cio investment club

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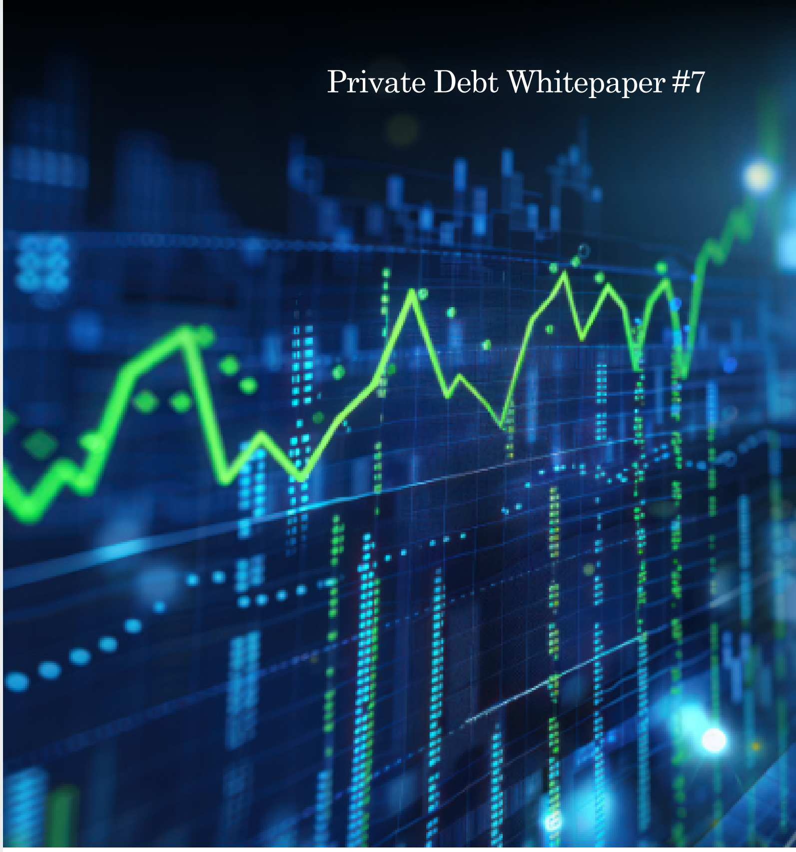
Private Debt Whitepaper – Next Steps in Private Debt



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Contents

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Introduction

Signs of excess in private markets have been there for all to see for years. Fundraisings have been getting bigger; concentration among the biggest players has grown; covenants have been getting lighter and lighter.

Yet nothing seismically bad has happened yet. This, to some extent, reflects the expertise of practitioners in private markets. It also explains why regulators fret but have not engineered profound change to markets which have experienced transformational growth since the GFC.

But nothing ever lasts forever. Public debt issues are having something of a renaissance as borrowers hunt cheaper deals. The mountain of committed capital gives new investors into private debt pause for thought.

The question for those asset owners already in the game - insurers, pension funds and family offices - is how they manage to reap the benefits of a sector which still has tailwinds, notably the retreat of banks from corporate lending; while clearly struggling to maintain the high returns of yesteryear.

One obvious way to answer the question is to be humble and accept lower returns. Credit is, after all, more expensive now than it has been for decades. Inflation continues to hurt economic activity.

Another way would be to find niches in lending that others are too big or too inexperienced to commit to. The cio investment club Private Debt roundtable of 2024 will explore these niches and their risks.

> *“I’m not sure you get all the data to weigh up the story. The bilateral relationship [between private equity sponsor and creditor] is a huge benefit in many cases but it is not always transparent.”*

The Next Steps in Private Debt

Twenty years ago private debt was not on the radar of institutional investors. If they wanted to diversify away from publicly-traded stocks and bonds, private equity was their target.

Change began when banks began retreating from corporate lending after the Global Financial Crisis. Pure-play asset managers gradually took over more and more of this function; tapping insurance companies, pension funds and wealth managers as clients to supply the capital.

