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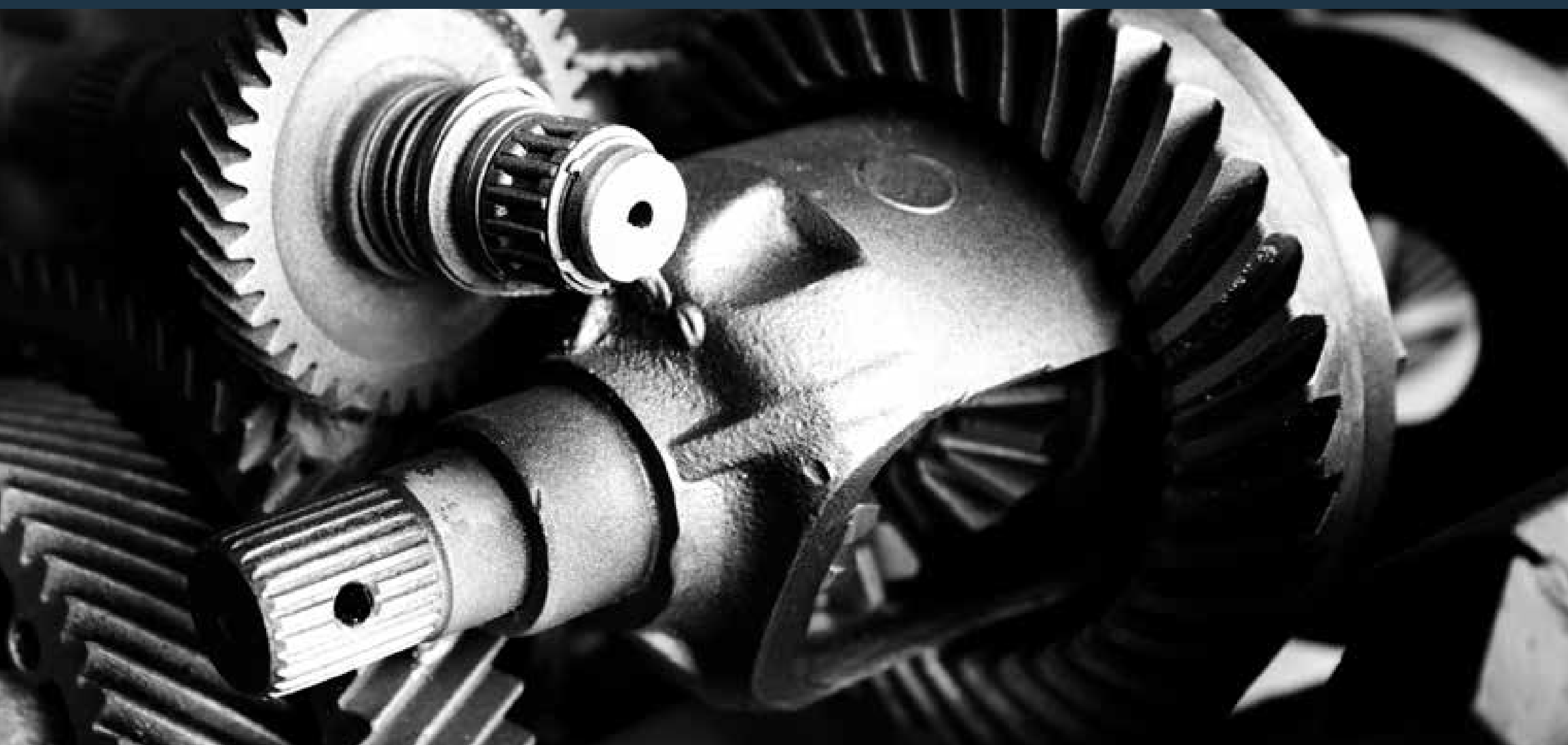
WHITEPAPER

The case for private debt

Identifying investment strategies post-COVID

December 2021



AVIVA INVESTORS

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The case for private debt: Identifying investment strategies post-COVID

The private debt market is a growing focus for institutional investors. Having shown resilient characteristics, we look at the outlook for the sector in what could be a more challenging period, as well as the features that can make it a useful diversifier in portfolios.

