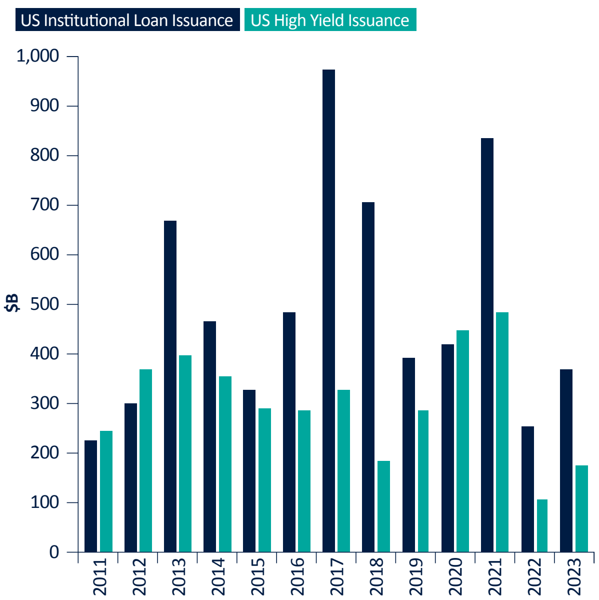
Private Debt

Major Trends

The Private Debt opportunity continues to be driven by constrained capital availability, although spreads on loans to the largest borrowers have started to tighten. The availability of debt financing to the middle-market from traditional sources remains limited. Commercial and regional banks have pulled back from lending activities, anticipating increased regulation following the bank failures in early 2023. The syndicated loan markets, a traditional source of financing for leveraged buyout (LBO) and other M&A activity, have also remained subdued. Total issuance increased slightly from the depressed levels of 2022 but was still 55% below the 2021 peak (Exhibit 1).

Exhibit 1

US Leveraged Loan and High Yield issuance significantly lower than 2021 peak



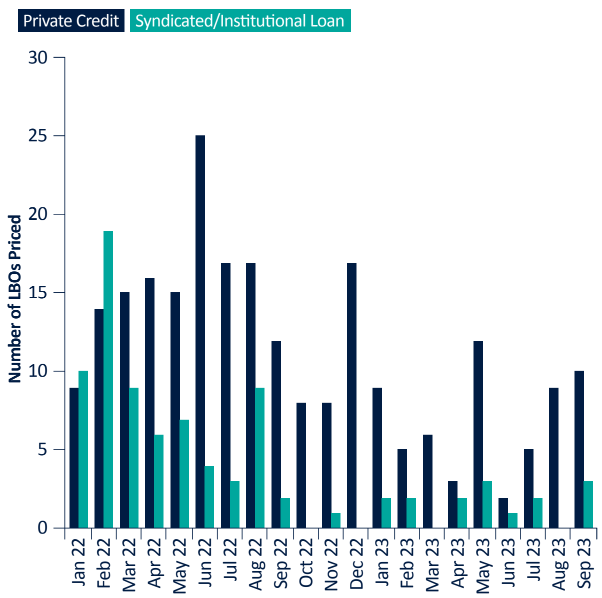
***Source:** JP Morgan Markets*

1 $252B in 2022 vs. $835B in 2021, Source: JP Morgan Markets.

New entrants have arrived in the private credit markets. Investment banks, which traditionally underwrite and syndicate institutional loans, have seen their market share eroded by private lenders (Exhibit 2). To protect their banking relationships and retain access to corporate clients, investment banks have either allocated a portion of their balance sheet to allow them to lend directly or have partnered with large private lenders to expand their lending capacity. It is worth noting that the incremental lending capacity added is limited to the bank balance sheet participation, as asset manager partners will continue to raise capital from the same pool of institutional investors as previously.

Exhibit 2

The majority of LBOs priced since January 2022 have been financed privately, rather than in the public loan market



