Q&A

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Headquartered in Munich, YIELCO Investments is an innovative investment boutique that focuses on alternative assets, specifically infrastructure and private debt. It offers a variety of services and products including multi-manager portfolios, customised mandates, asset allocation, market research consultations and alternative investment monitoring.

What is your perception of the current private debt market?

Many investors are looking to allocate capital to private debt opportunities due to the prospect of strong risk-adjusted returns in a low interest rate environment. Ever increasing regulatory pressures have restricted the flow of debt financing from traditional sources (mainly banks, but also CLOs and hedge funds), creating opportunities for private debt fund managers to become a preferred source of capital for companies looking to secure financing for growth, acquisitions or recapitalisations.

The private debt fundraising market is at an all-time high. Currently, there are almost 200 private debt funds on the road targeting aggregate capital commitments of over $100 billion. Despite an increasingly crowded fundraising environment, we think there is currently a very positive sentiment towards the private debt industry with investors planning to increase their allocations to private debt.

While private equity managers have quickly adopted alternative ways of financing their deals, the readiness of corporate borrowers to accept non-bank lenders still varies by region.

Borrowers in the UK and France are very open to private debt solutions due to their long-term experience with private equity and the inability of their banks to provide further loans. In Germany and the Nordics, local banks are still relatively healthy and continue to provide loans to mid-market companies. However, the acceptance of alternative lenders in these countries is expected to grow in the future.

To date, the activity in private debt has mostly been driven by private equity transactions. Now there is a huge opportunity for direct lending – the provision of loans to companies without the involvement of a private equity sponsor. However, it will take time for this market segment to reach its full potential since deal sourcing is time and people intensive.

In the US, managers spotted the opportunity for private debt very quickly after the financial crisis started and managed to raise dedicated loan funds as early as 2008 (in some cases as side pockets from their private equity funds). Since then the market has grown significantly. Like in Europe, many private equity houses have set up private debt teams and operations and there is also now a large universe of independent fund managers. When listed credit funds called 'Business Development Companies' emerged on the scene, the competition for deals in the US increased considerably, which led fund managers to differentiate their strategies. Investors can choose between many different strategies from broadly syndicated senior secured loans to sponsorless mid-market financings with equity upside.

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An assessment of the attractiveness of the private debt market depends very much on the segment under consideration and the time horizon. While we see a lot of developments that remind us of 2007 and raise some concerns, the overall positive market dynamic is still intact. However, in the short term exuberance is a risk since many managers can easily raise large funds based on track records that look very attractive but do not have to stand the test of a less benign economic climate. Even in today's hot market there are still some segments where the pressure on pricing and terms is a bit muted. This is mainly true for sponsorless transactions and for deals in the lower mid-market.

What macroeconomic issues are currently of most concern to you as a private debt investor?

We currently observe a huge capital inflow from institutional investors, leading to great fundraising success of some debt players. We believe the market is still reasonably healthy and offers a number of interesting market opportunities, especially at the lower end.

However, there is an increasingly borrower-friendly environment both in the US and in the European leveraged loan market. Covenant-lite loans are not only a feature of large deals any more but have found their way to the mid-market and could lead to a mispricing of risk. Vast amounts of capital and lack of quality deal flow have led to intense competition among lenders. In the US, as well as in Europe, the average senior debt leverage multiples have steadily increased for middle market transactions since 2008. An overarching theme is obviously the instability of the Eurozone and the European Union, which is a general concern in its own right.

Which regulations are of most concern to you?

Bank regulations like Dodd Frank will foster institutional money going into private debt as banks are, to a certain extent, pushed out of the lending business. In addition, banks have to de-lever and sell legacy loan positions and eliminate or substantially reduce their proprietary trading activities. While the increased regulation of banks spawned the private debt market in the first place, there are also regulations that negatively affect both fund managers and investors. We are not so much concerned about specific regulations but rather about the general trend of politicians to leave no single financial market unregulated. This bears the risk that we will see an over-regulated market, hampering alternative investments.

For the alternative fund industry, AIFMD is rather a nuisance than a real obstacle, since it has by and large not prevented new business – although it has made it much more expensive and cumbersome to raise alternative investment funds. The biggest negative effect we see is a selection bias for non-European managers that investors are facing. Many smaller fund managers, which are pursuing niche strategies and therefore can provide further diversification for investors, are not willing to comply with the marketing rules of AIFMD and are stopping the marketing of their funds to European investors. This limits the fund universe considerably for investors that follow a passive approach and rely on fund managers knocking on their door.

What could regulators do to protect private debt markets?

The private debt market has thrived in recent years despite the intervention of regulators. The market does not seem to need much protection but rather a stable regulatory environment without further negative surprises. Within Europe it could certainly be helpful to establish a uniform European legal framework for the documentation of loans and the protection of lenders. This could also promote a secondary market for mid-market loans.

What are your views on the impact of monetary policy on private debt in the Eurozone?

We are still in the phase of cheap money, which might slowly come to an end within the next months or years, depending very much on the overall economic climate and the solution of the situation in Greece. The current quantitative easing policy and the low interest rates forces institutional investors to look for alternative investment strategies, including private debt. The abundance of available capital in the lending market generates future risks as market participants take less prudent decisions and accept higher leverage since the cost of capital is low. On the other hand, in times of slow economic growth debt investments typically offer more attractive risk-adjusted returns than equity investments, especially if you can invest in floating-rate instruments like leveraged loans.

Which factors are most important when choosing a private debt manager?

YIELCO uses a combined top-down/bottom-up approach for constructing portfolios of private debt funds. Starting with a top-down approach, we first evaluate the key markets, regions, sectors and strategies that provide the highest level of market attractiveness. The fund selection itself applies a bottom-up approach and is based mainly on the following six evaluation criteria: management/team; investment strategy; track record/performance; deal access/deal generation; back office and terms & conditions. In addition, we also evaluate aspects of socially responsible investing.

A private debt manager should have already gained experience with stressed or distressed situations by investing over multiple credit cycles. Due to the low multiples on invested capital for private debt transactions, the margin for error is rather thin. Risk management and credit experience are therefore very important features a fund manager has to offer. The team size has to match the investment strategy (that is, a larger team is necessary when a manager wants to arrange and lead transactions, and a combined credit and equity skill set is vital for managers that pursue a sponsorless strategy). We only accept modest team fluctuation, especially among the senior professionals, and the team should not be dominated by only one or two partners. With regards to deal sourcing, the fund should have extensive relationships to key intermediaries in the relevant industry for generating proprietary deal flow or at least to have some edge over other debt providers in an auction. Finally, and maybe most importantly in the current fundraising spree, the fund size should match the mid-term opportunity in the target segment of the manager.