Nebraska Investment Council
Fixed Income Review – Illiquid Credit

June 2021
Overview

- In March, NIC investment staff and Aon provided a high-level overview of a DB Plan fixed income structure that had emerged from the fixed income blank sheet review project.
- The Council requested further information on the “illiquid credit” allocation and on active vs. passive management in core / core-plus fixed income.
  - This presentation addresses the former; i.e., the proposed 5% target allocation to illiquid credit.
Illiquid Credit Allocation would Focus Primarily on Direct Lending

- NIC investment staff and Aon recommend that the illiquid credit allocation be predominantly comprised of direct lending mandates
  - Direct lending is a segment of the private debt universe that is characterized by non-bank lenders who are providing capital to middle-market companies, primarily in the form of a loan rather than equity
  - The companies targeted by direct lenders are typically unable to access the capital markets to issue new public debt or equity because of their size
    • Typically ranging from $2 million to $100 million of EBITDA
  - Traditionally, these small- to mid-sized companies have relied on loans from commercial banks to support their capital structures
    • Increasing government regulations since 2008 (e.g., the Dodd-Frank Act and Basel III) have caused commercial banks to reduce lending for companies of this size
- The expectation is that the direct lending allocation would be built slowly, and could be supplemented by more transient, opportunistic exposures, should attractive opportunities present themselves
  - E.g., Distressed Mortgage strategies funded by NIC post GFC, PIMCO BRAVO II, etc.
- As direct lending exposure is phased-in, bank loan exposure would be phased-out
# Comparison: Direct Lending vs. Bank Loans

<table>
<thead>
<tr>
<th></th>
<th>Bank Loans</th>
<th>Direct Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lending Base/Loan Size</strong></td>
<td>Large &gt;$250mm</td>
<td>Middle-Market (EBITDA &lt; $100mm) $20mm - $250mm</td>
</tr>
<tr>
<td><strong>Structure</strong></td>
<td>Syndicated</td>
<td>Direct Origination</td>
</tr>
<tr>
<td><strong>Term</strong></td>
<td>Floating Rate: LIBOR + Spread</td>
<td>Floating Rate: LIBOR + Spread</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Liquid: Trade OTC</td>
<td>Originate and Hold; limited trading</td>
</tr>
<tr>
<td><strong>Maturity</strong></td>
<td>6-8 years</td>
<td>5-7 years</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td>2-3 years</td>
<td>2-3 years</td>
</tr>
<tr>
<td><strong>Secured by</strong></td>
<td>Cash Flows/Assets</td>
<td>Cash Flows/Assets</td>
</tr>
<tr>
<td><strong>Drivers of Return</strong></td>
<td>Coupon (LIBOR + Spread); Capital Appreciation (Limited); Losses from Defaults</td>
<td>Coupon (LIBOR + Spread); Fees (Origination, Syndication, Pre-Payment); Losses from Defaults</td>
</tr>
<tr>
<td><strong>Primary Risk</strong></td>
<td>Borrower Default/Loss</td>
<td>Borrower Default/Loss</td>
</tr>
<tr>
<td><strong>Management Fee</strong></td>
<td>0.50% - 0.70% per annum</td>
<td>1.00% - 1.50% per annum</td>
</tr>
<tr>
<td><strong>Incentive Fee</strong></td>
<td>N/A</td>
<td>10%-20% carried interest</td>
</tr>
<tr>
<td><strong>Return Expectation</strong></td>
<td>4.0%</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

*Aon 3Q 2020 CMAs*
### Comparison: Direct Lending vs. Bank Loans (Cont’d)

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<th>Direct Lending</th>
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<tbody>
<tr>
<td><strong>Control of Debt Terms</strong></td>
<td>No - terms dictated by arranger</td>
<td>Yes - negotiates terms directly with sponsor/borrower</td>
</tr>
<tr>
<td><strong>Due Diligence</strong></td>
<td>Limited - typically 2 weeks</td>
<td>Extensive - weeks/months</td>
</tr>
<tr>
<td><strong>Covenants</strong></td>
<td>Less</td>
<td>More</td>
</tr>
<tr>
<td><strong>Credit Monitoring Capability</strong></td>
<td>Limited - receives information from arranger through a data room</td>
<td>Direct - receives information direct from borrower and has consistent dialogue with sponsor/borrower</td>
</tr>
<tr>
<td><strong>Ownership of Loan</strong></td>
<td>Small</td>
<td>100% or significant</td>
</tr>
<tr>
<td><strong>Workout Capabilities</strong></td>
<td>Limited</td>
<td>Extensive</td>
</tr>
<tr>
<td><strong>Control in Workouts</strong></td>
<td>No – small % of loan and unable to influence outcome</td>
<td>Yes – directly engages with sponsor/borrower and has voting control over the debt</td>
</tr>
<tr>
<td><strong>Default Rate</strong></td>
<td>LT average ~5-6%</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Recovery Rate</strong></td>
<td>75%</td>
<td>80%+</td>
</tr>
<tr>
<td><strong>Loss Rate</strong></td>
<td>~1.0-1.5%</td>
<td>&lt; 0.6%</td>
</tr>
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</table>

- Bank Loans have less control over debt terms and workout situations, less access to management/sponsor and information, and limited due diligence.
- Bank Loans are more likely to sell a non-performing loan at a discount than workout of the loan for a higher recovery.
- Leads to lower recovery rates and higher loss rate for bank loans.
Comparison: Direct Lending vs. Bank Loans (Cont’d)

- Middle market loans with comparable risk to broadly syndicated loans have an illiquidity premium averaging approximately 180 bps historically with current levels above 200 bps.
- The illiquidity premium helps boost portfolio returns in a low-rate environment.
- Levered direct lending funds can add an additional 200 bps to 400 bps yield to the portfolio.