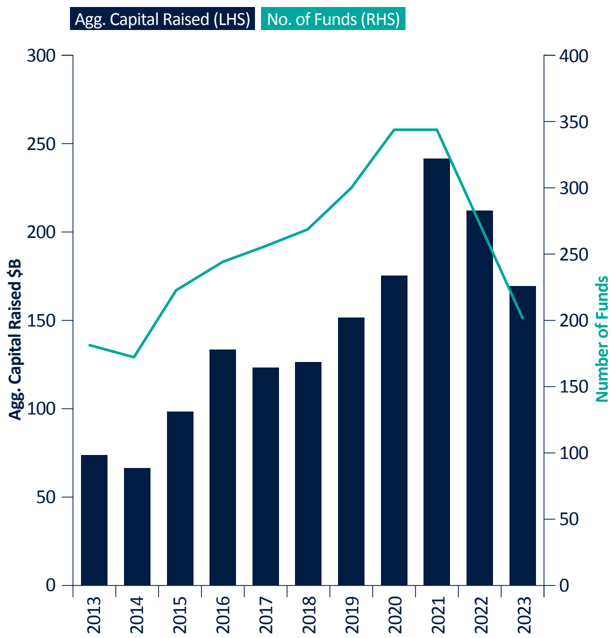
***Source:** JP Morgan Markets*

Asset raising from traditional Private Debt investors has been slow, leading to an increase in structures which allow retail clients and those with a greater need for liquidity to access the asset class. Assets raised for private credit strategies in 2023 were below the peak seen in 2021, despite the attractive opportunity set (Exhibit 3). This has led

Private Debt
continued

to a proliferation of new Business Development Companies ("BDCs") and evergreen structures from managers seeking to tap into a retail client base and non-traditional private credit investors who would not typically commit to closed-end funds. While these structures offer an apparently more liquid way to access an illiquid asset class, investors should remain cognizant of the risks of liquidity transformation and should not rely on these structures as sources of liquidity during more challenged market conditions. Similarly, an increase in the relative attractiveness of other investment strategies (potentially on the back of declining interest rates) could see retail flows reverse.

Exhibit 3
Assets raised for private credit strategies in 2023 were ~30% below the 2021 peak

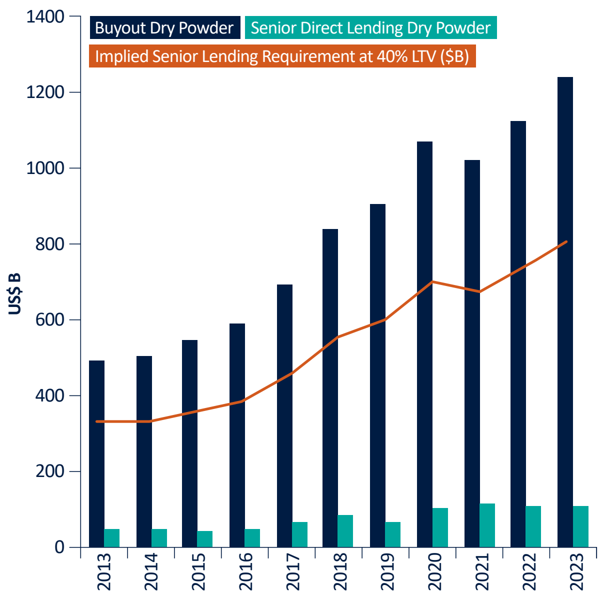


Source: *Preqin*

Additional capital flows to private lending have had a muted impact on overall pricing. New capital has been focused on more commoditised and institutional direct lending strategies. As a result, spreads in the upper middle market, and on large institutional loans ($1B+) have tightened over the course of the year, to ~550-575bps, while middle-market and lower middle market lenders have maintained spreads of 600bps-650bps.

The medium-term outlook for pricing remains supportive if we consider the broader market dynamics: capital availability outside straightforward, institutional direct lending remains constrained and refinancing pressures are starting to build in public and private markets. Should M&A activity increase from the lows of 2023, there is insufficient private lending capital available to meet future Private Equity funding needs, given the current disparity in buyout dry powder and senior direct lending dry powder (Exhibit 4). That gap has historically been filled by the syndicated loan markets, but in the future we expect public and private credit markets to be more fungible, with borrowers seeking tight pricing and a broad ownership base favouring public issuance while those with more complex capital structures or a need for flexibility preferring to borrow in the private market.

