Private Debt in an Institutional Portfolio

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Background

Over the last few years, institutional investors have been increasing allocations to return-seeking fixed income strategies and illiquid alternative assets. In doing so, the level of portfolio sophistication within both allocations has also been increasing and roles within the portfolio get more explicitly defined. Some investors are looking for higher yield, some for more diversification and some taking opportunistic positions resulting from market dislocations. Consistent with this development, one of the investment opportunities that Mercer has highlighted over the years has been private debt; as an asset class that we believe is attractive on risk-adjusted grounds, which can play different roles in the portfolio context and directly plays into the financing void which has arisen post the global financial crisis. Private debt is similar to a loan in that it is capital provided (as an investment) to an entity in exchange for interest (and possibly other payments) and the return of the original principal at a defined point in the future. The debt is typically secured and has various protections/covenants in place. The debt is also not widely held, and is customised to the borrower's requirements, thus rendering it illiquid. We note Private debt strategies investments have existed for a number of years, but were for a long time the preserve of a minority of investors of whom banks were the most significant. Today, private debt is an asset class increasingly considered by a broad range of institutional investors.

Although we see private debt as, first and foremost, a return opportunity, a degree of diversification with more traditional credit exposures can also be expected. Private debt encompasses corporate debt, real estate debt and infrastructure debt, as well as some opportunistic credit strategies. For each form of debt, exposure could be via senior loans or subordinated/mezzanine loans. Issuers may be investment grade, but on the whole the private debt market is sub-investment grade and similar in some regards to the syndicated/bank loan and high yield markets, but typically with higher yields, additional return sources and different market dynamics.

Introduction and Classification

The attractiveness of the private debt market is often linked to the aftermath of the global financial crisis, overleveraged banks, shrinking balance sheets, and the impact of international banking regulation on banks' lending activity. While there is a positive tailwind from the changed market dynamics (particularly in Europe), we believe there is a strategic role for private debt in institutional portfolios.

With the long-term nature of liabilities, pension funds and other institutional investors are in a position to offer liquidity to the market and thereby realise an illiquidity premium. Considering the attractive return potential of private debt, it is one manner in which investors can diversify from equities and yet maintain a similar level of expected return.

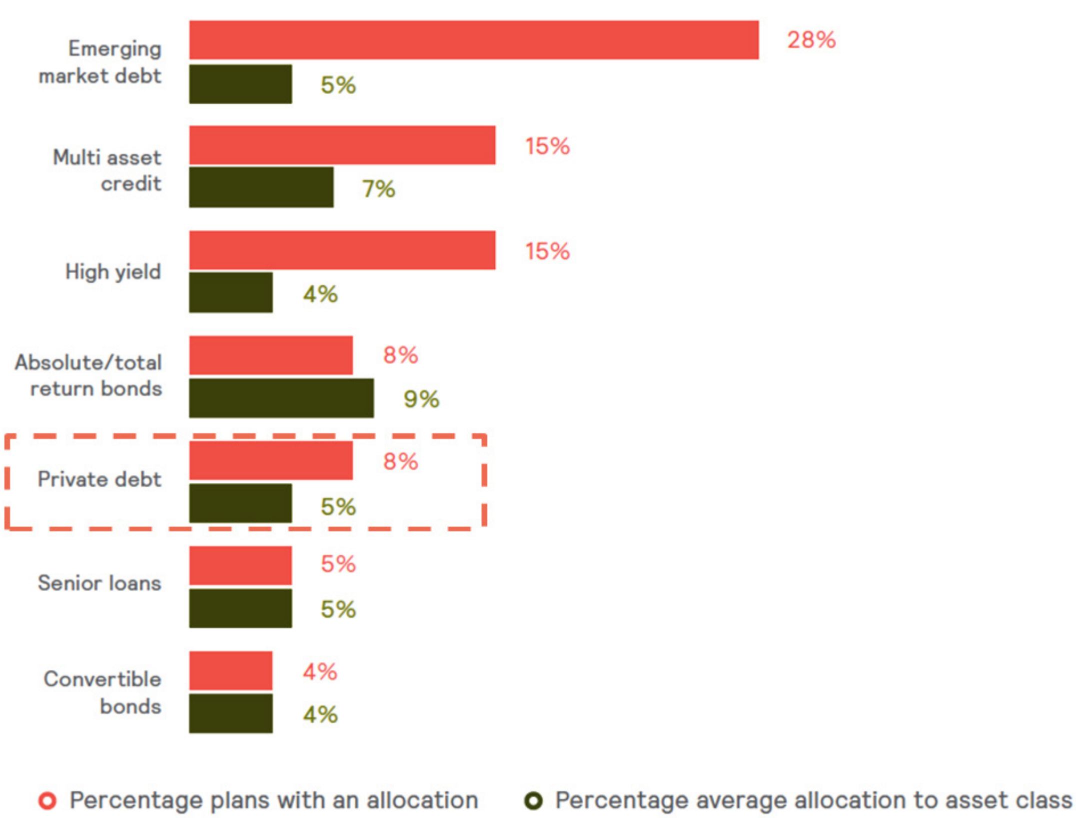
Depending on how a private debt portfolio is constructed, it could qualify for different allocation categories in an institutional portfolio. Private debt portfolios are typically seen as a complement to existing return-seeking fixed income allocations, also called "growth-oriented fixed income". Subordinated (and some senior) private debt strategies with significant equity upside might also qualify as a complement in the private equity allocation or investors might implement this as a broader private markets allocation (across private equity, private debt, infrastructure and other real assets).

