Market Commentary Private Debt

The risk of private debt investments during a downturn

Munich | April 2019

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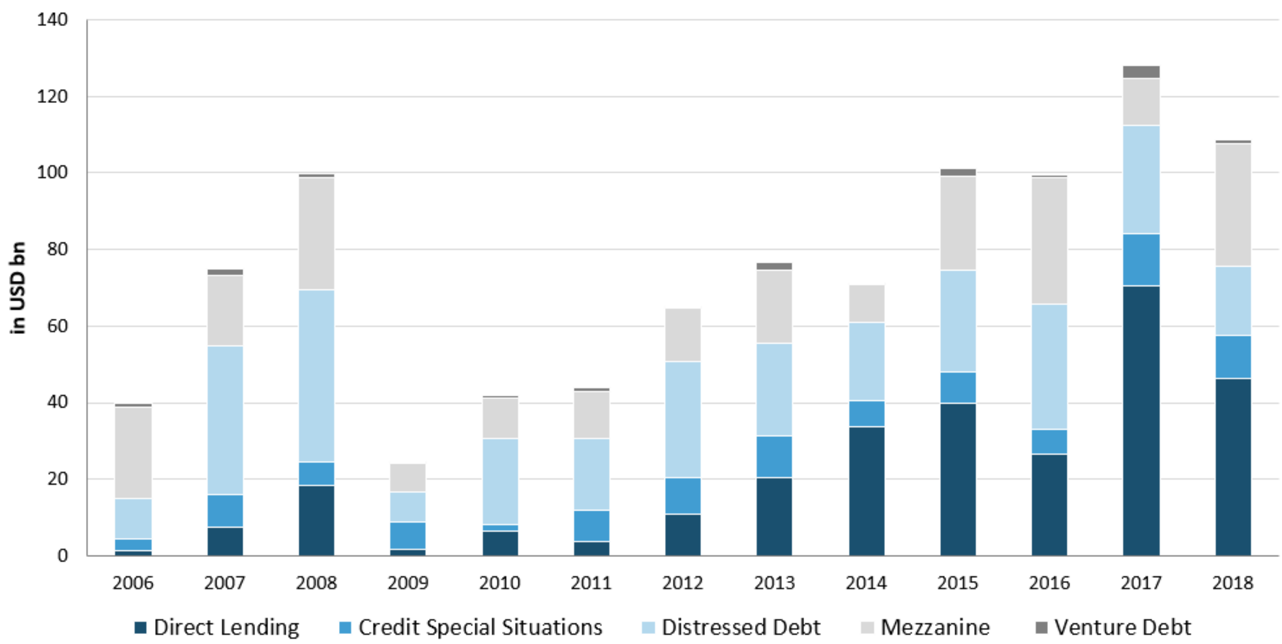
In recent years, investors have become increasingly interested in the private debt asset class. Significant allocations have led to the availability of unprecedented amounts of capital and to new records for the fundraising of private debt funds. As a result of the amply supply of debt for leveraged finance transactions, the leverage ratios of companies have been steadily increasing, whilst credit conditions have been worsening. The situation resembles in many ways the years 2006/2007 and evokes memories of the last financial crisis. Understandably, many investors today are questioning whether they should continue just now to allocate capital to direct lending strategies or whether the current risk in today's transactions is already too high considering the possibility of a short to mid-term turn in the credit cycle. This paper examines the performance of private debt during the last financial crisis and highlights the market opportunities for investors today.

Development of the private debt market since the financial crisis and current market environment

The origin of private debt/direct lending can be traced back to the mid-1990s in the USA, when insurance companies started providing senior and mezzanine loans to companies without banks acting as intermediaries. Institutional investments in North America have gradually gained importance and have become the major source of leveraged financing in the years following the financial crisis with a market share of about 80% today. In Europe, banks have traditionally been the dominant lenders, however, the situation has started to change, especially in the buyout segment, triggered by stricter regulatory requirements for banks in the aftermath of the financial crisis. Increasingly higher capital requirements have made the leveraged finance business less attractive for banks, which resulted in European private debt funds taking over about 50% of this market.

