Asset Class Investment Strategies

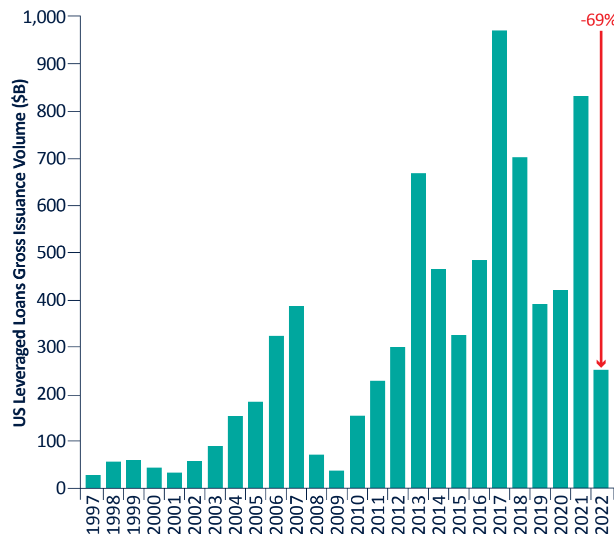
Private Debt

Major Trends

Constrained capital availability creates a compelling opportunity set for private lenders. Banks have reduced lending activity in the face of higher capital requirements, increased loss reserves and lower deposits. Meanwhile, US leveraged loan issuance declined 70%[1] year-on-year in 2022 to the lowest level since 2011 amid reduced demand from collateralised loan obligation (CLO) buyers, constraining access for issuers to public debt markets. These market dynamics leave limited financing options for sponsors and corporates looking to raise debt capital for acquisitions and refinancing, with private lenders now stepping in to fulfil the needs of often higher-quality issuers.

Exhibit 1

US leveraged loan issuance declined by 69% in 2022 compared with the prior year

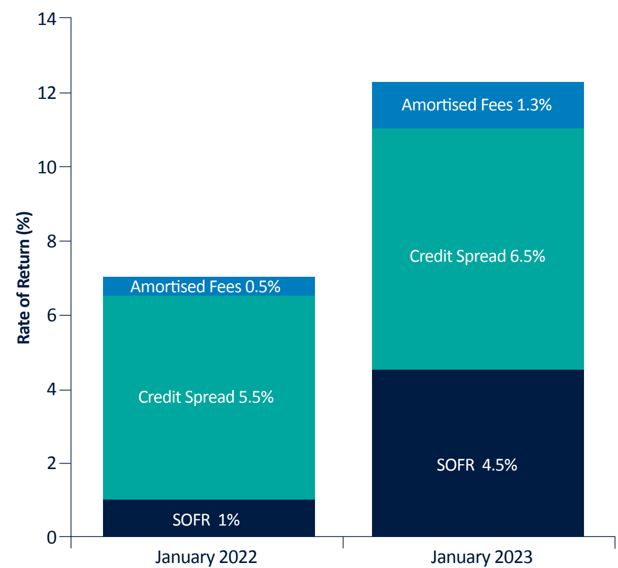


Source: *JP Morgan Markets*

Power has shifted into the hands of the lenders. Private lenders have not only benefitted from rising interest rates but, against a backdrop of scarce capital, are able to demand both higher credit spreads and increased up-front fees. Senior loans to cash generative companies which would have generated a ~7% yield in early 2021 are now pricing with yields in excess of 12% (Exhibit 2). This new pricing power also allows lenders to negotiate lower loan-to-value ratios and tighter legal protections and covenants.

Exhibit 2

All-in yields for senior debt have increased by over 5% since early 2022



Source: *Partners Capital Research, Pooled Private Debt Vehicle underlying portfolio funds, Federal Reserve Bank of New York*

Lower valuations and a declining appetite for equity financing creates opportunities in non-dilutive capital solutions. Specialist lenders that are able to offer highly structured financing solutions are taking the place of equity investors in situations where borrowers are seeking to fund growth, M&A, restructurings, or business transformations but would rather not do so with a dilutive equity round. These transactions often comprise a hybrid solution combining senior debt, benefitting from high contractual returns and substantial covenant protection, with an equity interest via warrants which introduces conv exity and enables the lender to benefit from any upside arising from the business transformation.

