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CASH-FLOW DRIVEN INVESTING, PRIVATE CREDIT AND REAL ASSETS

BNP PARIBAS ASSET MANAGEMENT

The asset manager for a changing world

INSTITUTIONAL INVESTORS IN THE UK AND GLOBALLY ARE FACING A PERFECT STORM, AND IT IS ONE THAT IS THREATENING THEIR RETURNS AND WITH IT THEIR ABILITY TO MAKE RIGHT ON FUTURE LIABILITIES. HISTORICALLY, A 60% EQUITIES AND 40% BONDS (60:40) PORTFOLIO STRUCTURE, BUOYED BY POSITIVE MARKET TAILWINDS, WORKED WELL FOR INVESTORS BY DELIVERING ROBUST AND RELIABLE RETURNS. HOWEVER, VULNERABILITIES IN THIS TRADITIONAL PORTFOLIO CONSTRUCTION MODEL ARE BECOMING APPARENT AND IT IS FORCING ALLOCATORS TO CONSIDER ALTERNATIVE APPROACHES TO CASH-FLOW DRIVEN INVESTING. AS A CONSEQUENCE, INVESTORS ARE INCREASINGLY DOWNSIZING THEIR EQUITY AND BOND HOLDINGS IN FAVOUR OF DIFFERENT ASSET CLASSES, SUCH AS ILLIQUID INSTRUMENTS AND STRATEGY-SETS.

LOW INTEREST RATES FORCE AN INVESTMENT RETHINK

In a low yield environment, pension funds will naturally struggle to make returns. Post-Global Financial Crisis, interest rates have been set at unprecedented lows or even in negative terrain in some markets driving down yields. While interest rates will undoubtedly rise at some point – not least in the US – there is less certainty about what the Bank of England's (BOE) monetary policy intentions will be over the coming months. "If I was speaking in March 2018, I would have said a BOE interest rate rise would be fairly guaranteed. Since then economic data has pointed towards weaker-than-expected growth in the UK, thereby ruling out a rate hike in May 2018," said Richard Barwell, a senior economist at BNP Paribas Asset Management.

With inflation falling faster than expected and a drop off in consumer spending, many are expecting modest rate rises to be pushed back by the BOE until later in the year. Nonetheless, Barwell acknowledged two scenarios would likely drive the BOE's monetary policy going forward. "An upbeat scenario could see the data for growth in Q1 being revised upwards, and a subsequent bounce back in Q2 economic data. Equally, if inflation stays stubbornly strong and rising wages keep inflation above the target over the next two years, we would expect the BOE to implement a modest hiking cycle, namely three hikes over the course of three years," continued Barwell.

A downbeat forecast, however, will spell an end to any imminent interest rate rises, and could conversely prompt the BOE to trim rates and potentially implement another round of quantitative easing. "If the UK loses growth momentum as a result of a cooling in domestic and global demand, coupled with inflation falling below 2% and wage pressure not materialising, there will be no real case to raise rates," said Barwell. Looking ahead, many investors are conscious interest rates are unlikely to return to levels seen in previous cycles (i.e. 5%), an opinion shared by Central Bankers, academia and other market participants.

THE CHALLENGE FACING PENSION FUNDS

On-going low rates adversely impact institutional investors such as pension funds. Analysis in 2017 by consultancy LCP found there was a £17 billion pension deficit at defined benefit (DB) plans operated by companies listed on the FTSE 100 Index.[1] Meanwhile, metrics compiled by PwC also illustrate the scale of the problem, highlighting that the circa 5800 DB pension schemes in the UK had a collective deficit of £200 billion at the end of April 2018, although this was a significant drop from 2017 when that figure stood at £450 billion.[2] As many pensions are underfunded, they are struggling to meet liabilities, a situation which is only going to deteriorate with demographic change, as the pool of retirees expands and average life expectancy increases.

Efforts are being made by governments to alleviate these deficits. In the Netherlands, the authorities are looking to transition from a DB to a defined contribution (DC) model, with DB assets and liabilities scheduled to be transposed into a "Collective" DC set-up by 2020.[3] The UK is also in the process of moving away from a DB pension fund model, and is instead pushing more people into saving through DC schemes. A failure to address the challenges in the DB model will result in more pension funds becoming in the end cash-flow negative, a point made by Anton Wouters, head of solutions and client advisory at BNP Paribas Asset Management.

A report by Mercer found 55% of DB pension funds were cash-flow negative in 2017, an increase from 42% in 2016, and a figure that is projected to jump to 85% by 2027.[4] Being cash-flow negative exposes pensions to undue risks, especially if the market corrects itself during a period of volatility. Normally, negative cash flows can be resolved through asset disposals, although being a forced seller - particularly in a stressed market – is often counterintuitive and can lead to deficits widening if assets are realised at below their stated value. In order to meet their beneficiaries' liabilities, pension fund managers need to reconsider their investment approach.

