

# MOODY'S

## INVESTORS SERVICE

### CREDIT OPINION

27 August 2018

#### Update

 Rate this Research

#### RATINGS

##### PSP Capital Inc.

Domicile	Canada
Long Term Rating	Aaa
Type	LT Issuer Rating
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

#### Contacts

Jason Mercer, CFA +1.416.214.3632  
VP-Senior Analyst  
jason.mercer@moody's.com

Rabia Yusufzai +1.416.214.3853  
Associate Analyst  
rabia.yusufzai@moody's.com

Robert M. Callagy +1.212.553.4374  
Senior Vice President/Manager  
robert.callagy@moody's.com

Marc R. Pinto, CFA +1.212.553.4352  
MD-Financial Institutions  
marc.pinto@moody's.com

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Japan 81-3-5408-4100  
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## PSP Capital Inc.

### Update to credit analysis

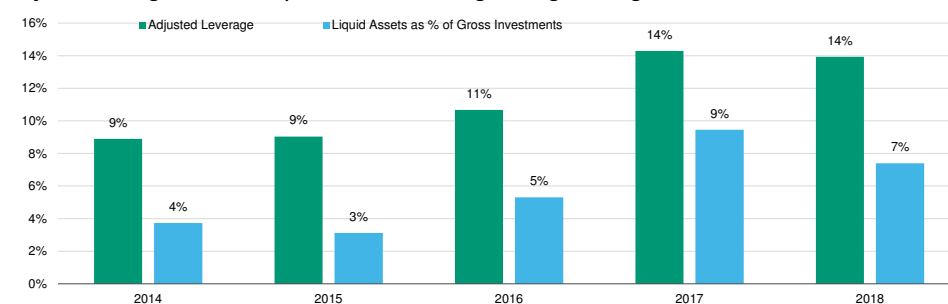
#### Summary

PSP Capital has a long-term issuer rating of Aaa and backed commercial paper rating of Prime-1, reflecting the unconditional and irrevocable guarantee of its debt obligations by the Public Sector Pension Investment Board (PSPIB). PSPIB uses this subsidiary to add a moderate degree of leverage and increase the return of its investment portfolio by issuing medium term notes and commercial paper.

PSP Capital's long-term issuer rating of Aaa is equal to that of its sponsor anchor, the Government of Canada (Aaa stable), based on the guarantee from PSPIB. The strength of the guarantor is the product of (1) a legal framework that mandates PSPIB as exclusive investment manager for certain pension Plans sponsored by the Government of Canada; (2) highly predictable cash flows, with positive net contributions expected for at least 5 years; and (3) strong coverage of obligations by high quality liquid assets. PSPIB creditors have an effective priority claim on PSPIB's assets because the statutory framework provides that the Government of Canada may only call upon the net assets of PSPIB to pay Plan benefits. As a result, PSPIB's obligations under the PSP Capital guarantee rank senior to the amounts that become due to the pension Plans and pari passu with PSPIB's other senior unsecured obligations.

Exhibit 1

#### Adjusted leverage is low and liquid assets offer strong coverage of obligations



Fiscal year ending March 31, Liquid assets represents cash and money market securities and securities purchased under reverse repurchase agreements

Source: Data from company reports, Moody's Investors Service

## Credit strengths

- » Unconditional and irrevocable guarantee from PSPIB
- » Statutory framework mandates PSPIB as exclusive investment manager for certain Canadian government sponsored pension Plans
- » Highly predictable cash flows, with positive net contributions projected for at least 5 years
- » Strong coverage of obligations by high quality liquid assets
- » Moderate use of leverage, since PSPIB limits recourse debt to a maximum of 10% of assets under administration

## Credit challenges

- » Execution risk associated with the transition to a higher allocation to private investments
- » Private investments suit PSPIB's long-term investment horizon but weaken portfolio liquidity
- » Maintaining effective risk management as PSPIB continues to grow

## Outlook

The rating outlook is stable.

