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# TRENDS, DIVERSIFICATION AND RELATIVE VALUE IN PRIVATE DEBT

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# Trends, Diversification and Relative Value in Private Debt

As we exit an extended period of low interest rates, it seems an opportune moment to reflect on the private debt asset class and to consider how it may continue to evolve. In this white paper, we discuss why we believe the private debt asset class will continue to grow, the trends within the asset class and where we see diversification and relative value opportunities.

## Key points

- *We expect the private debt asset class to continue to grow.*
- *We see a trend of capital being concentrated in fewer funds that pursue broadly similar sponsor-backed, direct-lending strategies.*
- *New sub-asset classes are emerging, including new living private debt, that offer diversification and relative value compared with public bonds and sponsor-backed direct lending.*

# Growth in Private Debt AuM

The private debt asset class enjoyed dramatic growth during the extended period of low interest rates following the global financial crisis (GFC).

Looking beyond aggregate figures for the asset class, we can see that the lion's share of fundraising has been for direct lending, with lower allocations to real estate, mezzanine, and distressed strategies (Figure 1).

The current rising-rate environment begs the question of how the asset class will evolve, and in particular, is continued growth dependent on low rates and what will happen to allocations to its sub-strategies?

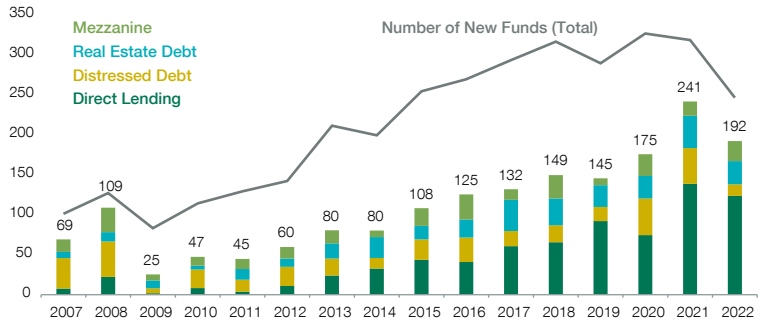
To address the first question: the private debt asset class is forecast to continue to grow. In their Private Debt Global Report 2023, Preqin forecast, "[… ] private debt assets under management (AuM) to increase at a slightly slower pace than in recent years, rising from USD 1.2 trillion – as of year-end 2021 – to USD 2.3 trillion by the end of 2027"[1]. It may be that higher rates have slowed the forecast rate of growth in the asset class, but it appears that other factors continue to drive both borrower and investor demand for private debt.

## BORROWERS' DEMAND FOR PRIVATE DEBT FINANCING

Commentary on the private debt asset class typically focuses on investor demand and often overlooks why borrowers turn to private debt providers. Put simply, borrowers look to private debt, as the banking system is not providing sufficient financing to meet demand. It has also been suggested that, in some cases, the banking system is not meeting the requirements for speed of execution. Since the GFC, bank lending as a percentage of GDP has fallen. Figure 2 shows the downward trend in aggregate EU bank lending to the domestic sector as a percentage of GDP. We note there was an uptick in 2020 which we expect was connected to Covid-19 (borrowers deferring repayments and state-backed support schemes administered through the banking system), rather than a reversal of the underlying trend of declining bank lending as a percentage of GDP.

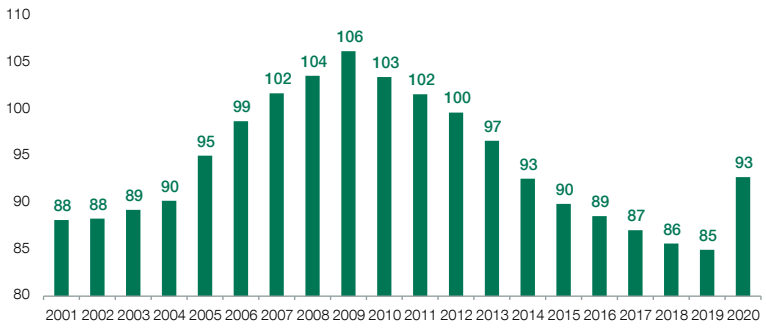
Direct lending has grown into the largest component of the private debt asset class, as the banking system could not meet sponsors' demand for M&A-related financing (including acquisitions, recapitalisations and refinancing). However, there are long-term structural changes in the banking system that are driving the growth of the wider private debt asset class. For example, there has been a reduction in both the number of credit institutions (down 30% in the EU between 2008 and 2019[2]) and number of bank branches (down 31% between 2008 and 2019[3]).

