The Rise of Private Debt as an Institutional Asset Class

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Contents

Overview

- **The 2008 credit crisis was a watershed for private debt markets; bank lending shrank as banks were forced to repair their balance sheets**
- **Meanwhile mid-market companies needed fresh capital to refinance their existing loans and raise new ones to fund their business growth**
- **Institutional investors were able to step into the breach, attracted by private debt's two merits: returns which can outperform some equity and fixed income indices (demonstrated in this report) and low correlation with other asset classes**
- **As a diversification play, private debt is perceived as having superior protections vs traditional bonds and equity-like returns**
- **54% of institutional investors are invested in private debt now and a further 13% are considering it**
- **Lately, private debt has made the list of the top ten asset classes – as expressed by asset choices and return expectations**
- **Next to private equity, private debt is expected to deliver the highest return over the next three years, thus taking it into newly emerging asset allocation models**
- **The US remains the epicentre of the non-bank lending industry, but its growth engines will be in Europe over the rest of this decade.**

Note: References are detailed in this report on page 13

The British Venture Capital Association on this report:

"The changing strategies of traditional institutional lenders in the wake of the recession continues to act as a drag on business expansion plans. This has spurred a rapid growth and increased interest in alternative forms of lending, with demand from Europe's SMEs matched by a strong appetite from institutional investors faced with continuing low yields from traditional fixed interest vehicles.

The increase in both supply and demand is having a significant impact on how alternative lending funds are being used. In recent years not only has there been an influx of new entrants there is now a far greater diversity of investment strategies. It is a dynamic area and one where interest has accelerated dramatically in recent years and is only going to increase as more assets come onto the market. Next to private equity, private debt is expected to deliver the highest returns over the next three years, thus taking it into newly emerging asset allocation models.

Yet despite this rise in activity and obvious appetite, research into the sector has been surprisingly limited. In fact, one of the biggest weaknesses in the private debt market is the availability, or lack thereof, of quality data. Which is why this report by ICG is so welcome. To understand the asset class better and explain the merits of investing in it, information such as this is vital. "

Tim Hames, Director General of the British Venture Capital Association, September 2015

1. Introduction

For private debt, the 2008 credit crisis was a game changer.

The ensuing turmoil hastened its migration as an institutional asset class from the periphery to the core in the wake of two developments.

First, after ravaging their balance sheets, the crisis severely curtailed banks' ability to lend to mid-market companies. The new Capital Requirements Directive IV under Basel III exacerbated the need for banks to beef up their capital base and so force them to shrink their loan books. The process has started but it has a long way to go. For example, European banks are still carrying €2.4trn of non-core loans on their balance sheets [1]. These are being off-loaded via sale or run-off.

Credit markets in Europe have opened up alongside traditional bank lending

Second, as the global economy has recovered from the worst crisis since the Great Depression of 1929-32, the demand for fresh capital by mid-market companies has grown rapidly to fund their business growth as well as to raise fresh capital to refinance existing loans. In Europe alone, for example, the sums involved could be between €2.4trn and €2.8trn over the next five years [2].

Accordingly, asset managers have been taking advantage of the shortfall in the provision of bank debt with debt financing solutions backed by their clients.

They are attracting a growing number of institutional investors at a time when the quantitative easing (QE) programmes on both sides of the Atlantic have crowded out investors from traditional fixed income securities. Such investors are looking for new asset classes in search of positive real yields and diversification opportunities.

As a result, credit markets are finally emerging in Europe alongside traditional bank lending. They are following the US model where non-bank debt accounts for 75% of total corporate lending, compared to 10% in the Eurozone and 28% in the UK [3].

In the process, two questions have come to the fore:

- what long term track record does private debt as an asset class have?
- why has it become an attractive tool for asset diversification at a time when the correlation between different asset classes has been rising?

There is a dearth of data on private debt, especially its performance, because of its private nature and relative immaturity as an institutional asset class.

This white paper therefore aims to plug some gaps by collating information from various published and unpublished sources.

Key components of private debt

- Direct lending: non-bank lenders providing capital to small- and medium-sized companies in the form of a loan rather than equity. In the context of the data presented in this paper direct lending refers to a broad spectrum of risk profiles beyond just senior debt.
- Mezzanine: a private loan subordinate to a senior secured loan but senior to equity in the capital structure of a company.
- Venture debt: loans provided to small companies, often start-ups with low or negative free cash flows for working capital purpose. They come with rights to purchase equity.
- Distressed debt: debt of companies with an impending or actual covenant default.

The measure used to assess the investment performance of a private debt fund is *internal rate of return*: the % rate earned on each dollar invested for each period for which it is invested.

2. Investment merits

a) Track record

Over the longest period for which data are available, private debt has outperformed two key fixed income indices, Global High Yield and US Investment Grade (Figure 1).

