Mercer

Private debt

Why more investors are turning to the asset class now

welcome to brighter

Private debt appears to be a core part of many institutional investors' portfolios. In this paper, we look at its growth and appeal and consider how to allocate to the asset class.

What is private debt?

For much of the 20th century, lending to small and midsize companies was almost exclusively done by banks.

This changed in the 21st century, particularly in the last decade, with non-bank lending — now commonly referred to as private debt — growing in popularity as an alternative source of debt financing.

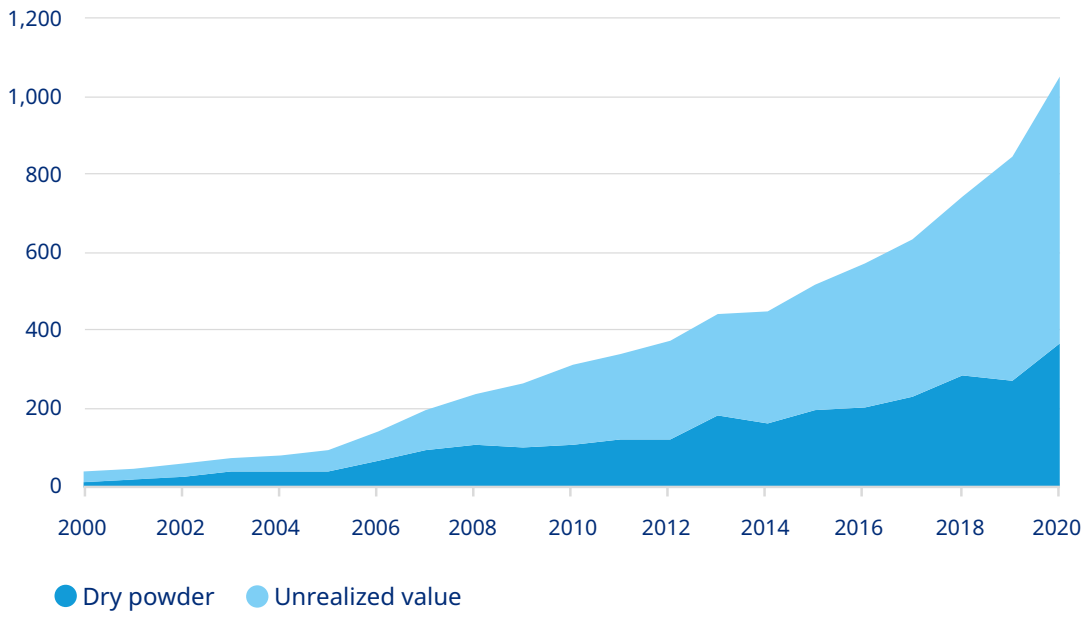
The asset class has tripled in size since 2008 (see Figure 1), driven by three high-level macro trends:

1. The retrenchment of banks resulting from regulation following the global financial crisis (GFC)
2. The growth of private-equity-owned companies
3. Investors' hunt for yield as interest rates have continually fallen

This growth, combined with higher returns compared to traditional fixed income, has meant private debt has become a core part of institutional investors' portfolios. We expect to see appetite for private debt accelerate further in the aftermath of the COVID-19 pandemic.

... private debt has become a core part of institutional investors' portfolios.

Figure 1. The growth of private debt ($bn)



Source: Preqin, as of September 2021

The premise of private debt is straightforward: a loan that provides capital to companies in the real economy that is used to purchase property, plant and equipment to grow, as part of a mergers and acquisitions plan, or to more efficiently finance their balance sheets. These loans are negotiated and transacted directly between a borrower and a non-bank lender and are not traded publicly, as is the case with corporate bonds.

