CIO Perspectives

ALTERNATIVES

An Introduction to Private Debt

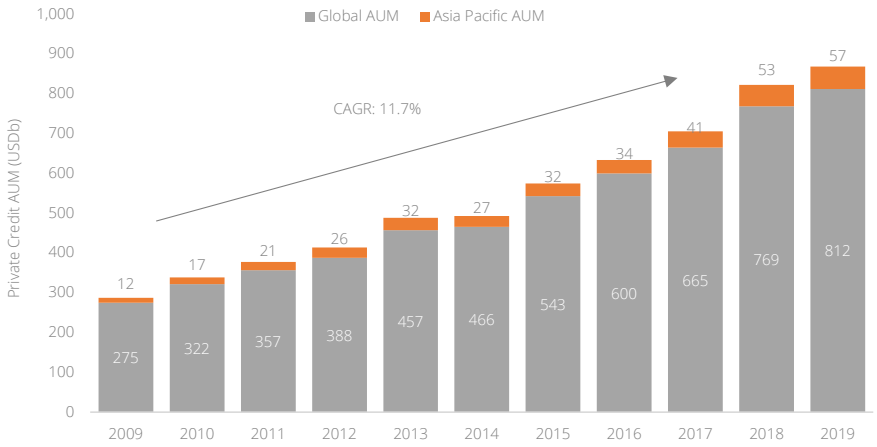
DBS Chief Investment Office

Key Points

- The hunt for yield and a stellar track record have seen private debt go from niche to mainstream
- Investors gain access to a variety of strategies including direct lending, mezzanine funds, and distressed debt, among others
- Returns of private debt eclipse most forms of public debt, even direct lending - the category of lowest risk
- Private debt default rates have been kept low, keeping risk-taking manageable
- Benefits of private debt include protection from rising rates, more control, and lower volatility
- Private debt now also boasts knowledgeable fund managers with good track records
- Risks to be aware of would include absence of a liquid market and more lax due diligence

Broadening the search for yield. The decade since the Global Financial Crisis (GFC) in 2008 has shown investors that unbelievably low yields can go lower still. This seemingly "no-exit" strategy of unconventional monetary policy around the world simultaneously creates a (i) Dearth of income-generating assets on top of (ii) Excessive amounts of financial liquidity, turning investors into scavengers looking far and wide in search for yield.

Figure 1: No stopping the (in)flow



Source: Preqin Pro, EY, Alternative Credit Council, DBS

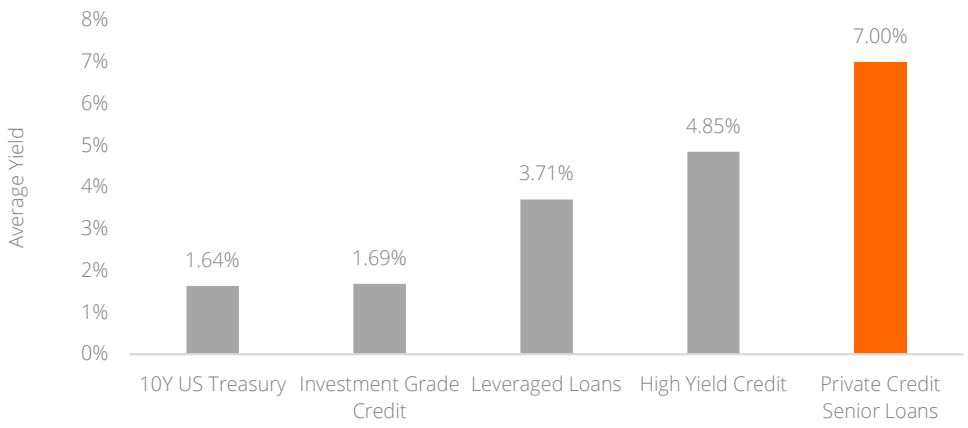
The hunt has led many investors to warm up to the niche world of private debt – an alternative asset class that once drew caution due to its opacity. That is no longer the case. Private debt investments have since been able to produce a stellar performance track record, leading investors of all types – including perennially-conservative pension funds – to continue to allocate capital to this alternative with rising enthusiasm. Most notably, the AUM of private debt has seen steady growth in the last decade, with a compound annual growth rate (CAGR) of 11.7% in the ten years since 2009.

