



PRIVATE DEBT OUTLOOK & REVIEW

SAN BERNARDINO COUNTY
EMPLOYEES RETIREMENT SYSTEM

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TOPICS

- Private Debt Outlook
- Year-in-Review & Outlook
- Key Themes

2024 NEPC PRIVATE DEBT OUTLOOK

Investors should be ***cautiously optimistic*** about the private debt markets in 2024. While several forward-looking opportunities have emerged, issues in existing portfolios are expected to increase. NEPC expects the dispersion in both manager activity and performance to further widen, highlighting the importance of manager selection.

Capital Structure Stress: Widespread defaults have not yet occurred; however, **indications point towards trouble ahead**. A second year of higher rates, potentially coupled with depressed profit margins, will be challenging for borrowers. Total return-focused managers that excel in deal structuring and have material workout experience are expected to outperform.

Bank Retrenchment: Due to increased regulatory pressure, banks continue to pull back from several markets. The **financing gaps being left behind provide opportunities** for private debt managers to step in and offer alternative solutions for borrowers.

Portfolio Finance: LPs and GPs alike are increasingly seeking bespoke solutions to help them achieve asset-level, portfolio-level and/or other strategic goals. While deal flow has been muted in the past, this opportunity set is **poised for rapid growth**.

2024 PRIVATE DEBT THEMES

Year 2 of higher rates and regulatory developments will make things significantly more challenging in 2023...

...These factors continue to put stress on existing capital structures, accelerated bank retrenchment and created portfolio concerns...

CAPITAL STRUCTURE STRESS

- Transitional Capital
- Structured Capital
- Credit Opps/Special Sits

BANK RETRENCHMENT

- Regulatory Capital Relief
- Asset-Based Finance

PORTFOLIO FINANCE

- Credit Secondaries
- Structured Solutions

2024 PRIVATE DEBT THEMES

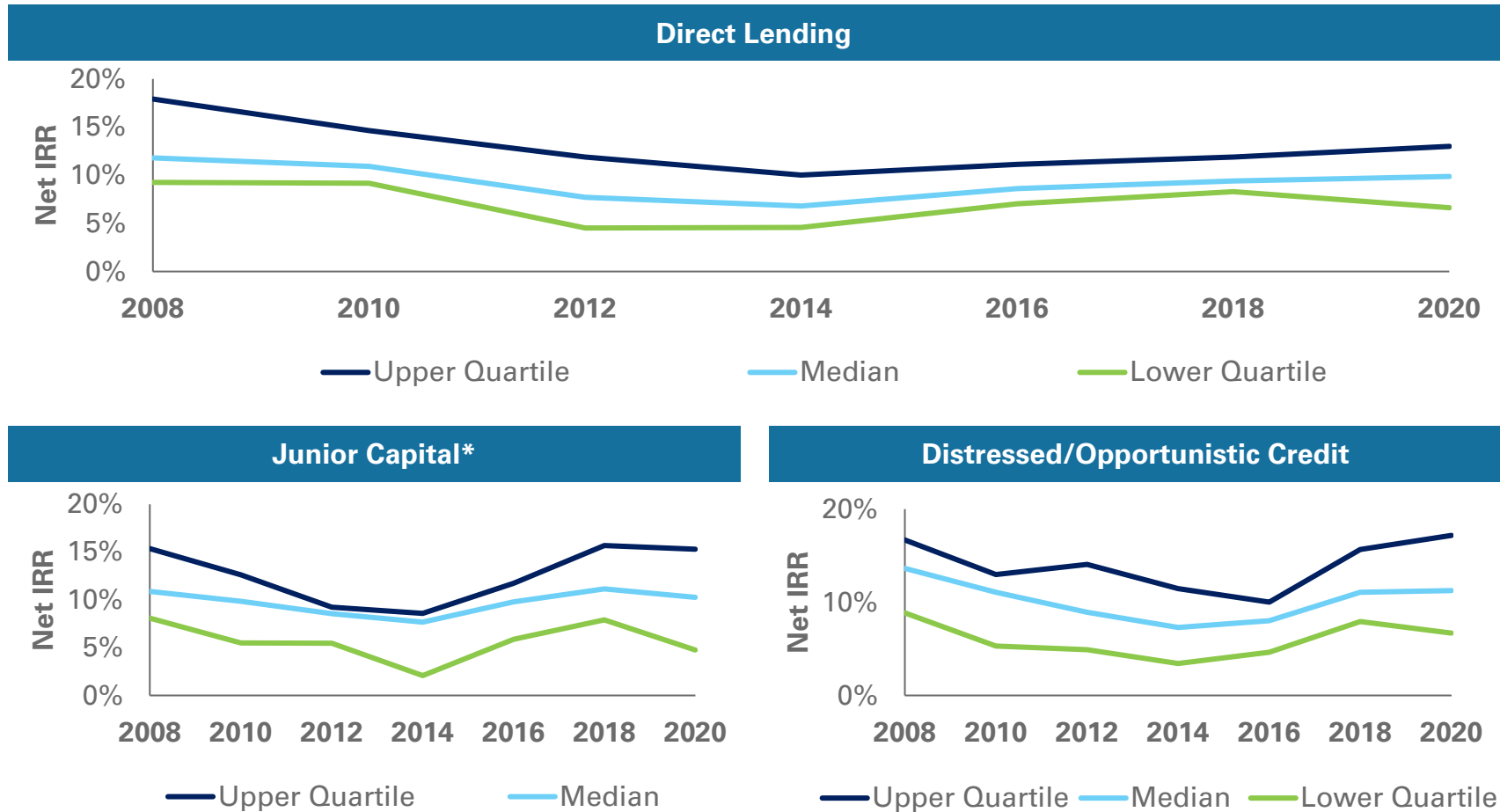
Theme	Overview	Merits	Risks	Implementation
Capital Structure Stress	▪ Entering second year of higher interest rate environment ▪ Companies have burned through a significant amount of liquidity in 2023 ▪ First lien lenders are unwilling to extend further down capital structures ▪ Borrowers are in need of creative/bespoke financing solutions	▪ Lenders have negotiating power to drive more favorable terms including better protections and, in some cases, equity upside	▪ “Catching a falling knife” ▪ Subordination/priming ▪ Lack of equity support ▪ Poor deal structuring ▪ Lender-on-lender violence ▪ Sponsor-on-lender violence	Benefit to Client Portfolios ▪ Return enhancement Strategy Options ▪ Transitional capital ▪ Structured equity ▪ Opportunistic credit ▪ Distressed/stressed ▪ Special situations
Bank Retrenchment	▪ Due to recent bank failures and increased regulatory pressure, banks continue to pull back from several markets ▪ The financing gaps being left behind provide opportunities for private debt managers to step in and offer capital to borrowers	▪ Private debt managers can partner with banks to create mutually beneficial solutions ▪ Lenders can gain access to potentially high-quality borrowers/assets that otherwise would not typically be available	▪ Poor credit selection ▪ Selectivity/adverse selection ▪ Incorrectly valuing or understanding collateral ▪ Potential for limited control of a workout/restructuring	Benefit to Client Portfolios ▪ Diversification ▪ Return enhancement Strategy Options ▪ Multi-strategy credit ▪ Asset-based finance ▪ Regulatory capital
Portfolio Finance	▪ LPs are in search of capital solutions for portfolio management reasons (ex. liquidity needs, rebalancing, etc.) and strategic goals (ex. change in mandate, relieve administrative burden, etc.) ▪ GPs are seeking financing for fund & asset-level purposes (ex. extend duration to maximize value, crystalize performance, etc.) and strategic goals (ex. balance sheet capital, develop new product offerings, etc.)	▪ A significant increase in total deal flow, coupled with a broader opportunity set in terms of new forms of deal structures, enables managers to be more selective with investments and hopefully achieve better risk adjusted returns	▪ Counterparty risk ▪ Inadequate price discount ▪ Misalignment/poor deal structuring ▪ Underperformance of underlying portfolio companies	Benefit to Client Portfolios ▪ Diversification Strategy Options ▪ Multi-strategy credit ▪ Credit secondaries ▪ Structured solutions