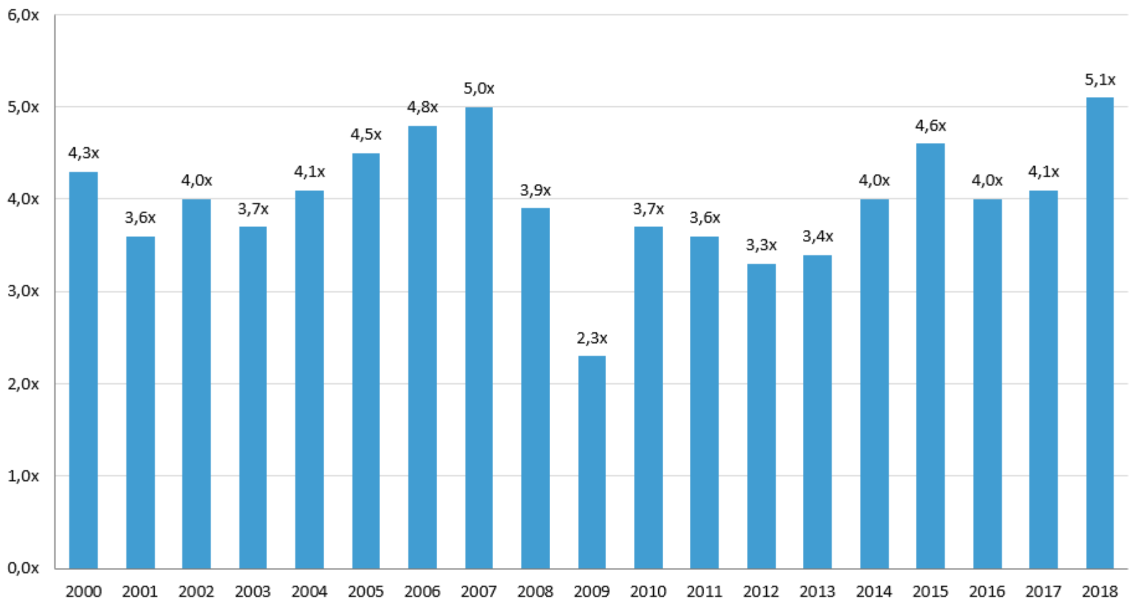
Due to historically low interest rates, investors have turned to alternative investments in the same time period and have identified private debt as an attractive - though illiquid - supplement to their fixed-income portfolios. This enabled private debt managers to launch increasingly larger pools of capital, resulting in an inflow of capital into private debt funds (direct lending, mezzanine, distressed debt, credit special situations and venture debt funds), reaching a historic peak in 2017, as shown in the chart below. Direct Lending, with a global fundraising volume of around USD 70 billion, is now the dominant asset class, followed by Distressed Debt.

Global Private Debt Fundraising by Strategy



Source: Preqin Feb. 2019

With the increased availability of debt and equity capital for buyout transactions the debt ratios of private equity transactions also rose to levels last seen prior to the financial crisis (see chart below).



Source: CEPRES Feb. 2019, Median Total Debt to EBITDA-Multiples for each Investment year

The high inflow of capital has resulted in increased risk for investors, particularly in recent years, while yields became compressed. This applies primarily to larger companies in the upper mid-market, however, while the lower mid-market segment was not entirely immune to this trend, the levels of debt are much lower.

The increased risk is not only reflected in higher leverage levels, but also in a decline of covenants and a loosening of the earnings figures used to define debt limits ("adjusted EBITDA"). This trend follows conditions in the syndicated leveraged loan market with a time lag, which reflects the effects of capital inflows and supply/ demand imbalances more rapidly. These trends can be seen in Direct Lending, especially in the large-cap and upper mid-market, while lower mid-market deals are still more conservatively financed.

Risk and return of private debt as a function of the credit cycle - Empirical results

