



# Principal Credit Fund - Pooled Fund Financial Statements

DECEMBER 2018

**British Columbia Investment Management Corporation  
Principal Credit Fund - Pooled Investment Portfolio**

**MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING**

British Columbia Investment Management Corporation (BCI) manages the Principal Credit Fund (Fund) on behalf of governing fiduciaries such as pension fund trustees and other public sector clients. This report contains the financial statements for the Fund for the period ended December 31, 2018.

The financial statements of the Fund have been prepared by management of BCI and approved by the Chief Investment Officer/Chief Executive Officer. All of the financial statements have been prepared in accordance with International Financial Reporting Standards. The significant accounting policies used in the preparation of these statements are disclosed in note 3 to the financial statements. The statements include certain amounts that are based on management's judgement and best estimates.

BCI's Board has established an Audit Committee. The Committee's mandate includes making recommendations on the appointment of the external auditor for the Fund, reviewing the external audit plan; reviewing BCI's Service Organization Controls Report for the Investment System of British Columbia Investment Management Corporation, and reviewing the annual audited financial statements of the Fund. The Committee reviews the recommendations of the internal and external auditors with respect to internal controls and the responses of management to those recommendations, and also meets with management and the internal and external auditors to review annual audit plans.

BCI maintains systems of internal control and supporting processes to provide reasonable assurance that assets are safeguarded; that transactions are appropriately authorized and recorded; and that there are no material misstatements in the financial statements. BCI's internal control framework includes: a strong corporate governance structure; a code of conduct that includes conflict of interest guidelines; an organizational structure that provides for appropriate segregation of duties and accountability for performance; an enterprise-wide risk management framework that identifies, monitors and reports on key risks; and Board-approved Pooled Investment Portfolio Policies and client-approved investment mandates. BCI's system of internal control is supported by external auditors who review and evaluate internal controls and report directly to the Audit Committee.

The Fund's external auditors, KPMG LLP, have full and unrestricted access to the Audit Committee and BCI management. KPMG LLP discusses with management and the Committee the results of their audit of the Fund's financial statements and related findings with respect to such audits. The Fund is audited by KPMG LLP in accordance with Canadian generally accepted auditing standards. KPMG LLP has performed such tests and other procedures as they considered necessary to express an opinion on the Fund's financial statements.

[S] Gordon J. Fyfe

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Gordon J. Fyfe  
Chief Executive Officer / Chief Investment Officer

[S] Lawrence E. Davis

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Lawrence E. Davis  
Senior Vice President, Finance

Victoria, British Columbia  
July 4, 2019



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## INDEPENDENT AUDITORS' REPORT

To the Unitholders of the Principal Credit Fund managed by British Columbia Investment Management Corporation:

### ***Opinion***

We have audited the financial statements of the Principal Credit Fund (the Fund), which comprise:

- the statement of financial position as at December 31, 2018
- the statement of comprehensive income for the period from inception on April 1, 2018 to December 31, 2018
- the statement of changes in net assets attributable to holders of redeemable units for the period from inception on April 1, 2018 to December 31, 2018
- the statement of cash flows for the period from inception on April 1, 2018 to December 31, 2018
- and notes to the financial statements, including a summary of significant accounting policies.

(Hereinafter referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Principal Credit Fund as at December 31, 2018, and its financial performance and its cash flows for the period from inception on April 1, 2018 to December 31, 2018 in accordance with International Financial Reporting Standards (IFRS).

### ***Basis for Opinion***

We conducted our audits in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the "***Auditors' Responsibilities for the Audit of the Financial Statements***" section of our auditors' report.

We are independent of the Fund in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

## ***Responsibilities of The Manager and Those Charged with Governance for the Financial Statements***

The Manager is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS, and for such internal control as the Manager determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Manager is responsible for assessing the Fund's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the Manager either intends to liquidate the Fund or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Fund's financial reporting process.

## ***Auditors' Responsibilities for the Audit of the Financial Statements***

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.

The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Manager.



- Conclude on the appropriateness of the Manager's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Fund's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Fund to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audits.

*KPMG LLP*

Chartered Professional Accountants

Vancouver, Canada  
July 4, 2019

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO

**PRINCIPAL CREDIT FUND**

**Statement of Financial Position**

(all amounts in thousands except number of units)

	Note	December 31, 2018 (note 1)
<b>Assets</b>		
Investments		\$ 1,665,240
<b>Liabilities</b>		
BCI cost recoveries payable	4	558
Other accounts payable		12
		<u>570</u>
<b>Net assets attributable to holders of redeemable units</b>		<u><u>\$ 1,664,670</u></u>
<i>Number of redeemable units outstanding</i>	5	1,516.453
<b>Net assets attributable to holders of redeemable units per unit</b>		<u><u>\$ 1,098</u></u>
<i>Unfunded committed capital</i>	6	

