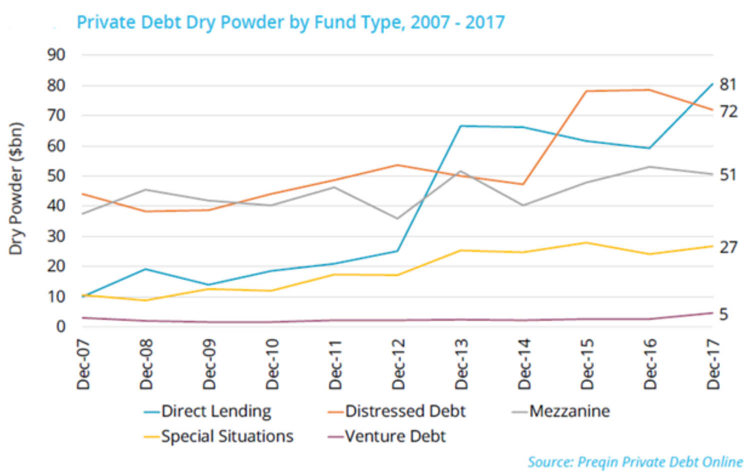
Private Debt: Getting crowded, but top managers can still add great value above public markets

The state of the Private Debt space calls for caution. Over the past years, an increasing amount of money has been invested in Private Debt funds, much of which remains to be deployed. This excess liquidity has caused prices to rise, making investments less attractive. In addition, at a time when market conditions may be becoming less favorable, borrowers have been able to negotiate less restrictive terms on their debt as funds compete to "win the deal". Despite the caution needed, we still prefer Private Debt over public debt investments. In this environment, it is important to select a manager who maintains the discipline of lending to companies at terms that properly compensate the investor for the risks being taken and not chasing unattractive deals in order to deploy capital.



The Thinking Man's Approach

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- More money is being invested in Private Debt, at a time when market conditions are becoming less favorable.
- Growing AUM and dry powder, increased competition between managers, and investors' search for yield could increase fund managers' risk-taking.
- Despite caution needed in the private space, investors can still find attractive opportunities.
- Investors need to exercise due diligence not only on the security in question, but also on the fund manager's investment approach.
- Still, Private Debt may be safer than public debt, given there is more pricing discipline and increased oversight over investments.

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Growing liquidity decreases returns, while higher rates and regulatory changes increase risk

Private capital markets (debt and equity) have more than doubled over the past 10 years, according to The Wall Street Journal. PwC estimates they will more than double by 2025, to $21 trillion. According to Preqin, the fastest growing segment, Private Debt, has tripled in 10 years, to $638 billion as of last June.

Rising interest rates, along with recent tax changes limiting the deductibility of interest expenses, may reduce the number of companies interested in issuing new debt. If Private Debt funds keep growing, the supply and demand dynamics will continue to get less attractive for lenders. Fund managers may be more aggressive and less selective, perhaps accepting expected returns that don't properly compensate the risks being taken. Investors may not realize that they are receiving inadequate returns until problematic loans create more losses than the returns generated from performing loans can cover.

Tightening credit conditions cause companies to pay more for their debt, which impacts their financial flexibility. Overleveraged companies are poised to suffer the most, as it will be harder for them to tap additional financing or restructure their debt. Even if they do, rising rates will make it increasingly difficult for them to service their debt obligations. In particular, "zombie firms"[1] might not be able to access capital in public markets and may turn to private sources of financing or bankruptcy. In addition, we need to consider that the Trump administration is set to deregulate the financial industry. Banks are increasingly being allowed to underwrite riskier loans. Funds, such as BDCs[2], are now allowed to double their leverage – giving them more flexibility to make riskier investments. This means risk-taking may increase while regulatory oversight may decline.

Private Debt and Public Debt have very important differences

Historically, Private Debt markets have been intended for sophisticated institutional investors. They are largely unpoliced and disclosure is not as comprehensive as in public markets. This lack of transparency makes it more important that private fund managers have the proper due diligence and monitoring capabilities, as well as strong relationships with the borrowers.

Whereas a publicly traded bond may be owned by many mutual fund managers and hundreds of individual investors, The Wall Street Journal reports that the typical private deal has fewer than 10 investors. In many cases, a private fund may be the only lender for a loan. This has several important benefits. It allows for a more stable pricing process, because the investor group can control the rate they are willing to accept, whereas public deals need to satisfiy a large group of investors, many of whom may be willing to accept lower rates than appropriate.

Private fund managers have oversight over the borrowing companies, as the group owns enough to exert influence over the company, whereas public deals may not have any investor with enough invested to affect the company. This not only applies to the original loan negotiation, but also to any subsequent changes if the company has problems. A good manager can help the borrower restructure the debt and, often, provide advice to help the company improve before bankruptcy becomes necessary.

In Private Debt, the fund is lending directly to the borrower and can dictate the terms to be more beneficial for lenders. In addition to pricing, this allows them to insist on proper covenants to protect

[1] Zombie firms are those whose interest payments exceed their earnings. The Financial Times estimates that the number of zombie firms has increased, from 2% to 10% since 1987

[2] Business Development Companies, a type of close-end fund that makes investments in developing and financially distressed companies

their investment. In public markets, investors accept the terms negotiated by the underwriting bank, who represent the borrower and whose priority may be completing the issuance to earn their fees and not negotiating the best protection for the buyers. Later buyers must accept the conditions determined originally, with no control.

