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US Roundtable: Coming of age

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A maturing asset class, private debt continues to attract increasing volumes of capital from investors hoping to find steady, superior returns. But questions remain about risk. AtPDI's US roundtable in September, Anastasia Donde spoke to a group of fund managers and advisors about how the asset class reached the point where it is poised to earn a permanent home within institutional portfolios. While our experts were positive, the discussion inevitably also looked at the risks dogging the market.

If private debt was a young American, he might be old enough to drive, maybe to vote and buy cigarettes, but not yet ripe enough to drink alcohol or rent a car. Everyone can probably agree that private debt is still maturing as an asset class and some speakers at *PDI*'s second annual US roundtable suggest the asset class is akin to an adolescent at this stage.

Ted Koenig, chief executive of Chicago-based mid-market lender Monroe Capital, thinks the sector has three to four more years to go before it becomes a consistent and in his view permanent part of institutional investors' portfolios.

"The private debt business is like a teenager," Koenig says. "When we first started in this business in the late 1990's, it was a struggle because there was no easy bucket for limited partners to invest into this space.

It was like an infant, you had to go sell this product in a private equity allocation bucket, because fixed income was only liquid and anyone that wanted a yield-generating fixed income product was only concerned with liquidity."

These days, institutional investors are starting to dedicate express allocations to private debt but that still has some distance to go. Though there are certainly many players in the space that are interested in helping the teenager grow up.

Since the roundtable in New York on 18 September, several large firms have announced new plans for first-time direct lending businesses, or new funds in the space. Private debt managers seem to be raising money around the clock as banks across the US and Europe continue to shed loan portfolios, which are quickly scooped up by private debt firms.

So LPs are keen, and GPs are in deal-doing mode, eager to deliver returns. But as the asset class grows, so do the risks. And so inevitably, our discussion touched on both the external macro-economic threats, as well as those driven by increased growth and competition.

INVESTORS: DRIVING GROWTH

Attracting investor capital is the first consideration for any fund hoping to operate in the private debt space. Koenig notes that he has seen his investor base change dramatically over the years. To start with, in the late 1990s, most of Monroe's LPs were insurers and endowments.

"They tended to be the more thoughtful early adopters in the private debt world," he says. "Then what happened was, a lot of the consulting firms did a deep dive into the space and some of them led the way and identified differentiated, safe and secure returns through mean regression analysis and dug into a number of things to show double digit risk adjusted returns in this space," he explains.

Initially, most of Monroe's capital was drawn from private equity buckets at clients' portfolios. "It's an illiquid space, so we were competing for illiquid dollars, which very often was the private equity dollar. Our returns were very strong, in the low- to mid-double digits over a ten year period. Private equity funds were promising returns in the 20s, so a lot of those investors utilized our product as a J-curve mitigant in their private equity portfolios. That way they wouldn't be naked in terms of returns for the first several years of their private equity investments.

"And then, as the cycle wore on and investors understood that the returns that they were promised in private equity didn't materialize and our returns held true to the low-to mid- double digits promise, a lot of those investors started to come over to our product and the fixed-income world suddenly changed," continues Koenig.

Investors like pension funds need to make incremental yield on their capital to achieve their actuarial rates of return and following the fall of Lehman Brothers, when interest rates fell to record lows, they weren't getting that return. With large chunks of their portfolios allocated to fixed income, they had to look elsewhere for that yield.

“Once pension funds got into the space, our business grew significantly,” Koenig says, adding that many of the large private equity players have morphed into rather large credit managers in the post-financial crisis years.

“Many of the large asset managers have converted to more debt than equity, such as Carlyle, KKR and Apollo. Many of those are more debt players now than they are private equity investors,” says Koenig.

At Hastings, Nick Cleary runs the North American infrastructure debt operation. He says that infrastructure debt has always attracted a lot of interest from some of the most important institutional investors: insurers. “The insurers as a class have always had these private placement allocations.”

Many insurers are now increasing them: where the allocation has historically been at about 5 percent of their portfolios, now it is often up to 10 percent, and sometimes 15 or 20 percent even.

“Insurers have always invested in infrastructure through the private placement channel and now that channel is getting very crowded, so they’re looking at how they can participate to get better value, better scale and global exposure,” Cleary explains.