Exhibit 4
There is insufficient private lending capital available to meet future PE funding needs



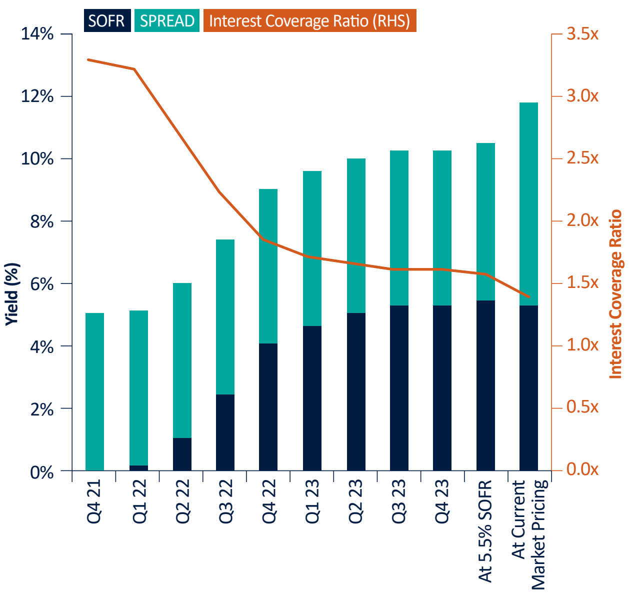
Source: *Preqin*

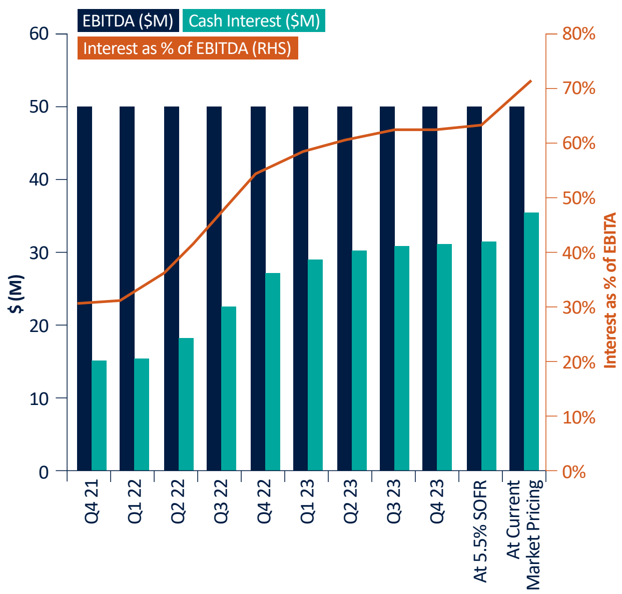
While higher rates are positive for lender returns, they are also starting to impact borrower credit metrics. The rise in base rates has been the main contributor to the increase in private credit yields since 2021. SOFR - the reference rate over which private loans price - has contributed over 5% of the ~6% increase in yields, with higher spreads and upfront fees making up the balance. This raises some potential issues. Firstly, the cash cost of interest for many borrowers has almost doubled, impacting credit metrics. In the worked example below (Exhibit 5) a typical borrower with a loan originated in 2021 at a cost of SOFR+300bps has seen interest rate coverage halve, and 70% of EBITDA consumed by increased cash interest. If this issuer were to attempt to refinance in the current market the cash cost would further increase as a new loan would likely price with a higher spread. While this has not yet led to a significant uptick in default rates, even in a positive economic environment, the lagged impact of this cash cost will be detrimental to more highly levered issuers.

While private credit defaults have remained stable over 2023 (Exhibit 6), persistently high rates will test marginal corporate issuers' ability to service their debt, likely resulting in distress for more highly levered corporates. In a downside economic scenario, while we would expect interest rates to decline to ~3.25%, the cash cost of interest would still be at an elevated level relative to the pre-2022 period. Combined with pressure on corporate cash flows from more challenging operating conditions, the need for forbearance, covenant waivers and other forms of restructuring will increase, creating opportunities for managers with the capacity to step in and offer flexible capital solutions.

