TD Asset Management

Private Debt + 10 Minutes
= New Thinking

Finding Resilience During a Pandemic: Private Debt

Around the world, nations have taken unprecedented action to flatten the spread and duration of the COVID-19 pandemic. While these initiatives have led to improved health outcomes across many countries, there are still other nations in the earlier stages of virus transmission. As we navigate potential future waves of the virus, we maintain conviction in the income resilience exhibited within our private credit strategies.

In this paper, we highlight opportunities and strategies across the private debt asset class that we believe will provide resilience through the pandemic.

Private Debt

The COVID-19 pandemic has exacerbated the need for accretive and durable income streams as yields reached all-time lows and high yield private debt managers dealt with a deluge of impairments. The TD Asset Management Inc. (TDAM) Private Debt strategy, which is focused on investment-grade quality private debt investments, has not experienced any impairment, including on those investments exposed to the hospitality industry. The strengths of TDAM's investment-grade quality private debt investments are attributable to three main factors: strong contractual cash flows, structural protections like seniority and collateral, and diversification across different geographies and sectors.

Contractual cash flows provide the foundation for an effective investment-grade quality private debt strategy. When stemming from a creditworthy counterparty, contractual cash flows ensure stable revenues and sufficient debt servicing capabilities under a multitude of economic scenarios. Examples of contracted cash flows include a long-term take-or-pay power purchase agreement between a generator and a government-owned agency, an availability-based revenue contract for the construction and long-term maintenance of a social infrastructure asset (hospital, courthouse, bridge, etc.) or a "bondable" lease between a landlord and an investment-grade public company where all property-related risks are passed to the tenant.

Structural protections in private debt bolster the stable income profile of the strategy and are often the product of a long negotiation process, stretching from two to over six months in any transaction. This process requires a thorough due diligence analysis involving external experts, such as engineers, appraisers, lawyers, insurance consultants, working exclusively on behalf of lenders. There is not a standard covenant or security package, as each industry, jurisdiction, term and deal have their own idiosyncrasies, and therefore each transaction demands unique features. Ultimately, structural protections put in place are solely designed to ensure that income is paid and capital is preserved.

Another way of considering the role of structural protections for TDAM's private debt portfolios is detailed in **Figure 1**. It shows how a spectrum of fixed income securities will differ with respect to the structural protections offered, and the ultimate yield enhancement delivered to reflect those protections.

Figure 1: Spectrum of Fixed Income Securities

	Yield Enhancement	Security	Solid Covenants	Diversification
Government Bonds	No	No	No	Partial
Corporate IG Bonds	Partial	Partial	Partial	Partial
High Yield Bonds	Yes	No	No	Yes
Levered Loans	Yes	Partial	Partial	Yes
Investment Grade Private Debt	Moderate	Significant	Yes	Yes

