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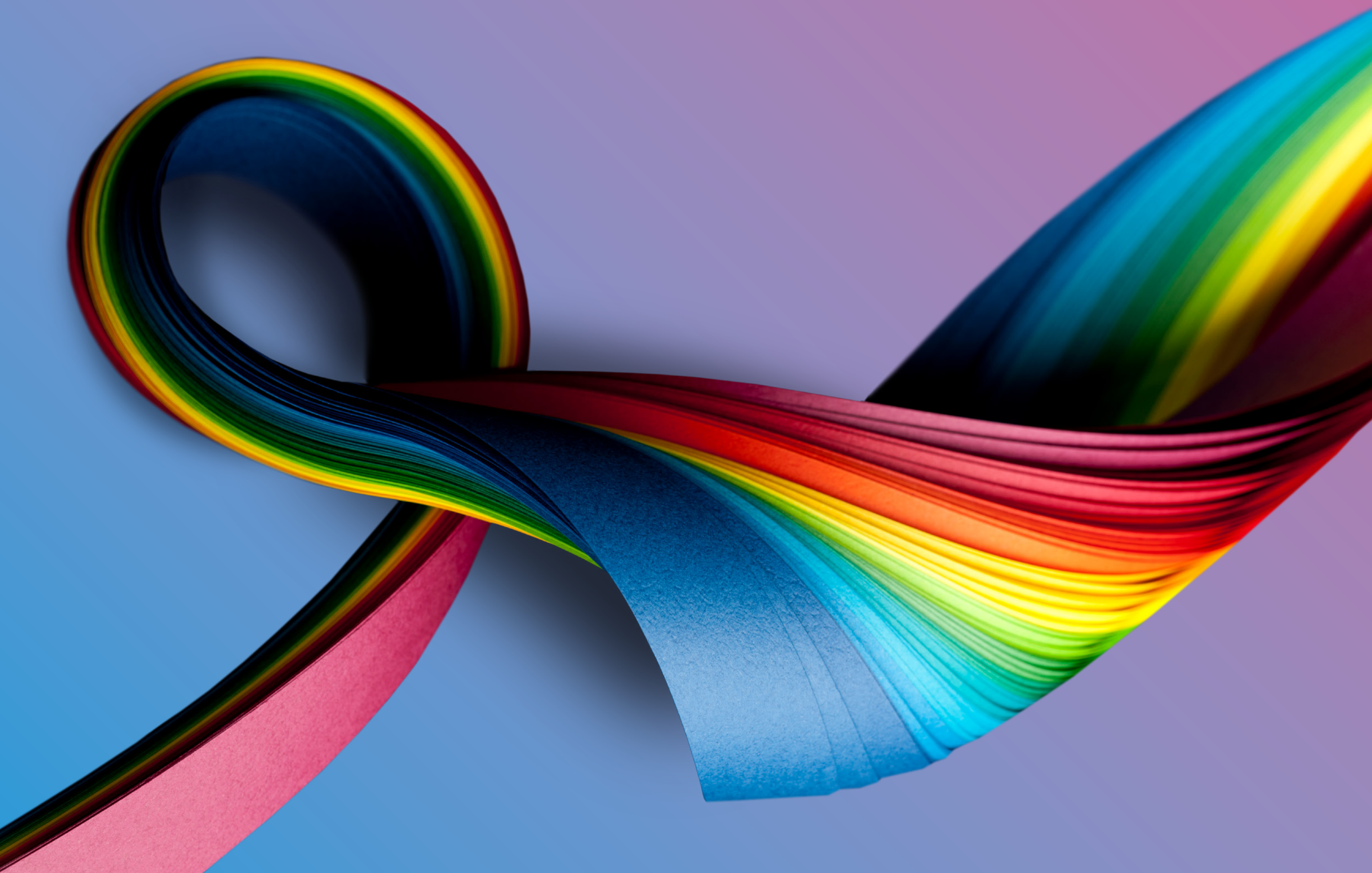
Private debt

