

M&G Distressed Debt Fund

Purpose of note

The attached M&G document provides a detailed overview of the key characteristics for M&G's 'Debt Opportunities Fund'.

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The note is designed to complement M&G's document, commenting on the strategic fit for the Fund and providing an independent view of its key characteristics. We have deliberately avoided re-iterating M&G's existing Fund information, on the basis that the Pension Committee can receive further information and / or training more efficiently from M&G's internal experts if required.

Background

The Debt Opportunities Fund will invest in distressed debt investments. There is no standard industry-wide definition of what constitutes 'distressed' or 'stressed' in debt markets. Most market participants make reference to the price of the debt as a starting point for identifying a distressed universe, typically on the basis of a specified discount to par value (often at 30%-40%, or more).

This discount might exist for numerous reasons. These include deterioration in the credit-worthiness of the borrower, perhaps due to its underlying business suffering, or uncertainty regarding a future requirement for re-financing or restructuring of the debt (or both). In these instances, investors rightly expect higher rates of return and running yields to compensate them for the elevated risks they face.

However, discounts can also exceed the proper 'fair value' for the debt, even accounting for the fundamental credit position of the borrower(s) and proper consideration of the risks involved. This may be due, at least in part, to the bonds being secured on assets with a value close, or even in excess of the value of the debt. Although the situation will vary significantly from one circumstance / debt instrument to the next, this is often due to two broad drivers:

- **Complexity** – many investors will be unwilling or unable to get to grips with the detailed and complex forensic analysis required to properly determine those debt securities that are "cheap for good reason" versus those offering attractive returns in a wide range of potential future scenarios. For example, this might include the ability and appetite to interpret the legal position of different bond holders in terms of their seniority of a claim on backing assets, as stipulated in lengthy and often intertwined bond covenants.

Debt investors might also need to be interventionist, through a willingness to participate in and negotiate 'work out' situations with company management. This calls for a level of specialist resource and hands-on involvement that is beyond the capabilities of many participants in the capital markets.

- **Illiquidity** – investors are also frequently reluctant to wait for borrower issues and restructuring situations to be resolved, during which time their capital will be tied up. This unwillingness to supply capital for longer-term gain at the expense of short-term liquidity will be particularly evident when lending finance is in scarce supply. This is the case currently, as one of the main the historic sources of funding – Banks – are looking to curtail their lending activities.

We think that both of these drivers could be targeted by the Fund through investing in the Debt Opportunities Fund.

In terms of exploiting the complexity premium, we believe that M&G has the requisite skills and experience in conducting the required analysis and undertaking direct intervention (i.e. managing restructuring efforts, work-out situations etc.). In terms of illiquidity, the Fund does not have an immediate need for liquid assets (or at least can afford to use proceeds from asset sales elsewhere in the asset mix if required) and can therefore afford to tie up part of its capital, given its longer-term investment horizon.

M&G fund attributes

We would note the following basic attributes, followed by what we consider the key “so what’s” from the Fund’s perspective:

- **Management:** The fund will be managed by M&G Investments, led by the fund manager, Paul Taylor.

Our view: We think there is a strong case for employing M&G in this area. This is both in terms of its ability on a standalone basis and its competitive position over alternative providers (i.e. why should the Fund use M&G rather than another distressed debt specialist?).

On a standalone basis, the team has provided reasonable evidence of demonstrable experience and track record in dealing with similar investments in the past. It has also shown sufficient due diligence resource, with a team of credible restructuring specialists and large private and public credit research teams. In terms of its competitors, M&G’s position as a leading debt investor (both for external investors and its own Life Fund) provides it with a competitive edge in this area. This is for a number of reasons. Firstly, the exposure and information gained on underlying borrowers by M&G through its current debt and/or equity investments (e.g. within its Life Funds) will be critical in identifying opportunities. Secondly, M&G’s debt ownership outside of the Debt Opportunity Fund’s assets (in many instances, M&G will, in aggregate, own 25% or more of the debt capital / instrument involved) is important in establishing control during any restructuring. Finally, subject to appropriate arrangements as to equal treatment of the different investors, we regard the common ownership of M&G with the Fund as being attractive in terms of aligning interests.

