PRIVATE DEBT: FROM THE SHALLOWS TO THE MAINSTREAM

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From small beginnings

Prior to the global financial crisis, private debt was in its infancy. The higher yielding segments of institutional credit portfolios were typically focused on allocations to more liquid instruments such as high yield bonds or syndicated loans to corporates while private debt investments were infrequent. However, much has changed since 2008. Fuelled by greater regulation of the banking sector and ever increasing attention from investors who have been forced to adapt to a near zero interest rate environment, the private debt asset class has ballooned. In 2007, Preqin estimated total assets under management were US$205 billion; nine and a half years later, and following a compound annual growth rate of 12.7%, total assets at the end of June 2017 were estimated at US$638 billion.

Behind the headline growth figures, the asset class is also evolving and diversifying. In terms of product, the core strategies remain sponsored and sponsor-less direct lending, mezzanine financing, and distressed debt but there has been a proliferation of more niche specialty finance offerings. More recently, firms have successfully raised funds relating to activities such as royalties and litigation claims while the technology and data-based marketplace lending platforms continue to gain traction with the institutional investor community.

Geographically the US remains by far the most mature market with bank loans now accounting for less than 30% of non-financial corporate funding, compared to a figure closer to 70% in Europe. The discrepancy in the figures suggests there is plenty of scope for growth in Europe and current market conditions are supportive. Bank lending continues to be constrained as legacy non-performing loan (NPL) exposures remain elevated. The latest update from the European Commission, released in January, shows that progress is being made with the European Union's NPL ratio falling from 5.6% to 4.6% in the twelve months to June 2017. Similarly, early estimates indicate that 2017 was on track to be the third successive year with NPL sales in excess of €100 billion. Nevertheless, the stock of NPLs remains significant at circa €950 billion and pressure on the banks to reduce this figure materially is unlikely to recede any time soon.

Along with this, bank activity is being further curtailed by the on-going roll out of regulatory guidelines and legislation. In addition to the continued implementation of Basel III, the new accounting standard, IFRS 9, came into effect at the start of January 2018. IFRS 9 replaces IAS 39 which was heavily criticised during the crisis for failing to recognise credit losses on loans at a sufficiently early stage of their impairment as it adopted a backward looking, incurred loss approach. This approach was designed to prevent companies from smoothing out their earnings by creating provisions when profits were high and then releasing them when earnings were low. In reality it had the opposite effect. Banks postponed reporting losses because the incurred loss approach required evidence of the likely impairment. In contrast, IFRS 9 adopts an expected loss approach, ensuring that banks report today on anticipated future losses. While there is a five year transitional period, moving to an expected loss accounting regime will inevitably result in larger and earlier provisioning on loans and become another example of legislation hitting bank capital ratios.

Against this backdrop, banks have become increasingly focused on those activities that generate the strongest risk-weighted returns. Balance sheet efficiency is at the top of every bank's agenda and a by-product of this focus, particularly in Europe, has been increased sales of NPL exposures and the exiting of non-core markets and business lines. For private debt managers the benefits are twofold: not only can they acquire the assets being sold but also help fill the lending void created in the gaps that traditional lenders have exited.

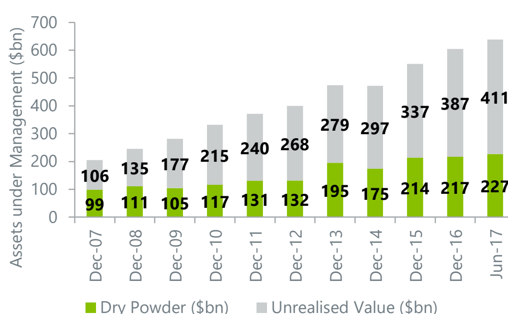
More than just the illiquidity premium

Since the financial crisis, pension funds and other institutional investors have faced their own challenges. During a period of unprecedented government intervention and low interest rates, concerns have grown as to how these investors can meet their long term target rates of return whilst at the same time not taking undue risk given their liabilities or capital requirements. For many of these investors private debt has emerged as a viable solution, particularly in the US where dedicated portfolio allocations to the asset class have become more prevalent. We expect this trend to continue across all geographies as private debt continues to mature and investors become more familiar with underlying strategies.