![Chart 1: Average 1st lien term loan yield by arranger type](image)

Source: Refinitiv LPC’s 4Q20 Middle Market Sponsored Private Deal Analysis; Excludes unitranche loans
### Direct Lending vs. Private Equity

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<th>Private Equity</th>
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<tr>
<td><strong>Investment Structure</strong></td>
<td>Drawdown Vehicle</td>
<td>Drawdown Vehicle</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Closed End/Open End</td>
<td>Closed End</td>
</tr>
<tr>
<td><strong>Length of Investment Period</strong></td>
<td>1-3 Years</td>
<td>4-5 Years</td>
</tr>
<tr>
<td><strong>Average Fund Life</strong></td>
<td>5-10</td>
<td>10-12 Years + Extensions</td>
</tr>
<tr>
<td><strong>Source of Return</strong></td>
<td>Interest Income/Fees</td>
<td>Equity Gains</td>
</tr>
<tr>
<td><strong>Distribution Timing</strong></td>
<td>Quarterly yield Year 1 and repayments starting Year 3</td>
<td>Distributions Years 5-10+</td>
</tr>
</tbody>
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- Private Equity allocations require a high level of manager diversification
  - Underlying partnerships are relatively concentrated
  - NIC makes 3-5 private equity commitments per year within the DB Plans in order to maintain its targeted allocation of 5% to private equity
- The need for manager diversification is much less with direct lending
  - Underlying loan assets are less risky than PE and more diversified portfolios
  - 1-2 Direct Lending investments each year initially and 1 every year thereafter or 2 bi-annually
Industry Trends

- Private debt fund raising has increased in response to bank’s exiting the market.
- Private equity fund raising continues to support new direct lending opportunities.
- Direct lending returns have remained consistent despite more competition.
Covid Impact

The direct loan market experienced significantly less volatility than the broadly syndicated market as measured by the CSLLI Index.

The spread over LIBOR increased during peak of Covid. It has declined since then but is still above pre-Covid levels.

Source: Ares Presentation 2020
(5) CSLLI – Credit Suisse Leveraged Lending Index
Leverage

- Some direct lending funds utilize leverage at the total fund level; others do not
  - Non-levered vehicles would generally have lower return expectations vs. levered vehicles
    - Net return of 6-7% vs. 8-12%
- Desired returns can help guide the leverage decision
  - As a general rule, we prefer leveraged funds that issue loans to high quality borrowers vs. unlevered funds that issue riskier loans (jr. debt, lower quality borrower)
- Fund-level leverage has implications not only for strategy risk / return expectations, but also for fees
  - Fees are typically charged on invested capital
    - If a fund uses a 1:1 debt to equity ratio (i.e., $2 of loans for every $1 invested), manager fees are based on $2
    - Gain comfort on fee structure given: (i) the fund is managing $2 of loans; and (ii) the expected return net of fees is still compelling from a risk/return basis
- It is worth noting that banks and finance companies have historically used significantly higher levels of leverage ratios on their balance sheets
Proposed Structure of Direct Lending Allocation

- Some investment staff and Council time required at the outset of the program, but time demands should be low after the first year or two
  - 2 new direct lending managers in year 1, $100 million to $150 million each
  - 1 new direct lending manager in year 2, $100 million to $150 million
  - 1 re-up manager each year thereafter, $100 million to $225 million each year
Is Direct Lending “Worth It?”

- An allocation to direct lending would:
  1) Increase fees
     - NIC bank loan managers currently charge ≈40 bps; direct lending fee burden would be a multiple of this figure
  2) Increase demands on staff and Council time
     - Drawdown structure means managing cash flows, finite-lived vehicles
  3) Decrease liquidity

- What is the potential reward?
  - Bank loans have delivered a (net) return of 2.5% - 3.0% per annum over the 6.5 years since initial funding by NIC in 2014
    - Our current CMAs suggest that a return in this range, or perhaps slightly higher, would be a sensible expectation going forward
  - We believe a reasonable forward-looking return expectation for a direct lending allocation would be 6-10% depending upon fund leverage
Q&A

- **Question: Do we really want to add more illiquidity to the portfolio?**
  
  - **Answer:** We are always mindful of liquidity risk, but note that Nebraska is in an enviable position from a cash-flow / illiquidity tolerance standpoint. We believe the pension plans can afford to take on more liquidity risk, and in so doing could take advantage of additional illiquidity risk premia.

- **Question: Is it too late in the cycle to add an allocation to private credit / direct lending?**
  
  - **Answer:** Private lending is a long-term strategy and NIC’s manager selection would give significant consideration to institutions with a long-track record of operating through a full credit cycle. NIC’s focus would primarily be on senior secured loans vs. more junior capital, which should provide more protection during a downturn.

- **Question: Does the addition of direct lending lower the quality of the fixed income portfolio too much? Is it worth the risk?**
  
  - **Answer:** The suggested private credit allocation would be sourced primarily from NIC’s bank loan allocation, which is also a non-investment grade portfolio. Although these strategies are technically more liquid vehicles, in a downturn prices will fall and liquidity will be less available.

- **Question: Are the extra fees worth it?**
  
  - **Answer:** All of our modeling is done on a net of fees basis. Manager selection will be key, but if the selected managers are able to deliver performance that approximates their long-term track records, we believe the private credit allocation will improve the risk / return profile of the DB Plans’ the fixed income component.
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