

The Opportunity in Private Debt

Fixed Income investors have heard the same story repeatedly over the past few years: there is no juice in traditional fixed income products, and investors will have to look elsewhere to earn any meaningful yield. We see an opportunity for our clients in private debt, as the risk premium of over 5% above comparable high yield bonds nicely compensates for the illiquidity of this asset class, which is arguably the most common barrier to investing. However, we find that most of our clients hold over 85% of their family portfolio in highly liquid securities (i.e. with less than a week of liquidity). The expansive monetary policies of central banks, coupled with some distortions formed by the 2008-2009 financial crisis, have created a great opportunity to lend to middle market private companies.

Brief Overview of Private Debt

Private debt is often utilized by small and mid-sized companies looking for capital or financing. These firms are known as “middle-market” companies- broadly defined as those firms with EBIDTA of \$15mm to \$100mm and capital needs of \$50mm to \$500mm.¹ Because of their size, these middle-market firms have limited access to liquid capital markets, which have high minimum issuance sizes. The average issue size per bond in the iBoxx High Yield Corporate Bond index is currently \$855 mm.¹

There are different types of private debt securities- the most typical are in the form of senior loans (first and second lien); unsecured and subordinated debt; and hybrid instruments (combining senior and subordinated debt). The two principal sources of private debt deals are private companies and private equity sponsors. Private companies may look for funding to make acquisitions, to refinance or for growth capital. Private equity sponsors also look to the private debt markets when a transaction such as leveraged buyout or add-on acquisition occurs, or a company needs refinancing.¹

Investors in private debt earn returns from two factors: 1) contractual return components and 2) equity upside. The contractual return component is the base of the return stream (consisting of high coupons typically 10-15%), plus up-front commitment fees and sometimes premiums relating to early redemptions. Equity upside can be a source of return in some private debt deals. A private debt investor will usually have the opportunity to make equity co-investments in a deal to enhance returns; or sometimes have warrants which potentially benefit from capital appreciation. Private debt investments are positioned higher in the capital structure than equity, giving investors a priority on cash flows of the company.

The Thinking Man's Approach



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In today's world, investors are looking beyond traditional fixed income products to earn meaningful yield. We see an opportunity for our clients to invest in private debt, where they can earn a significant yield premium. In this note we provide a brief overview of private debt as an asset class and also a breakdown of the current opportunity in the private debt market. Finally, we discuss some key characteristics we look for in private debt managers.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

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¹ Rocaton Insights, “Opportunities in Private Middle Market Lending”, January 2013

¹ iShares, data as of January 31, 2014

¹ ICG, “Introduction to Private Debt,” January 2014



To understand the risk/return profile of private debt investments it can be helpful to compare this asset type with high yield bonds and private equity (see Table 1 below). While private debt is illiquid when compared to high yield bonds, when compared to private equity we see two main differences: 1) Private debt has a shorter investment period(usually 3-5 years); and 2) Private debt generates attractive cash flows (today we expect around a 9% current yield).

Table 1

	Private Debt	High Yield Bonds	Private Equity
Capital Structure Rank	Subordinated to senior debt and more senior than common equity	Subordinated to senior debt and more senior than common equity	Subordinated to all securities
Due Diligence Access	Detailed proprietary information	Public resources	Detailed proprietary information
Transaction Leverage	3.5x-5.5x	5.5x-7.0x	3.5x-7.0x
Coupon	10%- 15%	7%-10%	None
Upside	Warrants/Equity co-invest	None	Equity investment
Targeted Gross Return	14%-17%	7%-10%	17%-23%
Fees	1%-3%	None	2%-3%

Source: ICG

Current Opportunity in Private Debt

Favorable Demand & Supply Dynamics

As previously mentioned, public markets have not been a source of funding for middle-market companies. However, these companies historically have had access to funding from banks- who used to offer loans to small and mid-sized companies. This changed after the 2008 financial crisis, when regulations such as Basel III were enacted, forcing banks to clean up their balance sheets and focus on core tier assets. As a result, many banks stopped lending to middle-market companies. In 2013, the majority of these loans were provided by non-banks, an opportunity for third party private debt suppliers (see Chart 1 on next page).

