

HEALTH WEALTH CAREER

# PRIVATE DEBT ASSET CLASS UPDATE

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# ASSET CLASS OVERVIEW

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Private debt (sometimes referred to as private credit or direct lending) refers to loans that are privately negotiated between a lender and a borrower (as opposed to syndicated loans, also known as bank loans, where the bank negotiates the terms with the borrower and then syndicates the loan to 100+ investors, creating a semi-liquid tradeable market for the loan).

Private debt generally is broken into two broad categories: corporate and asset-backed. The asset-backed category is, in turn, broken into real estate, infrastructure and niche subcategories, such as aircraft lending.

Corporate private debt lending strategies can be broadly characterized as either cash-flow-based or asset-based. Cash-flow-based lending strategies dominate in terms of dollars committed and the number of investment options offered. The focal point of these strategies is the cash flow (EBITDA or adjusted EBITDA) of the borrower, and private debt funds are differentiated by a wide variety of criteria, including, for instance, by how deep in the capital structure a manager is willing to lend (for example, senior, junior or preferred equity).

These various private lending strategies are generally compared to non-investment grade syndicated leveraged loan and high-yield bond markets. The syndicated loans and bonds are rated and relatively liquid, whereas private loans are of similar credit quality (unrated, but typically B/BB equivalent, and can range wider depending on strategy) and provide both an illiquidity premium (100–500 basis points) and a stronger ability to drive outcomes if a loan's credit quality weakens.

Private loans range in duration from a few months to seven years, but typically the actual tenure of these loans is around three to five years, with some being repaid early, bringing the average life down to around three years. Although many variations are used, typically private debt fund structures have a two-to-four-year investment period followed by a two-to-four-year wind-down period.

# INVESTMENT RETURN UPDATE

Fund offerings are highly nuanced, vary by the level of leverage utilized to augment returns and reflect some mix of the following characteristics:



## PRIORITY OF LOAN

- Senior debt
- Junior debt
- Unitranche



## SIZE OF BORROWER

- Lower middle market
- Middle market
- Upper middle market



## OWNERSHIP OF BORROWER

- Sponsored
- Non-sponsored

### Explanations:

**Senior debt:** First lien. Generally provides up to 4.5x EBITDA in capital to the borrower. An exception would be loans to venture-stage companies (that is, venture lending), which are typically based on revenue rather than EBITDA.

**Junior debt:** Mezzanine and second lien. Generally provides additional debt capital to borrower (behind the first lien in priority) in a range of 4.5x–7.0x EBITDA. Second lien can be considered senior or junior capital (based on the actual legal rights of the tranche) but, in the main, should be considered junior debt.

**Unitranche:** These loans cover the entire debt needs of the borrower (senior and junior debt combined) and have elements of both senior and junior debt. Unitranche loans generally go as deep into the capital structure as junior debt (4.5x–7.0x EBITDA), but are importantly first lien in priority, as no debt tranche is in front of them.

**Lower middle market:** Companies that generate EBITDA ranging up to \$20 million annually.

**Middle market:** Companies that generate EBITDA in a range of \$20 million to \$60 million annually.

**Upper middle market:** Companies that generate EBITDA over \$60 million annually.

**Sponsored:** Companies owned by a professional private equity investment firm.

**Non-sponsored:** Companies owned by management or family owned businesses.

For example, some funds focus on first lien lending to sponsor-backed lower middle market companies, whereas other funds focus on mezzanine debt lending to upper middle market non-sponsored companies. Return objectives vary by strategy and the level of leverage utilized. Most private debt funds are unlevered outside the US, but when leverage is used it is typically 0.5x to 1.0x debt/equity (although some can use more leverage).

### US AND EUROPEAN APPROXIMATE CURRENT MIDDLE MARKET RETURNS

	US	EUROPE
	Effective yield*	
Senior first lien	6.50%–7.25%	7.00%–8.00%
Unitranche	8.00%–9.25%	8.00%–9.00%
Second lien	10.00%–11.50%	9.00%–11.00%
Subordinated	11.00%–13.00%	12.00%–14.00%

\* Assumes fee income of 2%–3% in the US and 3%–3.5% in Europe, three-month LIBOR of 2.3% in the US and GBP LIBOR of 0.5% in Europe. Assumes fees amortize over three years.

# OPPORTUNITY OUTLOOK

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In Europe, private senior lending began in earnest in the wake of the global financial crisis (GFC) as banks reduced their lending to middle market companies due to regulatory pressures and for strategic reasons. Many European-focused senior lending managers have track records of five years or less, and very few have track records of 10 years or more. The US private senior loan market (as well as the syndicated loan market) is more mature compared to Europe. US banks have been reducing their leveraged lending activities since the 1990s, and a number of senior private debt managers have 10-to-20-year track records.

