Whitepaper 2022

The Case for *Credit*

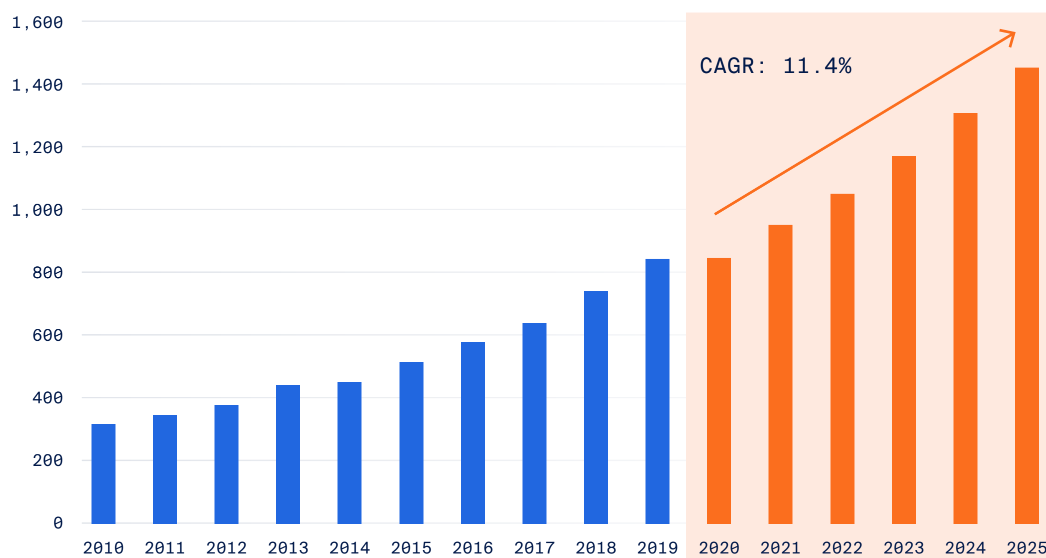
Moonfare®

1. Private Credit - ‘flexible’ and ‘complementary’ asset class

The rise of private credit assets under management is by no means unexplained: as an asset class, it encompasses a wide spectrum of risk and return as well as capital appreciation and yield generation profiles. Simply put, Private Credit is lending to private companies, by non-bank entities (typically Private Credit funds), in bilaterally negotiated arrangements between the lender and borrower, based on the specific requirements of the borrowers.

Figure 1:

PRIVATE DEBTS ASSETS UNDER MANAGEMENT ($BN)*



* 2020 figure is annualized based on data to October. 2021-2025 are Preqin’s forecasted figures.
Source: Preqin

Among many reasons to invest, 36% of investors have chosen private debt for a reliable income stream and 37% for its high risk-adjusted returns, according to a survey conducted by Preqin in their 2022 Global Private Debt Report.

Portfolio benefits

There are a number of compelling reasons to consider investing in private debt with regards to portfolio construction considerations. These can be broken down into the following main aspects:

- **Diversification**
  Credit is the most widely used diversifier in an equity investment portfolio, due to its ability to provide contractual returns, ability to generate a steady income, and mitigate volatility in equity markets. Traditionally, investors have sought this diversification through the public credit markets, by lending to public companies that can issue bonds to investors.

  In recent times, due to the diminished returns registered in public fixed-income markets and to a generally lower interest rate environment, private credit markets have become an interesting proposition. Investing in private credit funds to access these underlying loans can provide significantly higher returns to investors with the same diversification benefits as public credit, provided that the investment's holding period is not an issue.

- **Attractive risk-adjusted returns profile**
  Many investors tend to compare the returns of Private Debt with Private Equity returns due to the illiquid nature of both asset classes. According to Preqin, over 2009-2018, Private Debt funds had a median net IRR of 9.4%, and a standard deviation of 12.8%, significantly less exciting than private equity returns of 17.7% and venture capital returns of 22.0% over the same period.