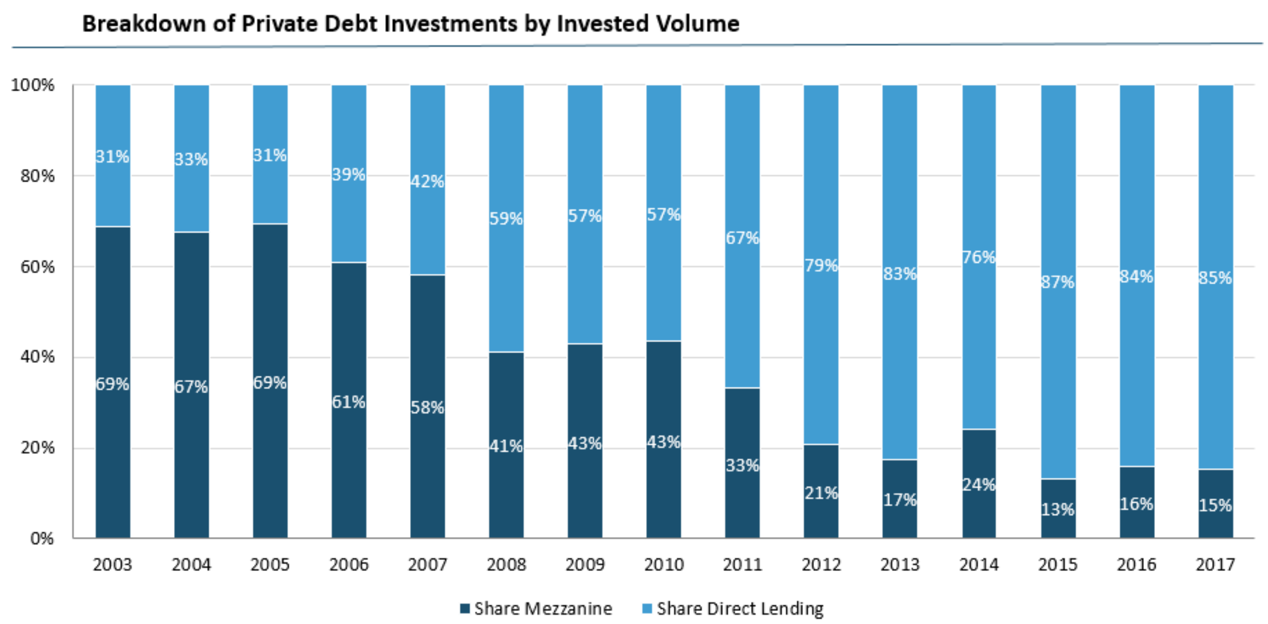
The trends described above raise the question for investors whether they should maintain existing allocations for private debt and whether new allocations should be made at all. While high leverage levels imply that the current market environment does not offer the best investment opportunities, a wait-and-see strategy is also not advisable due to the difficulty or even impossibility of market timing, especially as funds cannot be invested at attractive interest rates in other debt instruments.

Therefore, it is useful to examine the impact of timing of private debt investments on the risk and return profile of private debt investments during the Global Financial Crisis. YIELCO Investments performed an analysis based on data from the Center of Private Equity Research (CEPRES), an independent information service provider. CEPRES maintains one of the world's most comprehensive data sets on private debt transactions and collects data on both portfolio company level (individual loans; gross returns) as well as on fund level (net returns).

The following table presents the data used, covering a reasonably long period before the 2008 financial crisis. To ensure that results are not distorted by (subjective) valuation effects, only fully realized transactions were considered for our analysis. Furthermore, the focus was on the US and Europe as established private debt markets. The average transaction size of around USD 24 million indicates that the majority of over 16,000 loans recorded were granted in the mid-market segment.

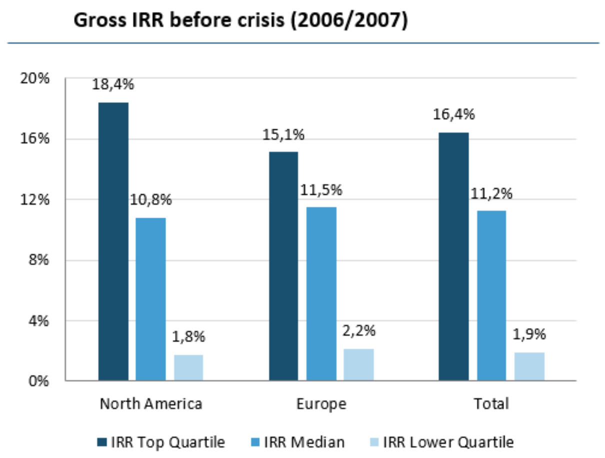
Category	Data set
Data	Realized transactions
Private debt strategies	Direct Lending (Senior Loans, Unitranche) & Mezzanine
Number of funds	440 funds
Number of transactions	16,127
Ø Transaction size	USD 23.7m
Ø Holding time	3.37 years
Cum. Invested capital	USD 143.4bn
Regional allocation	55,4 % USA – 44,6 % Europe
Time period	01/2004 – 12/2018