Exhibit 5

The cost of debt service is impairing credit metrics for some borrowers





Source: *Partners Capital Analysis*

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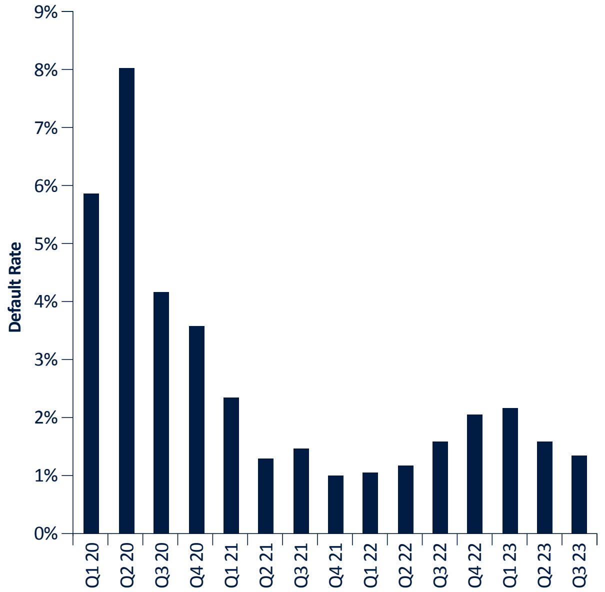
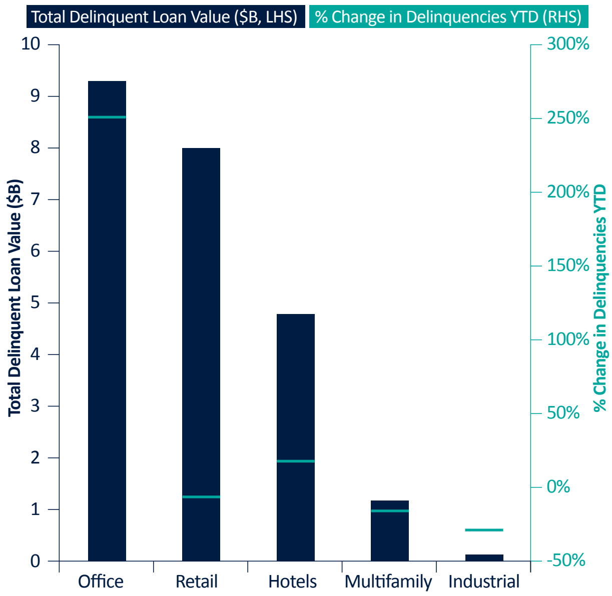
continued

Exhibit 6
The Proskauer Rose Private Credit Default Index showed moderating defaults in Q3 22



Source: *Bloomberg*

Exhibit 7
Commercial Mortgage-Backed Securities (CMBS) delinquencies increased by 42% in the year to September 2023, led by Office



Source: *Trepp*

Real Estate Lending is the key area where there has already been a material increase in defaults. The valuation adjustment that has taken place in Office has led to rising delinquencies and elevated defaults in 2023 (Exhibit 7). J.P. Morgan predicts US Office defaults at 11% under a soft-landing scenario, with multi-family defaults at 0.5% under the same conditions. There is a growing opportunity set in Real Estate Lending to provide senior capital to challenged projects and to restructure over-levered assets.

A rising rate environment has been beneficial to private credit, given that the majority of debt is floating rate. However, various protections could result in returns remaining elevated even as base interest rates fall. In an environment where rates are declining due to a challenged operating environment, credit spreads typically increase, to reflect higher credit risk. This maintains yields at an elevated level, even as base rates decrease.

In an environment where the economic picture is stable or improving, more commoditised lending strategies which are currently using low levels of leverage can increase their leverage to compensate for contracting yields. While we typically do not commit to funds with significant fund-level leverage, we view the diversification of BDCs and some direct lending portfolios as allowing capacity for judicious use of leverage to enhance returns.

Due to the limited capital available over the last two years many lenders have been able to demand covenants and other terms to protect their returns. Interest rate floors have moved up from 0% to ~2% and call protection can protect overall returns if the financing environment allows for cheaper refinancing of debt – either by dissuading issuers from refinancing and keeping loans in place for longer, or by compensating the lender for early termination of the loan. Capital Solutions and Specialist Lenders are increasingly able to agree fixed rate terms, which will support overall returns as interest rates decline.

The opportunity set for Capital Solutions managers is particularly attractive in this environment. They are able to provide both public and private issuers with flexible financing for restructurings, business transformation and acquisitions, or as a replacement for highly dilutive equity financing where company valuations remain depressed. The flexibility of Capital Solutions strategies to provide solutions for companies with idiosyncratic requirements, allows the manager to obtain attractive contractual returns (often fixed rate, or for a minimum multiple) as well as potential upside via warrants or an equity grant.

Golden Rules

- Target specialists in niche strategies: specialist providers of capital offering certainty of execution can command a premium due to lower levels of competition and higher degrees of complexity.
- Focus on downside protection: identify and partner with disciplined investors who i) take senior positions in the capital structure, ii) lend at low loan-to-value (LTV) ratio and iii) maintain discipline on covenants and documentation. Underwrite investors that can protect capital and have the necessary skillset to directly manage assets in the event of a restructuring.
- Generate outperformance through customisation and direct investment: seek structures which offer enhanced discretion, tax benefits, fee savings and customised risk exposures. Partner on co-investments to benefit from more immediate deployment and greater transparency.
- Allocate selectively to uncorrelated strategies: these strategies can offer attractive diversification benefits and resilience in a market downturn. Given their esoteric nature, they can pose a unique diligence challenge and it is critical to be aligned with best-in-class managers.