  We would contend however, that due to the difference in risk-return spectrum positioning and in value drivers between the two asset classes, together with the non-correlation of credit in general to equity markets, it is more sensible to compare private debt against public credit markets. Private debt returns' ranges are considerably higher than that of public credit, even when compared to the high-yield issuer market in the US and in Europe (4.4%[1] and 2.5%[2], respectively).

  Private debt includes a wide range of strategies from direct lending and mezzanine strategies, to higher risk-return non-performing credit strategies. Respective IRRs in the range of c. 6-12% for corporate private credit strategies are both reasonable and attractive, when considered in relation to the risk being taken in private markets. In fact, by way of example, during the period 2001 – 2016, the market registered an annualised loss rate of 0.70%[3], seen as quite low, especially when compared to other higher-risk investment strategies.

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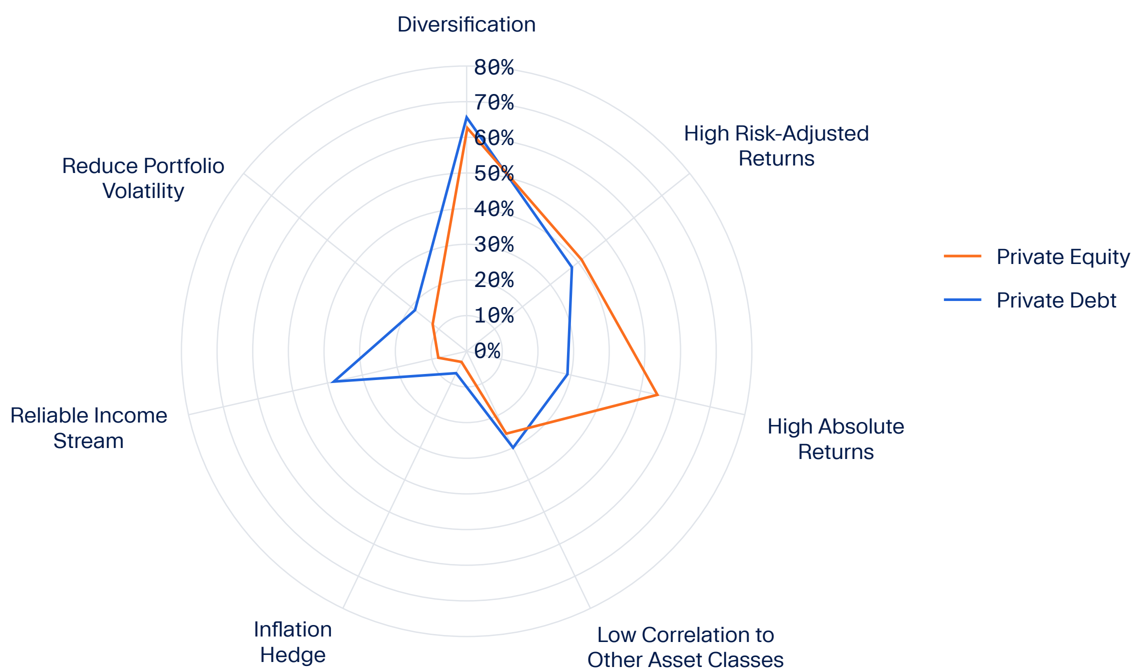
[1] BofA ML US HY Effective Yield (FRED Economic Data as of 31st March 2021
[2] BofA European HY Effective Yield (FRED Economic Data as of 31st March 2021
[3] Market loss data retrieved 22nd October 2020 from CEPRES. Based on annualised realised loss rates of all European subordinated debt within: Computer/Technology, Healthcare/LS, Consumer Industry, Industrials, Others/Unspecified, Financials with investment year 2001-2020. Realised investments only. Sponsored investments only. Data period from 2001-2020. 2017 – 2020 data not available/not meaningful from CEPRES.