Figure 1 – Private Debt Historical Fundraising (USD bn)




Source: Preqin.com

Figure 2 – Domestic Credit to Private Sector by Banks (% OF GDP) - EU




Sources: International Monetary Fund, International Financial Statistics and data files, and World Bank and OECD GDP estimates.

1 Preqin Private Debt Global Report 2023
2 European Banking Federation, Banking in Europe: EBF Facts and Figures 2020
3 European Banking Federation, Banking in Europe: EBF Facts and Figures 2020

Consolidation and branch closures may promote banking industry efficiency and profitability, but the contraction in communication channels between banks and would-be borrowers reduces access to bank lending, especially for smaller borrowers. As the UK's Federation of Small Businesses (FSB) noted in their recent report, *Credit Where Credit's Due*[4], "[… ] less than 1 in 3 small business owners find it easy to speak to the right people to get help with their financial applications." The FSB went on to note:

> *[...] the primary reason for difficulties accessing different forms of finance is due to application processes being too long and the inability to speak to anyone about the process itself."*

Of course, the nature of the difficulties in accessing bank lending faced by SMEs will differ from those faced by the sponsor-backed companies. Even so, the undersupply of bank credit impacts borrowers large and small and will continue to drive demand for private debt.

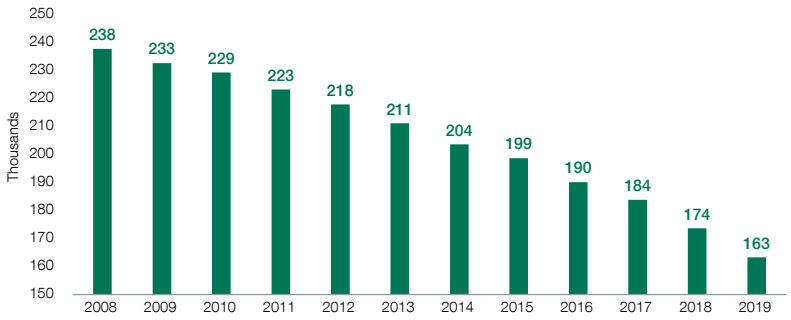
Coming into 2023, it was generally accepted that a rising-rate environment would be positive for the banking sector, as rising rates would improve net interest margins. The collapse of Silicon Valley Bank (SVB) has demonstrated that this rule of thumb would not work for every bank. Smaller banks in particular are exposed to duration risk in their fixed-income portfolios and to loans made to the commercial property sector. Moreover, depositors are proving to be sensitive to deposit rates such that even large banks are experiencing deposit withdrawals. We expect the uncertainty around bank deposits to lead to a further contraction in bank lending. This is key, as any contraction in bank lending will promote the private debt asset class as a whole and will also generate interest in strategies other than direct lending and sponsor-backed lending.

## INVESTOR DEMAND FOR PRIVATE DEBT

Private debt is a yield product, in particular a yield product that is an alternative to the public debt markets. The word "alternative" may be misleading: it is not an either/or choice, rather a complement and we expect that investors looking for yield would hold both public and private debt. It is a question of relative allocation.

When we consider the allocation between public and private debt, it is worth noting that the public debt markets have performed poorly for investors over the past ten years (see Table 1). In view of the performance of the public debt markets, many investors are increasing allocations to private debt to add diversification and the attributes of private debt to their portfolios.