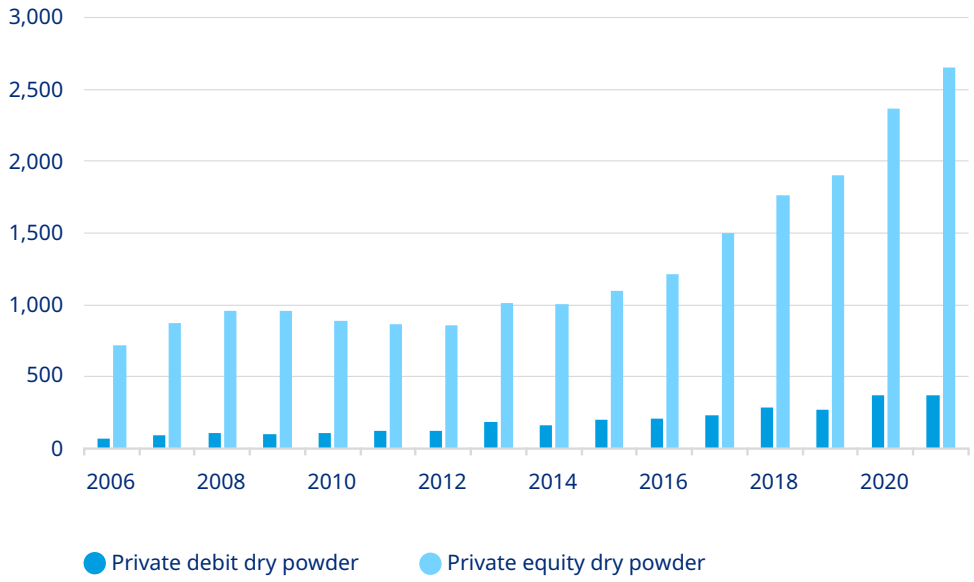
Although private debt can be used by any company as a means to raise capital, a significant portion of the private debt universe relates to lending to private-equity-owned businesses. The supply of credit from banks has declined by 50% in the wake of stricter regulation post-GFC.[1]

Consequently, companies and their owners — largely private equity firms, or "sponsors" — have turned to the private debt market as their preferred source of financing. Companies have increasingly come to favor the bespoke nature of private debt, coupled with the speed and flexibility that a privately negotiated loan can help deliver. As private equity dry powder has increased and bank financing has plummeted, the demand for credit from private equity continues to grow (Figure 2).

As demand for private debt continues to grow, institutional investor demand for yield has also ratcheted up, reflecting a world of low interest rates. Investors typically access private debt investments from alternative-credit asset managers (that is, the non-bank lenders) through traditional limited partnerships or emerging evergreen structures that provide for redemption features.

The majority of private debt returns are generated through income rather than capital gains and are seen as an attractive source of higher yields, compared with traditional fixed income. Investors use private debt as a yield-enhancer within a broader fixed income portfolio and/or a diversifier within an overall growth portfolio.

Figure 2. Relative growth in private debt and private equity dry powder ($bn)



Source: Preqin, as of September 2021

[1] Bank share of US and European primary loans. Source: LCD Global Leveraged Lending Review Q3 2020.

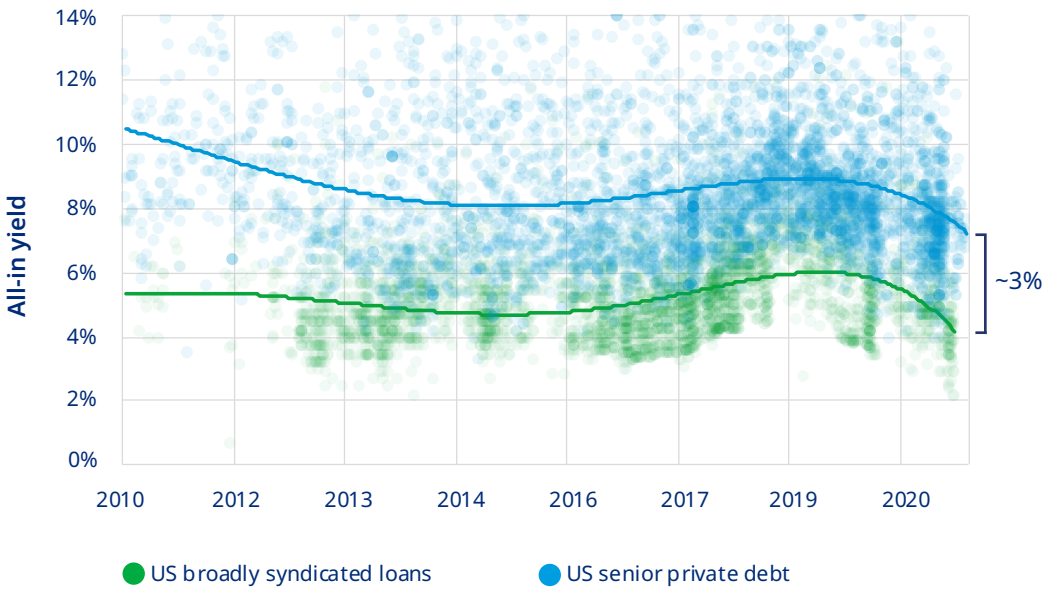
Why invest in private debt?

