TD Asset Management

Private Credit + 20 Minutes
= New Thinking

Private Credit
at TD Asset Management

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The 2018 integration of Greystone Capital Management Inc. into TD Asset Management Inc. has significantly increased the size and breadth of our private market offerings to clients, but also deepened the firm's investment knowledge on said asset class. Presently, clients can access investment-grade quality private debt through TDAM's two private debt funds, TD *Emerald* Private Debt Pooled Fund Trust and TD *Emerald* Long Private Debt Fund Pooled Trust; and invest in a well-diversified portfolio of commercial mortgages through TD Greystone Mortgage Fund.

TDAM's private credit capabilities cover the entire duration spectrum **(see Table 1 below).** Our private credit offerings acknowledge that institutional investors have a degree of capacity for liquidity risk within their risk budget, given their long-term horizons and well understood near-term liquidity needs. Simply put, investors do not require the ability to convert their entire portfolio to cash overnight, but rather have room in their total portfolio allocation for investments that are less liquid and offer higher yields as compensation.

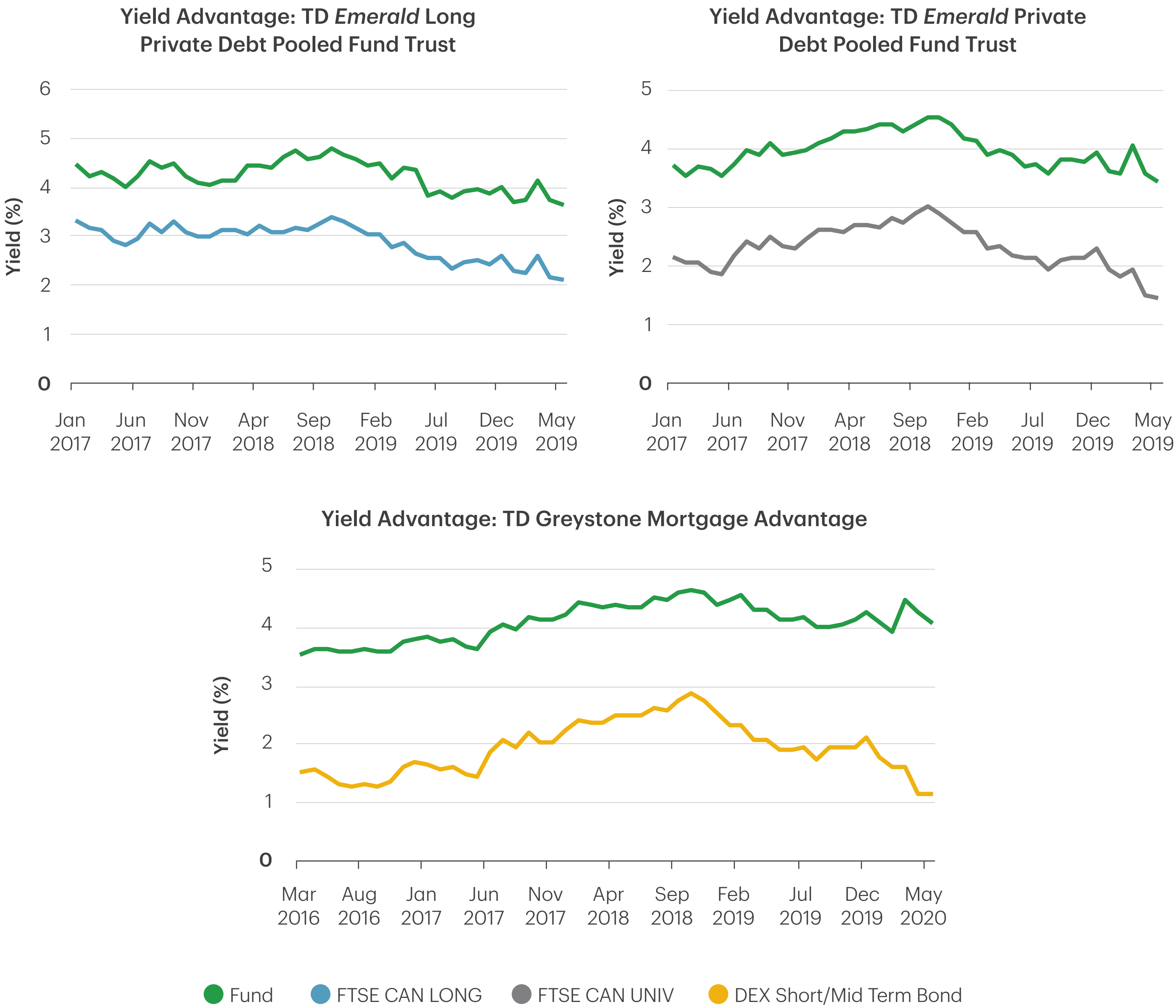
Table 1

	AUM ($ millions)	Yield (%)	Duration (Yrs.)
TDG Mortgage Fund	5,148	4.11%	2.4
TD *Emerald* Private Debt	649	3.44%	8.3
TD *Emerald* Long Private Debt	951	3.65%	15.5

Note: All data as at May 31, 2020. Source: TDAM.

With private credit, investors can accept reduced near-term liquidity for the opportunity to enhance yield and increase diversification without significantly increasing risk. Furthermore, all of TDAM's private credit funds feature investments secured by hard assets and include a comprehensive set of covenants. **Chart 1** shows the premium income that TDAM private credit solutions can generate over their benchmarks.

Chart 1



Source: TDAM Internal. Data as of May 31, 2020.

Given the benefits private credit brings to a fixed income portfolio across the entire duration spectrum, TDAM has made an intentional effort to include private credit into its comprehensive client solutions.
But what is private credit exactly?

Like the term "Hedge Fund", "Private Credit" is a broad label that may mean different things to different people. It is therefore important to define what these private credit strategies entail.

[1] Press Release: TD Bank Group completes acquisition of Greystone Capital Management Inc.; available **here**.

Private Credit Defined

TDAM's private credit offering includes commercial mortgages and investment-grade quality private debt. These investments are private for any of these 3 reasons:

1. They are rarely rated by any of the major credit rating agencies;
2. They are held by a handful of investors and/or the issue size does not meet the criteria for inclusion in the major fixed income indices or
3. Each investment is unique to the particular borrower situation. Private credit transactions are often negotiated directly with borrowers, providing the ability to influence terms – allowing investors to become price makers rather than price takers.

As a result, private credit instruments tend to be of the buy-and-hold securities. Let's take a deeper look into commercial mortgages and private debt.

Commercial Mortgages

A mortgage is a financial and legal instrument that secures the repayment of a loan by way of a registered charge against the underlying real estate. The borrower agrees to repay the loan, with interest, on a predetermined schedule. It includes loans secured by office, retail, industrial and multi-residential rental properties. Changes in property values or reductions in income affect property owners before mortgage debt holders. Equally important, lenders are registered on the property title and are first in line in the event of default or bankruptcy.

The TDG Mortgage Fund categorizes loans as either Conventional First Mortgages or High Yield. Conventional First Mortgages are loans that have a first charge on a real estate property and a loan to value ("LTV") below 75%. Conventional First mortgages make up close to 90% of the TDG Mortgage Fund, however, in order to provide more granularity, we break this loan type out into two sub-categories: Conventional and Conventional Plus.

- **Conventional mortgages** are secured by a property that, when underwritten in its current state, meets conventional financing metrics. These types of loans are generally longer-term (5 – 10 years) with a first charge on a real estate property that has a stabilized income stream (i.e. office, retail, industrial, and multi-unit residential).
- **Conventional Plus mortgages** are secured by a property that have not yet fully recognized the income potential of their location. These types of loans are generally shorter term (i.e. 1 – 3 years), floating rate loans with lower LTV ratios and greater recourse to the borrower. Loan types generally include land, land servicing, construction and interim/bridge financing. The supply of capital for these shorter-term loans tends to be lower than for Conventional loans, allowing for higher yields. Barriers to entry result from the commercial real estate expertise required, the modelling systems needed to minimize cash drag and finally that other lenders, such as Life Insurance Companies, tend to focus on long-term opportunities in order to match their liabilities.

