Private credit offers a variety of opportunities for institutional investors, particularly those with long-term time horizons. A variety of strategies is available to match fixed income assets with liabilities, capture a return premium, or pursue high-yield options. In any case, the private credit sector can bring stability and diversity to an investment portfolio.

In contrast to publicly traded bonds, private credits are relatively illiquid, so investors typically follow a buy and hold strategy rather than a total return trading strategy, says Chris Lyons, managing director and group head, private credit, Voya Investment Management. “Most insurance companies have liabilities with 5- to 10-year durations, so an asset class with a similar duration that provides fixed income and covenant protections aligns well with their goals,” says Lyons. “Pension plans are also natural buyers for private credit, which typically returns 80 to 100 basis points a year over public debt.”

While private credit means different things to different investors, this asset class includes broadly syndicated loans, infrastructure loans, corporate private placements, and middle-market loans. “We think of it as assets that are not freely traded,” says Eric Lloyd, head of global private finance, Babson Capital Management. Both investment-grade and non-investment-grade products are available, including loans whose rates can be adjusted in the event of inflation.

Lloyd has seen an increase in interest in private credit from investors seeking to pick up an illiquidity premium by allocating a portion of their fixed-income portfolios in this sector. “The type of private credit varies by investor because each portfolio is different,” he adds. “The credit cycle has shifted into a period of higher volatility, rising defaults and potentially rising rates,” says Ken Kencel, president and CEO of Churchill Asset Management, a TIAA-CREF company. “Now is a good time for investors to consider private credit, assess the sub-asset classes and determine which strategies best match their goals.”

Weighing the options
Private credit investors need to understand the nuances of allocating to this sector as well as the various risk-return profiles. That’s because loans offering similar yields could come with significantly different levels of risk, says Kencel. “Broadly syndicated loans are floating rate loans made to large-cap corporate borrowers,” Kencel says. “A broadly syndicated loan may have 15 to more than 100 investors in a senior credit facility, the vast majority of whom are mutual funds or collateralized loan obligations (CLOs).”

That’s a different structure from middle market loans, which are typically made by a small number of co-lenders in a “club” structure where the lenders know each other and cooperate closely, he adds. “Middle-market senior loans offer better overall terms, along with a yield premium of 100 to 200 basis points,” Kencel says. “They have traditional financial covenants that provide (continued on page 4)

“Now is a good time for investors to consider private credit, assess the sub-asset classes and determine which strategies best match their goals.”
Ken Kencel, president and CEO of Churchill Asset Management, a TIAA-CREF company.
What is driving interest in the private credit market?
Roelke: Private credit investing has been a hallmark of TIAA’s investment program for decades. Given our firm’s long-term investment horizon, we are comfortable with less-liquid investments, like private credit, that provide offsetting benefits when compared to public market investments. Those benefits include yield premiums, diversification, and structural elements such as traditional financial covenants that help mitigate risks inherent in holding an illiquid investment through maturity. In today’s yield-constrained environment, we have seen a dramatic increase in investor demand for this asset class.

What are the different segments of the private credit markets?
Vichness: Private credit investments can be found across the credit spectrum from traditional, fixed-rate debt private placements, credit tenant loans, and infrastructure debt in the investment grade world, to senior and junior middle-market loans and mezzanine in the speculative grade category. Given the scale of TIAA’s platform, we have teams that specialize in each of these sectors.

Kencel: Churchill Asset Management is TIAA’s majority owned middle-market senior loan affiliate. We make loans to companies with up to $50 million of cash flow that are arranging senior credit facilities of up to $250 million in size. In our market, financing is provided by a small club of lenders that conduct primary due diligence on the borrowers and negotiate covenants and pricing. Given recent volatility in the public non-investment grade credit markets, we believe middle-market senior loans are a compelling proposition for institutional investors from a risk/reward perspective with a buy-and-hold orientation that drives a focus on deep fundamental analysis. We identify financing opportunities with private equity owned companies that are not yet large enough to access the more liquid broadly syndicated loan market. Our senior loan investments always have a first lien senior secured position in a company’s capital structure and traditional financial covenants, and we enjoy better pricing and lower leverage than broadly syndicated loans.