The principal mechanics of private debt loans are much like any other loan: The borrower receives a floating-rate loan, and, in return, the lender receives interest payments.

Loans are largely held to maturity, or refinanced, and are not traded in a liquid secondary market. So what is the appeal? Returns, resilience and diversification.

Investors in private debt receive a yield premium over traditional fixed income, which is typically floating-rate in nature. This excess spread is often referred to as an "illiquidity premium," which is driven by the complexity involved in originating, underwriting and structuring private loans. This return premium can vary depending on the type of loan or investment strategy; however, as shown in Figure 3, it has been both durable and robust over the last decade.

Figure 3. All-in yield at entry — US senior private debt versus US broadly syndicated loans



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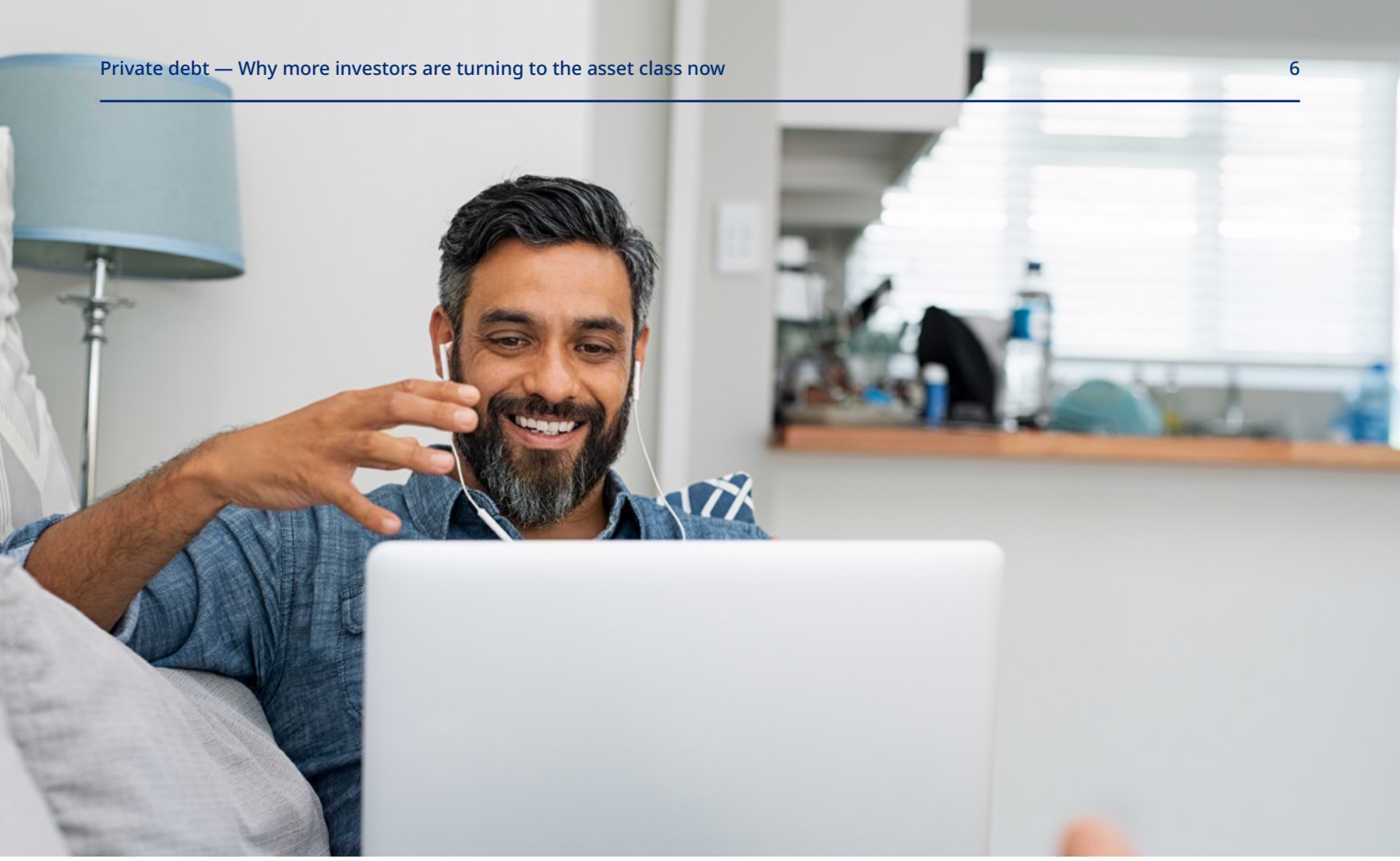
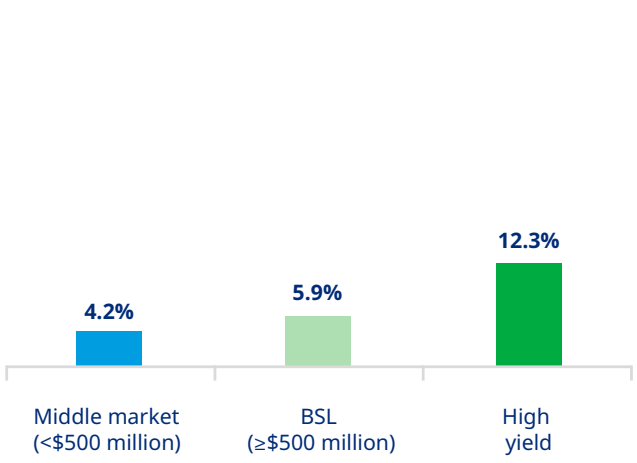
So what is the appeal? Returns, resilience and diversification.



