NON-SPONSORED DEBT

Northern lights

Philip Robson and **Theresa Shutt**, president and chief investment officer, respectively, of IAM Private Debt, give their outlook on non-sponsored deals in Canada and the macro risks facing the North America market

Q What kind of loans do you like to make?

Philip Robson: Our strategy is focused on originating and managing private debt investments in mid-market Canadian companies – typically businesses with between C$5 million ($3.8 million; €3.2 million) and C$25 million in EBITDA. We structure highly customised fixed-rate loans with maturities ranging from five to 10 years.

We always structure our loans as senior secured debt and invest in companies that meet our internal criteria for investment grade credit. To eliminate prepayment risk, we impose strong penalties for prepayment – borrowers who opt to prepay the loan before maturity will be subject to a fee that is approximately equivalent to the net present value of all future interest payments.

Unlike other private debt managers, we focus on non-sponsored transactions and source our deals directly from borrowers or smaller advisors due to our strong preference to be the sole term lender to a company. This mentality of lending to the kind of non-sponsored businesses that commercial banks lend to, rather than into the private equity world, is reflected in our personnel: we hire commercial bankers rather than investment bankers.

Q Why do you like non-sponsored transactions?

Theresa Shutt: As the sole lender rather than one among several, as is often the case with private equity deals, we can get the covenants we want, and the terms that we want, including prepayment penalties. Another attraction is that non-sponsored businesses tend to be private businesses, and we like borrowers where owners and management have a significant economic interest in the business. Moreover, we believe the non-sponsored market is significantly less competitive than the sponsored market. This allows us to achieve returns that meet our investment criteria.

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Q What coupons can one reasonably hope for in the Canadian non-sponsored market?

PR: Our coupons have changed very little over the years, because the absence of severe competition in this market allows us to be price makers rather than price takers. For our funds, which are unlevered, we target an internal rate of return of 6 percent for investment grade credit. Because we never take any equity participation we rely entirely on our coupons to achieve this, and the coupon range is narrow: between 5.5 percent and a maximum of about 6.95 percent.

Q Some fund managers and investors in the US have complained that even in parts of the non-sponsored market, too much capital is chasing too few deals. What is your experience in Canada?

TS: We are often asked if this is the case in Canada, but this has not been our experience. Significant capital is indeed being raised for private debt globally, but Canada is not seeing the levels of undeployed dry power as you see in the US and Europe and very little capital is coming across the border into the Canadian market. While US fund managers do come to Canada occasionally, they don't fundamentally have the boots on the ground that you need to do non-sponsored deals in this market. They are not going to get on a plane or train to look at an opportunity in northern Ontario, as we will. Our main competition continues to be the local banks.

Q Are the banks rather competitive in Canada, when it comes to mid-market lending, because they did not have much of a credit crunch?

TS: It is true that the impact of 2008 was not nearly so great in the banking sector here as it was in western Europe and particularly the United States. It is also true that for more plain-vanilla deals, the banks can typically provide cheaper financing.

However, Canada's banks are now subject to higher capital charges for long-term lending, created by the Basel III regime, and therefore, more restricted in their ability to provide longer maturity loans which is where we focus. As a result, our competitive advantage has grown significantly versus the banks. Moreover, as in other markets private debt funds such as ours can be faster, more flexible and more innovative.

Q Aside from the competition, you also have to cope with economic risks, such as Canada's trade tensions with the US. Is this a risk for your borrowers?

PR: We talk to our borrowers about their risks and what their plans are frequently. Trade is obviously an issue for them – we are more concerned about it, presently, than we are about rising interest rates, for example. A large portion of Canada's GDP comes from natural resources. Because much of what is extracted is exported, it can be affected by trade disputes. It can also be affected by a sharp decline in commodity prices; for example, some of our borrowers were hit by the 2015 slump in oil and gas prices, though a large portion of our portfolio was not impacted.

A serious trade war would also have second-order impacts. For example, in Ontario, auto and auto parts manufacturing accounts for a sizeable proportion of total output. If plants closed down, this would hit the economies of the local towns where the plant is based, draining income from the wider community.

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Having said this, we are not convinced that there will be a trade war with the US, because it is not in either country's interest. Moreover, for the auto industry and some other industries, a trade war would be many orders of magnitude more painful for the United States than for Canada.

Q But although you are reasonably sanguine, presumably you are reacting to these risks?

PR: We constantly identify risk and how to mitigate it, and we look at how geographically diversified potential new borrowers are, since diversification mitigates risk. If we feel that they are not sufficiently diversified and are therefore at too great a risk from trade tensions, then we will not approve a loan. More generally, we always look at the worst-case scenario for the industry which a potential borrower is in.

We also take comfort in the fact that all our funds are highly diversified, with prescribed limits for minimum number of investments and maximum sector exposure– something that we monitor very closely.

Q The size of your funds has generally increased, with your sixth core fund likely to close at almost C$1 billion later this year. Do you expect further growth?

TS: Over the past three years investors have for the first time started calling us, rather than us knocking on their doors, as institutional investors develop a deeper understanding of private debt. We are now seeing more interest from private pension funds, small life insurers and family offices, boosting our investor base from four or five when we launched our first fund in 2005 to almost 30 now. We expect the number of interested institutions to keep growing, and many existing investors are likely to want to allocate more money than before.

Another potential source is non-Canadian pension plans. We have had some interest from outside Canada and have participated in a number of global requests for proposal.

While the demand for our private debt funds continues to grow, we continue to be cautious of not raising too large a fund as we want to preserve the quality of our investments. To put this in numbers, in an average year we approve 15 to 20 transactions out of the 250 to 350 that we look at. This lies behind our extremely low cash loan loss: C$5.6 million out of almost C$2.4 billion invested over the past 14 years.

To put it in a more human way, we ensure our investment team remains cautious about risk by reminding them all the time that because our investors are largely pension plans, the money we are ultimately managing is an individual's retirement savings. ■