PitchBook

Private debt performance warrants a closer look

Analysis of increasingly popular private debt strategies

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Contents

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Key takeaways

- The 10-year horizon IRR for private debt funds is 8.2%, nearly the same as the 8.0% and 9.6% produced by venture capital (VC) and private equity (PE) funds, respectively. More recently, however, private debt performance has lagged that of all other private strategies due to the limited upside of held-to-maturity debt securities in a period of historically low yields.
- Compared to the Bloomberg Barclays US Corporate High Yield Index, private debt funds have outperformed in 10 of the 15 vintages from 2001 to 2015.
- A US government spending bill passed in March 2018 included language that doubles the leverage limit of BDCs. This will create further competition amongst lenders, likely leading to more favorable rates and terms for borrowers.

Introduction

As we've covered in previous notes, private debt fundraising and capital deployment in 2017 surpassed pre-crisis highs. The most notable growth has come from direct lending funds, which have filled the mid-market lending gap created by regulations like Dodd-Frank and Basel III. However, direct lending funds have not been alone in their growth. Other sub-strategies of private debt, such as mezzanine and distressed, have enjoyed a resurgence in fundraising. More recently, a US government spending bill passed in March 2018 included language that doubles the leverage limit of business development companies (BDCs), a legal structure designed to encourage direct loans to mid-market companies. This will create further competition for lenders, but will likely create more favorable rates and terms for borrowers.

As traditional PE strategies have become more crowded, private debt is viewed as a key area for firms to expand their business. Carlyle Co-CEO Kewsong Lee compares the strategy to "where PE was approximately 20 years ago," referring to the enormous opportunity in AUM growth.

Note: We define "private debt" at the fund level, including all vehicles structured as limited partnerships. As such, some of the funds classified as "private debt" may invest in publicly traded securities.

Categorization of private debt sub-strategies

Private debt is a fluid space, with the categorization of sub-strategies varying by manager, fund structure and LP expectations. Managers, for instance, may classify their offerings based on the risk/return profile (e.g., senior secured portfolio with mid-single digit net returns to LPs vs. opportunistic credit targeting returns in the mid-teens). Conversely, for LPs, private debt may be one bucket within a larger allocation to alternative strategies (including PE, VC, real estate, etc.), or as an illiquid sleeve in a traditional credit and fixed-income allocation. Lastly, both LPs and GPs may consider sector exposure and expertise to be the most important variable within a private debt allocation. This is most commonly the case for real estate and infrastructure debt, which often fall within real assets or under their own umbrellas due to the distinct management requirements and valuation techniques used in these industries.

For example, Deloitte's European private debt advisory views the market in the following way:

Fund strategy	Description	Target return (Gross IRR)	Investment period	Fund term	Management fee	Preferred return	Carried interest
Direct senior lending	Invest directly into corporate credit at senior level of capital structure	5-10%	1-3 years	5-7 years (plus 1-2 optional one-year extension)	Typically around 1% on invested capital	5-6%	10%
Specialty lending/ credit opportunities	Opportunisitic investments across the capital structure and/ or in complex situations Typically focused on senior levels of the capital structure	12-20%	3-5 years	8-10 years (plus 2-3 optional one-year extensions)	Typically 1.25%-1.50% on invested capital or less than 1% on commitments	6-8%	15%-20%
Mezzanine	Primarily invest in mezzaine loans and other subordinated debt instruments	12-18%	5 years	10 years (plus 2-3 optional one-year extensions	1.50-1.75% on commitments during investment period, on a reduced basis on invested capital thereafter	8%	20%
Distressed	Invest in distressed, stressed and undervalued securities Includes distressed debt for control	15-25%	3-5 years	7-10 years (plus 2-3 optional one-year extensions)	Various pending target return and strategy: 1.50-1.75% on commitments or 1.50% on invested capital	8%	20%

Source: Deloitte Alternative Lender Deal Tracker Q3 2017

At the same time, Ares views the alternative credit universe as follows:

Alternative Credit Strategies	Target Return
Direct Lending Assets—including Business Development Companies	5-14%
Commercial Real Estate First Mortgage Assets—including commercial mortgage REITs	4-10%
Bank Loans & High Yield Bonds—including closed-end funds	4-7%
Structured Credit Assets:	
public asset-backed investing	5-15%
private asset-backed investing	8-15%

Source: Attractive Yield Opportunities in Illiquid and Liquid Alternative Credit Assets, Ares Management, February 2018

Both Deloitte and Ares view direct lending as a distinct arm of the private debt landscape, targeting slightly different returns (5%-10% for Deloitte and 5%-14% for Ares). From there, however, the taxonomies differ greatly. They include a mix of public and private securities, real estate, bank loans, special situations, mezzanine and distressed debt.

PitchBook takes a hybrid approach to private debt fund categorization, considering seniority in the capital structure and risk/return profile, as well as industry exposure in select cases. Private debt sub-strategies are presented in ascending order of relative risk/return characteristics below. Each of these categories should provide higher net returns, compared to analogous publicly traded investments, due to the relative illiquidity of private market investments.

Each of these private debt categories should provide higher net returns, compared to analogous publicly traded investments, due to the relative illiquidity of private market investments.

- **Direct lending:** generally senior loans made to mid-market companies without the use of an intermediary, but may include revolving credit lines and second lien loans. Unitranche facilities, which combine different debt instruments under a single umbrella, are also becoming more common.
- **Real estate debt:** The most common real estate debt strategy is direct lending for real estate acquisitions, but may also include the buying and selling of securitized real estate loans in the secondary market. Risk profiles vary based on the nature of the underlying assets (the equity components of which often fall into different fund types), including:
    - *Core:* lowest risk/return of the real estate sub-strategies. Desirable locations with low vacancy rates. Majority of income from leasing activities

- » *Core-plus:* slightly higher risk/return profile. Property may have expected vacancies or need renovation
- » *Value-add:* medium risk/return profile. Property may need major renovation or repositioning
- » *Opportunistic:* high risk/return. Property may need major renovation or repositioning, or have higher vacancy rates. Includes new property development
- » *Distressed:* resemble distressed debt investments (see below), with the distinction that the debt is secured by real estate assets

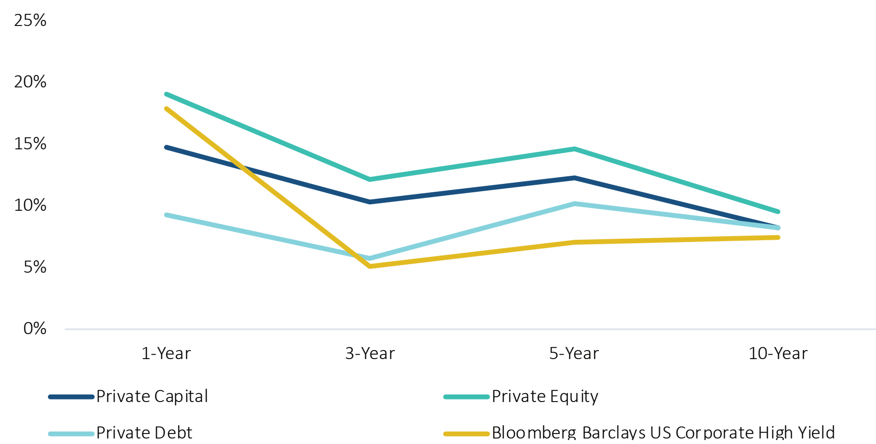
- **Infrastructure debt:** debt used for infrastructure development (i.e., greenfield) and investment in existing assets (i.e., brownfield), generally with longer terms (30+ years) due to the extended useful life of the assets.
- **Mezzanine:** subordinated debt, generally with features similar to preferred equity, such as warrants. Often used in LBO transactions.
- **Special situations:** debt or structured equity investments (i.e., convertible debt, convertible preferred, debt with warrants) made with the intent of gaining control of a company, generally one in some type of financial distress. Special situations can include trading in the secondary market, direct origination or distressed debt in which the manager believes price dislocation is present.
- **Distressed debt:** differs from special situations in that it generally involves the purchase of securities in the secondary market, rather than new origination of debt or structured equity. Distressed strategies likely involve identification of the "fulcrum" security, or the most subordinated part of the capital stack to be paid back in a bankruptcy or other restructuring, which can trade at steep discounts to NAV.
- **Venture debt:** debt financing extended to companies with venture capital backing. For entrepreneurs, venture debt serves as a way to extend the runway to exit without further diluting ownership.