1. A growing opportunity for investors

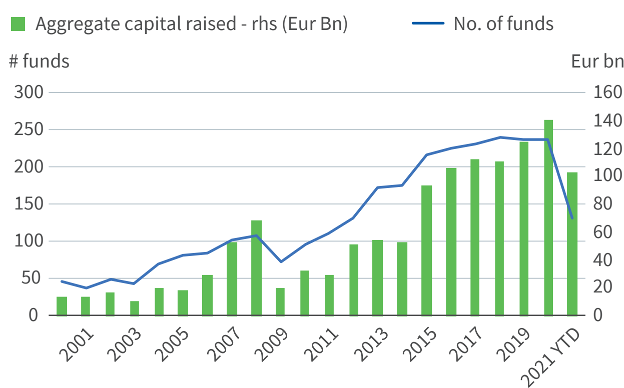
a) Investors' entry into the market

Over the last decade, private debt has become a core part of the alternative income sector, cementing its place alongside real estate and infrastructure.

Note: The private debt universe includes many secured assets such as infrastructure debt and real estate debt, but the focus for this report is private corporate debt.

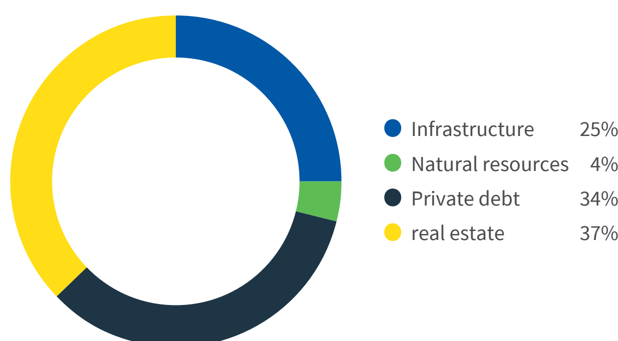
The balance sheets of many companies have been stressed and stretched by COVID-19. This report looks at the impact of the crisis and longer-term outlook for private corporate debt and the key considerations when building resilient portfolios from our perspective.

Figure 1. **Private debt fundraising**



Source: Preqin, September 2021. For illustrative purposes only

Figure 2. **Alternative income (ex-private equity) fundraising 2017-2021**



Source: Preqin, September 2021. For illustrative purposes only

b) A diverse investment universe

The private corporate debt universe is vast and varied: from floating-rate loans to fixed-rate private placements; investment grade to unrated; senior to junior; and large to small borrowers. Each offers a different risk and return profile. Here, we focus on unrated or non-investment grade loans and private placements. A typology of this market is presented below (figure 3).

Leveraged loans are familiar to most investors. These are syndicated loans extended to companies owned by private-equity sponsors, often to back an acquisition (leveraged buyouts or LBOs). This market has been largely disintermediated from banks. According to *Leveraged Commentary & Data*, institutional investors took up approximately 70 per cent of primary leveraged loan issuance in 2019 – 60 per cent came via collateralised loan obligations (CLOs).

Institutional money has also flowed to smaller companies, including some that are not owned by private equity sponsors. This market, in Europe at least, used to be the preserve of banks. The mid-market[1] sector attracts a higher margin than debt from larger companies of an equivalent credit rating. These loans are generally provided as club deals or bilateral loans, affording more negotiating power to lenders.

Whether sponsor-owned or not, companies can now borrow from institutional investors via floating-rate loans or fixed-rate private placements. Several markets have developed in Europe to facilitate access to institutional investors.