**Statement of Comprehensive Income**

(all amounts in thousands)

	Note	Period Ended December 31, 2018 (note 1)
<b>Revenue:</b>		
Foreign exchange loss		(26)
Change in fair value of investments:		
Net realized gain		26
Net change in unrealized appreciation		90,247
Total revenue		<u>90,247</u>
<b>Expenses:</b>		
BCI cost recoveries	4	3,741
Administrative fees		71
Pursuit costs		708
Total operating expenses		<u>4,520</u>
<b>Increase in net assets attributable to holders of redeemable units</b>		<u><u>\$ 85,727</u></u>

[S] Gordon J. Fyfe

Gordon J. Fyfe  
Chief Executive Officer  
Chief Investment Officer

*See accompanying Notes to the Financial Statements.*



BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO

**PRINCIPAL CREDIT FUND**

**Statement of Changes in Net Assets Attributable to Holders of Redeemable Units**  
(all amounts in thousands)

	Period Ended December 31, 2018 <i>(note 1)</i>
Balance, beginning of period	\$ -
Increase in net assets attributable to holders of redeemable units	85,727
Redeemable unit transactions:	
Proceeds from units issued	<u>1,578,943</u>
Net increase from redeemable unit transactions	<u>1,578,943</u>
<b>Balance, end of period</b>	<b><u>\$ 1,664,670</u></b>

**Statement of Cash Flows**  
(all amounts in thousands)

	Period Ended December 31, 2018 <i>(note 1)</i>
<b>Operating activities:</b>	
Increase in net assets attributable to holders of redeemable units	\$ 85,727
Adjustments for:	
Effect of exchange rate changes on cash	26
Net realized gain from investments	(26)
Net change in unrealized appreciation of investments	(90,247)
Proceeds from sale of investments	15,537
Amounts paid for purchase of investments	(1,590,504)
BCI cost recoveries payable	558
Other accounts payable	12
	<u>(1,578,917)</u>
<b>Financing activities:</b>	
Proceeds from issuance of redeemable units	<u>1,578,943</u>
	<u>1,578,943</u>
Net increase in cash	26
Effect of exchange rate changes on cash	(26)
<b>Cash, beginning and end of period</b>	<b><u>\$ -</u></b>

*See accompanying Notes to the Financial Statements.*

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO

PRINCIPAL CREDIT FUND

**Schedule of Investments**  
as at December 31  
(all amounts in thousands)

	2018	
	<u>Fair Value</u>	<u>Cost</u>
<b>Private Debt Investments<sup>1</sup>:</b>	\$ 1,665,236	\$ 1,574,989
<b>Money Market Investments:</b>		
Units in BCI Pooled		
Investment Portfolio:		
Fund ST1	<u>4</u>	<u>4</u>
<b>Total Investments</b>	<u>\$ 1,665,240</u>	<u>\$ 1,574,993</u>

<sup>1</sup> The private debt investments are held through private corporations and limited partnerships.

*See accompanying Notes to the Financial Statements.*



BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**1. The Portfolio**

British Columbia Investment Management Corporation ("BCI") was established under the *Public Sector Pension Plans Act* as a trust company authorized to carry on trust business and investment management services. The address of BCI's registered office is 750 Pandora Avenue, Victoria, British Columbia, Canada. These financial statements have been prepared by BCI and are the responsibility of BCI management.

Under the *Public Sector Pension Plans Act* and the *Pooled Investment Portfolios Regulation*, B.C. Reg. 447/99 (the "Regulations"), BCI may establish and operate pooled investment portfolios ".... in which money from trust funds, special funds or other funds, other public money and the money of government bodies and designated institutions may be combined in common for the purpose of investment by means of investment units of participation in a pooled investment portfolio." In addition, pooled investment portfolios "the Funds" previously established under the *Financial Administration Act* and the *Pooled Investment Portfolios Regulation*, B.C. Reg. 84/86, were continued under the *Pooled Investment Portfolios Regulation*, B.C. Reg. 447/99, to be held in trust by BCI and invested by the Chief Investment Officer of BCI.

The Principal Credit Fund ("the Fund") was established on the following date:

Pooled Investment Portfolio	Dates Established
Principal Credit Fund	April 1, 2018*

\*As this Fund was established in 2018, no comparative figures have been presented in these financial statements.

**2. Basis of preparation**

(a) Statement of compliance

These financial statements have been prepared in compliance with International Financial Reporting Standards ("IFRS"). These financial statements were authorized for issue by the Chief Executive Officer / Chief Investment Officer on July 4, 2019.

(b) Accounting for investments

The Fund qualifies as an investment entity as it meets the following definition of an investment entity outlined in IFRS 10, Consolidated Financial Statements (IFRS 10):

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services.
- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both.
- Measures and evaluates the performance of substantially all of its investments on a fair value basis.

