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The Case for Alternative Yield Strategies in Private Credit Portfolios

By Mark Perry



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The scarcity of yield globally has driven investors toward increasing levels of risk to obtain it. The private credit market historically has been an attractive source of return for yield-oriented investors willing to trade lower liquidity for higher absolute performance, but excess fundraising in that market has depressed returns and increased risk in this current cycle. Fortunately, the private markets—long at the forefront of financial product innovation—offer an emerging set of differentiated strategies that provide investors the dual utility of attractive risk-adjusted return and enhanced portfolio risk management. This article will examine this area of the investment frontier and make the case for the inclusion of alternative yield strategies in diversified credit portfolios.

BACKGROUND

Today's interest rates are historically low on a global basis. The period following the global financial crisis saw the lowest U.K. base rate in the Bank of England's 322-year history, a negative Japanese bond yield for the first time since 1870, the first-ever negative yield on German government bonds, and the lowest yields on the benchmark U.S. Treasury bond since records began in 1790. Today, half of all European government bonds have a negative yield, driving the amount of negative-yielding debt globally to an astounding peak of \$17 trillion in 2019 (see figure 1).

In response, capital has flooded those areas of the market where yield can be extracted—including the private credit market. As a result, the dual forces of capital supply imbalance and limited

Figure 1

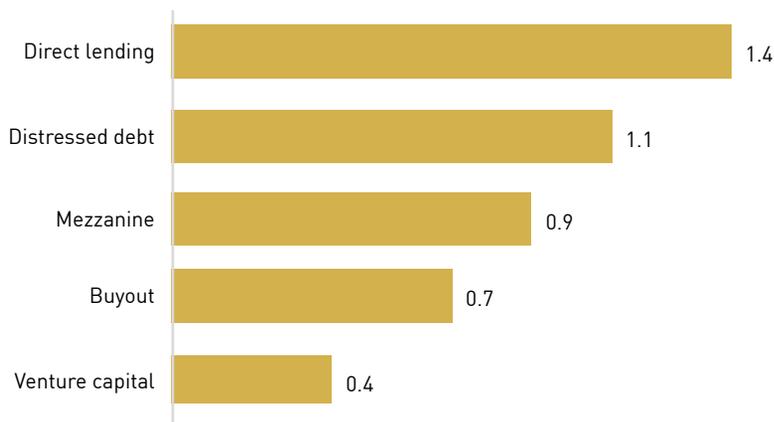
MARKET VALUE OF NEGATIVE-YIELDING BONDS IN THE BLOOMBERG BARCLAYS GLOBAL-AGGREGATE INDEX



Source: Bloomberg

Figure 2

PRIVATE MARKET HISTORICAL SHARPE RATIO



Note: Prequin custom benchmarks, using earliest available data for each strategy, based on vintage year. Sharpe ratio assumes 3-percent risk-free rate. Due to the varying vintage years for each strategy, no comparison for performance of the strategies should be inferred. Earliest data dates are 2008 (Direct Lending), 1991 (Distressed), 1989 (Mezzanine), 1980 (Buyout and Venture Capital). Past performance is not indicative of future results.

product differentiation have driven lenders to compete on price and structure, together driving down returns and simultaneously increasing risk.

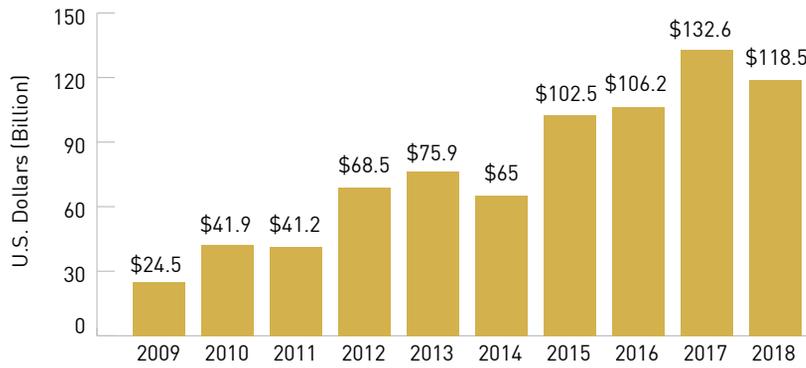
PRIVATE CREDIT AND RISK

Private credit historically has offered among the best risk-adjusted returns in

the private markets. Viewed on a Sharpe ratio basis, each of the core private debt strategies (defined here as direct lending, mezzanine, and distressed debt) have outperformed private equity (including buyout and venture capital) historically (see figure 2). Unsurprisingly, private credit has seen a surge in fundraising

Figure 3

GLOBAL PRIVATE DEBT FUNDRAISING (\$B, USD)



Source: Preqin

activity globally, with more than \$118 billion of aggregate capital raised in 2018 representing a nearly five-time increase from 2009 and a 19-percent compound annual growth rate during that period (see figure 3).