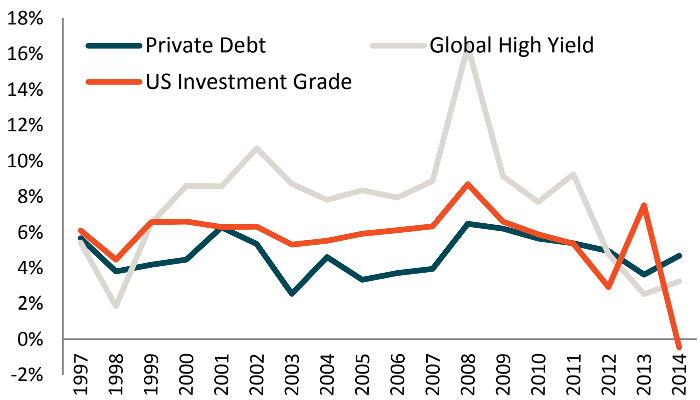


Figure 1 Cumulative average growth[1] return of private debt compared to high yield and US investment grade corporate credit

Source: Preqin Private Debt Database 2015, Bank of America Merrill Lynch

[1] 1997-2004 Each data point represents the ten year annualised CAGR from that date. 2004-onwards each data point represents annualised CAGR to 2014. Last data point YTD return to August 2015.

The equity index data analysis (Figure 2) shows that:

- Private debt funds returns are stable throughout market cycles relative to equity indices with a standard deviation over the period of 0.017 vs 0.71 over the sample period.
- For the whole sample all private debt net return figures are positive.
- 2015 YTD net performance of private debt investments has outperformed major equity indices, such as the FTSE by 6.7%.

Figure 2 also shows that the relative lack of volatility of private debt to equity indices.

The data are indicative, not definitive, as the method for calculating returns on private debt are different from those of the indices. The data set runs from 1997 when the Global High Yield index launched which is a key comparator index for private debt data.

Further examination of the IRR data for private debt since 1983 in Figure 3 reveals that (see appendix for breakdown of asset classes):

- funds launched in 21 out of 28 years have delivered 10% or above
- funds launched in 13 out of 28 years have delivered 15% or above
- funds launched in 4 out of 28 years have delivered 20% or above

In so far as there is a mild cyclical pattern in returns, the contributory factor has been the state of the credit markets.

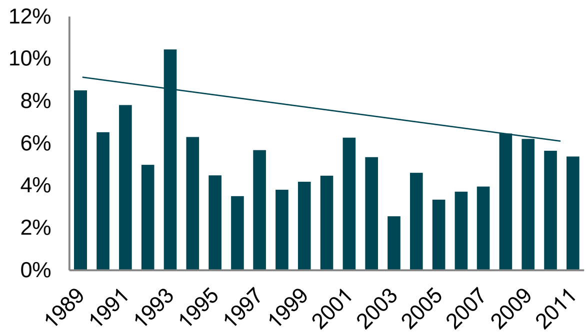


Figure 3 Private debt: average net IRR by vintage

Source: Preqin Private Debt Database 2015

Good returns aside, private debt is perceived as having other merits

The IRR data for the individual categories of private debt are given in the Appendix (stated net of fees), they show that private debt can frequently deliver double digit returns:

- *direct lending* did that in 5 out of 11 years, with a median average IRR across all funds of 11.40%. In Europe the median average IRR is 15.35% and in the US this is 11.55%. These returns reflect a range of capital lending and not senior loans only (see definition before).
- *mezzanine* exceeded it in 17 out of 27 years, having a media average IRR across all funds of 10%,. In Europe the median average IRR is 8.85% and in the US 10.05%.

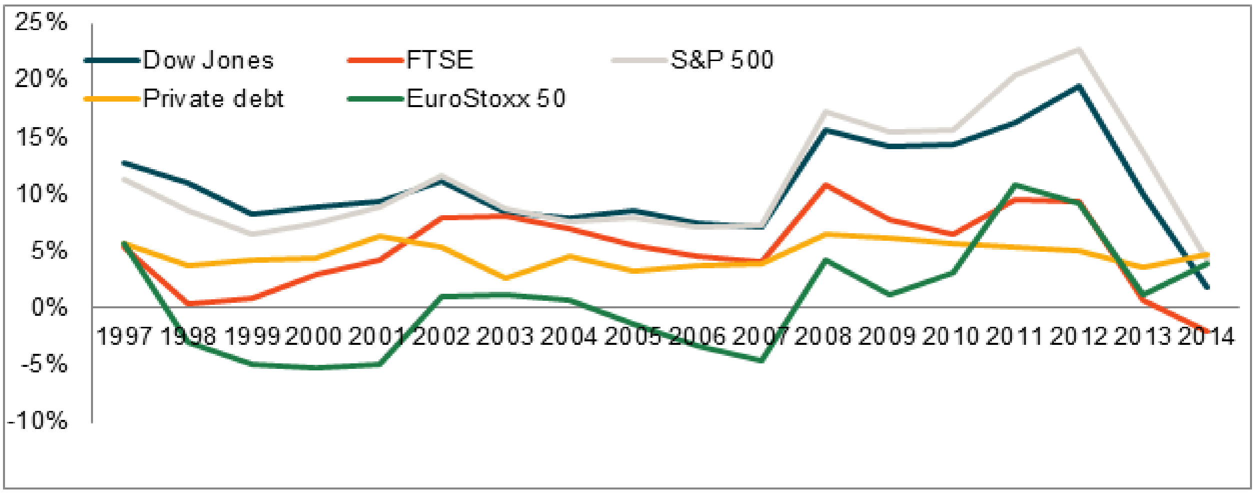


Figure 2 Cumulative average growth return[1] (see note below Figure 1 for calculation) of private debt compared to selected equity indices (including dividends not reinvested)