No significant judgments or assumptions were made in determining that the Fund meet the definition of an investment entity as defined in IFRS 10.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**2. Basis of preparation (continued)**

(c) Basis of measurement

These financial statements have been prepared on a historical cost basis except for investments, which are measured at fair value.

(d) Functional and presentation currency

These financial statements are presented in Canadian dollars which is the Funds' functional currency.

(e) Use of estimates and judgment

The preparation of financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, revenue and expenses. In determining the fair value of some of its investments, BCI reviews and assesses external managers' estimates and assumptions regarding investment industry performance and prospects, as well as general business and economic conditions that prevail or are expected to prevail. By nature, these asset valuations are subjective and do not necessarily result in precise determinations. Financial results as determined by actual events could differ from those estimates and assumptions, and the difference could be material.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to estimates are recognized in the period in which the estimates are revised and in any future period affected. Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next fiscal year is included in note 8. This information relates to the determination of fair value of investments with significant unobservable inputs.

**3. Significant accounting policies**

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

(a) Financial instruments

(i) Recognition and measurement

Financial instruments are required to be classified into one of the following categories: amortized cost, fair value through other comprehensive income ("FVOCI") or fair value through profit or loss ("FVTPL"). All financial instruments are measured at fair value on initial recognition. Measurement in subsequent periods depends on the classification of the financial instrument. Transaction costs are included in the initial carrying amount of financial instruments except for financial instruments classified as FVTPL in which case transaction costs are expensed as incurred.

Financial assets and financial liabilities are recognized initially on the trade date, which is the date on which the Fund becomes party to the contractual provisions of the instrument. The Fund derecognizes a financial liability when its contractual obligations are discharged, cancelled or expired.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**3. Significant accounting policies (continued)**

(a) Financial instruments (continued)

(i) Recognition and measurement (continued)

Financial assets and liabilities are offset and the net amount presented in the Statement of Financial Position only when the Fund has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

A financial asset is measured at amortized cost if it meets both of the following conditions:

- it is held within a business model whose objective is to hold assets to collect contractual cash flows; and
- its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A financial asset is measured at FVOCI if it meets both of the following conditions:

- it is held within a business model whose objective is to hold assets to collect contractual cash flows and sell financial assets; and
- its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

All financial assets not classified as measured at amortized cost or FVOCI as described above are measured at FVTPL. On initial recognition, the Fund irrevocably elects to measure financial assets that otherwise meets the requirements to be measured at amortized cost or at FVOCI as at FVTPL when doing so results in more relevant information.

Financial assets are not reclassified subsequent to their initial recognition, unless the Fund changes its business model for managing financial assets, in which case all affected financial assets are reclassified on the first day of the first reporting period following the change in the business model.

The Fund has not classified any of its financial assets as FVOCI.

A financial liability is generally measured at amortized cost, with exceptions that may allow for classification as FVTPL. These exceptions include financial liabilities that are mandatorily measured at fair value through profit or loss, such as derivative financial liabilities. On initial recognition, the Fund irrevocably designates a financial liability as measured at FVTPL when doing so results in more relevant information.

(ii) Fair value through profit and loss

Financial instruments classified as FVTPL are subsequently measured at fair value at each reporting period with changes in fair value recognized in the statement of comprehensive income in the period in which they occur. The Fund's investments and redeemable units are classified as FVTPL.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of financial assets and liabilities traded in active markets (such as publicly traded derivatives and marketable securities) are based on quoted market prices at the close of trading on the reporting date. The Fund's policy is to recognize transfers into and out of the fair value hierarchy levels as of the date of the event or change in circumstances giving rise to the transfer.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**3. Significant accounting policies (continued)**

(a) Financial instruments (continued)

(ii) Fair value through profit and loss (continued)

The fair value of financial assets and liabilities that are not traded in an active market is determined using valuation techniques. Valuation techniques include the use of comparable recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, and others commonly used by market participants and which make the maximum use of observable inputs. Should the value of the financial asset or liability, in the opinion of BCI, be inaccurate, unreliable or not readily available, the fair value is estimated on the basis of the most recently reported information of a similar financial asset or liability.

(iii) Amortized Cost

Financial assets and liabilities classified as amortized cost are recognized initially at fair value plus any directly attributable transaction costs. Subsequent measurement is at amortized cost using the effective interest method, less any impairment losses. The Fund classifies BCI cost recoveries payable and other accounts payable as amortized cost.

The effective interest method is a method of calculating the amortized cost of a financial asset or liability and of allocating interest income or expense over the relevant period. The effective interest rate is the rate that discounts estimated future cash payments through the expected life of the financial asset or liability, or where appropriate, a shorter period.