## Factors that could lead to an upgrade

- » An upgrade is not possible

## Factors that could lead to a downgrade

- » A material reduction in PSPIB's liquid assets relative to our stress assumptions
- » A change in the legislative framework, although we do not view this as likely
- » A downgrade of the sponsor anchor, the Government of Canada

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Key indicators table

Exhibit 2

### PSP Investment Board [1]

Statistics for Public Sector Pension Investment Board	2018	2017	2016	2015	2014
Total Assets (C\$ millions)	179,139	158,973	131,660	124,637	103,621
Net Assets (C\$ millions)	152,994	135,562	116,761	111,967	93,705
Fixed Income % Net Investments	18%	18%	21%	20%	20%
Public Equities % Net Investments	34%	41%	41%	50%	53%
Private & Real Assets % Net Investments	48%	41%	38%	30%	28%
Liabilities C\$ millions	26,145	23,411	14,899	12,668	9,916
Liabilities % Gross Assets	15%	15%	11%	10%	10%
Unsecured Debt (C\$ millions)	12,249	10,846	8,878	7,445	6,258
Unsecured Debt % Gross Assets	7%	7%	7%	6%	6%
Secured Funding (C\$ millions)	12,459	11,258	5,258	3,426	2,568
Secured Funding % Gross Assets	7%	7%	4%	3%	2%
Other Liabilities % Gross Assets	1%	1%	1%	1%	1%
Derivative Notionals (C\$ millions)	391,213	311,339	207,550	284,383	202,356
Annual Reported Return (%)	9.8%	12.8%	0.7%	14.2%	15.9%
Benchmark Return (%)	8.7%	11.9%	0.3%	13.1%	13.9%

[1] Information based on IFRS financial statements for 2014-2018

Source: Source: Moody's Financial Metrics

## Profile

PSPIB was established by the Public Sector Pension Investment Board Act (PSPIB Act) in 1999 to manage assets for the pension plans (Plans) of the Canadian Federal Public Service, the Canadian Forces, and the Royal Canadian Mounted Police in respect of service since April 2000, as well as the Canadian Reserve Force for service since March 2007.

## Detailed credit considerations

### Statutory framework mandates PSPIB as exclusive investment manager for certain Canadian government sponsored pension plans

PSPIB's has a strong franchise value underpinned by its role as the exclusive investment manager for four public service pension plans (the Plans) sponsored by the Government of Canada (Aaa, stable). See 'Corporate Governance' below for a detailed description of PSPIB's structure and mandate. A change in PSPIB's status would have to be approved through a legislative process. PSPIB's strong investment track record makes such a change unlikely: with a portfolio return of 10.5% over the five years to 31 March 2018, PSPIB has outperformed its benchmark index by approximately 110 basis points.

### PSPIB's creditors effectively rank ahead of amounts due to the plans

PSPIB is an exclusive asset manager of the four pension plans, but does not have legal responsibility for their liabilities, which are those of the Government of Canada. We note that the legislative acts constituting PSPIB do not explicitly define the priority of PSPIB's unsecured creditors relative to the amounts due to the Plans. However, it is our view that PSPIB creditors have an effective priority claim on PSPIB's assets because the statutory framework provides that the Government of Canada may only call upon the net assets of PSPIB to pay Plan benefits. In this context, net assets means assets with a fair market value in excess of liabilities, including the unsecured obligations that PSPIB guarantees. As a result, PSPIB's obligations under the PSP Capital guarantee rank senior to the amounts that become due to the pension Plans and pari passu with PSPIB's other senior unsecured obligations. Similarly the Plans are only entitled to the net returns after PSPIB's operational costs. On a gross asset base of CAD179 billion at 31 March 2018, PSPIB had CAD153 billion in net assets, which we view as a loss absorbing cushion to the benefit of PSPIB's creditors. Adjusting for nettable, but not offset, repurchase agreements, PSPIB's leverage ratio was 14% as at 31 March 2018.

PSP Capital had outstanding debt of CAD12.2 billion at 31 March 2018, of which CAD6 billion matures within 12 months. PSPIB's policy is to limit recourse debt, including guaranteed credit facilities, to a maximum of 10% of total assets under management (defined as

net investments plus recourse debt). In January 2013, PSP Capital established a US commercial paper program in order to diversify its funding sources and provide a natural hedge for its US dollar denominated assets.

### **Strong fundamental liquidity allows PSPIB to pursue a long-term investment strategy**

PSPIB's fundamental liquidity position is particularly strong as a result of the actuarial profile of the Plans for which it invests. These Plans relate to employee service since 2000 (or 2007 in the case of one of the Plans) and net contributions to PSPIB are expected to exceed benefit payments for at least 5 years. PSPIB's net assets increased by 2.9% in fiscal 2018, before investment returns, as a result of positive net contributions. With investment returns, total growth in net assets was 12.9%. Actuarial projections indicate that the PSPIB's net assets will increase to over CAD200 billion by 2025 from CAD153 billion at 31 March 2018. PSPIB is also not subject to plan redemptions or loss of mandate, except in the unlikely event of a change in legislation. These characteristics allow PSPIB to adopt a long-term investment horizon. Under the current legislative framework, the Government of Canada has only limited discretion around the funding of the Plans.