While the institutional interest in private debt is steadily growing, the proportion of European institutional investors with a private debt allocation is still relatively low, based on Mercer's Asset Allocation Survey 2015. Within the "growth-oriented fixed income" allocation private debt is competing with a broad set of fixed income categories but in particular with high yield bonds and senior loans (referring to syndicated, senior, bank loans) as more liquid options in the leveraged finance sector. The allocations are, however, not far behind the proportion invested in private equity (which is not shown in Exhibit 1 but stands at approximately 11% with an allocation and at an average of approximately 5%).

The table in exhibit 2 shows that private debt offers several advantages over high yield (incl. floating rate, lower mark-to-market volatility) or senior bank loans (incl. higher returns, prepayment protection) and also often stronger covenants and better information/monitoring rights. This comes however at the price of lower liquidity, access via closed-ended funds, and the need for more resource-intensive implementation and monitoring processes.

In an environment of low yields, extended equity bull markets and where many assets (across equity and fixed income markets) remain volatile and sensitive to market sentiment, we believe it is worth exploring a private debt allocation in more detail.

Exhibit 1: Strategic Allocation to Growth-oriented Fixed Income*



**Growth-oriented fixed income is a category, which includes fixed income assets and strategies expected to generate returns in excess of government bonds and investment grade credit.*
Source: Mercer

Exhibit 2: Private Debt vs. High Yield Bonds vs. Senior Bank Loans

Characteristic	Private Debt	High Yield Bonds	Senior Bank Loans
Instrument	Loans (kind of contract)	Bonds (securities)	Loans (kind of contract)
Coupon structure	Mainly floating (Libor + X%) (US Mezzanine often fixed rate)	Fixed rate (Y%)	Floating (Libor + Z%)
Prepayment option	Yes, often with penalties for the borrower	No	Yes
Arranged by	Investment Managers	Banks	Banks
Liquidity	Low	Moderate	Low to moderate
Strategy	Active sourcing, then Buy and Hold	Active portfolio management	Active portfolio management
Typical positions per fund/portfolio	15-30	80-120	100-150
Market volatility	Low	High	Moderate
Typical target return (2015)	Senior 6-8%, Unitranche 8-11%, Mezzanine 11-16%	4.5-6.5%	4.0-5.5%
Recovery in default	Depending on seniority, but typically secured	Low (unsecured)	High (senior secured)
Sources of return	• Libor • Credit spread • Credit research (avoiding defaults) • Illiquidity premium • Arrangement fee	• Credit spreads/coupon • Credit research (avoiding defaults) • Upgrades/price moves • Interest rate risk	• Libor • Credit spread • Credit research (avoiding defaults)
Implementation	Typically investment in Limited Partnership	Typically segregated account or institutional pooled funds	Typically segregated account or institutional pooled funds