(b) Redeemable units

The Fund classifies financial instruments issued as financial liabilities or equity instruments in accordance with the substance of the contractual terms of the instruments. In accordance with the Regulations, the Fund is required to distribute, to unitholders of the Fund's redeemable units, the taxable income and taxable capital gains of the Fund at least annually. Accordingly, such units are classified as financial liabilities at FVTPL and measured at redemption amount. Distributions to holders of redeemable units are recognized in comprehensive income when they are authorized and no longer at the discretion of BCI.

(c) Issue and redemption of units

Participation in the Fund is expressed in units. The initial value of a unit on inception is \$1 million. For each subsequent unit issuance and redemption, the unit value is determined by dividing the fair value of the net assets of the portfolio by the total number of units outstanding. Where one Fund invests in another Fund, the unit issuances and redemptions are transacted on the same basis as client transactions. All unit transactions are recorded on a trade date basis. The Fund was open participation throughout the year where the number of units available for issue was unlimited and the proportion of units issued or redeemed by each client on a particular valuation date depended on changes to their desired asset allocation.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**3. Significant accounting policies (continued)**

(d) Revenue recognition

Interest income is recognized on an accrual basis using the effective interest method. Dividend income is recognized on the date that the right to receive payment is established, which for quoted equity securities is usually the ex-dividend date. Portfolio transactions are recorded on the trade date. Realized gains and losses arising from the sale of investments are determined on the average cost basis of the respective investments. Commissions and other identifiable transaction costs that are directly attributable to the acquisition or disposal of an investment are expensed as incurred. Pursuit costs are charged to net income of the Fund in the period incurred.

(e) Income taxes

The Fund qualifies as an inter-vivos trust under section 108(1) of the *Income Tax Act (Canada)*. All of the Fund's net income for tax purposes and net capital gains realized in any period are required to be distributed to unitholders such that no income tax is payable by the Fund. As a result, the Fund does not record income taxes. Income taxes associated with any of the Fund's underlying investments are accounted for in determining the fair value of the respective investments.

(f) New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations as listed below are not yet effective for the period ended December 31, 2018, and have not been applied in preparing these financial statements. None of these will have a significant effect on the financial statements of the Fund.

Effective on January 1, 2019:

- IFRS 16 Leases
- IFRIC 23 Uncertainty over Tax Treatments
- Prepayment Features with Negative Compensation (Amendments to IFRS 9)
- Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)
- Plan Amendment, Curtailment or Settlement (Amendments to IAS 19)
- Annual Improvements to IFRS Standards 2015-2017 Cycle - various standards

Effective on January 1, 2020:

- Amendments to References to Conceptual Framework in IFRS Standards

Effective on January 1, 2021:

- IFRS 17 Insurance Contracts

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**4. Related party transactions**

Third-party costs that are attributable to the Fund are charged to the Fund. Other costs initially borne by BCI are recovered from the Fund. BCI cost recoveries and the corresponding payable are disclosed in the Fund's Statement of Comprehensive Income and Statement of Financial Position, respectively.

The Fund has a limited partnership investment in Hayfin Sapphire II LP, which is managed by Hayfin Capital Holdings Limited as the general partner. A BCI pooled investment portfolio has a 66.51% ownership interest in Hayfin Capital Holdings Limited.

**5. Redeemable units**

The Fund is authorized to issue an unlimited number of units. Units issued and outstanding represent the capital of the Fund. The Fund is not subject to any internally or externally imposed restrictions on their capital. BCI manages the capital of the Fund in accordance with the Fund's investment objectives, including managing the redeemable units to ensure a stable base to maximize returns to all investors, and managing liquidity in order to meet redemptions. The following is a summary of the changes in redeemable units outstanding during the year ended:

	<b>PRINCIPAL CREDIT FUND 2018</b>
	<i>(note 1)</i>
Outstanding, beginning of year	-
Issued for cash	1,516.453
Issued on reinvestment of distributions	-
Consolidation of units	-
Redeemed	-
Outstanding, end of year	<u>1,516.453</u>

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**6. Unfunded committed capital**

Unfunded capital commitments represent total commitments minus net contributions outstanding as of the reporting date. Net contributions equals contributions less any recallable capital distributions. Recallable capital are distributions or previously contributed capital that has been returned, that may be recalled at some future date. Thus, due to changes in recallable capital, unfunded commitments may change at different reporting dates.

Furthermore, commitments to unlisted private debt investee funds are typically made in US dollars, but reported in Canadian dollars. Unfunded commitments are translated at the spot rate and net contributions are translated at historical exchange rates. Therefore, due to foreign exchange movements, unfunded commitments will vary on the reporting date.

The amounts in the table represent the contractual undiscounted cash commitments that can be called on demand.

