PRIVATE DEBT: BEHIND THE HEADLINES

The flood of money into Private debt in 2017 demonstrates the strength of investor appetite and points to an optimistic outlook for this asset class in 2018. However, behind the headline grabbing figures and positive growth stories there is good reason for investors to remain careful.

As is often the case, different markets have to respond to different pain-points but there is an overwhelming sense that investors risk being misinformed or misrepresented. At Idinvest Partners, we have seen numerous cases where investors have put their money into what they believe to be senior secured financing deals, but which are in reality turn out to be a mixed strategy of senior and junior financing – a complete re-routing of the approach that they were sold. In the European market, we are seeing firms frequently privileging commercial gains over investment returns by failing to price risk appropriately – thereby not only posing a threat to investor returns, but also creating unstable and perhaps unsustainable pricing structures in private debt. This goes against Idinvest's commitment to its clients: to maintain total honesty and to adhere to the agreed-upon risk/reward characteristics of the transaction for the duration of the investment period.

The debt market's growth has unsurprisingly attracted new players to the marketplace which puts constraint on returns and the quality of documentation, and could lead to questionable market evolutions. For example, in continental Europe and particularly in the German market, we are starting to see the appearance of structures called synthetic loans (initially pioneered in the UK) which consist of recreating two distinct asset classes in the same financing, while unitranche debt aims to combine senior and subordinated debt. In a synthetic loan, a tranche said to be 'first out' is brought by a bank and a 'last out' tranche by a private debt fund. The relation between the two loans is managed by an inter-creditor agreement. The issuer finds interest there by obtaining a lower average financing cost thanks to the bank-issued tranche. Certain unitranche debt funds use these synthetic loans to make it easier to put unused resources to work.

This type of structure presents a risk for investors as well as introducing the type of unnecessary financial complexity in to the market that is synonymous with the 2009 crisis. The investor risk is due to the fact that in cases of defect, no jurisprudence can, at this stage, guarantee the solidity of the agreement between creditors in front of a commercial court. The Private debt funds, which are contractually subordinated to banks, can therefore lose everything. This rerouting of unitranche debt means that investors in these funds who believe themselves to be engaged in a "senior secured" asset category are actually exposed to more risk than is immediately obvious. Typically, the type of returns these funds generate are not reflective of the risk taken.

That many investors don't recognize this is due in part to the failure of banks and funds to clearly explain the complex risk profile of synthetic loans. However, it is also true that in periods of calm, which we have been experiencing until very recently, investors are less likely to have concerns about companies defaulting and, therefore, are slower to question the structure which would reveal the layers of hidden dangers associated with these vehicles. If they were to do so, they would surely be astounded by the realization that despite the substantially higher risks, synthetic loans are priced the same as single unitranche debt funds.

A small amount of this activity has been executed via the partnerships, or 'club deals' that we sometimes enter to create a unitranche pari-passu. This generally occurs when one fund cannot take on the entire financing needs of a transaction. In these instances, we would look for third party GPs that understand and share our approach to managing money and attitude towards monitoring risk and work together to deliver this for our investors.

These kinds of 'club deals' are becoming more popular and we can expect this trend to continue to gain momentum as market participants feel the pressure to maintain high levels of activity and deploy capital. Idinvest maintains that these should be seen as opportunistic opportunities and there are a range of factors that need to be considered before entering into these kinds of agreements. Arguably, the most important of these is for all parties to carefully examine how they monitor risk to ensure that this is compatible. Firm's risk profiles tend to be indicative of their general business model and strategy, so it's essential that partners' attitudes are complimentary particularly in the case of a response to a recovery scenario.

Despite this increase in exterior market pressures, we continue to believe that significant opportunity exists for funds to lend to companies across Europe, so long as this is done with a degree of fairness and prudence. Idinvest focusses its core activity on unitranche for SMEs and leveraged loans for medium-sized enterprises. We believe these key products best represent value for both the investor and the businesses.

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