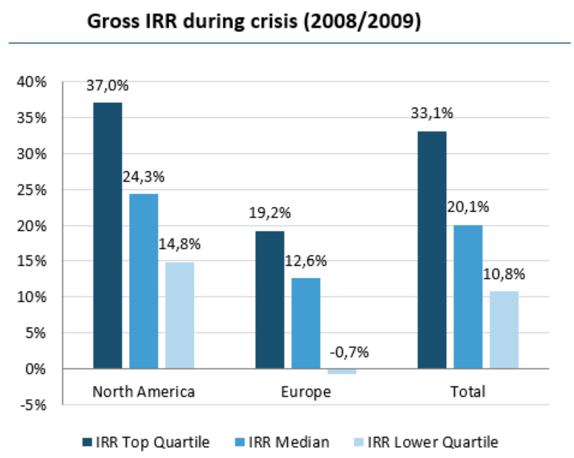
The private debt market has undergone major structural changes in the last 15 years. Whilst private debt mainly related to mezzanine loans at the beginning of the millennium, in the aftermath of the financial crisis direct lending established itself as the dominant financing strategy with approx. 85% of transactions in recent years covered by CEPRES. Only ca. 15% of private debt transactions today are mezzanine loans (see figures below).

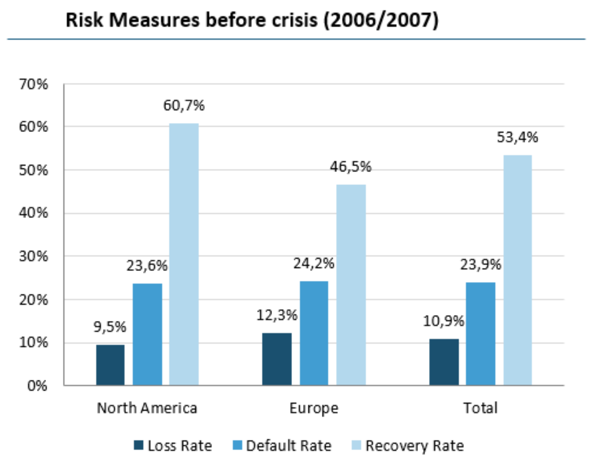


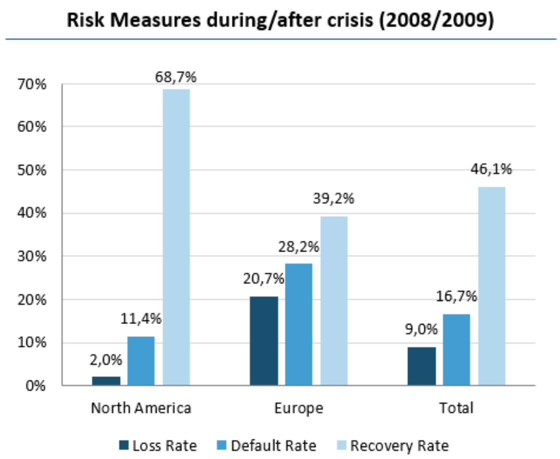
This change means that the current market situation is not directly comparable with that of the years before or during the financial crisis. Therefore, any conclusions from our analyses have to be interpreted with a grain of salt. However, for the purpose of this analysis, we perceive this short-coming as less critical, as we are primarily interested in the analysis of risk, especially the risk of losing capital. For a market where most of the loans are senior secured, in a future market downturn one can reasonably expect more positive results in terms of defaults and loss risk.

The analyses below show the returns (split per 25/50/75% quantile of gross IRRs at transaction level) and the risk (breakdown by loss rate, default rate, and recovery rate[1]) at transaction level for the two investment years preceding the 2006/07 financial crisis and the years 2008/09. We also look at North America (almost exclusively US investments) and Europe separately, as the significant differences in market maturity between these two regions affect their respective performance.









Firstly, we observe that US investments have achieved significantly higher returns compared to European investments with significantly lower risk. Additionally, only the worst 25% of transactions in Europe during the financial crisis generated a slightly negative result. At 10 – 12%, loss rates are well above values currently being observed or the long-term average. Taking into account the above holding period, annual loss rates based on CEPRES data are 3 – 3.5% (nota bene: for a data set dominated by sub-ordinated loans), while the long-term average for senior loans the US is only 0.5 – 1.3% annually, depending on the size of the loan[2].

