Modern Finance

The new finance

A Centrus report and route map

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“We’ve returned to a simpler funding model, with a virtuous and mutually beneficial circle of capital”

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Introduction

"We've returned to a simpler funding model, with a virtuous and mutually beneficial circle of capital"

Phil Jenkins
Managing Director,
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In the last five years we have seen powerful new shifts in the way companies and other organisations obtain finance.

These changes place more real money from savers and investors into real economy borrowers, such as universities and infrastructure projects.

Finance directors and corporate treasurers have never had so many funding options.

These changes follow a first phase of change when, after the financial crisis, banks retreated from lending to re-build their capital bases and work through problematic loan portfolios. Slowly but steadily, the management teams of mid-sized companies, utility firms, housing associations, universities and infrastructure projects identified a new group of finance providers.

But, from about 2013, markets started changing again, gravitating towards a simpler, lower risk and more transparent financing model where the users and providers of long-term capital interact more directly. This return to simplicity is creating a virtuous and mutually beneficial circle of capital. It is reminiscent of the nineteenth century building societies, mutuals and credit unions that provided so much of the finance required for housing and community infrastructure. Although today's version includes sophisticated systems that manage data and reporting.

The modern funding model can also be characterised as finance with purpose. This is illustrated by UK pension funds and insurance companies generating stable and reliable returns by directly financing renewable energy, transport, power and water infrastructure or new affordable housing. In addition to direct, pension fund investment , the new finance features a rapidly growing direct lending market and new alternative income funds - with issuers and borrowers often supported by the advice and technology of imaginative and independent corporate finance houses.

At the same time, and partly in response to these changes, banks have instituted fundamental changes to their lending focus, making fewer long-term loans and freeing up capital for short-term lending. They are also selling legacy long-term loan and swap exposures to those investors with a natural appetite for long-dated assets to match pension and insurance liabilities.

This report explains the main features of the new finance and maps them out graphically. We hope you and your colleagues find it helpful.

Phil Jenkins
Managing Director
and Founding Partner, Centrus

Part 1 - Funding options expand

A rapidly changing finance model

As the financial crisis fades into memory so does the world when banks (and for very large borrowers, public bond markets) alone constituted a company's whole range of funding options.

Figure one shows just how limited those options were, with dominant roles for investment banks and fund management houses, whether owned by banks, insurers or operating independently.