Source: Mercer

Private debt can be classified into a number of different sub-categories. The three most common methods are by seniority in the capital structure (senior, subordinated, unitranche), the type of lending transaction (corporate, infrastructure or real estate) and geography (North America, Europe, Asia/Emerging Markets). This allows the defining of expected target returns; although exceptions might apply for specialist/niche strategies.

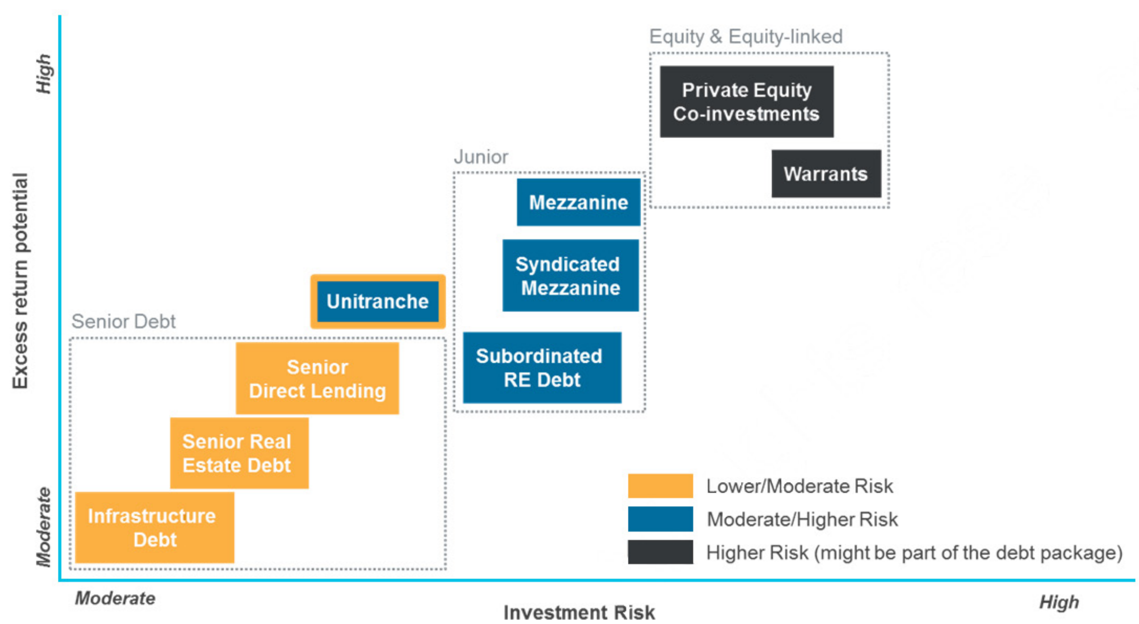
The broad private debt universe allows investors (who have some tolerance for illiquidity) to structure a portfolio that meets their individual risk/return objectives, to realise an illiquidity premium and to benefit from further diversification.

Implementing a Private Debt Allocation

Compared to traditional asset classes and most other growth-fixed income categories, the private debt implementation process looks different and operates more in line with the implementation of private equity allocations. Private debt funds are typically less diversified (by number of positions) than senior bank loan funds so it is in the hands of investors to ensure adequate portfolio diversification exists.