YEAR-IN-REVIEW & OUTLOOK



PRIVATE DEBT PERFORMANCE

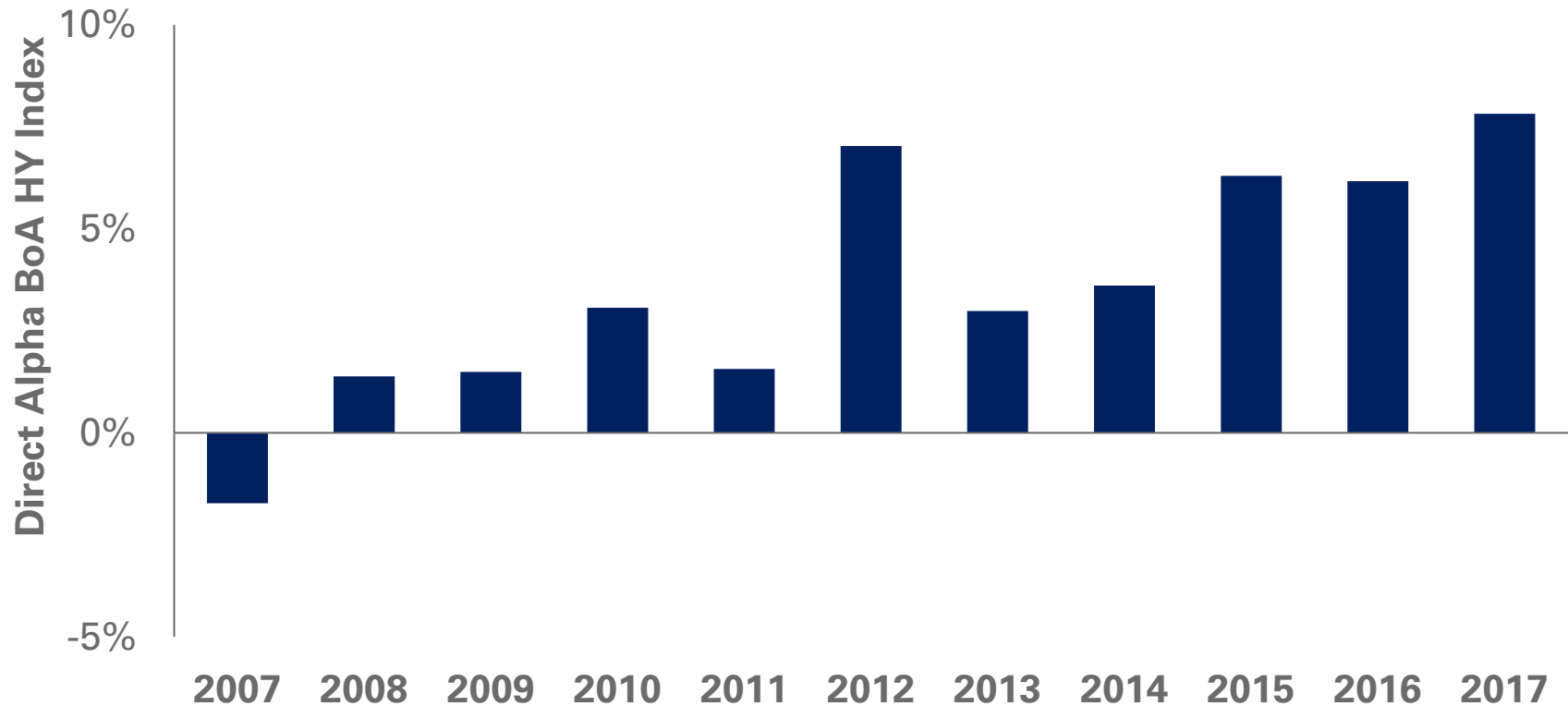
HEIGHTENED IMPORTANCE ON MANAGER SELECTION



PUBLIC MARKET EQUIVALENT

CONSISTENT OUTPERFORMANCE BUT NOT ENTIRELY CYCLE TESTED

Private Credit - PME



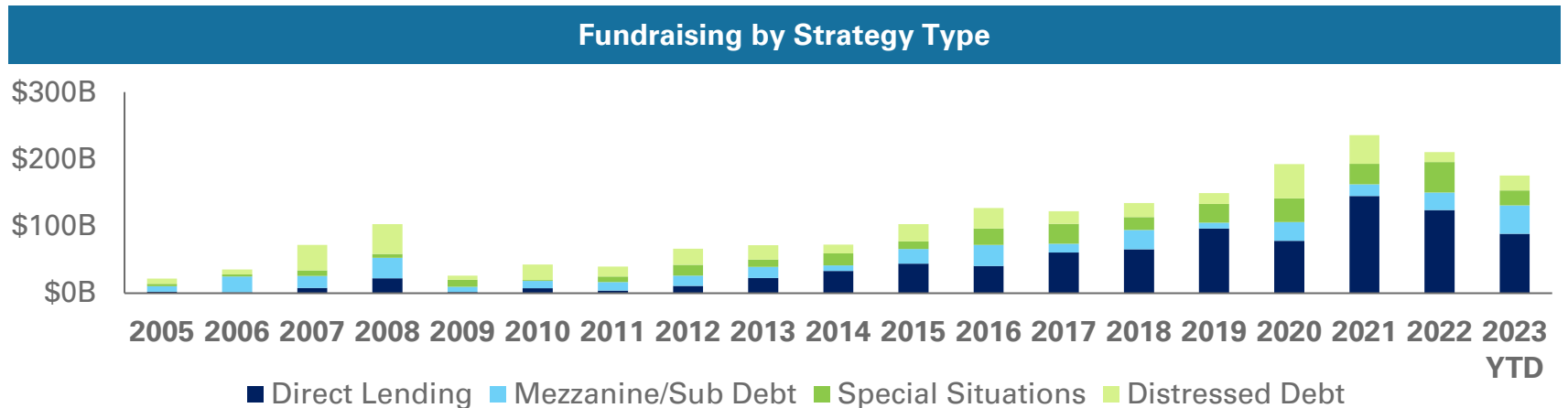
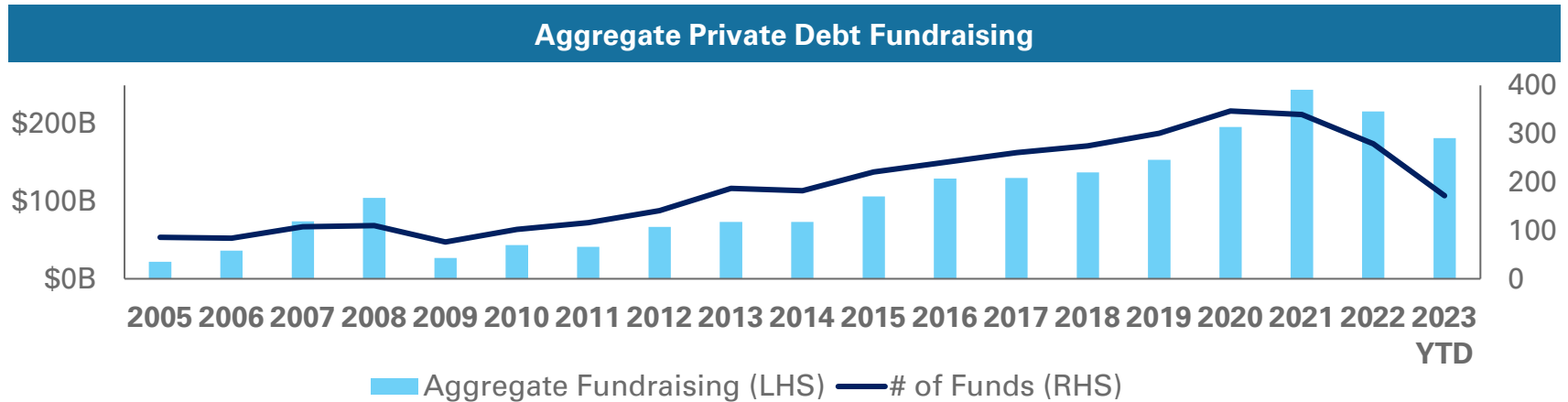