Figure 1:
Financing Model pre-2009

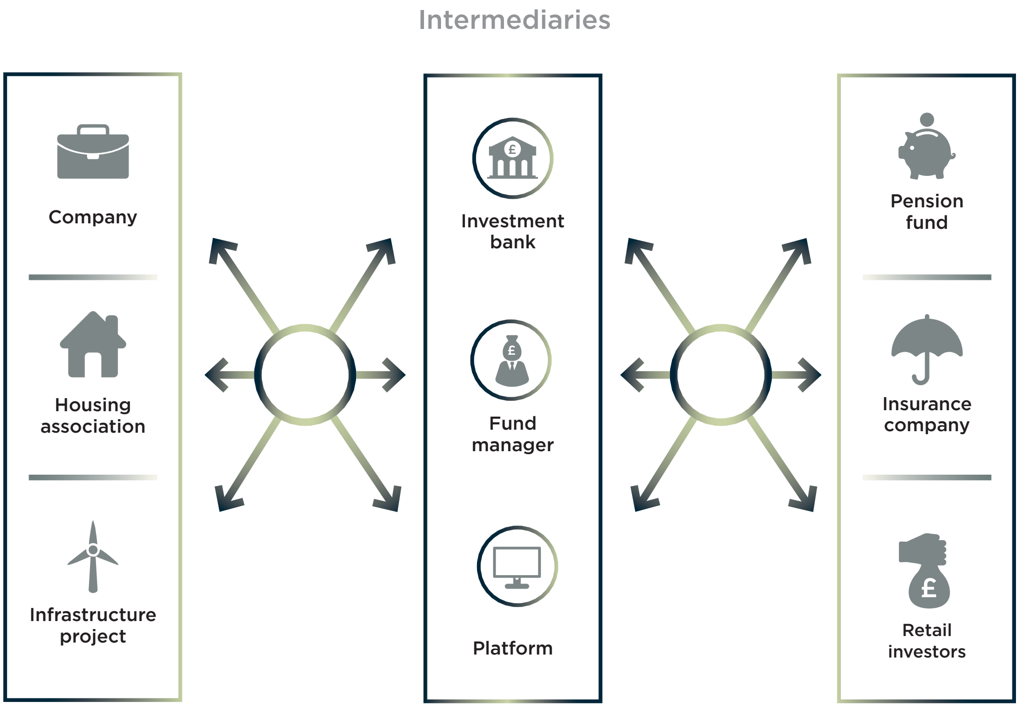
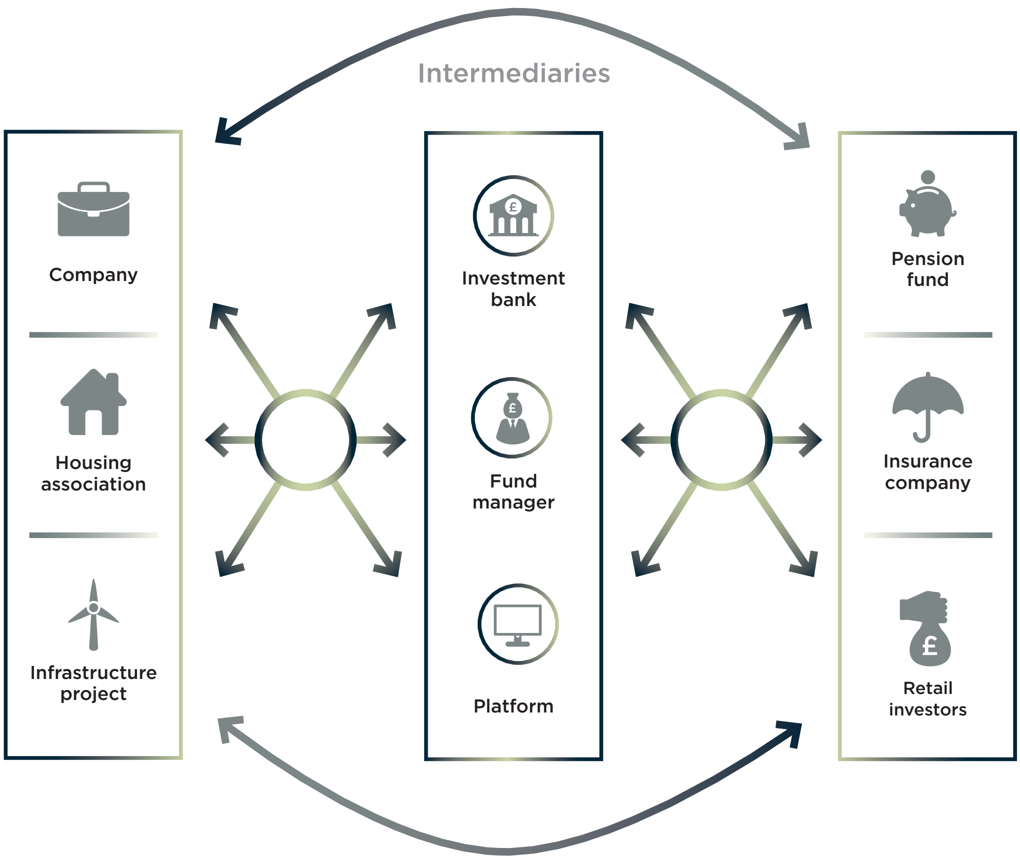


Figure 2:
Financing Model from 2009 to 2013



> "The dividing line between the public sterling bond market and the private placement market has almost been erased"

From 2009, as regulatory and commercial pressures took hold, forward-thinking UK investment groups such as M&G Investments, Legal & General, Aviva Investors and others stepped in to the vacuum left by the banks and put their significant resources to work, using both internal capital and money raised from external clients such as UK local authority pension funds.