- **Income yield, and reduced overall volatility**
  Credit as an asset class is more resilient during economic downturns relative to equity, as most credit strategies tend to sit lower on the risk-return spectrum than equity. Additionally, a significant portion of the returns are contractual, allowing a private credit portfolio to generate income yield. In turn, this provides an additional 'smoothing' effect to portfolio returns over a cycle.
  As public markets become increasingly correlated (as shown most recently during the pandemic), the illiquid nature of private investments, with capital locked up for a number of years, provides a natural hedge against overly volatile market movements. For this reason, sellers are not forced to sell in a short-term down market.
- **Inflation hedge**
  Rising interest rates, and rising inflation, are generally bad news for traditional debt instruments. While traditional fixed income investors may find it difficult to obtain similar returns given the current rising rate environment, private debt typically consists of floating rate loans, which can be resilient to inflationary pressures and can help hedge against rate risk.

Figure 2: Institutional Investors' Main Reasons for Investing in Alternative Assets



Source: Prekin
https://www.preqin.com/academy/lesson-4-asset-class-101s/private-debt

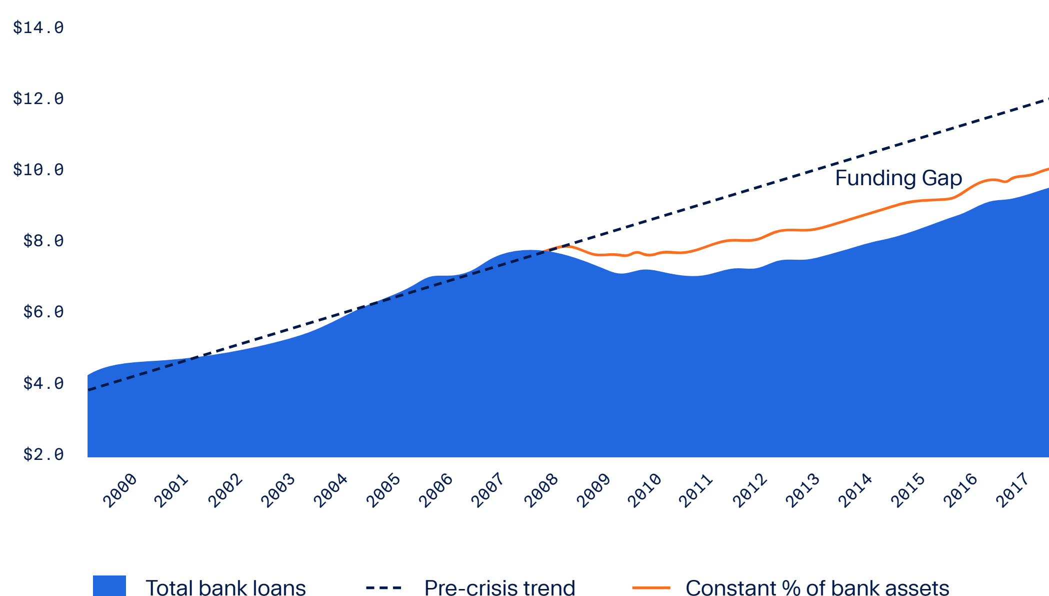
2. What is Private Credit? An overview

Private debt is by no means a new phenomenon (lending is as old as money itself), however, the asset class as we now know it has experienced unprecedented growth since 2009, going from $320bn in 2010 to $875bn at the end of 2020 [Preqin]. This has meant that, by assets under management, it is now the third-largest asset class in the alternatives space, after private equity and real estate (though it is still dwarfed by the public corporate bond market, which is over $10tn in the US alone). Furthermore, Preqin forecasts an 11.4% compound annual growth rate from the end of 2020, which would take the total AUM to nearly $1.5tn in 2025.

Why has private debt grown at such a rate?