The evolution and next frontier for investors

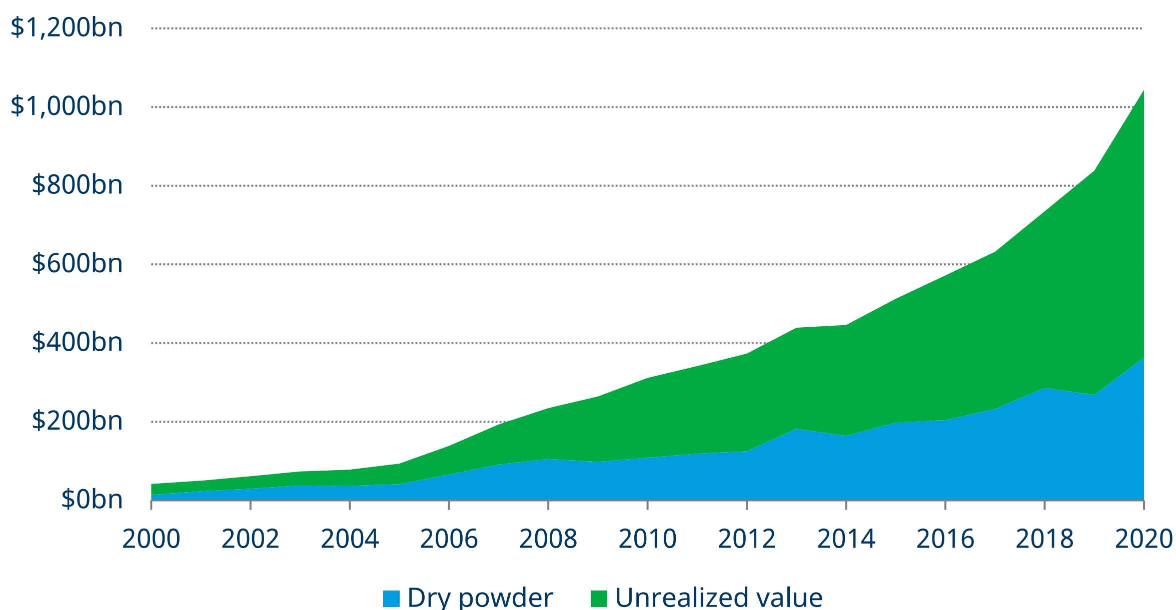
Private market insights



What is private debt?

Private lending has existed since the dawn of civilization, when farmers began to borrow seeds, to be repaid with interest at a later date. In fact, the first ever recorded bill of exchange was in 321 BC, developed by the Maurya Dynasty to support overseas trade. If we jump forward a few thousand years to the early 20th century, we see the advent of the modern banking system, where lending to small- and medium-sized companies was almost exclusively provided by banks. This trend continued well into the late stages of the 20th century. Since then non-bank lending, now referred to as "private debt" has become more prevalent, propelled by a confluence of factors. These include principally three high level macro trends: (i) the retrenchment of banks resulting from regulation post-Global Financial Crisis (GFC); (ii) the growth of private equity-owned companies; and (iii) investors' hunt for yield as interest rates have continually fallen. Private debt has quadrupled in size since 2008 (figure 1). It is now an over $1 trillion-sized global asset class and rising.[1] This growth, combined with higher returns compared to traditional fixed income, has resulted in an asset class that is now a core part of institutional investors' portfolios. In the wake of the global pandemic, we expect these macro trends to accelerate, further bolstering private debt as both a mainstream asset class and a key source of financing.

Figure 1. The growth of private debt



Source: Preqin as of September 2021.

The premise of private debt is straightforward: a loan that provides capital to companies in the real economy which is used to purchase property, plant and equipment to grow, as part of a mergers & 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.

