WHITE PAPER | APRIL 2024

PRIVATE DEBT: A RESILIENT AND DIVERSIFIED MARKET

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws

Asset Management | Marketing communication

UNION BANCAIRE PRIVÉE

A resilient and diversified market

INTRODUCTION

There is a narrative that private debt emerged as an asset class following the global financial crisis. The contraction in bank lending combined with quantitative easing and the zero interest rate policy created conditions where both borrowers and investors turned to private debt. This perspective of private debt, in which it is a relatively new asset class, associated with specific monetary policy conditions, invites the question as to the sustainability of private debt, and in particular, how it will continue to be relevant for borrowers and investors now that interest rates have normalised.

In this paper we explain why the above narrative is misguided and why continued growth of private debt is not a function of monetary policy. We give some historical context for private debt, discuss bank lending (the main substitute to private debt), explain how the observable universe of private debt is only part of the private debt market, discuss two dominant segments of the observable private debt universe (direct lending and commercial real estate), explain why investors will continue to invest in private debt and set out why we believe residential real estate and asset-backed financing will attract investors in the coming years.

IN SUMMARY, WE SET OUT OUR VIEWS THAT

- Private debt has existed in various forms for more than 4,000 years
- Private debt's market size is determined more by the undersupply of bank credit than by monetary policy
- The private debt universe, by definition, is not easily measured and is much bigger and broader than meets the eye
- Private debt is too broad to be a single asset class – asset classes likely exist within private debt
- Investors will continue to allocate to private debt for its combination of resilience, diversification and returns
- Investors will increasingly look for diversification in new private debt strategies
- Attractive risk–return will be found in residential real estate and asset-backed financing, two sectors which offer the combination of returns, diversification and resilience.

The Long View

The terms "private debt" and "private credit" are typically used interchangeably. Private debt is generally accepted to refer to debt (i) provided by non-banks, (ii) not offered publicly and (iii) that is unlisted. Some commentators add a further qualification that the borrowers be companies, and some refer to a preponderance of transactions being for acquisition finance.

Banks, as we understand them, emerged in medieval Italy. The oldest surviving bank is Banca Monte Dei Paschi Siena, founded in 1472. However, lending far predates these banks. For example, there are many surviving records of loan activity in ancient Mesopotamia, written in cuneiform on clay tablets. This example, in the Metropolitan Museum of Art's collection, dates from before 1800 BC and records a loan of silver owed by two men to a merchant[1]. Some commentators refer to these early loans as a form of "proto-banking", but that understanding appears to be predicated on an impression that only banks lend. We think it more correct to say that lending predates banking, that since the advent of banks, private and bank lending have coexisted.

Many commentators, including UBP, have referred to the private debt "asset class" though it is more appropriate to say "sector" or "market". An asset class is generally considered to be a grouping of financial assets that share the same characteristics. The spectrum of private debt is too broad for it to be a single asset class. That said, we think direct lending and commercial real estate each fit the description of an asset class.

Private debt's strength is its diversity of strategies and transactions. Its longevity is due to its flexibility and how it can be reinvented for new financing opportunities. The recent growth of private debt arises from an undersupply in bank lending coupled with the evolution of non-bank financial intermediaries. As we discuss below, we expect private debt to continue to grow and in particular to grow in strategies other than those that have been pre-eminent in the last decade.

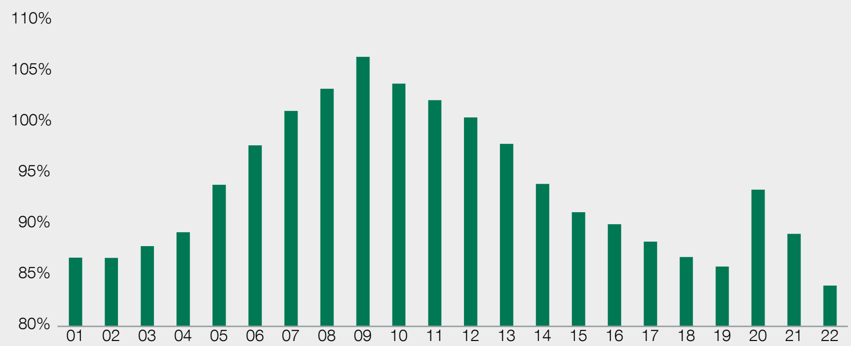
1 Source: https://www.metmuseum.org/art/collection/search/325858

Bank Lending

For borrowers, private debt is typically seen as an alternative to bank debt. We think this is generally true, though the larger direct lending deals are likely substitutes for broadly-syndicated leveraged loans.