1 $252B in 2022 vs. $835B in 2021, Source: JP Morgan Markets

Private Debt
continued

Rising defaults could see the first true test of private credit structures. Higher yields and credit spreads reflect the market's expectation of higher default rates in public and private credit. In a more expensive financing environment levered issuers may struggle to service existing debt and face significantly higher costs of capital as they refinance maturing debt. The need for debt restructurings and non-dilutive financing solutions provides an attractive opportunity to generate outsized returns in rescue lending and other capital solutions strategies. These conditions will also test the credit underwriting and structuring discipline of private lenders, which has always been a focus of our asset manager selection.

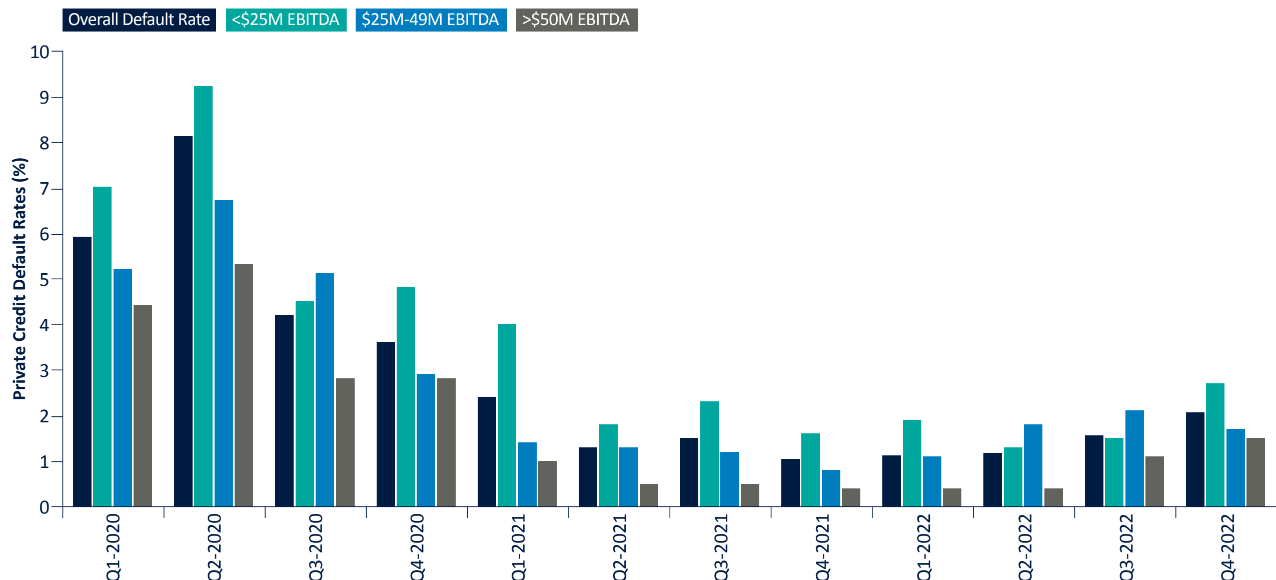
New opportunities in portfolio financing. A more challenging operating and financing environment has driven private equity sponsors to seek alternative sources of capital to support, grow and protect underlying portfolio companies. Opportunistic lenders are well placed to provide senior debt or structured equity financing at low advance rates, collateralised by multiple portfolio companies and benefitting from priority over distributions, at yields in the low teens.

