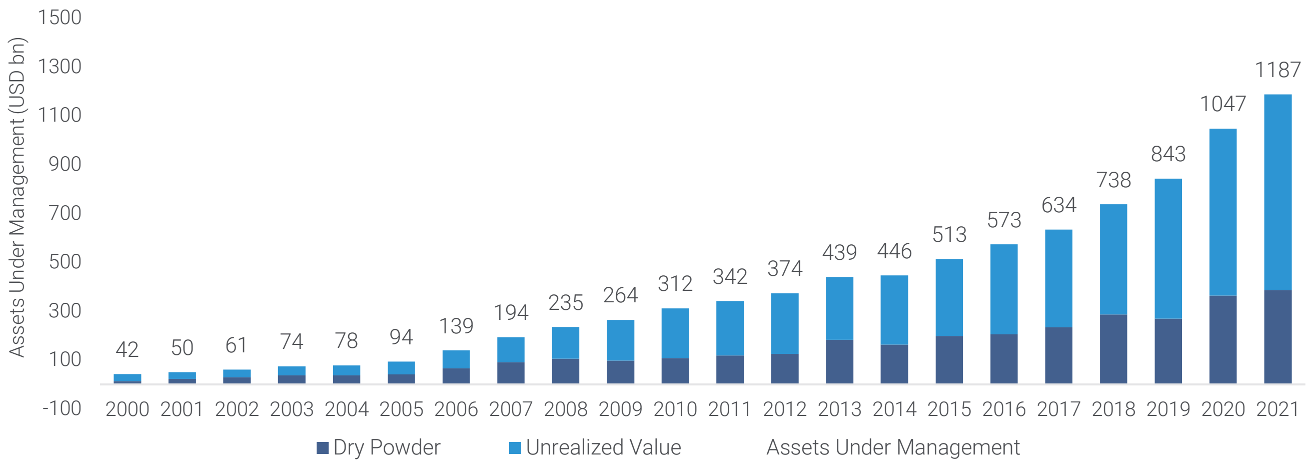
Private Debt is Booming

Introduction

The private debt landscape has changed significantly since the foundation of MV Credit back in 2000, transitioning from a niche asset class to a vital part of an asset owner's investment portfolio. In 2000, the senior debt market was dominated by investment banks, with funds offering more bespoke solutions typically within the subordinated debt space. Following the Great Financial Crisis ("GFC") the banks that were historically active retrenched, leading to the development of the private debt market as it is known today.

MV Credit has been active in the market since its infancy, and invested through multiple cycles, something that few managers can attest to. This experience in private debt is crucial when constructing a portfolio of defensive and robust assets. Private debt as an asset class has a multitude of benefits when an investor partners with the right manager. This piece aims to provide an insight into private corporate debt and the benefits it can bring within a diversified investment portfolio, alongside the growing push for ESG.

The Rise of Private Debt



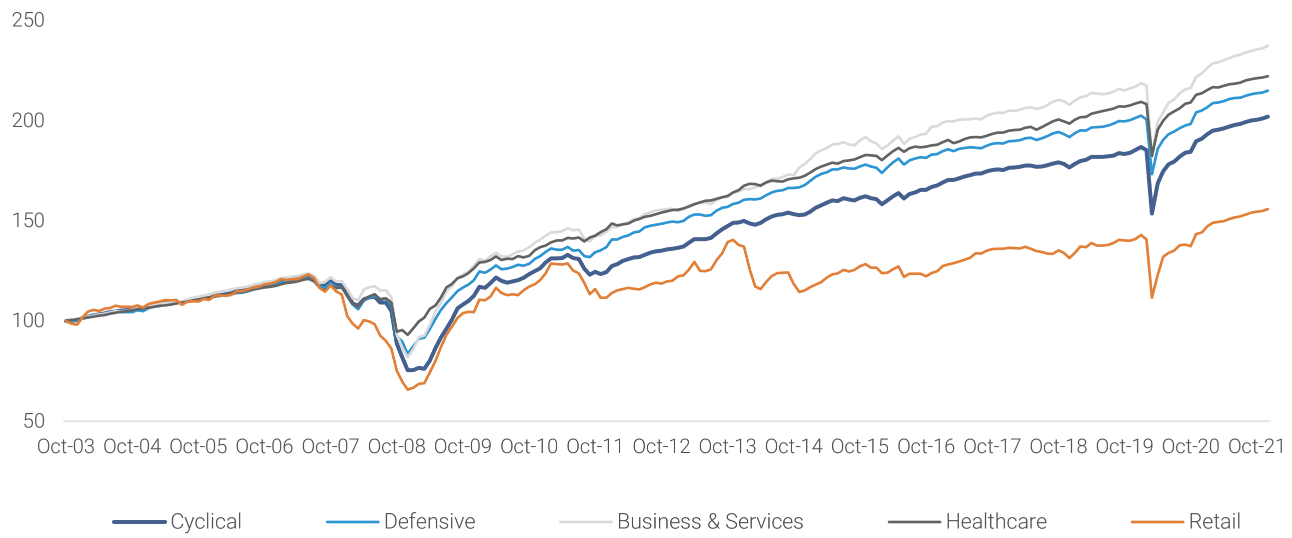
Source: Preqin, Dec 2020 – Jun 2021, Global Private Debt.

