Investment Intelligence

Allianz Global Investors

Private Debt Investing in the Late Stage Of the Credit Cycle

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Introduction

A key trend in the financial markets continues—capital flows into private debt remain strong. Both structural and opportunistic drivers have contributed to this development. Structurally, regulatory changes in the wake of the 2008 financial crisis have prompted many traditional lenders (e.g., banks) to reduce the capital available for trading liquidity and loans to below-investment-grade corporate borrowers. Opportunistically, institutional investors are starved for yield in the midst of one of the longest bull markets for bonds in history. To that end, 62% of institutional investors surveyed recently by Preqin expected to increase their allocations to private debt—an asset class that has historically been associated with higher yields—in the coming year.[1]

These factors have combined to create an opportunity for institutional investors to replace banks as lenders to domestic, below-investment-grade borrowers. These borrowers include both middle-market businesses with a limited ability to raise capital in the public markets and public companies seeking private financings that generally offer greater flexibility to the borrower.

A global surge in liquidity provided by central banks has resulted in record-low yields in the debt market and reduced volatility in the equity market—putting pressure on investors to take on more risk at a time when risk premiums are deteriorating. Low equity market volatility and tight credit spreads are among the indications that we have entered the "late-expansion" stage of the credit cycle—which has produced an environment with a limited number of high-quality investment opportunities and a significant accumulation of "dry powder." To that end, Preqin in its recent survey reported that approximately

[1] 2017 Preqin Global Private Debt Report

Key Takeaways

- After a long period of exceptionally low rates and abundant liquidity, we believe that the US economy has entered the "late-expansion" stage of the credit cycle, as evidenced by low default rates, tightening spreads and deteriorating covenant quality.
- Investor demand continues to support strong capital flows into private debt, resulting in record levels of both assets under management and "dry powder"—defined as committed but as yet uncalled capital—available to non-traditional lenders.
- Amid the ongoing low-yield environment, investors have delayed capital deployment and remain unsure of how to proceed in a market that could change direction at any time. Uncertainty over the exact timing of a shift in the credit cycle, however, should not discourage investors from proactively establishing or adjusting their private debt investment programs.
- In our view, it is this very uncertainty that creates the need for investors to position themselves now in advance of the market eventually transitioning toward the next stage of the credit cycle, when a growing number of potential "value" opportunities should arise.
- Deploying a private debt investment program today could generate meaningful current income, with the longer-term benefit of enabling a portfolio to capitalize on the expanding number of opportunities likely to be available to providers of long-term, committed capital during a subsequent period of lower liquidity.

$530 billion of undrawn capital was available to private equity funds[2]—which is expected to create substantial new-issue loan demand (approximately $763 billion of debt financings, assuming a 41% current average equity contribution, as measured by S&P Global Market Intelligence) as this capital is deployed.

As a result, institutional investors are left pondering how to adjust their allocations to account for lower value and higher risk inherent in this late-expansion phase of the credit cycle. As they consider their options, however, these investors may be sidelined or frozen into maintaining their current portfolio allocations at a time when the environment demands active engagement in alternative strategies.

A Solution Offering the Potential for Immediate and Long-Term Benefits

We believe that investors cannot predict a market peak or the onset of a recession with any degree of precision—but they can look to reliable indicators to identify where we stand in the credit cycle at a given point in time. This knowledge should help enable credit investors to resist the pressure to chase yield when value is low and seize opportunities when the rewards are high for those willing to provide liquidity when others cannot.