Golden Rules

- Target specialists in niche strategies: specialist providers of capital offering certainty of execution can command a premium due to lower levels of competition and higher degrees of complexity.
- Focus on downside protection: identify and partner with disciplined investors who i) take senior positions in the capital structure, ii) lend at low LTVs and iii) maintain discipline on covenants and documentation. Underwrite investors that can protect capital and have the necessary skillset to directly manage assets in the event of a restructuring.
- Generate alpha through customisation and direct investment: seek structures which offer enhanced discretion, tax benefits, fee savings and customised risk exposures. Partner on co-investments to benefit from more immediate deployment and greater transparency.

Exhibit 3

Private credit default rates started to increase in the second half of 2022



Source: *Proskauer Rose*

- Allocate selectively to uncorrelated strategies: these strategies can offer attractive diversification benefits and resilience in a market downturn. Given their esoteric nature they can pose a unique diligence challenge and it is critical to be aligned with best-in-class managers.

Sub-Strategy Attractiveness

Capital Solutions and Corporate Special Situations: Positive view of lenders with the ability to provide flexible capital to complex situations, restructurings and businesses in transition.

Middle Market Direct Lending: Currently positive view of the strategy driven by attractive pricing and competitive dynamics which may not persist long term, so we favour intermediate-term exposure here. Continue to avoid commoditised strategies with limited credit protection and higher leverage. Favour lenders who maintain a controlling stake in their transactions.

Portfolio Finance: Positive view of a growing opportunity to lend against portfolios of companies with significant commitments from high quality LPs and strong alignment with the managing GP.

Specialist Lending: Positive view. Target sector specialists in collateral that requires expert underwriting (e.g., healthcare, emerging technology, energy transition) where declining equity valuations are creating opportunities to offer non-dilutive financing with embedded equity upside.

Asset-Based Lending: Neutral view. Asset based lending can provide an attractive yield base to a private debt portfolio. However, near-term uncertainty over the strength of consumer lending portfolios and a lag in pricing adjustment for more complex assets vs. the broader market makes this likely to be more attractive in late 2023/early 2024.

Real Estate Lending: Neutral view. Attractive opportunities with senior and mezzanine lending specialists with proven sourcing advantages and the ability to manage assets where necessary. Focus on more opportunistic transactions in an uncertain market environment. Tactical opportunities to add to semi-liquid strategies such as mortgage-backed securities and bridge lending in the event of further dislocation later in 2023.

Distressed for Control: Negative view of long and legally-intensive bankruptcy and recovery processes which culminate in full equity ownership and which can carry a high opportunity cost as compared with capital solutions and special situations strategies. Participate selectively where managers have a defined edge and market conditions are particularly favourable.

Private Debt
continued

2023 Strategic Priorities

- **Favour specialists:** Continue to identify managers in sectors with secular drivers of return, including SAAS, life sciences, energy transition and digital infrastructure. Bias towards specialists over generalists in all sub asset classes.
- **Selectively commit to capital solutions and rescue lending:** Favour capital solutions to performing companies over distressed for control, but continue to seek opportunities to invest with high quality managers with extensive distressed and workout experience.
- **Make use of managed account structures to build flexibility and scalability:** Establish managed accounts and funds of one that will offer the flexibility to pivot portfolios to sub strategies offering the most compelling risk return opportunities and to scale assets in less well trafficked strategies.
- **Identify opportunities for positive societal impact in private lending:** Collaborate with managers to support their ESG initiatives and identify opportunities to invest alongside managers who invest with an ESG or impact mandate. Increase the number and range of women and minority owned investment managers in our pipeline.
- **Revisit previously excluded strategies:** The recent repricing has brought previously unattractive lending strategies back into scope, such as consumer lending, senior direct lending, mortgages and credit risk transfer. Consider whether these strategies could offer attractive risk-adjusted returns and further risk diversification for our direct lending portfolios.