There is also healthy demand for private debt. It is estimated that there is over \$300 billion of middle market debt maturing over the next four years, as demonstrated by Chart 2 (on next page). Additionally, private equity firms are currently holding a significant amount of dry powder (high liquid, cash like reserves); there is an estimated \$240 billion of private equity capital available which typically target middle market transactions.¹ This will likely generate high transaction volumes in the near term, increasing the demand for private debt.

¹ ICG, "Introduction to Private Debt," January 2014



Chart 1

Share of Primary Middle Market Leverage Loans

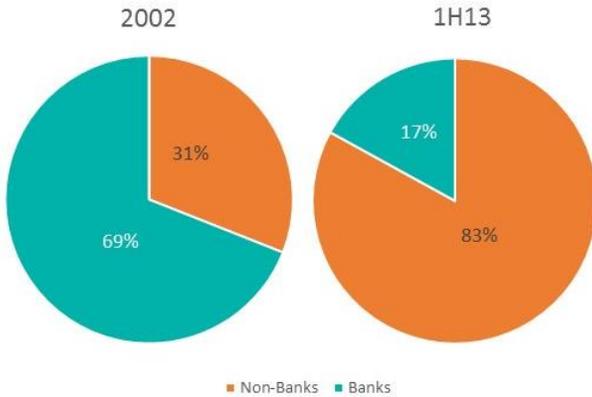
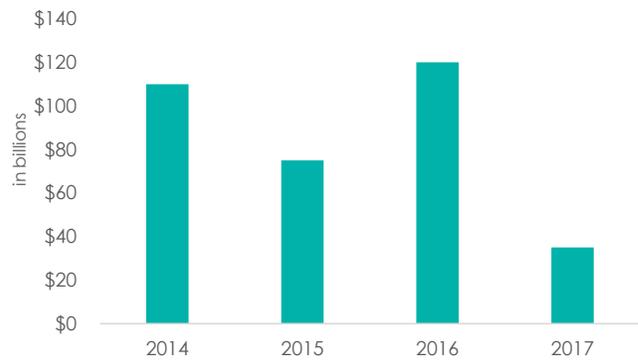