[1] *Source: Preqin (September 2021).*

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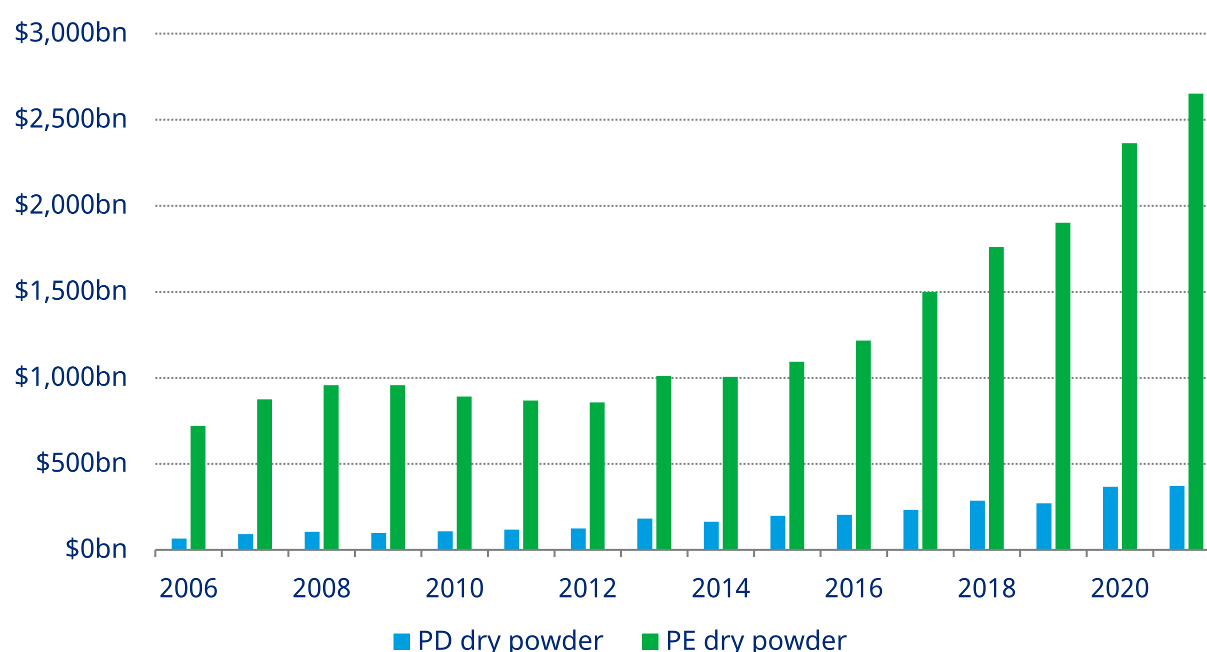
While private debt can be used by any company as a means to raise capital, a significant portion of the private debt universe relates to lending to private equity-owned businesses. The supply of credit from banks has declined by 50% in the wake of stricter regulation post GFC.[2]

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 favour the bespoke nature of private debt, coupled with the speed and flexibility that a privately negotiated loan can 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).

Figure 2. Relative growth in private debt and private equity dry powder



Source: Preqin as of September 2021.

As demand for private debt from businesses 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 (i.e. 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 regarded as an attractive source of higher yields compared to 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.

