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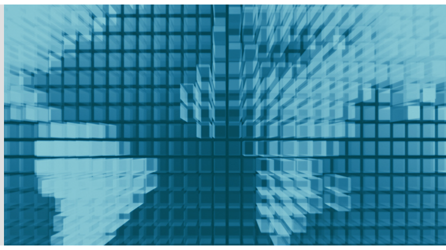

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Private debt investing, with a twist

Key Takeaways

- Many institutions, sovereign wealth funds and family offices ploughed in to government bonds 10-15 years ago when yields were attractive. Those bonds are now maturing and need replacing.
- One solution is to invest in leveraged loans. They have historically provided the best risk-return profile across the debt landscape.
- Focusing on less-cyclical businesses and investing in loans to private equity-owned companies provides a level of safety.
- A senior leveraged loans strategy is suitable for all investors hungry for yield and seeking to diversify their portfolios.
- Unlike many private equity and distressed debt strategies, committed capital can be put to work quickly, even if the commitment is sizeable.

Rafael Calvo,
Managing Partner,
Head of Senior Strategies
and Co-Head Origination

MV Credit

The search for yield is relentless. The days of meaningful yield from sovereign debt and blue chip bonds are long gone. The search continues elsewhere. But achieving higher yields than a long-only bond strategy while keeping risks in check is tougher than ever. For many investors, the range of viable options is narrowing, as their fears increase of both a downturn and rising inflation.

One of the solutions is investing in private debt and, specifically, leveraged loans. If the loans are senior and issued by non-cyclical companies with diversified sales channels, the risks presented by a downturn are strongly mitigated. If the companies are, in addition, owned by reputable and financially-strong private equity firms, the risks are further mitigated. And, because leveraged loans have floating interest rates, the risks presented by rising inflation can be offset too.

No investment strategy is recession-proof or fully resistant to inflation. But MV Credit believes a strategy which incorporates the elements above ought to provide superior yields on debt with relatively low risk.

Why leveraged loans?

Leveraged loans historically have provided the best risk-return profile across the debt investment landscape. They outperform senior corporate debt, high yield, REITS and infrastructure debt in terms of returns balanced against volatility. That's to say, they have more consistent, predictable performance.

Investing in loans to private equity-owned companies provides a level of safety because, in times of trouble, the owner typically has the financial muscle to step in and provide financing or know-how to help fix problems. Private equity houses are also used to dealing with distressed situations and are measured in their approach to both their portfolio companies and to creditors.

Within the leveraged loans spectrum MV Credit, an affiliate of Natixis Investment Managers, invests across the entire capital structure. The spread above investment grade fixed income is some 300bps to 500bps, meaning higher potential returns from senior leveraged loans.

Just as valuable amid the unwinding of Quantitative Easing (QE) and a rising interest rate environment, is the inflation hedge. Leveraged loans are issued with floating rates, which rise and fall with inflation and interest rates.

In addition, the average loan to value of senior leveraged loans is still attractive, providing a cushion against falling prices in difficult markets.

The twin firewalls: credit selection and monitoring

Downside protection underpins the strategy from start to finish. "Losses are an inevitable part of investing, just as taxes are inevitable for us all," says Rafael Calvo, managing partner, of MV Credit. "The key is minimising these losses, and that's what we prioritise."

The concept of loss minimisation is translated into action through two firewalls: credit selection and intense monitoring. These twin firewalls enabled MV Credit's clients to get through both the financial crisis and the euro crisis in much better shape than comparable debt strategies. "We are credit people, we can smell good credits and bad credits. We also have grey hair in abundance," says Calvo.

However, he is alive to the dangers of over-confidence in credit selection, which is why the second firewall, monitoring, exists. Early-warning systems aim to identify risky borrowers six to nine months before they face serious problems, enabling an orderly exit from investments. The creation of a divestment committee for underperforming credits enables exits at still-attractive prices.

The monitoring team's duty is to gather information, to highlight transactions performing below expectations and finally to call for divestment committees. This team independence is critical –

At many firms, investment and divestment decisions are taken by the same groups without relying in an unbiased judgment. The problem with this is that the passion required to argue for the inclusion of an asset in the portfolio can blind the analyst to problems as they arise.