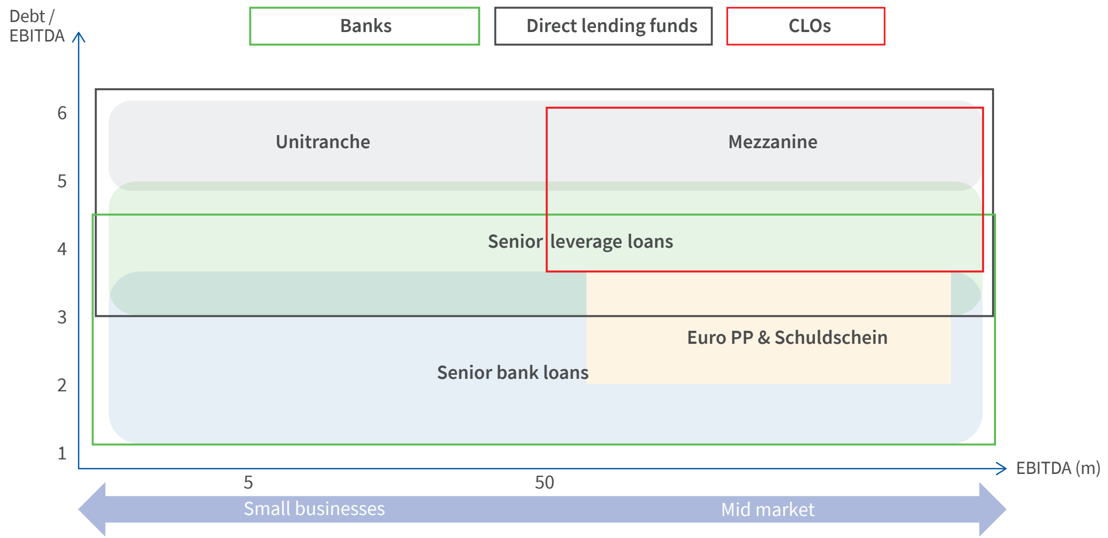
The Schuldschein market allows better-known issuers to raise large volumes of bilateral unsecured loans under simple standard documentation. Schuldschein transactions are increasingly popular with international investors and issuers.

In France, the smaller euro private-placement market (euro PP) offers an alternative to the USPP market for mid-sized companies of BB quality. Issuance is predominantly fixed rate and covenanted with tenors of around seven-to-eight years.

Each of these markets can offer different risk and return profiles. Figure 4 presents a schematic of the various segments of the private debt market.

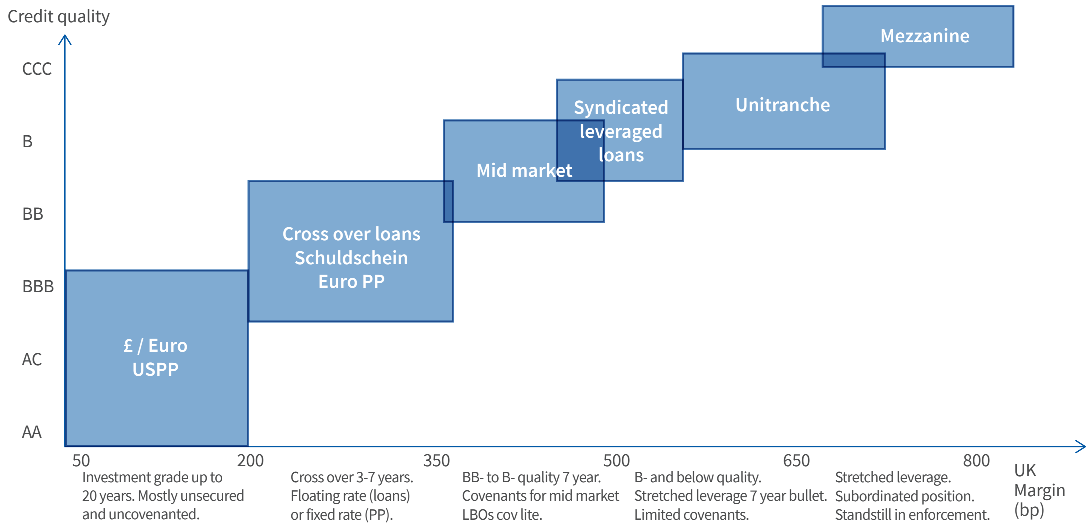
1. Definitions of mid-market vary. S&P refers to mid-market as companies with less than €1.5bn turnover and €500m of debt. Many market players refer to less than €/£50m EBITDA. EU defines Small Businesses as having less than €50m turnover.

Figure 3. **Typology of private loan market and players**



Source: Aviva Investors as at September 2021. For illustrative purposes only

Figure 4. **Focus on direct lending**



Source: Aviva Investors as at September 2021. For illustrative purposes only

c) Recent market trends

While helping grow the market, the appetite of funds and CLOs had, until the start of 2020, driven a progressive loosening of credit terms. Syndicated leveraged loans have become covenant-lite – meaning there are no maintenance financial covenants on term loans – while covenants are still standard in the mid-market sector. Additionally, higher leverage (as measured by debt/EBITDA) has been widely available by inserting a second-lien tranche or providing a unitranche loan (a single loan with leverage consistent with a senior-plus mezzanine structure). Such loans represented the majority of European mid-market funds' transactions in Q1 2021, according to GCA Altium.[2]

Despite this, the sector has been resilient in the face of low interest rates and a benign credit environment. During the last decade, the 2.5 to 3.5 per cent additional yield margin for leveraged loans over investment-grade bonds far outweighed credit losses for the asset class.