One perceived limitation of Private Debt is that it is illiquid. In general, an investor commits to invest a certain amount, which is usually "called" over a period of several years and not fully returned until the investments mature, generally 5 to 10 years. It is difficult to sell one's position to another, so investors consider the investment as totally illiquid. This is actually a very large benefit for the fund manager, who can deploy the capital with patience, knowing that he or she won't be forced to exit a position at a bad time. In contrast, a mutual fund manager facing large redemptions during times of stress might be forced to sell bonds that later recover fully, forcing remaining investors to suffer because of the decisions of others.

Lastly, Private Debt managers usually have their own capital invested in their funds, so their interests are aligned with the investors' and they are more motivated to control risks and seek appropriate returns for each investment. Mutual fund managers may not have much invested and are usually measured by their performance relative to a benchmark, not the risk-adjusted return. Finally, the banks that issue public debt usually have little or no economic incentive other than the fees they earn for completing the transaction.

A tale of two radios

A comparison between two real companies operating in the same struggling industry can be helpful to demonstrate how due diligence on companies' financial health and on fund managers' investment approach can help investors allocate capital safely. The comparison also highlights the advantages of investing in the private debt space over the public debt space. As we approach the 9th inning of the economic cycle, it will be even more important to stick to our best practices, carefully analyzing investment opportunities at both the security and manager levels.

Both companies are among the five largest in the radio broadcasting space – an industry that has been struggling and shrinking for the past couple of years due to the disruptive effects of other mediums such as music streaming services and satellite radio. The difference in both companies' financial health is large, even though the two companies are exposed to very similar adversities.

According to its financial statements, Company A generated just over $6B in yearly revenue and over $1.6B of EBITDA. The company had been a leveraged buyout (LBO) and the owners levered it with $20B of debt. This debt represents more than 12 times EBITDA and more than three time revenue. It has been struggling with it's debt payments, but management was able to keep the company running and meet the interest payments. However, because the debt was issued in the public markets, the covenants were not very strong, so management was able to transfer company assets to subsidiaries in order to shield them from lenders. It also sold assets to distribute part of the proceeds to the original financial sponsors. In addition, there was no strong bondholder able to force the company to protect debtholders. Lenders could not take action to prevent management from slowly "bleeding" the company to death.

Company B is much smaller, generating about $235MM in yearly revenue and EBITDA around $60MM, according to investor materials. In contrast, the company's debt, which is private, is only about 6.5 times EBITDA and one and a half times revenue, both figures about half the ratios of Company A. Because of the covenants imposed by the Private Debt lender, the company could not burden itself with the amount of debt that A was able to do. In addition, the lender has significant influence over the business itself and could help management improve the debt profile by positioning the company in strategic market segments, which helped to improve margins and to strengthen the company's cash flow generation capability.

There is also a difference in the investment approach taken by the fund managers involved in each respective company. Company A's financial sponsors loaded the company with debt and other aggressive transactions. This led to the financial asphyxiation of the company, forcing it to declare bankruptcy. As the number of investors with different claims along the capital structure increases, the messier and lengthier the restructuring process becomes. There's also the possibility that bondholders sue the company due to alleged irregularities mentioned. This highlights how investors in public debt can be more exposed to other stakeholders' actions, and how they have less control over their investment. While the deterioration of the radio-broadcasting industry afflicted company A, it was its indebtness that finally drove the company to file for bankruptcy. Its $1.4 billion in 2017 interest expense consumed almost 60% of its free cash flow.

The private debt manager who lent money to company B, one of the top managers in the space, has an approach that allows it to be more disciplined in the investing process. First, it raises capital according to the size of the investable market; something that prevents a situation where capital is hastily deployed into deals of less quality. Second, it achieves pricing discipline by avoiding excess risk-taking, and by focusing on credit fundamentals rather than growth prospects.

The fund manager also has an integrated credit platform that allows it to have greater oversight over all aspects of the investment. The manager has strong direct origination capabilities, taking responsibility for primary due diligence, maintenance of covenants and negotiation of documents. In addition, it has strong direct relationships and interacts constantly with other sponsors and the company's management – allowing it to be aware of any situation that arises within the capital structure of the borrower. The company has been negotiating a difficult environment, but this Private Debt investment has been very successful, with an IRR to date above 10%.

The table below shows the contrast between both companies' debt ratios:

	Company A	Company B
Revenue	$6,178	$234
EBITDA	$1,658	$58
Debt/EBITDA	12.3x	6.4x
Net Debt/Revenue	3.3x	1.6x

Revenue and EBITDA figures are LTM as of 09/30/2017, in millions

Sources: financial statements, fund manager guidance

Oppportunities still exist

Although the environment may be getting more challenging, attractive investment opportunities can still be found with managers that maintain a disciplined investment strategy. We consider Private Debt a safer investment space than public debt markets because there is less volatility, more pricing discipline, greater control over the investments and better alignment of interests. It also tends to provide better returns.

In addition to having safer, better paying loans, Private Debt funds can have other advantages for an investor. Some funds can charge fees to others who invest in the debt, in compensation for their underwriting services. This adds to the return of the fund. Often, in addition to the debt, the funds will accept a small equity stake in the company, which can provide additional return if all goes well.

As the economic and tax environment get more complicated, it will be even more important to stick to our best practices. To paraphrase Warren Buffett, the less cautious other investors become, the more cautious we need to be. Working with top fund managers in any segment of the market, like Private Debt, and conducting thorough and meticulous due diligence, allows us to find lucrative investment opportunities even in a struggling industry like radios. As we continue to be confident about our allocations in the private space, particularly in Private Debt, it will be of the utmost importance that we keep monitoring closely the risk-on behavior of fund managers and the market conditions that could affect the underlying investments of those funds.

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