Source: Preqin Private Debt Database 2015, Bloomberg

- *venture debt* delivered it in 6 out of 13 years, with a median average IRR across all funds of 9.45% relating to the US market (there are no venture debt funds in Europe).
- *distressed debt* delivered it in 19 out of 23 years, with a median average IRR across all funds of 14.40%. In Europe the median average IRR Is 15.70%, and in the US 14.10%.
- *special situations* delivered it in 15 out of 20 years, with a median average IRR across all funds of 12.90%. In Europe the median average IRR is 8.70%, and in the US.

Notably, only one component suffered negative returns in the years 1989-2011 for which data are available: special situations. It returned -2% in 1992 and -7% in 2003. The most volatile of the classes is venture debt, with an overall range showing the highest return of 63% and the lowest at 2%.

b) A credible diversification tool

Good absolute risk adjusted returns aside, private debt is perceived as having other merits:

(i) Enhanced structural protections

Before a loan is made a detailed due diligence process is undertaken, various scenarios are envisioned and tested to evaluate how the company might perform in differing market conditions, and if they would still be able to meet all of their financial obligations. This facilitates very informed decision making. The loans themselves have a final maturity date, a contractual return and a tailored set of terms and charge over the assets of the company that protect investors in the loan from the risk of loss in priority to other unsecured investors.

Private debt is perceived as having superior protections vs traditional bonds and equity-like returns

(ii) Relative appeal versus high yield bonds

Private debt finds itself in a sweet spot not simply because of the declining role of bank lending, as mentioned earlier. It is also the beneficiary of two unintended consequences of changes in mainstream bond investing over the past three years.

The first one relates to the way that the so-called Volcker Rule – banning proprietary trading by banks – has reduced liquidity in bond markets. Evidently, it now takes seven times as long for investors to liquidate their bond portfolios as it did in 2008.

Thus, bond investors may well face a liquidity crunch in the event of a large correction sparked by the rate tightening cycle in the US. QE has pumped up the primary markets, but the financial regulatory and other changes since 2008 have caused a drought of liquidity in secondary markets.

The volume of assets held by market makers is half the level it was five years ago, while the volume of assets held by investors has shot up fourfold [5]. This also reflects that previously liquid investments such as high yield bonds are now as equally illiquid as private debt investments and yet private debt earns a return premium over high yield bonds in compensation for its perceived relative illiquidity.

The second consequence relates to public capital markets. There has been a shift in issuance from floating to fixed-rate bonds, favouring issuers when rates rise; as a result investors are shifting to private debt markets which still offer floating rate returns.

(iii) Equity like returns

As seen in our IRR analysis of median private debt returns, they benchmark well against equities (Figure 2). In a rising interest rate environment the added appeal of returns from private debt is the fact that they are protected from this whereas a bond return is fixed and so exposed to this risk. The equity kickers that are often attached to private debt investments provide further equity upside for investors.

(iv) Cross over asset

Private debt as a cross-over asset is particularly compelling after the two equity bear markets of the last decade turned conventional wisdom on its head:

- buy-and-hold investing struggled as equities were outperformed by bonds over a long period
- actual returns diverged markedly from expected returns for most asset classes
- diversification became less potent, as the correlation between historically lowly correlated asset classes continued to rise. These weaknesses have, in turn, promoted innovations in institutional investors' approach to asset allocation in pursuit of broader diversification (Figure 4).

Since the first bear market of 2000-02, a growing number of them have been adopting a dynamic approach to asset allocation. It sets a glide path that targets rising funding levels, with clear trigger points at which assets are progressively shifted from the return-seeking portfolio to the liability-hedging portfolio (the two extremes in Figure 4).

The latter covers assets that correlate to liabilities and provide duration, credit spread and liquidity. The return-seeking portfolio, on the other hand, covers assets that offer liability 'plus' returns, low correlation and broad diversification. However, since the 2008 crisis, two problems have emerged.

In the *return-seeking bucket*, equities have proved ultra-volatile.

In the *hedging bucket*, there has been a 70% contraction in AAA-rated bonds since 2011, with the US losing its triple-A status.

Together, these developments have intensified the search for cross-over assets that act as surrogates: private debt as a surrogate for equities and real assets as surrogates for bonds (two buckets in the middle).

c) Size of allocations

Institutional investors' allocation to private debt has grown. In 2014, the mean allocation was 5.6% and the median was 2.1% [4].

So, when asked about their recent experience with this asset class (Figure 5):

- 76% reported that it *'exceeded expectations'*
- 10% *'met expectations'*
- 14% *'fell short of expectations'*.