Amounts are transferred to PSPIB on a semi-monthly basis, and a defined mechanism requires the government to make special payments over a fifteen year period if the actuarial valuation of a Plan indicates a deficit. If the Plans have a material funding surplus then contributions may be reduced or withdrawn. However, as at the most recent actuarial valuations, the three largest Plans (representing 99% of PSPIB's assets) all had funding deficits.

As at 31 March 2018, PSPIB's investment portfolio was comprised of 18% fixed income, 34% public equity, 48% private and real investments. PSPIB's liquidity monitoring incorporates valuation haircuts and stressed collateral funding requirements.

### **Growth in private investments suits investment horizon, but weakens portfolio liquidity and entails risk management challenges**

At March 2018, PSPIB's allocation to private equity and real assets stood at 48% of net assets compared to a long-term target weight of 50%. PSPIB's principal challenge will be to manage rapid portfolio growth while materially increasing its exposure to less liquid private asset classes. The long-term investment horizon and liquidity from expected positive net contributions leaves it well positioned to execute this strategy, but a rising proportion of private investments will inevitably weaken the overall liquidity of the portfolio. This kind of portfolio transition entails monitoring and other execution risks as well as potential asset concentrations. PSPIB has sought to address this through disciplined investment selection and an expansion of its in-house investment team and risk management infrastructure. Moody's believes risks are well managed, although this capability will need to continue to keep pace with asset growth and rising complexity in order to maintain credit quality.

PSPIB's investment approach is framed by a Policy Portfolio designed to achieve a return at least equal to the long-term actuarial return used by Chief Actuary in the valuation of the Plans (i.e. a real return of 4.0%) with an acceptable level of funding risk. In addition, PSPIB seeks to generate an additional return through active management within defined risk limits, for example by varying the allocation to a particular sector compared to the Policy Portfolio. In 2016, PSP changed its policy portfolio by reducing target allocations in public equity in favour of more private and real assets; adding a new asset class, Private Debt.

### **Corporate governance: Status as a Crown corporation entails a rigorous supervisory framework**

PSPIB was established by the Public Sector Pension Investment Board Act (PSPIB Act) in 1999 to manage the assets of certain public sector pension plans. PSPIB manages assets for the pension plans (the Plans) of the Canadian federal Public Service (72.6% of PSPIB net assets at 31 March 2018), Canadian Forces (19.7%), the Royal Canadian Mounted Police (7.3%) and the Canadian Reserve Force (0.4%). The amounts are transferred to the PSPIB according to the Superannuation Act of each Plan and relate to service since April 2000 (or March 2007 for the Reserve Force Plan).

According to its statutory mandate, PSPIB is required to manage the funds transferred to it in the best interests of the contributors and beneficiaries under the Plans and to maximize investment returns without undue risk of loss, having regard to the funding, policies and requirements of the Plans and their ability to meet their financial obligations. PSPIB's Board Directors are appointed by the Governor in Council upon the recommendation of the President of the Treasury Board. The Treasury Board President's recommendation is made from a list of qualified candidates recommended by a nominating committee comprised largely of representatives of the Plans.

While investment decisions are made at arm's length from the government, PSPIB's status as a Crown corporation entails a rigorous supervisory framework. The Chief Risk Officer has oversight of all enterprise risks and direct access to the Board. As required by the Financial Administration Act, a special examination is undertaken at least every 10 years to ensure that its governance and controls are robust. The last report, published in May 2011, found no significant deficiencies in PSPIB's systems and practices.

### Support and structural considerations

As noted above, PSP Capital's long-term issuer rating is at the highest level of Aaa. Therefore, PSP Capital's ratings do not have any uplift from the very high probability, in our view that the Government of Canada would provide PSPIB (and by definition, PSP Capital) extraordinary support if needed.

We note that PSPIB is not a crown corporation with agency status and is not guaranteed by the Government of Canada. We base our expectation of support on the fact that PSPIB's asset base supports the pension benefits of Canadian public servants, including members of the armed forces. We believe it is highly unlikely that the federal government would let the financial strength of PSPIB weaken such that its ability to meet its obligations was in doubt.

### Ratings

Exhibit 3

Category	Moody's Rating
<b>PSP CAPITAL INC.</b>	
Outlook	Stable
Issuer Rating	Aaa
Bkd Senior Unsecured -Dom Curr	Aaa
Bkd Commercial Paper	P-1

Source: Moody's Investors Service

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