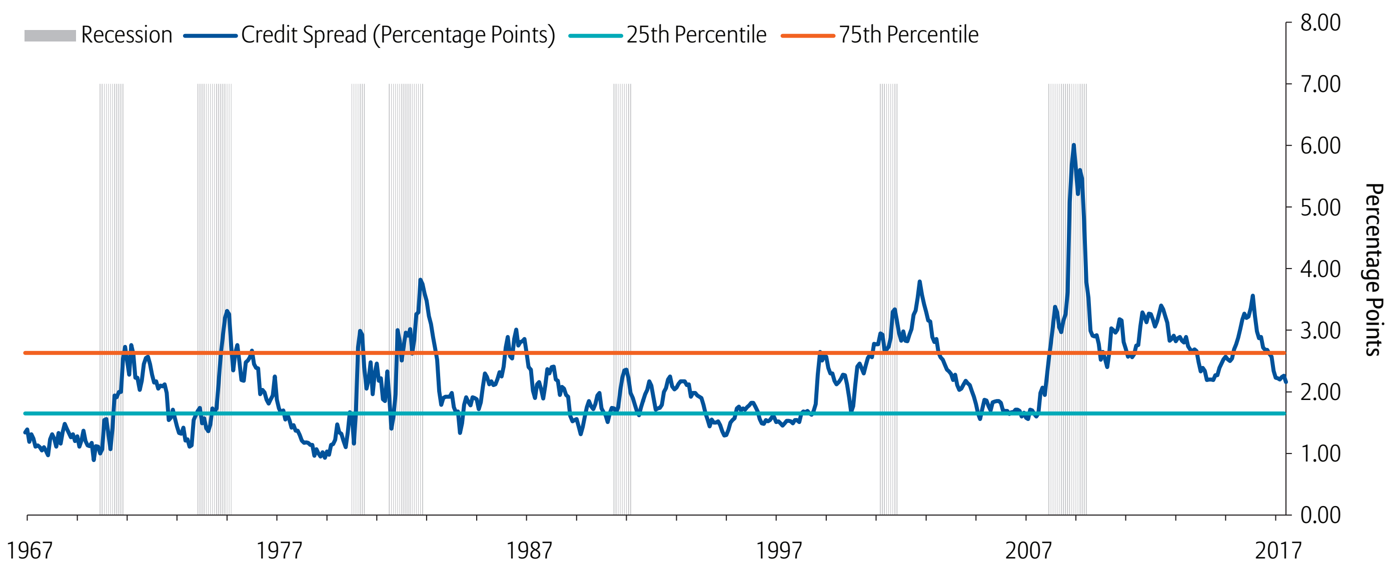
Thus, while we cannot forecast exactly when the market might enter into a downturn, we believe that this very uncertainty should prompt investors to establish or adjust their private debt investment programs now—especially investors interested in capturing the premium potential returns available to those who are able to provide critical credit solutions and liquidity when it is most needed. In lieu of predicting the next recession or equity market peak, recognizing the clear indications that we have entered the late-expansion stage of the credit cycle is a more realistic—yet still important—goal.

To that end, a study by the Federal Reserve found that tightening credit spreads have historically served as a reliable leading indicator of a cooling down in economic activity—and, as shown in **Exhibit 1**, spreads have been steadily tightening for the last couple of years due to strong corporate fundamentals and a continuing reach for yield.

At the same time, the Moody's Covenant Quality Index (CQI), which ranks the degree of covenant protections to borrowers ranging from 1 (most protective) to 5 (least protective), increased to 4.51 in August 2017—just one basis point shy of its record of 4.52 and 46 basis points weaker than its historical average of 4.05[3]. In addition, 47% of high-yield bonds in the August 2017 CQI were high-yield lite[4]—near the record high of 51% set in July. Moody's high-yield spread relative to the CQI benchmark remained, as of this writing, at a near-record low, suggesting a disconnect between investor protections and risk premiums as investors continue to reach for yield. As a result, we believe that the current market is exhibiting all the hallmarks of a late-expansion phase.

Exhibit 1: Tightening spreads—such as those currently—have historically presaged slower economic activity

Moody's Baa-Treasury Credit Spread



Source: Federal Reserve, Moody's through 6/1/2017

[2] 2017 Preqin Global Private Debt Report

[3] Moody's North American Credit Quality Index, September 2017

[4] High-yield lite defined by Moody's as "a speculative-grade bond with a covenant package that lacks a restricted payments covenant and/or a debt incurrence covenant."

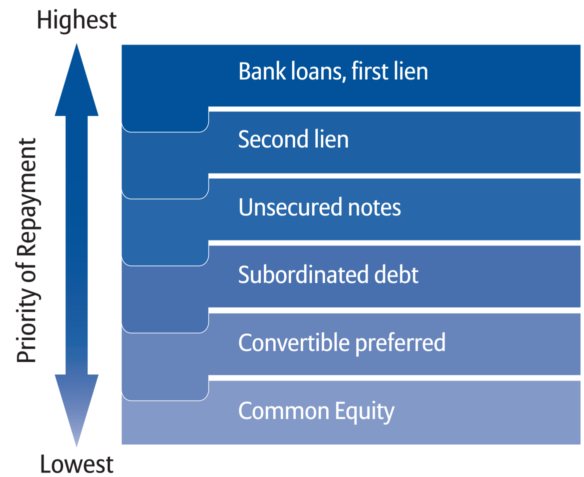
Although the universe of opportunities in the private debt space is relatively limited in the present environment, we believe that structural barriers to entry in the middle-market sector and the higher potential returns inherent in less liquid asset classes remain relatively attractive. These factors—combined with options to reduce risk by investing at the top of the capital structure—provide ample opportunity to wisely deploy capital in private credit during the late-expansion stage. Meanwhile, investors can position themselves for the wider spreads and potential defaults that should occur when we enter the "contraction" stage of the credit cycle, when there is more potential value to be unlocked by experienced private debt investors (**Exhibit 2**).