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

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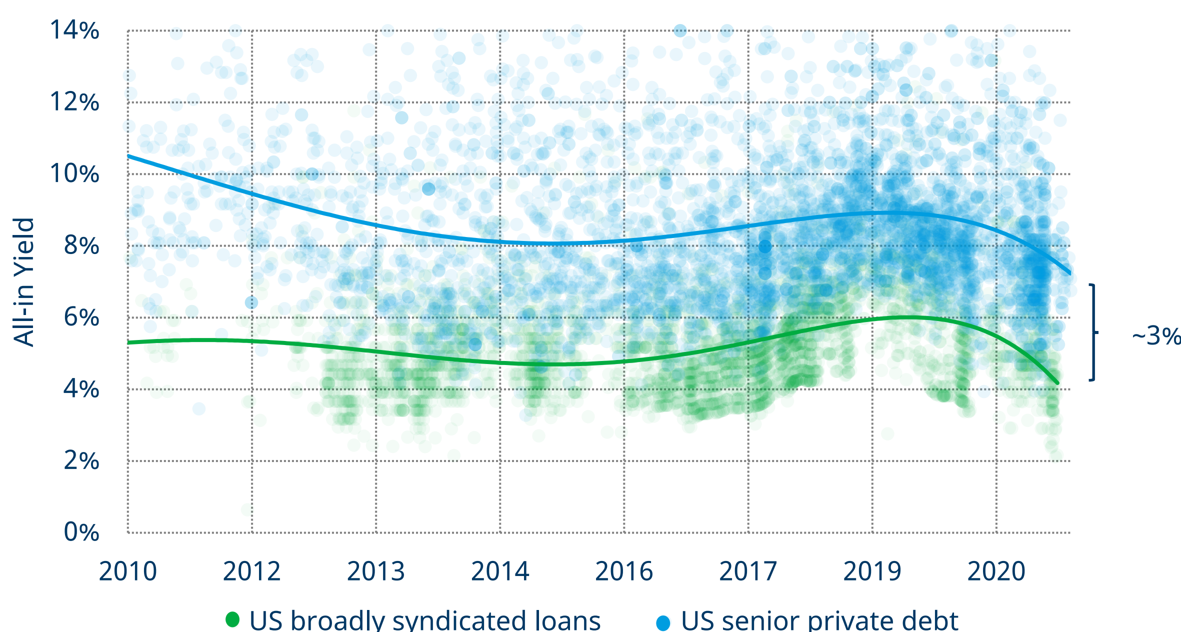
Why invest in private debt?

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 below, it has been both durable and robust over the last decade (figure 3).

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



Note: For illustration and educational purpose only. Source: US senior private debt, Mercer proprietary dataset of ~5,000 anonymized direct loans. All-in-yield for US senior debt is calculated, per loan, as the spread at the point of entry, plus the original issue discount recognized over an assumed weighted average life of three years, and the higher of three-month USD Libor or Libor floor. This analysis excludes any fund-level leverage level that might be employed to enhance the returns of the underlying loans. US broadly syndicated loans sourced from S&P LCD (as at June 2021) with all-in-yield calculated, per loan, as the original spread of first-lien loans within the S&P Leverage Loan Index, in addition to an assumed original issue discount of 0.5% and weighted average life of three years, and the higher of three-month USD Libor or Libor floor. Past performance may not be indicative of future results. There can be no assurances that any fund or investment objectives will be achieved.

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

Lender protections arise out of bespoke structuring and bilateral negotiation and include contractual limitations and covenants of 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 (figures 4 and 5).

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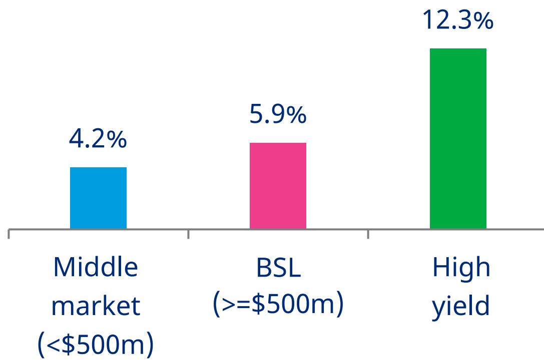
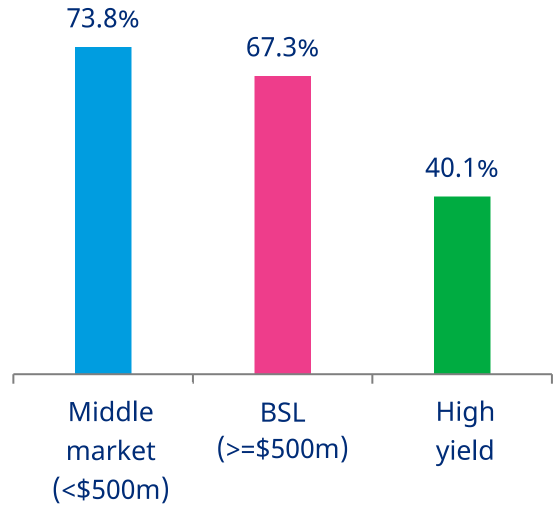
Figure 4.
Cumulative default rate 1995-2020