Source: Thomson One/C|A as of 06/30/2023.

PD Out/Underperformance is shown based on a PME using the pooled cash flows of all funds. 1st Quartile outperformance will be meaningfully higher
PME method is Direct Alpha and benchmark is BoA HY Index



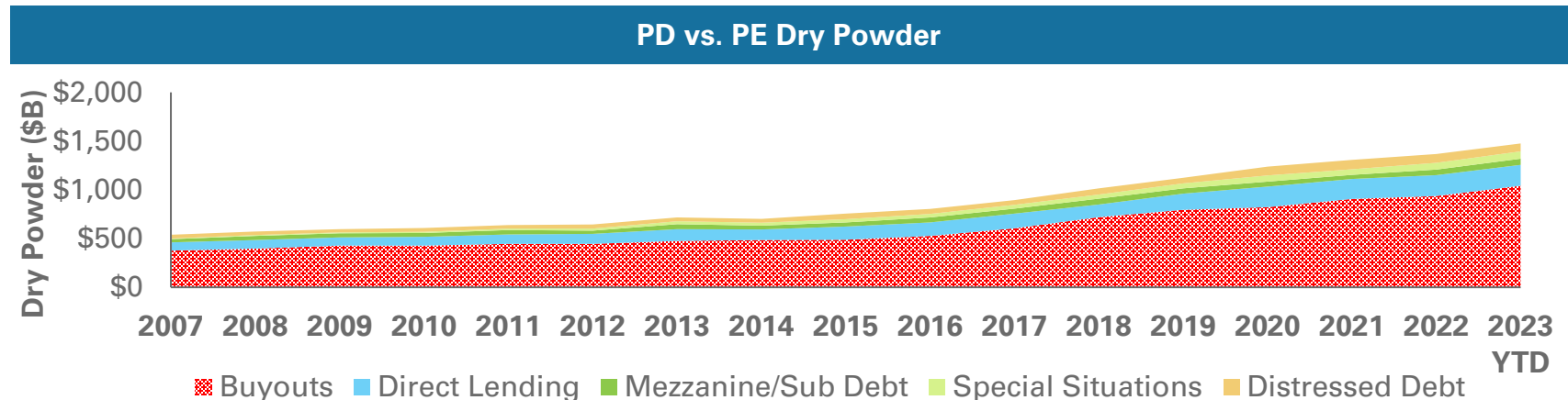
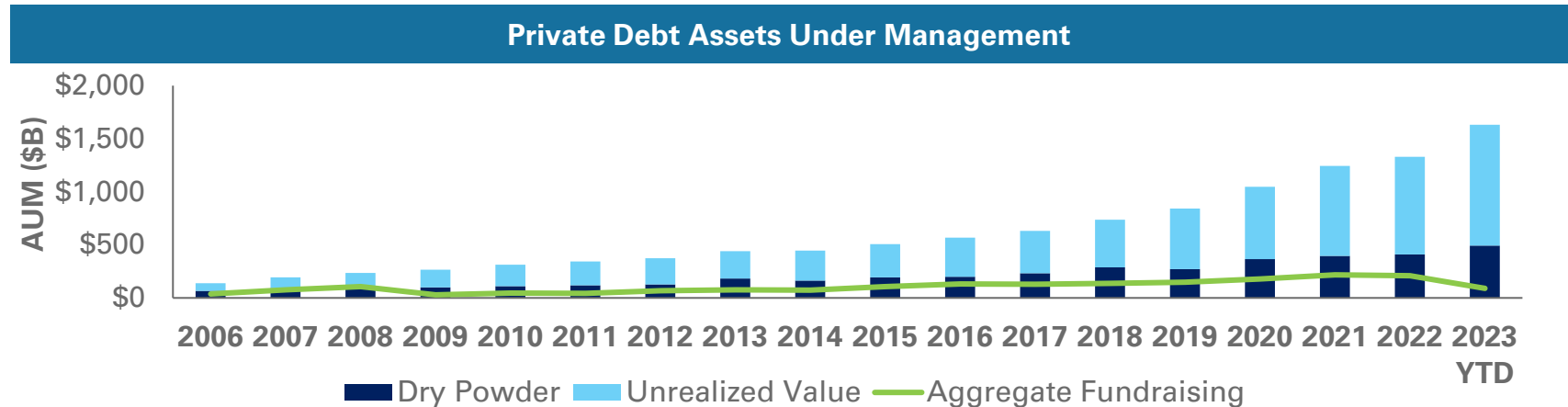
PRIVATE DEBT FUNDRAISING