We see this approach as an attractive alternative to accruing dry powder, particularly given the flexibility to invest at all levels of the capital structure. In other words, informed investors wisely deploying a private debt investment program today could generate meaningful yield over cash, with the additional advantage of being able to nimbly move into higher-risk/higher-return credit assets when market sentiment reverses and opportunities arise as we move into the next phase of the credit cycle—an advantage over monoline investment strategies.

Positioning a Late-Cycle Solution

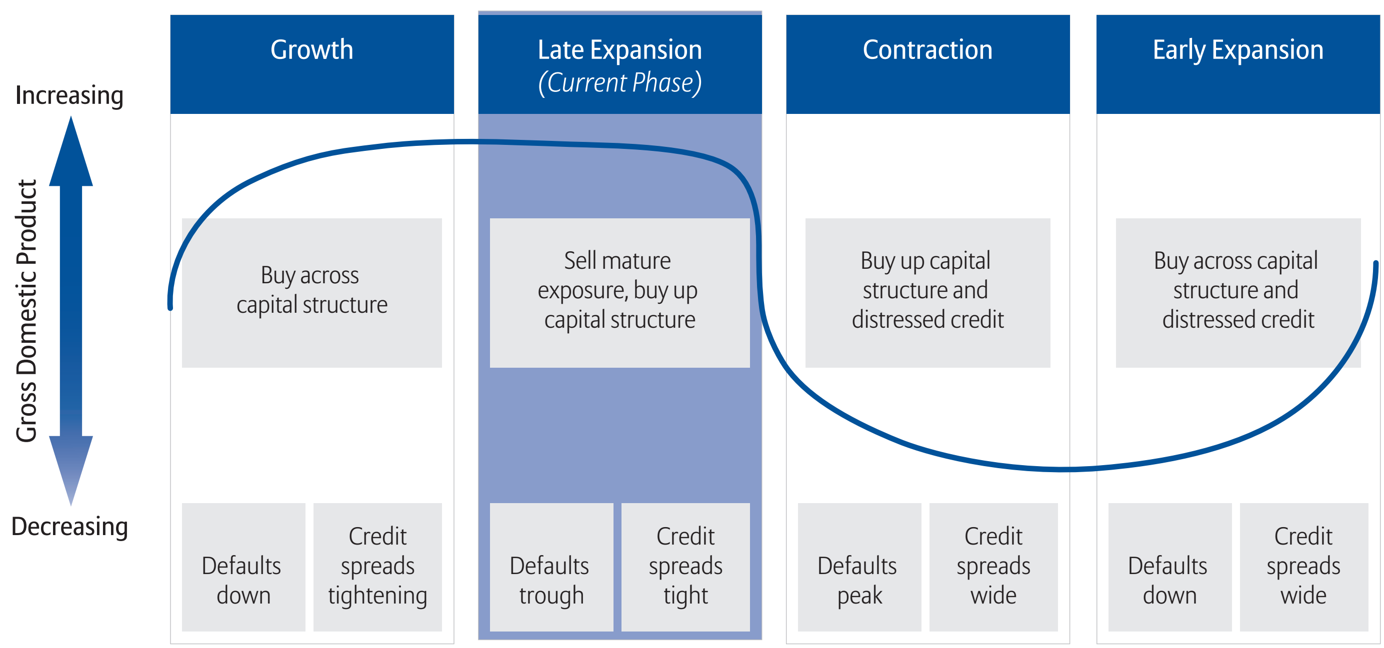
Institutions allocating to private debt can target attractive risk-adjusted returns at all levels of the capital stack through investments in syndicated loans, direct loans, mezzanine debt and equity-linked investments (**Exhibit 3**). Depending on an investor's risk profile and the perceived position in the credit cycle, a portfolio can be tailored to offer higher or lower expected returns at the expense of lower or higher seniority, with varying degrees of expected recovery in the event of default.

Exhibit 3: Private debt provides the flexibility to invest at all levels of the capital structure



Source: Allianz Global Investors

Exhibit 2: Private debt offers investors the opportunity to position a portfolio effectively across all phases of the credit cycle



Source: Allianz Global Investors

With that in mind, what should an investor do in the late-expansion stage of the cycle?