This mainly comes down to the 2008-2009 global financial crisis. Sweeping regulatory changes that were applied in the aftermath of the market turmoil required that the banks, who provided the majority of direct lending to companies, were no longer able to hold the same levels of exposure on their balance sheets while adhering to Basel II capital requirements.

Figure 3: Alternative lenders fill the funding gap left by banks post 2008



Source: World Economic Forum, Rice University's Baker Institute, FDIC

At the same time, extensive post-crisis quantitative easing implemented by central banks globally drove down yields in public bond markets. As investors have rotated away from traditional low-yielding instruments, they increasingly focused on private debt. The total assets under management and number of firms dedicated to the strategy as a result outpaced many other areas of investment.

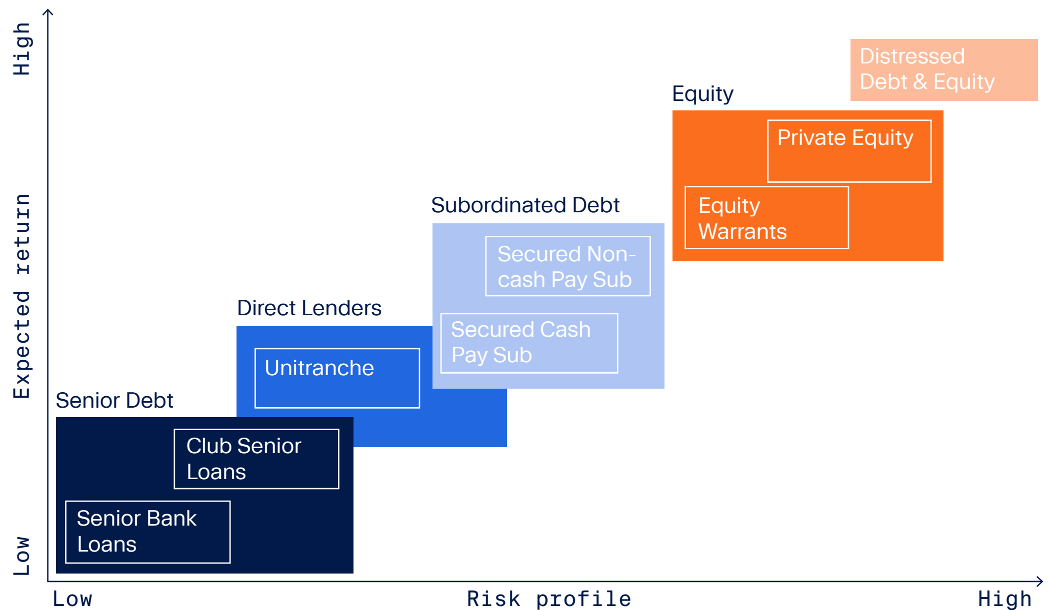
This rotation in turn fuelled a major expansion in a number of different lending strategies which fulfilled the requirements of borrowers, especially in the lower to upper middle market space, as well as investors seeking to take advantage of the yield premium on offer over public markets. These types of investments included vanilla direct lending, as well as a number of riskier, and more niche strategies.

Different forms of private debt

There is a wide-range of strategies that fall under the umbrella of private debt. The chart below includes the range of Private Credit strategies available to corporates. Private credit also includes other strategies including infrastructure and real estate debt, as well as more derivative instruments such as CLOs/ CDOs, which are out of scope for this introductory paper.

STRATEGY	DESCRIPTION	UNDERLYING INVESTMENTS	TARGET ANNUAL RETURNS
Direct lending	Largest slice of the private credit market by AUM. Direct lending consists of senior and junior loans made directly to companies, with lenders often choosing to specialise in particular industries and/or geographies.	Senior debt	4-7%
Specialty lending and credit opportunities	Opportunistic investments across the capital structure, which may relate to a specific situation at a company, such as a debt refinancing.	Variable - often focused on senior debt at companies in difficulty, or subordinated debt at stronger companies	6-12%
Mezzanine	Junior debt provided via loans, often in order to finance	Subordinated debt, usually only senior to equity	8-13%
Distressed	Purchase of loans and other assets of companies that are either bankrupt, or on the verge of bankruptcy.	Distressed	12-20%