The strategy also adds value through high-yield commercial mortgages, albeit to a lesser degree. A High Yield loan that has subsequent priority charge on a real estate property and, a higher LTV ratio on a first charge, or both.

The guiding focus of the TDG Mortgage Fund is generating stable and predictable income streams backed by high quality commercial real estate while lending to top-tier borrowers. Sophisticated modelling overlays this bottom-up process in order to provide robust diversification while minimizing the cash drag in order to enhance portfolio performance.

Bay Adelaide | Toronto, Ontario

This picture is for illustrative purposes only.

Real estate

Private Debt

TDAM's private debt strategy focuses on North American investment-grade quality opportunities within five broad categories:

- **Infrastructure debt:** Financing of social or economic infrastructure assets which include hospitals, long-term care facilities, roads, ports, airports and other similar facilities. These private debt transactions have terms ranging from 15 to 30 years and are supported by a strong contractual framework that matches the term of the financing. In addition, the financing terms could include a construction period, whether it is for the renovation or expansion of an existing facility ("brownfield") or the building of a brand-new asset ("greenfield").

- **Power and energy:** Financing of electricity generation projects, including renewables, as well as projects providing midstream services to the oil and gas industry. Just like infrastructure, power and energy financings consists of both brownfield and greenfield projects, with term ranging from 15 to over 40 years when including the construction period and supported by long-term power purchase agreements or similar contracts. Loans in that sector can also be the result of mergers and acquisitions activity. It is not uncommon for an independent power producer to borrow to acquire a portfolio of existing assets from a developer. These projects tend to focus on long-term debt in order to match the underlying contractual framework.

- **Corporate credit:** Loans for general corporate purposes to creditworthy borrowers. We gain access to corporate credit primarily through credit tenant leases ("CTLs"). A CTL involves the financing of a real property leased to a single, investment grade tenant. The loan is secured by a first charge on the property and an assignment of a bondable lease. A bondable lease passes all property risks through to the tenant with no landlord obligations. The credit risk is effectively similar to that of the public securities of the investment grade tenant plus the added bonus of real property security.

- **Real estate debt:** Primarily consists of long-term ground lease financings and, very selectively, first mortgage bonds. We like financing the purchase of leased land because of the long-term nature of the underlying contract, which can range from 50 to 250 years. Rent payments are generally pre-determined for the first 30 years. As ground financiers, we are in a "super senior" position in the capital structure: If ground rent isn't paid, lenders can realize on the land and property to recover our principal. At that point, the loan-to-value would generally be less than 50%.

- **Private securitization:** Monetization of pools of receivables such as equipment leases, auto loans and other type of contractual debts. Private securitization transactions tend to be very short in term and duration but come with a good yield given the underlying complexity.

The fund can invest up to 30% outside North America. However, each non-Canadian private debt investment is hedged back into Canadian dollars for the entire term of the transaction, effectively creating a stream of domestic fixed cash flows.

Fund

Offshore generation

This picture is for illustrative purposes only.

The Yield Advantage through the Uniqueness Premium

Because of their private nature, commercial mortgages and private debt command a yield premium over traditional corporate bonds. We call it the "uniqueness premium".

First, a significant amount of due diligence is required to assess and mitigate risks since no independent credit report is available. The due diligence period can stretch from 2 to over 6 months. This significant investment in time and resources must be compensated.

Second, investors must be compensated for the buy-and-hold nature of the investment. The lack of standard documentation makes each transaction unique and difficult to trade. Investors must be compensated for the lack of immediate liquidity.

