# Whither private debt?

As private debt matures we find an asset class that is in rude health, but this growth has not come without potential pitfalls. President **Philip Robson** and CIO **Theresa Shutt** from Integrated Asset Management give their outlook

The private debt asset class has grown from about $150 billion in assets in 2006 to over $600 billion. *PDI* data show that over $60 billion was raised globally in the first half of this year, with an average raise of around $500 million; at present, there are over 500 funds in the market looking to gather over $270 billion from institutional investors.

Our journey at Integrated Asset Management mirrors that trend. We spent significant time on "missionary" work when raising our first closed-end, direct investment fund in 2003-04. We explained what private debt was, how it fitted into the lending markets between bank loans and public bond markets and, more importantly, the role it could play in institutional fixed income portfolios. We believed properly constructed and managed portfolios could give investors returns equal to or better than BBB public market bonds with single A credit metrics and risk profiles.

Key factors that validated the asset class and propelled its growth remain in place today: superior risk-adjusted returns, diversification and lower correlation to traditional asset classes in an environment of persistent low interest rates and market returns. Market volatility remains a challenge, and while the impetus for interest rates is assuredly upwards, the overall economic factors that lead to markedly higher rates in the near to medium term aren't immediately clear.

From an investor's perspective, the underlying strengths of private debt remain compelling. Private loans offer higher returns, strong prepayment protection, stronger covenants and significantly better information and monitoring rights. Properly constructed private debt portfolios provide high returns and low volatility, can fill the gaps in fixed income caused by lower issuance of public bonds and provide more industry and duration diversification than normally available in the investment grade public markets.

As the asset class evolved, it expanded beyond the more traditional corporate debt, real estate debt and infrastructure debt – broadly seen as investment grade-like plays. Today private debt includes more opportunistic and higher yielding strategies in unitranche, mezzanine or distressed debt vehicles as well as hybrid strategies incorporating equity participation and leverage.

Overall market conditions and the continuing impact of changing regulatory burdens in banking markets will continue to drive growth in the asset class. At the same time, there is interest in, and comfort with, private debt and illiquid alternatives in general as alpha-seeking investments continue to drive new investors to private debt. This view is not groundbreaking, as 90 percent of respondents at the *PDI* conference in March agreed the asset class is a long-lived phenomenon. Moreover, alternative lenders have gained significantly higher profiles in the borrowing markets with more CFOs and treasurers realising they have some excellent sources of debt capital outside normal bank loans and relationships.

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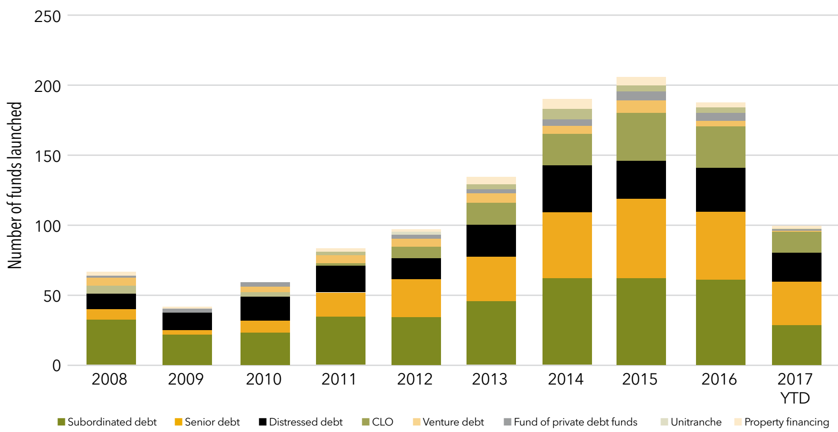
There are many potential risks ahead for private debt. There is a risk of overcrowding in the market as increasing numbers of new managers, many with short lending track records, enter the market. Crowding out can lead to an oversupply of dry powder with the resultant risks to structures, security and return. It can exert pressure on fees for managers trying to build business models that support direct origination, robust due diligence and credit analysis, active hands-on post-closing management and team succession to match the long-lived nature of some private debt portfolios. Further, growing interest in private debt by smaller or less experienced plans and investors puts them at risk as they attempt to navigate understanding the risks, benefits and rewards of various managers or strategies

Another area of risk exists in the

## EVOLVING STRATEGIES

*As the number of new funds coming to market has grown, so has the pursuit of high-yielding strategies*




*Source: PDI*

number of newer managers lacking experience with problem loans and tough credit market conditions. One of our most closely held tenets is that while anyone can lend money, getting it back is the real challenge – and it requires experienced and proactive, hands-on portfolio management to protect capital and generate return.

Scale also presents a risk to private debt. Credit is about assessing risk, pricing and taking exposure to risk. To be effective you need an experienced private debt team possessing the skills to generate investment opportunities, assess those potential loans for strategy suitability, complete due diligence, structuring and monitor the loan for terms of three years – or as much as 25 in an infrastructure debt fund. Building and managing such a team is expensive.

### MATTERS OF SCALE

Our experience is that sufficient scale, providing the profitability to build a balanced team with future leaders and fund managers being developed, requires more than $800 or $900 million in AUM to support a robust long-term business model.

Smaller managers and newer funds that can't achieve scale are destined to be either acquired by other managers – leaving investors with key man and other institutional risks perhaps not envisioned when they made their allocations – or provide less than sterling hands-on management in an asset class where problems will and do arise. Our fear is the large number of newer funds in the private debt markets could harm investors' view of the asset class and intentions to increase allocations.

We have concerns that, in seeking yield in the private markets, institutions can be mesmerised by target IRRs on offer by managers without considering increased risk of default and actual capital loss. Part of our current dialogue with LPs is to ensure they fully understand the impact one or two losses, with varying recovery rates, can have on actual returns at the end of a loan or fund life. This can be particularly true for leveraged strategies.

Finally, managers in the asset class need to pay attention to demographic risk; the impact of retiring baby boomers on retirement savings. The impact of decumulation on older and larger pools of capital, while not a short-term issue, has long-term implications for private debt. Baby boomers are drawing on retirement savings and new pools of retirement capital are trending to defined contribution, target date or other kinds of plans. Those kinds of investors have differing needs, and the private debt industry will need to continue to innovate to translate key attributes of the asset class to different investor needs.

We remain positive about the overall future of private debt. Increasing numbers of investors are learning to deal with illiquid investments (many managers provide regular distributions of interest income and capital, building structural and highly visible liquidity into their offer). Investors and consultants are learning to assess managers in the private debt space and understand the longer-term benefits of adding private debt allocations to their fixed income portfolios.

In times of changing market sentiment and overall low yield expectations, private debt investments can provide an excellent bridge to the gap between risk and return expectations. To justify the effort that goes into understanding the asset class, educating investment committees and changing portfolio investment guidelines institutional investors should be looking to allocate somewhere between 5 and 10 percent of their fixed income investments.

Not many plans have achieved that allocation, though the trends seem positive. Those who make the effort to seek and investigate seasoned and experienced managers that have lending records through various credit cycles will, we believe, be well rewarded. ■