But over the last five years we have seen significant structural changes.

Some build on developments in that 2009 to 2013 period, others are newer still.

One driver of change has been the emergence of independent corporate finance houses, such as Centrus, in providing a crucial bridge between supply of and demand for funding in society's essential services.

UK direct lending comes of age

Direct lending via a loan, listed bond or private placement enables a borrower, such as a company, housing association, university, infrastructure project or other mid-sized to large entity, to obtain long term finance (usually bi-laterally) from pension funds and other lenders.

Unlike public capital market finance, these are arranged privately and in most cases bi-laterally, giving borrower and lender a clear line of sight through the arrangement and much higher levels of control over it.

Prior to 2009, the direct lending market in the UK was limited, with only a small handful of institutions willing and able to provide long-term capital to companies and projects. Most borrowers employed bank finance (combined with derivatives, sometimes complex in nature), public credit markets (for deals of around £250 million and upwards) or the well-established and much deeper US private placement market (again the preserve of larger and generally international companies).

Now, the UK direct lending market (including senior lending such as loans and private placements plus more junior instruments) has grown dramatically. According to recent analysis, the number of quarterly deals has risen sharply since the beginning of 2013, with the UK now comfortably completing a significantly larger number of deals than other European nations. More broadly, the total quantum of European fund raising is now on a par with that of the US - which has a far longer history of private placements and other direct lending*.

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*Source: Deloitte Alternative Deal Tracker Summer 2018

Long-term finance for a classic institution

Keble College was founded in 1870 and is one of the largest colleges at University of Oxford.

The college required funding for the construction of new student accommodation and research space.

Centrus met the borrower's bespoke requirements with a 30-year fixed-rate, unlisted note structure that pays a carefully selected single investor 3.366% annually.

From around 2015, a broader and deeper pool of investors started to become more attracted to higher yields or better levels of protection available in private placement investment. And, with a growing number of borrowers and their advisers able to present market consistent deal agreements, investment took off, with **three major implications.**

- Firstly, **there are more lenders in this market.** These include UK pension funds, such as BAE and the Universities Superannuation Scheme; specialist insurers which acquire and manage pension liabilities such as Rothesay Life and Pensions Insurance Corporation and asset managers like Aviva, M&G Investments and Legal & General Investment Management.

  These have recently been joined by major U.S. lenders such as Metlife, Barings and Pricoa - with the latter's UK lending portfolio now standing at circa £11 billion. These institutions have been active in building up their origination and credit capabilities and marketing their propositions directly to issuers.

- Secondly, advisors such as Centrus, have introduced and employed **new innovations in lending formats and structures** that are changing the face of private borrowing (see figure 3).

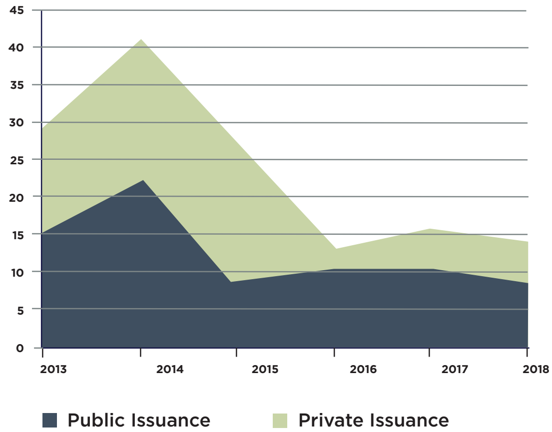
- Thirdly, and perhaps most importantly, **the dividing line between the public sterling bond market and the direct lending market has almost been erased.**