Figure 1 shows aggregate EU bank lending to the domestic sector as a percentage of GDP. The downward trend since the global financial crisis ("GFC") was interrupted in 2020 and 2021 (likely connected to Covid) but continued in 2022.

FIGURE 1: DOMESTIC CREDIT TO PRIVATE SECTOR BY BANKS (% OF GDP) – EU



Source: World Bank

The financial system includes bank lending, private debt, bond and other public debt offerings all serving to channel financing to borrowers. Not all borrowers can access all channels, in particular smaller borrowers cannot access the public markets. Since the GFC, as banks deleveraged, larger firms looked to the bond markets as an important source of financing. Smaller firms often turned to private debt. These channels are connected such that a change in one may ripple through to the others. For example, the ECB found that, at times of market disruption, e.g. at the start of the pandemic, at the onset of the Russia–Ukraine war and during the period of rising rates, larger firms replaced bond financing with bank lending. This switch led to a crowding-out of bank lending to high yield and smaller firms[2].

The increased demand for private debt among borrowers is driven by a change in the supply of credit by the banking system. Absent a change in the supply of bank credit, which we believe is unlikely, demand for private debt will continue to grow.

2 Source: ECB, "Corporate loans versus market-based finance: substitutes or complements?", May 2023

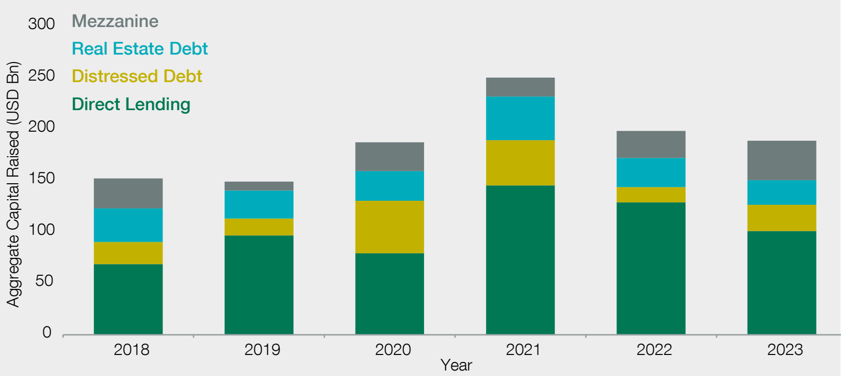
The Observable Universe

Private debt, by its nature, is negotiated privately between borrower and lender. Information on the sector is therefore typically compiled from surveys by data vendors and other specialist reports. Helpful though these surveys and reports are, they do not capture or represent the entire private debt universe. The private debt market is bigger than the easily observable universe.

Deloitte publish a quarterly "Private Debt Deal Tracker" for UK and European transactions. The report is compiled from contributions by private debt lenders, with 76 contributors to the Q3 2023 edition[3]. It is worth noting from that Deloitte report that, of the 600 deals recorded in the 12 months to end June 2023, "only 75 did not involve a private equity sponsored asset". The deal data in this report is largely confined to one segment of the private debt universe – sponsor-backed direct lending.

Private debt is often categorised as having four main subsets, **direct lending**, **distressed debt**, **real estate debt** and **mezzanine debt**; for convenience we call them the "**Big Four**". For example, Preqin, a leading provider of data on and insights into alternative markets, reports the following figures for private debt fund-raising since 2018.

FIGURE 2: PRIVATE DEBT FUNDRAISING BY SEGMENT



Source: Preqin

Direct lending is the largest segment within private debt as reported by Preqin, with distressed debt, real estate debt and mezzanine debt being significant segments varying in relative size. As we have seen with the Deloitte report, "direct lending" is, substantially, lending to sponsor-backed companies, which makes it nearly synonymous with "sponsor-backed lending".

These surveys and reports offer very helpful insights to the larger funds and dominant segments within the observable private debt universe. The narrative around private debt has been largely focused on the Big Four and the larger funds within them.