The monitoring process is not limited to formal mechanisms. It permeates the MV Credit investment ranks, who are all tasked with spotting emerging trends, particularly ones that could have a negative impact. "Once we invest in companies we adopt a healthy paranoia mentality," says Calvo.

The managers examine price information, newsflow, quarterly reports and hold weekly meetings to discuss performance metrics. "Any problems, we don't hesitate to pick up the phone to the business owner," Calvo adds.

Focus on less-cyclical businesses

The safety-first approach leads MV Credit to companies that are less exposed to economic cycles and to larger companies that have diversified customer bases.

The length and amplitude of economic cycles are not predictable, whatever economists say. To achieve consistent returns from debt strategies, less cyclical businesses are preferable. "We don't want to be constantly thinking about risk-on, risk-off," says Calvo. "We want to sleep at night. Every time we make a decision, we consider whether the company could withstand a downturn tomorrow."

Less cyclical companies include healthcare businesses that sell non-discretionary products and software companies with strong subscription services, which are relatively immune to economic cycles.

Meanwhile, investing in companies with gross annual earnings of more than €30m reduces the risk of default, because these companies tend to book sales right across the world and across customer segments. Larger companies tend also to have more professional management teams with better reporting. So while most of the loans in the portfolio are from Western European companies, their geographic reach is typically global, offering strong diversification effects to the portfolio.

Sourcing deals takes skill and reputation

Leveraged loans is not a bolt-on strategy and cannot simply be added to an investment firm's suite of funds. There are a number of investment firms attracted to the asset class because of the excess risk-return available.

But this return is only available to firms with experience of the segment, understanding of the complexity of the transactions, and years of working as a team to unearth and share relevant information.

Founded in 2000, MV Credit is dedicated solely to European credit, financing over €5.3bn in over 500 transactions since it launched. It is now one of the longest-established credit management teams in the industry. "We have stayed together through good and bad, seen many different credit cycles," says Calvo. "Focusing on one segment only gives us depth and perspective."

This perspective is also helpful in sourcing deals. While a secondary market does exist, the best value from leveraged loans is available by sourcing deals directly. This means establishing a reputation within the loans network and maintaining it through frequent transactions and professional behaviour.

As well as the technical expertise, the secret to successful loan origination includes being predictable and able to consistently deliver understanding the intricacies of the industry, not overpromising and not making mistakes. And experience is essential when quick decisions are required.

Who's the strategy for?

A senior leveraged loans strategy is suitable for all investors hungry for yield and seeking to diversify their portfolios.

Many pension funds, insurance companies, sovereign wealth funds and family offices invested heavily in government bonds 10-15 years ago when yields were attractive. Those bonds have reached or are reaching maturity now and need replacing. Cash is not an option.

Leveraged loans provide good returns per unit of risk in return for an illiquidity premium. Unlike private equity strategies, the J-curve is very shallow and interest payments start soon after an investment is made. And unlike many private equity and distressed debt strategies, committed capital can be put to work quickly, even if the commitment is sizeable.

In terms of its place in the portfolio, a leveraged loans strategy typically resides in the alternative segment or within the fixed income allocation. MV Credit's strategy could also belong to an ESG allocation given that there is a strong ESG component. ESG investing has been a part of the firm's DNA since 2000 and adds sustainability to MV Credit's strategies while meeting the constraints of investors with ESG mandates.

Current outlook for the strategy

The strategy provides strong returns when the economy is weaker and refinancing is required, but also vibrant performance when the economy is strong and M&A activity is buoyant. M&A has been strong in the last two to three years, but it is possible this is reversing and refinancing will become the more dominant theme.

In addition, private equity sponsors have sweated their assets harder since the financial crisis, ensuring that portfolio companies are able to navigate both rising and falling markets. Rather than focusing on financial structuring, private equity firms are refining business models, building business platforms and leveraging ideas and resources across their portfolios. The entire private equity-owned market is healthier as a result.

Conclusion

It is natural to be concerned about economic and market cycles. But it is not necessarily good for our health. A leveraged loan strategy focused on diversified companies, which are not highly exposed to the vagaries of markets, can help yield-seeking investors sleep at night.

Partnering with a team which has managed assets through the most difficult markets in living memory and not only survived, but prospered, should give investors more comfort about the sustainability of their debt portfolios.

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