So where are we now? The cio investment club roundtable began by asking panelists to describe private debt in 2024. “Resilient”, “misunderstood” and “fruitful” were just some of the answers.

“Private markets have had to play catch-up with public markets,” observed Punil Chaubal, head of insurance advisory at WTW, which has US$400bn of assets under advice. “A lot of institutional investors favour liquid markets right now.”

He said there were easy ways for insurers to organise their back book such as picking low-hanging fruit in US$ credit and Emerging Market debt.

A lot of private asset managers, on the other side, have underdeployed capital in equity and credit. Chaubal said this has led to innovation around structuring private debt in order to make it eligible for insurers’ Matching Adjustment (MA). Loans to small and medium enterprises (SMEs) packaged up in the right way can carry an Investment Grade wrapper. This is appealing to insurers as it lowers their capital requirements, avoiding the obligation to mark private debt exposure as surplus assets.

Jason Proctor, co-founder of Troviq, a private markets investment office that works with family offices and wealth managers, said it was hard to make an investment case for excluding private debt from portfolios: “Over the last 10-15 years deal volumes and fundraising have grown substantially. In terms of returns, many fund managers and their LPs have been pretty successful with remarkably consistent returns.”

Proctor noted, however, that this asset class is evolving, and always open to misunderstanding. “Private debt can mean different things to different people. You can pick your target return from 6% to 15%. How deals are structured and access points will continue to evolve.”

David Will, head of public and private credit for customer assets at Scottish Widows, is part of a team seeking to incorporate private credit into a workplace pension default strategy. The challenge is to include illiquid credit in a daily priced, daily-dealt vehicle.

Will agreed with Proctor that private debt is not homogenous. He also described it currently as “interesting” in the Confucian sense of the word, ie. “not a panacea”.

There have been recent signs of tension between lenders and private equity firms, which is perhaps the most public indication of the growing pains for the titans of private markets with large amounts of capital still to deploy.

Martyn MacDonald, credit specialist at XPS, an adviser to Defined Benefit (DB) pension schemes, said right now illiquid debt was not attractive to these clients. Most had sold out in response to the gilts crisis of two years ago. MacDonald nevertheless described private debt as resilient.

“The middle market still needs its financing,” he said. “There is now a discussion about DB schemes running on rather than going to buy-out. That could open the door once more to private credit.”

Private markets have had to play catch-up with public markets

> *returns from private debt have been strong while loss rates have been low, even in the current environment.*

Stephan Breban, a veteran adviser to pension schemes on private assets and current affiliate of Renewity, an investment platform dedicated to renewable energy and decarbonisation, said he has been trying to convince pension funds ever since 2005 to invest more in private debt.

He scotched the idea that DB pension funds should avoid this asset class on the grounds of illiquidity. "Plenty of schemes in the UK are not doing a buy-out. It would take two years to clean the scheme data in preparation anyway. So no fire sale of private assets is required."

Regarding Liability-Driven Investing (LDI), Breban claimed private debt would be a lot better than public debt. He remembered that when LDI was taking hold in the UK pensions sector there had been discussions that were interest rates to rise 50-100 basis points, then all positions would be closed. "That structure was never formalised – hence the chaos when those conditions finally hit the markets in September 2022," said Breban.

His other two words to describe private debt were "sexy" and "dull".

He explained that it was sexy because there is so much opportunity out there and investors should be curious about novelty. It was dull because this is credit that produces cashflow to meet requirements "and then some."

Breban criticised those folk in the sector who were trying too hard to make things interesting. He said that pension funds don't need everything to be really exciting. He added that the appeal of private debt extends to Defined Contribution savings in the UK, from which the risk of inadequate wealth in retirement is currently high. He recognised the challenge of fitting illiquids into liquid vehicles but noted that private debt would get you 50% more than annuities currently.

Steven Hickey, a private markets specialist at Apex Investment Advisory, said that returns from private debt have been strong while loss rates have been low, even in the current environment.

"The private debt market has evolved and the market is maturing," said Hickey. He gave the example of direct lending moving to larger deal sizes and U.S. club-type deals.