How then do these larger funds fit within the wider private debt universe? To make a maritime analogy, the large funds are like oil tankers. They carry and deploy high volumes of capital and play a major role in the financial system. To take the analogy further, maritime regulations include the concept of a "vessel constrained by her draught", meaning the depth of the hull in the water restricts a vessel's ability to deviate from course. The larger funds are similarly constrained by their size. They go where they can, which is not the same as saying they go where they wish.

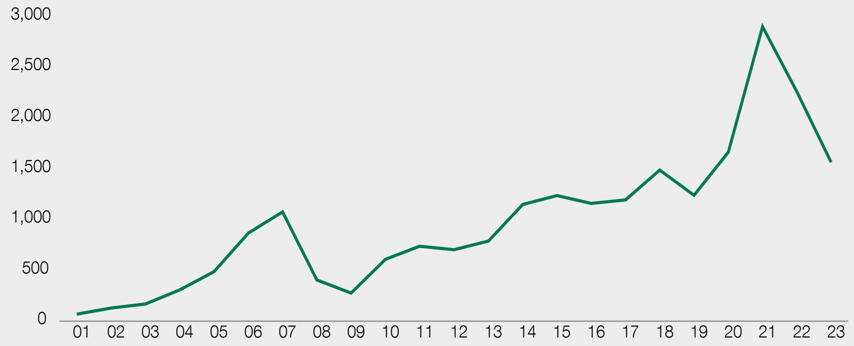
Within the observable debt universe, particular attention is paid to direct lending and commercial real estate, and we discuss both these segments in greater detail below.

3 Source: Deloitte Private Debt Deal Tracker, Autumn 2023

Direct Lending / Sponsor-Backed Lending

Direct lending refers to privately placed debt financing negotiated directly between a borrower and a lender (or club of lenders). As we have seen above, for the larger funds, direct lending now largely comprises lending to sponsor-backed entities.

FIGURE 3: GLOBAL PRIVATE EQUITY DEAL VOLUME



Source: Preqin

In a previous white paper we observed that capital flows like the tide, it flows fastest in the deeper channels. The deep channel here is the volume of acquisition financing required by private equity ("PE") firms. As the banks stepped back after the GFC, direct lenders found they could deploy high volumes of financing to sponsor-backed lenders. Moreover, the direct lenders would not need to find prospective borrowers, rather the PE firms would originate the transactions and present them to the direct lenders.

Investors in direct lending funds likely have an indirect exposure to the private equity industry. We note recent reports of a backlog in private equity exits[4] and increased borrowing within portfolio companies to fund dividends to the PE firms and payments to their investors[5]. These reports, very probably, reflect short-term cyclical issues, but they serve as a reminder that transaction origination is a determinant of diversification.

It is difficult to gauge the nature of the relationship between PE firms and direct lenders. S&P recently reported on their study of debt holdings by Business Development Corporations ("BDCs")[6]. BDCs are, in effect, a type of US publicly traded fund vehicle. The BDCs in the study held debt issued by 3,500 PE-backed entities. Though S&P identified c. 840 individual PE entities, 10% of the PE entities were involved with 50% of all the borrowers.

Recent reports, including in the *Financial Times*[7], on the prevalence of "whitelists" in sponsor-backed lending shed further light on the relative power of PE firms and direct lenders. These whitelists prevent financial institutions who are not specifically listed in the loan documentation from acquiring the debt, and give rise to a closed circuit among PE firms and lenders which may not be in the lenders' interests.

> ***"As many private credit groups rely on buyout shops for business – the bulk of their lending is often to finance private equity deals – they may have an incentive to avoid rocking the boat even if a company's strategy is failing.[8]"***