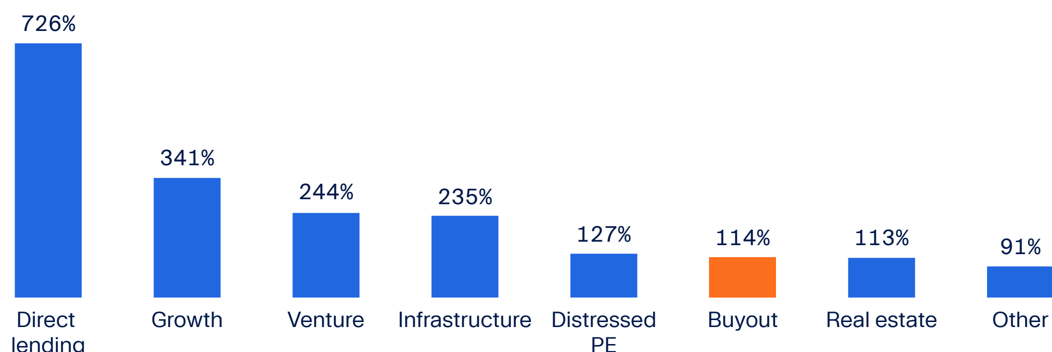
Figure 4: Risk/Return of Private Credit Strategies



An expected net return range can be attributed to each of these strategies (and where applicable, sub-strategies), relative to the amount of risk being taken. Direct lending, typically at the very top of the capital structure, sits at the lowest end of the risk spectrum, and typically has a low-to-middle single digit expected internal rate of return (IRR). On the other hand, distressed debt can in some cases exceed the returns associated with private equity, though such gains must be reconciled with greatly elevated levels of risk.

Private credit and private equity have many benefits in common. The privacy element ensures that companies are able to shield their finances (which would otherwise have to be disclosed) from competitors, while managers are able to have closer relationships with the companies they are lending to. Investors willing to set their money away for many years are able to benefit from the stability that is afforded to managers with such investment terms. These factors contribute to the widespread success that the asset class has experienced over the last decade.

Figure 5: Growth in dry powder. 2020 vs 2010, by fund type



Source: Preqin, Thomson Reuters, SPACInsider

3. How to incorporate private debt into a portfolio?

Investors have turned to private markets in search of higher yields amidst low interest rates and high stock valuations. Private equity, in particular, has been sought by individual investors for its compelling target high returns. We argue that private debt can be a good addition to a mature portfolio inclusive of private equity for its lower volatility, diversification benefits and downside protection offered through the attractive risk-return profile, and income generating abilities of the asset class.

Private debt fund managers are able to apply a number of criteria to help ensure the stability of the loans that are being made as part of their due diligence and ongoing monitoring. These include:

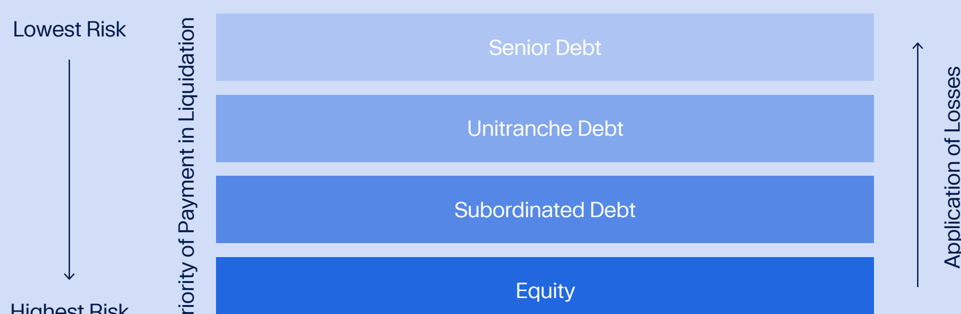
- Choosing strong businesses, often in defensive (i.e. non-cyclical) industries, for example B2B subscription-based software, private education services or healthcare technology.
- Identifying stable companies, relative to their peers, with proven recurring revenues, low capex and strong corporate cultures or values (including ESG).
- Ensuring portfolio diversification: monitoring, and in some cases limiting, oversized exposures to any one industry, geography or individual company.
- Partnering with reputable private equity sponsors, with proven track records, to ensure that the borrower's equity cushion is as robust as possible.