Uncorrelated Strategies

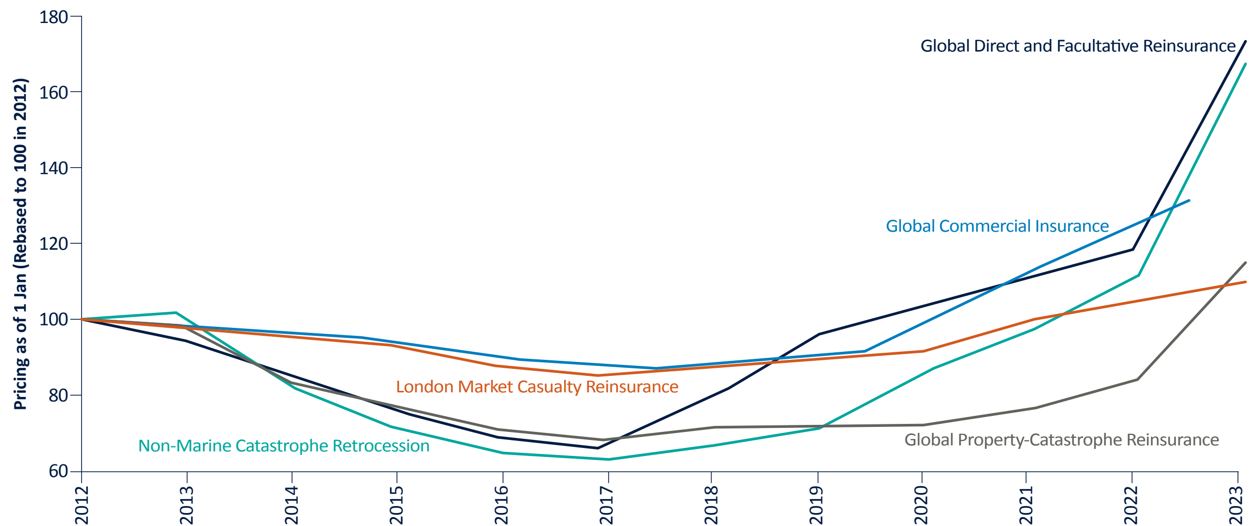
Major Trends

Lower capital availability and repricing of 'vanilla' lending strategies is driving an improved risk/return dynamic. Uncorrelated strategies experienced capital inflows driven by the search for yield during recent years compressing expected returns. As traditional lending strategies have repriced to offer yields in excess of 10%, investors' marginal dollar is more likely to be directed to 'vanilla' lending strategies rather than to more esoteric investments. We also expect the capital available for illiquid strategies to be constrained in institutional portfolios as the so-called 'denominator effect' puts them close to illiquidity limits. The combination of better pricing in less complex assets and declining capital availability is expected to drive improved risk/return and secondary opportunities in uncorrelated strategies. We have already seen evidence of this in the insurance market, where 2023 pricing is significantly above prior years.

Model-driven strategies suffering correlation effects of rising rates and contracting equity multiples. Strategies that were previously considered to be uncorrelated to the broader market are now seeing repricing as a result of macroeconomic conditions. Key model inputs such as interest rates and equity multiples have negatively impacted asset valuations (e.g., music royalties). Sensitivity to liquid market inputs is the primary reason for our historical scepticism around overly quantitative and model-driven approaches to valuations in esoteric strategies and can reduce the attractiveness of these strategies as a diversifier in multi-asset portfolios. The current environment may, however, create interesting opportunities for secondary trades as investors take account of current interest rates and the previously underpriced correlation risk.

Exhibit 4

Insurance strategies across all lines of business saw pricing at long term high levels in early 2023



Source: *Howdens, NOVA*

A new distressed cycle is likely to create additional litigation funding opportunities. We expect an increase in public and private market defaults over the next 12-24 months to levels above historical averages. Rising corporate and sovereign restructurings and bankruptcies should create additional opportunities for litigation investors, with investors able to participate either via single case funding or by investing alongside distressed specialists in bankruptcy claims and liquidations. A new distressed cycle is also likely to reduce competition for legal assets as credit investors in litigation redirect their focus away from niche assets.

