THE NEW LANDSCAPE OF PRIVATE DEBT IN EUROPE

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The market of private debt offers new possibilities to diversify allocation to traditional bonds.
Analysis of this new performance source by Thierry de Vergnes and Laurent Petit, credit market specialists at Lyxor Asset Management.

PRIVATE DEBT REFERS TO THE ASSET CLASS OF THE CREDIT MARKET IN THE FORM OF LOANS AND PRIVATE PLACEMENT

Broadly speaking, private debt essentially refers to credit asset classes that typically are in loan and private placement form, are not securities and do not trade on organized exchanges. Hence they tend to be buy-and-hold instruments with investment vehicles structured accordingly. On the more liquid side of private lending, namely the syndicated loan market, trading does take place in active OTC markets. Being private, transaction documentation – information memorandum and lending contract – is only accessible to lenders or potential investors after the signing of a comprehensive confidentiality undertaking.

In addition to corporate lending or private placements for M&A and refinancing purposes, infrastructure, real estate, shipping and aircraft finance, distressed debt are all sub-asset classes of the private debt market.

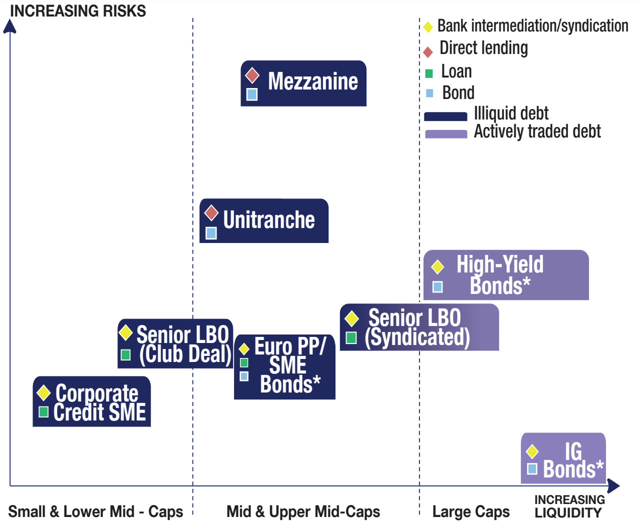
The “direct lending” market is a sub-segment of the private debt market where non-bank lenders have been filling the gap opened post crisis by bank retrenchment. In short, it is one in which a single, non-bank lender, originates, structures and invests in a corporate loan (sometimes arranged as bonds for regulatory reasons), with larger transactions increasingly being “clubbed” (with more than one direct-lender).

The instruments involved range from straight senior debt and private placements to the much talked about “unitranche” (a single tranche blending senior and subordinated debt), mezzanine and quasi-equity.

>>SPEED READ

- >> The temporary shortage of bank lending has encouraged the emergence of new financing solutions designated by “private debt” or “direct lending”.
- >> Investors in their quest for yield and uncorrelated returns show a growing interest for these new credit investment opportunities.
- >> Understanding the drivers of this market allow the investors to diversify their allocation to traditional bonds.

Figure 1: Risk/liquidity of credit instruments - Europe, March 2015



Source: Lyxor Asset Management

* Mainly fixed rates instruments (versus floating rates over Euribor for the other credit instruments).
Overview of credit instruments used by companies for mergers and acquisitions and (re) financing.

AT THE PEAK OF THE CRISIS THE SHORTAGE OF BANK LOANS HAS GIVEN RISE TO NEW DIRECT LENDING SOLUTIONS ON WHICH INSTITUTIONAL INVESTORS ARE INCREASINGLY ACTIVE

In the wake of the credit crisis, which led to the dearth of bank lending, institutional investors have steadily been filling the lending gap in a number of ways. In the early post-crisis days they participated in "opportunity" or "recovery" funds which bought up at a discount either syndicated loans in the secondary markets or large loan portfolios directly from banks on the basis that they were undervalued due to the disappearance of large segments of the loan investor base. As bank lending remained depressed for longer than expected, institutional investors and investment managers saw the opportunity to become a more permanent substitute for bank lending, particularly to mid-market companies.