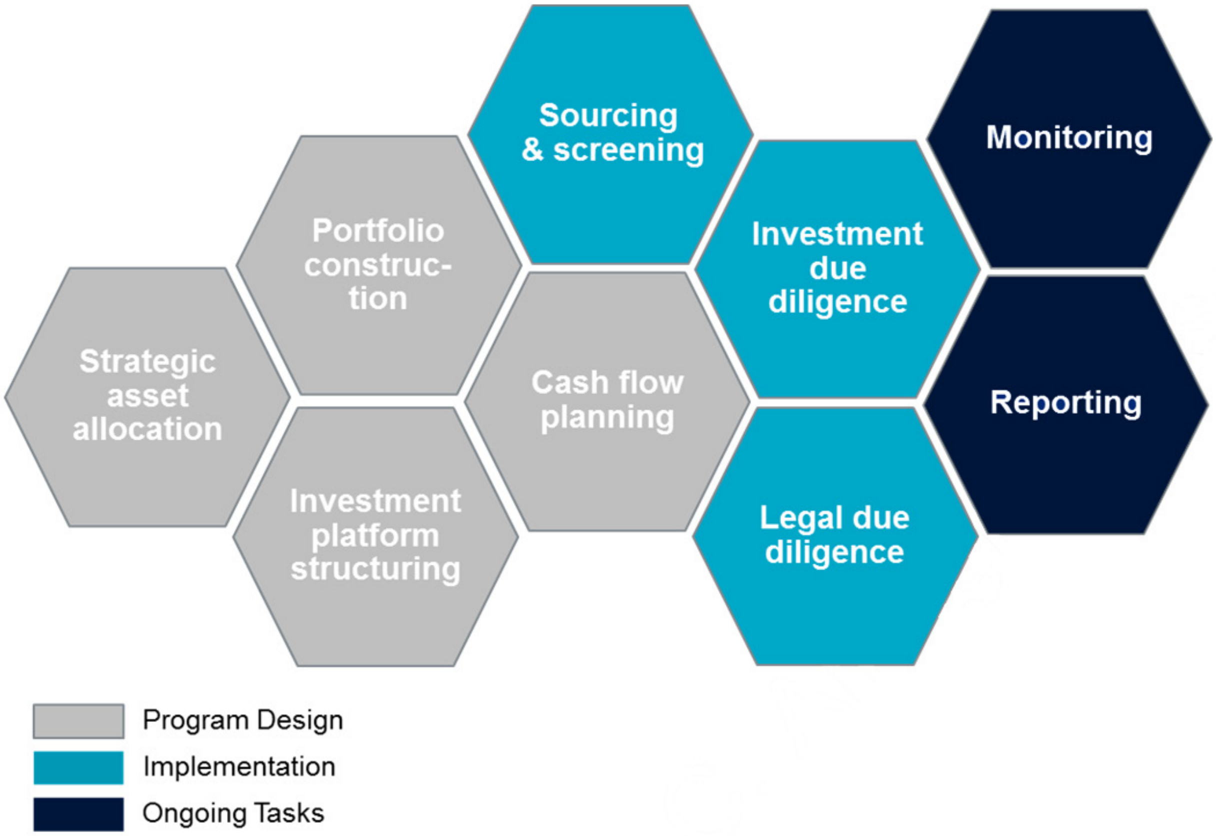
Private debt managers only accept new monies during their fund-raising periods and then call/invest the committed capital over the following years. Therefore, it will take time to allocate capital

Exhibit 3: Private Debt Risk/Return Levels by Category



Source: Mercer

Exhibit 4: Private Debt Investment Process



Source: Mercer

to a set of high quality managers, and it will take additional time until they have invested the committed amount (i.e. a high quality private debt portfolio cannot be invested overnight).

These factors have to be reflected in investors' strategic allocation planning and investment process. Many steps of the process are actually linked and should be considered in the overall context.

Program Design

Strategic asset allocation process

For many institutional investors, it can be challenging to consider new asset classes in their strategic asset allocation (SAA) process. While the SAA process is typically beta driven, when allocating to private debt investors should also be mindful of the implementation and portfolio construction considerations and the impact it can have on the SAA. We believe this is also true for other asset classes that have a significant part of the return influenced by alpha. This is because the risk levels of selected strategies can vary significantly between managers depending on their investment style.