FUNDRAISING DOWN FROM ITS PEAK IN 2021



PRIVATE DEBT ASSETS UNDER MANAGEMENT

CONTINUED GROWTH BUT STILL MEANINGFULLY TRAILS PE

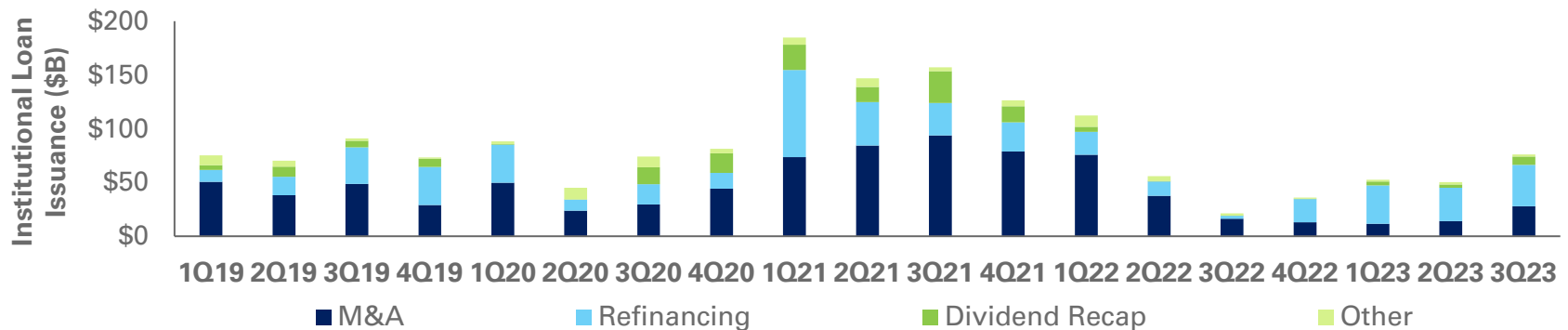


Source: Preqin as of 11/2023

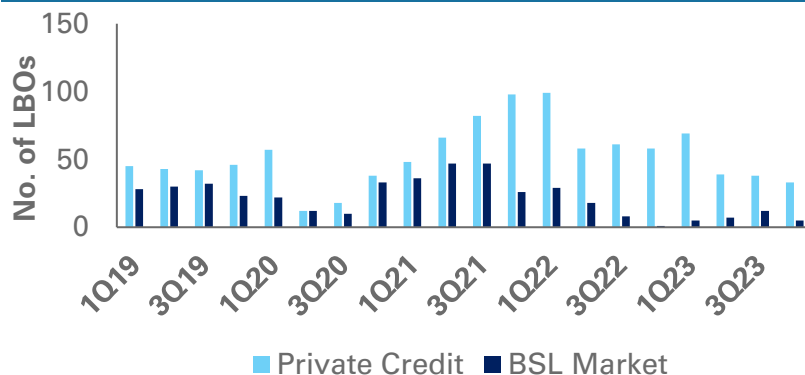
INSTITUTIONAL LOAN MARKET

ISSUANCE IS DOWN; OPPORTUNISTIC LOAN VOLUME INCREASED

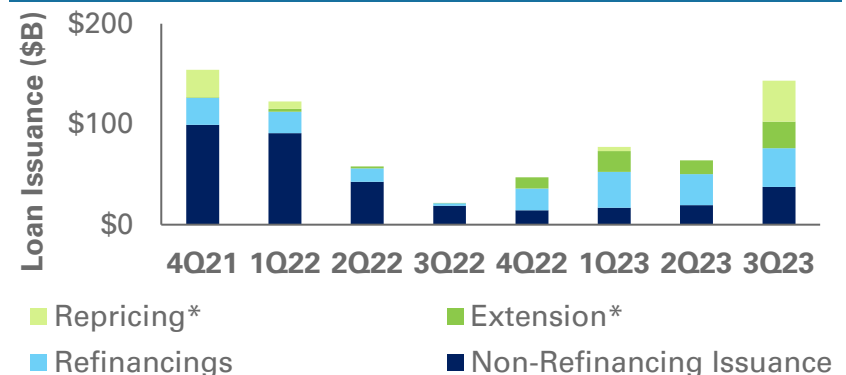
Institutional Loan Issuance



LBO Financings



