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European Private Debt: Quo Vadis?

Paul Burdell **discusses the growth of private debt within institutional portfolios**

WRITTEN BY PAUL BURDELL, CHIEF EXECUTIVE OFFICER, LCM PARTNERS

Private debt has today established itself as a recognised asset class for institutional investors. Following the global financial crisis, increased banking regulation has presented a plethora of investment opportunities for private debt managers while the near zero interest rate environment has attracted investors searching for yield. In 2007, Preqin estimated private debt total assets under management were US$205 billion; fast forward to June 2017 and that figure had more than tripled to US$638 billion. With approximately US$100 billion of capital raised in each of the last three calendar years, it is no surprise that the Alternative Credit Council forecasts the asset class could reach US$1 trillion by 2020.

Geographically the US remains the most mature private debt market with bank loans now accounting for less than 30% of funding to non-financial corporates. This compares to a figure closer to 70% for Europe. This dynamic is reflected in regional private debt capital raising activities with North American focused funds responsible for 55-75% of total assets raised in each of the last seven years. With Asian private debt markets still in their infancy, the lion's share of the remaining capital has been raised by European focused funds, driven predominantly by a handful of core investment themes such as the acquisition of non-core assets or non-performing loans (NPLs) and mid-market direct lending.

While US banks were quick to address their NPL exposures in the wake of the financial crisis, the process has taken much longer in Europe and is only now really gathering momentum. To put this in context, despite three consecutive years of NPL sales in excess of €100 billion, the European Banking Authority (EBA) estimates that NPL stock remains significant at €779 billion; according to the World Bank this equates to an NPL ratio of 3.7% for the EU which remains well above that of other developed markets such as the USA (1.1%) and Japan (1.2%).

Along with legacy NPL exposure, bank activity has been further curtailed by the on-going roll out of regulatory standards such as Basel III and IFRS 9. Against this backdrop, lending by European financial institutions remains below levels reached prior to the global financial crisis as banks have increasingly focused on balance sheet efficiency and those activities that generate the strongest risk-weighted returns. This has presented opportunities for more nimble, less capital constrained direct lenders to transact in areas of the middle-market previously occupied by traditional finance providers. However, with bank capital positions having improved and lending volumes stabilised in recent years, it is clear that European financial institutions are not going to retrench to the same extent as their American peers. In fact, banks remain fiercely competitive in areas of the market that remain core to their businesses. If European private debt is to maintain its current rate of growth, there is a need for the asset class to further evolve and innovate. Already there are some clear trends developing in this vein.

Investors deepen relationships with core managers

As the asset class has matured, a number of European managers have established market leading positions, with proven track records across the cycle and significant origination experience and resources. These managers are raising ever larger multi-billion dollar funds and look set to continue to do so as investors commit to larger and longer term relationships with their chosen managers.

Conversely, the market is likely to become increasingly challenging for those managers who do not have the required scale or resources. The strong returns generated by core direct lending and NPL strategies have attracted capital and competition has increased. Indeed, market participants have already expressed concerns about yield compression and deterioration in underwriting quality in

middle-market transactions. We see at first-hand heightened levels of competition from newcomers in some of our longstanding NPL markets, such as Italy, and believe that only those with a market leading or differentiated product offering will survive in the medium term.

At LCM we have been operating in Europe for 19 years and today have 10 offices in six countries, employing over 700 people. Our infrastructure creates barriers to entry since other managers are not able easily to replicate our approach. The experience and data from completing over 2,000 transactions across multiple economic cycles allied with our pan European origination and servicing footprint means we are able to switch our focus to markets or asset types that are providing the most attractive risk-adjusted returns at any point in time. This, in turn, allows us to continue transacting at our target rates of return whilst not compromising on asset quality even in tighter market conditions.

Proliferation of specialty finance ideas

As European private debt has evolved, the asset class has diversified and more recently a number of specialty finance strategies have gained traction with the institutional investor community. This is another trend we expect to continue since these innovations form a natural complement to core private debt holdings and can offer competitive returns with low correlation. Recent examples include strategies relating to royalty funding, insurance-linked notes, litigation claims and the technology-based marketplace lending platforms.