Chart 2

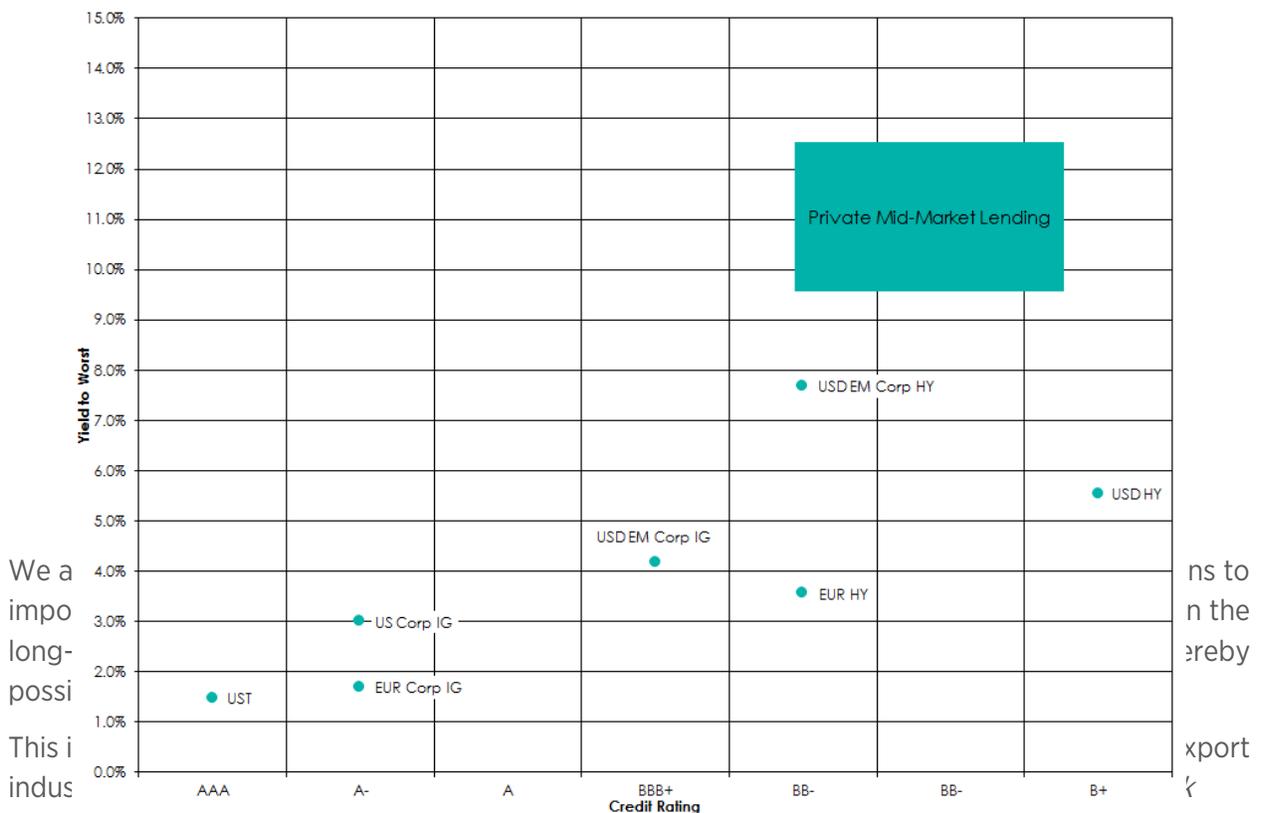
Middle Market Maturities 2014-2017



Source: Milken Institute Summit, October 2013

Attractive Valuations

The risk return profile of private debt was described earlier in this note. We find the 9% current yield on private debt attractive today, especially when considering the low yields investors earn on other fixed income asset types. Risk premiums for comparable high yield bonds (with credit quality equivalent to BB or B-rated) are above 500 bps (or 5%). Chart 3 below shows the credit rating and yield of a variety of fixed income assets. The illiquidity of Private Debt can be a risk for investors if they do not have the appropriate profile to hold an illiquid investment.



Source: Bloomberg, data as of 2/27/14



Risk

Default risk is a prime consideration when evaluating fixed income investments, but given the nature of private debt investments, there isn't widespread data on default rates in private debt securities. One way to evaluate this risk, however, is to see the default rate of a specific private debt manager. A quality manager we vetted had a default rate of 1.8% over a 20 year period. This compares nicely to the high yield default rate over the same period (about 4%) or leveraged loans (3.5%).¹

Access

Other risks to consider are liquidity and duration. The most common way for an ultra-high net worth individual to get access to private debt is through a private debt manager. These funds typically have a term of 10 years, with an investment period of 5 years. One fund we analyzed had a term of 10 years, but the average duration for their underlying investments was 2-3 years, much lower than the typical duration of high yield bonds. Most importantly, it pays a quarterly distribution of above 9% per annum. This means limited duration risk to earn such a high "carry".

Conclusion

We like the attractive yields and risk profile of private debt. Private debt is a highly specialized market. Thus, it requires managers with a strong track records as well as a solid network to gain access to deals. We believe the best way for our clients to invest in private debt is through a high quality third party manager. Over the past few months, we have been looking into different managers in the space, focusing on these core qualities:

- Track record through multiple credit cycles. We're looking for managers with a long track record through different market cycles. There are many funds which boast a 0% default rate- but have only been investing since 2009, a period of low defaults across the board. We want to see a team that has proven itself to invest in difficult market and credit environments.
- Access to private equity sponsors/ deal flow. We want to work with managers who have direct access to private equity sponsor and deals. This access is important because it ensures the manager is seeing the best deals first- and has first choice in participating. Managers with good access also avoid paying fees to a middle man - which would otherwise be absorbed by the investors in the fund.
- Strong investment process/ due diligence process. We want to see a proven track record as well as a strong investment process. We like to see highly experienced teams with the right firm infrastructure to allow for in-depth due diligences.

¹ Data as of December 31, 2010



- Alignment of interests. We are always looking for a meaningful alignment of interests when we invest, in this case a capital commitment to the fund from the fund senior managers and or the firm.
- Dividend Distributions. In line with our investment philosophy, we look for managers that pay distributions of around 75% of their gross yields. That means at least 9% current yields with expected gross returns of 13% to 17% per annum.



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