Opportunistic Loan Issuance by Type



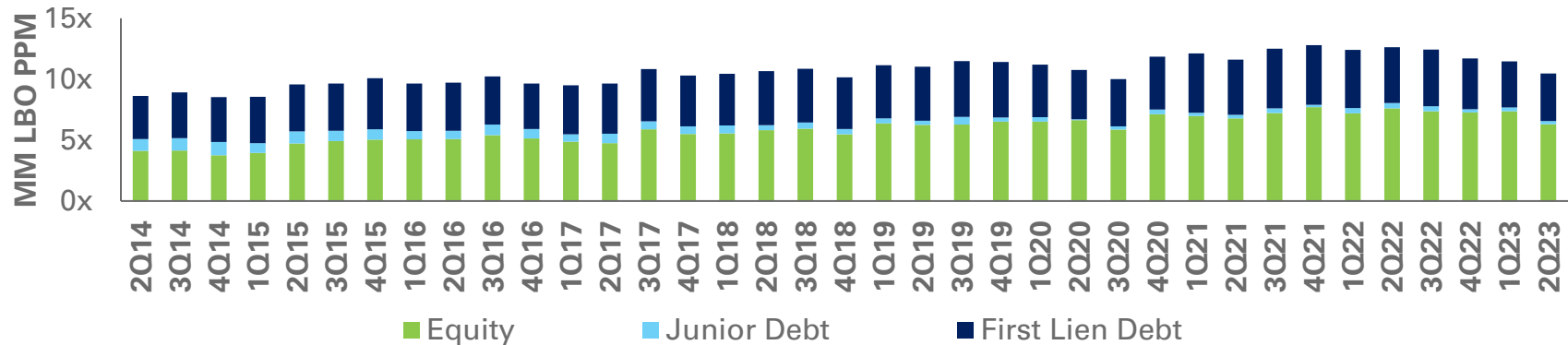
Source: Pitchbook LCD

*Reflects repricings and extensions done via an amendment process

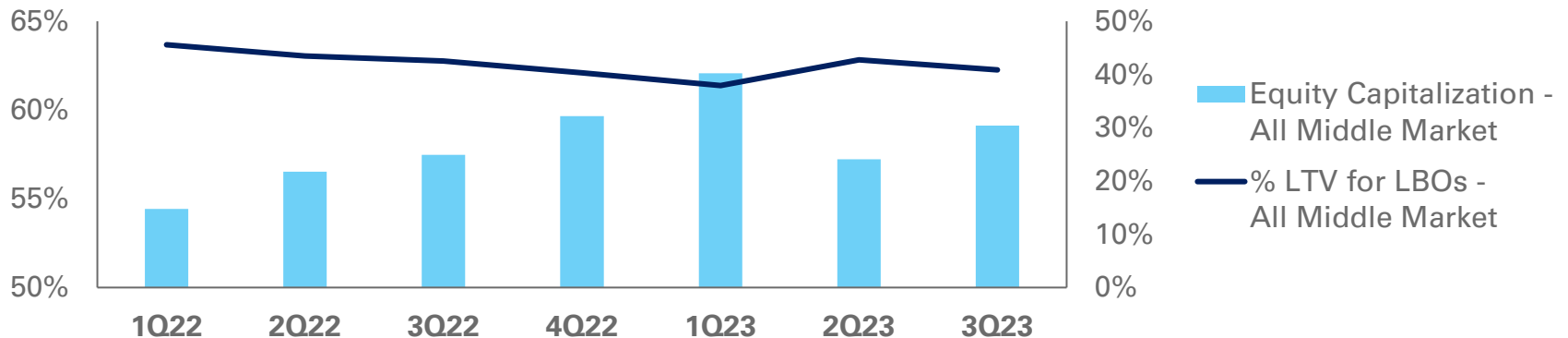


MIDDLE MARKET ENVIRONMENT

MM LBO Purchase Price Multiples



Equity & Debt Capitalization



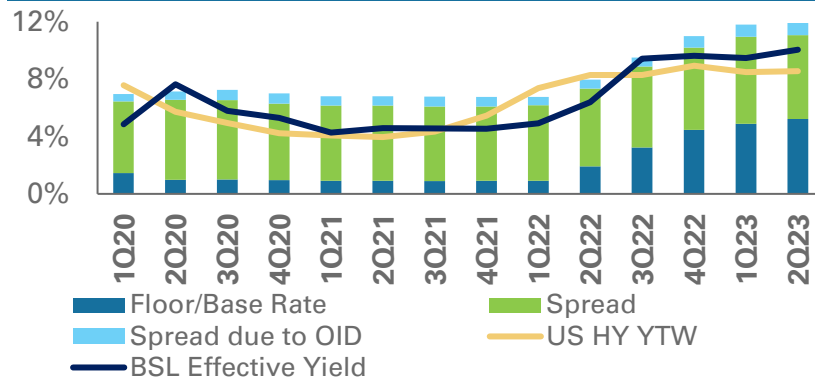
Source: Pitchbook LCD



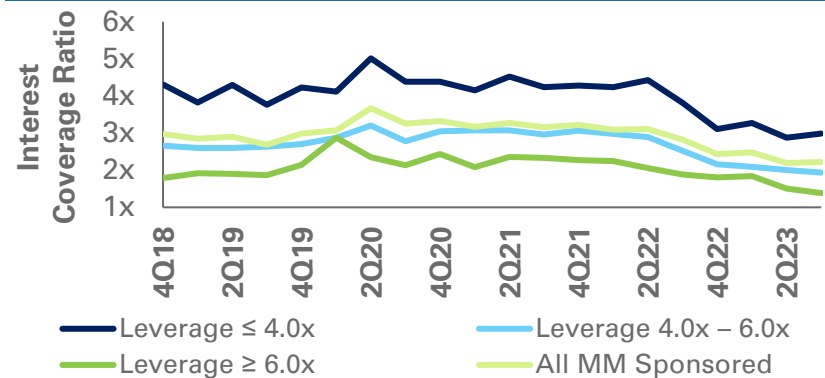
MIDDLE MARKET ENVIRONMENT