(in \$000s)	Unfunded committed capital
	As of December 31, 2018
Direct Private Debt Investments	35,097,347
Unlisted Private Debt Investee Fund	2,020,154,780

**7. Financial risk management**

(a) Risk management framework

The investment objective of the Fund is to exceed the returns relative to the Fund's benchmark, the S&P/LSTA U.S. Leveraged Loan 100 Index (net of cost of passive implementation) by 38 basis points per annum (to compensate for illiquidity and credit risk relative to the leveraged loan index). The primary purpose for investing in the Fund is to capture illiquidity premium in the fixed income market.

The Fund invests in publicly traded or privately negotiated debt investments involving private, and on occasion, public companies. Investments will consist primarily of senior and subordinated debt. Public debt that may be illiquid but offers the necessary yield may be included. The Fund maintains a prudent level of diversification by geographic location, investment type, investment size and risk.

The Fund invests in the following securities:

- Senior loans that are provided to non-investment grade borrowers to finance acquisitions, leveraged buyouts and/or business expansions. They are secured by a first lien against the assets of the borrower.
- Debt on a public company balance sheet that is issued by non-sponsored borrowers to a limited group of investors and may or may not be secured by specific assets.
- Second lien or subordinated debt with equity/warrants to boost total returns to lenders.
- Other debt, including senior or subordinated debt pools structured in the form of loan pools, equity issued by business development companies, collateralized loan obligations, asset-backed financings, other special situations financing and secondary market fund acquisition/dispositions.

The following restrictions apply to the Fund:

- Leverage is not used by the Fund manager but external fund managers may use low to moderate amounts of leverage in their funds.



BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

(a) Risk management framework (continued)

The Fund's overall risk management program seeks to minimize the potentially adverse effect of risk on the Fund's financial performance in a manner consistent with the Fund's investment objectives. In the normal course of business, the Fund is exposed to financial risks including credit risk, liquidity risk, and market risk (including interest rate risk, currency risk and other price risk). The level of risk varies depending on the investment objective of the Fund and the type of investments it holds.

The Fund holds its private debt investments through private corporations, trusts and limited partnerships. The corporations, trusts and limited partnerships hold the following net assets:

(in 000s)	2018	
	Total	% of Total
Direct Private Debt Investments	\$ 772,377	46.4 %
Unlisted Private Debt Investee Funds	882,827	53.0 %
BCI Money Market Funds	3,880	0.2 %
Cash and Cash Equivalents	4,625	0.3 %
Net Investment-Related Receivables	1,527	0.1 %
	<u>\$ 1,665,236</u>	<u>100.0 %</u>

The Fund's activities expose it to a variety of financial risks. For purposes of describing the financial risks of the Fund, the composition of investments held by the Fund have been considered.

(b) Credit risk

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation or commitment that it has entered into with the Fund, resulting in a financial loss to the Fund. It arises principally from debt securities held, cash and other receivables due to the Fund. The carrying value of these financial instruments as recorded in the Statement of Financial Position reflects the Fund's maximum exposure to credit risk.

The Fund holds private debt investments which are subject to credit risk. The following table outlines the direct private debt investments held and the related credit rating. The remainder of the Fund's investments are in private debt investee funds. Due to the private nature of the debt investments held by investee funds, they are not subject to rating by a rating agency. The fair value of the Fund's private debt and money market investments represents the Fund's maximum exposure to credit risk.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

(b) Credit risk (continued)

As at December 31, the Fund invested in debt instruments with the following credit ratings:

INVESTMENTS  
 BY CREDIT RATING  
 (in 000s)

	2018	
	Total	% of Total
Corporate Bonds:		
BB+	\$ 24,920	3.2 %
BB-	73,339	9.5 %
B+	75,822	9.8 %
B	491,886	63.8 %
B-	61,339	7.9 %
Not rated	45,071	5.8 %
Total	<u>\$ 772,377</u>	<u>100.0 %</u>

To avoid undue credit risk, BCI management has established specific investment criteria, such as minimum credit ratings for investees and counterparties. Counterparty risk represents the credit risk from current potential and future exposure related to transactions. In order to minimize counterparty risk, counterparties are required to provide adequate collateral and meet minimum credit rating requirements. BCI management frequently monitors the credit rating of its counterparties as determined by credit rating agencies and assesses mortgage investments for impairment, including significant changes in credit risk.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

(b) Credit risk (continued)

*Debt investments by Industry Sector*

Direct investments in the Fund are diversified across industry sectors. Sectors to which the Fund had exposure as at December 31 are as follows:

INDUSTRY SECTOR (in 000s)	2018	
	Total	% of Total
Aerospace & Defense	\$ 23,261	3.0 %
Asset Management	24,920	3.2 %
Chemicals	29,747	3.9 %
Electronics	51,116	6.6 %
Finance	61,339	7.9 %
Healthcare	209,106	27.2 %
Oil & Gas	123,095	15.9 %
Software	80,517	10.4 %
Telecom	39,872	5.2 %
Transport	84,333	10.9 %
Other	45,071	5.8 %
Total	<u>\$ 772,377</u>	<u>100.0 %</u>