In the direct lending market—the largest and fastest-growing private credit category—this influx of capital, absent sufficient product differentiation, has forced lenders to compete on price and structure, resulting in degradation of expected returns and credit quality. Using middle-market loan data as a proxy, spreads have decreased post-global financial crisis, leading to lower unlevered returns to traditional credit investors (see figure 4). Simultaneously, risk arguably has increased as debt multiples have grown, covenant-lite issuance has become increasingly commonplace, and earnings before interest, taxes, depreciation, and amortization (EBITDA) adjustments have become increasingly aggressive (see figure 5).

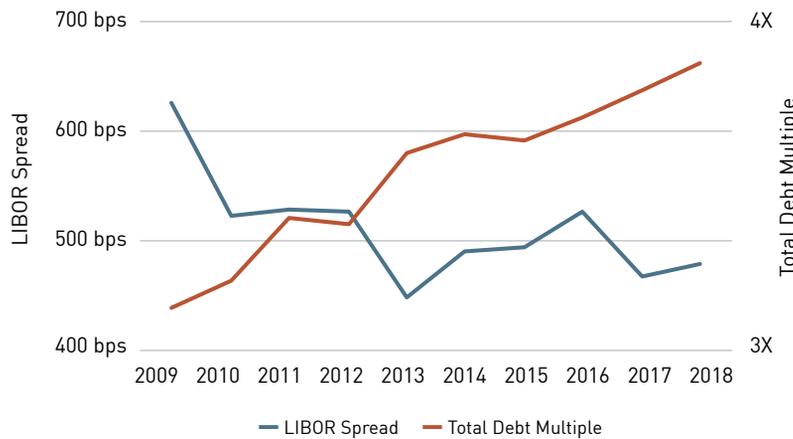
The consequences of this increased risk tolerance have yet to play out, but it is reasonable to assume that as these lower-quality credits are tested by economic difficulty, defaults may increase to the detriment of the yield-oriented investors with this exposure. Indeed, these forces have combined in the past to produce a remarkably consistent distressed debt cycle of low-quality debt build-up, correction, and consequences to investors. Clearly, an innovative approach is required to break this cycle and provide investors with the yield they demand without the outsized risk.

PRIVATE CREDIT OPPORTUNITIES

Although yield is available to various degrees in liquid and illiquid instruments, the private markets are uniquely positioned to address the demand for risk-adjusted return with innovative strategies that offer attractive yield with substantially lower risk and unique correlation attributes. Indeed, the rapidly evolving private markets frontier

Figure 4

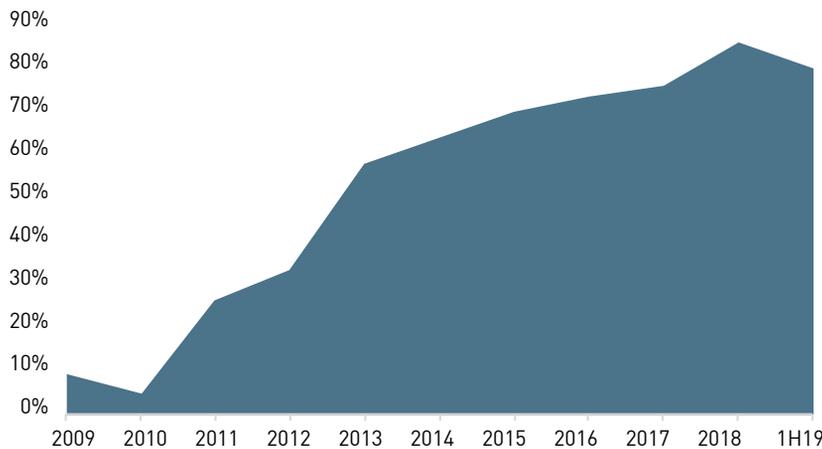
MIDDLE-MARKET LOAN SPREAD VS. DEBT MULTIPLE



Source: S&P LCD US Middle Market Leveraged Lending Report Q2 2019

Figure 5

NEW-ISSUE COVENANT-LITE LOANS % OF INSTITUTIONAL LOANS



Source: S&P LCD Quarterly Leveraged Lending Review Q2 2019

continues to expand the array of solutions that provide investors with the return that they demand, while enhancing their ability to diversify risk.