The resilience of private debt is evident in two ways: through lender protections and the way the loans themselves are valued.

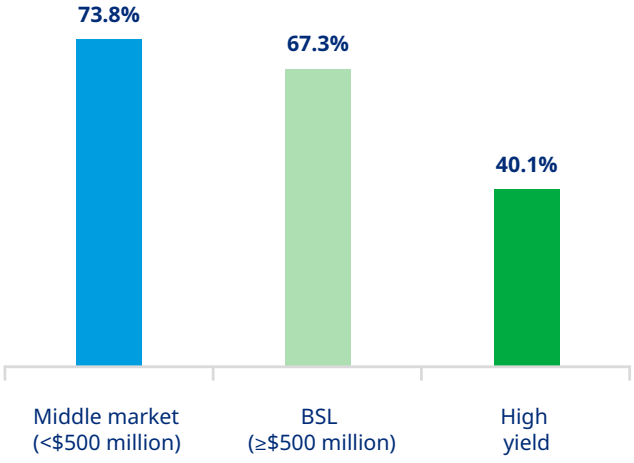
Lender protections arise out of bespoke structuring and bilateral negotiation and include contractual limitations and covenants on the borrower. Protections are also provided in relation to the priority of repayments to lenders in a default scenario. This affords enhanced protection to a private debt investor versus the high yield bond market for example, resulting in lower default rates and higher recovery rates (see Figures 4 and 5).

Figure 4. Cumulative default rate 1995–2020



Source: S&P LCD & CreditPro (1995–2020), as of Q3 2020. The S&P LCD cumulative default rate has a one-year lag since it assumes a loan will not default within one year of origination.

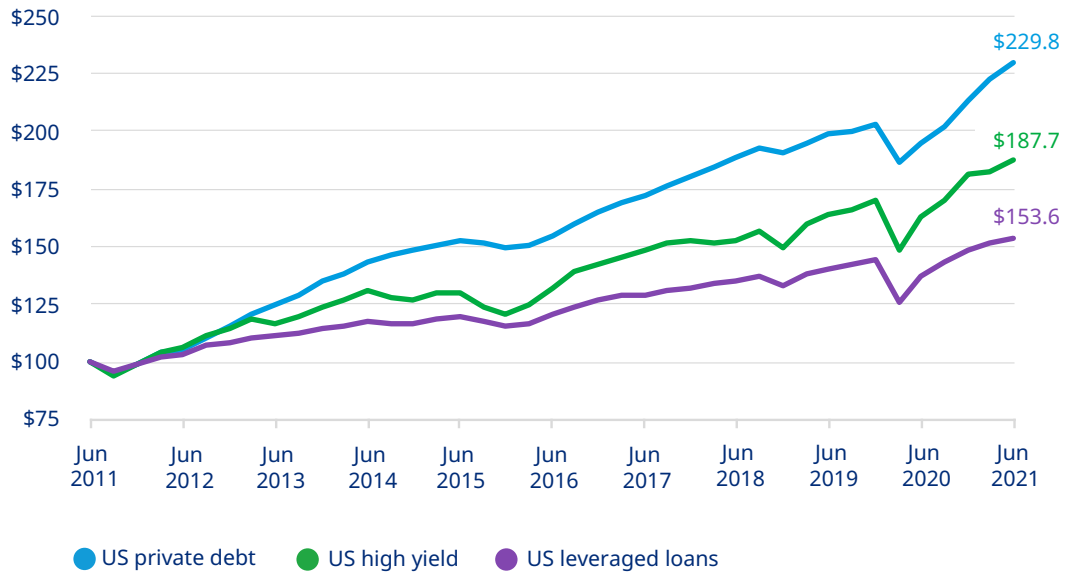
Figure 5. Average annual recovery rate 1995–2021