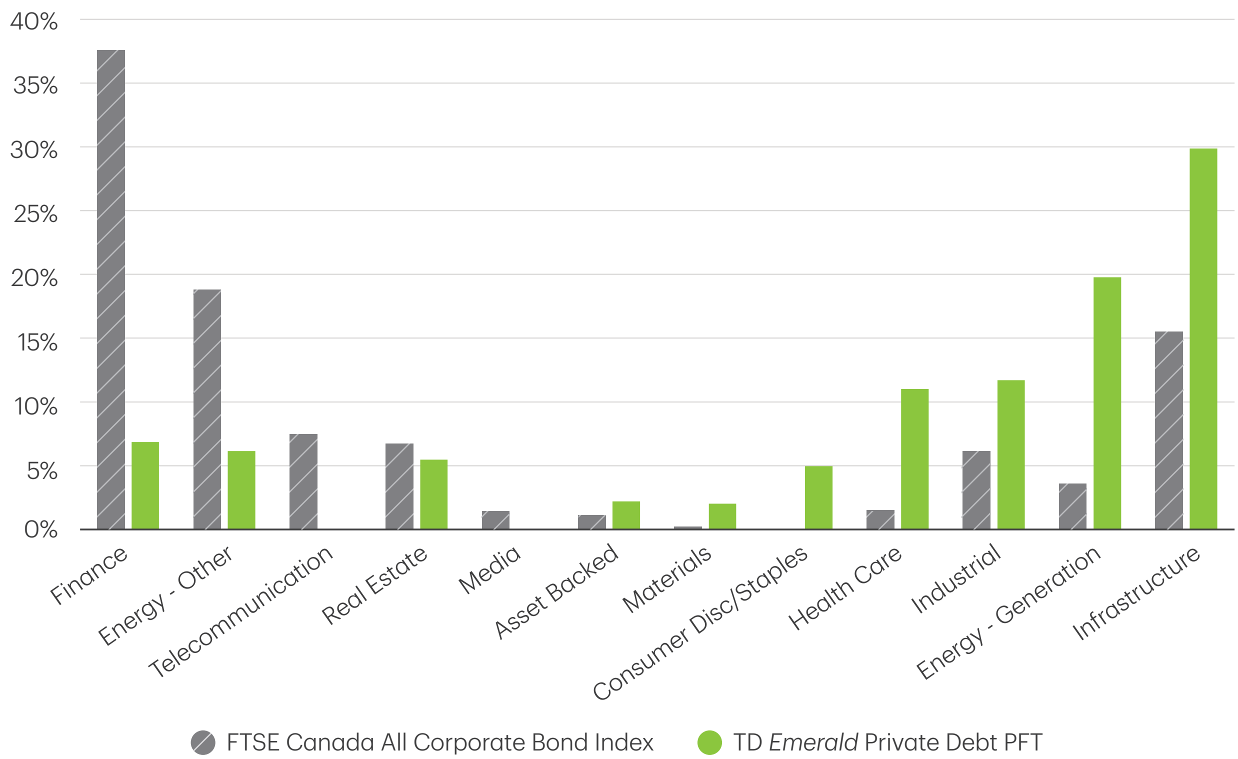
No Partial Moderate Significant Yes

Source: TD Asset Management Inc. For illustrative purposes only.

Proactive geographic and sector diversification has bolstered the durability of TDAM's private debt income profile as well. By targeting up to a 30% allocation to non-North American developed countries, TDAM's private debt strategy provides exposure in sectors and issuers that are scarce or non-existent in the Canadian fixed income market.

Figure 2 shows how the TD *Emerald* Private Debt PFT complements a typical exposure to Canadian corporate bonds.

Figure 2: Sector and Issuer Diversification



Source: FTSE Global Debt Capital Markets Inc. and TDAM. As at Oct 31, 2020.

While the Canadian corporate bond market is heavily weighted towards financials and energy, private debt is exposed mostly to infrastructure and energy. More importantly, the sub-sector exposure is vastly different. For example, corporate infrastructure bonds in Canada are mostly comprised of electric utilities and airports. Alternatively, corporate exposure to energy issuers is concentrated within the midstream oil and gas sector. TDAM's private debt exposure to energy is focused on renewable energy projects owned by independent energy producers that benefit from long-term take-or-pay power purchase agreements. As a result, TDAM's private debt strategy complements a traditional Canadian corporate bond strategy while adding yield without increasing risk.

Resilience

In Summary

The economic consequences of the COVID-19 pandemic continue to unfold and, unlike previous crises, there are direct impacts to real assets in the form of income disruption due to government-imposed restrictions on business activity. For private credit managers, portfolio construction, asset quality, managing relationships and risk management are critical factors in navigating the current environment. Moreover, during this pandemic, there are areas of the market that continue to provide enhanced income stability, capital preservation and income growth potential.

Ultimately, the role of private credit within an investor's total portfolio mix remains steadfast in providing attractive income, lower correlation and improved diversification with other asset classes, translating into higher expected risk-adjusted returns for total investment programs.

Connect with TD Asset Management