WHAT BUT ALSO WHERE

Todd Silverman, who covers the gamut of debt strategies as head of a dedicated private debt team at Meketa, says pension funds are increasingly investing money in Europe after focusing on the US for a long time. “It’s been largely US-focused to date, but I think we’re seeing an increasingly attractive opportunity within Europe, in particular, on the lending side, where the lending environment is at an earlier stage in terms of recovery than the US.

“To the extent that a lot of capital has flowed to US mid-market lending and some of that pricing has gotten a little bit tighter, Europe potentially offers a little bit more opportunity going forward,” Silverman adds.

Throughout the discussion, the consensus around the development of private debt as an asset class was that it will take another three to four years to fully mature.

Amid this evolution, more institutional investors are allocating to private debt from their fixed-income portfolios rather than private equity buckets. This is good news for the managers of course, because pensions’ fixed income allocations are normally a lot larger than their private equity portfolios. And from the pensions’ perspective, the return potential looks more attractive when compared to fixed-income than it does against private equity.

In contrast to last year’s roundtable discussion, which was negative towards opportunities in Europe, this year’s participants argued in favour of the continent being part of the overall private debt growth story.

For GSO’s Brad Marshall, the asset class is well positioned to take advantage of the European dynamic. “The capital markets in Europe are very different than in the US, in that banks hold the vast majority of corporate loans versus the broader capital markets. In Europe, there are a lot of structural issues preventing corporations from pushing out their maturities like we saw in the US,” says Marshall.

“So there is going to be, what we think, a huge opportunity to put capital to work in Europe, when these maturities come due and European banks are unable to provide capital. We’ve raised European funds to capture that opportunity, as well as invested some capital from our drawdown funds in Europe,” he adds.

RATES, RISK AND REGULATION

Much of the development of the private debt investor base has been in response to market forces. Interest rates have been kept at abnormally low levels for a long time, leading to paltry bond returns and forcing investors have to look elsewhere to spruce up their fixed-income returns.

Now all stripes of market participants anticipate interest rate rises and are positioning their portfolios for a rising rate environment.

Koenig notes that there have been many new entrants into the lending space and he’s curious to see what will happen to them as rates rise. “There have been a lot of money managers that have great asset management firms that have developed a strategy right now towards the direct lending space because it’s been relatively easy to raise money and there has been a lot of good product development.

“As interest rates go up, as I think they will, it will be interesting to see what happens to those new entrants and who’s left in that space and whether they might direct those dollars to other, less costly alternatives for deploying capital,” Koenig says, adding that the private lending business is expensive.

Meanwhile the risks in the overall credit market also appear to be rising. “Leverage multiples are at all-time highs. Most of the deals in the large, broadly syndicated loan market are covenant-light. You look at all those factors and people get scared,” Koenig says.

“If interest rates go up, it’s going to be a challenge for companies that are very highly levered, because their fixed charge coverage ratios will get hit and cash flow will suffer which in turn will create defaults and increase the default pool of loan portfolios.

“We saw this happen in 2008 and 2009. The borrowing companies that have high degrees of leverage will need to be restructured like [during] the last cycle,” Koenig explains. “It’s going to create opportunities for distressed debt investors and rescue funds and all that; the people that have been sidelined for the last three years will have their day in the sun again.”

Cleary is actually surprised how little people acknowledge risks in the market, or how dismissive they are of them. “I find it really odd that people aren’t talking about it more. There’re saying, ‘it’s a really benign environment’. They’re making these comparisons to 2008, ‘leverage is at the same levels as it was before, but it might not be too bad because default rates are low',” he notes.

Cleary says last time around, when growth fell away, rates also fell away, which added some buffer. “The environment we're in today is low growth, low rates, so I'd question what the downside buffer looks like. You can see why the Fed and Janet Yellen have been very cautious in balancing rate increase with growth. They're going to have to keep that growth and rates in check,” continued Cleary.

“It's not just about default rates, it's also about recovery rates and I think that's going to be the difference for the next cycle,” adds GSO's Marshall. “Because in the broader, liquid market, the structures are so loose that lenders just don't have the opportunity to get to the issue early to help solve some of the problems, which is great for the private equity firms, but I think it's going to be too late once these companies do default. The loans are going to be severely impaired. One of the things we think about is getting our companies to hedge out their interest rate risk, even though the loans are floating rate. In many cases, we'll ask them to hedge out so there is no surprise to the spike in interest rates. I think you'll see more of that happen now as we get closer to a rising rate environment. I think you'll see a pick-up in that type of requirement from lenders.”

