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PRIVATE CREDIT: IS NOW A GOOD TIME TO INVEST?

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As we approach the eighth year of economic recovery, headlines abound on whether or not a recession is near and what may cause it. Risk-taking appears to be on the rise not only in the equity markets but also in the credit markets. Identifying these potential risks and how they might impact the prevailing investment opportunity in private credit is a topic that has been on our minds, and it is one we believe is relevant to our clients, particularly given the increased level of investor activity we are seeing in the private credit space.

Market Dynamics

Credit fundamentals appear to be weakening, although there are divergent views. Covenant-lite deals (i.e. ones where investors are willing to forego maintenance covenants that provide for regular enforcements with respect to the company's free cash flow, debt to equity ratio, etc.) hit an all-time peak of 73% in 2016 and represent 70% of total loan issuance for the H1 2017 according to Credit Suisse and S&P LCD. Most market sources view covenant-lite as an indicator of higher risk tolerance and are recommending greater caution. Covenant-lite, however, does not necessarily mean the loan is more risky than a traditional loan. Oppenheimer[1] had an interesting perspective on this:

> *"[What is more risky?] A cov-lite deal with a debt incurrence limit of five times trailing cash flow, or a deal with traditional maintenance covenants that allow the company to leverage itself up to ten times its most recent quarter's annualized cash flow?"*

Regardless of which side you take on this topic, the increase in covenant-lite issuance does suggest we are experiencing a very strong credit market driven by robust investor demand and a willingness to accept less covenant-heavy deals.

The weakening of credit fundamentals may also forewarn an increase in risk-taking. Triple C high-yield bond (HY CCC) and 2nd lien leveraged loan (2nd lien) issuance has increased to 17% and 5% in 1H 2017 from 11% and 3% in 2016, respectively, but still lags the proportions seen in 2007 (i.e. 21% for HY CCC and 8% for 2nd lien)[2].

Credit spreads are also tightening, signaling that investors are willing to take on more risk without a commensurate increase in return, which could be a sign that higher volatility lies ahead. Eventually, this tends to lead to a cycle in which a higher number of less creditworthy companies access the credit markets, leading to a higher proportion of defaults and widening credit spreads.

High-yield (HY) and loan issuance for leveraged buyouts (LBO) has been on the rise since 2009 but is nowhere near the peak levels reached in 2007 and 2008. On the one hand, a commonly held view is that the current market, as a corollary, is characterized by less aggressively structured deals with more investor-friendly terms, since HY and loan LBO issuance is more attenuated today than during the 2007 to 2008 peak; we do not necessarily agree. It could suggest that other private capital sources are providing an increasing amount of the leverage for buyouts and refinancings, including direct lending fund managers, uni-tranche providers, regional banks, directly originated transactions from LPs with private lending teams, as well as fund managers targeting subordinated debt solutions.

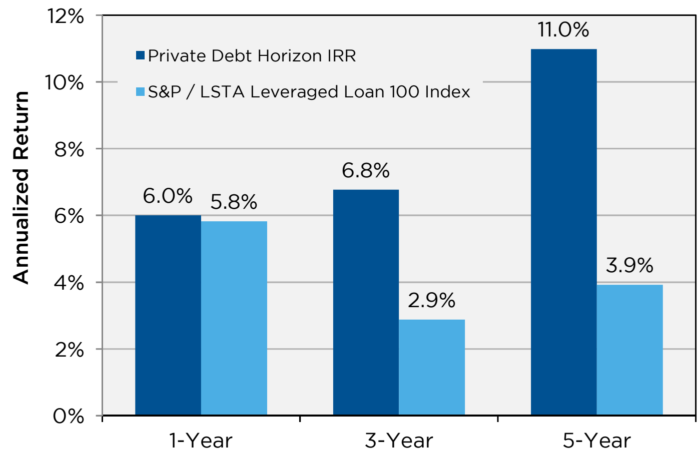
While the aforementioned trends in the larger end of the broadly syndicated market may not directly correlate to the private credit market, these trends do suggest that we are in a period where the credit markets have a lot of momentum and more risk-taking appears to be occurring.

