INVESTMENT

The Increasing Appeal Of Private Debt

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Benefits and Pensions
MONITOR

April 2018 Issue

The Increasing Appeal Of Private Debt

The world of private debt investing has become increasingly crowded over the past few years, which has attracted substantial investor interest.

Precipitating this growth is the low-rate, low-yield environment that has persisted since the 2008 global financial crisis. As investors search for yield, alternative investment opportunities with little or no correlation to public markets have gained popularity among both institutional and retail investors.

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With purchase multiples at historic highs, private equity funds are on the sidelines with lots of dry powder (amount of committed capital that is available). In many cases, private equity funds are naturally evolving and launching their own private debt funds.

Assets under management in private debt funds are expected to reach $1 trillion by 2020, most of which is accounted for in North American markets, according to recent ACC and Preqin data.

The explosive growth in private debt has two main underpinnings: investors are chasing yield in unyielding and uncertain fixed income markets and companies are turning to private debt as an alternative way to finance their operations that, post-2008, banks and other lenders have moved away from.

While not a new concept, private debt's explosive growth this decade stems from the global financial crisis, specifically increased bank regulation, which restricted banks' ability to lend to mid-market companies who desperately needed financing.

As the global economy struggled to recover from the worst crisis since the Great Depression, demand for funding continued to grow rapidly for small- to mid-sized companies. Accordingly, non-bank commercial finance companies began taking advantage of the banks' shortfall by offering alternative ways for these companies to obtain financing.

Types Of Private Debt

Private debt is characterized as non-public investments typically in small- and mid-market companies, but, in many instances, includes large corporates. This type of financing can be attained from various sources including banks, insurance companies, hedge funds, private equity company credit platforms, or specialty finance companies.

Over the years, companies have utilized alternative lenders as opposed to banks for financing due to their need for innovative structures, flexibility, leverage, faster closing speeds, and flexible covenants. Private debt not only meets all of these requirements, but also offers minimal interest rate risk as most loans carry a floating rate.

Various types of private debt have evolved from this demand. These include direct lending, distressed debt, mezzanine, structured equity, venture debt, and special situations.

Private debt investing can be separated into two distinct approaches. The first is return-maximizing, which includes distressed debt, venture debt, structured equity, and specialty financing. The second is capital preservation. Here you are lending money or providing mezzanine financing directly to companies.

In today's environment of low rates, expensive equity markets, and high purchase multiples, private debt portfolios consisting of loans can typically be built over a one- to two-year period versus private equity portfolios which can take as long as five years or more to be fully invested.

Direct loans are those made directly to companies both on a senior or junior basis, typically secured and with a lien against the company's assets. Direct loans, when compared to high yield unsecured debt, have lower default rates, lower loan loss rates, and higher recovery rates.

Direct loans can be further classified into different forms of lending structures with varying terms to maturity such as factoring, uni-tranche, bridge financing, and others.

Why Is Private Debt Evolving?

A variety of factors have attributed to the growth of the private debt space. Primary drivers include increased regulation in the banking sector and increased availability of capital.

There have been so many changes in how banks choose to do business – and, more importantly, who they choose to do it with. This, in addition to tightened regulations, has restricted the types of companies that banks are willing to lend to – usually because they do not have the type of collateral or business model considered acceptable under such regulations or, in some cases, banks do not consider their relationship with the company strategically important.

This has left a gap in funding, creating huge potential for non-bank commercial finance companies to provide alternative financing options. Private providers of capital are increasingly becoming 'go-to' institutions for companies that need innovative and flexible capital.

According to a recent paper published by the Alternative Investment Management Association, more private funds and lenders are willing to step in and provide financing to small- and mid-sized businesses in need of capital as the industry now has an established track record. What this means, according to the paper, is that private credit is now a permanent feature of the lending landscape with a host of different stakeholders. The industry is also reaching beyond its traditional market of the U.S. to Europe and Asia Pacific which will further the industry's growth.

Private Debt In Canada

The Canadian market is currently dominated by the five large national banks who maintain very stringent lending criteria. While there are many foreign domiciled banks operating in Canada, they mostly restrict their lending to corporate credits and strategies where there is a cross-border business opportunity.

Unlike the U.S., Canada does not have super regional banks, regional banks, and small local banks. Lack of secondary sources of capital in Canada is a critical issue for many Canadian companies that do not fit bank lending criteria.

The minimum loan sizes available from Canadian banks is generally $10 million or greater. Eligibility criteria are strict, with companies required to meet financial tests including strong historical EBITDA (earnings before interest, taxes, depreciation, amortization), regardless of the collateral they can offer.

There are approximately 6,000 mid-market companies in Canada. These companies generate roughly $655 billion in revenue, support 1.9 million jobs, and contribute 31.8 per cent to Canada's gross domestic product. Additionally, there are also more than 1.1 million small businesses in Canada, which generate an additional 27 per cent of Canada's GDP, or roughly $275 billion, according to figures from Statistics Canada, Industry Canada, and HSBC.

For these companies, the ability to access the secondary sources of capital is vital to not only the growth of these companies but also to the growth of the overall Canadian economy.

For the first time, Canada is seeing its own private debt space grow faster than any other country.

From an investor's perspective, private debt provides attractive capital preservation and income features. Private debt deals in Canada are typically structured as sole source loans and should an individual loan require workout, the lender and borrower have the ability to renegotiate terms to bring loans back into good standing.

Private debt can also act as a defensive asset class in a complex and uncertain global environment. Debt strategies are designed to offset the ups and downs of the stock market while offering stable yields that are higher than those available on most publicly traded bonds.

Like any other sector, private debt does have its risks and should be considered carefully.

The most prominent risk is the end of the credit cycle as that could impact the companies being funded and/or those providing funding. Because the marketplace is crowded and there is a great amount of opportunity, it is important as investors tend to focus on the details of the loans being issued and ensure these are well-protected and issued to viable borrowers.

Other potential threats include the possibility of rising interest rates, industry disruption, underwriting discipline, supply and demand imbalances, and liquidity.

Regulation itself could also pose a potential risk, just as it has to the banking sector. Non-bank financing companies could become subject to new regulations which could impact how – and who – they are able to provide financing to.

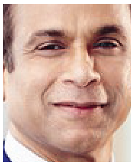
What's Next

The private debt space will continue to grow and offer opportunity for investors as more companies utilize alternative lenders as a source of capital. Investors are always looking for additional sources of stable cash flows to help them achieve their return objectives and companies are constantly searching for non-bank lenders as government regulations continue to restrict traditional bank financing.

So, as long as this demand from both investors and companies continues, the private debt space will continue to grow and evolve.

As for the future of the private debt sector, increasing participation of institutional and retail investors will likely bring more transparency.

Overall, private debt will continue to act as a defensive asset class that offers safety in capital structure and diversity in a complex investing world. **BPM**



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