Show of resilience

The private debt market is seeing strong growth and capturing investors' attention

By Donald Rice

INVESTORS are craving yield like never before. However, any extra pick-up on cash is increasingly elusive in an environment characterised by a myriad of uncertainties. The knock-on effect of the recent surprise vote in the UK to leave the European Union has driven yields even further to record lows. So how can investors find desirable yield without taking on increasingly greater credit risk?

The burgeoning private debt market, namely direct lending, may provide the clue. Direct lending can offer significant premiums, comparably low peak to trough drawdowns, with lower volatility. This segment has experienced strong growth since 2008 and is capturing the attention of individuals, as well as institutional investors, who seek returns that are higher than those of mainstream bonds. So, private debt does matter in the search for yield.

One increasingly popular form of direct lending is referred to as mezzanine debt financing. Although mezzanine debt has been around for over 30 years, the industry continues to grow in parallel with the need for alternative financing. Structural factors have prevented middle market companies from accessing broader traditional markets. Deteriorating balance sheets and regulatory pressures stemming from the financial crisis have caused many banks to limit the amount of total debt that can be obtained by a company. Not surprisingly, non-bank lenders (insurance companies and fund management companies) have stepped in to fill the gap.

Many such medium-sized companies are in fact cash flow positive. They are undertaking pivotal shifts in strategy, which might include plant expansion, pursuit of acquisitions, new product lines, recapitalisations and establishment of new distribution channels.

In order to provide a sense of size for this little known asset class, there are over 200,000 middle market companies in the US representing 25 per cent of GDP (gross domestic product). Putting this segment into perspective, it would rank as the world's fourth largest economy, on a par with Germany.

Subordinate to senior debt, mezzanine sits just above equity within a company's capital structure. It provides small to medium-sized enterprises a cost effective means of funding. Mezzanine financing continues to be a core segment of middle market buyouts for companies with US$10 million to US$75 million of Ebitda (earnings before interest, tax, depreciation and amortisation). Such companies remain too small to access the high yield markets.

Why has middle market mezzanine captured the attention of pension funds and sovereign wealth funds? As it sits between private equity and high yield credit, it provides better liquidity than private equity and yields significantly higher premiums than the traditional high yield market. Even in the current low interest rate environment, mezzanine debt opportunities can often generate low double-digit returns.

Unlike venture capital and private equity, mezzanine debt is characterised by shorter investment duration and regular yield payouts to investors. In addition, this segment has shown remarkable resilience during the financial crisis. These low drawdowns can be attributed to three important elements: high contractual yields, relatively low default rates and rather high recovery rate.

Mezzanine debt financing

Why would thriving companies with positive cash flows seek refuge through mezzanine debt financing? Bear in mind that equity remains the most expensive source of capital and equity issuance would have a dilutive effect on existing shareholders. Additionally, mezzanine debt has a flexible payment term, which is paid off over time. This factor drives the weighted average life of mezzanine debt to be as short as three years. Lowering the overall cost of capital ultimately results in an improved return on equity.

Holding liquidity is a long held strategy and is often a significant portion of an investment portfolio. But due to reluctance by investors to forego allocating a small portion of a portfolio into less liquid investments, investors may underestimate the extra returns from holding illiquid investments. This is obviously linked to the aftermath of the global financial crisis, which has significantly shaped investors' attitudes towards less liquid investments. As a consequence, certain asset classes still remain stigmatised. The private debt segment has stood out in the industry given its resilience throughout the market crisis.

Investing in private debt is not without its risks. Investors should be aware that the primary risk is the failure of the borrower to pay interest or repay principal, which would result in a default on debt obligations. Default risk, credit quality deterioration and deal complexity explain in part the relatively high risk premiums.

However, this risk can be mitigated not only through diversification of credits, but also by the inherent covenant standards, which in most cases make coupon payments materially tighter than their high yield counterparts. Lastly, with median recovery rates of 50 per cent, investors can endure a few defaults in their portfolios without making a dent in their principal.

Liquidity may not be evidenced by standard measures of risk, such as price volatility and standard deviation. In fact, under normal circumstances, illiquid investments are not necessarily more volatile than liquid ones. Of course price volatility may be masked by the fact that illiquid investments, like private debt, are priced at less frequent intervals.

The higher degree of illiquidity affords the fund manager to focus on successful outcomes as opposed to market directionality. Lastly, one should seek out specialised expertise when evaluating private debt opportunities, and similar to its private equity cousins, private debt investors should steer themselves to providers with top quartile managers with long, verifiable track records.

The emergence of shorter duration and yield producing opportunities derived from private debt investment in medium-sized companies provide an attractive alternative to individual investors seeking yield enhancement. This also provides investors who have a longer time horizon the opportunity to emulate some of the same strategies pursued by the heavyweights, namely institutional investors such as endowments and pension funds. For those investors willing to forego immediate liquidity, mezzanine debt's high contractual coupons provide steady cash flows and historically low drawdowns in this currently low interest rate environment. W

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