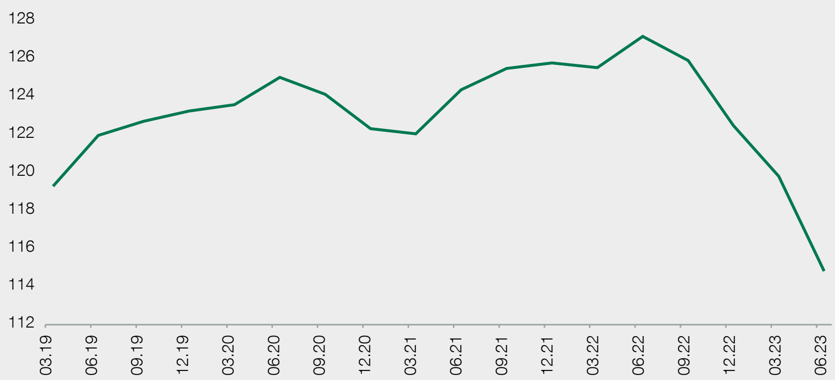
4 Source: S&P Global, Market Intelligence, "Urgency for exits grows as private equity hold times extend", 22 November 2023
5 Source: *Financial Times*, "Private equity owners pile on debt to pay themselves dividends", 6 February 2024
6 Source: S&P Global, Ratings, "Credit trends: Sponsor diversity can mitigate private markets risk", 8 December 2023
7 Source: *Financial Times*, "Hedge funds take on private equity in battle for distressed companies", 11 January 2024
8 Source: *Financial Times*, "Hedge funds take on private equity in battle for distressed companies", 11 January 2024

Direct lending has dominated the narrative around private debt since the GFC, so much so that at times it seemed private debt was direct lending. We note reports that fund managers are looking to diversify away from sponsor-backed loans, adding origination capacity to identify borrowers without sponsor backing and turning to other sectors including asset-based financing. It is becoming clear that the period of low interest rates was more a determinant of the PE funding model since the GFC than the growth of the private debt market

Commercial Real Estate

Difficulties within commercial real estate are widely reported. Covid and working from home have led to reduced occupancy, energy efficiency requirements have rendered many older buildings obsolete, higher interest rates and falling values pose challenges for refinancing.

FIGURE 4: EUROPEAN COMMERCIAL PROPERTY PRICE INDEX



Source: European Central Bank

As Figure 4 shows, there has been a significant fall in commercial property prices in the euro area. Anecdotal evidence suggests pockets of considerable stress, for example a Canary Wharf office building subject to receivership sold at a 60% discount to its 2017 purchase price[9], or an office building in West London, purchased for GBP 55 mn in 2017, reported to be marketed in 2023 for as little as GBP 16 mn[10].

The global commercial real estate company CBRE estimates that for six large European real estate markets[11] "a total of EUR 640 bn worth of private commercial real estate debt was originated over the 2019–2022 period [of which] at current market values…the debt funding gap for loans likely to mature over the 2024–2027 period [is] EUR 176 bn (27.5% of the debt originated in 2019–2022)"[12]. CBRE report that the largest funding gap appears to be with respect to offices, and the country with the largest gap is Germany. They expect that market recovery and subordinated debt will absorb some of this funding gap, leaving a funding gap of c. EUR 72 bn in 2024–2027. Some funding gaps present opportunity, but for the sector as a whole we suspect this funding gap poses a threat. CBRE say with respect to their estimated EUR 72 bn gap, "while trapped cash in existing loans might reduce this still further, we anticipate that most of the remaining gap will need to be met through capital restructuring or asset sales". We expect commercial real estate to experience headwinds in the coming years.

9 Source: *Financial Times*, "Canary Wharf office takes 60% hit in distressed sale", 6 February 2024
10 Source: *Financial Times*, "'Stranded assets': investors reckon with obsolete offices", 12th May 2023
11 France, Germany, the Netherlands, Spain, Sweden and the UK
12 Source: CBRE Research, "The debt funding gap for European real estate", December 2023

Investor Demand for Private Debt

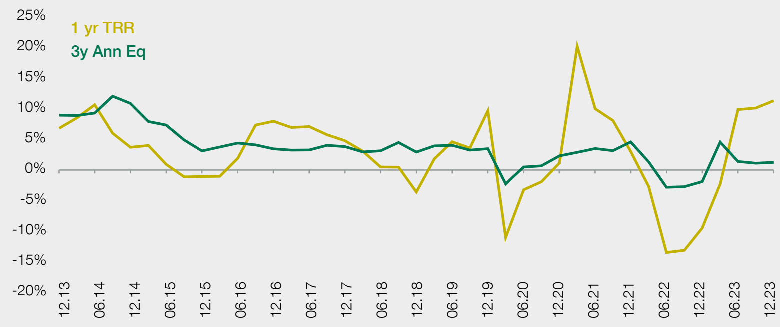
Investment consultants Mercer summarise why investors look to private debt as follows:

> *"Investors look to private debt for resilience, diversification and to pursue better returns. Investing in private debt could give your portfolio access to alternative sources of higher yield and flexibility to invest in the global real economy.*[13]*"*

RESILIENCE

We find it interesting that Mercer starts with "resilience", as we think it is an important characteristic of private debt. To appreciate the value of resilience, consider this chart of rolling 1- and 3-year total returns in European high-yield bonds.

