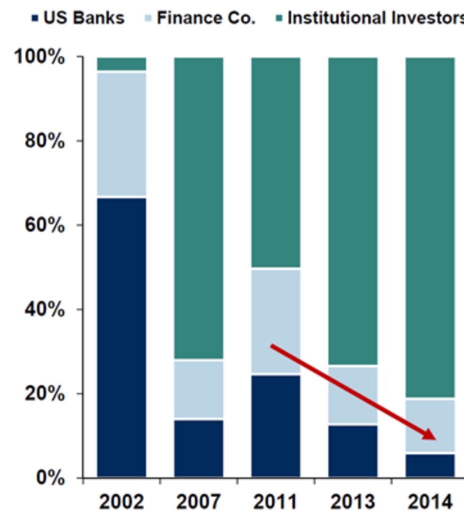
PRIVATE DEBT

Credit markets resemble nature in their diversity of species. The spectrum is indeed wide and colourful. Markets have continuously shown us that not all of these types were meant to persist and the evolution continues. Private debt on the other hand has always been part of the credit world, nonetheless it is lesser known as an investment instrument. More recently it moved into the spotlight. It is time to take a closer look at this type of investment.



Private Debt – The Other Type of Credit

The consequences of the financial crisis and in particular the subsequent impact on regulation spread out to the land of private debt. As banks are obliged to confirm with risk based capital requirements such as Basel III, their ability to lend to mid-market companies, which was once a key area of business, materially decreased. This development is frequently referred to as banking disintermediation. As banks stay away from more challenging transactions in lending, a gap for credit facilities for mid-sized companies emerges.

While banks partially withdraw or are restrained by regulation from this area of activity, investment managers increasingly enter the market and provide private debt to enterprises, which subsequently creates an interesting new field of investment opportunities for sophisticated investors. It is estimated that within the US market alone around 370,000 small and medium enterprises have approximatively USD 1 trillion of outstanding debt. More than two thirds of them do currently not have a strong partner who could help them with their future financing requirements. Therefore there is a substantial need for new financiers to support the middle market segment.

Mapping The World of Private Debt

The tendency of banks facing constraints in lending to mid-cap companies is similar on both sides of the Atlantic. Nonetheless the private debt markets differs quite substantial and the investible universe for investors has a clear bias to the US. The US benefits on the one hand from a more sizeable mid cap market with a homogenous legal framework. As the mid-cap market is a stronger contributor to the US economy overall, the lending market is also more mature and dominant than its European peer. A disadvantage of the European market is the diverse set of legal conditions. For example foreclosures are handled quite differently in Spain than in the UK. Despite these constraints the European private lending market has experience substantial growth in the recent past.

It is vital to highlight that the focus of private debt managers is on prosperous companies with sound financials and encouraging growth expectations. The fact that the lender faces challenges in raising debt does not imply the company is experiencing financial difficulties. The size of the company determines their options of taking on credit. Just because mid-cap companies do not have a credit rating, it does not imply that these companies would generally have a low creditworthiness.

The new lenders in the market are experts in credit with a long standing experience and deep understanding of credit structures. In many cases it is hedge fund managers, who have always been part in this market to a limited extent and now expand their activities.

Drilling deeper on the types of lenders it is key to look at their underlying motive: Growth investors emphasize on the strong outlook of the company. Their investment horizon is rather medium term, their terms of the debt are a fixed coupon (not floating) and the collateral is likely to be illiquid. This segment of private debt overlaps with private equity and therefore private equity sponsors dominate the field. Value investors, on the other hand, pay more attention to the current setting of the company. The collateral of the loan and the term of the credit are the centrepiece of negotiations. These loans are shorter in time and usually of floating rate nature. This article deals with the latter segment of the market.

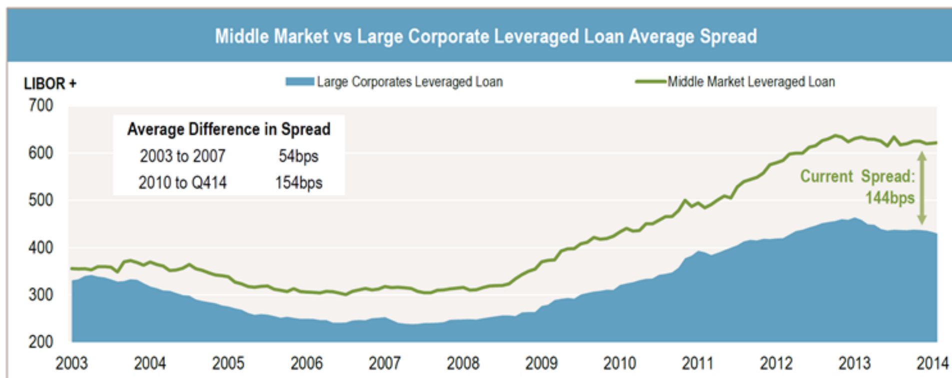
Wide Range of Instruments

Private debt comprises a wide range of different loan instruments. Overall three broad types of investments exist: direct lending, asset based lending and trade finance.