Silverman notes that as more capital has come into the lending space, returns have abated somewhat, but he thinks that's logical. “I think accepting less risk is the right trade-off as opposed to managers using more leverage, or moving farther down the capital structure to maintain the same level of returns that you might have seen three to four years ago. I think that's the right approach and what investors want.”

“A lot of the money that has come into the space, [and al]though it may be illiquid, it doesn't have a private equity opportunity cost to it, so people are viewing it as extra yield above public fixed income,” Silverman explains. “I think the expected returns have come down and the spreads have narrowed between private lending and public fixed income. But we haven't seen managers taking extra risk and, to me, that's the right approach. I think that once you do start to see that, it's a real sign of a turning point in terms of there being too much capital in this market.”

Cleary, meanwhile, is confident that the stable long-term nature of infrastructure assets means his side of the business hasn't been and won't be badly affected by some of these risks. He says he has been comfortable with the way the assets have been performing and that lending standards haven't changed. “Most infrastructure, if it's true infrastructure and not something infrastructure-like, you're more resilient [to] the economic piece,” he says.

“One of the things that we talk to our clients about is our experience and infrastructure's track record as highlighted in a report from Moody's that tracks 30 years of infrastructure and project finance default and recovery rates. It tells a very good story. Infrastructure has had the lowest default rates and the highest recovery rates,” says Cleary.

On the regulatory front, the managers expect more fine-tuning on bank guidelines to come forth from the Office of the Comptroller of Currency (OCC), and think it will lead to more opportunity for private lenders. “The OCC has set up some guidelines and they were somewhat vague and they're making an effort to make those less vague," says Marshall.

"They went through a review process with all the banks over the summer and that is ongoing. That review process will assess how they've acted since the guidelines have been put in place," Marshall says. "I think the banks are going to pay more attention to the guidelines and take them a little more seriously and net/net, I think that's a positive for the private debt market."

He adds that while regulators certainly can come after private lenders, he doesn't expect them to do so any time soon. "Private lenders own the risk they are underwriting vs syndicating and so I think things would have to be very stressed for them to go down that path."

EMBRACING THE FUTURE

Like any adolescent, private debt will have difficulties as it matures. Many of those are likely to be regulatory challenges. Across the board financial markets are dealing with moving goalposts and it is clear that regulators are not going to leave the private debt space out of those changes.

It is also evident that there are market risks too, particularly with loosening covenants and lower returns within leveraged finance. In October, global financial markets also suffered a general wobble and concerns about a potential deflationary spiral while continuing recession worries across the eurozone cannot be dismissed.

All that being said, it is also undeniable that a lot of progress has been made. Private debt has started to carve out a niche for itself within investor allocations and the prospects for investment opportunities are bright in the States, and are growing in Europe. This is one of the main reasons behind private debt practitioners' optimistic view of the future. But when the market turns they, like everyone else, will have their work cut out.

INFRA OPPORTUNITIES

Nick Cleary, newly appointed director of infrastructure debt at Australian infrastructure manager, Hastings, says investors like infrastructure debt because it is reliable. Unlike certain parts of private debt, infrastructure generally offers more long-term stability, which appeal to institutions like insurers and public pension funds, Cleary explains.

The US also presents an interesting case, as there is clearly a lot of work to be done in infrastructure and private investment that's needed and warranted, but, so far "it's been the promise that's not been delivered", Cleary says.

"There has been a lot of talk about the potential for the US to be the biggest infrastructure market globally," Cleary says.

"I remember in the banking industry, we were sitting around in project finance teams waiting for the growth and it didn’t happen,” he recalls.

“I’m not sure I’d quite call it ‘happening’ now, but we’re seeing some tangible signs in energy, transport and increasingly public private partnerships. So it feels more positive now than we’ve seen in the past. The underlying need is certainly there as roads are crumbling, bridges are collapsing, and government funding is running out,” says Cleary.

Citing a recent McKinsey & Co study, Cleary says there is $1.2 trillion to be spent on non-energy infrastructure and $1.4 trillion to be spent on energy-infrastructure in North America by 2020. The US is arguably behind other regions in terms of infrastructure maintenance and investment.