Hickey expressed caution, however, that it was tough to get full look-through. "Default rates are not so useful in private markets. Getting 'under the bonnet' means taking account of other metrics, such as amend-and-extend measures and Payments-in-Kind.

Proctor said that whilst "amend-and-extend" had a bad reputation, this was not always warranted as it could provide a mechanism to navigate a potential issue without having to formally default and subsequently restructure.

Hickey agreed. "In a bilateral relationship between sponsor and creditor, this can be a positive. But where you see a growing use of extensions in private debt, it's generally a concern."

He said there was a need for more client education. "I'm not sure you get all the data to weigh up the story. The bilateral relationship [between private equity sponsor and creditor] is a huge benefit in many cases but it is not always transparent."

"More needs to be done," said Chaubal. "We are seeing regulators, especially for insurance companies, becoming more inquisitive about assets." He gave the example of the Bermuda Monetary Authority relinquishing its scenario approach.

"It's a case of bridging the gap," said Chaubal. "[Insurance] companies make allocations first. Then when regulators come knocking on the door, they scrabble around for justifications."

Breban interjected: "When a regulator is being inquisitive, it usually means that they want education!"

Some of the biggest managers of private assets such as Apollo and Blackstone have come under the spotlight recently for their fast-growing presence in reinsurance on Bermuda. Chaubal noted, however, that not everyone on the island is putting private debt on their balance sheet.

He also noted that the BMA has a balancing act to play in enforcing prudence while wishing to encourage new entrants into reinsurance in order to alleviate concentration in that sector.

What Has Changed?

The cio investment club panel then discussed what was new in private debt. Breban remarked that back in the nascent period of the mid-2000s, any private debt fund was amorphous. You could find High Yield, mezzanine, and asset-backed securities all be in a single fund. “As a pension fund client, you had no control back then,” he said. “Now trustees have more power about the fit: where they want to be.”

Will said the evolution has been remarkable. His one concern was the number of new players coming to the market. “There has been no real downturn yet but in terms of new supply, it is a race to the bottom. We see broadly syndicated loans that are collateral-lite. Recoveries will be a lot lower than in previous cycles.”

Reading across to public markets, Will added that his sense was that High Yield is healthier now than pre-Global Financial Crisis. “There is more BB than CCC, which has migrated to private markets.”

MacDonald agreed that rising rates might cause some suffering in private markets.

Chaubal said that private markets managers have delivered and refinanced because there is so much dry powder; it’s supply outweighing demand. “That’s what keeps us busy. We need to partner with managers with a good track record.”

He reckoned that only a few of the giant private equity sponsors had the good relationships with lenders. “As a prospective Limited Partner, you can’t look through the loan schedule but you need that level of due diligence in private markets. This is a test of the underwriting capabilities of the managers.”

He warned that managing distressed assets was a specialism in itself, usually managed by teams with legal backgrounds who are used to arbitrating. “Our clients don’t want distressed with complications such as side-pockets waiting to unwind,” said Chaubal.

For XPS, MacDonald said that senior secured is “as far as we would go.”

Likewise, the risk department in Lloyds Group, banking parent of Scottish Widows, has been thorough in its assessment of potential credit exposure from private debt strategies. Will was asked whether there had been any

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“There is more BB than CCC, which has migrated to private markets.”

situation where Lloyds has vetoed loans but his team had nevertheless approved them?

Will responded that there had been a case where the risk team had taken some time to get comfortable with a private credit manager's credit underwriting process before approving it. It had helped that a senior executive there had been chief risk officer of a big bank in a previous role.

"Knowing how to answer the question in the right way is crucial," said Breban.The next question for the cio investment club panelists was whether private equity sponsors were too powerful. In the terms and conditions for large-cap broadly syndicated loans, the answer was arguably yes, according to Will. "But the core and middle-market is still much more bespoke and bilateral," he said.