Sub-Strategy Attractiveness

- **Capital Solutions and Corporate Special Situations:** Favourable view of lenders with the ability to provide flexible capital to complex situations, restructurings and businesses in transition.
- **Specialist Lending:** Favourable view. Target sector specialists in strategies that requires expert underwriting (e.g., healthcare, emerging technology, portfolio financing) where declining equity valuations are creating opportunities to offer non-dilutive financing with embedded equity upside.
- **Real Estate Lending:** Favourable view. A material repricing is taking place, creating attractive opportunities with senior and mezzanine lending specialists that have proven sourcing advantages and the ability to manage assets where necessary. Focus on more opportunistic transactions in an uncertain market environment.
- **Asset-Based Lending:** Favourable view. Asset-based lending strategies are benefitting from the withdrawal of the banks in some areas, improving pricing and the available opportunity set. Asset-based lending can provide an attractive yield base to a Private Debt portfolio.

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continued

- **Middle Market Direct Lending:** Neutral view. Direct lending should represent a core holding for investors in private credit at present. Our overall favourable view of the strategy is tempered by new entrants affecting pricing in some areas and the potential for declining interest rates and tighter spreads in a positive economic environment making the strategy less attractive than specialist strategies which may be more able to maintain pricing discipline. Continue to avoid commoditised strategies with limited credit protection and higher leverage. Favour lenders who maintain a controlling stake in their transactions.
- **Portfolio Finance:** Neutral view of a growing opportunity to lend against portfolios of companies with significant commitments from high quality LPs and strong alignment with the managing GP. Significant capital flows to high quality GPs from large lenders and banks has compromised the attractiveness of pricing in more mainstream transactions. Favour managers with clear sourcing and structuring advantage.
- **Mezzanine and Junior Capital:** Neutral view of junior capital at this point in the cycle but consider an allocation on evidence that any default cycle is nearing a peak in order to capture upside benefits and attractive risk-adjusted reward in a trending economic environment.

- **Distressed for Control:** Negative view of long and legally-intensive bankruptcy and recovery processes which culminate in full equity ownership and which can carry a high opportunity cost as compared with Capital Solutions and Special Situations strategies. Participate selectively where managers have a defined edge and market conditions are particularly favourable.

2024 Strategic Priorities

- **Maintain Discipline:** Focus on senior positions, lower leverage and bilateral rather than fully syndicated deals. Maintain some scepticism around credit metrics. Seek managers with workout experience, moderate fund leverage and clearly defined paths to exit and refinancing given the challenging funding environment.
- **Maintain exposure to Specialists:** Continue to identify managers in sectors with secular drivers of return, including Software as a service (SaaS), life sciences, energy transition and digital infrastructure. Bias towards specialists over generalists in all sub asset classes.
- **Commit to Capital Solutions and Rescue Lending:** Favour Capital Solutions to performing companies over Distressed for Control but continue to seek opportunities to invest with high quality managers with extensive distressed and workout experience.
- **Make use of Managed Account structures to build flexibility and scalability:** Establish Managed Accounts and Funds of One that will offer the flexibility to pivot portfolios to sub-strategies offering the most compelling risk-adjusted return opportunities and to scale assets in less well trafficked strategies.
- **Identify opportunities for positive societal impact in private lending:** Collaborate with managers to support their ESG initiatives and identify opportunities to invest alongside managers who invest with an ESG or impact mandate. Increase the number and range of women and minority owned investment managers in our pipeline.

Long-Term Expected Return

Exhibit 8

Based on our 10 year forecasts, we target the following long-term expected returns for Private Debt

	Private Debt
Risk-free Rate	4.0%
Risk Premium	2.0%
Illiquidity Premium	2.5%
Manager Alpha	1.0%
Total Return	**9.5%**

Private Debt expected returns reflect Liquid Credit beta return plus 2.5% excess return from the asset class and 1.0% from our strategy and manager selection.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

Uncorrelated Strategies

Major Trends

Limited capital availability is starting to impact both fund raising and valuations in Uncorrelated Strategies. Uncorrelated Strategies benefitted from material capital inflows during the period of zero interest rates as investors sought yielding investments as a replacement for traditional Fixed Income. Asset managers are now reporting challenges in asset-raising as capital has been diverted back to more traditional credit and fixed income assets on the back of higher base rates. We continue to view Uncorrelated Strategies as an attractive allocation alongside Private Debt, however pricing in some sub-asset classes has taken longer to adjust to the new interest rate regime than in Private Debt, reflecting the comparatively lower liquidity and limited price discovery that characterises these more esoteric strategies. Our required return reflects not only the current cost of capital but also a premium for complexity and shallow markets, therefore, we continue to maintain a high bar for investment and wait for opportunities to commit selectively where the risk-adjusted reward is sufficiently attractive.

