May 16, 2018 Pensions&Investments Plonline.com CRAIN
THE INTERNATIONAL NEWSPAPER OF MONEY MANAGEMENT
Industry Voices

Commentary: Private debt – a source of returns in a low-return world?


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Institutional interest in private debt has never been greater, at least based on the $107 billion raised by new funds last year, as tracked by Preqin. Yet, for many who are still familiarizing themselves with the asset class, several questions remain, particularly as the field becomes more crowded with new entrants and as different flavors of direct-lending strategies add complexity to a market that up to now has enjoyed its relative obscurity.

In some ways, this budding interest stems from challenges in other asset categories. In the most recent "2018 Asset Allocation and Market Outlook" report from investment adviser Cliffwater LLC, for instance, the consultant forecast that 10-year returns for buyout funds are expected to descend into the single digits, while hedge funds aren't even expected to eclipse the performance of U.S. equities. This comes at a time, too, when public pension plans need to quickly plug a growing funding gap. The Pew Charitable Trust, according to an issue brief published in April based on fiscal year 2016, highlighted that according to the most recent data, unfunded liabilities at state pensions collectively stand at $1.4 trillion, a shortfall attributable to returns that haven't met expectations.

But the biggest driver for private debt is a growing appreciation the category can serve as a defensive play against a backdrop of mounting geopolitical risk, declining central bank support and diminished expectations in other asset classes. A high-quality, yield-oriented private debt strategy provides a combination of current income from contractual interest and fees, but with a focus on capital preservation. Returns, meanwhile, are seen reaching the high single digits (see chart). In addition to its current cash yield, which helps mitigate the "J-curve" typical to private equity, most private debt utilizes floating-rate structures, so yields will increase with rising interest rates. While all of this has contributed to the buzz around private debt, investors new to the strategy are still faced with several questions, which will ultimately dictate whether the asset class meets their needs.

Table 1 Projected 10-year returns

Asset class	Return
U.S. stock market	6.5%
10-year Treasuries	~2.5%
High-yield bonds	5.25%
Liquid credit	5.4%
Private equity (buyouts)	8.75%
Hedge funds	6%
Private credit	7%
Private credit (levered)	9.45%
Real estate	6%
Farmland	6%
Infrastructure	6.25%
Inflation	<2%

Source: Cliffwater 2018 Asset Allocation and Market Outlook Report

Sponsored vs. non-sponsored deals

At a high level, the lack of volatility and consistency across the larger lending arena can conceal the diversity of the private debt ecosystem. And while the universe is composed of firms ranging from independent specialists in debt to insurers, hedge funds and, more recently, private equity, managers tend to differentiate themselves in a few critical ways. Many, for instance, often divide the universe by the types of transactions being pursued, be it either sponsored transactions, involving private equity firms, or non-sponsored deals. As a rule of thumb, non-sponsored transactions typically generate greater risk-adjusted returns because they are less heavily negotiated and tend to be more proprietary in nature. There are also hybrid managers, that will split their holdings between sponsored and non-sponsored deals. This can amplify origination deal flow and diversifies portfolios so as not to be solely reliant on private equity.

Origination

Of course, other distinctions exist as well. This is especially the case as new entrants have rushed into the market to take advantage of growing institutional demand. One of the more overlooked distinctions relates back to the origination strategy. Every direct lender "originates" loans. However, to most longer-term managers with a history in the asset class, origination means they directly source the investment opportunity through a proprietary network, which might include regional banks, sponsors or other circles of influence. For lenders that are sole agents, it means they structure, underwrite, execute, monitor and manage the investment.

As the market expands, it's surprising to see how few direct lenders actually source and manage their own transactions. Many just purchase club participations and rely on the agent to structure and manage the credit.

Target market

The focus on origination and underwriting becomes especially important as asset prices expand. We're now in the "extra innings" of the current cycle — as the median private equity-acquisition multiple eclipsed 12 times EBITDA last year — so these factors can become more pronounced. This underscores the distinctions between the different market segments.

Those focusing on the middle- and upper-middle-market categories, in this environment, have increasingly been utilizing the unitranche transaction to win deals and stretch themselves to transactional debt levels often from six to seven times EBITDA. Many of these same firms are also using financial engineering and additional fund-level leverage to increase their returns. This is essentially a "levered beta" approach, and often riskier at this late stage of the credit cycle.

The lower-middle market and small market, however, tend to use far less leverage — often around four times EBITDA through the last dollar of the investment for loan facilities. While smaller companies tend to be more exposed to the business cycle, more conservative loan-to-value ratios and full-covenant packages offer lenders more protection during downturns. It is also important to have fixed and variable amortization on loans and fund managers that are the sole or lead agent on transactions are typically better able to enforce credit documents. All of these factors tend to produce better risk-adjusted returns or "alpha."

Of course, other distinctions also come into play. Strategies can be categorized by the types of debt provided, such as cash-flow based or asset-backed facilities; the location of the debt in the capital structure, from senior debt to mezzanine and everything in between; or by sector specializations. Given where the market is in the cycle, however, the biggest differentiator investors will want to consider relates back to the depth of experience of the asset management firm, particularly across business cycles and in executing workouts and turnarounds.

The long-term opportunity of the private debt market remains compelling, which is why so many managers are moving into the sector. Asset owners, however, should remain focused on the manager's longevity, track record and credit-and-collection experience, while considering other factors that can help fine-tune their risk-adjusted returns.

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