Debt in all its shapes and forms. Within the realm of private debt, investors are offered a variety of strategies that cater to specific risk preferences and opportunity sets. We sum up a few of the major categories of private debt below:

1. Direct Lending – Investors extend loans directly to companies (generally small and medium enterprises, or SMEs) and receive regular interest income throughout the term of the investment.
2. Mezzanine Funds – Investing in instruments that are generally subordinate to senior debt or working capital facilities but rank above equity. Investors may capture more upside than vanilla debt through structuring of convertible rights or embedded equity options.
3. Distressed Debt – Purchasing deeply discounted debt securities in a distressed scenario and generating returns through restructuring or negotiation.
4. Special Situations – Participating in a lending opportunity that arises due to specific events rather than company fundamentals (M&A, corporate restructuring, bridge financing etc.)
5. Project Financing – Investing in debt used for infrastructure development or acquisition of real estate.
6. Venture Debt – Providing loans to early-stage companies for financing of equipment, receivables, or other general forms of growth capital.

Returns that eclipse most forms of public market debt. As much as the above strategies span a wide range across the risk spectrum, it is worth noting that even within the category of lowest risk in the domain of private debt investing – namely in direct lending – we observe returns at a magnitude almost unheard of in the realm of public debt. These loans are consistently able to generate returns in the range of 6-8% per annum, more than 500 bps above Treasuries and Investment Grade credit, and more than 200 bps above High Yield credit and Leveraged Loans (some of the most risky classes of public-market debt today).

Figure 2: Higher than High Yield

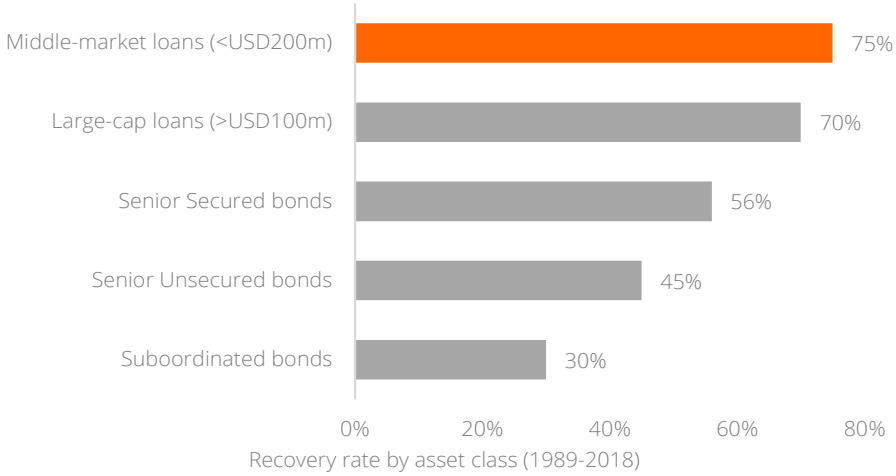


Source: Bloomberg, DBS

Higher returns were not made with excessive risk-taking. The experienced investor would look at such elevated yields and immediately wonder if there is inordinate exposure to insolvency risks in the underlying investments. However, an analysis of default trends shows otherwise – private debt default rates are surprisingly low. Even in 2020, a year devastated by both a coronavirus pandemic and an oil price shock, default rates in private debt did not rise above 3%. This is remarkable considering that defaults in global High Yield credit reached 6.7% and Leveraged Loans reached 4.2% in the same period.

Moreover, investors are often accorded significant protection in private debt even under a default scenario. More specifically in direct lending strategies, investors have stronger downside protection due to good asset collateralisation and higher ranking in the capital structure. This implies that lenders have the first claim on company assets such as cash, receivables, and equipment, ensuring that liquidation does not severely impair one's principal investment. The average recovery rate for US middle-market senior loans (1989-2018) was 75% – far higher than the 56% for senior secured bonds traded in public markets.