[1] Loss Rate = Capital loss in % of invested capital over the entire holding period; Default Rate = share (by number, not capital-weighted) of transactions in which a capital loss occurred; Recovery Rate = repayment rate (interest and capital) in % of invested capital

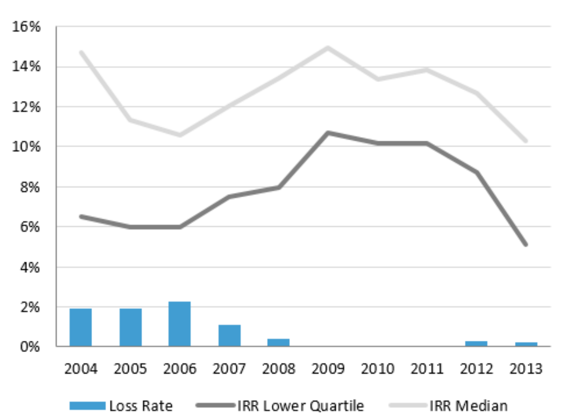
[2] Vgl. TIAA – Private Debt: The opportunity for diversification with illiquid assets, 2016; S&P LCD

It is also noteworthy that US loss statistics for investments made during the crisis years 2008/09 are consistently better than the corresponding European values. In our opinion, this surprising result is caused by private debt in Europe being issued primarily in the form of mezzanine during the observed time period, while in the US a significant proportion of direct ending (senior debt) was already evident at that time. Furthermore, the financing structures used in Europe were in many cases very complex, meaning it was not possible for lenders to act as quickly as necessary to prevent loan defaults in restructurings.

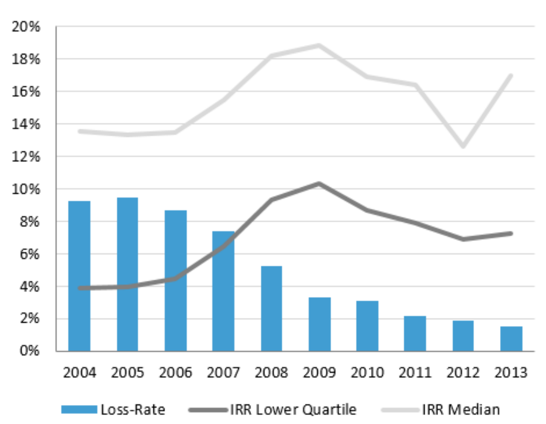
Finally, we examined how returns and loss ratios would have performed for an investor with a broadly diversified portfolio of at least 100 loans built up over a period of six years. We used rolling gross returns over a six-year period at the transaction level and rolling net returns for funds over three vintage years. This approach assumes an investment phase of three years for the funds. The effect of vintage year diversification shows a significant reduction in loss ratios.

Investments that were made during the 2008 crisis demonstrate a significantly lower loss ratio of only about 5%, while the highest losses were incurred by investors who made commitments in the last four years prior to the crisis (2004 - 2007). In this case, the higher risk manifested itself in individual (partial) defaults, while the positive overall returns for the 25% worst-performing transactions/funds (lower, dark grey lines in the graphs) show that losses were compensated at the portfolio level. This holds particularly true for portfolios constructed at the peak of the crisis. So, even with the worst possible timing in one of the most severe crisis, investors with a portfolio diversified over time and by number of loans (150 +) did still achieve a quite attractive performance both in absolute and relative terms.

Net IRR and Loss rates on Fund level (3-years rolling)



Gross IRR and Loss rates on Deal level (6-years rolling)



The decline in gross and net returns in recent years is primarily due to the change in the composition of the dataset, which has been characterized by Direct Lending transactions gradually replacing the higher-yielding Mezzanine transactions. Furthermore, increasing market competition in recent years also contributes to the decrease in returns.

Implications for the selection of direct lending funds

As demonstrated above, the best time to start building a private debt portfolio was in the middle of the crisis, or at least during the crisis, whilst investments just before or right after the crisis generated lower returns. While it is challenging anyway to precisely determine the optimal point in time, i.e. the peak of a credit crisis, it is even harder to convince investment committees to make new investments when the overall market sentiment is very pessimistic. This makes anti-cyclical investments so difficult. Realizing this, the most effective investment strategy is to systematically and continuously build up the portfolio over time and ensure adequate diversification. The empirical results prove the resilience of the asset class private debt and should help to overcome the fear of a wrong entry point.