- **Concentration:** The Fund will invest in between 10-20 individual investments.

Our view: This is a relatively small number of higher risk single securities, relative to other ‘growth asset’ portfolios. However, the opportunistic nature and stringent criteria for security inclusion are such that it would be unrealistic to expect name diversification in-line with the Fund’s other risk-asset investments (for example, the investment grade corporate bond portfolio and the equity portfolios are all well diversified). The best means of dealing with the limited diversification in the M&G fund, in our view, is to restrict the allocation to no more than 2% of Suffolk Fund assets, thereby ensuring that the exposure at the Fund level to a single opportunistic debt investment would not account for any more than 0.2% of assets.

- **Geographic remit:** The Fund will invest in UK and European debt instruments.

Our view: The uncertainty regarding the current macro-economic situation in the Eurozone might superficially draw into question the legitimacy of focusing on an investment in this region (rather than, for example, the US, or globally). However, we are comfortable with the Fund’s European focus for three reasons. Firstly, the investment is so security specific such that its outcome is unlikely to be primarily driven by broad economic outcomes, but rather the resolution of each specific debt situation.

Some of the businesses involved are also likely to have meaningful business interests / revenue streams outside of Europe anyway. Secondly, we regard the key to success in this fund as being the expertise brought by the investment manager and its knowledge of the underlying companies – M&G's European focus fits well here. Finally, it will arguably be some of the Eurozone stresses (i.e. knock-on on contraction in lending from Banks caused by peripheral sovereign debt exposure etc.) that will drive the magnitude and existence of the opportunities and their prospective returns in the first place.

- Investment universe: The majority of the lending will be made either to individual companies (through leveraged loans, high yield corporate bonds etc.) or as part of securitized structures such as 'Commercial Mortgage Backed Securities' (CMBS), ultimately providing mortgage finance to larger pools of commercial and residential borrowers. Investors in the Fund will not be able to 'see' the portfolio at the point of committing capital, with M&G identifying the debt assets during the first two years of investment.

Our view: These instruments would offer further diversification of the Fund's current asset mix. The exact composition (i.e. number of loans versus bonds versus Commercial Mortgage Backed Securities) of the ultimate portfolio will not be transparent to investors at the point of commitment to the investment. This means the Pensions Committee needs to be particularly confident in the skill of the underlying manager (which in this instance seems justified). Investors will not have the comfort or luxury of being able to make their own assessment of portfolio robustness to, for example, multiple future default and or recovery rate scenarios, based on viewing the assets at entry. We would note that some uncertainty regarding the future evolution of the Fund is part and parcel of this asset class. The lack of transparency on the part of underlying borrowers in terms of the availability and source of any required finance is one of the leading contributors to the high levels of return being garnered in the first place.

From a governance perspective, the concept of lending to companies should be relatively easy to appreciate. This would essentially be an extension of current investment in areas such as global credit. However, understanding the complexity associated with securitised structures in areas such as CMBS is likely to be a far more significant challenge from day one. This is not necessarily insurmountable, but the manager may need to provide training in this area on a 'need to know' basis.

- Returns target: The fund will target minimum returns of 15% per annum, net of fees and other costs.

Our view: The expected rates of return (>15%+ p.a.) look sufficiently attractive for an "opportunity" investment, even with a relatively small weighting given to the Fund. This return is significantly in excess of what we would expect to receive from equities in the long-term. If achieved, the return would be particularly attractive in an environment in which low levels of economic growth and / or recession are likely to challenge equity returns.

- The fund will be a 'closed-ended' vehicle that is intended to have a 5-7 year life, from the drawing of client funds during year 1-2, through to return of capital from year 4 onwards. Returns will be sourced through a combination of coupon payments, 'pull to par', redemption, debt buy-back, and the sale of assets.