While many specialty finance strategies can struggle to overcome doubts over scalability, there is plenty of scope for building size with the right product offerings within the sub-corporate, retail lending markets. In Europe alone, this consumer and SME financing space is estimated to be well in excess of €10 trillion with many areas of under-funding as a result of banks having simplified their operations or exited activities which they consider to be sub-scale or too capital intensive. However, so far European direct lending strategies have been less active in the retail and smaller ticket SME market than corporate debt or leveraged loans for two main reasons. First, Alternative Investment Funds are not allowed to originate consumer loans directly under AIFMD. Instead, a manager must provide financing to an intermediary who will ultimately make the loans in accordance with local regulations. Second, the management and servicing of many thousands of underlying borrowers is operationally complex and resource intensive. As a result, direct lending managers wanting to lend into this segment must develop their operational expertise and find intermediaries with whom to partner, else adopt a private equity strategy by buying a lender.

As a case in point, our Strategic Origination & Lending Opportunities (“SOLO”) direct lending strategy relies both on our own experience of servicing consumer and SME loans over the last two decades as well as the strategic partnerships which we have developed with third party originators such as original equipment manufacturers (OEMs) or specialty finance companies who typically require both our funding and pan European loan servicing infrastructure. This offers our investors a scalable investment opportunity which differs from their corporate or real-estate private debt exposures and has the diversifying benefits of access to thousands of underlying borrowers and the accompanying low correlation and concentration risks.

Concerns over the next downturn

The recent publication of several consultant reports highlighting growing interest from clients in more conservative, lower return private debt strategies appears to be a reaction to investor concerns regarding the onset of the next economic downturn. When the next downturn does occur, our hope is that relative performance across the private debt sector continues to deliver and that investors benefit from the broader features of the asset class. Without doubt firms that have made poor investment decisions will simply shut but private debt should not share the systemic issues that permeated the banking sector. Instead, a natural winnowing will only serve to improve the longer term prospects of the asset class. When conditions do turn, the existence of whole loan, rather than securitised, transactions will ensure greater transparency for all market participants. Furthermore, without the paralysis which grips the traditional banking model during times of crisis, managers will be free to react to market events more quickly. Finally, backed by long term capital, funds will be well-positioned to take advantage of the opportunities that arise as a result of the market dislocations.

Economic downturns are an unpleasant inevitability. As ever, there will be winners and losers but our expectation is that the next downturn will only serve to confirm that the private debt model merits its presence in institutional portfolios. ■

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David Whitehouse discovers how European private debt can open up new avenues for returns

WRITTEN BY DAVID WHITEHOUSE, A FREELANCE JOURNALIST

Exploring new opportunities

Since the financial crisis, private lending of all types has experienced significant growth both in volume and investor awareness. Private debt in Europe has become a flourishing and increasingly competitive marketplace.

Companies traditionally financed themselves in the banking market, and bigger companies used a combination of banking and the bond market, says NN Investment Partners head of specialised fixed income Han Rijken. Banking regulation developments in the wake of the crisis were a key driver of change. Banks were forced to optimise their balance sheets and subsequently focus on the most attractive parts of the loan market to reduce risk. This, Rijken says, opened up a gap that has been filled by private debt. NN Investment Partners recently held a survey among European institutional investors. A clear outcome was that pension investors will further increase their allocation to private debt.

There is no question that this allocation shift is a reality, according to BNP Paribas UK head of institutional sales Philip Dawes. Private debt helps with liability matching at the same time as improving real returns in a context of low government debt yields, he argues. Investments are marked to model and not to market, he says, so reducing volatility.

Patience is needed to build a private-debt portfolio, Dawes argues. The lack of public information creates a certain "mystique" around private debt, but that does not make the market any less efficient, he says. It's important to be aware of the amount of money chasing a finite number of deals. Dawes believes that there is less competition in small cap private debt.

It has historically been difficult and labour intensive to get access to private debt transactions in areas such as infrastructure, Dawes says. The amount of work involved in sourcing the transactions means high up-front costs. But, Dawes says, private debt investments are bought on a buy-and-hold basis. All being well, there is not much to do afterwards. He sees a trend whereby historically high charges passed on to pension funds are changing to an approach where the initial costs are spread over the life of the transaction.