Robust asset class where experience matters

Consistent Risk-Return in Targeted Industries

The primary goal of a private debt manager is to generate consistent, stable returns whilst recovering the loan's principal. Outsized risks are typically not rewarded in this asset class due to limited upside. Therefore, it is key to invest in defensive and stable industries, such as healthcare and information services which are cash flow generative and hence better suited to sustaining economic shocks. Defensive industries have outperformed cyclical industries on a risk-adjusted basis by over 20%[1]

Defensive Industries Outperform Cyclical



Source: LCD: October 2003 – December 2021.

[1] Risk-adjusted basis calculated as the annualised return divided by the annualised volatility from October 2003 to December 2021. LCD.

MV Credit has been investing in these defensive sectors for over 20 years. Ultimately, a debt manager's alpha stems from its ability to avoid defaults and minimise losses.

Inflation Protection

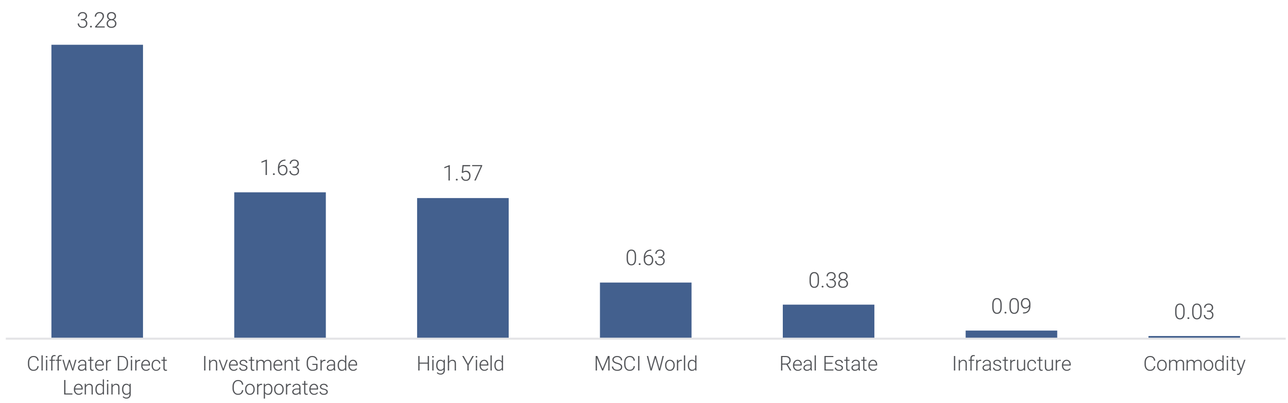
Prices are rising and assets owners are cautious while allocating capital to protect against inflation risk. Investors are concerned over inflated equity valuations and the impact that higher interest rates will have on returns and performance. Private debt is 100% floating rate, providing a natural hedge against inflation and interest rates, with loans typically containing a floor limiting the impact of any unexpected further drops in the base rate.