Figure 3:
Innovations in direct lending

Deferred drawdowns	A method of fixing and securing future drawdowns of long-term debt for periods out to 4-5 years which can be an attractive alternative to pre-funding as well as allowing borrowers to de-risk future repayments of existing debt.
Shelf arrangements	The ability to document and easily facilitate additional borrowings on similar terms without commitment on either party. This allows borrowers and investors greater flexibility and speed when it comes to future funding requirements.
Standardisation of loan documentation	In 2015, the Loan Market Association published a suite of English law, standarised private placement documentation. This creates more of a level playing field for lenders to assess risk. This crucial development, little remarked upon publicly, means borrowers can now tap public markets for significantly less than the old threshold of £250 million.

Not only has the dividing line between public and private markets been almost erased but borrowers now also move more easily between public and private markets according to their specific needs.

Figure 4:
Housing associations
Public v Private debt



> "Investors are allocating new finance to doctors' surgeries, distribution warehouses and renewable energy, in ways almost unimaginable before 2013."

In UK housing, that means direct lending on a private basis has closely tracked public debt issuance (see Figure 4).

Take, for example, the case of UK housing association A2Dominion. During the course of 2017 and 2018, Centrus advised the organisation on a major optimisation and diversification of its sources of finance with

- a £60 million unsecured private placement with IFM Investors (the latter's first investment in UK affordable and social housing),
- a £750 million revolving credit facility with BNP, in its first engagement in this sector, and two other financial groups and
- a £250 million 12-year unsecured public bond.

The birth of the alternative income market

The search for yield and a decade of low interest rates has spawned the rapid growth of a new investment class called "alternative income".

This sees investors funding parts of the real economy , such as doctors ' surgeries, distribution warehouses or project finance lending for infrastructure or renewable energy, in ways almost unimaginable before 2013.

Not to be confused with more established alternative asset classes, such as hedge funds or private equity, alternative income funds are structured as listed equity but they actually deliver returns more akin to a fixed income product. That means a stable source of income (yields fixed at 5% or more, or linked to inflation) backed by secure revenues from real assets or other receivables.

The main types of alternative income assets

- peer to peer lending
- secured lending
- social housing
- aircraft leasing
- social infrastructure debt
- economic infrastructure debt
- renewable energy
- real estate secured income

Many of the individual underlying real economy projects financed by these funds are very small in nature, In the past , management teams would have struggled to attract the attention of most equity and debt providers.

But now, pension schemes, insurance companies and other investors have sufficient demand for yield that they are allocating a growing proportion of assets to these real economy projects.

Moreover, such projects tend to offer low correlations to investments in public markets - giving investors a level of diversification hitherto unavailable.

Renewables

In the period from 2012-2017 **£82bn ($109bn)** of equity capital was invested in UK renewables*

NOTES

*Source: Bloomberg NEF - Clean Energy Investment Trends, 2Q 2018

From an investor's perspective, the most important part to the continued success of this market is assessing the underlying risks to determine whether the returns on offer adequately compensate for such risk.

As in so many other areas of the new finance, the role played by independent corporate finance and other advisers has been crucial in linking up real money investors with real economy borrowers.

Given the alternative income market in the UK has largely launched an operated in a low interest rate, low default and generally benign economic environment, the real test for many of these strategies will be their performance when these market conditions change. Robust credit assessments will help investors navigate it more successfully.

Direct pension fund investment in alternative assets

Many UK pension funds, and indeed insurance companies, have bypassed the funds route and are financing companies, housing associations and infrastructure projects directly and building their direct origination, structuring and internal credit capabilities to support this, often hiring people from the banking market where these skill sets have been more prevalent traditionally.

This is in part a direct result of the Government's decision in 2015 to force the UK's 89 local government pension scheme to pool resources and achieve economies of scale.

The theory runs that bigger schemes would also be able to compete for assets more effectively against the huge Canadian and Australian pension schemes, increasingly active in UK infrastructure.