In the recent market environment, the investment case for private debt has been simple. The asset class offers yields that are significantly higher than those available from investments in equivalent non-investment grade public debt instruments. This is most easily represented by looking at the estimated yields for direct lending funds with exposure to different parts of the capital structure versus those of syndicated bank loans and high yield bonds.

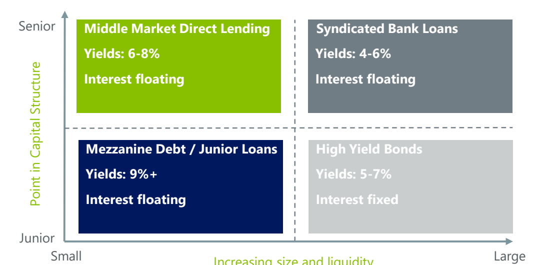
While it is difficult to accurately calculate the "illiquidity premium" provided by direct lending strategies, we believe it is reasonable to estimate that over time it is between 1% and 3%. Moreover, any return premium should be considered alongside other private debt return attributes. First, most loans are in a floating rate structure which provides protection against interest rate risk. Second, the asset class offers exposure to segments of the SME market that are otherwise

Figure 1: Growth in Private Debt AuM Dec 2007 – Jun 2017



Source: Preqin 2018 Global Private Debt report

Figure 2: Yields across non-investment grade public and private investments



Source: LCM Partners; for illustrative purposes only; all yields are estimates and subject to change over time

hard to access. This should provide diversification benefits within a broader portfolio context and a return stream with a relatively low correlation to traditional asset classes. This is certainly the case for the more granular products managed by marketplace lenders or other private debt strategies, such as consumer NPLs, where funds can have exposure to hundreds of thousands of underlying credits. Third, in structuring transactions direct lenders are working closely with the borrowers and therefore have the ability to put in place adequate levels of loss protection to ensure that default rates are kept to a minimum. Indeed, credit loss rates have historically been in line with, or even below, those experienced by either high yield bonds or syndicated bank loans. Finally, unlike other private market strategies such as private equity, private debt investments are typically immediately cash generative and therefore not subject to the same "J-curve" effect.

Offering better risk-adjusted returns

The diversification benefits of an allocation to private debt are best illustrated by analysing its impact on the risk-return characteristics of a broader portfolio. Figure 3 shows a breakdown of the exposures of three model portfolios, and the returns these portfolios would have generated between September 2004 and September 2017. The three portfolios are:

- A traditional asset class portfolio with a 60% allocation to equities and a 40% allocation to bonds
- A proxy for a typical diversified European pension portfolio with exposure to property and alternatives (8% hedge funds, 4% private equity and 3% direct lending)
- The same European pension portfolio adjusted for a 15% allocation to direct lending rather than alternatives more generally

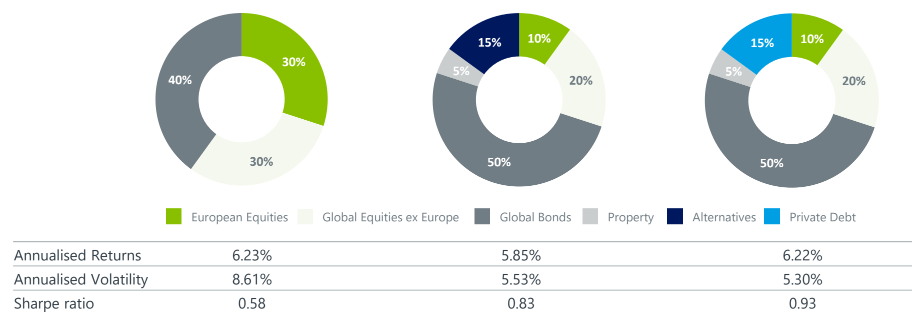
Figure 3 is for illustrative purposes only but it does, however, highlight the diversification benefits of adding uncorrelated alternative asset class return streams to a portfolio, including those of private debt. Risk adjusted returns can be improved considerably in comparison to those that are generated by an allocation to purely traditional equity and fixed income instruments. This is shown in greater detail in Figure 4 where we plot the returns of the two proxy European Pension portfolios in the context of the efficient frontier for traditional equity and fixed income portfolios between September 2004 and September 2017.

What about the risks?