Source: S&P LCD & CreditPro (1995 to 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.

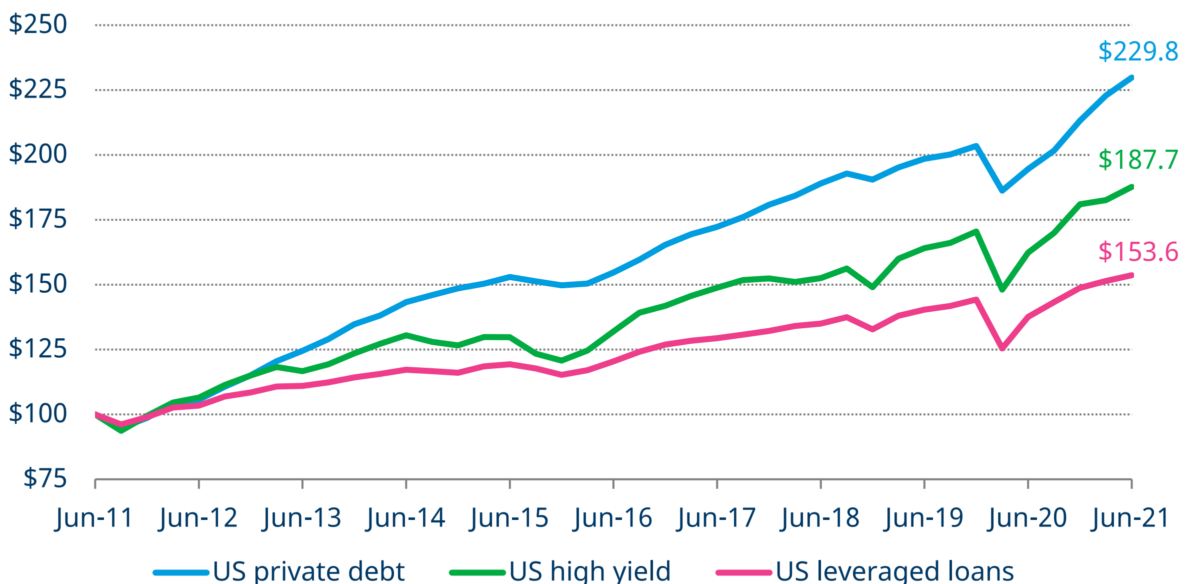
Figure 5.
Average annual recovery rate 1995-2021



Source*: S&P CreditPro (1995 to 2021). Middle market loans defined as those <$500m 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 versus liquid credit, which are more directly exposed to market price volatility. Combining both of these features, the resilience of the asset class can be seen below (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).

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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