The improving macroeconomic backdrop, driven in part by extended quantitative easing on the part of major central banks, has been a boon to equities, but has left yields for new debt issuances stubbornly low.

Returns compared to other strategies

Private debt funds in aggregate have produced returns in line with other private capital strategies over the long term. The 10-year horizon IRR for private debt funds is 8.2%, nearly the same as the 8.0% and 9.6% produced by VC and PE funds, respectively. More recently, however, private debt performance has lagged that of all other private strategies due to the limited upside of held-to-maturity debt securities in a period of historically low yields. The Cliffwater Direct Lending Index shows that the yield on mid-market debt held by BDCs dipped from 10.5% in early 2016 to 9.6% in the second half of 2017. The improving macroeconomic backdrop, driven in part by extended quantitative easing on the part of major central banks, has been a boon to equities, but has left yields for new debt issuances stubbornly low (notwithstanding Fed rate hikes in the latter half of 2017 and early 2018, which this performance data does not include).

Horizon IRR by strategy



Source: PitchBook
*Performance data through 6/30/2017

Compared to the Bloomberg Barclays US Corporate High Yield Index, private debt funds have outperformed in 10 of the 15 vintages from 2001 to 2015. In addition, private debt funds outperform public markets on a three-, five- and 10-year horizon (ending June 30, 2017), but significantly underperform on a one-year horizon, due in part to the high-yield spike in early 2016.

Private debt PMEs by vintage

Vintage Year	PitchBook Benchmark Return (%)	Bloomberg Barclays US Corporate High Yield Return (%)	KS-PME
2001	26.95%	7.87%	1.39
2002	28.29%	8.46%	1.52
2003	16.41%	8.94%	1.17
2004	15.22%	7.72%	1.37
2005	2.67%	7.58%	0.77
2006	5.77%	7.88%	0.80
2007	6.43%	7.51%	0.83
2008	12.95%	8.63%	0.93
2009	10.96%	12.90%	1.00
2010	18.49%	8.11%	1.29
2011	11.21%	6.91%	1.15
2012	11.36%	7.08%	1.15
2013	6.99%	5.61%	1.01
2014	9.91%	5.08%	1.04
2015	13.00%	6.34%	0.78