How has the middle-market senior loan landscape changed in recent years?
Kencel: After the global financial crisis, many of the large commercial banks that historically provided senior secured loans to middle markets companies exited middle-market direct lending to focus exclusively on underwriting and syndicating larger more liquid loans. This was in part driven by the increased capital requirements and regulatory burdens that made middle-market lending less economic for them. So the outcome is that today there are only a handful of firms, such as Churchill, that focus on traditional middle-market senior loans. That dynamic has resulted in more favorable terms and pricing and traditional covenants in these loans.

Where do you see the most appealing opportunities in today’s market?
Vichness: Investing in private middle-market senior loans can deliver consistent attractive yields in the 6 to 7 percent range each year...
without the inherent volatility of broadly syndicated loans, high-yield bonds and junior debt investments in the middle market.

What about liquidity?
Roelke: Private credit investments appeal to investors who have long-dated needs in their portfolios, such as insurance companies and defined-benefit (DB) and defined-contribution (DC) plans. That’s because these private credits are structured as “buy-and-hold” investments. Many institutional investors and plan sponsors are comfortable with the illiquidity in this asset class, because of their long-term horizons.

What about duration risk?
Kencel: Middle-market senior loans typically provide for a floating rate based on LIBOR, offering an element of protection against rising interest rates when compared to fixed-rate investments, like high-yield bonds. The majority of our loans tend to pay off in three to four years, further reducing interest rate risk.

Vichness: It’s also important to remember that middle-market senior lenders are generally like-minded investors who are committed to working closely with borrowers over the duration of a loan to resolve any potential problems directly with the company.

Are there other factors to consider?
Kencel: Generally, middle-market senior loans have lower leverage than broadly syndicated loans, high-yield bonds or junior subordinated debt. This has historically resulted in lower defaults and lower losses. The loan to value (LTV) ratio is typically 40 to 50 percent, reducing investment risk. It is also important for investors to look at the loan amount relative to a company’s historical EBITDA or cash flow. Our loans are typically funded at between three and four times historical cash flow in transactions where a private equity sponsor is acquiring a business for eight years, further reducing interest rate risk.

Let’s look at the outlook for 2016. How will global market volatility affect middle-market senior loans in 2016?
Roelke: In general, the private credit markets do well in volatile times, unlike the public credit markets, which can see strong inflows and outflows, or the high-yield market, which can be open or closed at certain points. Because of their illiquid nature, and due to the downside protection afforded by financial covenants, private credit instruments can serve as a stabilizing force in investors’ portfolios.

How do you make credit investment decisions?
Kencel: At Churchill, we look at sectors that are not subject to commodity price changes, such as the dramatic drop in oil prices. The objective is a portfolio that consists of solid companies in non-cyclical industries that have demonstrated the ability to perform well throughout the economic cycle.

Do you look for deal volume?
Kencel: No. We are very selective. We conduct a thorough credit analysis and ensure the traditional loan covenants are in place. We underwrite these credits based on the low point in the cycle in keeping with our goals of principal protection and consistent yield. Because we plan to hold these loans through maturity, fundamental due diligence on the front end is critical. We are defined as much by the deals we don’t do as by the deals we do.

What are the differences between U.S. and European private credit?
Vichness: The private credit market in the U.S. is much larger than in Europe. We estimate up to five times the size. Moreover, in Europe, the banks are still quite active, limiting the opportunities for direct lenders.

Kencel: From a creditor’s perspective, the U.S. has clear and consistent rules for bankruptcy and reorganization, compared to Europe where the bankruptcy laws vary widely by country.

Any additional thoughts about this market opportunity?
Kencel: We are big believers in the opportunity for institutional investors today in traditional middle-market senior secured loans. Consolidation in the banking industry and increased regulation on capital requirements have significantly reduced the supply of traditional senior debt capital to the middle markets. This has resulted in a very attractive supply-demand dynamic in the middle market in favor of the lenders. It has generally driven lower leverage and better pricing in the middle market. With all-in yields consistently in the 6 to 7% range, we believe it provides excellent risk adjusted returns for institutional investors with long-term horizons.