The positive experience is backed by good returns and diversification benefits. In contrast, the negative experience largely stems from lower liquidity.

Looking ahead, the allocations by institutional investors are expected to rise over the medium term [4]:

- the mean allocation from 5.6% to 6.8%
- the median allocation from 2.1% to 5.0%.

Private debt is set to become an established component in institutional portfolios

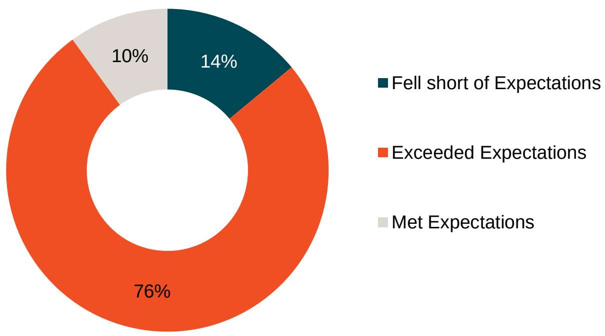


Figure 5 Proportion of investors that feel their private debt fund investments have lived up to expectations over the past 12 months

Source: Preqin Investor Interviews 2015

Figure 4 Cross-over assets have equity-like returns and bond-like features. They provide a bridge between return seeking assets and liability-hedging assets

Source: Alpha Behind Alpha, AMUNDI/CREATE-Research Survey 2014

This is further corroborated by investors' views on how the size of the private debt market will change over the next five years (Figure 6):

- 45% expect it to *"increase significantly"*
- 41% expect it to *"increase slightly"*
- 8% expect it to *"stay the same"*
- 4% expect it to *"decrease slightly"*
- 2% expect it to *"decrease significantly"*.

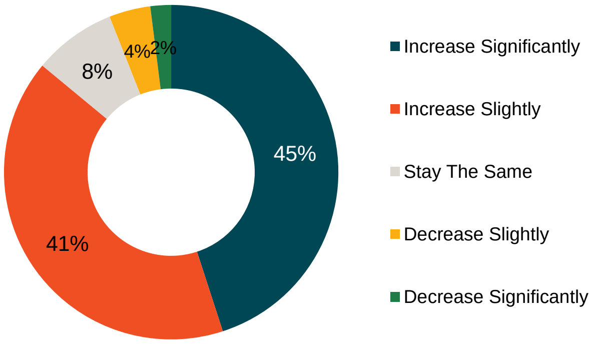


Figure 6 Investors' views on how the size of the private debt market will change over the next 5 years

Source: Preqin Investor Interviews 2015

The consequences are clear: private debt is set to become an established component of institutional portfolios.

Over time, this progression is likely to take private debt into the newly emerging array of retirement products that will routinely invest in alternatives, based on unconstrained mandates in search of yield.

Such funds deploy a broad palette of assets; with equities at one end, merger arbitrage at the other, and a whole spectrum of credit in between, including direct lending, high yield, emerging market bonds and investment grade bonds.

Such multi-asset class funds will hold special appeal for pension plans as they target regular cash flow to finance their maturing liabilities and predictable returns to generate capital buffers.

Institutional investors will aim to future proof their returns by reducing over-dependency on traditional fixed income strategies that remain highly vulnerable to interest rate rises, once the Fed kick-starts its rate-tightening cycle.

3. Institutional interest in private debt

a) Current take-up

As mentioned before, institutional investors have been making allocations to private debt and these are likely to grow. This section gives their background details.

To start with, the current take-up rate is notable (Figure 7):

- 54% already invest in private debt
- 13% considering doing so
- 33% do not invest in it.

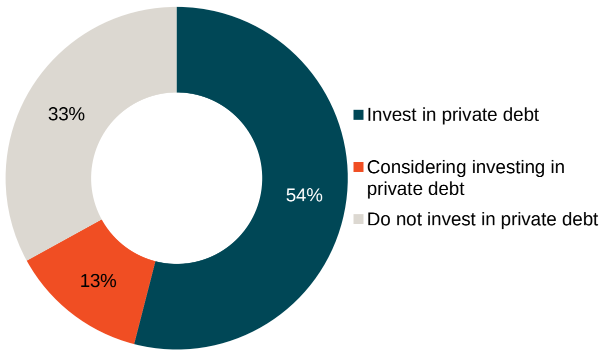


Figure 7 Proportion of institutional investors investing in private debt

Source: Preqin Investor Survey 2014

One of the reasons why a third of respondents do not invest is because many of them do not as yet have the necessary governance structures and skill sets to venture into the newly emerging asset classes.

54% of institutional investors now invest in private debt

The proportion that does invest is on a par with other credit assets, like high yield and emerging market debt.

It is all the more notable, given that the traditional 60:40 equity/bond allocation has long dominated the portfolios of most institutional investors apart from insurance companies.

Since the 2008 global crisis, this tried and tested allocation has run into severe headwinds. The combination of ultra-low yields and unprecedented volatility has forced institutional investors to develop new approaches.