Our view: The Fund can currently afford to 'lock-up' an element of its capital on a 5-7 year basis and accept illiquidity in exchange for additional return.

- Fees: M&G will charge an Investment management fee of 1.5% p.a. (on drawn capital) and a performance fee of 20% above 8% compound return to investors.

Our view: These fees, whilst high, are broadly in-line with those being charged by competitor managers for distressed debt funds, which can charge performance fees based on returns over LIBOR (rather than returns above 8% p.a. as is the case here). The fees are also lower than other 'alternative' investments targeting similar returns (for example, a successful hedge fund targeting 15% continues to gather assets while charging 2% base fees and a 20% participation in returns over LIBOR). The limited capacity available for the fund (Euros 300m) is likely to preclude any fee discounting.

Strategic rationale

We view the strategic fit for the Debt Opportunities Fund as follows:

- **Role.** As an investment targeting an annual return of 15% or more, this should – stating the obvious – be viewed as a growth investment. We would regard it as an Equity substitute.
- **Key risks.** These high levels of return cannot be achieved without taking meaningful risk. In this instance, the Fund would face the idiosyncratic and operational risks associated with individual securities selected by the Fund manager, Paul Taylor and his team. Security selection is key, and the Fund is subject to the risk that a handful of debt securities are subsequently proven to be less attractive than the analysis and due diligence initially suggested. The high level of income and returns sought at the fund level will provide some protection against the fund manager making one or two poor decisions. However, the expected portfolio concentration (10-15 likely investments) will not allow for many mistakes or unexpected outcomes. We would note that success in security selection is not necessarily dependent on the overall macro-economic environment, good or bad. However, we would expect that widespread recovery in the coming years would act as a tailwind to M&G's fund (to the extent that this had not reduced prospective returns through occurring during and / or prior to the investment period).
- **Diversification benefit.** We are attracted by the additional diversification that the fund could offer both in terms of valuation and returns outcomes; with an expected lack of correlation of returns with the Fund's other growth investments. The M&G fund could potentially meet its challenging return objectives without (at least the anticipation of) a widespread economic recovery required for other growth assets (e.g. equities) to perform strongly. The fund could also offer some embedded downside protection over and above equities. M&G has stated that one of the criteria for inclusion in the fund is that the recovery value (for example, gained through a bondholder claim on company assets in the event of default) will typically be at least equivalent to the debt cost or price at the time of purchase.
- **Timing risk.** In many closed-ended funds, the timing of exit or sale of the underlying securities can be an important determinant of total returns. Clients face the risk that the macro-environment during the 1-2 year window set-aside for return of their capital is not conducive to selling risky assets. The potential for a forced sale of assets at undesirable prices is particularly at odds with long-term investors, in terms of their time-frames and willingness to hold risky assets over time throughout market cycles.

However, in this particular fund's instance, we are comfortable with this risk. This is because its debt focus means that it will largely return clients' capital through the debt instruments reaching maturity and / or being redeemed or 'called' by the borrowers. Principle will be returned to investors accordingly, without the requirement to sell securities to other market participants. M&G has stated that one of its key criteria for fund inclusion will be that it can expect capital to be returned through debt maturity etc. within the 5 year period.

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In a small number of instances (no more than 1-2 of the c.15 securities) the securities involved could include equity (which has been received as part of a restructuring package from a borrowing company). In this instance, M&G may need to wait a further 1-2 year period for restructuring efforts to take place, before it looks to sell the equity.

Next steps

M&G is currently in the later stages of raising capital for the fund. At the time of writing, it had received over 100m Euros in commitments, with a further 50m Euros required to reach their minimum requirement. The close for the fund is currently planned for the end of April 2012.

Recommendation

We recommend that the Pensions Committee consider an investment of up to 2% of total Fund assets into the M&G Distressed Debt Fund. We would propose that the funding should come from gilts which have already performed extremely well and where yields are at historic lows.

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For and on behalf of Hymans Robertson LLP

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