For pension schemes, insurance companies, endowments and other institutional investors, private debt is becoming a strategic choice, according to M&G co-head of alternative credit William Nicoll. Pension schemes' need for income sources above government debt rates are underpinned by Europe's changing demographics and the EU's increasing old-age dependency ratio, a measure of the number of elderly dependents relative to the working age population. It is therefore unsurprising, argues Nicoll, that pension funds in Europe are the single biggest cohort of investors in European private debt, followed by insurance companies. Private debt is valued for many purposes, from the best-known goals of higher yields and diversification from public debt markets, to attractive outcomes that can include longer-dated maturities, inflation linkage, security over hard

assets, defensive or counter-cyclical properties, and access to borrowers not found in the bond market, he says.

There are multiple reasons for pension funds to add private debt to their portfolios, argues Rijken. The additional yield typically available consists of a higher coupon and sometimes upfront fees, providing compensation for lower liquidity and greater complexity. A second important reason is diversification. Pension funds can tap into new universes that are not available in public markets. Private debt markets have low correlation with public markets, and so reduce overall portfolio risk. Another beauty of private debt can be downside protection, due to strong documentation and close involvement of the lender with the borrower. This documentation gives the lender "a seat in the front row" if a company gets into trouble, and often results in higher recovery values, Rijken argues.

Private debt, Rijken says, can be structured in many shapes and forms: floating, fixed-rate, long and short maturities, amortising or bullet structures give the pension fund the opportunity to tailor the private debt to fit into the balance sheet as a whole. For investors that have a strong focus on ESG aspects, Rijken argues, engagement with the company throughout the life of the loan is potentially a very positive element. Tailor-made documentation allows for ESG-related covenants and the selection of specific investments to contribute positively on issues that investors deem important.

Turkish crisis

The risks presented by the Turkish crisis and the threat of US-China trade wars make it a good time to consider private debt as a way to reduce volatility, Dawes says. Private debt relies on many underlying asset classes, and some of these classes should be avoided at certain points in the cycle, he says. A multi-asset approach incorporating private debt provides the best insurance, he argues.

The volatility triggered by Turkey supports the diversification argument for including private debt in pension portfolios, Rijken says. LCM Partners chief executive Paul Burdell agrees. The Turkish crisis won't fundamentally affect the outlook for private debt and if anything will create new opportunities. "We purchase good loans from bad banks and bad loans from good banks," he says.

Burdell was a senior adviser to the European Central Bank on its asset-backed securities (ABS) loan level data initiative from 2008 to 2016. LCM has about 50 per cent of its private debt portfolio in the UK. It believes that private debt investment opportunities continue to proliferate in continental Europe and it is examining further leads in Spain, Portugal, Germany, Poland and Italy. Its Strategic Origination and Lending Opportunities (SOLO) fund, which has debt originators as its strategic partners, is more than halfway through raising €1.5 billion euros, and expects to reach its target by the end of 2018 or at latest in the first quarter of 2019.

"The zero-interest rate environment over the last three to five years has forced fixed-income managers to look at private debt," Burdell argues. "Pension funds now understand what private debt is about. The genie won't go back into the bottle." Possible higher interest rates in future will help, rather than hinder, the take-up of private debt by leading to higher debt spreads, he says.

The "elephant in the room", according to Burdell, is the question of liquidity. "How liquid is liquid? The fact that an asset is not publicly traded is not material if it is quickly cash generative, provided asset quality does not degenerate," he says. "Breakeven on our private-debt investments is typically reached at between 20 and 40 months, due to the low prices at which the assets are purchased." A portfolio of ING Leasing debt held by LCM is currently producing a yield of 11.1 per cent. Non-performing loans purchased in the UK are yielding about 6 per cent. These yields are a large multiple of what is available if the same underlying assets are securitized and then purchased as publicly traded securities, Burdell says.

Private debt as a transparent investment is a counter-intuitive proposition. Burdell is in no doubt that private-debt investors have access to a greater depth of information than is available to investors in public securities who may have only an annual or semi-annual report to rely on. LCM's portfolios, he argues are fully transparent. "If there is a problem in a portfolio, we'll tell you how we'll fix it." This combines with the higher returns available in private debt to create a compelling value proposition. Ultimately, Burdell argues, private debt is a question of "wholesale versus retail returns". ■

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