1 Institutional Investor (August 2, 2017) Biggest UK companies face defined benefit pension deficit
2 PwC (May 1, 2018) UK pension deficit drops to £200 billion according to PwC's Skyval Index
3 Financial Times (October 14, 2017) Dutch pension reforms target DB schemes
4 The Actuary (June 5, 2017) Half of DB pension schemes now cash-flow negative

CHASING THE ILLIQUIDITY PREMIUM

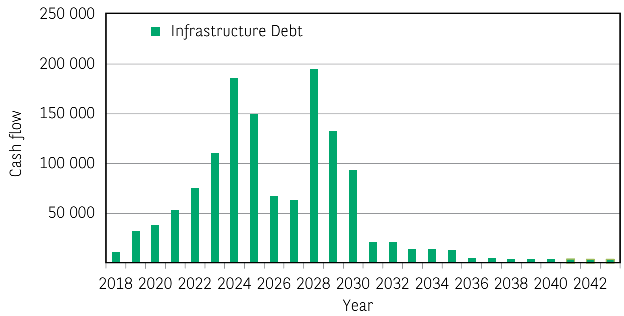
Cash-flow driven investing is not a new concept, but it is one that is seen as an effective model for pension funds to adopt in order to better manage their liability mismatches. Wouters acknowledged it would require pensions to buy and hold assets, which generate long-term, predictable and stable cash flows. These investments, he said, needed to be diversified away from traditional fixed income and equities so as to minimise correlation and enhance returns. By transitioning into illiquid assets, pension funds will stand a better chance of meeting their liabilities to their beneficiaries while adequately hedging themselves against interest rate risk and inflation risk.

Pension fund trustees - as part of their fiduciary obligations - must be cognisant of the risks that any asset class presents prior to investing. This is especially true of illiquids because capital is locked up for long periods of time – often several years or more– so it is crucial pension funds adopt well-thought-out and carefully managed approaches towards liquidity risk management, including regular portfolio stress testing. The consequences of suffering from a liquidity mismatch can be severe and highly destabilising for investors and their portfolios. But what sort of asset classes should institutions be looking at?

INFRASTRUCTURE DEBT

Infrastructure debt is a diversified universe, acknowledged Pauline Fiastre, senior fund manager, infrastructure debt at BNP Paribas Asset Management. “It encompasses the use of a variety of debt options to provide financing to large and tangible assets providing essential products or services, with high barriers to entry and sometimes benefitting from monopolistic situations. This includes transportation such as roads, railways and airports; social infrastructure, like universities, schools and hospitals; telecoms, which include high speed broadband networks; renewable and conventional energy; and utilities like gas and electricity,” added Fiastre. Investing in senior secured infrastructure debt offers a diversification of credit exposures.

Forecasted cash flows per GBP 1Mln



Source: BNP Paribas Asset Management, March 2018
No assurance can be given that any forecast, target or opinion will materialise.

Infrastructure assets and projects rely on regulated revenues or long-term contracts, with a low technological or obsolescence risk, ensuring stability of cash flow and relatively guaranteed returns to investors. Infrastructure debt is really about lending against a predictable cash flow stream.

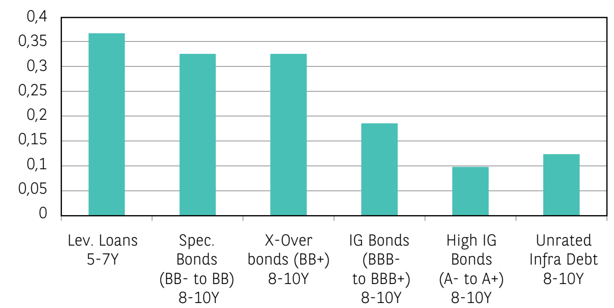
However, infrastructure debt can be vulnerable to political risks such as change in regulation or nationalisation, a point made by one expert. It is therefore key to call on the rightly-skilled asset manager: a deep industry knowledge and a strong experience of transactions are necessary to analyse the risks inherent to each situation and implement a financing structure that properly mitigates such risk, as well as all other risks related to the construction and operation of such projects.

Each infrastructure loan is therefore tailor-made to fit with the characteristics of the infrastructure assets (in terms of cash flow duration, asset technical life, etc.) with a view to outsource most of the risks to project counterparties who are in a better position to bear such risk (e.g. contractors) and, if such risks cannot be passed through, to mitigate any residual risk at the project’s level. Owing to such bespoke structuring, default rates are very low, and recovery rates compare favourably to other debt types through an exhaustive security package and set of covenants.