Junior capital lending has a longer history in both Europe and the US compared to private senior debt. Mezzanine debt investing was pioneered by insurance companies, along with a very small number of private debt managers (both in Europe and the US), beginning in the early 1990s and has been an important private debt niche ever since.

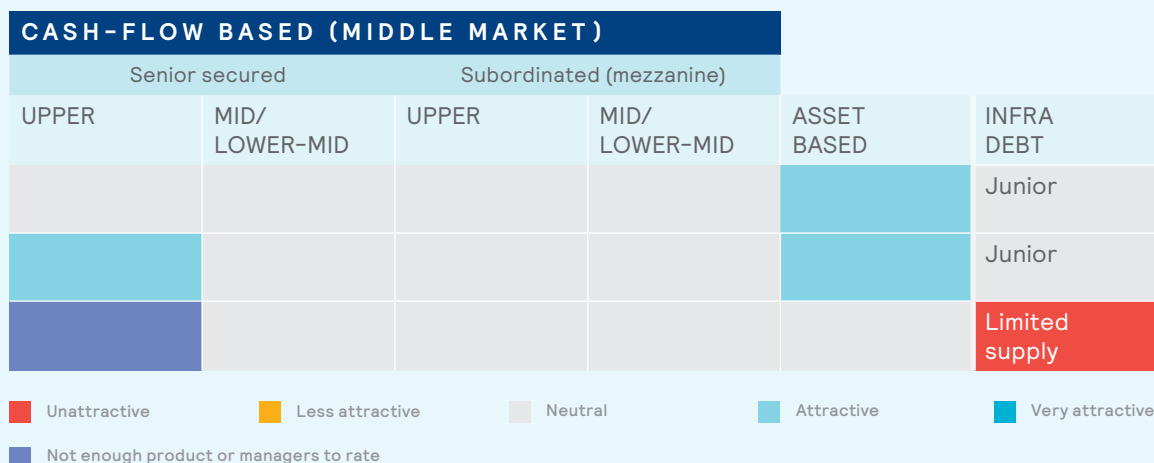
Still, private debt offerings have expanded considerably post GFC. Lengthy track records, both senior and junior, are relatively rare and are a meaningful differentiator in both markets. Track records that go back long enough to include the global financial crisis of 2007/2008 are rarer still.

Although there are excellent managers and strategies geographically focused on both markets, the opportunity set has shifted somewhat from the US to Europe due to the different speed of recovery from the GFC within the banking sector, different regulations influencing banks on their use of their balance sheets, and the differing role and prominence of the high-yield markets.

Currently, competitive pressures resulting from the high level of capital aimed at middle market lending and still low default rates have combined to create a borrower-friendly environment, particularly in the US. In recent years, loan covenants have weakened (or are nonexistent in some US upper middle market situations) and spreads (typically expressed as a premium to LIBOR) have become tighter; however, loan covenants are still attractive relative to the even greater tightening witnessed in liquid credit markets. Strategies that are least vulnerable to these competitive pressures often center on non-sponsored transactions and/or the lower middle market size segment.

The following represents our views in the context of building a private debt portfolio:

#### PRIVATE DEBT OUTLOOK – MERCER'S HEAT MAP



# RISKS AND IMPLEMENTATION

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Compared to traditional asset classes and most other growth fixed income categories, the private debt implementation process looks different and operates more in line with the implementation of private equity allocations.

Private debt funds are typically less diversified (by number of positions) than senior bank loan funds (usually by a multiple of around 10 times less diversified). Also, the issuers are typically quite small. For most corporate private debt funds, the sum of the enterprise values of all of the issuers would be less than the market cap of the typical issuer of a single corporate bond. These points underscore the importance of diversifying a private debt allocation across a number of underlying funds rather than investing it all into a single fund. Very little upside can be gained from holding a concentrated portfolio in private debt — leaving aside any equity-linked kickers, the best that can happen is that you get your money back with interest, as per the terms of the loan agreements. On the flip side, if your private debt portfolio is too concentrated and something goes wrong, then the downside could be significant, leaving you very few prospects for making enough from your other holdings to recoup your losses.

Private debt managers typically accept new monies only during their fundraising periods, with managers usually capacity constrained in terms of being able to accept new money, and then call/invest the committed capital over the following years. Therefore, it will take time to allocate capital to a set of high-quality managers, and it will take additional time until they have invested the committed amount — that is, a high-quality private debt portfolio cannot be invested overnight.

## CONCLUSION

In our view, the structural changes that have led to the emergence of private debt as an established asset class are here to stay. We strongly believe direct lending should not be viewed as a short-term investment thesis or a trade but, instead, a long-term investment opportunity in an established and growing asset class. Once the credit cycle does ultimately turn, direct lending is likely to be a defensive investment compared to many other asset classes. That being said, there is a high level of dispersion in the quality of managers, and we believe that successful investing in this area requires putting in place a long-term plan to commit capital to a diversified mix of high-quality funds.

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