More recently, COVID-19 has disrupted all markets, including private debt. In the first couple of months of the crisis, transaction volumes plummeted, and secondary prices fell. However, as markets have recovered post Covid, new lending activity has picked up and secondary prices have largely recovered.

Thanks to a combination of significant fiscal and liquidity support, the impact of the crisis on the level of defaults has been less marked than initially feared, and considerably lower than during the Global Financial Crisis. All corporate defaults and sub-investment grade corporate defaults reached 3.14 per cent and 6.71 per cent in 2020 compared to 4.98 per cent and 12.09 per cent in 2009.[3]

However, many companies used liquidity reserves and new loans to withstand the immediate shock caused by the pandemic, resulting in an increase in leverage. Lenders have shown forbearance, waiving covenant breaches on a temporary basis. The full impact of the pandemic on businesses is still playing out. Nevertheless, the following trends can be expected over the near term:

- **The tapering off of government support could trigger difficulties in certain companies** that have relied on it. Credit spreads will reflect these sectorial differences more fundamentally than in the past.
- Many companies have used government-guaranteed loans to help weather the crisis. However, these loans come with restrictions and there will be strong incentives for banks and borrowers to refinance them, creating the potential for **increased investment opportunities as the economy recovers**.
- We expect to see **a reversal of the former easing of credit trends for companies affected by the crisis**. While lenders may have to accept higher leverage in the near term, we believe they are likely to obtain stronger credit protection in the form of covenants and security in the medium term.

Such trends could create opportunities for new investors.

2. GCA Altium – Mid Cap monitor, Q1 2021.
3. Moody's default Reports, Q1 2021.

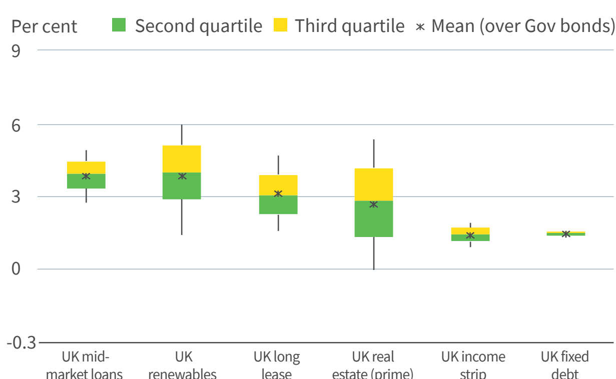
2. The positioning of private loans in portfolios

a) Through the cycle, private debt is attractive but timing matters

Our relative-value analysis compares the expected return and dispersion of potential outcomes (represented by the height of the bars in the graph below) of different asset classes. This analysis compares asset classes on a fully diversified basis and considers expected default rates for private debt through the cycle. Our central economic scenario is for rates to increase over time. In that environment, we find private debt[4] offers the most attractive risk-adjusted returns within the real asset universe.

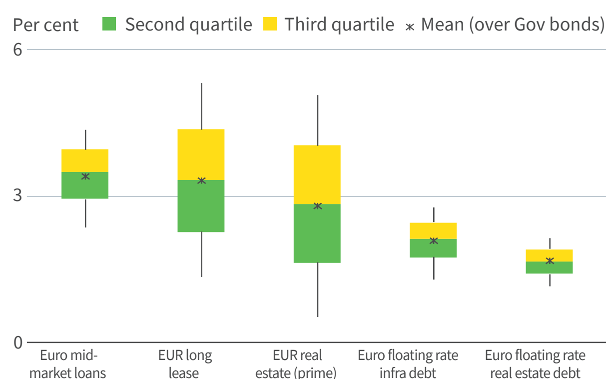
However, the point of entry into the asset class is important in capturing the disconnect between public and private markets. For example, Preqin data suggests private debt funds launched during the Global Financial Crisis outperformed funds launched two years before by taking advantage of reduced asset prices.