As a consequence of the strong contractual structure described above and thanks to its critical infrastructure nature, the asset class enjoys a low volatility and is not correlated to financial markets. Because of its illiquid nature, infra debt carries a premium over more liquid assets with equivalent risk such as corporate investment grade bonds.

Regulatory drivers – most notably Solvency II - are also pushing investors such as insurers into infrastructure debt. Solvency II obliges insurers to hold capital corresponding to the riskiness of their investments. Asset classes considered to be higher risk naturally command that insurers hold more capital and vice versa. "One of the main benefits of infrastructure debt is that it carries a lower capital charge than corporate investment-grade bonds," acknowledged Fiastre.

Solvency II capital charge

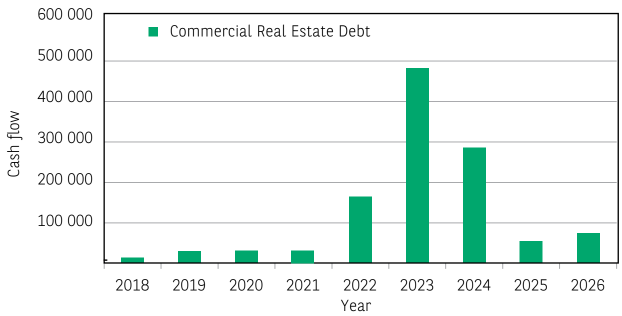


Sources: Bloomberg, S&P LCD, Moody's, BNPP AM June 2017, methodology detailed in appendix

REAL ESTATE DEBT

Like infrastructure debt, real estate debt is a diversified product as financing is provided to a range of different tangible assets including offices (commercial business districts, towers); retail (shopping centres, high-street shops, outlet centres); logistics (light industrial); hotels (across ranges); operating assets (student accommodation, nursing homes) and non-standard (data centres, parking, leisure). As banks retreat from financing real estate because of Basel III capital requirements, there is an excellent opportunity for non-bank lenders to enter the market, and chase opportunities.

Forecasted cash flows per GBP 1Mln



Source: BNP Paribas Asset Management, March 2018
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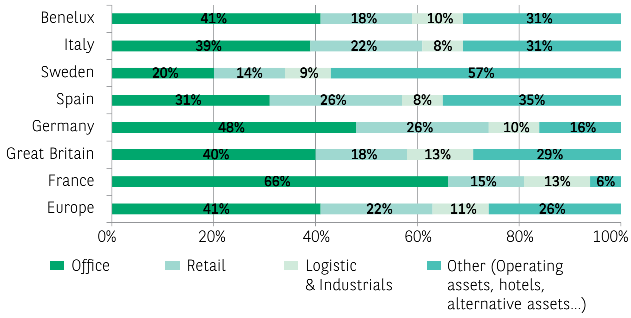
In addition to having diversification benefits, commercial real estate debt is endowed with low volatility and limited correlation to broader market risks, mainly because its private status shields it from short-term fluctuations in public markets. As a long-term investment play, the asset class delivers consistent, risk-adjusted returns, at a premium to corporate investment grade bonds, said Philippe Deloffre, head of real estate debt at BNP Paribas Asset Management. Given these benefits, fundraising in real estate debt has progressively increased, with the asset class attracting $28.6 billion in 2017, versus $18.3 billion in 2015.[5]

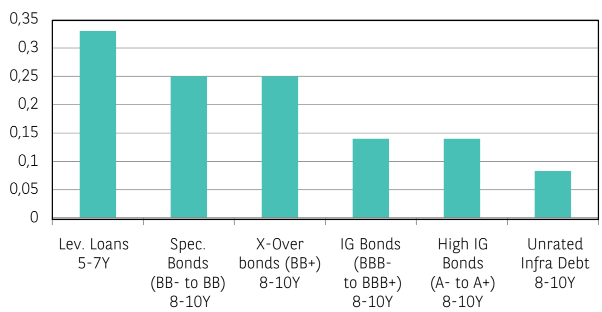
INVESTED VOLUMES BETWEEN 2015 – 9M 2017 (IN %)



Source: CBRE Research, Q3 2017
*Operating and alternative assets are not included

Real estate debt investors – in contrast to equity investors – are also fairly well insulated against the adverse impact of interest rate rises on property valuations, as they are lower down the capital structure waterfall so are less likely to incur heavy losses in the event of a significant price drop. However, some classes of debt such as mezzanine contain fewer protections than senior tranches, although the latter will pay much lower yields. Robust flows have been facilitated too by the generous capital treatment real estate debt is given under Solvency II relative to other debt instruments such as BBB corporate bonds.