Source: S&P CreditPro (1995–2021). Middle market loans defined as those <$500 million in size.

In respect of valuations, private debt loans are not traded; therefore, valuation methodologies can look through shorter-term market volatility and focus on true fundamentals. Although valuation methodologies can vary, in aggregate this generally smooths private-debt-portfolio return profiles compared to liquid credit, which is more directly exposed to market price volatility. Combining both of these features, the resilience of the asset class can be seen in Figures 6 and 7. This illustrates the performance of the asset class during periods of economic growth and turbulence, with shallower drawdowns and lower volatility.

Figure 6. 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)

Private debt also offers a number of diversification benefits by targeting different parts of the market.

Figure 7. Returns 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

Given the continued tailwinds for the asset class, the opportunity for attractive risk-adjusted returns is set to persist, in particular relative to low interest rates and public market credit spreads. Private debt also offers a number of diversification benefits by targeting different parts of the market and borrower profiles compared with liquid credit. Furthermore, private debt is a portfolio diversifier compared to other growth and private market allocations, as it offers 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 preferable to other asset classes.

The private debt universe — a diverse mosaic

We estimate more than 600 asset management firms and more than 1,600 funds/vehicles have private debt investment capabilities.[2]

So though the premise of private debt is straightforward, complexity arises when considering the plethora of different strategies across a large number of dimensions — including geography, sector, currency, seniority, security, collateral type, structure and tenor. We organize the private debt universe into five main strategy types, which act as the building blocks for an allocation within a broader portfolio.

Figure 8. Our coverage — Multi-faceted strategies to manage risk and help achieve returns

01 Direct lending

- Upper middle market
- Middle and lower middle market
- Venture lending/tech
- Senior and unitranche
- Sponsored and non-sponsored
- Multi-strategy direct lending and opportunistic
- Investment grade
- ESG/impact

02 Structured credit

- CLO debt
- CLO multi
- CLO equity
- Third-party CLO equity
- ABS multi
- Consumer ABS
- Commercial ABS
- Portfolio NAV lending
- Multi-sector structured credit

03 Specialty finance

- Music/film/media and royalties
- Healthcare lending and royalties
- Insurance and litigation finance
- ESG/impact
- Aviation, maritime, rail, real assets and energy
- Lender/platform finance
- Regulatory capital relief
- Factoring and trade finance
- Multi-strategy specialty financeand asset-based

04 Asset-based lending

- Real estate
- Infrastructure

05 Credit opportunities

- Special situations
- Distressed debt
- Credit dislocation

[2] Mercer estimate. As of June 30, 2021.

Private debt also offers a number of diversification benefits by targeting different parts of the market and borrower profiles compared with liquid credit.

Figure 9. Characteristics of the private debt universe

Strategy type	Description	Return profile	Loan type	Historical returns
Direct lending	Lending directly to companies, generally secured against assets and earnings	Income	Floating rate	~5%–8% senior, ~8.5%–12% junior debt or levered debt funds
Structured credit	Consists of loans dependent on performance of asset pools	Income	Floating rate	10%+ as compensation for complexity
Specialty finance	Includes niche lending that requires specialized knowledge	Income	Floating rate	10%+ as compensation for complexity
Asset-based lending	Broadly includes real assets such as real estate and infrastructure debt	Income	Floating, and, to a lesser extent, fixed rate	2%–4% senior; 5%–9% whole loan and junior debt
Credit opportunities	Potential benefit from dislocations in the credit or equity markets	Income and capital appreciation	Floating rate, fixed rate and equity exposure	12%+ during and following periods of market volatility

Source: Mercer, as of December 2021

Building an allocation to private debt

Having outlined the universe, investors can then consider building a portfolio. We broadly view there are three types of private debt portfolios.