Figure 5. **Income return over risk free rate: UK assets**



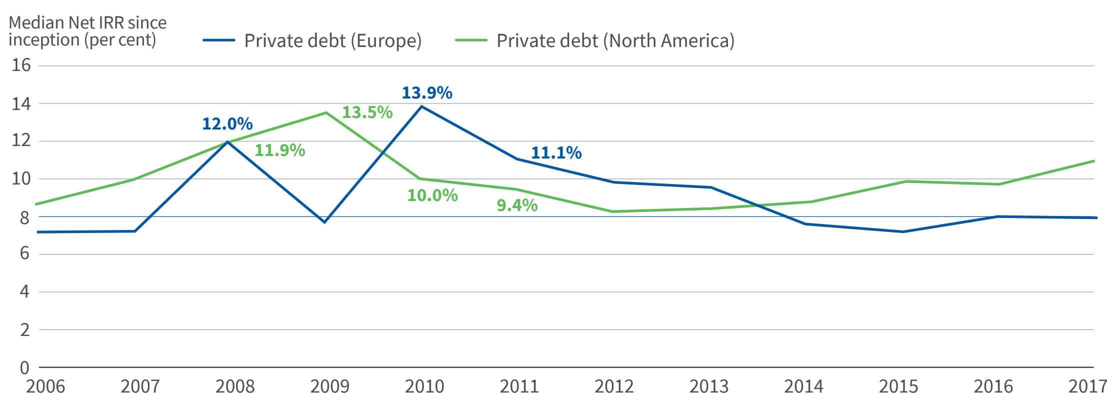
Source: Aviva Investors, as at September 2021. See Appendix for further information on the methodology used.

Figure 6. **Income return over risk free rate: Euro assets**



Source: Aviva Investors, as at September 2021. See Appendix for further information on the methodology used.

Figure 7. **Europe vs. North America-focused private debt: Median net IRRs by vintage year**



Source: Preqin as at 2020

4. In this analysis, we modelled a portfolio of 50% BB and 50% B rated loans. Figures refer to simulated past performance based on actual data. past performance is not a reliable indicator of future performance.

b) Potential benefits of private loans over public aternatives

Private loans differ from publicly-listed bonds. The market is more opaque, and does not benefit from the mandatory disclosure required on public markets. Most loans are unrated, and investors must assess risk in the absence of an external view.

This opacity, while shunned by many investors, comes with greater opportunities to generate outperformance. The depth of due diligence (including the ability to probe management over longer periods than a bond roadshow) and level of understanding of the borrower can make a significant difference to performance. The skill in structuring terms appropriate to the type of borrower is also vital, particularly for bilateral or club deals where lenders have more influence.

For investors with appetite for non-investment grade credit and a tolerance for illiquidity, private loans offer other benefits compared to public bonds. These include:

- Increased recovery in case of defaults

Historically, public corporate bonds experience lower recovery values after default compared to private loans. Loans are more often secured, and the covenants help lenders to detect and rectify credit issues at an earlier stage. The increased loss-given default for public corporate bonds not only has the potential to reduce the mean income return, but also increases the dispersion of returns. Based on our assumptions, lower recovery levels may depress returns by 45 basis points in both a through the cycle scenario[5] and in a stressed scenario for the same level of default.

- Euribor floor

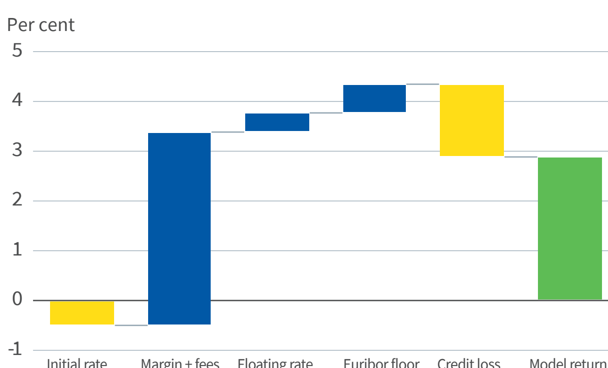
Furthermore, most euro-denominated loans have a zero per cent floor on Euribor. They are therefore positioned to benefit from interest rate increases, while also being somewhat protected from downside risk.

The positive contribution of the Euribor floor to the portfolio return can offset the credit cost, as shown below.

- Different capital treatment

For insurance companies subject to Solvency II regulations, unrated loans benefit from more favourable capital treatment than non-investment grade bonds, reflecting the lower volatility of the asset class in terms of market value.