As we saw in Section 2, pension plans have been adopting so-called surrogate assets and hybrid assets as part of the progressive immunisation of their portfolios.

Other investors, such as endowments, foundations and family offices, are also considering changes to the basis of their diversification, from asset class based to risk factor based. Seemingly different asset classes can have unusually high correlations due to their common exposure to underlying risk factors. For example, equities and high yield have a similar risk profile as they are exposed to the same risk factors. In the emerging risk-based diversification, assets are grouped into five clusters to target five distinct goals: capital growth, high income, cash flow, liquidity and inflation protection.

Private debt is included in clusters that target income and is now featuring into the newly emerging asset allocation models.

Notably, they have been adopted by 11 segments in the institutional space (Figure 8). The top six are:

- Public pension funds (21%)
- Private sector pension funds (17%)
- Foundations (12%)
- Insurance companies (10%)
- Fund of funds (8%)
- Endowments (8%).

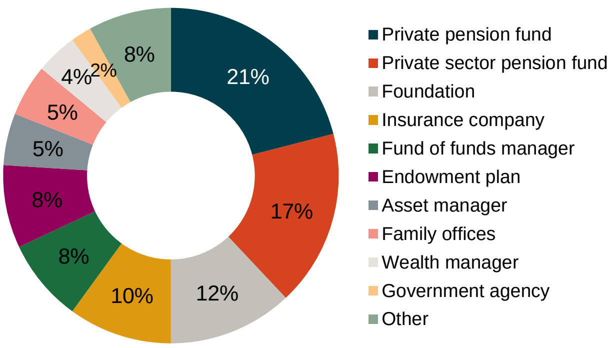


Figure 8 Breakdown of institutional investors in private debt by type

Source: Preqin Private Debt Online 2015

As such, the institutional interest in private debt is broad based and involves all investor segments. Regulatory changes in response to the crisis have provided tailwinds, as bonds with shorter maturity and higher credit quality have proved ever harder to find.

For example, amendments to the existing rules have allowed French insurance companies to increase their allocations to private debt. Similarly, changes to the pension rules in the Netherlands have also enabled giant pension plans to increase their allocations in pursuit of uncorrelated absolute returns.

The stereotype persists for some that private debt is for distressed companies. However, only 27% of LPs put the majority of their funds in distressed companies [6].

b) Investor asset allocation models

Among institutional investors, defined benefit pension plans have been adopting new asset allocation models since the 2008 crisis. Some have been embracing liability-driven investing and for some private debt has been treated as a surrogate asset for more volatile assets such as equities.

Unsurprisingly, out of a list of some 20 asset classes, private debt has made the top ten over the past three years (Figure 9). It was ranked 6th in 2013 and 7th in 2015.

There are three other avenues through which private debt has been entering the emerging asset allocations models

Other avenues in which private debt has been entering asset allocation models are; as a *product focused* allocation, an approach favoured by smaller plans where asset allocation is a blend of stand-alone strategies, covering equities, bonds, private debt and other asset classes. Asset choices are limited by plans' governance expertise and skills sets.

Another venue used mainly by plans in run-off is *time focused*. As plans advance into negative cash flow territory with aging demographics, their asset choices evolve through three stages; in the early stage they target inflation protection via real estate and infrastructure, capital protection via treasuries and high income via private debt and high yield bonds, capital growth via high dividend equities. As the plan moves to middle and later stages private debt becomes perceived as an income booster in the early phase of asset decumulation in the face of aging member demographics.

Finally, the third avenue larger plans can also take is *risk focused.* It uses risk factors as a starting point instead of using asset classes.

Some investors, such as insurers than follow Solvency II and Dutch pension funds that follow nFTK, all have a standard risk model that normally splits risk across: i) rate risk, ii) credit risk, iii) currency risk, iv) equity risk, v) commodity risk and vi) concentration risk.

Experience from the last two bear markets shows that seemingly different asset classes can have unusually high correlations due to their common exposure to underlying risk factors. So some pension plans are now focused on risk-factor investing.

Asset allocation factors come in many guises. First, there are the macro factors such as GDP growth, inflation, volatility and real interest rates. Then there are equity-specific ones like size, value, momentum, variance and currency. Then there are bond-specific ones like capital structure, duration, credit spread and default risks. Private debt is gradually featuring in this nascent approach to asset allocation.

c) Return expectations

With global economies growing again, doubts persist on three unknowns – each with the power to move markets and affect investment returns: the Fed's exit strategy, slow deleveraging in Europe and the credit explosion in China.

As a result, consensus forecasts envisage a notable reduction in return expectations for most asset classes over the next three years [5].

As shown in Figure 10, the future return expectations envisage a notable reduction since 2008. Returning 7% annually, private debt is expected to have the second highest return amongst 16 asset classes, ten of which are given in the figure.

