Private Markets 2021:
Resilient Outcomes Amid a Turbulent Ride

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The unprecedented market turbulence sparked by the COVID-19 outbreak last year struck both public and private markets, yet several private market sectors demonstrated remarkable resilience amid the challenges of the ongoing pandemic. Institutional investors continued to see private markets as a means of generating their target returns in a low-yield environment, and the overall transaction flow by year-end was strong. To find out which sectors are holding up well, which ones remain challenged, and where investors should expect to see opportunities next, Pensions & Investments spoke with Eric Lloyd, global head of private assets at Barings; Scott Baskind, head of global private credit and chief investment officer at Invesco; and Theodore Koenig, president and chief executive officer at Monroe Capital.

Pensions & Investments: As developed markets emerge from the COVID-19 pandemic, one of the remarkable takeaways is the resiliency of private capital, even amid the initial volatility in both public and private markets. Could you share your experience with how the private markets performed?

THEODORE KOENIG: You mentioned resiliency. We've certainly seen that, but we've also seen consistency in private credit and that inspired a sense of certainty among global investors. As a result, borrowers came into the private markets for capital at a time when there was very little certainty in the public markets.

Once the deals were getting done on a consistent basis, business leaders and investors could see that the private markets worked better than the public markets. You didn't have to do "best-efforts" syndicates or look at market pricings the day before. World events didn't affect whether deals closed or not.

Large companies got used to the fact that they could do private market deals without an overabundance of disclosure of terms, conditions and covenants. That interest is continuing. We're looking at billions of dollars of deals now that are held on a co-investment, co-lending basis by private market lenders. It just speaks to the size, development and efficiency of these markets.

ERIC LLOYD: Private markets generally held up very well through the crisis, performing largely in line with what many investors may have expected. That said, performance varied widely across asset class, sector and company. Within real estate, for example, industrial and logistics properties performed extremely well. On the other hand, areas like retail — which was already facing challenges due to the structural shift away from brick-and-mortar storefronts — were hit particularly hard. Other sectors, like office, still present a fair amount of uncertainty.

Through the ups and downs, one thing that has become increasingly clear over the past year is the importance of real relationships and partnerships, not only with private equity sponsors and portfolio companies, but also with investors. We were proactive in communicating challenges and sharing our outlook, which not only allowed investors to know how an asset was performing within their portfolio, but it gave us insight into their broader portfolio challenges. Ultimately, we were able to work with our partners in a more constructive way, underscoring the value of clear communication, transparent partnerships and strong relationships.

SCOTT BASKIND: I'll focus on the private credit space, within private markets. The pandemic in the first quarter of 2020 obviously brought on not only a health crisis, but also a liquidity and economic crisis across risk-based assets. It also created significant opportunities across risk assets in general and within the private credit arena.

Those opportunities were presented in a few different ways. One was in those sectors initially impacted the

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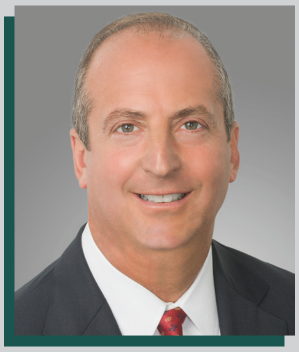

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most by the ongoing shutdown of economies, namely travel and leisure, and then the broader credit markets traded off in sympathy. But very quickly, the rebound in those sectors began occurring by the mid- to the end of the second quarter, led by higher-quality assets in general, and then followed by the rest of the private credit space.

In 2021, private credit has performed* quite well. The opportunity set remains attractive across the different elements of private credit, whether it's on the more liquid end, in the syndicated bank loan space, or the less liquid end, in direct lending and special situations, which remain a very interesting opportunity for investors.

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P&I: Let's drill down further into the private debt sleeve of the alternatives space. What are the takeaways on what worked and what didn't as portfolios repositioned to meet challenges as they arose? How will they shape future investment activity?

KOENIG: Strong underwriting worked well. That meant looking at a series of downside "what-if" scenarios to consider base-case and worst-case situations: What if business slowed? What if you lose customers? What if you lose margin? What if supply chains get interrupted? All those things happened during COVID.