In response, a number of forward thinking asset managers devised mechanisms and structured funds to lend directly to companies without the intermediation of banks. In addition to investing in funds of the bank-arranged "syndicated" loans, larger and sophisticated institutional investors - often pension funds and insurance companies – are now increasingly investing in funds of lending loans arranged by "direct" or "alternative" lenders. Some are even selectively co-investing alongside such lenders.

Effectively, whereas loans were historically the preserve of banks, the increased capital requirements imposed by regulators on them following the crisis has given rise to a parallel "direct" lending market alongside the more traditional bank arranged "syndicated" loan market. Institutions are increasingly active investors in both these segments of the loans market.

According to the investment consultant, Mercer[(1)], investors have migrated from investing in private debt as an opportunistic play targeting mid-teen returns teen returns (mainly mezzanine) and housed in their private equity portfolios, to making a longer-term strategic allocation to the asset class.

Asset managers, consultants and investors alike are increasingly dedicating resources to the analytics required to build robust private debt portfolios. Mercer goes further to say that in the current environment of low yields, there is a solid argument for building "growth fixed income portfolios" including a 20-40% allocation to private debt. In another recent study, of the 240 institutional investors worldwide surveyed by Preqin[(2)], two thirds had already invested or were considering investing in private debt, with the current average allocation being of 5.6%.

As such, this is creating a long-term source of non-bank lending thus changing the traditional structure of the loan markets.

[(1)] Source: Mercer, Private Debt Makes Its Way Into Institutional Portfolios, August 2013
[(2)] Source: Preqin, Prequin Special Report: Private Debt: The New Alternative, July 2014

Figure 2: Direct lending vs. syndicated loans

	Direct Lending Fund	Syndicated Loans Fund
Target markets	Small cap Mid cap	Large cap Mid Cap
Target assets	Senior loans Unitranche Mezzanine	Senior loans Second lien Mezzanine
Deal structures	Bespoke	Market Standard
Assets rated by ratings agencies	Not rated	Rated
Portfolio diversification	Concentrated	Highly Diversified
Sourcing of deals	Challenging	Easier
Secondary market liquidity	No	Yes
Target returns	Senior loans: E/L(*) + 4% Unitranche: E/L(*) + 6%-9% Mezzanine: E/L(*)+ 12%	E/L(*)+ 5-6%
Pace of capital deployment	Slow	Rapid
Management fee	On committed capital	On invested capital
Performance Throughout Cycles	Untested	Tested
European Market	Emerging	Evolving

DIRECT OR SYNDICATED LOANS: AN ACCELERATION OF THE MARKET FOR TWO YEARS

Since the sharp tail off in lending that occurred in the wake of the credit crisis, a steady recovery in lending has taken place, accelerating significantly in the past 2 years with lending approaching pre-crisis levels.

After several years of "more talk and less action", the direct lending market effectively took off in 2013 as a number of established and new credit managers built up their teams, raised funds and started to originate transactions. Interestingly, direct lending transactions confirmed their steady rise in Europe with 142 transactions for the first 9 months of 2014 (vs 136 for the full year 2013), according to the latest alternative lending deal tracker study by Deloitte, whose survey covers 35 "leading alternative lenders".

The syndicated european loan market reached post crisis record high in 2014 with with 206 transactions coming to the market after topping at 189 new transactions in 2013. In response to the increased competition from direct lenders, banks - with reinforced balance sheet and the ability to fund mid-cap lending at the ECB repo window - have sought to regain market share by devising more flexible instruments to compete with direct lenders, namely bullet "Term B" loans and even unitranche solutions.

Furthermore, US managers able to apply leverage to their funds and thus lower their yield requirement have entered the European market. Margins on direct lending transactions have subsequently declined to below E/L(*)+550 bp for senior Term Loan Bs and E/L(*)+700 bp for unitranche transactions. Meanwhile, the traditional syndicated bank loan market continued to go from strength to strength and though margins compressed in the first half of the year 2014, increased volatility in the second half has caused margins and yields to stabilise and even in some cases increase.

As a consequence, the spread differential between the direct and syndicated lending markets has led to a certain vigilance to take into account the lack of liquidity associated with private debt instruments.