Because of the mountain of dry powder currently available, Breban reckoned that we are now seeing a game of chicken. "The debt guys might think they are playing 3-D chess but they are playing chicken. The larger private equity borrowers are just brutal. The question is who gives up first."

Hickey said that geographies matter here: "The U.S. is more commoditised. Europe offers better pricing. We are a few years behind the Americans and further down the EBITDA ladder."

He added that size also matters: larger companies have more diversified revenue streams and customer segmentation. "It comes down to hiring managers with expertise, especially for non-sponsored loans. You need managers with good networks."

Chaubal agreed on these differences across the Atlantic. "In Europe SMEs typically demonstrate good cashflow generation. They are established businesses."

Proctor pivoted the conversation to vehicles and contrasting what works in private equity but does not work as well in private debt. Troviq's approach to private debt investing focusses on quick deployment of capital. This means avoiding the closed-end structures typical of private equity that were adopted by private

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debt. "Having no control over your cash flows for seven to nine years does not make sense for investments which are all about yield," he said. Instead, Troviq uses the likes of secondaries to put money to work faster; and an open-ended structure to enable a degree of liquidity.

Proctor acknowledged that regardless of structure, manager selection remained critical. The direct lending industry in particular presents a challenge for newer managers because- in a capped upside asset class, it is not so straightforward for investors to build a high-conviction case around groups with less scale of capital and deal flow.

Chaubal agreed that it was difficult to deploy to upcoming managers. "We need a track record and evidence of skills." He added that there were spin-outs from bank desks, e.g. in mid-market lending expertise, that could attract capital based on prior experience. But this was in contrast to private equity, where personal connections and endorsements were fostered as a matter of course.

"In private equity you build relationships with individual portfolio companies. You ask about the individual," said Chaubal.

Breban agreed. "You get specific references on a GP from a CEO or CFO. The key figure at the GP sits on their company board." He said that private debt operators, on the other hand, don't need to do that. "Only if the private debt is non-sponsored does it takes on more of the relations with C-suite."

Secondaries Come First

The discussion reverted to Secondaries, and their role in private debt portfolios. XPS recently established an advisory service on Secondaries in the wake of the LDI crisis as an opportunity for UK pension funds to both buy and sell stakes in private assets.

Hickey said that dealflow has become more consistent in the last couple of years. "Secondaries are a growing space, meeting the needs of LPs," he said. "They are not going to become core but are a sleeve for these investors."

Hickey described fees and charges as ever more consolidated, in part because of the success of the biggest houses.

Will suggested 0-5% discount-to-NAV deals were out there. Proctor suggested up to 10% depending on the portfolio in question, and a good way to "get your money into the ground". He noted that the rapid deployment offered by Secondaries enabled Troviq's clients to view private debt as akin to a savings bank account. "For our investors, wealth managers and family offices, if they want to allocate to private debt to benefit from the attractive yield, they want to do that immediately," he said. "If they put money into a deposit with a bank to generate yield, the bank doesn't turn around and say it will only accept the money over two to three years. The yield is from day one."

Will agreed. "From a workplace pension fund perspective, closed-end funds don't work for us. They usually have performance fees or carried interest that we are not prepared to pay; partly for operational reasons; party for philosophical reasons.

"We are looking to build a diversified pot of private assets. Some will be direct lending. They will be housed in evergreen structures, possibly the Scottish Widows' LTAF."

> *"When seasoned, the portfolio will be throwing off some liquidity naturally, perhaps up to 20% per year."*

Will added that other things you can do to speed up deployment would be getting a bank to warehouse assets. He was conscious that incoming new contributions to Scottish Widows could outpace deployment. "When seasoned, the portfolio will be throwing off some liquidity naturally, perhaps up to 20% per year." Meanwhile new premiums will need to be invested. "So we could be working quite hard to stand still."

Hickey asked how much of the Scottish Widows' workplace pension default fund would be in liquid credit. "A lot," replied Will.

"Currently, Scottish Widows' default fund for pension savings houses c. £70bn; around 25% of which is in fixed income; a good chunk of which is in liquid IG credit. That will have to be morphed into the new vehicle."