Additionally, an active portfolio management can further make a portfolio more resistant. Cycle-tested managers with a small/mid-market approach are exposed to less competition for transactions than managers from the upper end of the market. Recent increases in fund sizes exert substantial investment pressure on some managers, which has led to weakened credit conditions, e.g. covenant-lite and EBITDA adjustments as just two negative market trends. Furthermore, while selecting funds, investors need to examine if their portfolio approach is sector defensive and how conservative their leverage multiples are. In the current market environment, it is more important to manage risk well than to pursue high returns while at the same time accepting increased risks (i.e. no "stretch for yield"). Particular emphasis should be placed on the manager's restructuring expertise, sufficient team ressources and investment experience spanning over at least one credit cycle.

Portfolio expansion with Specialty Lending strategies

Niche strategies within the private debt universe, which are not used to finance Private Equity transactions and which are therefore not or at least less affected by the market dynamics discussed above, offer a further opportunity for portfolio diversification. These financing strategies, which can be referred to as "Specialty Lending", all have in common a tailored approach to special financing needs. Due to their high degree of complexity, there is significantly less capital available for these strategies. Furthermore, to be successful special expertise and long-term experience are required, such as valuation skills for specific assets (special machines, exploitation rights, used aircraft, construction machines etc.) or for royalty streams in the healthcare sector. Lending in these applications requires very specific expert know-how which is not readily available in the market. Special situations loans are generally secured (often senior secured asset-based loans) with relatively low LTVs.

At the same time, these markets are generally not scalable and the fund sizes are generally below USD/EUR 500 million. As a result, many funds fall under the radar of large investors. Only a maximum of 10% of global private debt fundraising is accounted for by specialty lending strategies. Another attractive feature for investors is, that, in addition to regular yield distributions, loans often offer further upside potential via equity kickers.

The chart below compares specialty lending to the better-known direct lending and mezzanine segments.

	Direct Lending	Mezzanine	Specialty Lending
Philosophy	▪ Cash flow-oriented		▪ **Asset-oriented**
Loan basis	▪ High corporate quality in terms of stability of the business model and resulting low cash flow volatility		▪ **Impairment of specific physical or financial assets**
Transactions	▪ Predominantly Private Equity Transactions ▪ Sponsorless Corporate Situations		▪ **Heterogeneous, niche-oriented financing events** ▪ **No Private Equity reference**
Instruments	▪ Senior Secured ▪ Unitranche	▪ Subordinated ▪ Second Lien ▪ (Equity Coinvestments)	▪ **Senior Secured** ▪ **Warrants (or similar equity participation)** ▪ **Preferred capital of a credit nature**
Return composition	▪ Interest ▪ Fees	▪ Interest ▪ Fees ▪ (Equity capital gains)	▪ **Interest, Fees** ▪ **Equity capital gains** ▪ **Acquisition of cash flows at discount**
Yield/ % Total return	▪ 6 – 9% p.a. ▪ 100%	▪ 8 – 10% p.a. ▪ 50 – 75%	▪ **10%+ p.a.** ▪ **60 – 75%**
Net return (fund level)	▪ 6 – 8%	▪ 8 – 11%	▪ **9 – 13%+**

Although the majority of specialty lending funds only have been set up in recent years, most managers have successfully implemented their strategy over a longer period of time (many as the financing department of large trading companies). Due to the low correlation to other segments of the private debt market, specialty lending allows for further risk diversification with simultaneously mitigating risks by a combination of elements such as fungible collateral, low LTVs (often significantly <50%), stable cash flows, predictable asset/liquidation values, accelerated repayments and purchase at discounts.

Summary and conclusion

Even though today' situation is not ideal for increasing one's private debt exposure, we believe that even in the current market environment one can identify attractive debt strategies that allow investors to build up or expand their private debt portfolios. However, a detailed analysis of the underlying financing and the various market segments is of utmost importance. Even if historical loss rates for the global financial crisis indicate that investors with a sufficiently diversified portfolio have not lost any money even in this extreme scenario, the current focus should be on strategies with a conservative risk profile, even if this means that one has to accept a lower return. Ultimately, however, "sufficiently diversified" also means that consistent investment behavior should be pursued over time, since even in the current market environment an investment freeze would be counterproductive in the long term.

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