Private Credit Strategies

Private credit is a broad term that encompasses a large opportunity set representing an estimated $4 trillion market[3]. We view private credit as encompassing two primary categories: Direct Lending and Special Situations. These categories are composed of various distinct strategies as summarized in Table 1.

Compared to 10 years ago, the areas we have seen the largest relative increase in LP demand and fundraising activity are in the senior secured direct lending (direct lending), structured credit and opportunistic segments. Of these three, however, direct lending has received increasing attention from LPs, with more than 230 funds having closed on more than $130 billion of capital since 2013[4]. This compares to a market opportunity of approximately $550 billion according to Carlyle and represents a significant increase from approximately $23 billion raised between 2009 and 2012. The primary catalyst for this increase in demand is historically low returns on public fixed income securities over a sustained period (see Graph 1).

Graph 1: Private Debt Relative Performance



Source: Preqin and Standard & Poors, as of September 30, 2016
Note: Private Debt includes Direct Lending, Mezzanine and Distressed Debt.

This dynamic has been particularly challenging for corporate and public pension plans or other organizations required to pay retirement benefits to plan participants. As a result, we have seen many LPs establish specific allocation targets to private credit, with these allocations either being combined with their liquid fixed income

Table 1: Private credit strategies

Private Credit Strategies					
Direct Lending			Special Situations		
Senior Secured	Mezzanine	Uni-Tranche	Structured Credit	Distressed Debt	Opportunistic
Issuers of senior loans secured by either the underlying assets of a business or the company's cash flows Includes transactions completed alongside private equity sponsors or directly originated transactions	Issuers of subordinated debt, often in conjunction with an equity position, in a sponsored or non-sponsored transaction Exposure can also be obtained through publicly-traded BDCs	Situations where the issuer provides the entire credit capital structure	Targets situations in the secondary market across a broad range of senior loans, either directly or through CLOs Includes risk/retention vehicles (provides an equity back-stop for CLOs)	Targets non-control transactions in the secondary market in a broad range of corporate credits acquired below par due to technical, event-driven situations Investments may go through a restructuring process and convert to equity	Broad range of strategies targeting specific industry or geographic dislocations, rescue financing, non-performing loan portfolios, balance sheet restructurings with banks and other situations with a high level of complexity
Blended and Hybrid Strategies					
Sector specific credit funds which may employ a range of the above strategies targeted specifically on areas such as Energy, Real Estate and Infrastructure, as well as funds that may include a blend of equity and credit securities in a broad range of performing and non-performing assets					
Expected Returns (net IRR)					
7% to 10% unlevered 11% to 15% levered	11% to 12%	< 8% unlevered 8% to 9% levered	10% to 20% depending on leverage	12% to 20%	15% to 25%

allocation or bucketed within their alternatives allocation. This is a significant change from a decade ago, when LPs typically solely targeted strategies with a private equity-like return profile (e.g. special situations) and bucketed them within private equity.

Potential Risks for Private Credit LPs

Relative to the prevailing environment, Pavilion observes a number of potential risks investors should consider with respect to private credit strategies, particularly given investor demand is expected to remain strong, as indicated by Graph 2.

<u>Fundraising cycle appears to be peaking although investor demand is expected to remain strong</u>