COMPELLING RISK ADJUSTED RETURNS

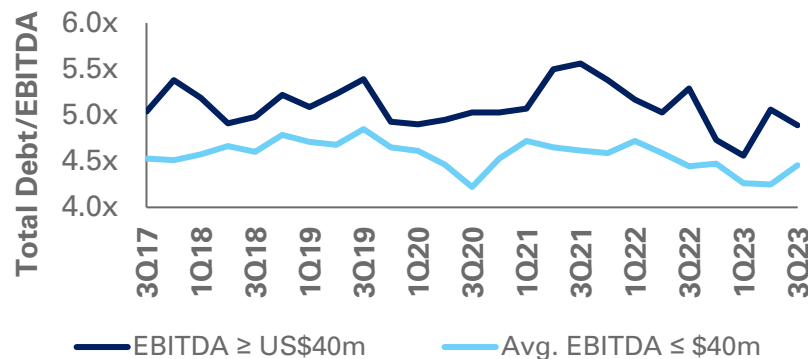
Public & Private Yields



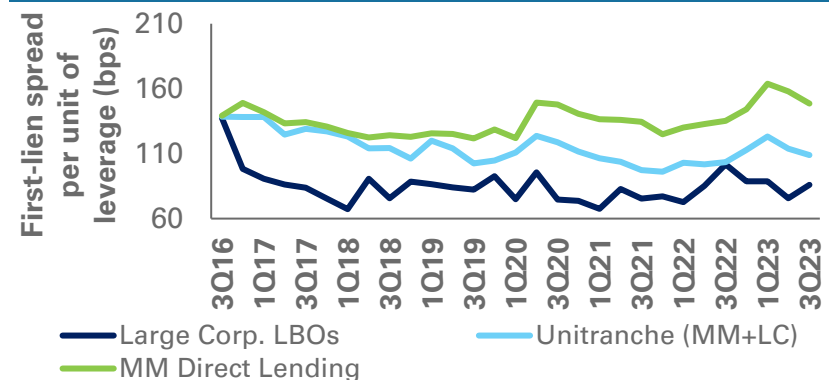
Coverage Ratios



Debt/EBITDA



Spread Per Unit of Leverage



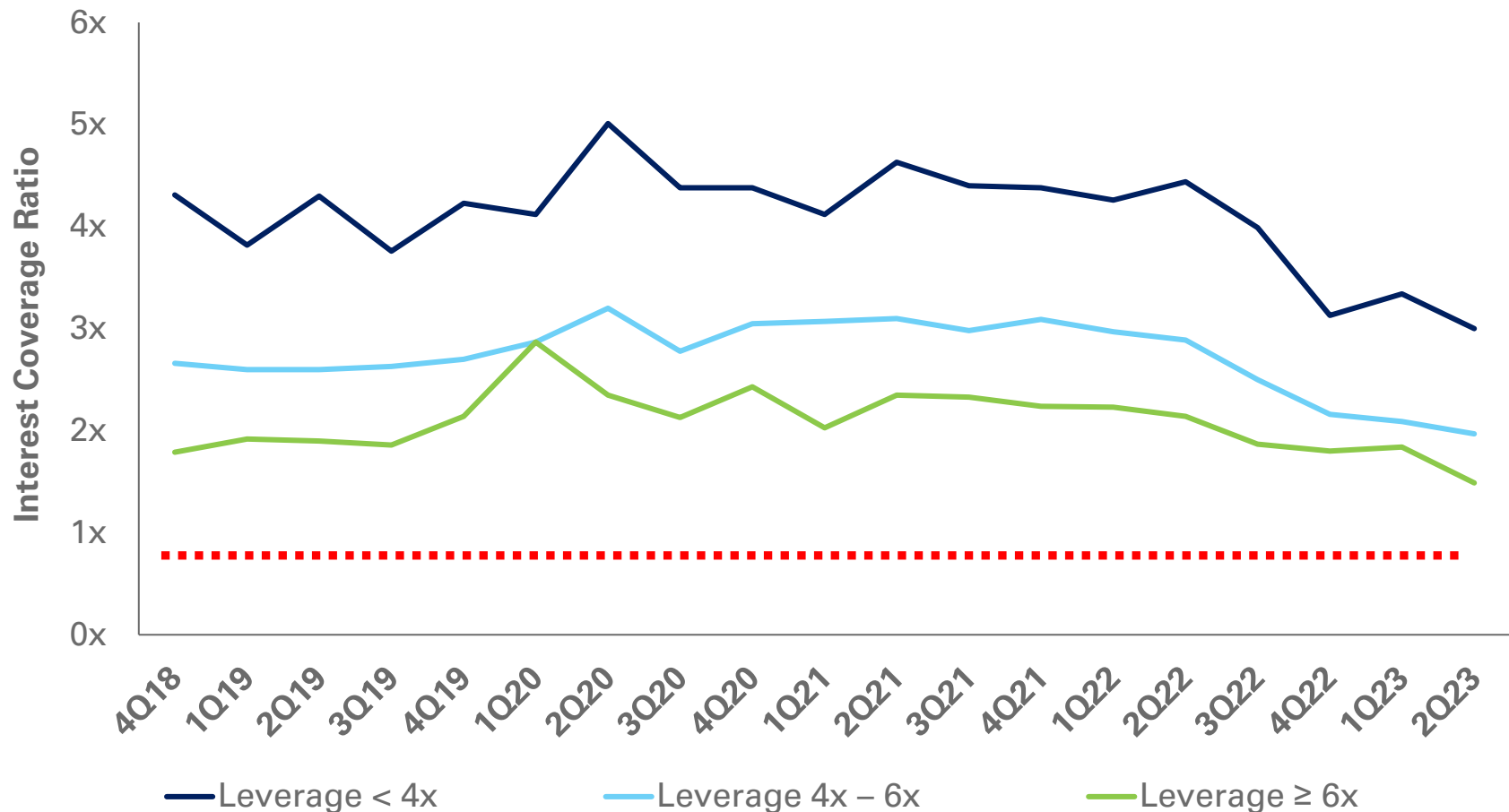
THEME: CAPITAL STRUCTURE STRESS



INTEREST COVERAGE RATIOS BY LEVERAGE LEVELS

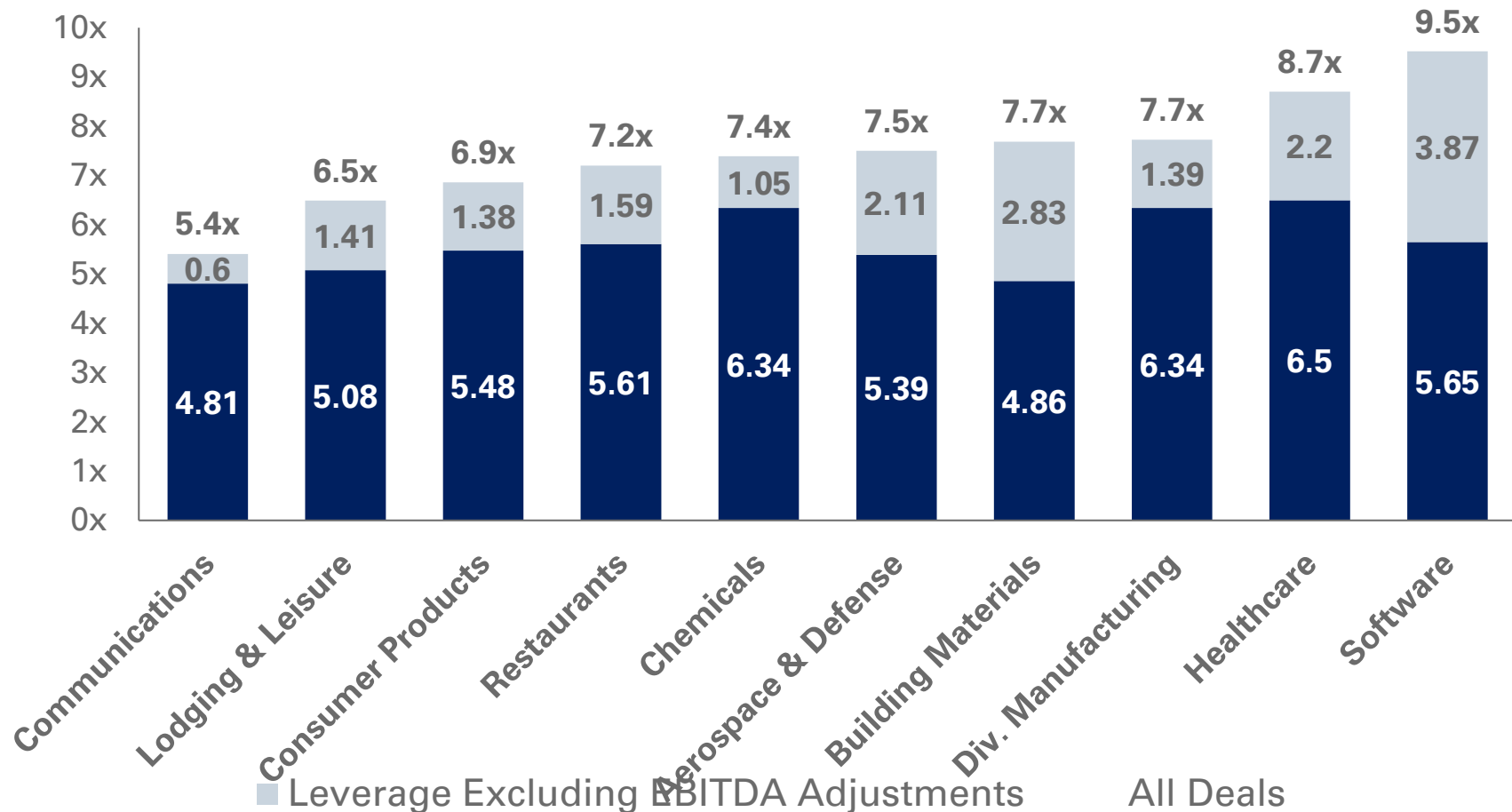
Exhibit A: Page 15