FIGURE 5: EUROPEAN HIGH YIELD ROLLING 1- AND 3-YEAR ANNUALISED RETURNS



Source: Bloomberg LLP

High-yield investors have experienced substantial variability in annual returns. Not all investors have the resilience to maintain their investment allocations through periods of market sell-off. Granted, this chart includes Covid and the recent adjustment to more normal rates, but even over the ten-year period one can understand why investors may look to private debt for a better combination of resilience and return.

DIVERSIFICATION

An allocation to private debt offers diversification relative to the public bond markets. Within private debt there are many opportunities to diversify, with the Big Four offering diversification relative to each other and to the public bond markets. However, a central message of this white paper is that the spectrum of private debt is much broader than the Big Four.

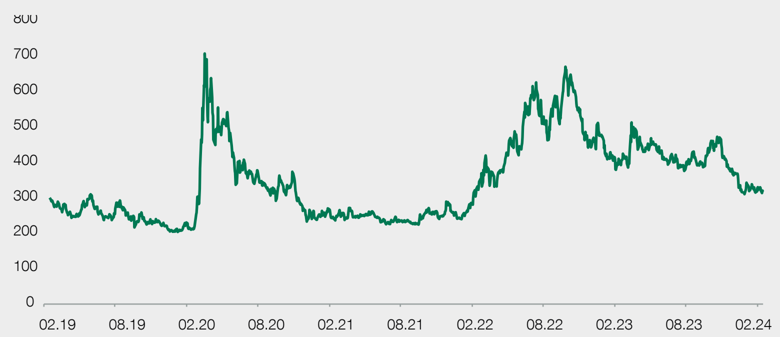
There is further diversification to be found away from sponsor-backed direct lending and commercial real estate financing. We believe investors will be increasingly attracted to strategies other than these.

13 Source: Mercer.com

RETURNS

Now that we have come out of the extended period of low interest rates, can private debt continue to offer relative value to the public bond markets? The short answer to that question is “yes”. Figure 6 shows the iTraxx crossover, an index of credit spreads on European high-yield bonds. We can see that credit spreads spiked in periods of market dislocation in 2020 (Covid) and in 2022–2023 (Russia–Ukraine, inflation, rising rates). Credit spreads have made a sustained move downwards in recent months.

FIGURE 6: ITRAXX XOVER



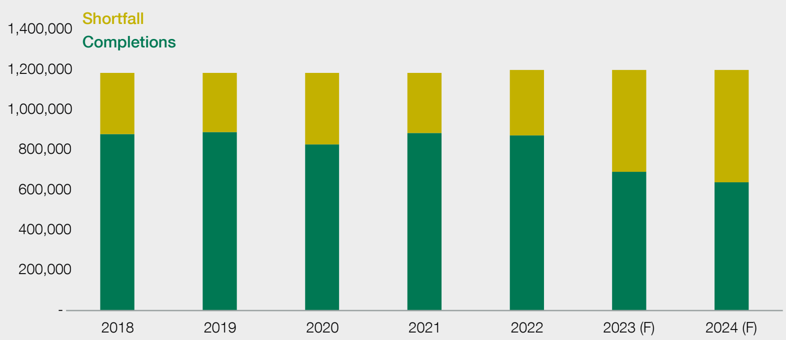
Source: Bloomberg LLP

The purpose of a private debt allocation is not to beat bond yields during periods of market sell-offs. Rather it is to give investors the resilience to stay invested through the sell-off and to earn a higher return over the cycle.

INVESTING IN THE GLOBAL REAL ECONOMY

We believe investing in the global real economy will spur the growth of private debt for years to come. Within real estate it’s time to look beyond commercial mortgages. We see great opportunity in the “new living” theme, that is financing the places where people live. Across Europe (and beyond) there is an acute shortage of mass market housing, student housing, critical worker housing, senior living and care homes.