Niche strategies are not new to the private markets. Investments in pharmaceutical royalties, for example, have existed since at least the mid-1990s when Royalty Pharma, Inc., was established. Today there exists an emerging set of differentiated strategies including niche credit, specialized asset-based lending, risk transfer, and intangible assets (collectively “alternative yield strategies”)—each generally uncorrelated to each other or to other external, cyclical factors. Because of their innovative nature, these strategies focus on markets where capital is still limited and, by exploiting these pockets of inefficiency, provide investors with compelling risk-adjusted returns in addition to unique correlation features. Although an estimate of total market size is difficult to obtain given the scarcity of data relating to these strategies, our database has captured nearly 200 sponsors with more than \$96 billion of total fund size targeting alternative yield strategies dating back to 2013. For perspective, although this is a small part of the broader private credit market, this represents roughly the same amount of capital raised in the mezzanine debt market over this period.

A description of each alternative yield category is provided below.

INTANGIBLE ASSETS

Strategies focused on intangible assets generate returns from contractual payments based on the use or sales of products derived from the ownership of the intellectual property that underlies those products. Examples of strategies in this category are music, film, or healthcare royalties, intellectual property (patent or IP) rights, water or air rights, or corporate tax factoring.

Case Study: Music royalty funds will invest in music IP assets often with an emphasis on the acquisitions of catalogs

with proven and long-duration royalty income streams. Several types of music IP assets can be acquired and monetized including catalog acquisitions, music administration, and new music deals. Value is created “on the buy” through the acquisition of under-exploited music catalogs and post-investment through active asset management with the goal of increasing asset cash flows. For example, managers often will focus on increasing synchronization royalties by licensing copyrighted music to films, television, commercials, video games, online streaming, advertisements, and any other type of visual media. Portfolios of music IP can be diversified across artists, decades, and music genres and typically target 10-12 percent net unlevered returns to investors with steady cash yield.

SPECIALIZED ASSET-BASED LENDING

The deepest part of the alternative yield market, these strategies offer current cash yield and a low credit risk profile given security interest in the underlying assets. Debt strategies exist in each of the real asset categories—real estate, infrastructure, energy, metals and mining, and agriculture—as well as more niche areas such as aircraft, shipping and railcar leasing, net asset value (NAV)-based loans, or stretch asset-based lending.

Case Study: NAV-based loans are originated to financial sponsor-owned companies that require capital but either cannot meet the lending criteria set forth by traditional sources of capital or would prefer to raise non-dilutive debt as an alternative to equity. Typical uses of capital include deleveraging or restructuring, funding mergers and acquisitions, supporting strategic transition (e.g., a temporary period with negative EBITDA), or bridging to a sale or refinancing. Returns for this strategy comprise coupons that will range from 9 percent to 11 percent and fees of typically 1 percent to 3 percent. Where this strategy really shines, however, is on the risk side of the equation, where

loans feature credit support from the financial sponsor typically in the form of a guaranty. To this end, loans will be collateralized by some combination of the total NAV of a sponsor’s portfolio, which will be at least 5x (although more typically 10x+) loan value, and/or undrawn limited partner commitments of the sponsor’s fund, which will be at least 1x loan value, and will require additional covenants on minimum NAV and portfolio size in the financial sponsor’s fund. Loans will stand in front of sponsor carry and limited partner distributions in the event of a default.

NICHE CREDIT

Niche credit strategies are exemplified by sector-focused lending funds targeting specialized, underserved markets. Enterprise software lending, restaurant franchise structured finance, consumer debt, and aerospace/defense credit are examples.

Case Study: Healthcare lending strategies originate senior secured loans to small- and mid-cap public and private healthcare companies with enterprise values typically below \$1 billion. These managers target commercial-stage companies (thus bypassing the binary development and clinical risk inherent pre-Federal Drug Administration [FDA] approval) with a sector focus that includes biopharma, specialty pharma, medical devices, diagnostics, research tools, and healthcare information technology. Barriers to entry exist in this market vis-à-vis the dynamic commercial and regulatory environment in health care broadly and the limited set of credit investors that will consider companies at the specific stage these strategies target (i.e., post-FDA approval but pre-scale commercialization). Capital preservation is emphasized through highly structured, well-collateralized debt instruments with loan-to-value (LTV) ratios typically below 25 percent and minimum tangible asset coverage—for example assets, intellectual property, and/or cash—above 2x. Investments are senior secured,

floating-rate loans with warrants or other equity upside features. Target returns are unlevered 15-20 percent gross internal rate of return (IRR) through floating rate coupons of approximately 10-13 percent, fees of 1-3 percent, and equity warrant upside of up to 2-5+ percent.

