said they use private debt primarily for yield enhancement, while seven out of ten also cited diversification and stable income.

This lines up with our experience of schemes using private debt to target different outcomes with the same scheme owning two different types of portfolios performing different functions in a number of cases.

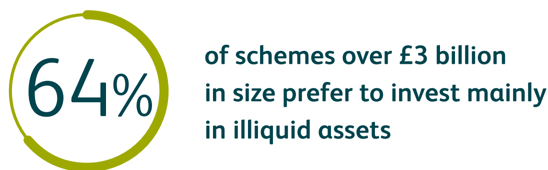
The risk-return characteristics of an individual private debt asset typically makes it more suited to a specific investor outcome. For those seeking stable income (including liability matching potential), potential investments will typically be investment grade, offering a spread of 0.5% to 2.5% over gilts. Growth assets tend to offer returns of 4% to 7% over LIBOR and are typically non-investment grade. Those targeting additional returns will likely seek a net IRR of 8% to 10%, with these investments mainly comprising non-investment grade or unrated debt instruments. The survey highlighted that schemes mainly use infrastructure debt and real estate debt with the aim of providing stable income. For yield enhancement, schemes are more likely to turn to direct lending, leveraged loans and structured credit or specialty finance.

The outcomes schemes target also determine which asset allocation 'bucket' they use for private debt. Overall, just under half of schemes allocate private debt assets to 'alternatives', and a similar number to 'fixed income'. However, three quarters of mid-sized schemes allocate private debt to 'alternatives', as they use these assets primarily for diversification. Meanwhile, half of large schemes consider private debt to be 'growth' assets, as their main focus is on yield enhancement.

More generally, pension schemes consider the relatively high coupons offered by many types of private debt to offer the potential to meet ongoing obligations and improve funding levels, while benefiting from diversification away from traditional asset classes, with lower volatility and better downside protection.

What were the respondents' views on liquidity?

Many schemes appear willing to give up some portfolio liquidity in exchange for the additional returns and downside protection private debt could provide. This is clear from both the conversations we are having with clients and the survey results.

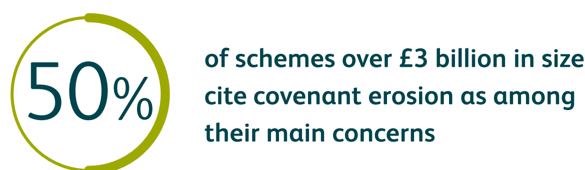


Among schemes over £3 billion in size, three out of five say they prefer to invest mainly in illiquid assets due to the additional returns and ability to match specific outcomes they can provide. Almost three quarters of schemes that are less than 85% funded are also willing to invest in illiquid assets, compared to less than half of better-funded schemes.

How can managers help to mitigate some of the challenges presented by private debt investing?

The survey responses show that pension schemes have a generally balanced view of the challenges involved in private debt investing. No single issue was identified as a key concern by more than a third of schemes overall; however, there were trends among schemes of similar sizes and funding levels.

Large schemes appear more concerned about financial covenants, whereas schemes below £1 billion in size, are more worried about illiquidity. For example, half of large schemes consider covenant erosion one of their top-three concerns, while two out of five have particular concerns about overpaying for assets. Meanwhile, half of the small schemes interviewed identify illiquidity as among their biggest potential challenges. Mid-sized schemes also worry about illiquidity, as well as complexity and default rates. For schemes that are less than 85% funded, eight out of ten worry about defaults and seven out of ten about covenant erosion. This reflects the findings that these schemes use private debt primarily for the opportunity of additional returns.



To mitigate these concerns, it is particularly important for a manager to demonstrate the strength and consistency of its investment process, including the ability to step away from or decline deals in which substantial due diligence has already been undertaken, if they do not provide adequate compensation for the risks.

Which areas of the market do you think present the best opportunities?

The relative attractiveness of individual areas of private debt can change and evolve over time, so investors are likely to benefit from looking at the private debt universe holistically and focusing on investment outcomes. We therefore believe an 'asset-agnostic' approach to investing across multiple parts of the European private debt investment universe is better. This favours disciplined, bottom-up credit analysis and selection over predetermined sub-asset class allocations.

Different parts of the universe offer different distinct advantages. Large, developed sectors, such as leveraged loans, provide a greater ability to deploy capital at relative scale and speed, as long as the opportunity offers sufficient compensation for risk and/or downside protection. From the survey, loans appear to be the main focus of underfunded schemes and those working towards self-sufficiency. 40% of all underfunded schemes (those funded to 85%) are looking to increase their allocation to secured or leveraged loans, versus 13% of fully funded schemes. In addition, two thirds of underfunded schemes looking to increase their private debt allocations are targeting secure and leveraged loans, versus a third of fully funded schemes.

Smaller, more niche lending sectors, such as trade receivables, present opportunities less frequently than some of the more established markets – however, they bring welcome diversification to a multi-asset portfolio and offer the potential to capture higher returns. These types of opportunities usually favour well-resourced managers, as they are not 'ready-made' and, in some cases, can take years of hard work to come to fruition. They also rely on strong origination capabilities to gain footholds in new markets, sectors or jurisdictions that were previously inaccessible to non-bank lenders. The survey highlighted that these opportunities appeal mostly to large schemes looking for additional yields, with 30% of those over £3 billion in size considering an increase in exposure to other private debt assets, such as specialty finance, compared to less than 6% of schemes under £3 billion.

Looking at how other scheme types view the opportunity in private debt, both the DB and DC schemes that were interviewed for the survey signalled their intentions to add to their private debt allocations. Historically, it has been more difficult for DC schemes to invest in private and illiquid assets due to liquidity and cost (fee) constraints and caps, with the expectation that most DC funds will typically offer daily liquidity. For DC schemes, the survey highlighted that fees are a top priority when selecting a manager.

Overall, the investor base and allocations to private debt are looking like they will both increase.

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