Spotlight on Private Debt Opportunities

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Purpose and Structure of the Fireside Chat

The fireside chat with Tony Ressler (Ares co-founder and Executive Chairman) and Jean Hsu (CalPERS Managing Investment Director) will be delving into the rapid rise of direct lenders to better understand the drivers that led to the fundamental shift in lending and to explore and highlight current opportunities in private debt. Mr. Ressler will be able to provide a unique perspective on this shift in the lending landscape through the lens of one largest private debt lenders that have participated in this space for 25 years. Topics and questions that the chat will cover include:

- *Is the growth of the private lending market short-term and cyclical or are we witnessing a long-term shift towards private capital?*
- *Why is there an opportunity for private credit providers to service the market and why have the banks retrenched?*
- *Which areas of the market are currently most attractive?*
- *How do you identify funding gaps in the market and how do you take advantage of these opportunities?*
- *Beyond corporates, where do you think the next growth area within private debt will be?*
- *Where is the greatest opportunity, geographically, in the private lending market?*

Because the private debt space is relatively new, we have included some background information for this fireside chat. Included are background on what is private debt, why invest in private debt, the risks of private debt, allocating to private debt, private debt in different macro environments along with a brief discussion on the integration of ESG into private debt investment decisions.

What is Private Debt

The basic mechanics of private debt loans are like that of any other loans. The borrower receives a loan (usually floating rate), and, in exchange, the lender receives periodic interest payments. These loans are usually highly negotiated and transacted directly between a borrower and a non-bank direct lender and are not publicly traded.

Some key events that led to the rise of private debt capital:

- ***Banks shift focus after many decades of consolidation***: There was a tremendous amount of bank consolidation that started in the mid-1990s that led to the reduction of lending to small and medium-sized companies. The number of commercial banks has declined by 50% since 1998 with the top 25 banks now holding more than 50% of all bank commercial and industrial (C&I) loans and with an emphasis on larger borrowers. This trend accelerated because of the increased bank regulations following the Great Financial Crisis (GFC). As a result, banks reduced their desire for illiquid assets and accelerated the pivot in traditional bank lending to an "originate and distribute" model.

- ***Public markets shift towards larger companies****:* Public equity, high yield and loan markets have moved away from smaller borrowers. The average market capitalization of public companies has increased from roughly $2 billion in 1998 to over $8 billion in 2019 while the number of public companies has declined by almost 50% since 1996.

- ***Rise of private capital:*** With the reduced traditional sources of public capital financing coupled with an increase in regulatory burdens on public companies, demand for private equity and private debt capital increased, which led more investors seeking the potentially strong and consistent returns from private equity and private debt investments.

- ***Global trends of private capital:*** In addition to the US, European and Asian markets also have a strong demand for private equity and private debt capital as traditional sources shift away from small and middle market companies.

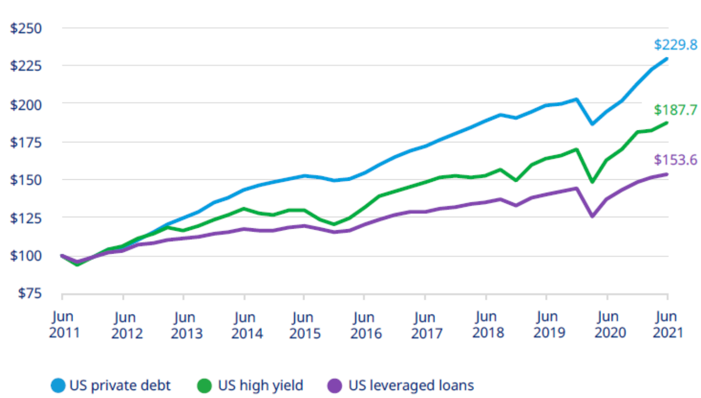
Although any company can use private debt to raise capital, a significant portion of the private debt universe is associated with lending to private-equity-owned (sponsored) businesses. As indicated above, the supply of credit from banks has declined by 50% due to stricter regulation post-GFC, which has resulted in companies and their owners (mostly private equity firms, or "sponsors") turning towards the private debt market as their preferred source of financing. Companies have quickly adapted to preferring the bespoke nature of private debt in addition to the speed and flexibility of a privately negotiated loan.

The increase in private equity dry powder and the dramatic decline in bank financing has created a significant demand in credit, and thus the opportunity for institutional investors accessing private debt investments via general partner/limited partner structure. Most of private debt returns are from income rather than capital gains, and are viewed as an attractive higher yielding alternative to traditional fixed income, as well as a diversifier to growth portfolio.

Why Invest in Private Debt

- ***Potential for attractive risk-adjusted returns****:* Private debt investors receive a premium over traditional fixed income. This premium (often referred to as an "illiquidity premium") is driven by the complexity involved in originating, underwriting, and structuring private loans. This return premium can vary but persistent and robust over the last decade. This is illustrated by Mercer in figures 1 and 2 by the performance of private debt during various economic periods.