As for other private markets, there is not one right, straightforward way to include private debt in the SAA process. The challenge is that three simple inputs (return, risk, correlation to other asset classes) have to be set to describe a complex asset class that doesn't have reliable, observable monthly return data to derive a return pattern. Additionally, institutional investors have to decide whether the risk assumption should reflect the fundamental risk (typically used) or the expected, visible mark-to-market volatility (which is typically quite low and represents an accounting perspective).

The SAA assumptions have a strategic nature (10+ year horizon) and represent the expected market performance. The assumptions therefore only hold for diversified private debt portfolios. Exposure to one manager with a portfolio of 15-30 loans bears material idiosyncratic risk, and this would not be an optimal approach to implement a strategic allocation.

The selected strategic return assumption is a key input, which will guide the portfolio construction and investment process at the next stages. A main consideration here is whether the focus should be on a steady yield with moderate risk (mainly senior private debt) or on higher growth potential and equity upside with an increased risk profile (focus on subordinated debt or opportunistic senior strategies).

To justify the implementation effort and to generate a meaningful contribution to the total portfolio, target allocations between 5% and 10% appear reasonable. Investors should, however, be mindful that it will typically take around 3-5 years to build up a robust private debt allocation; ongoing investments then have to be made to keep that allocation at the targeted level.

Portfolio construction and investment platform structuring

Once an allocation level is set, investors have to think about constructing an optimal portfolio structure to meet their targets. As for other asset classes, diversification is key to managing periods of market stress and surviving extreme events. We generally argue for a well-diversified portfolio. In the private debt case, several investor specifics must also be considered:

- Category: Corporates vs. real estate vs. infrastructure
- Seniority: Senior vs. unitranche/mixed vs. subordinated
- Region: Europe vs. North America vs. Global
- Currency: Often linked to regional allocation
- Managers: Optimal number and consideration of managers' fundraising schedules
- Deals: Number of, and diversification across, underlying deals
- Time: Diversification by vintage year
- Market: Opportunities and outlook

Category & Seniority: Both are linked to the investor's targeted return. Infrastructure debt and real estate debt have on average lower target returns (typically in line with their lower risk). Senior debt fits moderate return expectations while subordinated strategies target returns closer to/higher than equities. The recent development of the unitranche segment in Europe or a mix of senior/subordinated funds allow for a more balanced portfolio profile. Investors should consider the actual investment universe early in the process. The numbers of available debt providers globally vary significantly across categories. There is a large universe of corporate private debt managers, while the universe is smaller for real estate debt and infrastructure debt.

Region & Currency: Both are linked as most managers do not offer currency hedged share classes. It is therefore often the investor's responsibility to seek a hedging solution or alternatively accept the currency risk. North America and Europe are the two major markets; while North America is deeper and more institutionalized, Europe is evolving at impressive speed. Both markets have their own dynamics and are generally worth combining as different economic cycles drive asset values and default rates over time.

Managers & Deals: The spread of outcomes between top quartile and bottom quartile managers in the private debt universe can be high. This can be driven by different risk/return profiles, but also the quality of the managers (deal sourcing and credit analysis capabilities). Therefore extensive manager due diligence is key to understanding the actual strategy profile and quality of the manager. In any case, diversification by number of managers/strategies should be a core principle when building a private debt programme. Even for lower risk private debt programmes the impact of defaults can be material given the concentrated portfolios (often in the range of 15-30 underlying deals). Spreading exposure across individual loans is the most important way of controlling the asymmetric return profile of single deals (loans have capped upside, but the potential risk of a full write off).

Time & Market Opportunities: Individual managers typically operate closed-ended fund structures, coming to market every two to four years. Building a private debt programme with regular commitments is an approach designed to target specific top managers as they come to market. This is the best way to access top managers whilst diversifying across deals, tilting the portfolio towards opportunities or the target allocation. Vintage year exposure ensures diversification by time and is also integral to reaching a stable private debt allocation. It also helps to overcome single disappointing years with low deal activity, tight pricing or increased number of defaults; factors which influence returns but can only be measured with hindsight.