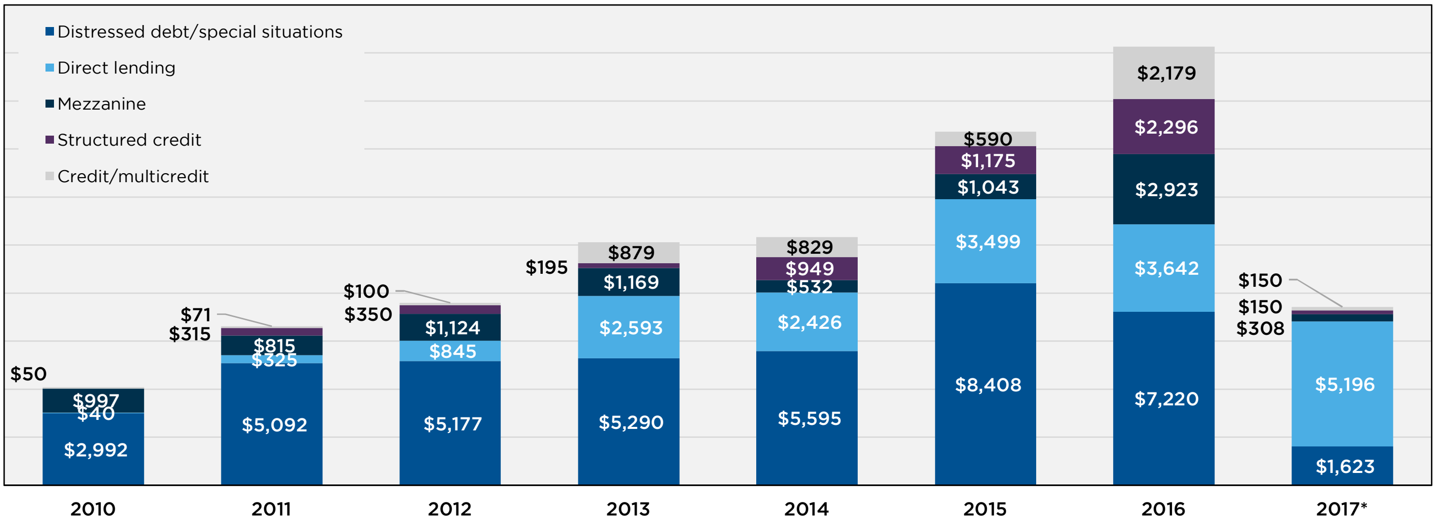
We are seeing fund sizes increase as volumes increase, but the total number of funds raised has remained relatively stable. While fund size increases do not necessarily foreshadow a degradation in net returns to LPs, they do indicate we are experiencing a strong fundraising cycle. Even some managers have sounded surprised by the amount of capital they were able to raise above their targets in such a short amount of time.

LPs should be wary of strategy drift, as we have heard anecdotally that new teams are being formed within existing, larger-sized fund managers in areas where the new team appears to have limited experience. Additionally, teams may not be able to keep pace with the amount of capital being raised, and investors should pay close attention to the number and skillset of individuals focused on underwriting and portfolio management. We have heard anecdotally that some fund managers are relaxing underwriting standards in order to win deal flow, and some control-focused credit fund managers have cited that direct lenders are one of their main sources of competition, particularly in companies with less than $75 million of EBITDA. We are also hearing that some smaller, regional banks are willing to lend at rates much more compelling than a few years ago, and this provides an attractive alternative to direct lenders for companies seeking more efficient capital solutions.

Strong fundraising cycles also tend to result in more team spin-outs and fund managers that may have not invested across multiple economic cycles. Track records for these teams may be limited and/or difficult to assess. There are more fund managers to choose from, and LPs should remain prudent and take adequate time to conduct their detailed due diligence.

Terms also tend to favor fund managers during strong fundraising cycles. Related to this, we have heard anecdotally that some credit fund managers' treatment of upfront fees may be written in the legal documents such that these fees accrue solely to the benefit of the fund manager rather than being split pro-rata with the LPs.

Graph 2: Alternative credit skyrockets - Investment in private credit by institutions, in milions



