WHY DIRECT LENDING?

Straight to the heart of the matter

Different institutions have varying motivations for expanding their allocations to include private debt. Two investment advisors, **Chris Domenghino** from Alpha Associates and Certior Capital's **Ari Jauho**, explain why different investors find European private debt a compelling proposition

Managers will always be eloquent when it comes to telling investors why they should trust them with their capital.

But the real drivers for investment decisions are both profound and shifting. The *Perspectives* survey gives a detailed look into the different reasons investors have for trusting in private debt and shows that direct lending is one of the most popular sub-sectors.

Opportunistic strategies and direct lending are two of the most preferred strategies, but when asked to choose between the two 36 percent of respondents plumbed for direct lending (see pie chart on p. 20).

Narrowing down the responses to just the European investors and direct lending's advantage over other alternative strategies becomes evident (see bar chart on p. 20).

Here we delve even more deeply into the motivations of investors in specific jurisdictions – German pension funds and insurers and Nordic investors – guided by two experts whose job it is to know what will work for their investor clients.

There are themes in common – stubbornly low interest rates and regulatory changes – but each offers a nuanced perspective on a specific market.

*Helsinki-based Certior Capital co-founder **Ari Jauho** advises Nordic investors on private equity and credit investments. Since 2011, Jauho's firm has advised on more than 180 investments and so he has a unique understanding of what Nordic investors need from their managers and what has prompted them to look more closely at this nascent asset class.*

ARI JAUHO WRITES…

Today, European institutional investors face two major problems. The first is historically low interest rates and the resultant almost non-existent returns from traditional fixed-income investments. The other serious problem is the very high volatility of listed equities which causes lack of visibility on annual returns.

That trend has very much continued this year.

There are sources of relief, however, and direct lending offers institutional investors a good compromise between traditional fixed income investments' strong visibility regarding yield and listed equities' higher return expectations. At the moment, with interest rates at historic lows, direct-lending investments provide also a natural hedge against possible interest rates rises, as they are typically floating rate.

NORDIC SOLVENCY

Why are our Nordic/Finnish clients, especially, investing in direct-lending funds?

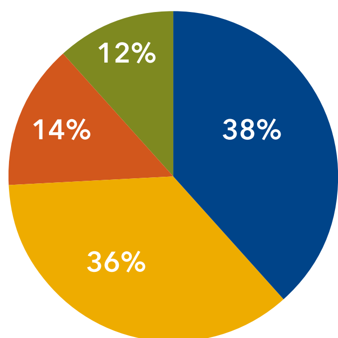
The main reason for Finnish investors, in addition to those above, derives from the solvency capital requirements of life assurance companies (Solvency II) and pension funds. Unlevered direct-lending funds are treated lightly in terms of solvency capital. This is particularly true when there is "look-through" reporting on the underlying assets. To be at their most attractive, direct-lending funds must adopt "look-through" reporting principles.

THE NEW FIXED INCOME

Our clients typically treat direct-lending investments as a part of their fixed income allocation. We also advise on private equity

WHY DIRECT LENDING?

DO YOU PREFER DIRECT LENDING TO OPPORTUNISTIC CREDIT FUNDS?



- No preference
- Yes, direct lending is more attractive
- Not sure
- No, opportunistic credit funds are more attractive

Source: PDI Research & Analytics

and mezzanine investments which, in contrast, are dropped into a broader alternatives allocation. It's an obvious solution as direct lending is, by its nature, fixed-income investing, despite offering variable interest rates.

But this is where the natural fit ends. Direct lending is generally offered through private equity-style closed-ended structures prompting a private equity investment approach. Larger investors typically have different specialists for fixed income and illiquid alternatives. This structure sometimes means the fixed income side is restricted from illiquid investments. This is compounded by the private equity people viewing direct-lending return targets as far too low.

So how are Nordic investors so advanced when it comes to direct lending compared with some other European countries? One explanation is that Nordic investors in general have significant experience in private equity. They are also often more open to new ideas.

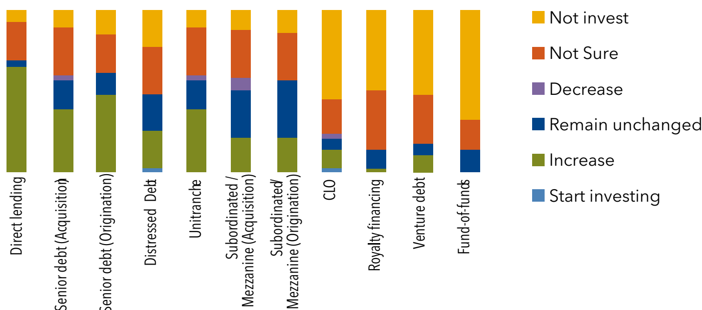
STRUGGLES

There is one major handicap related to investing in direct-lending funds and that is its illiquid nature, both at the underlying loan level and at the fund level. While syndicated leveraged loans offer some liquidity, it is combined with substantially lower returns. Typically, direct-lending funds are closed-end with zero liquidity outside of interest or amortisation payments that are distributed after costs.