This trend was evident as early as 2015, with the £160 million swap restructuring for Yorkshire Water, a deal Centrus advised on (see page 10 for details) , and it now provides the owners of infrastructure projects, housing and other projects with newer, more confident and more accessible sources of funding.

This UK phenomenon follows an international trend. In 2017, a State Street report indicated that a third of international asset owners have brought some asset management capabilities in house, and a further quarter plan to do so by the end of 2018.[1]

The impact of this development is twofold:

- **Pooled pension funds are more active in alternative strategies**, from non-listed debt and the acquisition of repackaged derivative portfolios to infrastructure and residential property. They pursue such strategies as a means of mitigating poor investment returns from traditional strategies.

- **It represents the new world of finance** which is replacing the complexity and disintermediation of the pre-2009 financial sector and bringing the natural providers of long-term investment capital much closer to those companies and projects with capital requirements which need investment.

Both provide new opportunities for borrowers. These are welcome developments for future financial stability, for the wider UK economy and also the ultimate beneficiaries of safe and predictable investment returns: hardworking savers and their dependents.

New homes made possible by the Pension Insurance Corporation

The Welsh Housing Partnership is a government-backed enterprise. Its remit is to deliver new, good quality affordable housing to those in low paid work who cannot afford to buy a suitable home, and do not have sufficient priority to be allocated scarce social housing.

In March 2017 Pension Insurance Corporation, an insurer of defined benefit pension funds, invested £93 million in secured debt issued by the Partnership, built around advice and structuring from Centrus.

NOTES

1. 'A New Climate for Growth: Cultivating Asset Intelligence to Thrive', State Street 11 September 2017

Customers to access cheaper energy bills thanks to long-term 100% debt financing

Cheaper energy for Northern Irish consumers

One of the key elements of the new finance is its ability to make real differences to people.

Centrus provided advice and structuring on a typical new finance deal for **Mutual Energy**, a Northern Irish infrastructure owner and operator. Given its mutual structure, the business can pass financial benefits straight onto its customers. In 2018, Centrus devised and advised on a £200 million debt finance package for Mutual Energy with Legal & General Investment Management.

This will enable a landmark extension of mains gas to thousands of homes currently not connected to the network.

But, just as importantly, Centrus structured the deal mindful of client's structure and purpose. It means that Mutual's debt repayments will be 35% lower than originally forecast - and cost savings such as this can be passed directly to consumers in the form of lower energy bills for many years to come.

2 Ground breaking swap restructures for the utility sector

Ground breaking swap restructures for the utility sector

As banks address their legacy balance sheets to free up more capacity for shorter term, economically useful lending they are selling longer-term assets. Many of these are in the utilities space.

In 2015 **Yorkshire Water** sought to restructure its index-linked swaps and diversify its sources of funding - and they turned to Centrus , with its extensive experience in the sector.

In a first-of-its-kind deal, the water supply and treatment utility company achieved a complete restructuring of its inflation exposure , with the removal of mandatory breaks from the swaps, packaged up for a consortium of pension schemes and other long-term institutional investors, with strong appetite for inflation risk.

In a similar vein, Centrus also advised **Electricity North West** on the restructuring of their index-linked swaps.

This gave the electricity distributor a more diversified book of lenders, including pension schemes and other long-term investors, and a simpler portfolio, divided into on-balance sheet and institutional swaps.

In all, Centrus has advised on ten comparable deals, with a combined value of £1.1 billion, linking up eight borrowers with long-term savings institutions.

Part 2 - Mapping out the new finance

Sometimes the past provides a guide to the future.

In 1775 a pub landlord in Birmingham called Richard Ketley founded what is believed to be the first building society named, perhaps immodestly, after himself. The goal of Ketley's Building Society was simple: pool members' financial resources to purchase land and build homes for them. So successful was his idea that by the nineteenth century almost every British town had its own society.

This was the heyday of community finance – where people put their own money towards projects that would benefit them and the place where they lived.

But fast forward almost 250 years and today it is possible to hear echoes of this in the new finance.