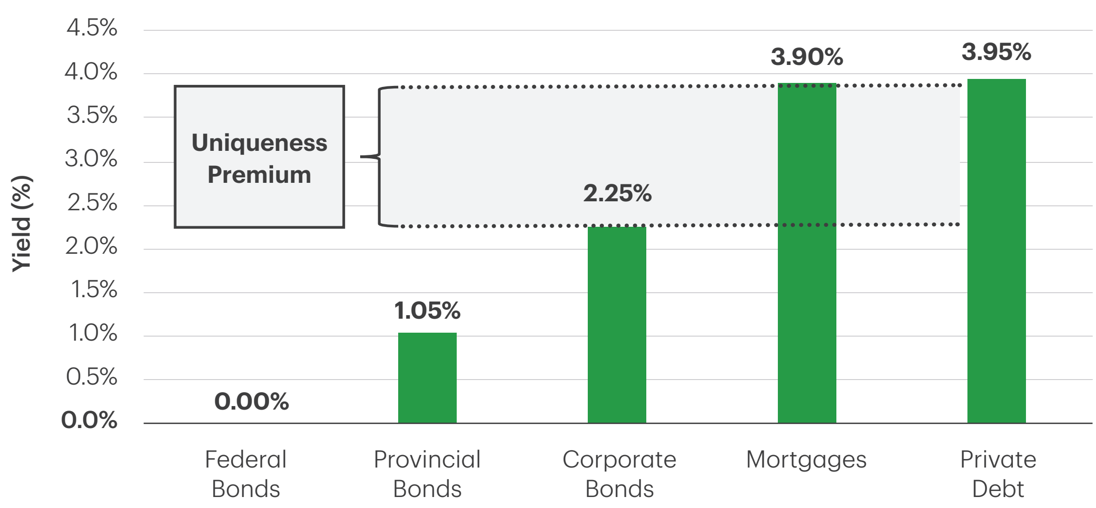
But why would a borrower choose to borrow privately and pay a uniqueness premium (i.e. a higher coupon) than what they would pay in the bank or bond market? The simple answer is flexibility. Bank lending criteria may appear rigid to some borrowers.

For example, the term of a commercial loan would rarely exceed 5 years. Similarly, bond structures are often driven by rating agencies and issuance costs can be onerous, especially for issues of less than $100 million.

A private loan offers a tailor-made solution that cannot otherwise be achieved in the bank or bond market. In return for giving borrowers the flexibility they need, lenders can demand a comprehensive set of covenants, and dictate tighter terms and conditions such as collateral. Typical covenants can include the maintenance of a minimum debt service coverage ratio, distribution restrictions, prohibition on asset sales, etc. The uniqueness premium for private credit investments in a portfolio such as that of the DIY Annuity Portfolio 2.0 can range from 50 to over 150 bps for conventional mortgages and private debt and up to 300 bps for conventional plus and high yield mortgages **(see Chart 2).**

Chart 2

Indicative Credit Spreads by Market Sector



Source: TDAM Internal. Data as of May 31, 2020.

Putting It All Together

TDAM has integrated private credit in numerous client solutions, which has helped those solutions achieve better outcomes through higher income and diversification without necessarily increasing risk.

Helping our clients with their most important challenges

Private credit can be a good complement to traditional fixed income. It allows investors to gain exposure to names that may not be included in the fixed income indices or to sectors that may be under represented. It allows investors to use existing portfolio liquidity to significantly increase yield by harnessing uniqueness premium through and allocation to illiquid investments.

This paper has touched upon two of TDAM's private asset strategies and explored how they are utilized by institutional investors. TDAM's private offerings include a rich stable of alternative investment exposures, including infrastructure and real estate, both focused on domestic assets as well as global asset investments.

The investment opportunities and use cases of private credit are varied in nature. To learn more about TDAM's viewpoint on private credit, and how it can be effectively utilized to help achieve specified investment objectives, we invite to read our library of thought leadership content on said topics:

- **Credit Tenant Lease Loans,** by Bruce Mackinnon, Managing Director and Donna Beck, VP & Director
- **Infrastructure: Anatomy of a Deal,** by Louis Bélanger, VP & Director and Matt Press, Vice President
- **Energy Advancement & Private Debt,** by Bruce Mackinnon, Managing Director and Craig Buckley, VP & Director

Our relationship management team would be happy to discuss how our **Private Credit** offerings can benefit you.

(0720)