1. **Core:** Portfolios that appeal to investors seeking to generate higher yields than are available in liquid credit or fixed income markets. Portfolios are typically anchored with senior secured unlevered direct lending funds and can include diversifying allocations to real estate debt, infrastructure debt, structured credit and specialty finance.
2. **Core plus:** Portfolios that appeal to investors seeking both diversified and higher levels of returns, exploiting the broader private debt opportunity set. Levered direct lending often acts as the anchor, with the addition of junior debt strategies, structured credit and specialty finance to diversify the portfolio further and increase the overall blended return profile.
3. **Credit opportunities:** Become more appealing as a return-enhancer within growth portfolios opportunistically, and in the wake of broader market volatility.

Figure 10. Types of private debt portfolios

	Core	Core plus	Credit opportunities
Ethos	Unlevered, income-focused and capital preservation	Higher levels of contractual return, exploiting a fuller opportunity set	Equity-like returns through debt investments
Building blocks	Direct lending, asset-based lending	Direct lending, structured credit and specialty finance	Credit opportunities
Allocation type	Strategic, through a cycle	Strategic, through a cycle	Opportunistic
Net IRR prospects	~5%–8%	~9%–12%	~12%–15%
Return drivers	> 90% income	>75% income/<25% capital gains	50% income/50% capital gains
Typical management fees (per annum, before allowing for fee discounts available to larger investors)	1%	1.5%	2%
Typical carried interest	10%	15%–20%	20%

Source: Mercer, as of December 2021

Providers of private debt recognize the opportunity available from improving their ESG integration.

Although private debt portfolios can differ by objective and style, they have common traits that are important to consider in implementation:

Diversification

Paramount in private debt, given the most you can typically gain is the yield on a loan, whereas the downside is unlimited. Therefore, diversification by number of underlying investments, geography, strategy and vintage becomes critical, minimizing concentration risk. Asset-based lending, structured credit and specialty finance can be used to diversify a core portfolio of direct lending.

Investment flexibility

Also a desirable trait to build into a private debt investment program. Asset managers can have multiple investment capabilities in sourcing different assets and, for example, can offer access to the most appealing investment strategies at different points in time. This can potentially result in the ability to allocate dynamically over time, to pursue value and opportunities.

Manager and strategy selection

Also vital to that end, helping ensure that not only are private debt commitments complementary to each other, but also that you access highly rated asset manager capabilities to source, underwrite and monitor loans. Capital preservation is critical to a private debt portfolio, as is resisting the temptation to naively “chase yield.”

Economies of scale and efficiency

Can make a meaningful difference in private debt portfolios. Most asset managers will offer fee discounts for larger investments. The gross-to-net return can also be minimized through the capital-efficient selection of funds, by selecting managers that have robust sourcing platforms.

Private debt and ESG

The integration of environmental, social and governance (ESG) into private debt investment decisions has been considered by some as lagging in comparison with private equity or infrastructure, where the scope to engage on ESG-related issues is direct.

ESG issues represent material risk factors when it comes to underwriting a loan, and private debt asset managers have bolstered their resources across the board to help identify such risks. This coincides with a definitive shift in the preference of investors to seek managers with these capabilities.

We also see greater scope 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, we have seen the emergence of loans that offer borrowers the ability to incrementally lower their interest payments once they have met pre-determined ESG-related reporting or metrics.

Although there is absolutely scope for further engagement between non-bank lenders and their borrowers on ESG, as well as improvements in transparency and reporting, the good news is that change is afoot. Providers of private debt recognize the opportunity available from improving their ESG integration, and many of the major global direct lenders are investing heavily in their ESG capabilities to drive this improvement through. We expect to see more action and innovation in this area over the coming months and years.

Conclusion

The high-level tailwinds remain in place and are set to further propel private debt as a mainstream asset class in a world otherwise starved of opportunities to earn higher yields. Private debt has historically delivered on performance and has been a source of sustainable and reliable income for investors.

It has become a broadly accepted category to diversify asset portfolios, and though the number and different types of investment strategies in the space have proliferated, so has the scope to tailor your exposure to the asset class, depending on desired risk and return characteristics. In summary, private debt provides potential advantages for investors, including higher yields, relative resilience and portfolio diversification — all strong incentives for investors looking to the asset class.

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