Figure 3 – Number of EU Domestic Bank Branches




Source: European Banking Federation, Banking in Europe: EBF Facts and Figures 2020

Table 1 – Annualised Returns in Selected Public Debt Markets

| High Yield | 1 year % | 5 year % | 10 Year % |
|---|---|---|---|
| US High Yield | -1.57 | 2.23 | 3.03 |
| European High Yield | -1.35 | 0.47 | 2.47 |
| Asian High Yield | -4.34 | -3.23 | 0.82 |
| **Leveraged Loans** | **1 year %** | **5 year %** | **10 Year %** |
| US Leveraged Loans | 2.85 | 2.43 | 2.51 |
| European Leveraged Loans | -3.41 | -1.10 | 0.11 |

Source: Bloomberg Finance L.P., 20 April 2023

4 The Federation of Small Businesses (FSB): *Credit Where Credit's Due*, December 2022

Investors typically look to allocate to private debt for its key attributes:

| | |
|---|---|
| **Relative yield** | Pricing in the public bond markets was distorted by quantitative easing following the GFC. This favoured allocations to private debt, where pricing was determined by market participants rather than policymakers. Even in the current environment of rising rates, pricing in the public markets may be impacted by index-tracking funds, which are natural buyers of any debt instrument included in their relevant index. Private debt markets are less susceptible to such pricing distortions, and offer a spread to public debt, especially for small transactions where there is little or no participation by the larger private debt funds. |
| **Volatility** | Yield investors typically prefer lower volatility of returns. Private debt transactions tend to have low duration, whether due to short maturities, floating rates, or both, and are typically not marked-to-market. In public markets, investors have experienced high volatility arising from outsized movements in rates and credit spreads. In 2022, US and European high yield debt returned -10.99% and -9.47%, respectively.[1] |
| **Diversification** | Private debt offers diversification relative to public markets. Though the large direct-lending firms adopt similar strategies, as sub-asset classes emerge, private debt will afford further diversification opportunities. Moreover, as private debt transactions typically have low duration and are concentrated in countries (in North America and Western Europe) that tend to have better country risk and lender protections, diversification may be added without compromising duration or country risk. We see an interesting emerging tendency for investors in certain asset classes, such as private equity or real estate, to add private debt within that particular asset class to their portfolio, thereby diversifying returns while benefiting from their knowledge of the underlying asset class. An example would be for real estate investors to add real estate private debt to their portfolios. |
| **Inflation mitigation** | Some asset classes can mitigate inflation risk. For example, residential rents, student housing, care homes and senior living are resilient in the face of inflation. Financing secured by real assets in these sectors may have inflation-resilient collateral. |

Last, when comparing public to private debt we have to address liquidity. For some investors the relative liquidity in public markets is a strong argument in favour of allocating to public markets. However, the experience of SVB reminds us to be cautious about conflating yield with liquidity: liquidity and price risk do not sit well together. When allocating, it is better to be clear whether the objective is liquidity or yield, rather than to conflate liquidity and yield.

4 Bloomberg Finance L.P.

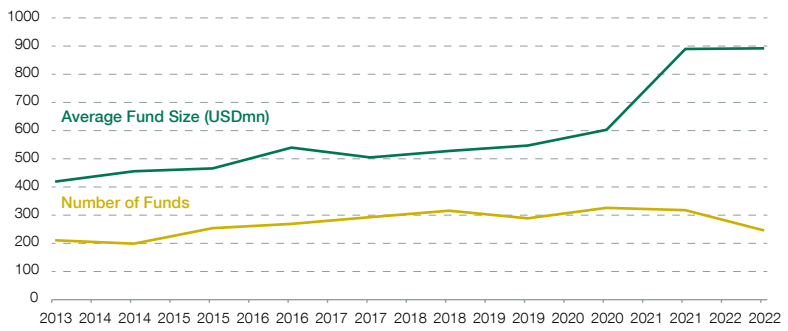
# Trends within the Private Debt Asset Class

## CONCENTRATION

There has been a clear trend of concentration with fewer funds raising more capital. Figure 4 from Preqin shows annual average fund size and the number of funds raised between 2013 and 2022.