We believe that institutions should focus on deploying capital defensively through first-lien and other senior debt positions, with attractive asset coverage and strong current income. In contrast, a slide into a recessionary environment would create an opportunity to invest in more distressed credits and take on additional risk deeper in the capital structure, with the benefit of future expansion as the cycle improves. As the market moves into an early-expansion phase, mezzanine debt and equity-linked securities offer the potential to deliver strong performance, providing equity-like returns through attractive current income and capital appreciation.

Investors can also pursue a strategy that involves purchasing the fulcrum security—the tranche in the capital structure (often the first lien) that would ultimately enable an investor to manage risk in a downside scenario. In other words, the investor would be positioned to be covered by asset protection (via the first-lien secured position) or, in a severe downside scenario, by the ability to tailor a restructuring of an investment into equity ownership.

Regardless of capital structure positioning, equity-like returns in the private debt space can potentially be achieved with lower volatility and higher risk-adjusted returns when compared to public investments. Additionally, while the returns from opportunities currently available higher in the capital structure might fall short of what many expect private debt to be able to deliver in the long run, they are nonetheless preferable to maintaining a capital position in cash or, for example, investing in the Bloomberg Barclays US Aggregate Bond Index—which, in addition to a lower return, would carry a high level of duration risk at a time when investors should be reducing interest rate sensitivity.

By the same token, an allocation to private debt at this stage makes sense, in our view, because it can potentially mitigate interest rate risk due to the floating rate nature of the asset class (typically, coupons are tied to three-month LIBOR). Private debt—as represented by leveraged loans in **Exhibit 4**—has also generally exhibited a low correlation to other major asset classes, which can serve as a key differentiator during potential shifting stages in the credit cycle.

Leveraged loans have also historically provided superior recovery rates upon default versus high-yield bonds. As shown in **Exhibit 5** (please see next page), loans have experienced approximately 30% fewer defaults and a 60% higher recovery rate than high-yield bonds. As of year-end 2016, loan default rates were at a 10-month low of 2.73% on an issuer-weighted basis, while recoveries for first-lien secured loans have held steady at 69% on a weighted average basis over several market cycles.

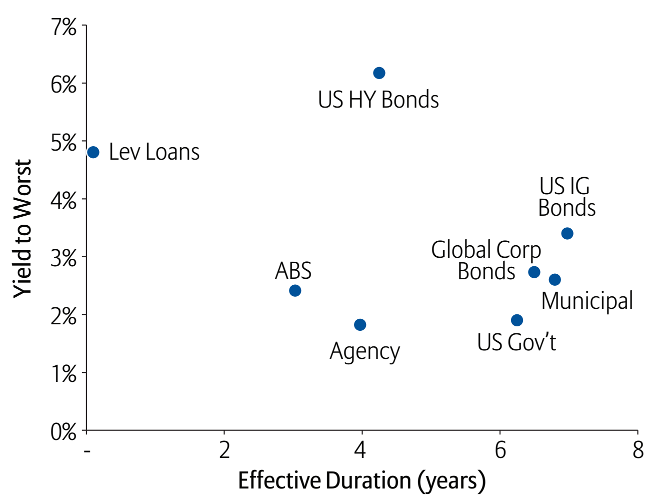
Exhibit 4: Leveraged loans have historically offered diversification benefits and inflation protection vs. other fixed-income securities and asset classes

Leveraged Loan Correlation to Select Asset Classes

	Lev Loans	Direct Real Estate	Private Equity	IG Bonds	HY Bonds	Dom Equities	Int'l Equities	EM Equities	REITs
Lev Loans	1.00	(0.04)	0.46	0.27	0.82	0.55	0.53	0.59	0.54
Direct Real Estate	(0.04)	1.00	0.29	(0.20)	(0.10)	0.05	0.02	(0.10)	0.06
Private Equity	0.46	0.29	1.00	(0.03)	0.48	0.78	0.75	0.64	0.51
IG Bonds	0.27	(0.20)	(0.03)	1.00	0.45	0.20	0.21	0.18	0.30
HY Bonds	0.82	(0.10)	0.48	0.45	1.00	0.65	0.59	0.71	0.59
Dom Equities	0.55	0.05	0.78	0.20	0.65	1.00	0.96	0.87	0.57
Int'l Equities	0.53	0.02	0.75	0.21	0.59	0.96	1.00	0.86	0.51
EM Equities	0.59	(0.10)	0.64	0.18	0.71	0.87	0.86	1.00	0.50
REITs	0.54	0.06	0.51	0.30	0.59	0.57	0.51	0.50	1.00

Source: Morgan Stanley Research; 1/1/1984 -12/31/2016.