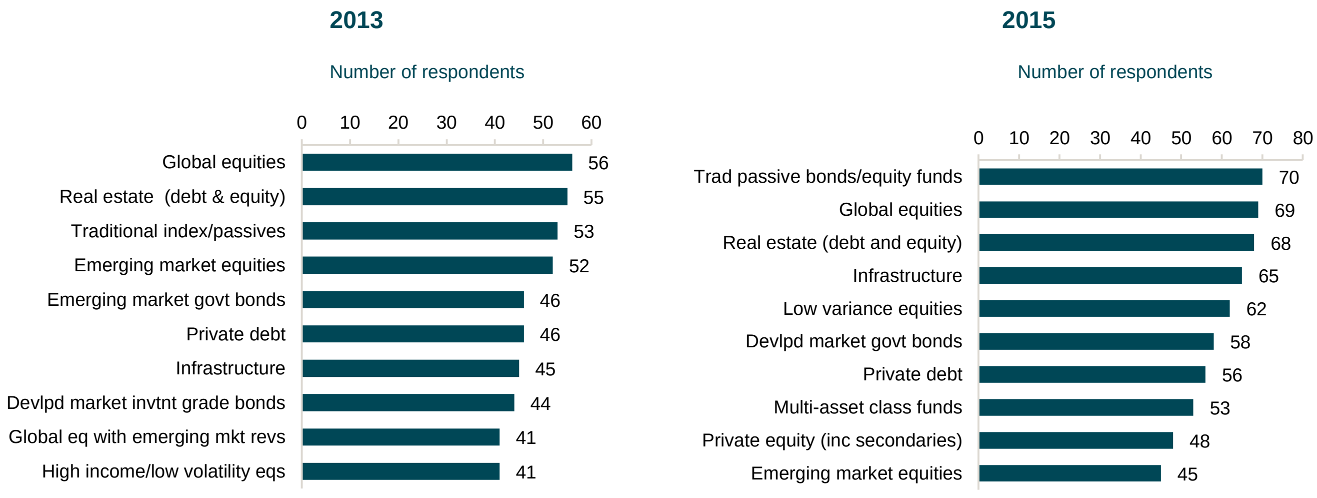


Figure 9 Which asset classes and investment vehicles are most likely to be chosen by DB investors for medium-term asset allocation?

Source: The Principal ® / CREATE-Research survey 2015

Returning 7% annually, private debt is expected to have the second highest return amongst 16 asset classes favoured by institutional investors.

Like private equity, it is expected to fare noticeably better than traditional asset classes like global equities, real estate, emerging market bonds and developed market government bonds.

The rise of private debt reflects the reaffirmation of the old belief: investors chase returns, not asset classes.

Private debt is in the ascendancy because it offers an alternative deal: uncorrelated absolute returns in good times and bad.

growth will continue over the next five years and expect assets under the management of the private debt industry will be 50% higher than they are today [7].

4. Future opportunity

Currently North America accounts for the bulk of the funds raised (Figure 11). Previously, it has also been the main driver of growth. Since 2009, however, Europe has rapidly emerged on the scene. This speaks to an important difference.

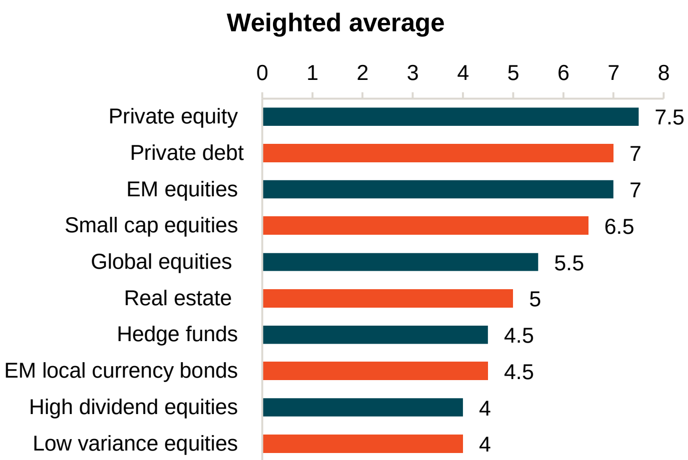


Figure 10 Return expectations: 2015-17

Source: The Principal ® / CREATE-Research survey 2015

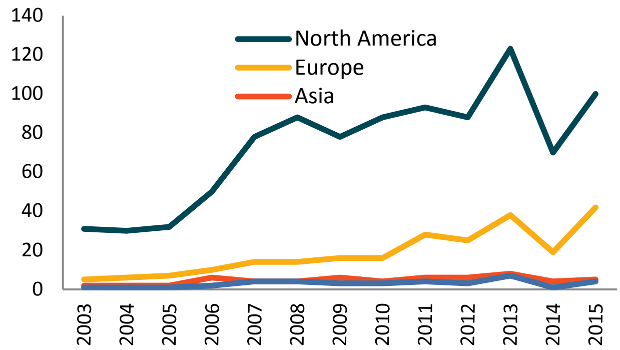


Figure 11 Private debt: number of funds raised by region

Source: Preqin 2015

As returns remain historically low across asset classes, the hunt for yield has entered new territory. Private debt has gained traction among investors with longer time horizons, who want to exploit illiquidity premia.