He reckoned that around £6bn per annum would flow in by way of new contributions to workplace savings, meaning that subscriptions and redemptions could be netted off in most scenarios. Clients would have to give notice - at least 90 days - of their intention to sell out of an LTAF and in practice it could be up to 12 months before assets are transferred where a scheme decides to leave.

The cio investment club closed with thoughts on how to tackle that issue. One promising new area, for example, is Emerging Markets Illiquid Credit. Another, well-known to UK institutional investors but with a chequered recent history, is Commercial Real Estate debt.

Breban left the panel with one final thought regarding positive and negative cashflow – germane to the drive to include private markets' exposure in retail investors' portfolios. From historic data on UK pooled pension funds, there is some evidence that institutional investors with negative cashflow outperformed those with positive cashflow. The hypothesised explanation, never fully proven, is that negative cashflow pressed a sell discipline on investors. "They would give up the dogs in the portfolio more readily," suggested Breban.

Participants

David Will

Senior Manager, Portfolio Management, Scottish Widows

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead. Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to his role at Scottish Widows, David is a regular speaker at industry events.

Jason Proctor

Managing Director, Troviq Private Markets

Jason is Managing Director of Troviq and a member of the Firm's Investment Committee. Jason has spent his career selecting and investing in a range of private markets funds on behalf of some of the world's largest and most sophisticated institutional investors.

Prior to Troviq, Jason was a Vice President at StepStone, one of the largest private markets investment firms with activities across private equity, private debt, real estate and infrastructure. At StepStone, Jason was responsible for private debt investments, working closely with Troviq's Chairman John Bohill on the development of StepStone's private debt group.

Jason started his career at Partners Capital, a private investment office serving endowments and UHNW investors, where he also covered private markets investments. Jason graduated with a degree in Physics from the University of Bristol and is a CFA charterholder.

Martyn MacDonald

Senior Investment Associate, XPS Investment

Martyn is an Investment Consultant who has been working at XPS Investment for 4 years, having joined as a graduate in 2020. Splitting his time working on a wide variety of DB/DC consulting projects and sitting on various investment research teams, Martyn is a key member of the XPS ESG research team and sits as deputy head of Credit, focussing on Private Debt.

Prior to entering the investment industry, Martyn, originally from the Isle of Skye, studied Aeronautical Engineering at the University of Glasgow, and now also spends much of his time outside of work focussing on music.

Punil Chaubal

Insurance Investment Advisory Leader, WTW

Punil is the Insurance Investment Advisory Leader at WTW. He leads a team of over 20 dedicated insurance investment professionals advising on over $500bn of assets globally. His team are committed to supporting insurers consider their investment strategy, strategic asset allocation and portfolio implementation.

Punil has over 13 years of experience and joined WTW in 2022, working with insurance companies globally. Prior to joining WTW, Punil supported numerous UK and European insurers with management of investments, capital and sustainability risks.

He earned a BSc in Mathematical Science from City University and an MSc in Actuarial Science from Heriot Watt University.

Steve Hickey

Investment Consultant, Apex Group

Steve is a CFA Charterholder with vast manager research experience across the key public and private asset classes utilised by institutional investors. He is also skilled at advising clients on strategic investment matters, including asset allocation, portfolio construction and implementation. Prior to joining Apex, Steve worked at XPS Pensions Group where he was a senior consultant and head of their credit research team.

APEX

Stephan Breban

Head of Research, Renewity

30 years advising pension plans on private equity investment and GP/fund of funds selection.

Stephan started out with Bacon & Woodrow (now Aon) in London in 1988 covering private equity manager research and selection. After working for different larger pension plan consultants Stephan decided to strike out on his own to provide a conflict free service to institutional investors. Throughout his career he has advised pension plans, and other institutional investors, on a range of investment issues but, focused on private markets.

renewity

Rapidly Scaling Renewable Energy Investing

In attendance

Brendan Maton (Moderator)

Director, Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.

Sean Thompson

Founder & Director, cio investment club

Sean has nearly 40 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

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