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CONSIDERING PRIVATE DEBT STRATEGIES?

Manager Selection and Oversight are Essential

Alternative investments are less transparent than public equities or bonds, have few benchmarks, little or no secondary markets, and are relatively illiquid.

As the investment universe evolves, so do investors. Investors are becoming increasingly knowledgeable even while investment options are becoming increasingly complex. Using a simple formula for equities and fixed income in differing proportions, hoping to generate alpha while controlling beta, is becoming harder to do. Investors today are realizing that they need to diversify away from public securities — and one good way to do that is to include an allocation to alternative strategies.

A growing category of alternative investments is private investments in debt, equity, real estate, special situations, among others, that have little or no correlation to publicly traded securities. They are less volatile and less market-driven than equities yet can often provide attractive returns, particularly for those who remain patient. It's no wonder that significant institutional capital is expected to continue flowing into this asset class, as shown in Figure 1.

Figure 1: Projected Growth of Alternative Assets

2018		2023
Natural Resources $0.2tn	**+300%** →	$0.8tn
Infrastructure $0.5tn	**+100%** →	$1.0tn
Private Debt $0.8tn	**+75%** →	$1.4tn
Private Equity $3.6tn	**+36%** →	$4.9tn
Real Estate $0.9tn	**+33%** →	$1.2tn
Hedge Funds $3.6tn	**+31%** →	$4.7tn

Source: Preqin, 2019

In general, however, alternative investments are less transparent than public equities or bonds, have no meaningful benchmarks, have little or no secondary markets and are relatively illiquid. As a result, strategy and manager selection along with ongoing oversight are critical.

Nowhere is oversight and careful selection more important than in the fastest growing segment within alternative investments — private credit or private debt as it is also known.

Behind the Rise of Private Debt

Why is so much capital flowing into private debt? There are several reasons, which are best understood within a historical context.

Assets under management in Private Debt have grown more than threefold over the past 10 years and now exceed $800B.

Source: Preqin, 2019

The financial crisis of 2008-10 had a meaningful impact on the financial sector. Increased banking regulation moved banks out of the business of mid-market lending, creating a broad range of opportunities for non-bank lenders.

For investors, the rise of private debt has been positive, creating the potential for:

- A reliable income stream;
- Diversification into proprietary private transactions;
- Little or no correlation to public markets (equity or fixed income); and
- Attractive yields — typically 6% to 9% unlevered and 9% to 12% levered.

Reasons for Caution

While private debt has attractive benefits, it is important to bear in mind that we may be approaching the end of a credit cycle. Rising interest rates, indications of stagflation and inverted or flat bond yields are all pointing to a broad contraction in equity markets, the results of which could have a spillover effect across the economy. This could include private loans.

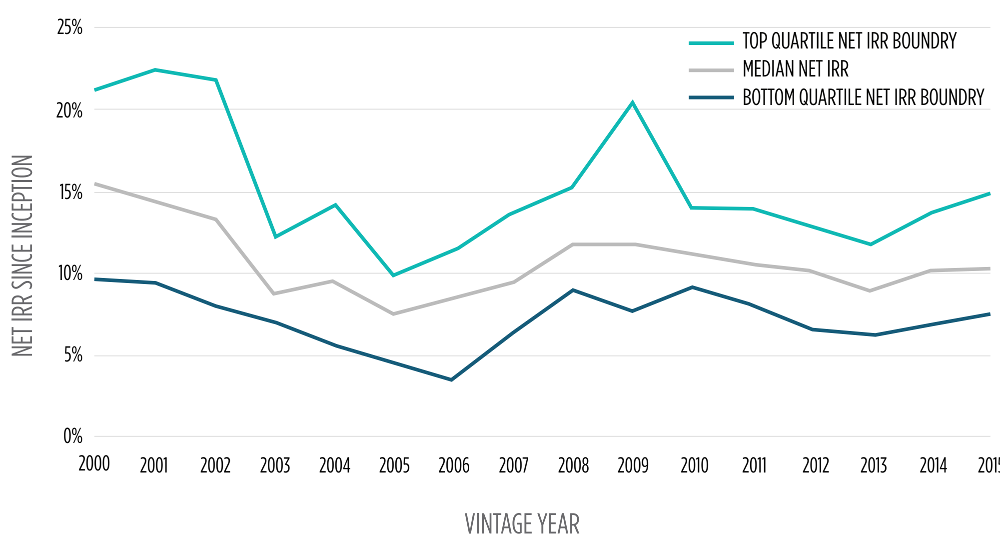
Increased capital flow into private debt, while good in one sense, is creating a frothy market where there is pressure on pricing, covenants and structures, suggesting that some Private Debt managers may accept lesser-quality deals and lower returns. Figure 2 illustrates the increase in pressure on pricing in the private debt space.