Investments in music royalties made prior to the change in interest rate regime have experienced a meaningful adjustment in pricing. In Insights 2023 we highlighted the risk of strategies which were marked-to-model, and which had considerable sensitivity to interest rates and the terminal value of their portfolios, such as music royalties. There was considerable expansion in purchase multiples for music catalogues prior to the change in interest rates, with acquirors paying 15-20x net income, compared with high single digits 5+ years ago. While transparency on closed-end vehicles is limited, the price movement in publicly listed vehicles such as Hipgnosis Songs Ltd. provide a public comparable and reflect a negative market view on valuations

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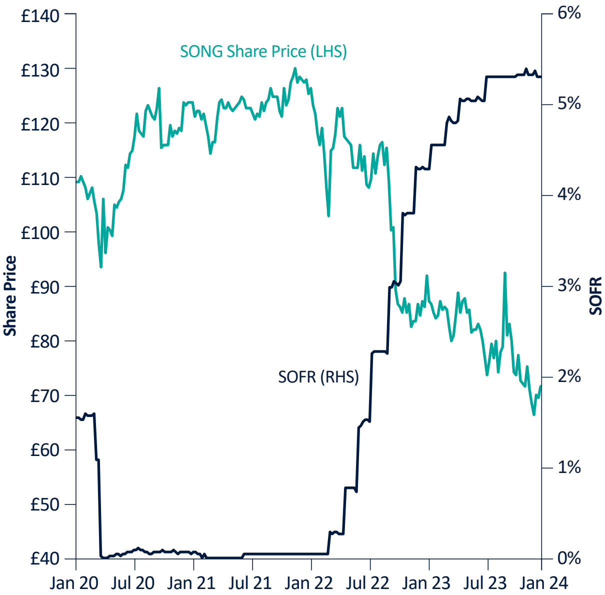
continued

given an increasing cost of capital (Exhibit 1, below). We continue to evaluate investments in music royalties, particularly considering the ongoing correction in valuations. We seek experienced teams, a clearly defined and disciplined investment strategy and potential value-add from sourcing off-the-run assets, differentiated data and sophisticated portfolio management.

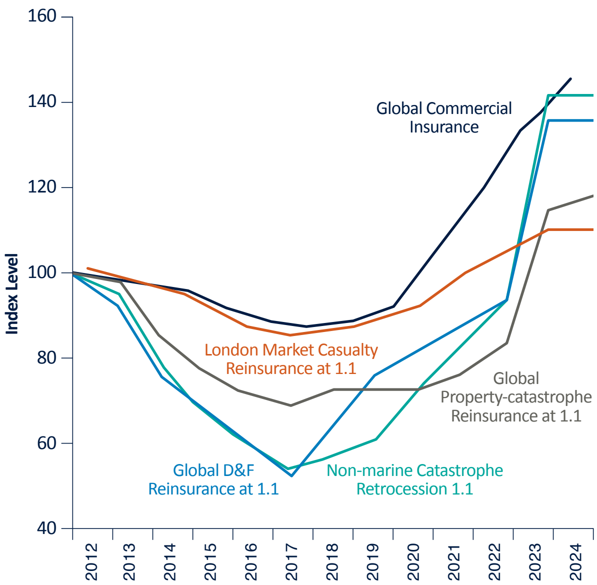
Exhibit 1
Hipgnosis Songs Ltd share price has fallen -43% from its peak in late 2021



***Source:** Bloomberg, FRED*

Valuations in the insurance market now reflect a more volatile market environment and reduced capital availability. We remain cautious on property-catastrophe insurance, but more constructive on opportunities in life insurance and other markets. A requirement to renew annually means that pricing in insurance has been more reactive to a higher cost of capital than other less liquid strategies. 2023 renewals resulted in higher premiums across most of the markets (Exhibit 2) and remained stable at or near those levels in January 2024. There is also evidence that pricing in property-catastrophe insurance is starting to reflect 'persistent outsized natural catastrophes'[1] as well as a more volatile environment for insured risk with the years since 2020 characterised by the pandemic, wars, and other geopolitical instability. While more risk-driven pricing in property-catastrophe is welcome, pricing can still be disproportionately affected by inflows from certain large insurance market participants, and the available investment structures create a material drag on overall returns. In other sectors, such as life run-off, we continue to review potentially attractive niche opportunities, while remaining cognizant of the potential negative impact of regulation on long term returns.