FIGURE 7: HOUSING COMPLETIONS AND SHORTFALLS VS NATIONAL TARGETS FOR FRANCE, GERMANY AND THE UNITED KINGDOM



Source: JLL: “Why Europe’s housebuilding crisis will get worse before it gets better”, 23 November 2023

JLL reports that Germany, France and the UK had a combined housing undersupply of almost 1.6 mn homes in the five years between 2018 and 2022. Moreover, JLL says that

> *“...if [2018–2022] were a ‘housing crisis’, the situation is becoming something of a catastrophe. Over the course of 2023 and 2024, JLL predicts a further undersupply totalling 1.1m homes – equivalent to building only 50% of the three countries’ housing need[14]”*

This structural undersupply of housing contributes to high rental incomes and house price resilience. In addition to housing, the new living sector includes student housing, senior living and care homes. These assets generate rental income which is defensive in relation to inflation and therefore particularly attractive to institutional investors.

For investors looking for physical asset-backed opportunities, it may be better to pass on financing those assets in structural oversupply, for example commercial real estate, and to focus instead on financing those assets in structural undersupply, in this case where people live, through all stages of their lives.

We expect Asset-Backed Finance (“ABF”) to be a major growth area for private debt. ABF refers to financing secured by physical or financial assets. Physical assets may include capital equipment, machinery, and property. Financial assets may include receivables, student loans, credit cards and intellectual property. ABF will encompass transition infrastructure and capex, including solar energy-generation and battery storage, for example.

The growth in ABF will be driven by multiple factors. Historically, this sector was substantially financed by banks. It is likely to outgrow the banking system, creating an opportunity for non-bank lenders. In addition, ABF is attractive for debt providers as it offers secured exposure to diversified pools of obligors. Aside from the added diversification, many ABF transactions have attractive repayment profiles. For example, we refer to receivables-financing as “high frequency” because within the receivables pool there is a high turnover of individual receivables, each with a short maturity. Capex and equipment financing is typically amortising. Contrast these repayment profiles with a five-year bullet financing to a leveraged sponsor-backed borrower, and you can see the attractiveness of ABF.

Origination will be a key differentiator for asset managers active in financing the real economy. It is one thing to say that private debt providers will step in to fill the space left by banks, but it is easy to overlook how banks have built their origination platforms over decades and longer. Asset managers will have to develop their origination of real-economy financing opportunities, which will likely present more of a challenge than originating sponsor-backed or commercial real estate loans.

Current Opportunity in Private Debt

The market’s expectation is that the transition to normalised interest rates has been completed and that short-term rates have peaked. Market commentary has turned to when rates will start to fall and how quickly they will fall. The bond markets have already moved. Credit spreads have fallen significantly, anticipating better times ahead.

However, some sectors have yet to emerge from the transition, and they will likely continue to experience headwinds. For highly leveraged borrowers it is not enough that rates have peaked, they need rates to fall. In commercial real estate it may take some years to work through the oversupply and funding gap.

We believe it makes sense to invest now, as we enter a period of falling rates. However, we submit that it is better to choose those strategies that (i) are not reliant on rates falling quickly, (ii) are less leveraged and (iii) are not expected to face headwinds in the coming years.

14 Source: JLL, “Why Europe’s housebuilding crisis will get worse before it gets better”, 23 November 2023

CONCLUSION

Private debt will continue to evolve and grow. This growth will continue as long as there is an undersupply of bank financing and there are non-bank financial intermediaries such as funds to channel financing to would-be borrowers. In particular, though the period of low intertest rates spurred the growth of private debt, its continued growth is not predicated on any particular monetary policy.

Over the last decade direct lending, and to a lesser extent, commercial real estate, were the dominant segments within private debt. We believe that investors will increasingly look to diversify away from these segments and will favour those segments that offer both resilience and attractive returns. We believe that the real economy sectors of residential real estate and asset-backed finance satisfy those requirements and will attract investors.

Origination will be an important differentiator among asset managers. The real economy is more fragmented than the world of PE firms or commercial real estate. Originating transactions in the real economy will require origination capability, through which asset managers will differentiate themselves.

Colin Greene

Head of Private Debt

Nicolas Roth

Head of Private Markets Advisory

Kayte Hodgson

Senior Investment Specialist, Private Markets

Disclaimer

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com