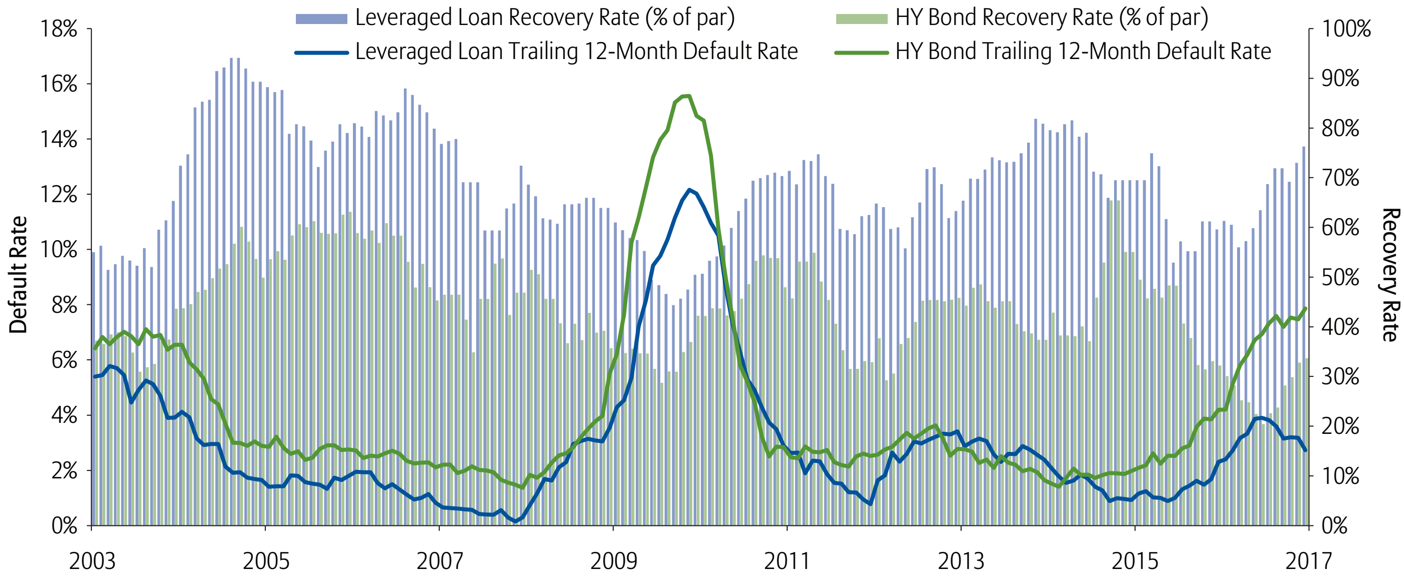
Leveraged Loan Duration vs. Other Fixed Income



Source: Bloomberg, Bank of America Merrill Lynch, S&P LCD as of January 31, 2017.

Leveraged Loans based on S&P/LSTA Leveraged Loan Index. Direct Real Estate based on CRE Transaction-Based Total Return Index. Direct Private Equity based on Preqin PE Index. Investment Grade Bonds based on Citi US Broad Investment-Grade Bond Index. High Yield Bonds based on Citi US High-Yield Market Index. Domestic Equities based on MSCI World Index. International Equities based on MSCI EAFE Index. Emerging Market Equities based on MSC Emerging Markets Index. REITs based on FTSE NAREIT All Equity REITs Index. Sources: S&P LCD, MS Research, Preqin, Citigroup Index LLC, Bloomberg

Exhibit 5: Leveraged loans have historically exhibited low default rates and high recovery rates compared to high-yield bonds



Source: Moody's as of December 2016. Default data is issuer-weighted.

Conclusion

Given the relatively low returns and high risk levels exhibited across numerous asset classes in today's markets, it is certainly understandable that investors would exercise caution in deploying capital. Nevertheless, we do not think that caution should mean paralysis, particularly when the current environment of strong valuations and ample liquidity provides investors with maximum flexibility to adjust their portfolios in advance of a potential market contraction.

Against this backdrop, we believe that institutions should consider allocating to an investment program in private debt that offers both current income and low duration risk, as well as the potential for strong risk-adjusted returns as compelling opportunities arise over the medium to long term. A flexible approach that can strategically capitalize on opportunities up and down the capital stack would enable an investor to both quickly rebalance and deftly deploy capital at all stages of the credit cycle—including the current late-expansion phase—in order to unlock value.

Ultimately, we believe that private debt represents a particularly compelling option for institutions who want to be proactive in the current challenging investment climate, while also positioning their portfolios to capitalize longer term on the historical attributes of the asset class.

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