Figure 8. **The impact of Euribor floor**



Source: Aviva Investors, as at July 2020

5. See appendix 1 for recovery assumptions in base and stress case for loans and bonds.

3. Considerations for portfolio construction

We have also modelled a stressed case, replicating the defaults experienced during the Global Financial Crisis and increasing the loss-given default to 50 per cent. In this scenario, the expected return for private corporate debt drops by 30bps but remains attractive on a fully diversified basis, despite the higher risk of default. However, portfolios are not fully diversified: debt funds generally hold ten to 40 loans rather than thousands. Portfolio construction is therefore key to protecting against the impact of defaults and capturing the expected increase in illiquidity premium between private and public markets.

a) Sector diversification is beneficial, but individual asset underwriting even more so

Careful portfolio construction can maximise diversification, while also identifying assets that perform better than the broader sector. The recent pandemic has accelerated the transformation of the economy. Some of the more exposed sectors such as autos, retail, and transport have always been cyclical. Yet some traditionally cyclical sectors, such as technology and telecoms, are proving resilient. It is important to understand the fundamental risks of each sector rather than rely on historic correlation data when building diversified portfolios.

Focusing on resilient sectors is important; yet even within each sector, the differences between winners and losers can be significant. Market leaders in niche markets are more likely to retain value through the cycle. Unlike equities or publicly-traded bonds, it is more difficult to generate profit in a loan to offset losses elsewhere. As such, portfolio diversification, while beneficial, is comparatively less important than robust credit underwriting of each individual loan.

b) Resilience and sustainability more important than leverage

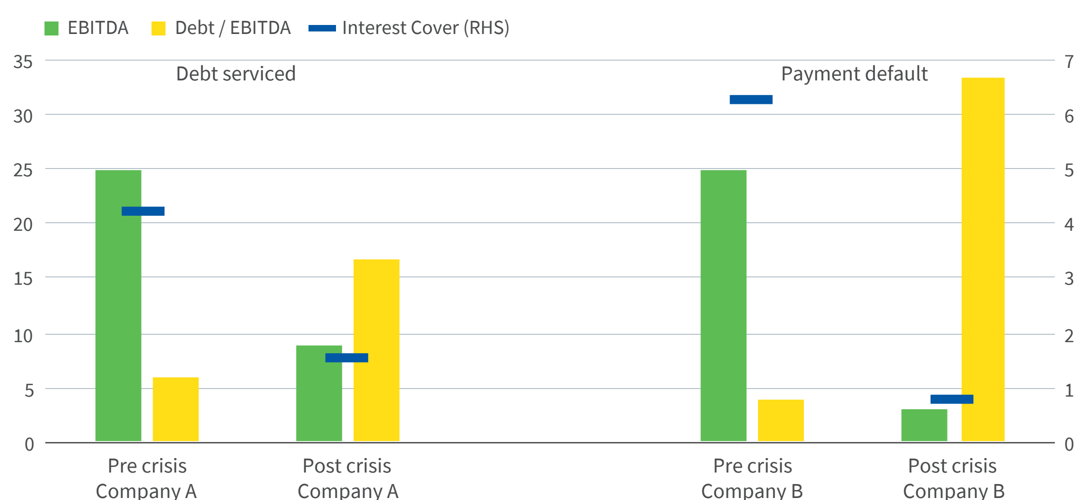
The industry has traditionally assessed risk based on leverage metrics such as debt/EBITDA. Such headline numbers should be treated with caution. For example, if we compare company A in a resilient sector with senior debt at six times debt/EBITDA and the more cyclically-oriented company B with a more modest leverage of four times, the stable company could experience a ten per cent fall in turnover and still service its debt comfortably, while the more cyclical company may experience a 20 per cent fall in turnover. Despite being less leveraged at the outset, it would then default on its debt.[6]

This illustrative example (figure 9) demonstrates that focusing on operating cashflow is fundamental to build resilient portfolios.

In addition, companies with strong environmental, social and governance (ESG) credentials are more likely to outperform. The recent crisis has highlighted differing management attitudes to ESG factors such as employee health and community impact. Demonstrating strong ESG values will therefore be a significant differentiator for companies looking to access finance from banks and institutional investors.

As such, incorporating ESG factors into the investment due diligence process will help ensure borrowers can deliver sustainable performance. The green or sustainable loan market, while still in its infancy, can also offer investors seeking a positive impact an alternative to green bonds.