Certainly, modern finance contains many of the best aspects of that early financing model, with more direct interaction between providers and users of capital.

But today there are two major differences. Firstly, with such a broad array of funding options for any borrower- with varying levels of price, client service and vaue add - the new finance can appear complex. This is why we have mapped it out on the following page.

Secondly, it can also be data intensive.

It has been estimated that information overload cost the U.S. economy almost $1 trillion and 28 billion hours in 2010[3]. Worldwide data is predicted to grow to 163 zettabytes (or one trillion gigabytes) per annum by 2025, according to IDC research[4].

In some respects, there is little that's new here. Human complaints about information overload go back as far as the written word – The Book of Kohelet (Ecclesiastes), 12:12, complains, "of making books there is no end".

But, for mid-sized businesses and other borrowers, the necessity of accurate data management, interrogation and reporting is growing more significant – and more commercially material by the day. And reliance on Microsoft Excel spreadsheets is increasingly risky.

Modern systems remove or reduce this risk, by helping finance departments manage real-time data to facilitate prompt, accurate and reliable decision making and reporting. They can do so by adding real commercial value too.

virgin atlantic

Adding value to a transatlantic leader

When the finance department of leading airline **Virgin Atlantic** wanted to move beyond Excel spreadsheets, they called in the experts at Centrus Analytics.

Some of the challenges faced by the group included the valuation of complex instruments and the time-consuming nature of compiling reports. Above all, the department wanted to streamline its processes and reduce risk.

Centrus designed a solution that not only delivered detailed daily dashboards but also saved significant hours of administrative work. Moreover, Centrus consultants worked closely with the finance department to ensure its edging strategy fitted wider internal goals and kept up to date with market best practice.

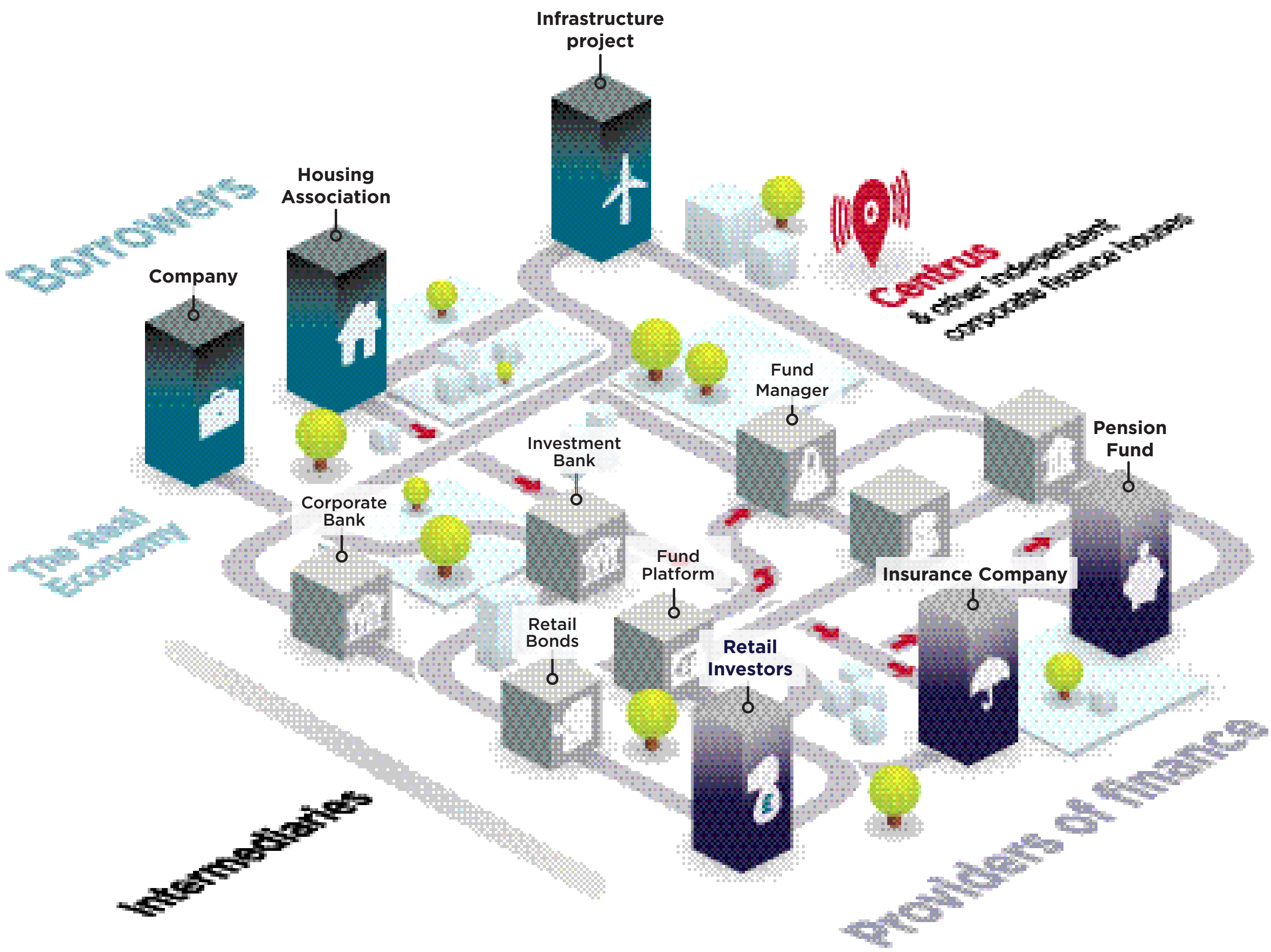
With independent advisors working closely with those that need finance and those able to supply it, the role of advisers in the new finance is characterised by the addition of value to clients through ideas, independent, non-conflicted advice and an unwavering focus on mutually beneficial and long-term relationships.