The Fund's activities may also give rise to settlement risk. Settlement risk is the risk of loss due to failure of an entity to honour its obligations to deliver cash, securities, or other assets prior to the settlement of the transaction as contractually agreed. All investment transactions are settled or paid upon delivery with approved brokers. The risk of default is mitigated since the delivery of securities sold is made simultaneously with the broker receiving payment. Payment is made on a purchase once the securities have been received by the broker. The trade fails if either party fails to meet its obligations.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

**(c) Liquidity risk**

Liquidity risk is the risk that the Fund will encounter difficulty in meeting the obligations associated with its financial liabilities that are settled by delivering cash or another financial asset.

The Fund's financial assets include direct private debt investments, which are generally illiquid. In addition, the Fund holds investments in unlisted private debt investee funds. As a result, the Fund may not be able to liquidate some of its investments in these instruments in time to meet its obligations when they become due. However, the Chief Investment Officer may obtain funding from unitholders of the Fund through additional unit issuances to meet the Fund's ongoing liquidity requirements.

BCI's approach to managing liquidity risk is to ensure, as far as possible, that the Fund has sufficient liquidity to meet its liabilities when due. The Fund is also exposed to the liquidity risk associated with the requirement to redeem units. Units of the Fund may only be acquired by eligible clients or client groups in accordance with the Fund's purchasing limits that may be established by the Chief Investment Officer (CIO). In order to protect the interest of all clients, the CIO may also establish redemption limits for the Fund. The purchase and redemption limits may vary depending on market circumstances, client demand, and the liquidity of the underlying investments.

The Fund's liabilities are due within three months of the year-end of the Fund.

The Fund's cash position is monitored on a daily basis. In general, investments in cash and BCI Money Market Funds are expected to be highly liquid. BCI management utilizes appropriate measures and controls to monitor liquidity risk in order to ensure that there is sufficient liquidity to meet financial obligations as they come due. The Funds' liquidity position is monitored daily by taking into consideration future forecasted cash flows. This attempts to ensure that sufficient cash reserves are available to meet forecasted cash outflows.

**(d) Market risk**

Market risk is the risk that changes in market prices, such as interest rates, foreign exchange rates and equity prices will affect the Fund's income or the fair value of their holdings of financial instruments. The Fund's strategy for the management of market risk is driven by the Fund's investment objective.

**(i) Interest rate risk**

Interest rate risk is the risk that the fair value or future cash flows of financial instruments will fluctuate as a result of changes in market interest rates.

The money market investments, and mortgages are subject to interest rate risk. The Fund has established duration bands based on its relevant benchmark to avoid undue active interest rate risk. Money market funds invest in short-term investments and have low interest rate risk.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

(d) Market risk (continued)

(i) Interest rate risk (continued)

The Fund's directly held private debt instruments are fixed term debt instruments with maturities typically ranging from 3.0 to 12.0 years. The average duration of the Fund is 0.2 years. Lending rates are generally based on LIBOR plus a risk and liquidity premium. As a result, the Fund is not exposed to interest rate fair value risk. As at December 31, the Fund invested in the following debt instruments:

	2018		
	Carrying Value (in 000s)	Interest Rate	Maturity Date
Variable-rate debt:	772,377	3.80% to 11.27%	2022 to 2031

(ii) Currency risk

The Fund holds net financial assets denominated in U.S. currency totaling \$1,660,598,000 CAD which represents 99.8% of the net asset value of the Fund. As at December 31, if the Canadian dollar had strengthened/weakened by 1 percent in relation to all other currencies, holding all other variables constant, net assets would have decreased/increased, respectively, by \$16,606,000 CAD, representing 1.0% of the Fund's net assets. In practice, the actual trading results may differ from the above sensitivity analysis and the difference could be material.

As at December 31, the Fund had additional exposure to currency risk through its future unfunded commitments in U.S. currency totaling \$2,055,252,000 CAD. As at December 31, if the Canadian dollar had strengthened/weakened by 1 percent in relation to all other currencies, holding all other variables constant, future unfunded commitments would have decreased/increased, respectively, by \$20,553,000 CAD. In practice, the actual trading results may differ from this sensitivity analysis and the difference could be material.

(iii) Other price risk

Other price risk is the risk that the fair value of a financial instrument will fluctuate as a result of changes in market prices (other than those arising from interest rate risk or currency risk), whether caused by factors specific to an individual investment or its issuer or factors affecting all instruments traded in the market.