- Direct lending encompasses the majority of private debt and usually consists of term loans, which have a maturity between 1 to 10 years. These loans are either amortizing or paid at maturity. Bridge financing is also part of this category.

- Asset Based lending is different in nature as the loan is secured by a specific asset. Due to this extra layer of security the return is lower as in case of a default, the lender can recoup losses through the sale of the asset.

- Trade Finance resembles asset backed lending in all major aspects. The only prime difference is the fact that these transactions are across borders and therefore lenders and borrowers face different jurisdictions.



Differentiation to Syndicated Bank Loans

The private debt market differs in quite some respects from the well-known credit market. High yield bonds as well as syndicated bank loans are launched by large cap companies, who face fewer obstacles in issuing debt instruments via banks. This way they target a diversified investor base and the terms are negotiated by the banks. Private debt, on the other hand, is originated and structured by the investment manager directly and therefore requires an experienced team with substantial know-how. The focus is on mid-sized companies with an approximate enterprise value of USD 50 million to USD 1 bln, which have smaller capital needs. Usually the time horizon for direct lending with an average of 3 years is shorter than those of high yield bonds or syndicated bank loans.

Privat Debt	Publicly Traded Debt (high yield bonds, leveraged loans)
Origination and Structuring directly by Investment Manager (Know-How and Costs)	Syndicated by Banks
Mid-cap Companies	Large Companies
Short Term Financing	Broad Investor Basis
Limited Credit Needs	Substantial Credit Volume

Hands-on Tasks of Private Debt Portfolio Managers

The investment manager screens the universe for the most attractive deals. The focus is entirely on sound and good performing medium sized enterprises. Lending has been the bread and butter business of banks for centuries. As discussed previously banks shy away from middle market lending, which leads to perfectly health companies which are no longer serviced. For successful lending the following elements need to hold: access to supply, outstanding negotiations/structuring skills, ability to seize assets and in depth know-how of corporate restructurings.

In detail the work flow of private debt manager is best explained by the following steps:

(1) Origination:
The private lenders screen the universe for the most attractive deals. The manager's access to the best deals are a key factor to success. The deal origination may go through various channels – a direct relationship, a bank or a broker.

(2) Structuring:
The next step, the structuring phase, involves setting out the terms of the loan. Major elements of discussion are the subordination of the loan (e.g.: 1st lien versus 2nd lien, mezzanine), the leverage ratio, the financial covenants, the time horizon as well as whether the investor is the sole lender or part of a club deal. On average only 8-13% of the deal in the due diligence process are underwritten in the end. The manager's expertise in structuring these terms and his bargain power are essential in this stage.

(3) Monitoring:
Once the investment takes place, the monitoring process starts as the loans are continuously revalued (e.g. collateral and financials review). Needless to say that this process requires an in depth skill set and a lot of time. Next to picking the right loans, the managers have to focus on building a diversified portfolio overall. Direct lending portfolios vary by the degree of sponsored deals.

Key Findings for Investors

- Investments into private debt share similarities with publicly traded credit instruments (e.g. high yield bonds and syndicated bank loans) as they all have a strong link to the general health of the economy. Consequently, the level of corporate defaults remains an important indicator. Historically, mid cap companies produced higher recovery rates than their large cap peers.

- Based on the idiosyncratic origination, structure as well as the limited liquidity, direct lending offers higher returns to investors. The excess spread of private loans vary significantly depending on the underlying company and the specific structure.

- The majority of private debt benefits from the floating rate nature of loans as the interest payment is not fixed but floating based on Libor plus a spread. Accordingly, investments into direct lending are well positioned to face a rising interest rate environment and potential spread widening.

- Based on the less liquid nature of direct lending portfolios the terms of such funds are more restrictive than what hedge fund investors usually expect. The life time of a single private debt loan is on average 2-3 years, however liquidity of the loan is limited. Moreover, the portfolio manager has to keep an eye on the overall liquidity and term structure of the entire portfolio.

- The single private debt investments are pooled in funds, which do not rely on leverage. Therefore these investment vehicles are not structured products such as CDOs, which is caused concerns in the last financial crisis.

In a nutshell

While the sector of private debt is not "new" in nature, it only recently emerged as an investable asset class to investors. The characteristics of a short duration credit investment as well as the link to mid-cap companies provide essential diversification benefits. The excess spread compared to high yield bonds and syndicated loans render the investment even more attractive.