The illiquidity premium is the expected higher level of return an investor demands for committing to an asset that cannot be easily sold or converted to cash. The illiquidity premium causes prices to lower and interest rates to rise.

Against the background of overall returns, it is not surprising that investors are optimistic about the size of the private debt market over the next five years, as we saw in Figure 6. This view is shared by the industry itself. Preqin's latest survey of fund managers showed that a significant 64% believe

Historically, the share of US bank loans has been in decline, from around 27% in 1999 to 7% today (see Figure 12). In Europe the trend has been less pronounced; however, you can clearly see below that the trend is following the US: a much greater share of lending is now being held by institutions. Figure 12 further illustrates how the increase in non-bank lending is creating a structural shift, with European bank lending at 81% as a percentage of external long term financing vs 19% in the US.

The much higher share of non-bank lending in the US is attributed to its more sophisticated fully functioning well-developed capital markets, capable of competing with banks across a range of credit instruments.

Whilst the US non-bank lending market is much larger, the European credit cycle is at a much earlier and hence more favourable stage in its evolution with the European QE programme and hoped for economic recovery some four years behind that of the US. This is duly confirmed by data from the European Central Bank: the share of non-bank lending increased from 8% in 2009 to 11.5% in 2014 [3]. This shift has also now begun in Australia.

Within Europe, the pattern of development is somewhat uneven. Over the period 2012-14, the country share in the private debt deal volume was approximately [3]:

- UK 47%
- France 25%
- Germany 11%
- Rest of Europe 17%.

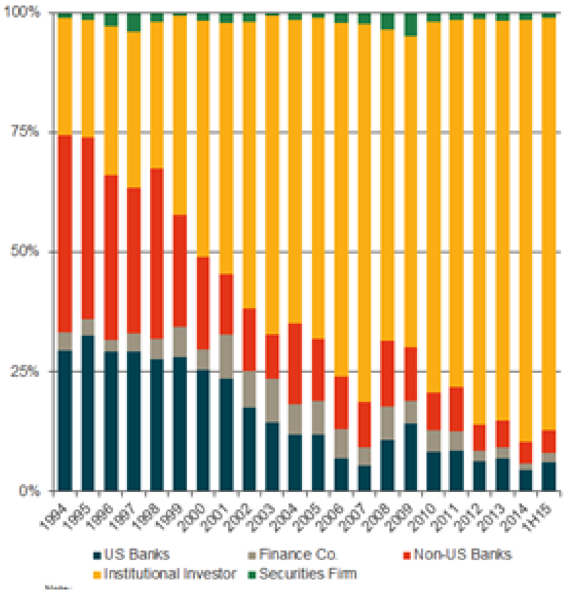
Today's investment landscape has changed

Asset classes once considered peripheral are acquiring added significance as the macro environment has changed. Banks can no longer provide the levels of lending they did before the global financial crisis, and the regulations now in place mean this change is structural and is unlikely to reverse.

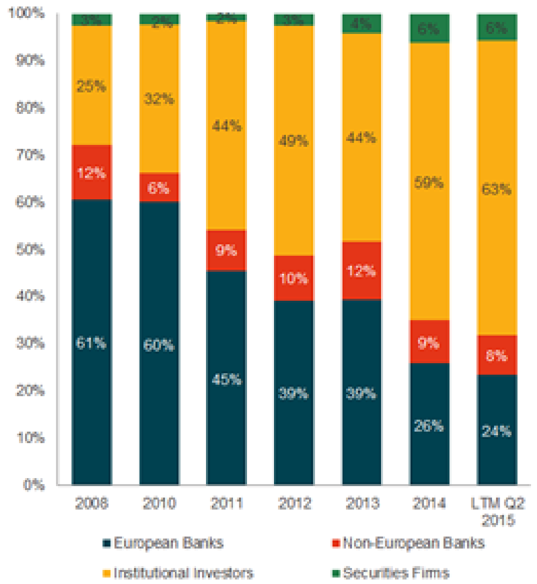
Private debt is perceived to have special appeal, whilst interest rates remain depressed. As excess liquidity has heightened the correlation between historically uncorrelated asset classes, investors have intensified their search for new asset classes with good diversification potential. As valuations of most asset classes have hit all-time highs due to excess liquidity from QE, and as rates are expected to rise, private debt remains well protected. Fears of correction always lurk in the background. Investors have intensified their search for alternatives.

Unsurprisingly, 69% of respondents in a recent Preqin survey [8] see Europe as providing the best investment opportunities. Whereas the US will remain the epicentre of the direct lending industry, its growth engines will be in Europe over the rest of this decade. In the process, debt markets in Europe continue to become more sophisticated. The credit space will be characterised by diversity. The figures are indicative of a new structural shift in Europe.

Thus, private debt has emerged as a credible candidate along with other esoteric asset classes like infrastructure, energy investing, and shipping finance.



