5 THINGS TO CONSIDER WHEN INVESTING IN PRIVATE CREDIT

IAN FOWLER OF BARINGS DISCUSSES FIVE KEY CONSIDERATIONS FOR INVESTORS INTERESTED IN ALLOCATING TO PRIVATE CREDIT

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1. Private credit, or direct lending to the middle market asset class, can offer investors a range of investment opportunities that can be customized to meet their risk/return objectives.

In the U.S., the middle market is a large and critical component of the economy. It represents roughly a third of U.S. GDP, employs a little over 30% of the U.S. labor force and consists of nearly 200,000 companies, providing managers with a large opportunity set to construct diversified portfolios.[1]

Transactions can be structured to offer a range of risk-adjusted returns and yields through allocations to different parts of the corporate capital structure. For instance, senior secured loans, which sit at the top of the capital structure, have historically delivered returns ranging from 6%–8%.[2] Because these loans sit at the lower end of the risk/return spectrum, they have the potential to provide stable cash flows over time and can be useful for liability matching or yield enhancement for low beta portfolios. Mezzanine/junior capital, on the other hand, has historically looked attractive for its potential to deliver higher average returns—typically from 10%–15%[2]—with lower volatility than some public market asset classes.

Institutional investors have historically allocated mezzanine and distressed debt to alternative or private equity allocation buckets. With senior secured debt, a relatively new investment option for institutional investors, there is no consensus on the allocation bucket. Investors tend to create a separate private debt bucket, use senior secured debt as a subset of their fixed income allocation to enhance yield, or allocate to the alternative bucket either as a diversifier or as a warehouse strategy until a more attractive private equity entry point emerges.

2. Within North American private credit, the U.S. and Canadian markets look fairly different.

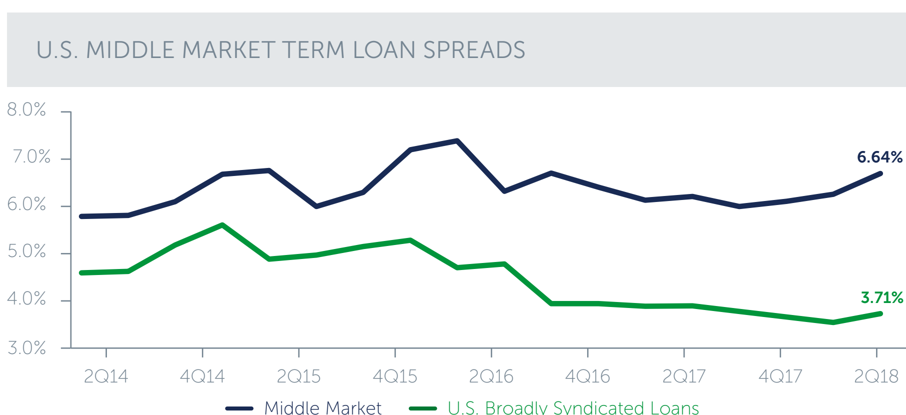
Unlike Canada, most of the capital invested in U.S. middle market loans has been from non-banks—insurance firms, finance companies, and institutional investors. This has been the case since the early 2000s and has become more pronounced in recent years, as secular changes in financial regulation have continued to limit the activity of banks.

The market in Canada is different—junior capital opportunities exist for non-bank lenders, while Canadian banks remain firmly established as the primary source of senior secured lending to the private middle market.

3. From a relative value perspective, North America continues to look attractive.

As we look across the global private credit landscape today, we see opportunities across North America, Europe, Australia/New Zealand and developed Asia.

U.S. MIDDLE MARKET TERM LOAN SPREADS



SOURCE: *THOMSON REUTERS. AS OF JUNE 30, 2018.*

1. SOURCE: National Center for the Middle Market. As of June 30, 2016.
2. SOURCE: Based on Barings' market observation. There is no guarantee the stated returns will be achieved. As of June 30, 2018.
3. SOURCE: Thomson Reuters; Credit Suisse. As of June 30, 2018.
4. Thomson Reuters. As of December 31, 2017.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

North America, in addition to its large and diverse opportunity set, is a mature market that can offer a degree of stability for investors. Non-banks have been cycle-tested as the primary source of capital to the leveraged lending market for nearly two decades. Spreads, which quantify the premium that investors can earn for taking on credit risk, are currently attractive, in our view—as of June 30, U.S. middle market loans offered a yield premium of roughly 200–250 basis points versus the broadly syndicated loan market.[3]

In addition, despite record levels of new debt funds and capital raised, credit metrics in North America have remained relatively stable and attractive on a risk-adjusted return basis, in our view.

Specifically, elevated levels of private equity dry powder have fueled buyouts, evidenced by 2017's record level of new loan volume.[4] Healthy loan volume has created a more balanced supply/demand equilibrium, keeping yields, leverage and loan-to-value relatively stable. Also on the demand side, we expect to see roughly $550 billion of outstanding U.S. loans mature over the next five years, suggesting there will be continued opportunities for buyout and refinancing activity in the coming years.

4. Private credit is becoming a permanent and fundamental allocation of institutional investment portfolios.

Private credit can offer many potential benefits to investors, and as such has become a fundamental allocation of institutional portfolios. The asset class has the potential to offer:

- High absolute returns
- Attractive relative returns
- Current income from cash interest coupon
- Mitigated J-curve risk relative to private equity
- Low relative volatility/losses
- Low correlation to public debt and equity
- Structural protection (covenants) and conservative structures to help manage through a cycle

While we see many opportunities in private, middle market lending, it is nonetheless important for investors to carefully consider the potential risks. The private, middle market is less liquid than the broadly syndicated market, and many of the transactions in the space have ratings or implied ratings below investment grade or, more typically, are unrated.

5. There are three major components to manager selection.

- *Flexible Capital, Solutions-oriented Approach:* Investors can benefit from partnering with an asset manager that has flexible capital to provide a range of financing solutions rather than a one-size-fits-all approach.
- *Robust Origination Capabilities:* Many transactions in this space are sourced through private equity sponsors. As such, managers that have strong, established relationships with sponsors and other intermediaries may be best positioned to source the highest quality deals for investors. Hold size, international capabilities, flexible capital and revolver capability are all critical factors.
- *Deep Relationships, Long Track Record:* Experience investing through multiple credit cycles can be beneficial, as can experience working through difficult situations that can occur in market downturns.

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