All financial instruments are subject to other price risk and a potential loss of capital. The maximum risk is determined by the market value of the financial instruments. There are established investment criteria for the Fund related to diversification of investments and investment mandates for external managers to avoid undue market risk.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**7. Financial risk management (continued)**

(d) Market risk (continued)

(iii) Other price risk (continued)

As at December 31, the Fund's direct private debt investments and unlisted private debt investee funds are concentrated in the following geographic regions:

GEOGRAPHIC REGION (in 000s)	2018	
	Total	% of Total
Direct Private Debt Investments:		
Canada	\$ 73,339	4.4 %
Cayman Islands	59,890	3.6 %
United States	639,148	38.6 %
Total Direct Private Debt Investments	772,377	46.6 %
Total Unlisted Private Debt Investee Funds diversified globally	882,827	53.4 %
	<u>\$ 1,655,204</u>	<u>100.0 %</u>

As at December 31, had the fair value of the investments increased or decreased by 10 percent, with all other variables held constant, net assets attributable to holders of redeemable units would have increased or decreased by approximately \$166,524,000 or 10.0 percent of net assets attributable to holders of redeemable units. Actual trading results may differ from the above sensitivity analysis and the difference could be material.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**8. Fair value of financial instruments**

(a) Fair value hierarchy

The fair values of financial assets and financial liabilities that are traded in active markets are based on quoted market prices or dealer price quotations. For all other financial instruments, the Fund determines fair values using other valuation techniques.

For financial instruments that trade infrequently and have little price transparency, fair value is less objective, and requires varying degrees of judgment depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument.

The Fund measures fair values using the following fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Level 1 inputs that are quoted market prices (unadjusted) in active markets for identical instruments.

Level 2 inputs other than quoted prices included within Level 1 that are observable either directly (i.e., as prices) or indirectly (i.e., derived from prices).

Level 3 inputs that are unobservable.

The tables below analyze financial instruments measured at fair value at the reporting date by the level in the fair value hierarchy into which the fair value measurement is categorized. The amounts are based on the values recognized in the Statement of Financial Position. All fair value measurements below are recurring.

	2018			Total
	Level 1 (Quoted Price in Active Market)	Level 2 (Significant Observable Inputs)	Level 3 (Significant Unobservable Inputs)	
(in 000s)				
Direct Private Debt Investments	\$ -	\$ 772,377	\$ -	\$ 772,377
Unlisted Private Debt Investee				
Funds	-	-	882,827	882,827
Cash and Cash Equivalents	-	4,625	-	4,625
BCI Money Market Funds	3,884	-	-	3,884
Net Investment-Related				
Receivables	-	1,527	-	1,527
Total Investments	\$ 3,884	\$ 778,529	\$ 882,827	\$ 1,665,240

During 2018 there were no significant transfers between Level 1 and Level 2.

The carrying amount of the Fund's net assets attributable to holders of redeemable units also approximates fair value as they are measured at redemption amount and are classified as Level 2 in the fair value hierarchy.



BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**8. Fair value of financial instruments (continued)**

(a) Fair value hierarchy (continued)

The following table shows a reconciliation from the beginning balances to the ending balances for fair value measurements in Level 3 of the fair value hierarchy.

(in 000s)	2018	
	Unlisted Private Debt Investee Funds	Total
Balance, beginning of year	\$ -	\$ -
Total gains or (losses) recognized in profit or loss	60,061	60,061
Purchases	822,766	822,766
Sales	-	-
Balance, end of year	<u>\$ 882,827</u>	<u>\$ 882,827</u>
Total unrealized gains or (losses) for the year included in profit or loss relating to financial assets and liabilities held at the reporting date	<u>\$ 60,061</u>	<u>\$ 60,061</u>

During 2018, there were no significant transfers into or out of Level 3.

(i) Significant Unobservable Inputs Used in Measuring Fair Value

The following table sets out information about significant unobservable inputs used at year-end in measuring the fair value of unlisted private debt investee funds categorized as Level 3 in the fair value hierarchy as at December 31:

	2018				
	Fair Value (in 000s)	Valuation Technique	Unobservable Input	Amount / Range	Sensitivity to Change in Significant Unobservable Input
Unlisted Private Debt Investee Funds	\$ 882,827	Unadjusted Net Asset Value	Net Asset Value	\$ 882,827	The estimated fair value would increase (decrease) if the net asset value of unlisted private debt investee funds was higher (lower).

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**8. Fair value of financial instruments (continued)**

(a) Fair value hierarchy (continued)

(i) Significant Unobservable Inputs Used in Measuring Fair Value (continued)

Significant unobservable inputs are developed as follows:

(1) Net Asset Value:

Represents the net asset value of the unlisted private debt investee funds. BCI management values these funds primarily based on the latest available financial information provided by their general partners.

The unlisted private debt investee funds are subject to redemption restrictions and accordingly the Fund is unable to dispose of the investee until the maturity or wind up and liquidation of the respective investee. In such cases, it is the Fund's policy to categorize the investee as level 3 within the fair value hierarchy.