The portfolio return analysis is restricted to a thirteen year period. This is principally because of the lack of historical quarterly return data that is available for private debt and helps to explain why, in our opinion, institutional investors remain underinvested. For the purposes of our analysis, we used the Cliffwater Direct Lending Index which has been constructed using the SEC filings for Business Development Companies (BDCs) in the USA since 30 September 2004.

The lack of data highlights that the asset class is still young, unfamiliar, and to a certain degree

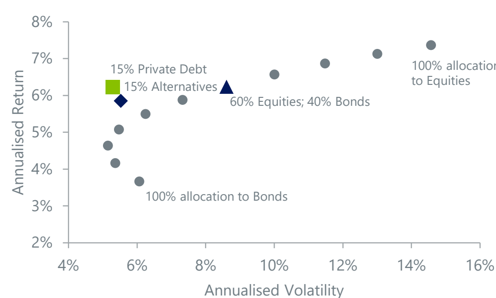
Figure 3: Return characteristics of three portfolios with varying allocations to Private Debt (Sep 2004 – Sep 2017)



Annualised Returns	6.23%	5.85%	6.22%
Annualised Volatility	8.61%	5.53%	5.30%
Sharpe ratio	0.58	0.83	0.93

Source: LCM Partners; Bloomberg; Mercer European Asset Allocation Survey 2017; Index returns from MSCI Europe, MSCI World ex Europe, Barclays Global Aggregate Index (unhedged), UK IPD All property Index, HFRI FoHF Composite Index, Cambridge Associates US Private Equity Index, Cliffwater Direct Lending Index; Risk free rate used is 1 month Euribor; All performance figures are based on quarterly returns; For illustrative purposes only.

Figure 4: Impact of allocations to Alternative assets on a traditional asset class portfolio efficient frontier (Sep 2004 – Sep 2017)



Source: LCM Partners; Bloomberg; Index returns from MSCI Europe, MSCI World ex Europe, Barclays Global Aggregate Index (unhedged), UK IPD All property Index, HFRI FoHF Composite Index, Cambridge Associates US Private Equity Index, Cliffwater Direct Lending Index; All performance figures are based on quarterly returns; For illustrative purposes only.

untested. Prior to the global financial crisis, allocations were minimal and while these have increased materially it has happened during a prolonged period of relatively benign market conditions. As a result, the next turn in the credit cycle will be an important stepping stone in the development of the asset class. If private debt is to establish itself as a valued building block in institutional portfolios then it will have to demonstrate an ability to perform in line with investor expectations during a period of market distress. Indeed, one of the major concerns expressed by investors is that as assets have grown, competition has increased, and returns are gradually being eroded. This is leading to a belief that in some cases, in order to maintain returns, managers are being forced to take on additional risk at exactly the point in the economic cycle when a more prudent approach is required.

In the meantime, the emphasis for managers should be to continue educating the institutional investor community. With little information readily available in public, and a plethora of strategies being offered to investors, there is little standardisation in the reporting of portfolio exposures. For the industry to continue developing it is imperative that communication improves and managers provide increased transparency.

The future's looking bright

Pension fund allocations to private debt are increasing and the asset class exhibits many of the return attributes that are valued by institutional investors. Return streams have historically provided diversification benefits to typical pension fund portfolios with investments generating high yielding, stable cash flows. Investors who are less liquidity-constrained have the potential to earn above market returns with an equivalent or lower risk. In the current low interest rate environment, this illiquidity premium has proved particularly attractive as investors grapple with the dual requirements of searching for yield to meet target returns whilst not wanting to compromise on credit quality at this point in the economic cycle. However, this comes with an expectation that the asset class will deliver performance in the event of either a turn in the credit cycle or rising interest rates.

In reality, there will be winners and losers amongst private debt managers during the next market downturn. The asset class is complex, with a wide range of strategies that differ from one market to the other. This places more emphasis on the importance of manager selection. Nonetheless, managers have an important role to fulfil, providing increased levels of transparency and better client reporting. For those managers that are willing to do this, and have a demonstrable track record of delivering performance across the economic cycle, we believe there is huge potential to build long lasting partnerships with pension funds and other major institutional investors. The Alternative Credit Council appears to agree, forecasting that the asset class could reach the US$1 trillion mark by 2020. Private debt, it seems, is very much moving into the mainstream.

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