MV Credit considers the impact of inflation when analysing each portfolio company and the ultimate flow through to costs (and the bottom line). This analysis is a key part of the stress testing of each potential investment. Private debt is not a flow business, and each transaction can be analysed in greater detail than the equivalent public market investment.

Cycle Resilient

The recent pandemic has arguably provided the first real test of the 2nd generation of private debt managers (those managing money post the GFC) and some have fared better than others, testing their resolve as investors. However, the asset class has remained remarkably resilient through the cycle so far. It delivers stable returns with low volatility acting as safe harbour in times of crisis and has outperformed other asset classes.

Sharpe Ratio Risk-Return Analysis



Source: LCD and Bloomberg market data as at Q4 2021. Returns and Standard Deviation figures are calculated over the period Jan 2010 – Nov 2021. Cliffwater Direct Lending Index; Investment Grade Corporates (iBoxx Euro Corporates (3-5y)); High Yield (Bloomberg Pan-European High Yield); MSCI World; Real Estate (S&P Europe REIT); Infrastructure (MSCI Europe Infrastructure); Commodity (Dow Jones Commodity)

MV Credit has experience through multiple cycles including the GFC where its 2005 subordinated vintage demonstrated resilience through a downturn. Experience matters when investing in the market.

ESG aligned

ESG in private markets

During the past two years, ESG has firmly moved to the top of the agenda, as a drive for change has accelerated during the Covid-19 crisis. ESG has always been a topic of conversation for private debt managers who are seeking to avoid losses and protect against downside risks. 20 years ago, this meant avoiding certain industries which could face potential regulatory issues, such as oil and gas, tobacco and gambling.

This is now seen as the bare minimum as the outdated notion that private debt managers cannot impact ESG has changed, and ESG is now integrated at every stage of the due diligence process and ongoing monitoring. MV Credit has worked with a third party to develop a proprietary scoring system, whereby each portfolio company is ranked on a scale. This tool has enabled engagement with the private equity owners of the businesses that MV Credit lends to.

Investors are starting to realise there is more potential for impact within the private markets: where private equity sponsors own the entire company, vs. public market participants who only own a small piece. Private market investors typically have more control over their portfolio companies.

ESG linked loans

A development MV Credit has been involved in is the growth of the Sustainability Linked Loan ("SLL"). The defining feature of the SLL is that the terms of the loan incentivise the borrower to improve the company's performance against certain pre-determined ESG criteria. This is then implemented via a ratchet mechanism on the margin, the typical adjustment being +/- 2.5bps. The structures of the loans have evolved from the use of standard third-party rating agencies to more bespoke KPIs. MV Credit will continue to offer SLLs across all its funds, in order to positively influence the behaviour of the underlying borrowers.

Diversity and Inclusion

It is important for private market participants to not only focus on their portfolio companies, but also to look within the firm at corporate practices. For example, gender diversity within the alternatives space is 20.3%[2] according to Preqin. Within private debt this figure is lower at 19.9%[3] compared to the MV Credit team which is 52%[4] female across the firm. Gender diversity has been built over years of commitment to equality across the team and this diversity aids in the investment decision making process.

MV Credit is proud to have been awarded the inaugural Diversity and Inclusion Leader of the Year-GP Mid-Market award at the 2021 Private Equity Awards and believes it is a trend setter in the space[5]. The journey does not stop here as the team at MV Credit will continue to strive for best practice.

Conclusion

The private debt market has been resilient in times of crisis and provides an attractive opportunity to hedge against inflation whilst delivering consistent returns. Experience is key and partnering with the right manager is paramount when investing in the asset class. MV Credit is able to work with investors to tailor solutions to their specific requirements and will be launching a 3rd senior private debt vintage (featuring ESG characteristics) in the first half of 2022 to address the needs of investors seeking to allocate to private debt.

[2] Preqin impact report: women in alternative assets, March 2021.

[3] Preqin impact report: women in alternative assets, March 2021.

[4] Based on headcount for November 2021.

[5] Reference to a ranking and/or a price does not indicate the future performance of the strategy or the fund manager.
Past performance is not a reliable indicator of current or future performance.

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