Figure 1: Growth of $100



Source: Mercer analysis, Thomson Reuters Datastream (ICE BofAML US High Yield Master II, S&P Leveraged Loan) and Burgiss (US Private Debt)

Figure 2: Return Analysis

Risk-adjusted performance	US private debt	US high yield	US leveraged loans
10-year return	8.7%	6.5%	4.4%
10-year standard deviation	5.4%	8.1%	6.4%
10-year risk/return	1.6	0.8	0.7

Source: Mercer analysis, Thomson Reuters Datastream (ICE BofAML US High Yield Master II, S&P Leveraged Loan) and Burgiss (US Private Debt). Data is annualized to June 30, 2021

- ***Accounting Diversification**:* According to Mercer, private debt loans are not traded; therefore, valuation methodologies are less affected by shorter-term market volatility and more driven by fundamentals, which generally smooths private debt returns compared to liquid credit, which is more directly exposed to market price volatility.

- ***Complements Private Equity**:* From an overall diversified portfolio context, private debt is complementary to other asset classes because it expands access to the less efficient market without the typical J-curve impact of Private Equity. Private debt also sits higher in the capital structure than equity while offering lower volatility and income-based returns. Given concerns over inflation and rising interest rates, the floating-rate nature of private debt is another factor that can make it an attractive asset class.

Risks in Private Debt

- ***Illiquidity**:* The inability of an investor to liquidate a portfolio at a time when liquidity is needed as secondary markets often do not exist for these investments. If a secondary market exists, the investor may only be able to sell the investments at a significant discount.

- ***Dispersion of manager performance:*** Successful non-bank lenders will need deep sourcing capabilities to originate the highest quality credits, disciplined underwriting processes, extensive portfolio management skills and significant available capital to inject liquidity into potentially troubled companies. It is expected to see greater dispersion among credit managers lacking these required competencies.

- ***Less transparency**:* Unlike public markets where data is readily accessible, private debt markets tend to be opaque with little or no observable market data with borrowers that tend to be unrated

- ***Higher investor demand for private debt**:* As more investors seek higher yields and more capital flow into the private debt space, private debt managers forced to deploy may drive spread compression and/or a loosening of underwriting standards

Allocating to Private Debt

A Preqin report showed that pensions have been the largest allocators to private credit by dollars invested – comprising of approximately 52% of top 100 institutional investors (by investment size) in private debt. Approximately two-thirds of the pension group are public pensions with increasing capital being committed. Preqin estimated public pensions added almost $35 billion in capital to private credit funds in 2020, which is up from both 2018 and 2019. The average asset allocation to private credit by US public pensions is 3%.

Given their size, pensions tend to build complete portfolios of private credit investments comprised of several strategy types with investments of various tenors and seeking diversification across vintage and across underlying asset types. A pension looking for an alternative to fixed income may pursue a capital preservation strategy such as a senior secured direct lending that could generate mid-single digits to low double-digit returns. However, the investor must be mindful of the illiquidity of private credit, which may be mitigated by having excess liquidity in other parts of the portfolio.

Private Debt in Different Macro Environment

	Growth	Inflation
Rising	• Private Debt (↑) EBITDA, asset valuations rise, lowering loan-to-value ratios, lowering default rates and spreads	• Private Debt (↑) Principal devaluation protected by rising Libor; cost of default event falls from higher discount rates, asset values.
Falling	• Private Debt (↓) Falling EBITDA increases default risk but mitigating factors include covenants, amendment fees, and sponsor equity support	• Private Debt (↔) Libor floors provide yield protection, but present value of expected future default events cause spread widening

Source: Cliffwater

Private debt is expected to perform well during a *Rising-Growth* environment because improving EBITDA of borrowers, which leads to fewer defaults. Private debt also tends to do well in a *Rising-Inflation* environment, where stocks and bonds will likely suffer due to higher interest rates, because private debt investments are a floating-rate instruments.

In a *Falling-Inflation* environment, the results may be mixed as private debt yields may initially decline due to falling interest rates, which may be mitigated with reference rate floors. However, falling rates may also increase the present value cost of future defaults due to a lower discount rate. This challenge may be mitigated by stronger underwriting standards by lenders.

Private debt will struggle the most In a *Falling-Growth* scenario due to a potential impact to the borrower's EBITDA, which may make it more difficult to service the debt. Private debt lenders tend to mitigate this issue with loan covenants, additional fees for amendments and requiring sponsor-backed borrowers for additional cash equity.

ESG integration in Private Debt

Private debt asset managers have recognized that ESG issues are material risk factors in underwriting a loan and have bolstered their resources to help identify such risks, which also coincides with a clear shift in investor preference for managers with these capabilities.

There is also greater opportunity for ESG-related engagement with private debt portfolio companies compared to publicly issued and traded corporate bonds. For example, in the case of European direct lending, there have been loans that offer borrowers the ability to incrementally lower their interest payments once they have met pre-determined ESG-related reporting or metrics.

Providers of private debt recognize the opportunity to further their ESG integration, and many of the major global direct lenders are allocating resources to enhance their ESG capabilities; therefore, more action and innovation in this area are expected over the coming years.