*As of Q1.
Source: Pension fund officials and documents

Risk-taking behavior appears to be on the rise

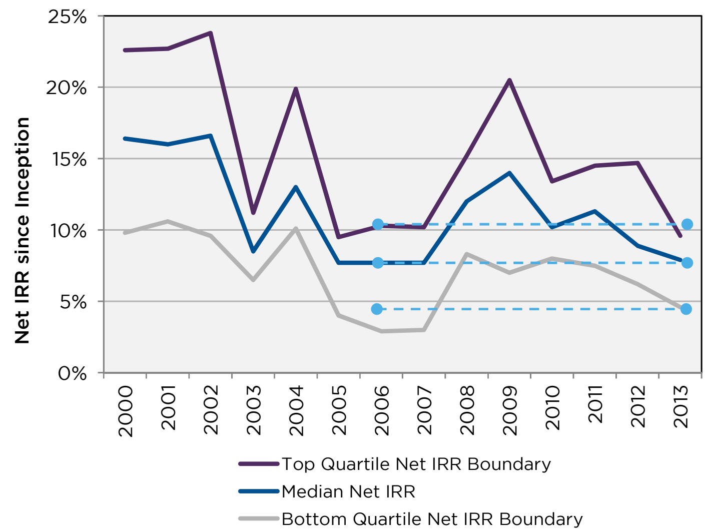
While club deals in the private credit space may not be a new phenomenon, we would advise LPs, during their detailed due diligence, to inquire about whether the manager has completed club deals, and if the manager had its own legal counsel review these deals and what counsel focused on, particularly in situations where the fund manager writes a smaller check compared to others in the debt syndicate.

As a follow-on point to the discussion about the strong fundraising cycle, we are seeing some direct lending-focused fund managers creating or adding to their restructuring and turnaround teams. This is interesting given most direct lenders target the top of the capital structure, and it may foreshadow that fund managers are anticipating an increase in defaults that could result in control of the company. In reviewing chart 3, it does appear that we may be nearing an inflection point in the cycle where direct lending fund managers, particularly those without restructuring experience that take 2nd lien risk with no mezzanine between them and the equity, may face difficulties in a restructuring situation and may not achieve the returns they or their LPs originally anticipated. This could potentially be most concerning for vintage years 2012 and later when direct lending fundraising has proliferated, although given the lag in performance information, it is still too early to label the data as meaningful (see Graph 3).

A conundrum for LPs

More philosophically, the dynamics at play in private credit make it more difficult for LPs to assess the private credit landscape. Several years ago, an investor could rely more on private credit fund managers to caution against excesses in the private equity space. These fund managers tended to focus on more event-driven strategies and mainly sought to acquire secondary stakes in LBO corporate debt at stressed or distressed prices. Now, with the expansion of private credit beyond more opportunistic and special situations to direct lending strategies, many private credit fund managers are pointing to the amount of private equity dry powder as an opportunity to put their capital to work. While the checks and balances have not completely disappeared, the investment decision certainly appears more challenging to decipher as both sides are raising large amounts of capital with a common goal to persuade investors that their strategy is the most attractive one.

Graph 3: Private Debt Median Net IRRs and Quartile Boundaries by Vintage Year



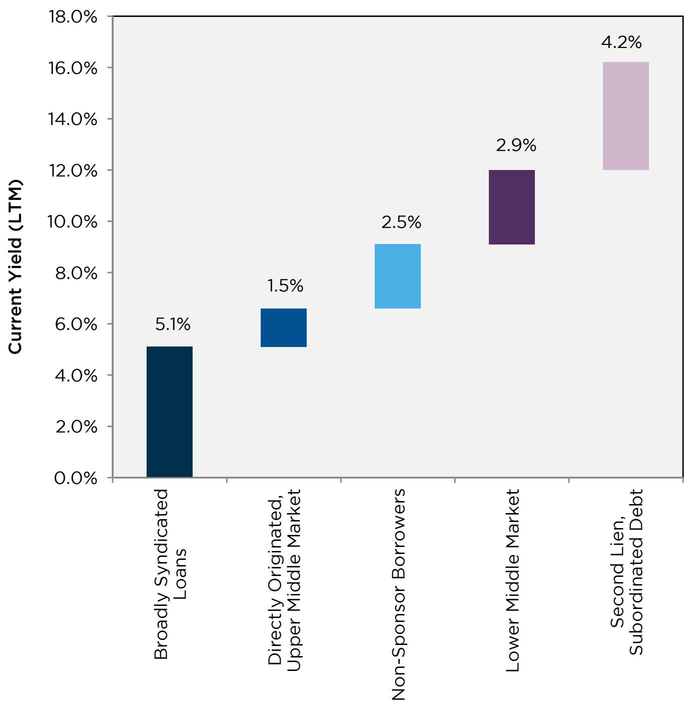
Potential Opportunities for Private Credit LPs

Despite the risks, we remain optimistic about the private credit space as it is an evolving market that presents a myriad of opportunities for LPs. Below, we discuss some of these opportunities.