A strong pedigree as a credit manager is also essential. Ideally, senior team members will have had experience in managing debt relationships over a number of credit cycles in order to be able to build portfolios that can weather, or in some cases profit from, economic downturns. A stable infrastructure to execute and manage the loans is also important - having the right organisational set up, as well as sufficient capital to be able to offer competitive loans in both size and pricing to borrowers, without compromising the quality of the lender's portfolios.

There is a compelling case for private debt to be included in portfolios alongside traditional private equity holdings. It is particularly suitable for more mature portfolios which have less of a focus on capital appreciation, as cash returns are generated on a shorter time horizon compared to private equity. The attractiveness of the added diversification that private credit's returns bring to a portfolio, coupled with access to well-seasoned managers with proven track records, mean that Moonfare is in prime position to offer you privileged access to this important part of the private markets universe.

Subordinated debt

Capital structure is how a corporation finances its operations that includes different levels of debt and equity. This structure, then, determines the priority of payment in the event of liquidation and, thus, the risk and return of each level. Equity holders are essentially “owners” of the companies - receiving the bulk of the upside when things go well, but equally being the last to receive any payments in the unfortunate event of a liquidation. Senior debt holders on the other hand are the first to receive payouts in adverse circumstances, but as described above in the returns chart, take a significantly lower return in exchange for this security.

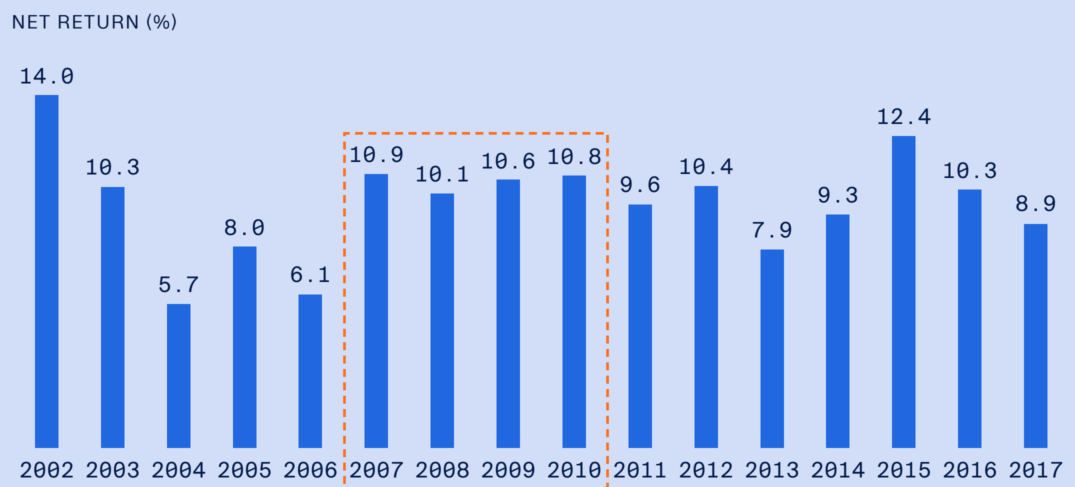


Once the case for private credit is made, then the next is choosing where to focus on the capital structure. While the largest slice of the debt market is in direct lending - senior and unitranche loans made directly to companies - we, at Moonfare, believe the current market conditions have made the subordinated debt segment attractive on a relative basis for retail investors. We see subordinated debt as quite attractive since:

- It is not a crowded market as the senior debt / direct lending segment is. The latter represented c.58% of Private Debt Fundraising in 2021 according to Preqin. This leads to a generally higher level of competition, and lower returns, as firms compete on loans’ pricing and potentially have to find compromises on covenants and collaterals, to be more competitive against peers.
- Given the high amount of capital focused on senior lending, there is more opportunity in the Subordinated Debt segment for a manager to search (and be rewarded) for finding special or complex situations. These can be easily resolved through the manager’s specialised skills, in terms of being able to structure bespoke loans to suit the lender, or to rapidly respond thanks to a deep understanding of the company’s needs. This can be done without compromising on the downside protection metrics that are so important in capital preservation strategies like Private credit.

Further to this, as shown below, subordinated vintages from periods of financial stress have proven to perform well. As the global economy adjusts and recovers from the Covid-19 pandemic, subordinated debt is a good place to be. The returns of subordinated debt are also attractive relative to senior direct lending, especially when considering the impact of income tax.

Figure 6: Average Subordinated Debt Fund Returns[1]



[1] Data period from 2002-2017 showing weighted net fund returns. Subordinated Debt universe consists of global mezzanine with vintages 2002-2017. Performance for funds with vintage year 2018-2020 not yet available. Data retrieved 21st October 2020. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of future results.

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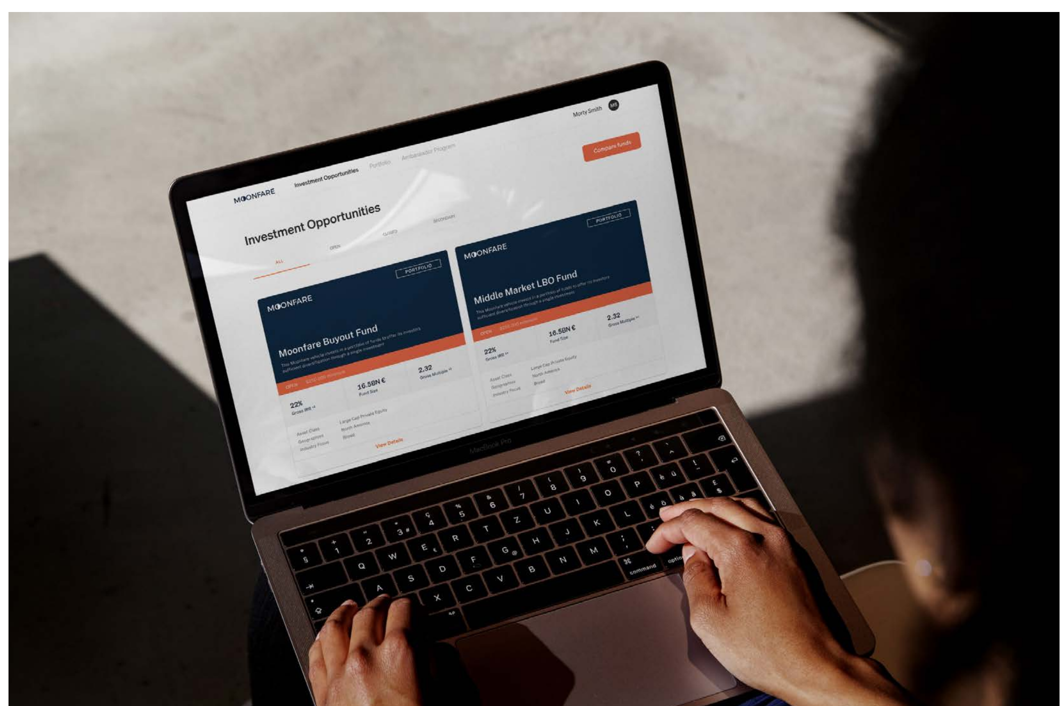

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