Source: PitchBook
*Performance data through 6/30/2017

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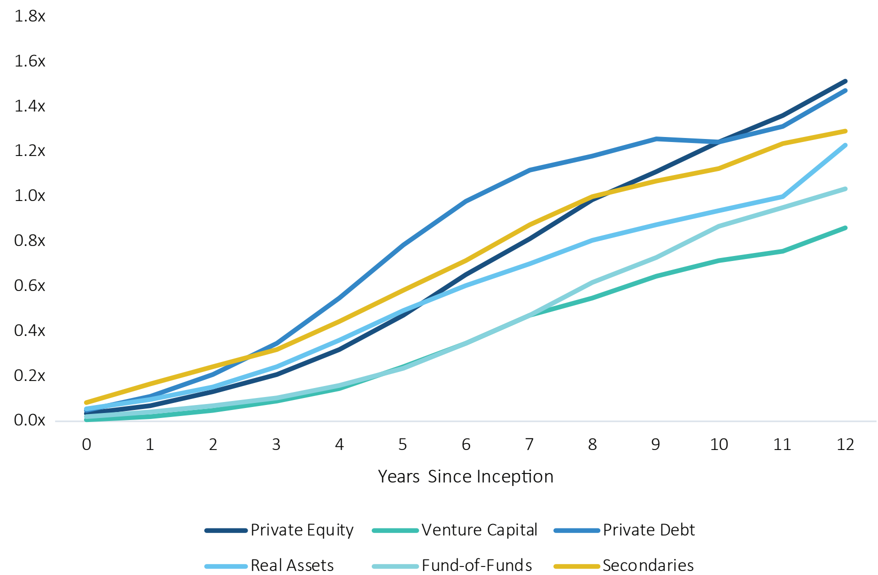
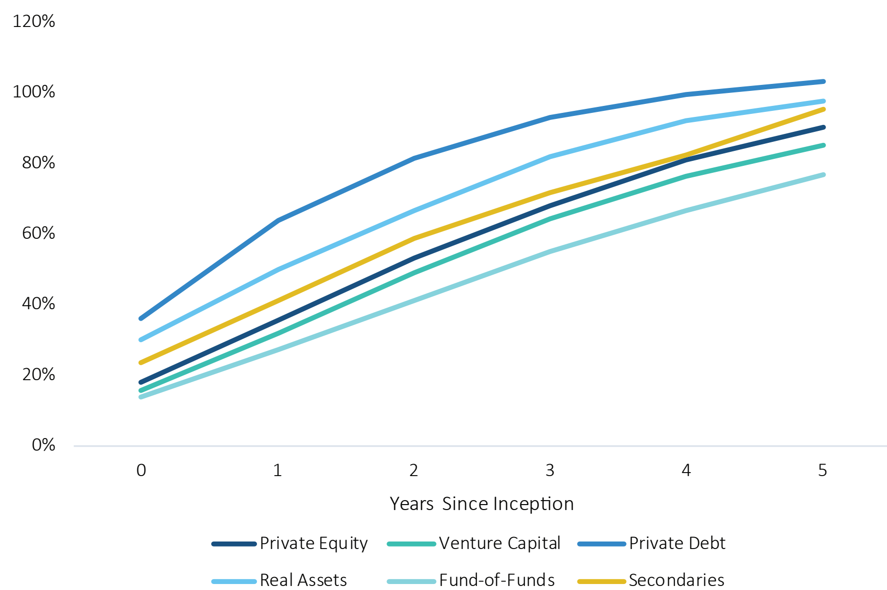
Though they have underperformed private market strategies on an IRR basis in recent years, private debt strategies reliably return capital to LPs more quickly than other private market strategies. The historical median distribution-to-paid-in (DPI) for private debt funds reaches 1.0x in its sixth year, compared to the eighth year for PE. The main reason for the speedier return of capital in private debt funds is the strategy's reliance on interest payments, rather than principal appreciation, for a large part of its returns. Distributions from private debt funds also keep pace with other strategies when nearing the end of a fund's life. Twelve years from inception, when most funds have already reached or are nearing completion, the median DPI for private debt funds is 1.47x, nearly equivalent to PE—the top-performing strategy by this metric—which produces a median DPI of 1.51x over this timeframe.

DPI since inception by strategy



Source: PitchBook
*Considers all vintages from 2000-2015, as of 6/30/2017

Called down % since inception by strategy



Source: PitchBook
*Considers all vintages from 2000-2015, as of 6/30/2017

Outlook

Borrower perspective

Public credit markets still usually offer the cheapest financing, but not all borrowers can tap into those sources. And, in many instances, well-qualified borrowers are willing to pay a premium for private market debt when they can negotiate favorable and flexible terms, such as certainty of close and minimal covenants. Unitranche facilities, in which senior and subordinated debt are combined into one a loan with a single rate, exhibit many of the advantages typical of private debt issuances. They tend to be slightly more expensive for the borrower but afford the convenience of working with just one lender while avoiding the syndication risk associated with leveraged bank loans.

LP perspective

The increase in funds flowing to private debt has raised concerns that returns will be compressed by competition for new originations. Of course, this is a boon to borrowers, who will benefit from lower rates and less-restrictive covenants. As we have shown, short-term horizon returns lag the five- and 10-year returns for private debt strategies. If monetary policy is tightened too quickly, a rise in adjustable rates could lead to a rise in bankruptcies. Similarly, if leverage levels continue to rise as they have in recent years, private debt funds will be even more exposed to a downturn in the global economy.