Larger funds have coincided with larger deals. Capital flows like the tide: the tide flows more quickly in deeper channels. For private debt, the deep-water analogy relates to those funds and sectors where high volumes of capital may be deployed relatively quickly in large transactions with repeatable execution profiles.

Figure 4 – Number of Funds vs Average Fund Size

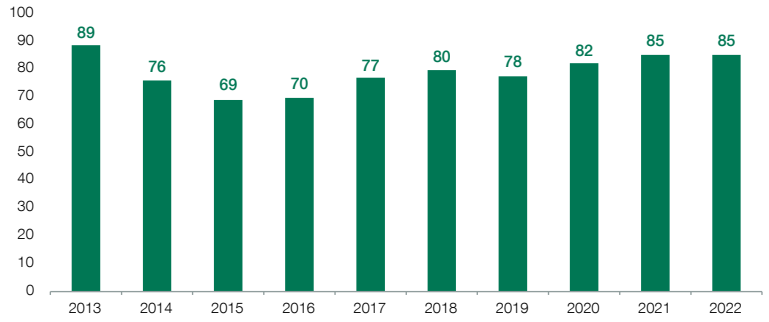



Source: Preqin.com

## LENDING TO SPONSOR-BACKED COMPANIES (DIRECT LENDING)

The second major trend is the continued growth of direct lending, and in particular sponsor-backed lending. Sponsor-backed companies require high volumes of M&A financing and provide a deep channel for capital flows. Deloitte reports that, "[… ] sponsor-backed opportunities make up the majority of Private Debt deals," and report the following survey data:

Figure 5 – Europe (ex-UK) direct lending to sponsor backed firms (%)




Source: Deloitte Private Debt Deal Tracker Spring 2023

In recent years, some 85% of the transactions (in Europe, ex-UK) in the funds surveyed by Deloitte were to sponsor-backed borrowers. The concentration of sponsor-backed deals within these funds suggests a high level of correlation among them and that investors may find diversification opportunities in other parts of the private debt universe.

## GROWTH IN OTHER PRIVATE DEBT SUB-ASSET CLASSES

While we expect a continuation in the trends of concentration and the dominance of the direct-lending sub-asset class, we also expect other sub-asset classes to emerge, to grow and to offer attractive diversification opportunities. Some of this is not new – distressed and mezzanine funds have always been part of the asset class. Even so, direct lending has tended to overshadow other private debt sub-asset classes, partially due to industry data collection concentrating on larger funds. The recent decline in M&A activity (global M&A activity in Q1 2023 was the third lowest quarterly global M&A volume in the last 10 years[5]) has given space to other sub-asset classes, with some direct lenders looking to increase allocations to non-sponsor-backed deals.

One such sub-asset class is real estate lending, where we have seen increased fundraising[6] typically providing mortgage financing for commercial real estate (CRE). However, as with any credit decision, investors need to prioritise whether the sector is the right one to lend in over whether it is an easy one to deploy capital in. CRE (especially second-tier assets) may be entering a sustained period of headwinds from higher funding costs, higher cap rates and lower occupancy. The difficulties may be more acute in the US, where there is reported to be a high concentration of CRE loans among smaller banks. Even so, we doubt that Europe can be immune to refinancing concerns over CRE debt.

We envisage portfolio construction where investors allocate to both public and private debt, and within private debt they allocate to direct lending and also to other sub-asset classes. The emergence and growth of other sub-asset classes will focus attention on origination channels. Investors in sponsor-backed lending have accepted that transactions originate from a relatively small pool of sponsors. Away from direct lending, investment managers are differentiated by their origination networks and capabilities.

5 Bloomberg LLP, as at 4 April 2023
6 Preqin.com data

# "New Living" Emerging as a Mega-Investment Theme

Within the real estate space, "new living" is emerging as a mega-investment theme. The new living theme includes single- and multi-family housing, build to rent, student living, care homes, senior living and other spaces where people live.