Direct lending is also difficult for investors because of its resemblance to Nordic combined skiing. Investors need the mind-set and methodology of a private equity investor in tandem with fixed income expertise. As an example, private equity investors are always looking for the "up-side" and "value creation", whereas in fixed income investors need to focus on downside protection and deployment.

Building up the targeted volume for a direct-lending investment strategy also takes at least three years. Diversification is essential, but in Europe there are a limited number of high-quality lenders fundraising at any given time and you must invest in several funds in order to get a broad enough mix. Of course you can tap into the North American markets as well, but that bears foreign exchange risk for which there is no natural hedge with debt instruments.

INVESTMENT PREFERENCES AMONG WESTERN EUROPEAN LPS



Source: PDI Research & Analytics

THE FUTURE

I personally believe that there is a bright future for direct lending in Europe. Tightening capital adequacy regulations for the European banks clearly increases demand for alternative sources of debt capital. In October, Deutsche Bank revealed €5.8 billion worth of impairments reflecting "higher expected regulatory capital requirements". Banks will inevitably focus on less capital intensive business lines and leave other areas (for this read longer maturity term loans) to alternative lenders funded by institutional investors matched by long-term liabilities.

From Europe's financing system's point of view this match-funding of debt is a healthy development. Assuming there is no leverage in the fund, the vehicle cannot go bankrupt, avoiding asset fire sales and producing a more stable financing system.

*Swiss-based Alpha Associates has advised investors on illiquid alternatives such as private equity and, increasingly, private credit investments since 2004 when it spun-out from the private equity arm of Swiss Life Insurance and Pension Company. **Chris Domenghino** joined in 2008 and now covers all private debt strategies.*

CHRIS DOMENGHINO WRITES…

With expansionary monetary policy driving down returns on traditional yield generating assets, investors with fixed-liability schedules, such as pension funds and life insurance companies, are facing growing challenges in servicing their client obligations. The well-diversified portfolios of mostly fixed-income assets that investors relied on to deliver the necessary returns are failing to do so.

In Germany, for example, many pension funds and insurance companies have material allocations to Schuldscheindarlehen, or domestic senior loans, and covered bonds known as Pfandbriefe. These have traditionally been a stable way of generating running yields that would substantially cover return requirements.

Low interest rates have driven down spreads on newly-issued Schuldscheindarlehen and Pfandbriefe, and these assets no longer generate enough current interest to cover the investors' running liabilities. This is compelling investors to consider structures for which they previously saw no need. What helps in the case of direct lending, in particular, is familiarity. Schuldscheindarlehen are an established form of small- to mid-sized corporate financing, so the asset class itself naturally falls into German investors' comfort-zones.

LENDING LEG-UP

Given this backdrop, investors are opening their eyes to the wider benefits of a well-diversified portfolio of direct-lending investments, including current cash-yields that match portfolio distribution requirements and boost current yields.

"IN DIRECT LENDING, THE J-CURVE TYPICALLY ASSOCIATED WITH ILLIQUID STRATEGIES IS LESS SEVERE AND THERE IS LESS CONCERN ABOUT THE DEPLOYMENT PACE"
Chris Domenghino

In direct lending, the J-curve typically associated with illiquid strategies is less severe (as well as the fee burden being lower) and there is less concern about the deployment pace, which has put off some investors committing to slowly invested private equity strategies. Notably, we rarely hear the negative interest rates on cash holdings mentioned as a concern.

Investors acknowledge the higher risks associated with direct lending compared with traditional investment grade credit. Nevertheless, these concerns can largely be overcome by portfolio diversification and construction, which must be tailored to complement the investor's current assets and risk profile. Our direct lending investors rarely seek to achieve double-digit IRRs, rather tending to seek more predictable and stable mid-single digit returns.

ALTERNATING ALTERNATIVES

Depending on the investors' time horizon, Alpha Associates previously offered clients with fixed-liability schedules a well-diversified private equity portfolio to enhance returns as well as generate diversification benefits. In today's environment, investors' desire for current yield and rapid deployment are no longer best matched by a traditional private equity portfolio.

While the J-curve of a diversified private equity investment programme can be substantial, direct lending offers a suitable solution with its faster ramp up and return generation. In essence, for our clients it becomes a trade-off between interim liquidity versus absolute returns, with many prioritising the former.

Finally, one must also address the regulatory front, which has significantly changed post-crisis not only for banks, but also for the majority of our clients. With regulations still in flux, appetite for illiquid investment strategies, including direct lending, can be limited, particularly in light of the looming introduction of Solvency II.

Increasing capital charges and other regulatory restrictions can make illiquid assets expensive or even impossible for some investors. Others may have already filled their traditional allocation buckets for alternatives (into which direct lending funds often fall), even while they are still in need of better returns.

Fortunately, such hurdles can be addressed by appropriate product structures, which for many investors now bear equal importance with the merits of an investment strategy and manager quality. At Alpha Associates we focus on innovative structures that enable our clients to benefit from direct lending exposure while adhering to increasingly stringent regulatory requirements. ■