Direct lending strategies are typically more insulated from larger-market dynamics and continue to offer a return premium

In the mid-market private credit space that typically targets businesses with between $10 million and $75 million of EBITDA, return premiums remain achievable. This is due to a number of factors, including differentiated sourcing channels where fund managers with strong networks are able to bypass other sources of competition. We favor fund managers that possess strong underwriting skills and directly originate transactions. This is important because these fund managers appear more protected against losses given they structure transactions and covenant provisions that are customized to the specific financial and operating metrics of the business while also providing companies with more flexibility than solutions offered by traditional financial institutions.

Graph 4: Risk Premiums Available in Direct U.S. Middle Market Loans

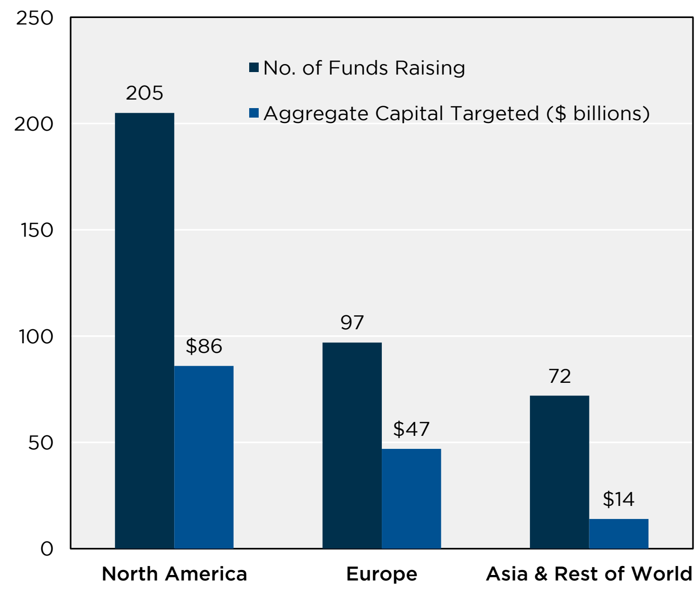


Source: Pavilion Analysis, White Oak Global Advisors, Cliffwater Research

Notably, private credit lenders typically hold the most senior securities in the capital structure and, in many instances, are able to garner yields that are not generally afforded to this level of seniority. To our earlier point about spread compression in the larger, broadly syndicated market, we have heard that spreads have compressed between 100 and 200 basis points depending on where lenders are in the capital structure. For uni-tranche or other subordinated securities, one fund manager indicated that spreads have compressed 200 basis points while first lien loans have compressed around 100 to 150 basis points. Some fund managers offer levered sleeves to their senior secured lending strategies, and relative to the yields that some sponsor-backed mezzanine managers are targeting (~11%), we believe direct lending may offer a more attractive risk/return trade-off, although there are some mezzanine fund managers, particularly at the larger-end of the market, targeting opportunities that appear attractive given their scale and execution capabilities, although LPs should be mindful of the amount of equity risk they are taking.

With respect to geography, the U.S. provides the most opportunities to invest as a result of a number of dynamics, but European and Asian opportunities are also on the rise (see Graph 5).

Graph 5: Private Credit Funds in Market by Primary Geographic Focus



Source: First Avenue LLP, 'In-Depth Private Debt Overview', Q2 2017 (Preqin as at February 2017).