Figure 3: High recovery rates for direct lending



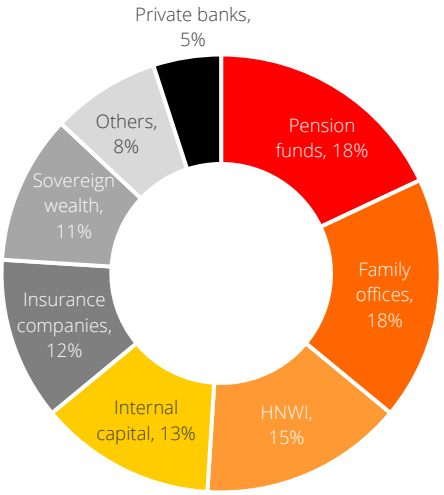
Source: S&P CreditPro, DBS

Private debt liquidity nearly crisis-proof. A large part of the steady performance of private debt in 2020 was the persistence of ample funding, unlike in public markets which ironically saw bond prices gap downwards on thin liquidity during the crisis. Global fundraising for private debt dipped merely 6.7% from 2019 levels, with commitments remaining above USD100b for the year.

What made up for the decline in direct lending (the largest portion of the private debt market), was the resurgence of the distressed and special-situations strategies. This was in part fuelled by "trigger funds"; funds where institutional investors pre-commit capital to a strategy that is triggered upon a market dislocation – one which a global pandemic would result in no shortage of. These strategies proved effective as dislocations generally turn out to be more short-lived than the market expects.

Inflows undergirded by structural trends. The continued success of such strategies, together with other long-term secular trends such as the (a) disintermediation of bank lending due to regulatory obligations following the Global Financial Crisis, as well as (b) sustained low interest rates from unconventional monetary policy, ensures that demand for private credit investments would continue on its rising trajectory for years to come. Even in Asia, where private credit remains a nascent segment of the global markets, AUM has more than doubled from USD27b in December 2014 to USD57b in June 2019.

Figure 4: Sources of capital for Asia Private Debt



Source: Preqin Pro, EY, Alternative Credit Council, DBS

Opportunities in private debt. Apart from the favourable risk-return profile described above, investors in private debt gain several other unique advantages:

1. Protection from rising rates – Loans in direct lending are generally structured with floating-rate coupon payments which rise with the interest rate environment. Additionally, these floating rate loans normally have contracted floors on the reference rates to protect against a decline, allowing both upside capture and downside protection at the same time.
2. More control – Investors are accorded better access to the company both before and after the deal inception; this allows for greater control over the terms and structure of the deal.
3. Lower volatility – Mark-to-market values of investments are not as volatile as publicly traded High Yield debt, resulting in favourable risk-adjusted return calculations.
4. Diversification benefits – Private debt is often lowly correlated with other asset classes, as well as the business environment in general due to its penchant for counter-cyclical deployment.

Risks in private debt. That said, investors would also do well to familiarise themselves with the unique prevailing risks pertaining to private debt investments:

1. Illiquidity – Unlike public debt markets, there is an absence of a liquid market to sell positions in private debt investments, implying that capital commitment may be required for extended periods.
2. Covenant-lite loans – The downside of large pools of funds chasing limited private debt assets is the relaxation of investor due diligence; loans increasingly issued with fewer borrower restrictions and lender protections.

From niche to mainstream. The aggressive actions of central banks in 2020 – despite rescuing markets from a tsunami of distress – did not eliminate defaults; they merely dispersed a giant wave into smaller ripples, creating plenty of distressed investing opportunities in the years to come. Combined with the maturation of the markets, private debt now boasts knowledgeable fund managers with observable and verifiable track records, making it easier to select managers in this asset class.

Investors now stand at a unique inflection point where opportunity meets expertise, making private debt an asset class that will be increasingly difficult to avoid for the discerning investor in the foreseeable future.

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