Cash flow planning

Cash flow and commitment planning is important when building a strategic private debt allocation. It facilitates structured diversification across vintage years (allowing for expected capital calls and distributions), stronger ability to allocate to high quality managers, and also to tilt the portfolio towards attractive markets. Regularly committing to private debt will also enable investors to maintain a steady target allocation to the asset class. If a commitment is only made to private debt every couple of years the overall amount invested in private debt will go through peaks and troughs, and the investor may rarely be at a point where the overall target allocation is reached.

Implementation

Fund Sourcing and Due Diligence

A thorough due diligence process is one of the most important elements of the private debt investment process. Unlike in the traditional fixed income world, there is no reference benchmark managers aim to replicate and the concentrated portfolios increase credit risk and the impact of single defaults. The outcome of private debt strategies will therefore vary significantly depending on the strategy profile (investment universe, concentration, subordination, etc.) but also credit analysis skills, default protection or restructuring experience of the managers. A detailed due diligence exercise should disclose whether lower performance results are consistent with lower levels of investment risk, weak implementation or excessive costs (for example, traditional senior loans should yield lower returns than mezzanine portfolios).

A thorough manager due diligence process should cover several dimensions. For example, strategy profile, experience of the investment team, resources, sourcing capabilities, credit expertise, track record, current opportunity set, attractiveness of fund terms and legal/tax aspects.

If the strategy passes the initial strategy review, the next objective is to figure out if the manager is able to deliver the target return and also if it is well positioned against peers in that market segment. Those details are covered in the actual due diligence process, which should combine a qualitative and quantitative assessment. The focus should always be the specific fund/strategy; established firms might offer mediocre/weak strategies, move into new segments or offer unattractive fund terms.

One key element assessing the quality of a private debt strategy is the experience of the investment team. Important to consider is that direct lending is a relatively young segment in Europe and therefore not many managers will tick the box for a 10+ year performance track record. The focus should therefore be on adequate experience across the team –often a mix of direct lending experience, mezzanine investing, levered finance and credit analysis backgrounds. As sourcing attractive deals is an important element of any successful strategy, there should be members on the team that can demonstrate a strong deal sourcing network (with access to non-competitive opportunities) and have actual experience structuring and underwriting deals.

With the growing universe and increasing competition in the market, the sourcing network is a critical differentiator. While on paper the deal sources appear similar across managers, the true quality can be quite different. Strong sourcing capabilities require resources and an adequate team size is an imperative; local people on the ground or native speakers can provide a competitive edge. The actual breath and quality of deal channels can further be verified by reviewing the deal history on a case by case basis (deal source – sponsor, advisor, bank etc.; number of different counterparties, primary vs. secondary opportunities, role in each transaction – lead, co-lead, follower; attractiveness of negotiated terms, pre-payment protection, leverage, defaults, recovery ratios, etc.). If the firm/strategy history is short and the overall setup nevertheless looks attractive, one might look at the personal track record of selected senior people or related activities (e.g. mezzanine or smaller senior loan transactions).

Credit expertise (main focus for senior) and operational experience (esp. for deals with significant equity exposure or higher restructuring risk) are also highly important. Most credit reviews follow a similar blueprint across most private debt managers – in particular for sponsored deals (deal team reviews due diligence package, discussion with the investment committee at several stages, building of models, stress testing, benchmarking vs. industry peers, background checks, etc.). Differentiation is thus the area of focus.

For managers with a longer history, track records of the predecessor funds summarise all elements in a few numbers (IRRs, multiples, gross and net). Drilling down historical results (e.g. income vs. capital gains, defaults, recoveries) on a single deal basis provides a good understanding of strengths and weaknesses of a strategy/team.

The difference between gross and net results is a good starting point to review the cost and compensation structure. A fair combination of components in the proposed cost structure (management fees, carried interest, adequate hurdle rates) is key to make a good strategy an attractive investment net of fees.