Primary syndicated loan market by investor type: US



Primary syndicated loan market by investor type: Europe

Figure 12 Levels of bank and non-bank lending in the US and Europe

Source: LCD, S&P Q2 2015

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6. *Capital for Commerce: Fuelling Growth Through Non-Bank Lending,* Grant Thornton, 2014

7. *Preqin Special Report: Private Debt Fund Manager Outlook*, August 2015

8. *Preqin Investor Survey* 2014

Note on 'The Principal ® / CREATE-Research survey 2015', this is a perception study conducted by CREATE Research in partnership with Principal Global Investors to test institutional investors opinions across pension plans, sovereign wealth funds, pension consultants, asset managers and fund distributors globally.

Data appendix

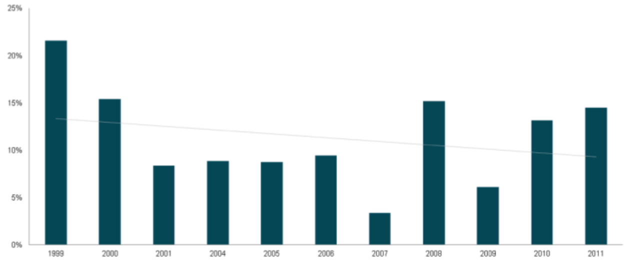

Figure A1: Average IRR by vintage (%) – Direct lending

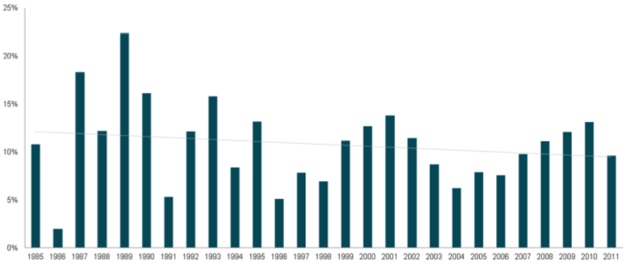

Figure A2: Average IRR by vintage (%) – Mezzanine

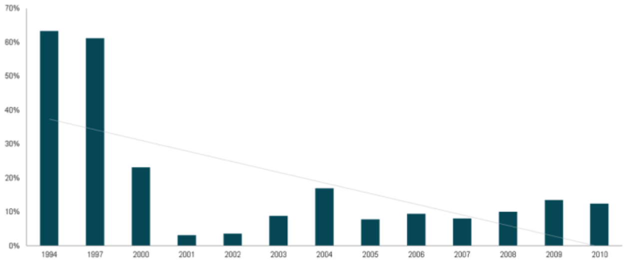

Figure A3: Average IRR by vintage (%) – Venture debt

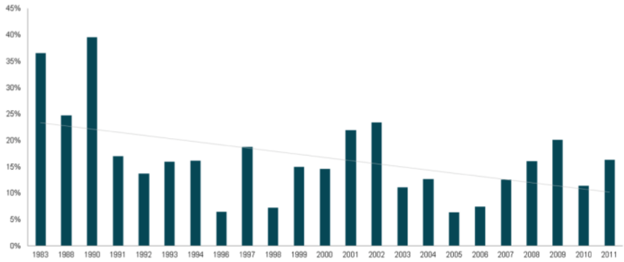

Figure A4: Average IRR by vintage (%) – Distressed debt

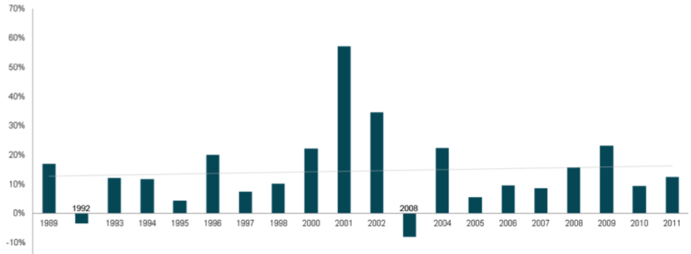

Figure A5: Average IRR by vintage (%) – Special situations

Source: Preqin Private Debt Database

Biographies

About Amin Rajan, CREATE

Amin Rajan is the CEO of CREATE–Research, a UK based research boutique that specialises in future trends in global fund management. It works with prominent partners to publish acclaimed annual reports on prospective challenges and potential responses in the industry; with special focus on the emerging asset allocation models.

Amin also offers strategic advisory and coaching services to CEOs and CIOs in fund management as they grapple with unfolding industry dynamics. He has developed special expertise in emerging business models and their successful implementation. Since 2001, he has undertaken specialist advisory assignments for clients including Aviva Investors, Allianz Global Investors, Axa Investment Managers, BlackRock, Citigroup Asset Management, Credit Suisse Asset Management, Deutsche Asset Management, Invesco, ING Investment Management, JPMorgan Asset Management, M&G, Martin Currie Investment Management, Morgan Stanley Asset Management, Principal Global Investors, T. Rowe Price, and UBS Asset Management.

He is a visiting professor at the Centre for Leadership Studies at Exeter University and until recently a Fellow at Oxford University's Said Business School. He is a Fellow at Windsor Leadership Trust. Visit: www.create-research-uk.com

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