Figure 9. **Impact of cyclicality**



Source: Preqin, June 2020

6. For illustration, we have assumed both have 25% EBITDA margin, 60% fixed cost and pay 4% interest rate.

c) Covenants and seniority

As shown above, the return on a loan portfolio is sensitive not only to the probability of default but, critically, to the recovery value following a default. In turn, the seniority of loans, security afforded to creditors and specific covenants attached all contribute to maximising recovery values.

Besides financial covenants, clauses such as negative pledge or restriction-on-disposal are more commonly available in private loans than public bonds. Negotiating a security and covenant package appropriate to the size and nature of the business financed is a key part of asset underwriting.

Portfolio construction is key to resilient investment outcomes

Private corporate debt offers an attractive and diverse alternative to bonds. The non-investment grade sector experiences greater volatility in defaults, which will bring greater differentiation between strategies. In this environment, portfolio construction with a focus on resilient and sustainable business models to enhance returns will be more critical than ever.

Appendix 1: Assumptions used in our models

The portfolio models in section two of this report have been modelled with the following central assumptions. The return distribution shows the distribution of return where the interest rate, level of defaults and recovery values have been independently varied using a Monte Carlo simulation.

Please note forecasts are not a reliable indicator of future performance.

	Upfront fee	Margin	Maturity	Amort	Rating	Comment	Fixed/Floating
£ MM	2.25%	450 Bps	7	Bullet	B	Sonia floor at 0%	Floating
Euro PP	0%	300 bps	7	Bullet	BB	No Euribor floor	Fixed
Euro MM	1%	375 bps	7	Bullet	B	Euribor floor at 0%	Floating

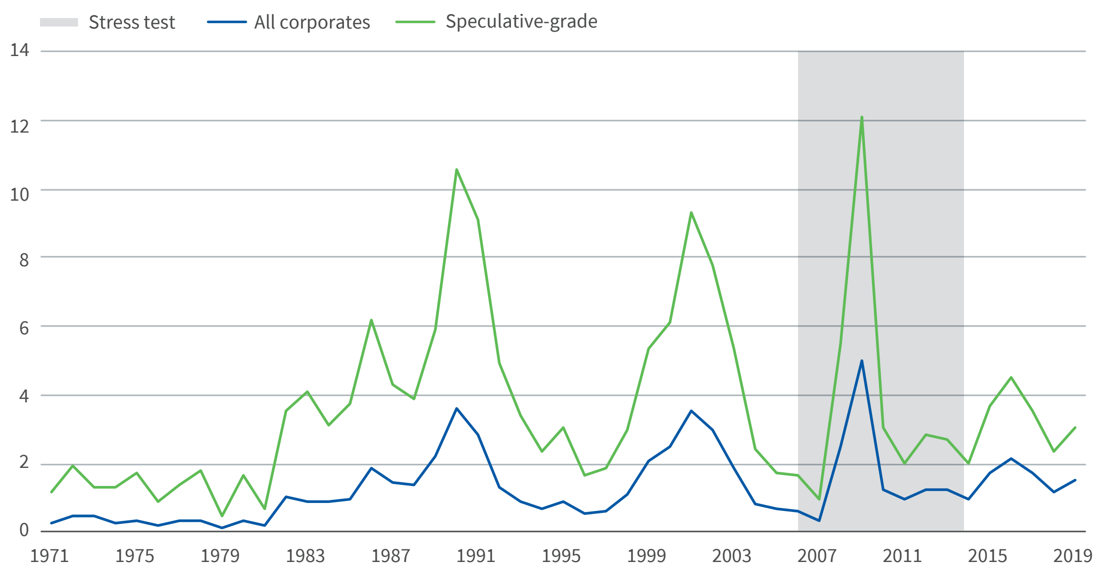
Default and recovery

We used the Moody's Corporate Default Study to model the cumulative default rate. For the through the cycle analysis, we used the historic average through the full data set.

We have modelled defaults in a stressed scenario based on the 2008 recession. The impact of, and response to, the recent pandemic was very different in many respects to what we saw back then.

- Harsher economic downturn.
- Massive monetary and fiscal stimuli, including guaranteed loans and job retention schemes.
- Greater differentiation by sector as this crisis was triggered by healthcare rather than economic triggers.