Exhibit 2
Howden pricing index showed higher pricing across all insurance categories in 2023-2024

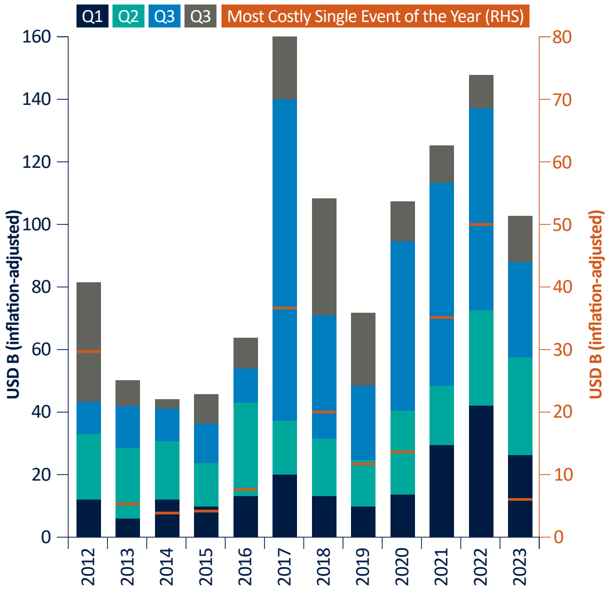


***Source:** Nova, Howden*

1 Source: Howden, The Great Realignment

Exhibit 3

Losses from single events in 2023 were unusually low, given the recent trend of higher annual aggregated losses and higher loss severity

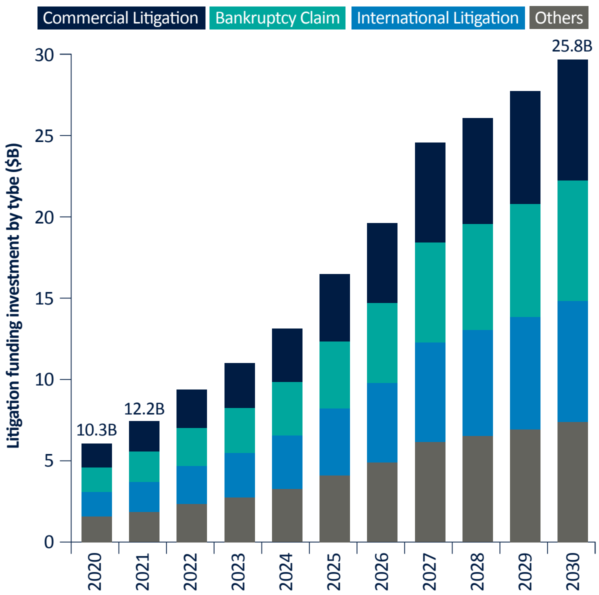


Source: *Howden, NOVA*

Lending strategies in Litigation Funding currently offer attractive value relative to both single-case financing and middle-market asset backed lending. In line with other Uncorrelated Strategies, Litigation Funding has faced a challenging asset raising environment in 2023. Given its uncorrelated nature, single-case litigation funding has not seen a notable increase in expected returns and as such is not currently as attractive as other opportunities in the space such as legal loans financing future legal fees, which benefit from SOFR-linked pricing and currently carry a material premium (~+5-8%) to middle-market asset backed loans. Law firm lending also benefits from greater predictability of cash flows than single case litigation. Underwritten returns in single cases remain in the range of 15-20%, with little evidence of funders' terms coming under pressure, however individual managers' success rates vary widely, and ultimate performance can be negatively impacted by duration extension. Our ability to partner with managers in niches as a value-added limited partner allows us to access less crowded areas of the litigation funding market such as intellectual property, and access to justice cases such as the recent Post Office case in the UK.