RISK TRANSFER

This category encapsulates various strategies including acquiring and managing (re-)insurers' run-off portfolios, providing underwriting capital to insurance syndicates, purchasing existing life insurance policies, litigation credit, or bank regulatory capital relief.

Case Study: Life settlement strategies target investments in life settlements assets (i.e., life insurance policies). Life insurance policies typically are acquired at a discount to face value from policy holders or from other investors seeking to sell the payouts of their policies. The existence of this market allows individual policy holders to monetize their life insurance assets at a value that exceeds (often far exceeds) that policy's cash surrender value, allowing for more optional personal balance sheet management later in life. Post-acquisition, buyers of such policies will assume responsibility for the required premium payments and will receive the face value (or death benefit) upon policy maturity. Managers focused on this market typically will build large portfolios of 500+ individual life insurance policies to prudently

diversify longevity risk. Policies can be acquired either from the secondary market (direct from policy holders) or from the tertiary market (where policies are traded between investors), acknowledging the varying degree of underwriting risk and competitive forces between the two markets. Active policy monitoring post-investment, including exit optimization, is important to risk management. Life settlement strategies are typically 15-percent+ net returns with quarterly income distributions once the portfolio has reached steady state.

The universe of alternative yield strategies offers what we consider to be an attractive source of return both on an absolute basis and relative to the liquid and illiquid opportunity set. The combination of contractual coupon payments, fees, and unusually deep subordination lead to many of the niche credit and specialized asset-backed strategies standing out relative to their opportunity set of investable peers. Indeed, in the case of the NAV-based loan case study above, a 10-percent+ net contractual return at 10-percent LTV is one of the better risk-adjusted returns anywhere in the private credit market today. Other strategies, such as the music royalty example given above, are made more attractive through the managers' ability to effectuate value creation post-investment through hands-on, active management of the assets. As opposed to financial engineering alone as the sole or primary source of value creation, we

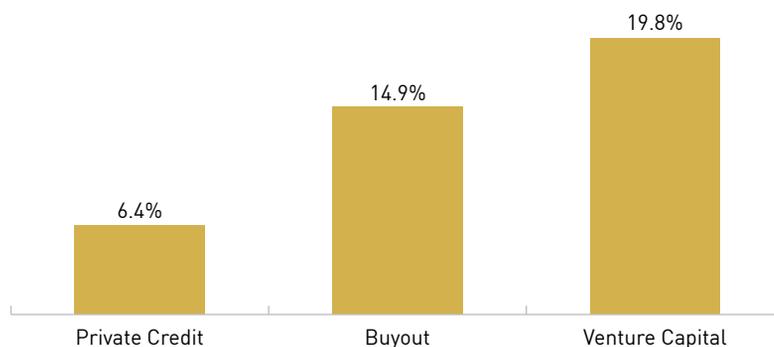
believe that such transformative post-investment engagement makes these strategies more robust and less susceptible to external, uncontrollable forces such as macroeconomic or sector-specific cycles. Even on an after-tax basis, we consider alternative yield strategies to be excellent sources of return both on an absolute and risk-adjusted basis.

ALTERNATIVE YIELD STRATEGIES AND RISK MANAGEMENT

Given the current late-cycle dynamics and the elevated risk inherent to the liquid and illiquid credit markets alike, alternative yield strategies are a compelling source of return and an important tool for risk management. Risk management in a core private credit portfolio is often difficult given the homogeneity of that market. Investors can diversify risk across geographies, vintage years, position in the capital structure, and to some extent market size segments (small-cap, mid-cap, large-cap), but the result is still a relatively tight-band of returns. This is illustrated by the manager selection premium—defined as the spread between top-quartile and bottom-quartile managers as ranked by fund performance—in private credit, which is a fraction of that found in other parts of the private markets (see figure 6).