A CHOICE BETWEEN THE TWO MARKETS THAT DEPEND ON THE SIZE OF THE BORROWER

Larger corporates require the market depth of the syndicated loan market whereas the direct lending market mainly caters to mid-cap borrowers to which banks have sometimes cut back lending. At the margin however, a growing number of the larger mid-cap companies are attracted to the speed of execution, simpler documentation and flexibility in structuring and amending a loan agreement that comes with having only one or a couple of lenders.

This additional flexibility needs to be weighed against the fact that direct lenders do not shy away from taking a company over in the event of default whereas banks tend to accept ownership only as a last resort and are more likely to amend and extend loan facilities. Direct lenders only provide term facilities while banks can also grant a number of ancillary services (e.g. fx, revolving credit and trade finance facilities).

(*) Euribor/Libor

A RATING PROFILE AND DATA AVAILABILITY DEPENDING ON THE MARKET

One noteworthy difference is that the syndicated loan market has a high proportion of rated transactions enabling investors to have a rapid first blush understanding of the risk profile of their portfolios. In contrast, direct lending transactions are not rated and investors therefore rely entirely on the manager's assessment of credit risk.

In contrast to the syndicated loan market in Europe, which has been followed by rating agencies, investment banks and information aggregators for well over a decade, very little data is currently available on the nascent direct lending market. This can pose a challenge for investors who prefer to rely on robust historical data for key risk parameters such as historical default and recovery rates to run stress tests and other portfolio construction tests or simulations.

DIFFERENT RISKS/YIELDS PROFILES THAT DETERMINE THE TYPES OF CREDIT ALLOCATIONS

For all the talk about differences between the markets, the key question effectively boils down to the tradeoff between risk (both credit and liquidity related) and return.

The syndicated loan market offers a more predictable, albeit lower yield profile as well as sufficient liquidity in the underlying loans for an astute loan manager to be able to reposition the portfolio throughout the life of a fund in the event of a change in economic, market and idiosyncratic credit condition. This makes them well suited for "a credit allocation " in a fixed income portfolio. Direct lending funds more closely resemble private equity in their stronger vintage stamping and longer investment period. In addition, they tend to lend deeper into the capital structure and therefore part of the yield premium on offer effectively comes from taking on more subordinated or equity like risk than do typical syndicated loan funds comprised mainly of senior debt. As such, these are more appropriate for an alternative portfolio as an ''alternative credit allocation''. From a diversification perspective, the nascent direct lending market has yet to develop the broad geographic spread of its more mature syndicated loan cousin with the UK, France and Germany representing 47%, 25% and 12% of transactions in terms of volume respectively, the remaining 16% being the rest of Europe according to Deloitte[3].

From a return perspective syndicated loan funds tend to have lower fees and put money to work faster and produce more predictable returns than do direct lending funds. Direct lending funds have higher fees, typically charged on committed capital and can offer an attractive higher return profile in return for taking on vintage stamped illiquid credit risk. This is provided the manager has a broad sourcing capability enabling it to select the best opportunities, minimize potential defaults and invest in a reasonable time frame. Otherwise, the risk of negative selection combined with a drawn out capital deployment period and higher fees charged from commitment can result in a much lower than expected return which does not compensate for the illiquidity. Manager selection is therefore all the more important when it comes to direct lending.

THE KEY TO COMPOSE AN OPTIMAL PORTFOLIO AND DIVERSIFY ITS TRADITIONAL BOND ALLOCATION

The ability to source a wide range of transactions from which to choose the best is vital to the construction of a "best selection" portfolio. This is all the more important for direct lending investments as an asset will be held until maturity even if it underperforms where as a syndicated loan can be sold when the manager thinks it will produce a better outcome. For a syndicated loan manager, trading acumen is therefore also important to ensure the credit quality of the portfolio can be maintained over the life of the fund and also to boost returns with additional alpha from trading. In both cases, deep credit and jurisdictional knowledge is key along with having a sufficiently large and experienced analyst team to monitor individual credits closely. Additionally, strong arranging and restructuring skills are required to ensure the most value can be extracted from direct lending including in the event of default.

[3] Source: Deloitte, Alternative Deal Tracker, September 2014.

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