Exhibit 4

The breadth of opportunities in litigation finance continues to expand



Source: *Custom Market Insights*

Uncorrelated Strategies in Life Sciences continue to offer an attractive risk/return profile. Strategies such as pharmaceutical royalties and clinical co-development offer diversifying returns at opposite ends of the risk/return spectrum. With $200B+ of pharmaceutical and biotech R&D spend annually, of which $50B is on clinical trials, there is a continuous need for capital which enables biotech companies to fund significant clinical trial expenses and avoid equity dilution. We continue to view clinical trial funding as offering attractive uncorrelated upside but seek to size exposures appropriately given the potentially binary nature of returns. Pharmaceutical

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continued

royalties offer an attractive yield base to the portfolio but provide lower absolute yields than are currently available in senior lending to life sciences companies. As a result, we are currently biased more towards lending strategies than royalties but expect that could change as the relative value between the two normalises over time.

Golden Rules

- Partner with specialist investors in niche strategies rather than opportunistic generalists: We believe a key differentiator in investment outcomes in Uncorrelated Strategies is manager expertise and familiarity in pricing niche assets. Generalists tend to suffer from adverse selection given their comparative disadvantage in sourcing and evaluation of transactions in comparison to specialists.
- Establish close alignment not only with investment managers but also with other end-investors in those vehicles. In smaller, less liquid markets, a clear alignment of interests is essential and close relationships with other investors can deliver informational advantages which lead to better investment outcomes.
- Seek contractual returns, rather than an equity exit: Limit investments where the ultimate return is contingent on an equity bid from a third party. Favour investments with a defined contractual return and embedded date of maturity.
- Be sensitive to model risk: It is critical to fully understand the factors that influence investment pricing and to be sceptical of model-based valuation approaches.

Sub-Strategy Attractiveness

- **Litigation Finance and Intellectual Property:** Favourable view. Financing portfolios of corporate litigation is an area that remains relatively underexploited and is attractive in our view. Companies are more likely to need to monetise their legal assets in an environment where interest rates are rising and financing options have narrowed. We also view opportunities in patent and IP litigation as offering attractive uncorrelated returns. Lending structures in litigation finance now offer attractive opportunities given higher base rates, wider credit spreads and a flatter J-curve than in single case strategies. We are more cautious on single-case litigation funding strategies, where the complexity premium to conventional lending strategies has narrowed over the past two years as rates have risen. Accordingly, we have narrowed our focus to a smaller number of particularly high-quality managers.

- **Pharmaceutical Royalties:** Neutral view as lending to Life Sciences companies currently offers a more attractive risk-adjusted return. Pharmaceutical royalties are complementary to our healthcare lending and drug trial financing investments and offer a long-term source of realisable yield to our portfolios.
- **Drug Trial Financing:** Neutral view. Clinical co-development offers the opportunity to finance phase 3 drug trials in partnership with pharmaceutical companies, in exchange for a royalty stream or fixed cash payments. Given the specialisation required to assess trial outcomes, drug trial finance remains an under-exploited opportunity with few

participants. However, there are challenges in achieving deployment and adequate diversification, which mitigates our overall positive view of the strategy.

- **Insurance strategies (Life, Insurtech):** Neutral view. Continued consolidation and disruption in life and health strategies offer potentially interesting opportunities. Insurtech is a growing area which may offer opportunities to provide senior financing.
- **Music Royalties:** Neutral view. We have upgraded our previously negative view of music royalties to reflect a potentially attractive secondary opportunity set as existing portfolios are revalued.

- **Insurance strategies (Property and Natural Catastrophe):** Negative view. We remain less constructive on catastrophe insurance strategies despite recent repricing given the binary nature of the strategy at the portfolio level (i.e., the high correlation of individual policies), we view the available investment structures to have significant drawbacks (specifically the trapped capital at the end of each investment period) and believe the risks of climate change to still be inadequately reflected in underwriting models.

2024 Strategic Priorities

- Focus on contractual returns. Strike new partnerships with managers that focus on assets generating contractual cash flows rather than back-ended equity pay-offs. Attractive examples include royalties and litigation lending.
- Expand the range of Uncorrelated Strategies with a view to diversifying exposures and avoiding unintentional factor concentration. Concentrate capital in managers with clear and quantifiable competitive advantages through scale, specialism, or sourcing.
- Re-evaluate previously richly priced and disrupted strategies for secondary opportunities and opportunistic allocations, i.e. music royalties.

Long-Term Expected Return

Our required return for Uncorrelated Strategies is in line with our expectations for Private Debt strategies, assuming an equivalent risk profile. For more esoteric or longer tenor strategies, we require an additional return premium to reflect the increased risk or longer duration.