Another thing that worked was equity support from sponsors. A lot of in-person businesses, such as physician practices and dentist offices, restaurants, entertainment companies and fitness centers, all of which had to close for extended periods of time, were able to survive when sponsors stepped up and provided liquidity. For businesses where the sponsors didn't step in, they were taken over by lenders and creditors. A lot of these cyclical industries got hurt. They're just starting to come back, and it will be through 2022 before we see any real positive growth.

Diversification clearly worked well. Credit diversification is your friend. The wider the portfolio, the less the concentration of risk.

BASKIND: [What has worked] is the ability to not only build strategies from an asset allocation perspective and manage them within the different verticals, but also to combine the different asset classes. It's about creating portfolios that are dynamic across a full cycle. The ability to actively manage that asset allocation within a portfolio strategy is incredibly powerful for the partnership between an investor and a manager with expertise across different marketplaces, whether it's bank loans, distressed assets and special situations, direct lending, collateralized loan obligation securities or other opportunities.

[Investors] want a manager who can add value not only from a bottom-up standpoint, but also at the macro level of asset allocation. There's value in partnering with someone who has the ability to shift from liquid assets to illiquid assets and then back in the opposite direction through a full cycle.

*As of June 30, 2021

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P&I: Given the importance of diversification — in both private equity and private credit — where should institutional investors look for diversification today, and why?

LLOYD: We saw the importance of diversification over the last year, as managers with the right portfolio composition and good diversification fared much better, overall, than those that were overly concentrated in a particular industry or asset.

As we think about diversification and consider areas of potential opportunity today, one area that comes to mind is infrastructure. If we see a material infrastructure bill passed in the United States, for instance, it will likely generate a fair amount of interest in the asset class. Aside from traditional infrastructure, there is also digital infrastructure, which might create a different opportunity set. We've also seen some interesting opportunities in residential real estate, such as build-to-rent or single-family real estate, both on the equity and debt sides.

In private equity, we're more focused on the middle-market and emerging-manager space. Compared to the really large private equity funds, emerging-manager vehicles tend to be smaller and more nimble, and typically are less correlated with public markets.

BASKIND: Within the world of private credit, we believe it's important to not only think about diversification within the context of a particular investment strategy but also to consider the opportunity to assemble a portfolio of complementary strategies within private credit via asset allocation.

There are different avenues to look for alpha-generating opportunities within a strategy. One is at the security-selection level. We would suggest that over the last year, the opportunity to drive alpha is at elevated levels versus historical periods, particularly post-financial crisis and pre-pandemic. That's quite exciting, and it holds across all ratings and risk spectrums, within both liquid assets and illiquid assets, and in lending to companies from an origination perspective at elevated spreads.

The second avenue is asset allocation — having a particular view on a go-forward perspective in terms of risk-return and maintaining a volatility-adjusted framework that allows for a dynamic approach. So, it's moving from loans to direct lending, to special situations and distressed assets, and then as the cycle moves to a more stable environment, taking the opportunity to invest in other types of assets.

P&I: With the challenges of 2020, there was also a chance for private markets to be opportunistic. How were you able to capitalize on these opportunistic strategies?

KOENIG: One of the areas where we were able to capitalize is within our opportunistic private credit strategy, which is focused on more asset-backed situations. We have built a strong business in this area. It is a great space because it is counter-cyclical and allows us to spread the portfolio over private equity-backed loans supporting leveraged buyouts and non-sponsored cash flow facilities for middle market companies, as well as loans that have significant asset protection.

We also were able to take advantage of the idiosyncratic speedbump generated by the pandemic to provide increased liquidity and rescue capital to good companies. In both areas, we were able to generate premium pricing and structures and, thus, a better overall risk-reward for our investors.

P&I: What other opportunities are you watching in the private markets space, and what are the tailwinds driving them?

LLOYD: We've started investing more in real assets that may offer some protection in an inflationary environment. We're also looking at continuation funds, since some investors have good assets in their portfolios that they don't want to monetize in this environment. So we're looking at ways to create a continuation vehicle for those particular assets as they come out of a private equity fund.

Another area we're watching is office repositioning. As the office environment changes, there will be some interesting opportunities to see what demand will look like going forward. For instance, who will be able to take existing office space, repackage or reposition it in a value-add way, and also tie in environment, social and governance components? Companies want to have buildings that really speak to their values and their culture.