Corporate default rate



Source: Moody's Investors Service.

We nevertheless selected this period because this saw a sharp increase in defaults followed by equally sharp drop, which reflects current forecasts for the impact of COVID-19 on default rates.[7]

For recoveries, we have likewise made expectations based on the Moody's Corporate Default Study, summarised below:

	Moody's Corporate Default data set			Aviva Investors Model Assumptions	
Recovery post default	Average ultimate recovery	Average recovery based on trading price	Minimum recovery based on sale price	Base case	Stress case
Senior loans	80%	66%	53%	65%	50%
Senior secured bonds	62%	55%	33%	50%	30%
Senior unsecured bonds	47%	38%	21%		

Key Risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency exchange rates. Investors may not get back the original amount invested.

Where invested in illiquid private assets, investors may not be able to redeem any units in the fund when they want because illiquid private assets may not always be readily saleable. If this is the case we may defer a request to redeem units.

7. Moody's Annual Default Study 2020

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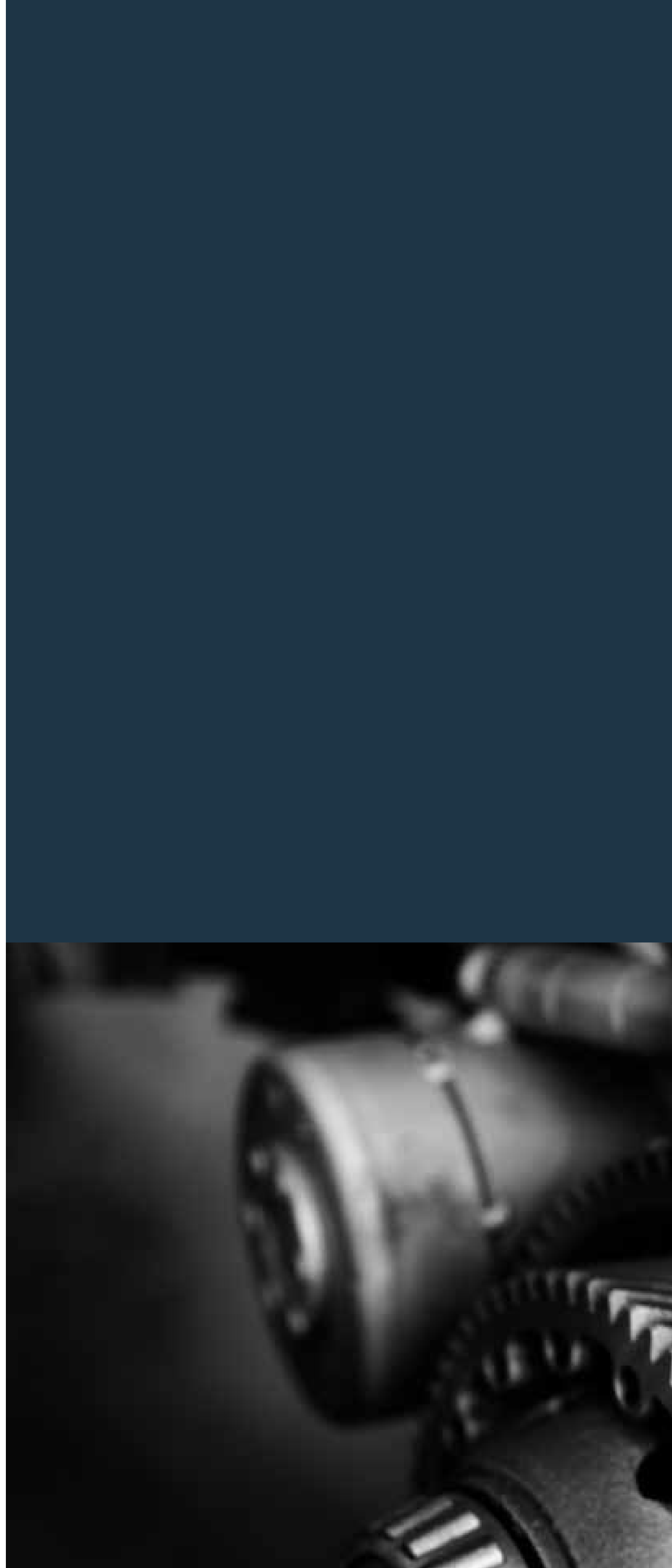

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