TIAA Global Asset Management provides investment advice and portfolio management services through Teachers Insurance and Annuity Association and affiliated registered investment advisors, including Teachers Advisors, Inc., TIAA-CREF Alternatives Advisors, LLC and Nuween Securities, LLC, TIAA-CREF Individual & Institutional Services, LLC and Teachers Personal Investor Services, LLC. distribute securities products.

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greater protection to lenders than mezzanine loans or other types of junior debt.”

Noting that Churchill focuses on traditional middle-market senior lending, Kencel says loans that go deeper into the capital structure typically carry a higher risk, as do senior loans to small companies that are less able to withstand a downturn in the economic cycle.

Lyons says Voya’s private credit portfolio runs from investment-grade through triple CCC loans. “While investment-grade private credits offer more yield and better downside protection, we also hold high-yield, middle-market and mezzanine loans,” he says. “We also provide credit to smaller companies, typically $75 million and below, that are trying to build their business and grow to the next level.”

In the high-yield sector, Lyons has seen a pullback in bank lending, allowing Voya to focus on club deals with a handful of other large investors rather than organizing a syndication. “Having a club arrangement has other advantages compared with syndication,” he adds. “Having fewer lenders means you have an opportunity to get better deals on the front end and manage the credit more effectively over the life of the loan.”

Lyons points out that investment opportunities exist throughout the capital structure, from traditional senior secured and second-lien loans to mezzanine debt with equity features. In the U.S. and Europe, Babson has seen growing interest in unitranche structures, which combine characteristics of senior and mezzanine debt.

Minimizing the risks

Because private credits are long-duration, illiquid loans, they require extensive due diligence. “We pay attention to macro trends, including political, economic and interest rate risk,” says Lloyd. “However, our investment process begins with a bottom-up credit analysis looking at companies with strong fundamentals in stable industries.”

Lyons notes that underwriting is significantly deeper – more in keeping with a bank loan than a public bond. “It involves spending more time with management, making site visits, and developing a relationship,” says Lyons.

One of the keys to minimizing risks in middle-market loans is incorporating strict financial covenants that are similar to a bank loan, such as maintaining a certain debt to cash flow ratio, or forbidding the sale of business assets. In fixed-rate loans, the credit agreement also can include an adjustment if interest rates rise.

“Investors should look to lenders who understand the importance of traditional financial covenants,” says Kencel. “If a company is underperforming, the lenders can bring management back to the table and address those issues in advance of a payment default.”

Lyons agrees, adding that the inclusion of covenants is one reason losses are lower with senior secured loans and with public bonds. “On the other hand, if the company performs as expected, we can do follow-on loans, continuing our relationship with the company just like a banker,” he adds.

Advice for investors

Professionals who focus on the private credit sector have several suggestions for institutional investors:

• Think globally. “A strategy that includes assets from different geographies provides a larger funnel for the fund manager who can look across regions in an effort to maximize opportunities,” says Lloyd. “Some investors may prefer a U.S. or a European private credit strategy, while others want to connect these strategies across different regions.”

• Combine public and private credits. One strategy that appeals to many institutional investors is a combination of liquid and illiquid credits, says Lloyd. “That strategy provides exposure to the credit market without the pressure of finding suitable private credits immediately,” he adds. “An investor could access the liquid market first, and then transition part of that portfolio to the illiquid side based on an assessment of relative value.”

• Look at your position in the capital stack. “As part of the due diligence process, you should look at the average equity contribution in the manager’s transactions,” Kencel says. “You also should understand how much junior capital is in the stack below you and look at the overall leverage.”

• Analyze the projected return. “Investors should be sure the private credit opportunity meets the desired risk-return profile,” says Kencel. “If returns are in the 9 to 10 range, the lender is operating in a higher-risk segment compared with middle-market senior loans.”

Finally, investors should do their homework to be sure they understand all the characteristics of the private credit, as well as the risk profile of the manager. As Lyons says, “Be sure you are getting true transparency.”

“Pension plans are also natural buyers for private credit, which typically returns 80 to 100 basis points a year over public debt.”

Chris Lyons, managing director and group head, private credit, Voya Investment Management.