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Senior loans investors can rise to the challenge of competition

How meaningful ESG targets, robust credit selection in mid-caps, and inflation mitigation can add value.

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Senior loans have historically provided one of the best risk-return profiles across the debt landscape, given their low standard deviation of returns and high sharpe ratios.[1]

Investors have poured capital into the private debt space, as the traditional bank lending continues to lose market share. Pricing in this market tends to move in waves, with the recent wave creating a more heated market.

Senior loan managers who can select the best-performing loans, enhance the ESG profile of their portfolios and manage emerging inflation risks will outperform despite seasonal pricing pressures.

A defensive approach to senior loans

During the euro crisis in 2012-2014, many institutions invested in government bonds when yields were far higher than they are today. Those bonds have matured or are now maturing and need replacing in portfolios. Most European five- and 10-year government bonds yield significantly negative real rates, given the current inflationary environment.

A solution for asset allocators is to invest in private debt or direct lending funds buying private debt issued by private equity-owned companies. Senior secured debt is suitable for most investors requiring yields higher than on comparable bonds, and who are seeking to diversify their portfolios.

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. The default rate is historically very low and recovery rates on defaults are high.

Loss minimisation at MV Credit is further enhanced by a monitoring process led by an independent monitoring team which acts as an early-warning system for transactions that are performing below expectations.

The spread above investment grade fixed income is some 300bps to 500bps, meaning higher potential returns from senior secured debt. "To date we have invested in a diversified pool of predominantly senior loans, issued by companies with typically between €30m and €100m of EBITDA," says Rafael Calvo, Managing Partner at MV Credit.

"These companies are all based in western Europe, and operate in defensive industries, like healthcare and information technologies, meaning our overall portfolio has good defensive properties."

Support from secular trends

MV Credit's core focus is on healthcare and information technology/software companies with a strong growth profile, business-to-business models and a subscription-based client base with recurring revenues.

Key takeaways

- MV Credit has pioneered tying ESG performance directly to manager compensation in the private debt markets. The team has aligned interests with investors by linking carried interest to ESG, as well as performance.
- Amid market challenges, additional value can be found in trusted bilateral relationships with PE sponsors.
- Rising inflation concerns are mitigated by floating rates coupons and by investing only in companies with strong cashflow cover.

The return objective is 6-7% and there is no reason to lower expectations going forward, Calvo says, despite increased competition for assets and a challenging macro environment.

"Since 2000, we have managed private debt portfolios through a number of different – and challenging – credit cycles," says Calvo. His credit team plans to remain focused on western Europe and invest in companies in industries with secular growth – namely healthcare and software. "We strongly believe in the

1. Past performance is not an indicator nor a guarantee for future results. Views and opinions expressed are those of MV Credit at the date of publication and are subject to change without notice.

trend of an ageing global population, and we believe in the continuing automation of processes and cybersecurity," says Calvo.

"Despite the strong rally in tech stocks over recent years, we think there will be still more demand for IT and more growth."

The Nordic countries also offer attractive prospects going forward. Companies based in Nordic nations have always featured strongly in MV Credit's portfolios, given those countries' success in producing valuable healthcare and technology businesses.

An innovative approach to ESG

ESG, done well, is another way to ensure high credit quality in a private debt portfolio.

MV Credit ties its ESG efforts to the principles of the European Union's Sustainable Finance Disclosure Regulation (SFDR), which demands that investors "follow good governance practices". Investing with these principles in mind is challenging and requires capabilities that are not available to all investment houses.

MV Credit has incorporated ESG in its portfolios since its inception in 2000. Today ESG analysis is performed for all its investments, examining the policies of sponsors, assessing governance and diversity and screening for regulatory and legal breaches.

Where MV Credit differs most from other debt investors is that it ties its ESG performance directly to compensation. The MV Credit team is only entitled to the full carried interest when all ESG key performance indicators (KPIs) are met. If none are met, only half of the carried interest is due.

In the latest approach, MV Credit carried interest has three levels of key performance indicators (KPIs). The first KPI is at GP level and stipulates high levels of diversity, including that at least 35% of MV Credit's senior staff are women. This compares with an industry average of around 12%. The second KPI is to achieve a predefined response rate to the ESG questionnaire MV Credit sends to its portfolio companies. The questionnaire is detailed and wide-ranging, consisting of about 50 topics across the ESG spectrum. The third KPI relates to ESG performance across the portfolio, based on the questionnaire responses.

"We think we are the first in the market to implement something like this," says Calvo. "I think it shows our commitment to ESG principles and it is a clear way to show alignment with the ESG policies of our investors."

The value of relationship-driven, bilateral deals

Market issues are always on the minds of investors. In the private debt market, deal-making was hugely elevated in late 2021-early 2022, leading to upward pressure on pricing for loans.

In addition, inflation is always carefully watched by debt investors. Inflation has run way ahead of expectations in most markets, with the potential to erode the value of investors' returns.

Value can still be unearthed, despite the market challenges. "We have found better value, margins and fees in investments involving non-rated upper-mid market companies, those with €30m-€60m EBITDA," says Calvo.

Why? Well, larger transactions are typically rated and, once this happens, loans can be traded in the secondary market, a buoyant secondary market with plenty of liquidity and many potential buyers. This market boosts bidding and pricing.

Another way to bypass buoyant secondary markets is through bilateral investments. "On the sponsor side, speed of delivery, certainty of financing and convenience will provide a premium," says Calvo. "Given our experience in this market, we are able to assess and execute transactions rapidly, so the sponsor does not need to spend their time syndicating the debt and can just move on to the next investment. That is enticing for many sponsors."

Inflation protection through credit selection

Inflation is a perennial danger to fixed income portfolios. To some extent, private debt has built-in protection since they have floating rates coupons which rise in line with rising rates.

But this will not lessen the likelihood of defaults. That risk can only be mitigated through credit selection. For that reason, MV Credit has, in recent years, increased expected input, labour and interest costs in its models for prospective portfolio companies. Calvo says: "It was clear all the money in the system would lead to inflation, it was just a question of when."

"Inflation risks are always in our models," Calvo adds. "For many years we have factored in the possibility that inflation could happen very fast, in addition to factoring in a significant raise in the cost of debt for companies through the increase in base rates."

MV Credit's base case is that the elevated inflation levels at the beginning of 2022 will subside to more normal levels in the medium term. However, it is positioned for a possible acceleration of inflation in the short and medium term, reducing the profitability of many companies.

"Our models are built so we invest in companies that can afford a reduction in profitability margins amid cost inflation" says Calvo. "They tend to have very strong cashflow cover."

Unapologetically focused on risk

Factoring in risks, however small they seem to be, is a critical aspect of senior loan investing. Capital protection is paramount and Calvo is unapologetic for MV Credit's defensively-minded approach.

"We don't play the cycles, so we will not get all the upside in strong markets," he says. "But in the mid-cycle and lower parts of the cycle, we tend to do very well – the standard deviation of our returns is pretty low."

"Put another way, we set ourselves up to be a safe pair of hands."

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