SEEKING RELATIVE VALUE IN GLOBAL PRIVATE DEBT

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As institutional investors continue to turn toward private debt for potentially attractive risk-adjusted returns in a low-yielding environment, they may benefit from taking a global approach to the asset class.

Private debt continues to gain favour as yield-hungry investors look for solutions to help meet their portfolio return targets. Institutional investors in particular are often drawn to private loans for the potential to earn incremental yield relative to broadly syndicated markets. As private debt has become a more common element of institutional portfolios, investors may benefit from allocating to managers that cast a wider net when looking at investment opportunities.

The direct lending market offers investors a range of attractive potential benefits, including:

- Potential return premium versus broadly syndicated markets
- Conservative structures and loan documents with strong investor protection
- Investment diversification
- Access to a broad universe of investment opportunities
- Limited correlation to public markets

There are some key potential advantages to taking a global approach to private debt. For one, investing globally significantly increases the opportunity set of potential private loan investments, which can allow managers to invest more selectively. This is an important point because the relative value of private debt investments in each region shifts from time to time depending on market dynamics, such as the demand for debt capital by private equity funds and the supply of debt capital from both banks and unregulated institutional lenders.

SEEKING RELATIVE VALUE ACROSS GEOGRAPHIES

North America

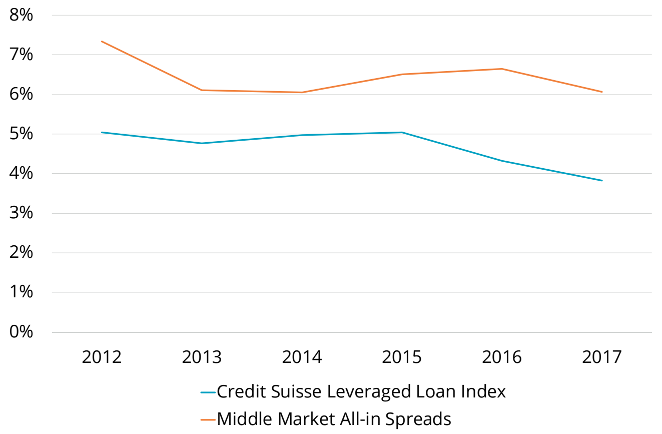
North America is the largest and most developed private debt market from both an investor and borrower standpoint. In fact, the volume of private debt issued in the US and Canada is roughly 4-5x the volume of private debt issued in Europe. The breadth and depth of the North American market lends itself to building a diversified portfolio of private loans to middle-market companies that operate across a wide range of sectors. In North America, companies that issue private loans tend to be mid-sized, with EBITDA between $10mn and $50mn – companies not quite large enough to access the broadly syndicated loan and bond markets. These companies are typically unrated but have a credit profile generally equivalent to S&P B.

In North America, private debt spreads were relatively tight during the first half of 2014, while the pricing of risk was much more attractive in Europe. Spreads in the US then widened in the latter part of 2014 through 2016, but began to tighten modestly in 2017 as US base rates increased. However, given the more pronounced tightening of spreads for broadly syndicated loans, the "originate-to-hold" spread premium for private debt remains attractive, in our view. Generally, private loans to US issuers that are structured with more conservative leverage and loan-to-value than broadly syndicated loans currently yield a premium of roughly 125 to 150 basis points, although it can be substantially higher[1].

Europe

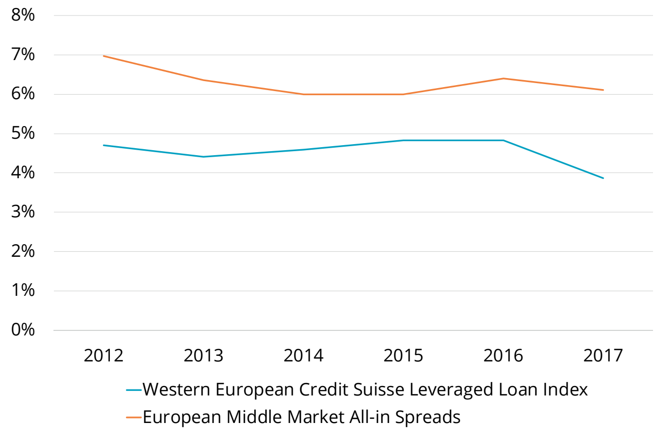
In Europe, banks still provide the lion's share of financing for middle-market companies. That said, there is an increasing opportunity for non-bank providers of private debt capital that may be able to operate with more flexibility than banks, which have been under

Fig. 1: US All-in Spreads (DM-3): Middle Market vs. Broadly Syndicated Loans



Source: S&P Margin Data (U.S.). As of October 31, 2017.