Market volatility tends to uncover areas of weak diligence and poor controls. We tend to find that due diligence issues and poor operational controls surface in more challenging economic environments and during periods of market volatility. We have already seen evidence of this in cryptocurrency-related investments, which has served as a reminder to maintain our investment discipline in more niche strategies, ensuring high levels of alignment with reputable managers and being prepared to step away from investments where we are unable to reach a high level of comfort through our diligence process.

Golden Rules

- Partner with specialist investors in niche strategies rather than opportunistic generalists: We believe a key differentiator in investment outcomes in uncorrelated strategies is manager expertise and familiarity in pricing niche assets. Generalists tend to suffer from adverse selection as they are more likely to invest in deals passed over by specialists.
- Establish close alignment not only with investment managers but also with other end-investors in those vehicles. In smaller, less liquid markets, a clear alignment of interests is essential and close relationships with other investors can deliver informational advantages which lead to better investment outcomes.
- Seek contractual returns, rather than an equity exit: Limit investments where the ultimate return is contingent on an equity bid from a third party. Favour investments with a defined contractual return.
- Be sensitive to model risk: It is critical to fully understand the factors that influence investment pricing and to be sceptical of model-based valuation approaches.

Private Debt
continued

Sub-Strategy Attractiveness

Pharmaceutical Royalties: Positive view. Pharmaceutical royalties are complementary to our healthcare lending and drug trial financing investments and offer a long-term source of realisable yield to our portfolios.

Litigation Finance and Intellectual Property: Positive view. Financing portfolios of corporate litigation is an area that remains relatively underexploited and is attractive in our view. Companies are more likely to need to monetise their legal assets in an environment where interest rates are rising and financing options have narrowed. We also view opportunities in patent and IP litigation as offering attractive uncorrelated returns. Lending structures in litigation finance now offer attractive opportunities given higher base rates, wider credit spreads and a flatter J-curve than in single case strategies.

Drug Trial Financing: Neutral view. Clinical co-development offers the opportunity to finance phase 3 drug trials in partnership with pharmaceutical companies, in exchange for a royalty stream or fixed cash payments. Given the specialism required to assess trial outcomes, drug trial finance remains an under-exploited opportunity with few participants. However, there are challenges in achieving deployment and adequate diversification, which mitigates our overall positive view of the strategy.

Insurance strategies (Life, Insurtech): Neutral view. Continued consolidation and disruption in life and health strategies offer potentially interesting opportunities. Insurtech is a growing area which may offer opportunities to provide senior financing.

Music Royalties: Neutral view. We have upgraded our previously negative view of music royalties to reflect a potentially attractive secondary opportunity set as existing portfolios are revalued.

Insurance strategies (Property and Natural Catastrophe): Negative view. We remain less constructive on retrocessionary reinsurance strategies despite recent repricing as we do not like the binary nature of the strategy at the portfolio level (i.e., the high correlation of individual policies), we view the available investment structures to have significant drawbacks (specifically the trapped capital at the end of each investment period) and believe the risks of climate change are still to be adequately reflected in underwriting models.

2023 Strategic Priorities

- Focus on contractual returns. Strike new partnerships with managers that focus on assets generating contractual cash flows rather than back-ended equity pay-offs. Attractive examples include royalties and litigation lending.
- Expand the range of uncorrelated strategies with a view to diversifying exposures and avoiding unintentional factor concentration. Concentrate capital in managers with clear and quantifiable competitive advantages through scale, specialism, or sourcing.
- Re-evaluate previously richly priced strategies for secondary opportunities and opportunistic allocations.
- Partner with emerging managers to establish early exposure to novel and innovative strategies like clinical co-development.

Long-Term Expected Return

Exhibit 5

Based on our 10 year forecasts, we target the following long-term expected returns for Private Debt

	Private Debt
Risk-free Rate	3.5%
Risk Premium	3.0%
Illiquidity Premium	2.5%
Manager Alpha	1.0%
Total Return	**10.0%**

Private Debt expected returns reflect Liquid Credit beta return plus 2.5% excess return from the asset class and 1.0% from our strategy and manager selection.

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