One framework for dimensioning the risk inherent to the core private credit market is to consider those risks that are controllable, such as capital structure, credit spread, and structural protections, and those that are not controllable by the manager, such as macroeconomic cycles or interest-rate events. As previously stated, the data seem to suggest heightened controllable risk today and the non-controllable, admittedly more subjective, risks are at a minimum worrisome considering the duration of the current expansion and yield curve dynamics. By contrast, alternative yield strategies offer similar if not better returns to core private credit with fundamentally different risk. Going back to

Figure 6 PRIVATE MARKETS MANAGER SELECTION PREMIUM

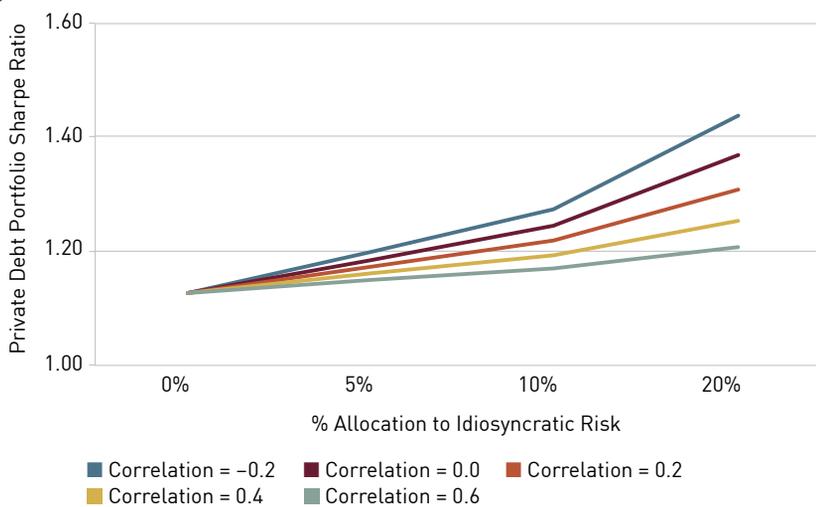


Note: Preqin custom global benchmarks as of most up-to-date. Manager selection premium defined as spread between top and bottom quartile boundaries.

the music royalty example, we consider the factors that influence the risk to that strategy—i.e., global music consumption, music catalog acquisition pricing, and music IP enforcement laws and regulation—to be minimally if not completely uncorrelated to those forces affecting the core private credit market. The life settlements strategy outlined above provides a similar example, where its key risk—policy holder longevity—shows minimal if any correlation to the cyclical or underwriting risks characteristic of the core of the market. By diversifying risk with the potential for excess returns over most other credit categories, investors that add alternative yield to their portfolios can achieve significant diversification benefits and improve Sharpe ratios (see figure 7).

Figure 7

PORTFOLIO BENEFITS OF LOWER CORRELATION



Note: Analysis by Wilshire Associates Incorporated. Assumes identical expected return and expected risk in mezzanine debt and private income strategies. Percentage allocation to private income and estimated correlation varied as displayed on graph.

In an era of increasing market efficiency and heightened risk—both in the public and private markets—the use of innovative private markets strategies within diversified investment portfolios can have significant effects. These include:

- Return profiles that can generate steady, resilient yield without outsized market risk
- Portfolio diversification benefits vis-à-vis low or no correlation to business, credit, or market cycles
- An established universe of institutional-quality managers offering a broad, diversified opportunity set

At the core of what makes many of these strategies so compelling is the increasingly rare notion of market inefficiency. Many of these specialty markets have barriers to entry where a threshold of domain expertise is required to operate and other, often cheaper, sources of capital lacking such specialization are deterred. As a result, capital supply and demand dynamics in many of these markets remain imbalanced—and with capital demand higher than capital supply an outsized risk-adjusted return can be extracted. This same dynamic, however, creates the

difficulty that investors must overcome to access these returns. With limited market participants, the process of comprehensively identifying the investable opportunity set in these markets can be difficult. Even with large sourcing networks, it can take several years to adequately map the set of investable opportunities. The process of underwriting the opportunity set to identify the best-in-class manager targeting a certain market is equally treacherous because these firms are typically younger with shorter track records. Indeed, a thorough underwriting framework that balances the qualitative aspects of an organization, investment team, strategy, investment process, and target market with the quantitative techniques of underwriting limited track records is required to mitigate the underwriting risk inherent to accessing alternative yield.

SUMMARY

The current low-interest-rate environment has driven investors into increasingly risky assets in search of yield. Private credit—long at the forefront of financial product innovation—offers an emerging set of differentiated strategies that offer compelling return potential and provide

investors with an additional tool to manage risk at a point in the cycle when risk management is needed most.

By building a diversified portfolio of best-in-class private credit managers using the alternative yield strategies, investors are offered exposure to the outsized risk-adjusted returns generated within these inefficient markets while benefiting from the steady cash yield and diversification benefits of income streams with low or no correlation to business, credit, or market cycles. Furthermore, the unique interfund correlation attributes of these strategies may minimize total portfolio volatility (risk) and, in doing so, create a stable cash-flow stream that is attractive both in terms of the yield it produces and the diversification benefits it affords. ●

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