(ii) Effects of Unobservable Inputs on Fair Value Measurement

The unlisted private debt investee funds are valued based on information received from external managers through co-investment arrangements. The fair value of these investments fluctuates in response to changes in specific assumptions for that particular investee as determined by the external manager.

Although the Fund believes that its estimates of fair value in Level 3 are appropriate, the use of different methodologies or assumptions could lead to different measurements of fair value and net assets attributable to holders of redeemable units.

The following table shows how net assets attributable to holders of redeemable units would change if the valuations of unlisted private debt investee funds were calculated by adjusting the respective underlying investee fund's net assets by 10%.

(in 000s)		2018
Favourable	\$	88,300
Unfavourable	\$	(88,300)

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**8. Fair value of financial instruments (continued)**

(b) Valuation models

The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date.

The Fund uses widely recognized valuation methods for determining the fair value of common and more simple financial instruments such as foreign currency contracts and money market instruments that use only observable market data which requires little management judgment and estimation. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which observable market prices exists and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other factors used in estimating discount rates, money market prices, and foreign currency exchange rates in estimating valuations of foreign currency contracts.

Observable prices and model inputs are usually available in the market for listed debt and equity securities, exchange-traded derivatives and simple OTC derivatives. The availability of observable market prices and model inputs reduces the need for management judgment and estimation and reduces the uncertainty associated with the determination of fair values. The availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

(c) Valuation framework

When third party information, such as broker quotes or pricing services, is used to measure fair value, then management assesses and documents the evidence obtained from third parties to support the conclusion that such valuations meet the requirements of IFRS. This includes:

- ◆ verifying that the broker or pricing service is approved by the Fund for use in pricing the relevant type of financial instrument;
- ◆ understanding how the fair value has been arrived at and the extent to which it represents actual market transactions;
- ◆ when prices for similar instruments are used to measure fair value, how these prices have been adjusted to reflect the characteristics of the instrument subject to measurement; and
- ◆ if a number of quotes for the same financial instrument have been obtained, then how fair value has been determined using those quotes.

(d) Financial instruments not measured at fair value

The carrying value of BCI cost recoveries payable and other accounts payable approximates their fair value given their short-term nature. These financial instruments are classified as Level 2 in the fair value hierarchy because while prices are available, there is no active market for these instruments.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
 PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
 NOTES TO THE FINANCIAL STATEMENTS  
 FOR THE PERIOD ENDED DECEMBER 31, 2018

**9. Involvement with Structured Entities**

The Fund's investments are held primarily through 4 intermediary holding corporations, a trust and 2 limited partnerships, all of which constitute structured entities. Structured entities are entities that have been designed so that voting or other similar rights are not the dominant factor in determining who controls the entity. These structured entities have been set up by BCI to manage legal, tax and other risks that may arise in the course of administering the underlying investments. The carrying amount of these entities, approximately \$1,665,236,000, is included within Investments in the Statement of Financial Position.

In addition, the Fund holds interests in other structured entities, both directly and indirectly (i.e. through the intermediary holding corporations and limited partnerships). The other structured entities are comprised of directly held investee money market funds organized as unit trusts and indirectly held investee funds organized as limited partnerships. All of these investee funds have been constituted to manage assets on behalf of third party investors and are financed through the issuance of units to investors or capital contributions made by the investors. Accordingly, the Fund's interest in these entities is reflected through the holding of trust units, partnership units or a partnership interest. The tables below set out the direct and indirect interests held by the Fund in these other structured entities:

Entity	December 31, 2018		
	Number of Investee Funds	Total Net Assets of Investee Funds (in 000s)	Carrying Amount Included in Investments in the Statement of Financial Position (in 000s)
Investee money market funds administered by BCI	2	\$ 2,521,901	\$ 3,884
Unlisted private debt investee funds administered by third party managers	3	\$ 882,827	\$ 882,827

The carrying amount of the investments held in these underlying funds represents the Fund's maximum exposure to loss. During 2018, the Fund did not provide financial support to these structured entities and has no intention of providing financial or other support.

BRITISH COLUMBIA INVESTMENT MANAGEMENT CORPORATION  
PRINCIPAL CREDIT FUND - POOLED INVESTMENT PORTFOLIO  
NOTES TO THE FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED DECEMBER 31, 2018

**10. Taxes**

Net cumulative capital losses and non-capital losses for the Fund having such losses are as follows:

Pooled Investment Portfolios (in \$000s)	As of December 31, 2018	
	Net Capital Losses	Non-capital Losses
Principal Credit Fund	-	4,532

Net capital losses are available to be carried forward indefinitely and applied against future net realized capital gains. Non-capital losses may be carried forward up to 20 years to reduce future taxable income.