<u>Special situations fund managers with established track records across multiple economic cycles can provide diverse ways to achieve attractive returns relative to their risk profile</u>

As noted in the Table 1, special situations encompass a number of different strategies. Fund managers that can provide liquidity quickly in situations where pockets of dislocation occur are particularly attractive over the near to medium-term. Dislocations may include market-specific dynamics, where the lack of broker-dealer inventory to backstop sell-offs driven by situational events (e.g. a sell-off from ETFs or mutual funds, for example, driven by macro-related fears) provides a distressed-for-trading opportunity to purchase debt on the secondary market in companies believed to be fundamentally sound but mispriced based on future expectations. These opportunities have not been available for quite some time and require patience.

Fund managers that target specific industry dislocations are also well positioned. These include a full spectrum of fund managers at both the larger and smaller end of the market that can structure capital solutions for companies to solve a balance sheet problem. Given the change in retail dynamics, with the online channel continuing to gain market share from traditional brick-and-mortar stores, fund managers are positioning themselves to provide more bespoke solutions and restructurings or capital when debt maturities expire. The energy industry is another key target as certain businesses are in need of restructuring solutions to right-size their capital structure relative to the persistent trend of lower oil prices.

Company-specific dislocations are also expected to provide fund managers of all sizes with investment opportunities. These fund managers tend to embrace complex situations where competition is relatively less intense but where financial structuring acumen and deep knowledge of the company is required. Fund managers we favor include those that possess the flexibility to invest throughout a company's capital structure and deploy capital opportunistically across economic cycles. Fund managers may focus on rescue financing opportunities or other opportunistic debt investments where they can generate an equity-like return. Investments are typically structured with significant protections in order to minimize the potential for losses, and most investments include coupon payments or preferred equity dividends. While this investment approach remains prevalent in North America and Europe, we are seeing an increase in this approach in Asia.

Other opportunities that appear favorable over the near to medium term include diversified, non-performing loan portfolios across numerous sectors as well as balance sheet trades with financial institutions in need of repositioning more toward core assets given regulatory changes. These types of situations generally target an 8% return and can be leveraged at the investment or fund-level to achieve mid-teen returns. We typically see total leverage targets of between 1.0x and 2.5x, and specific leverage conditions and limitations vary across fund managers.

Real Estate and infrastructure may offer better risk-adjusted returns than corporate mezzanine

Subordinated debt in the infrastructure and real estate segments remain interesting due to the strong collateral coverage these investments typically offer. Given infrastructure's more predictable, long-term earnings profile, LPs may be able to achieve yields typically not afforded to more junior assets in the capital structure of other asset classes. The overall macro dynamics are also favorable given the estimated $500 billion that is needed annually for new projects and privatizations[5]. Assets in favor include airports and shipping ports, which typically have lower projected default levels and relatively high recovery rates when compared to corporate mezzanine opportunities.

Within real estate credit, there is a strong regulatory undercurrent driven by new limitations imposed in January 2015 on financial institutions' ability to fund new development, construction and acquisitions. This new regulation also increased capital reserve ratios for commercial mortgage-backed securities given prior defaults. Private lenders have closed this gap, particularly as the commercial real estate market has rebounded, property fundamentals have improved, and as refinancings are anticipated to meet upcoming maturities.

Conclusion

We believe private credit is an exciting and evolving part of the private market that offers a unique opportunity for LPs to generate an attractive return while providing downside protection and a growing selection of fund managers from which to choose. While risks are prevalent, this is true for any asset class. As we've discussed here, there are a number of attractive ways for LPs to allocate capital across the private credit spectrum.

1 - "Cov-Lite" Senior Loans: Much Ado About (Almost) Nothing, Oppenheimer Funds, July 25, 2017.
2 - CS Credit Strategy Daily Comment – Leveraged Finance. Credit Suisse. August 15, 2017.
3 - The Carlyle Group. Spring 2017.
4 - First Avenue LLP, "In-Depth Private Debt Overview", Q2 2017 (Preqin as of April 24, 2017).
5 - Infrastructure – Seizing the Subordinated Debt Opportunity. AMP Capital. January 2016.

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