Fig. 2: European All-in Spreads (DM-3): Middle Market vs. Broadly Syndicated Loans



Source: S&P Margin Data (Europe). As of October 31, 2017.

increasing regulatory pressure. While new private debt managers have emerged to capitalize on this opportunity, more established private debt managers with longstanding deal referral relationships retain an advantage, and the low level of non-bank penetration relative to the US suggests private finance has room to continue taking market share from banks. The credit profile of private debt issuers in Europe is similar to that of issuers in North America.

While substantial capital has been raised to invest in direct lending, pricing in Europe has tightened only marginally, suggesting that there is sufficient room for the capital and that the capital is in the process of being deployed. Private loans to European issuers continue to benefit from high upfront fees, stable spreads and, in some cases, base rate floors that exceed prevailing Euribor. As a result, the current premium for private debt as compared to broadly syndicated debt is particularly attractive in Europe, in our opinion. In Europe, private loans structured more conservatively than broadly syndicated loans tend to generate illiquidity premiums of 175 to 200 basis points or more[2].

Australia, New Zealand and Developed Asia

There are also opportunities in Australia, New Zealand and developed Asia. These markets are still mainly bank dominated, but there is an emerging opportunity for non-bank lenders and there are very few established players in the region. The companies in these markets may be mid-sized but in many cases are larger, sometimes with EBITDA from $50mn to $100mn. While these are not necessarily very large companies by global standards, due to the smaller size of the market, private loan issuers in Australia and New Zealand in particular often have dominant market positions, enhancing their credit profile. These companies are typically unrated but have a credit profile roughly equivalent to S&P BB.

In the Australia, New Zealand and developed Asia markets, spreads are currently tighter compared to the US and Europe, but issuers are typically larger and have more conservative credit structures. In Australia, competition has intensified over the past year as banks have sought to grow their loan books. However, due to the lack of depth of capital markets in the region, select opportunities exist to achieve a potentially attractive illiquidity premium while investing in issuers, which if located in the US or Europe, would be large enough to issue broadly syndicated loans.

MEZZANINE DEBT

In addition to the global opportunity in senior debt, investors can find potentially attractive opportunities in private mezzanine debt, a subordinated part of the capital structure that can offer attractive absolute and relative returns. Notably, due to the "originate-to-hold" nature of private mezzanine debt, these investments tend to have lower volatility relative to liquid traded assets. Whether secured by a second lien or unsecured, private mezzanine debt is structured more conservatively than high-yield bonds, and loan agreements typically provide stronger creditor protections. Additionally, given the lack of liquidity in the asset class, investors may be compensated with significant illiquidity premiums relative to the high-yield bond market[3].

Given the currently high purchase prices paid by private equity managers to acquire portfolio companies, the returns for some current vintage private equity funds may not significantly exceed returns from investing in private mezzanine debt, which tends to exhibit much lower volatility.

A COMPELLING OPPORTUNITY

A global strategy can be an efficient way for private debt investors to access opportunities as they are sourced across different regions and markets. Because countries differ in terms of where they are in their respective economic, interest rate and business cycles, the relative attractiveness of their private lending markets can change over time. Diversifying across North America, Europe, Australia and developed Asia, therefore, may better position investors to seek relative value as private debt yields tighten or widen from time to time in each region.

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*As of September 30, 2017

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[1] *Based on Barings market observations. As of December 2017.*
[2] *Based on Barings market observations. As of December 2017.*
[3] *Based on Barings market observations. As of December 2017.*