Solvency II Capital Charge



Source: Bloomberg, BNPP AM, June 2017

SME (SMALL TO MEDIUM SIZED ENTERPRISE) DIRECT LENDING

SME direct lending funds have emerged as a consequence of regulation, chiefly Basel III, which forced banks to redouble their focus on preserving balance sheet strength and with it rein in their loan books to comply with strict capital requirements. Bank credit lines to companies categorised as higher risk such as SMEs have been impacted the most, with many left unable to access traditional funding sources. Direct lending funds have spotted a commercial opportunity to issue SME loans, an initiative supported by a handful of European regulators, which have loosened restrictions on non-banks providing financing.

"At one end of the corporate universe, there are very small enterprises which will use digital platforms to attract funding. Ticket allocations made through these platforms by individual investors are fairly small and usually in the region of approximately 100,000 euros. Conversely, there are large private debt funds, who will often issue loans of around 50 million to 80 million euros. We believe there is a large segment of the market in between those two demographics which is being underserved," said Stephane Blanchoz, Head of SME Alternative Financing at BNP Paribas Asset Management.

While returns generated by direct lending funds have slowed over the last few years from 10.7% IRR (Internal Rate of Return) in 2010 to 7.9% in 2014[6], these gains are still superior to the yields on offer at traditional fixed income strategies. Direct lending has, however, become a saturated market, as evidenced by the large quantities of dry powder. It is crucial therefore that investors identify direct lending opportunities which are suitable according to their risk profiles. With the number of credible deals in retreat, pension funds and other investors need to ensure they are not directly/indirectly extending financing to companies whose underlying fundamentals and assets are weak or un-creditworthy.

Through a properly diversified and well-risk managed direct lending portfolio, investors can potentially benefit from steady, consistent returns over the long-term which are isolated from short-term bouts of market volatility. Direct lending products are also structured to protect investors from interest rate movements and volatility. This is because the debt instruments used in many of these strategies are less sensitive to interest rate rises and assessed according to fair valuations not dependant on highly volatile marked-to-market measurements. These positive traits have helped drive strong flows into direct lending funds, with Preqin reporting the asset class accounted for more than $50 billon of the $100 billion raised by all private debt funds last year.[7]

GOING DIRECT OR INDIRECT

Investing into illiquid assets directly or indirectly via a pooled fund or managed account structure brings a number of advantages and disadvantages. Direct investing is typically lower cost as the allocator is not paying management or performance fees, but is simply receiving a gross return. It also enables allocators to have greater control over the assets in their portfolios, as well as the exit strategy. There are, however, limitations of going direct, namely it is only available to institutions who have scale to make meaningful investments and can effectively monitor their exposures and the operational processes that go with it.

Utilising a third-party manager – while more expensive – does have its benefits. Firstly, asset managers are more diversified and will have exposure to a number of different assets and projects across various markets. Investors do not have this luxury if they go at it alone, because they are more constrained in the number of investments they can actually make. While using an external provider does take away a lot of the control an investor would nominally enjoy by allocating directly, it eliminates the need for institutions to build internal systems and operational infrastructure to manage their exposures, helping them to curtail costs in margin constrained times.

6 Financial Times, November 2017, Investors flock to world's top direct lending fund
7 Preqin 2018 Preqin Global Private Debt Report

OUR BELIEFS

- As investors struggle to cope with low interest rates, rising deficits, increasing liabilities and negative cash flows, illiquid assets such as infrastructure debt, real estate debt and direct lending could provide an excellent opportunity to generate returns and match liabilities.
- Illiquid asset classes provide diversification away from fixed income and equities, but also offer protections* against market volatility and other downsides helping to deliver consistent returns.
- While investing directly into illiquids has its cost and oversight benefits, it is only available to large scale institutions with deep pools of capital. The use of third party managers, however, can help institutions realise diversification benefits.

For more information

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APPENDIX

Solvency II SCR calculation - assumption & methodology

For European first lien loans = 33.1% (Source Moody's - Corporate Issuer-weighted recovery rates, Europe, 1985-2016)

SII SCR

- Infrastructure debt: SCR = spread risk for a qualified infrastructure 9Y duration = 12.35% (Source Article 180 of R 2015-35 Complement (SII Delegated Regulation complement))
- Corporate bonds: Spread risk on bonds and loans with equivalent rating (Source Article 176 of SII delegated Regulation R 2015-35)
- European leveraged loans: SCR = Spread risk on a portfolio of loans with comparable rating structure as ELLI index = 36.7% (Source S&P LCD, 30 April 2018 and Article 176 of SII delegated Regulation R 2015-35)

* BNPP AM doesn't provide any formal capital guarantee of the funds. No information given or any term used herein shall be interpreted to provide such a guarantee. There is no guarantee that the performance objective will be achieved.

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