INCREASINGLY DIFFICULT FOR BORROWERS TO SERVICE DEBT



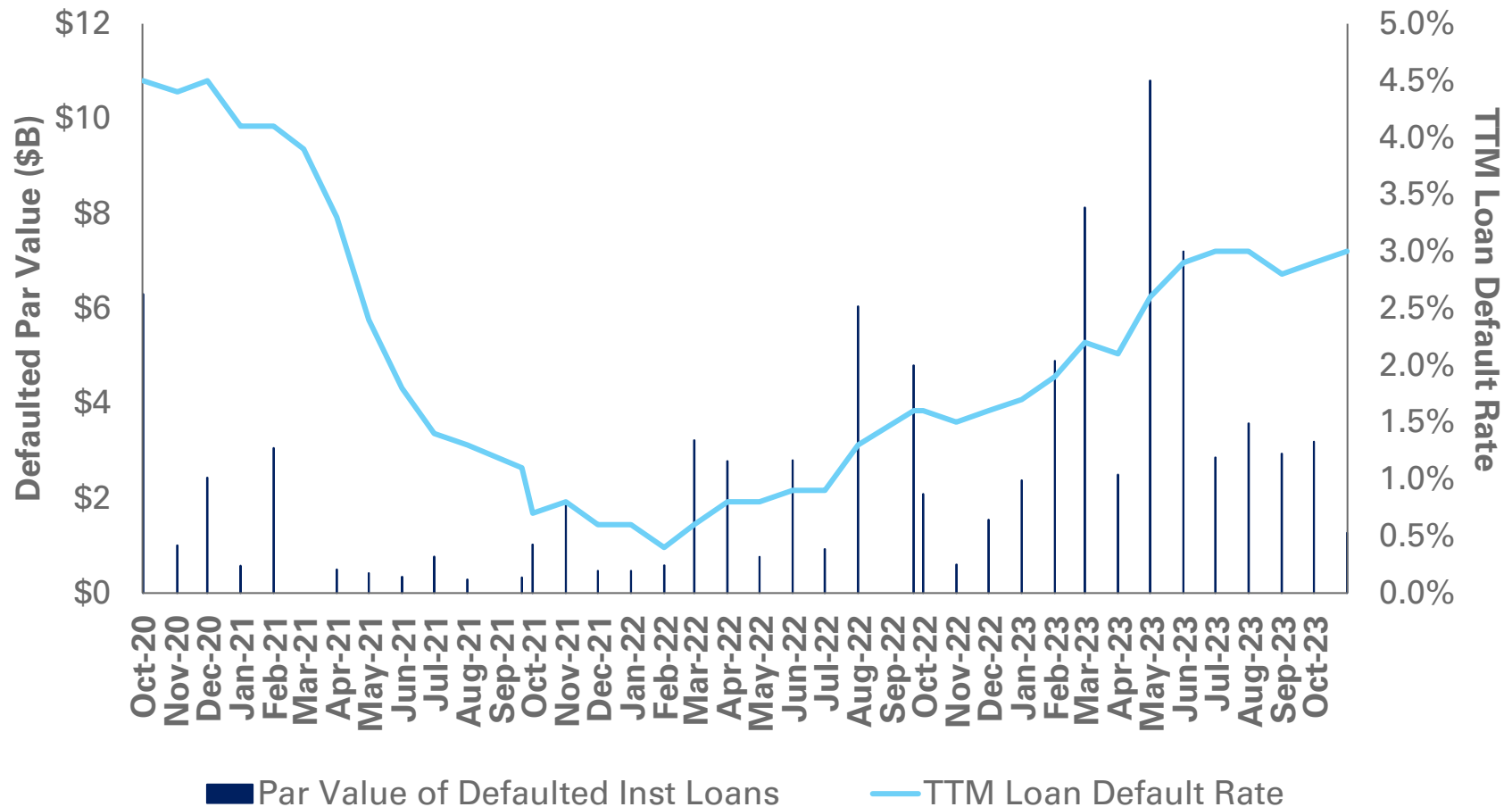
LEVERAGE IS UNDERSTATED

ACTUAL RISKINESS OF COMPANIES MAY BE VEILED BY FINANCIAL ADJUSTMENTS



INSTITUTIONAL LOAN MARKET

DEFAULT RATES HAVE PLATEAUED....FOR NOW



Source: LSEG LPC's Distressed Market Review as of November 2023

THEME: BANK RETRENCHMENT



OVERVIEW OF REGULATORY CAPITAL RELIEF

("REG CAP")

What is Regulatory Capital Relief?