Above all it means financing activities with a real, every day impact on people and communities – finance with purpose.

NOTES

[3] Jonathan B Spira: Overload! (2011)

[4] Source: IDC and Seagate: Data Age 2025, April 2017"



The new finance
Map

Company
Corporate borrowers are diversifying their sources of funding, typically through independent advisers and by using more direct finance.

Housing association
Registered providers have blurred the line between public and private borrowing markets – setting new benchmarks in imaginative, long-term deals.

Infrastructure project
The range of infrastructure borrowers is expanding all the time – as are the long-term financing options open to them.

Centrus and other independent corporate finance houses
The last five years has seen the birth of a more vibrant, independent advisory sector – with businesses such as Centrus playing a more central role in the flow of finance from real money lenders to real economy borrowers.

Consultant
The gatekeeper between pension funds and their fund managers and / or underlying assets.

Investment bank
Once predominant in shepherding the flow of finance between fund managers and clients, these intermediaries are now moving from from long-term lending towards more economically useful short-term finance.

Corporate bank
Formerly a key player in helping companies gain access to funding, corporate banks are seeing greater competition from more independent advisers, sometimes with a more holistic offering.

Fund manager
A key player in the allocation of asset owner finance, fund managers now enjoy access to a broad range of simpler, more transparent deals and securities.

Retail bond platform
A key development in recent years, retail bonds can enable companies to tap new long-term sources of finance without excessive and sometimes costly intermediation.

Fund wholesale platform
A key development in recent years, fund platforms can provider consumers with access to a broad range of investment options.

Institutional platform
An emerging trend, seen particularly in infrastructure investment, that pools asset owner funds d to achieve economies of scale and lower investment fees.

Pension fund
Defined benefit and defined contribution pension schemes, with a broad spectrum of asset allocation, duration, return target and liquidity requirements.

Insurance company
Typically life insurers but also general insurance companies.

Retail investors
A broad spectrum of consumers, advised or unadvised, investing in mutual funds and / or direct securities – all ultimately providing long-term finance to the real economy.

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