Investing in Private Debt in the Current Environment

When investing in any alternative asset or strategy, patience is a virtue. When that alternative asset is private debt, other important factors include:

- **A long-term focus.** Don't let short-term movements in markets dictate your goal and strategy.
- **Due diligence.** Choose a manager or strategy with a long history of performance that includes one or more downturns. Do not get taken in by strategies that have done well over the past two to four years — as we all know, it's easy to look skilled in a bull market.
- **Discipline.** How well have managers stayed on course? It is important for a manager to demonstrate no strategy drift in uncertain markets.

Figure 2: Private Credit Net IRRs and Quartile Boundries by Vintage Year



Source: Preqin Q4/2018

- **Safety.** Senior loans with first lien on company assets offer the safest risk-return profile. While junior loans, subordinated debt, and mezzanine debt will provide higher potential yields, they are progressively more illiquid and may be susceptible to increased risk in turbulent markets.
- **Security.** The right covenants will help provide protection against worst-case scenarios. Managers must underwrite transactions at base case with adequate covenants such as fixed-charge coverage, minimum EBITDA, maximum CAPEX, pledge of shares, and personal guarantees.
- **Management infrastructure.** People, processes and systems play a key role in a manager's ability to manage and scale loan portfolios.
- **Deep manager experience.** It is critical for the manager to have a credit or workout team with strong tenure in loan workouts and restructuring. A good manager is one that has been in the private debt area originating, underwriting and managing loans through many credit cycles.

Finding an optimal allocation to alternative investments

How much of an investor's portfolio should be allocated to alternative investments? The answer depends on individual circumstances, but in most cases will range from 10% up to 50% for more advanced investors, with roughly two thirds drawn from fixed income and the remaining one third from equity. Allocating less than 10% would have little effect on overall performance while allocating more than 25% could affect liquidity and risk profile. Please consult your professional asset allocator for your specific situation.

Ongoing Oversight is Essential

While initial due diligence on a manager is very important, it is even more important to have ongoing oversight. Private debt is a very transactional; it is a loan-by-loan business. With continuous change in borrowers' businesses, managers must proactively monitor loans and supporting collateral and be prepared to act if any borrower strays from the agreed terms of the loan.

As part of oversight it is important to:

- **Review the loan term sheet**, commentary, collateral audit reports, inventory appraisals, market studies and quality-of-earnings report.
- **Review the loan portfolio monthly**, including loan status, risk ratings, covenants, defaults, and workouts.
- **Review the loan agreement.** A good credit agreement provides the legal framework for managers to exercise their rights should things not work out.
- **Monitor non-performing loans.** This includes examining status, exposure, exit plan and potential loss (or gain) on realization.
- **Monitor operations and controls.** Manager infrastructure, process, controls and board mandates should be reviewed periodically by a qualified third-party firm.

As the famous saying goes, "the devil is in the details," and when it comes to private debt, true oversight involves asking the right questions at the right time and proactively evaluating and managing risk. As this asset class is used to stabilize and diversify more retail portfolios, finding the right manager to provide this oversight for you will be a critical factor in your success.

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