We're also looking at a potential rebound in the hotel sector, which should benefit from supportive tailwinds as the economy continues to open and travel patterns start to normalize. Leisure seems to be driving the rebound for now, but as corporate travel picks up, we expect to see other parts of the hotel sector follow suit. From an investment perspective, it ultimately

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comes down to your time horizon on a particular asset.

There are a number of macro trends that are also creating tailwinds. We see that, for instance, in digital infrastructure, with investment in fiber towers, e-commerce infrastructure, logistics and intermodal transportation. We also see it in clean-and-green investments, such as on- and off-shore wind, solar, battery storage and carbon-capture technology.

KOENIG: Cloud storage and data has been a strong business over the past five years. Software and technology also continue to be very strong from a lending and an investing standpoint. We have gone from valuing these companies on an EBITDA [earnings before interest, taxes, depreciation and amortization] multiple basis to [valuing them on] a multiple of revenue, underscoring the growth.

We're also seeing opportunity in healthcare and a chance to capitalize on the changes in how it's being delivered. Five years ago, nobody would have thought that telemedicine had a shot. Today, we're seeing it everywhere.

These are sectors where you really need specialists. You need deep knowledge of these industries, in terms of underwriting, because the market is shifting so much and the rules are changing. In software, you need to understand the recurring nature of the revenue. In healthcare, especially, there are government-reimbursement rates, trend lines, margins, product innovation and insurance company pushback.

BASKIND: Some industrial and cyclical sectors have had tremendous tailwinds. There's cyclicality around the auto space that has led to very strong performance, and energy has also outperformed. One of the strongest sectors in the credit space is oil, as a result of the dramatic increase of the commodity price of oil. That inflection point in terms of creating value in the energy, oil and gas sectors has been quite opportune.

P&I: With the evolution of the secondary market space, do you expect to see continued interest in limited partner stakes in private equity?

BASKIND: The illiquid parts of the market continue to develop, and investors are always looking for opportunities to create both liquidity as well as return opportunities for investors. Secondary markets started evolving in the private equity markets years ago, in terms of investors providing secondary liquidity to LPs.

That same transition is beginning now in the credit markets. It's at the infancy of the evolution, but it's certainly something that is developing. And as we look toward the future, there will likely be opportunities for investors to gain liquidity and take advantage of that opportunity set from a return standpoint.

P&I: How does the low-yield environment today impact investor interest in the private markets? Is there continued interest in private debt as an alternative to traditional fixed income?

LLOYD: The low-yield environment has certainly been a positive for private assets. Private debt typically offers a yield premium, compared to its public counterparts, to compensate for the illiquidity of the market — a potentially attractive characteristic, particularly for longer-term investors willing and able to hold an investment until maturity. In an environment where base rates remain very low, an extra 200 or 300 basis points of illiquidity premium is fairly meaningful.

Against this backdrop, it is perhaps unsurprising that we're seeing existing investors increase their exposure and new investors come into the asset class as well. Given the leverage levels, stronger documentation and improvements in pricing, versus what we were seeing immediately preceding the [pandemic] crisis, many investors are looking at private debt as a way to pick up yield while maintaining their risk discipline.

KOENIG: Since the great financial crisis, there's been

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a steady flow of investors and LPs moving out of traditional fixed income and into private credit. Private credit is the fastest-growing asset class in alternative investments.

There's been a wind at the back of private credit because interest rates have been so low for so long. All types of institutional investors, whether an insurance company, pension plan, university endowment or health-care system, have needs from a return standpoint. For instance, you must hit your actuarial numbers if you're a pension plan to cover your benefits or an insurance plan to cover your policies.

Now we're seeing another seismic shift where high-net worth investors are pushing into private credit as well. They have historically been invested in the public markets and in bonds. They're moving to private markets for the same reasons that institutional investors did — they want safe, secure yield as part of their portfolios.

BASKIND: There is a tremendous need for global investors to invest in current-yielding assets. Credit tends to be one of the most favored asset classes, broadly. When you look at the private credit space, the vast majority of it is in floating-rate loans, whether performing or nonperforming, liquid or illiquid.