Of further relevance are GP/team commitments, investor rights (no fault provision, a strong key person clause), investment limits and the fund structure in general. Incentive structures and items like carry distribution within the investment team are often linked to the firm/team stability. This is another important layer of analysis considering the longer lock-up period of private debt funds.

Additionally, a legal/tax due diligence is important considering the nature of the closed-ended funds (typically Limited Partnerships). This is a country- and even investor-specific analysis and should typically be performed in cooperation with a local legal advisor reflecting investor's individual tax and regulatory framework.

Ongoing Tasks

Monitoring and Reporting

This should be familiar to most institutional investors and would be expected to cover similar issues investors seek to address for the other asset classes in the portfolio. Such issues include changes with the manager, updates to the fund terms, performance issues, reporting and meeting regulatory requirements.

Unfortunately, our experience shows that this is not as easy for investors to undertake when it comes to private markets, including private debt. Monitoring is long term, time-consuming and often requires investor's to invest more time and resources than initially expected. We often find that private markets measurement and accounting systems might not interface with the reporting systems used for the traditional portfolio holdings. While experienced investors should have the know-how and budget to manage post-investment issues, newer investors may struggle or require assistance.

Going Forward

Private debt investing by institutions has witnessed tremendous growth since 2008 and continues to accelerate. What was once an opportunistic play has become a viable longer term choice for investors as part of the SAA process. However, the allocation needs to be made in a thoughtful manner, recognising the nuances of this asset class and requires more investor resources relative to traditional markets.

As the private debt market continues to grow and managers gain experience, choices will increase, and investors will become more familiar with the private debt market. We thus believe the window for private debt investing will continue to open wider over time, as will the need for increased resources and expertise, for both the implementation and monitoring of the allocation.

It is our view that for investors to succeed in the private debt market, they need to ensure they cover the range of options in the market, establishing clear implementation plans with appropriate diversification, have expertise or support to undertake extensive due diligence and relationships to gain access to high quality managers. Only then will investors ensure their risk-adjusted performance is truly rewarding.

Important Notices

Authors' Bios

Sanjay Mistry, *IMC*
Mercer Private Markets

Sanjay Mistry is a senior member of Mercer Private Markets ("MPM"), a specialist unit within Mercer's Wealth business and has been leading MPM's efforts in the area of private debt since 2009 and sits on the MPM Investment Committee. Based in London, he invests as a portfolio manager in private debt and private equity on a primary, secondary and co-investment basis on behalf of MPM's discretionary funds and delegated clients as well as advising across the full range of private market investment activities for MPM's advisory clients. He began working on private markets portfolios and covering the European private markets industry in 1999. Over the years he has worked with numerous institutional investors, globally, building their private markets allocations, assisting with fund selection, portfolio construction and implementation of such investments and has produced numerous white papers on private markets. Sanjay also sits on a number of LP Advisory Boards on behalf of MPM and MPM clients.

Sanjay has over nineteen years of experience within the investment industry, beginning his career with Mercer in 1998 originally in a wider investment consulting role advising multi-billion $ Government Funds, Pan European endowments and multi-national corporate pension plans. Sanjay graduated from City University with a first class honours Bachelor of Science in actuarial science. He is a member of the Institute of Actuaries and holds the IMC.

Tobias Ripka, *CFA, FRM*
Mercer Private Markets

Tobias Ripka is a Principal within Mercer´s Wealth business. He is the Alternative Investments Leader in Germany and a member of Mercer's Private Markets group. He started to work at Mercer in 2005; over the years he has been advising many clients on investment strategy, portfolio construction, and implementation topics with a particular focus on alternative investments. He was further a member of Mercer's Alternatives Research Boutique responsible for researching private debt and other alternative investment strategies. Tobias holds a master-level degree in business administration from the Justus-Liebig-University Giessen, Germany. He is a CFA Charterholder and also a certified Financial Risk Manager, and completed the private equity post-graduate program at the European Business School, Germany.