**We see three major drivers of the new living investment theme:**

1. **Structural undersupply**: housing and living spaces are in structural undersupply across Western Europe. Since the GFC, not enough houses have been built. Reasons may vary from country to country (but generally include austerity measures, reduction in bank lending and planning delays), but the net result is the same – a housing crisis with too few houses available, spiralling rents, and overcrowded housing.

2. **Housing energy efficiency**: many EU countries have large stocks of old and energy-inefficient housing. Across the EU, almost 30% of all energy consumption is used by households, of which around 80% was used for space and water heating in 2020[7]. Moreover, the recent energy crisis highlighted how poor-quality housing exacerbates fuel poverty. High volumes of new, energy-efficient housing are required to address both climate change and social needs.

3. **Institutional investment**: institutional investors are increasing allocations to the new living theme. There is a sense that institutions are fully allocated to office and retail, yet they remain underallocated to living. Knight Frank reports,

   *"Investment into residential assets has become a core strategy for institutional investors seeking stable income streams"*[8]

Private debt investors are looking to new living for asset-backed yields that offer diversification relative to public markets and to the main sub-asset classes in private debt, including direct lending and CRE lending.

# Opportunity: Why Now for Private Debt?

In the run-up to 2022, public markets were borrowers' markets thanks to a combination of monetary policy, investment industry regulation and the growth in index-tracking funds.

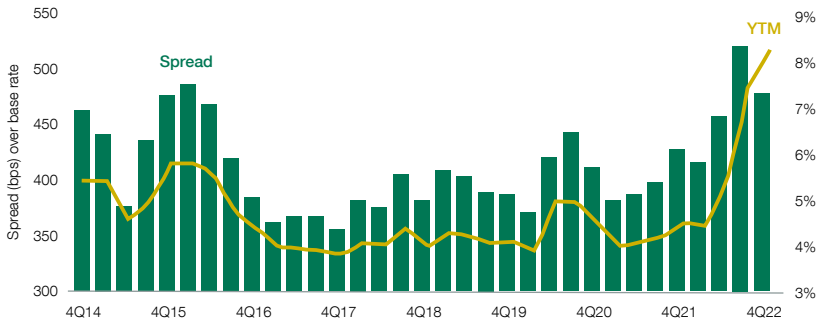
Rising rates have moved public markets more in favour of investors. Figure 6 shows how European leveraged loan spreads and yields have risen through 2022. Comparable data for private debt is not so readily available. Even so, private debt spreads and yields are typically higher than those in public markets, including leveraged loans. In addition to private debt's yield pick-up, structural imbalances and volatility continue to support the private debt asset class.

In general, the banking system is not meeting demand for financing. Moreover, recent failures among US banks and the demise of Credit Suisse are expected to lead to a contraction in bank lending. Constrained bank lending will provide opportunities for private debt lenders to achieve an attractive premium relative to public markets.

We see value in the primary space where investors can choose sectors and borrowers to suit current market conditions. Moreover, we expect greater opportunities in those parts of the private debt market where there is less competition among debt providers, i.e. for non-sponsor lending and for smaller transaction sizes (those under EUR 50 million).

Floating rates, rising spreads, relative value and undersupply of bank landing are all supportive of private debt. We continue to see investors finding diversification and relative value, along with low volatility, in private debt, without taking on duration risk or significant country risk.

**Figure 6 – European leveraged loan spreads**




Source: S&P LCD (January 2023)

7 https://www.eea.europa.eu/publications/decarbonisation-heating-and-cool
8 Knight Frank: Residential Investment Report 2022

# CONCLUSION

We believe the private debt asset class will continue to grow. This growth is a necessary by-product of the structural changes in the banking sector and resultant undersupply of bank lending. Deep channels will see capital concentrated in larger funds, whose transaction sizes are larger. The high financing requirements among sponsors will see direct lending continue to dominate the asset class.

However, as private debt matures as an asset class, investors, who, until now, have primarily looked to direct lending as a diversifier to public markets, will look for new sub-asset classes within private debt to add further diversification to their yield allocations. Those investment managers outside the bulge bracket will differentiate themselves by offering sector-specific funds and in these shallower waters where less capital flows, investors will find both diversification and relative value.

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