But now inflation concerns have increased dramatically. We've seen a steepening of the yield curve, and short-duration assets, as a result, have performed quite well. Investors are looking at that opportunity to capture not only the potential for increased return in these short-duration assets, but also as an offset against the principal challenges that longer-duration assets face in a rising-rate environment. That's a tremendous trend.

We've also seen a dramatic shift in bank loan flows over the course of the last several months. We had seen outflows in the bank loan asset class throughout 2020, and that has reversed course. There is tremendous demand from all types of clients, including U.S. retail and institutional clients, insurance and pension clients globally, family offices and private wealth channels. The demand environment has shifted quite significantly as a reflection of the interest rate and inflation environment.

P&I: With environmental, social and governance investing at an all-time high, how do you see it impacting private markets?

LLOYD: ESG has evolved from something investors wanted managers to include in their investment process to something they expect and demand — and its importance will only increase from here. Of course, the application and integration of ESG varies widely based on asset class, manager and a number of other factors.

For instance, a real estate equity asset manager who owns physical assets looks at ESG considerations differently than a real estate debt provider who, by definition, does not own or sit on the boards of companies. That said, we are seeing more green-financing initiatives on the debt side. In fact, our European direct-lending business last year was involved in one of the first European middle-market transactions in which ESG criteria, in the terms of a loan, directly impacted the overall price. Specifically, our team put criteria into the loan document that rewarded the achievement of certain ESG metrics via more attractive pricing.

Ultimately, with ESG, it comes down to how you influence and promote sustainable, long-term behaviors in different asset classes and companies. It can be challenging, to be sure, and there is much work to do going forward. But what we have seen thus far is encouraging.

BASKIND: ESG is an exciting focus for us and our investors. It's another opportunity for the investment community to effect change in the global environment. We have been focused on ESG investing for many years in the private credit space.

Ours is an investment-led perspective as we underwrite transactions, conduct due diligence, and monitor transactions over time. We look to engage with management teams and sponsors and educate them, particularly with smaller companies that are in the financing markets. We have created a great marriage between traditional credit-risk analysis and ESG analysis. Bringing the two of them together is an incredibly powerful tool for building portfolios, and in strategies and developing outcomes for our investor base.

P&I: Looking ahead, do you have any predictions — grand or otherwise — in terms of your respective markets that institutional investors should be aware of as they set their allocations?

LLOYD: Institutional investors will look to do more things with fewer managers, which can offer greater consistency and more streamlined reporting. Rather than working with various managers in various asset classes, we think investors will look increasingly toward multi-strategy options with a single manager—which could include a variety of asset classes, from infrastructure to private equity and real estate. In our view, the primary benefit of a multi-strategy mandate is that it gives managers the flexibility to go where they find the best value at any given point in time. It also offers the potential for diversification and differentiated returns.

BASKIND: We are quite positive on the trajectory of increased allocation to private markets in totality and capital coming into the private credit space. We think that the theme of moving from public to private markets is something that's likely to continue as many investors look to barbell their capital deployment and asset allocation decisions to meet their return hurdles, their internal targets and their need for current income and high total-return opportunities. Private markets are critical to them to balance out the more variable and lower-return public markets.

KOENIG: Private markets will remain in high demand, alternatives will continue to stay hot in terms of performance and yields in traditional fixed income will continue to be low. Inflation will pick up modestly, and we will see that on a consistent basis. We will continue to see volatility in public markets stemming from geopolitical and macro-economic reasons. We should see interest rates start to rise because of all that, but traditional fixed income still won't be sufficient to meet the needs of the institutional investor community. We will continue to see pension funds and insurance companies embrace the private markets, and private credit over public debt, because they recognize how the illiquidity premium enhances their risk-return.

The diversified alternative asset management firms — the ones that do a good job — will continue to grow and their assets under management will increase. You'll also see the larger mutual fund companies get into the alternative space. Firms that focused on public equities and mutual funds are already experiencing demand for more products. They will respond by creating joint ventures or partnerships.

I'm excited. The market over the next several years is going to be very interesting. There's a lot of green grass ahead of us in private credit. Our job is going to be to mow as much of that grass as we can. ■

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