Reg Cap refers to the methods banks use to reduce risk on their balance sheet by transferring said risk to investors. These transactions can take a few forms, such as acquiring assets directly from the bank's balance sheet or participating in tranches of securitized assets. Investors are offered the first- or second-loss position of the large portfolio of performing loans. Reg Cap is also referred to as risk sharing transactions ("RSTs"), capital relief transactions ("CRTs"), capital release transactions, or synthetic securitizations.

Why do Banks participate in risk sharing?

Banks have been required to meet the balance sheet requirements imposed by regulators through the implementation of the BASEL framework. Reg Cap transactions improve capital ratios, reduce P&L volatility, etc. Investors bear the risk of potential defaults, allowing banks to better manage and mitigate risk on their balance sheets.

Why do investors participate in Reg Cap?

These are bond-linked exposures offering diversification from traditional asset classes and access to a swath of highly-diversified credit instruments on bank balance sheets (diversified across geographies, size, asset types, etc.).

How do Reg Cap investments fit into the portfolio?

Reg Cap may provide investors income-oriented returns and diversification from traditional asset classes. The underlying credits are typically investment grade and may include 1) revolving lines of credit and term loans to large corporate borrowers; 2) term loans to small/medium enterprises; 3) short-term trade finance; and 4) other types of credit instruments on bank balance sheets.

CURRENT MARKET DYNAMICS



Tighter Capital Requirements

Recently, there have been a number of North American and European bank failures, and as such regulators have begun to tighten requirements. In the US, there is an upcoming ~20% increase in bank capital requirements for banks with assets more than \$100 billion.



Increases in Issuance

Historically, the majority of successful reg cap transactions have been issued by ~50 international banks in Europe and North America. The number of banks issuing in each jurisdiction has expanded. As an example, Canadian issuance has historically been limited to the Bank of Montreal. In 2022, the majority of Canadian banks entered the market. Regulators in each respective jurisdiction are looking to build resiliency.



Rising Interest Rates

Historically, pricing for reg cap transactions ranged from S+8% to 12%. The pandemic inflated pricing to S+10% - 12% through the end of 2020 when pricing tightened. However, inflation and recessionary fears caused spreads to widen again. Today, pricing is at 14% to 16% (USD) and 12% to 14% (EUR). These are buy-and-hold “bond-like” instruments with 3 to 4 years terms.

THEME: PORTFOLIO FINANCE



USES OF PORTFOLIO FINANCING

TAILWINDS FOR INCREASED DEAL ACTIVITY

LP PORTFOLIO MANAGEMENT		GP FUND & ASSET LEVEL SOLUTIONS	
Short-Term Liquidity Needs	Portfolio Rebalancing	Extend Duration to Maximize Asset Value	Maintain AUM base while generating liquidity for LPs
Accelerate Distributions	Reduce Unfunded Liabilities	Crystallize Performance	Finance GP Commitment
STRATEGIC GOALS		STRATEGIC GOALS	
Change in Investment Mandate	Ownership/Managerial Changes	Seek Permanent B/S Capital	Address Succession Planning Concerns
Generate Dry Powder to Support New Commitments	Relieve Administrative Burden	Develop New Product Offerings	Explore Growth Capital Alternatives

IMPLEMENTATION



IMPLEMENTATION OVERVIEW

	Investment Opportunity	Implementation	Return Expectation	Managers
Public Markets Credit	Attractive all in yields Positive convexity	Liquid multi-sector credit (daily or monthly liquidity) High Yield (monthly liquidity)	High single to low double-digits	Artisan High Income Loomis Credit Asset
	Stressed corporate hedge fund credit Discounted entry points (issuers)	Credit / Event-driven hedge funds (1–3-year lock)	Low-mid double-digits	Nut Tree Nut Tree Drawdown HG Vora
Private Credit	Direct Lending	Private drawdown (5-7 years fund term)	IRR: low-mid double-digits MOIC: 1.3x	Comvest
	Junior Capital, Credit Opportunities, Distressed	Private drawdown (7-10 years fund term)	IRR: mid-high double-digits MOIC: 1.75x	Arbour Lane L2 Point Francisco Partners

BEST PRACTICES



PRIVATE MARKETS INVESTING

BEST PRACTICES

- **Strategic targets are encouraged but don't be dogmatic**
- **Pacing plans are a critical portfolio management and risk management tool**
- **Private markets are long-term investments and should not be used express tactical investment views**
- **Re-up with strong managers**
- **Ensure overall asset allocation has enough true liquidity to meet calls and spending**
- **If you are early in your private markets investment journey, or building out a larger allocation, know that it will take time**

NEPC DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

Some of the information presented herein has been obtained from external sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this content, we cannot guarantee the accuracy of all source information contained within.

The opinions presented herein represent the good faith views of NEPC as of the publication date and are subject to change at any time.

This presentation contains summary information regarding the investment management approaches described herein but is not a complete description of the investment objectives, portfolio management and research that supports these approaches. This analysis does not constitute a recommendation to implement any of the aforementioned approaches.

ALTERNATIVE INVESTMENT DISCLOSURES

It is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment
2. Leverage and other speculative practices may increase the risk of loss
3. Past performance may be revised due to the revaluation of investments
4. These investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value
6. These funds are not subject to the same regulatory requirements as registered investment vehicles
7. Managers may not be required to provide periodic pricing or valuation information to investors
8. These funds may have complex tax structures and delays in distributing important tax information
9. These funds often charge high fees
10. Investment agreements often give the manager authority to trade in securities, markets or currencies that are not within the manager's realm of expertise or contemplated investment strategy