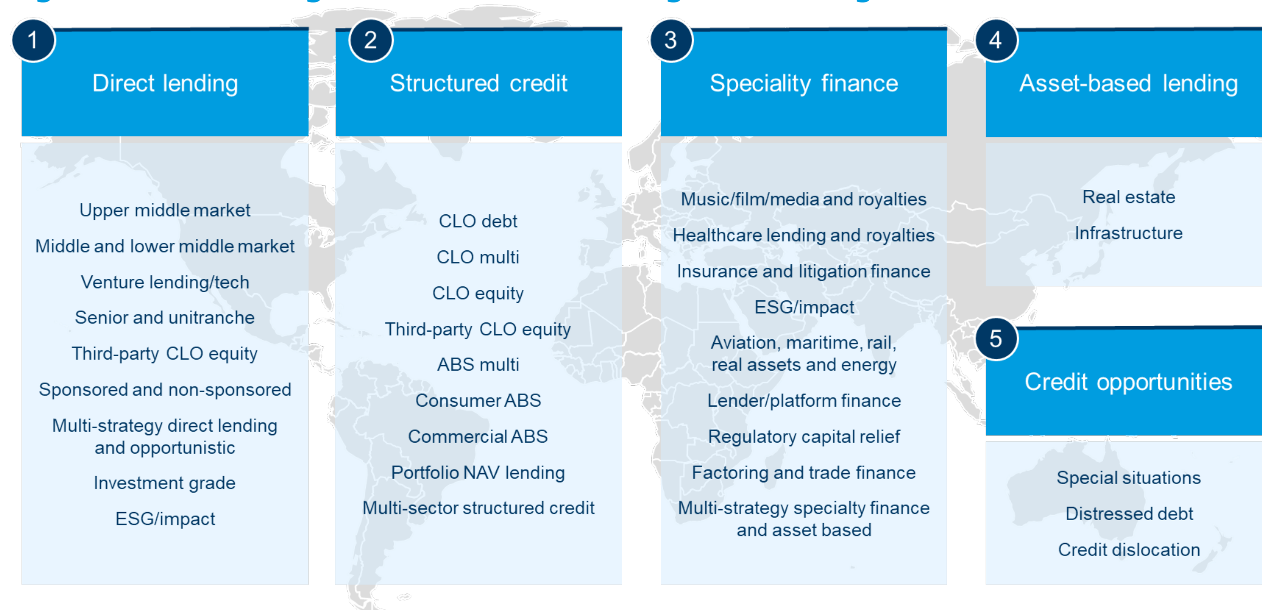
Source: Mercer analysis, Thomson Reuters Datastream (ICE BofAML US High Yield Master II, S&P Leveraged Loan) and Burgiss (US Private Debt). Data is annualized to June 30, 2021.

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 versus 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 which can make it preferable versus other asset classes.

The private debt universe – a diverse mosaic

We estimate that there are over 600 asset management firms with private debt investment capabilities and over 1,600 funds/vehicles.[3] So, while 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 organise 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 achieve returns



[3] *Mercer estimate. As of June 30, 2021.*

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Figure 9. Characteristics of the private debt universe

Strategy type	Description	Return profile	Loan type	Historical returns
Direct lending	Lending directly to companies, secured generally against assets and earnings	Income	Floating rate	~5%–8% senior; ~8.5%–12% junior debt; or levered debt funds
Structured credit	Consists of loans that are dependent on the performance of asset pools	Income	Floating rate	10%+ as compensation for complexity
Specialty finance	Includes niche lending that requires a specialised 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 lesser extent, fixed rate	2%–4% senior; 5%–9% whole loan and junior debt
Credit opportunities	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

Building an allocation to private debt

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

- **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 Speciality Finance.

- **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 Speciality Finance in order to diversify the portfolio further and increase the overall blended return profile.

- **Credit opportunities** – become more appealing as a return-enhancer within growth portfolios opportunistically, and in the wake of broader market volatility.

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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 speciality 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 (p.a., before allowing for fee discounts available to larger investors)	1%	1.5%	2%
Typical carried interest	10%	15-20%	20%

Source: Mercer

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

- **Diversification** – is 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.

- **Manager and strategy selection** – is also vital to that end, ensuring 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'.

- **Investment flexibility** – is also a desirable trait to build into a private debt investment programme. 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.

- **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 selection of funds that are capital efficient, by selecting managers that have robust sourcing platforms.

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Private debt and ESG

The integration of 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, versus 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.

While 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 whilst the number and different types of investment strategies in the space has 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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