AFA Sees Long Term Opportunities in Direct Lending

Stockholm (Hedgenordic) – AFA Insurance was one of the early adopters in the Nordics when it comes to private debt. In recent years, the Swedish insurance company has added exposure to direct lending as they see opportunities for the asset class in the light of changing banking regulations. In an interview with Hedgenordic, AFAs head of alternative investments, Mikael Huldt (pictured), gives his view on direct lending as an asset class and shed some light on AFAs investments in the space.

How does AFA incorporate direct lending into its alternatives portfolio?

– AFA made their first investments into private debt a long time ago, I think the first investment that was done within loans stretches back to 2007/2008. These investments were then put on hold for a number of years and no targeted allocation towards the space was done during this time period. Private debt investments were not separated during this time but rather put into the Private Equity portfolio.

– When I joined AFA in the autumn of 2015, I quickly realized that private debt was going to be a very interesting investment but it needed to find a "home" in our investment universe. It was not fair to compare the returns of private debt to

those of PE-investments, we argued.

– I therefore created a private debt bucket amounting to approximately 3 percent, corresponding to approximately SEK 6 billion, with the purpose of being able to invest in things that has lower expected return and risk compared to PE. What we today have is a barbel strategy within the alternative investment portfolio where the private equity investments are there to generate higher returns to a higher risk whereas private debt is the low return/low risk part

What expected return do you set for the strategy?

– We have a return target of the private debt portfolio over the longer term of 6-7 percent. The goal we had when setting up the private debt structure was to find strategies that would prevail for the longer term and that were not dependent on shorter term market conditions, for example we were looking for strategies that would still work well should the interest rate environment normalize.

Why did AFA decide to go with direct lending?

– I believe currently that there are a number of strategies within the private debt space that are doing well simply as a result of the low rate environment, some strategies within infrastructure debt would be some of those examples.

– I started looking at strategies within private debt where I believed returns came from something else than just as a result of the low rate environment and the quantitative easing from central banks. What I looked specifically at was the changes in regulations such as the Basel accords and what impact that had on the bank's lending activities to small and mid-sized companies.

– My conclusion was that banks will find it harder to lend to these companies under the new regulations. They want to work more as syndication partners, which has been a long lasting trend in the US where banks have a very small part of the lending activities, in Europe, the banks are still the major lenders but that will likely change. As a result of this we believe direct lending will be a strategy that will prevail for longer, which is why we invest in the strategy today.

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Describe the manager sourcing process and implementation in portfolios

– What we have done in the direct lending space is that we have focused on the US and Europe. We did a thorough research before deciding on the allocations where we screened about 70 managers in the US and around 40 in Europe. We mapped the market according to the size of the managers, how they lend and what individual qualities they had. We have decided to go with larger and established managers since we believe this is a volume business, especially when sourcing deals you need to have a wide range of capabilities, which smaller managers typically don't have, We also decided to go with names that have managed assets in difficult environments such as during the financial crisis, and who have proven their abilities in these markets.

– We believe the skill of a manager in the direct lending space shows in how well he manages the downside of the portfolio. One of the most important differences we see with this asset class compared to high yield and levered loans, is that recovery rates are much higher. This I believe has to do with the fact that there is a closer and more long term relationship between lender and borrower within direct lending than compared to levered loan syndicates, for example.

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– Our investments are done through funds and we have allocated a majority of what we had anticipated in the first round. Now it is all about evaluating how they have performed and whether they deliver in line with expectations.

– Regarding the liquidity of the investment, one positive thing is that the Solvency 2 framework sees non-rated and non-traded loans as less risky than traded high yield loans for example. This is an advantage for us being an insurance company where we can allocate from liquid rates to direct lending and lock-up capital, thereby gaining an illiquidity premium of 150 to 200 basis points to the same risk profile.

What risks do you see with the asset class?

– The risk I see with the investment is that direct lending has seen tremendous inflows in recent years, which could potentially lead to a less disciplined approach as managers are eager to gather as much assets as possible.

– I see some managers being influenced by the levered loan market where there is a large portion of non-covenant deals. Should this enter into direct lending, that would be a warning sign for me since it means that the ability to act swiftly when markets turn more difficult disappears.

– What is important as an investor in the space is that you can trust the manager not to tamper with the credit quality of the underlying investments. It is very difficult to have a detailed view on the covenants in the underlying deals, you need to have faith in the process and the manager behind the program.

– In terms of transparency, we have full transparency on the loans underlying the investment.

– One piece of research we have done is that we looked into the managers that are receiving the highest inflows and see to what extent they have also increased the investment teams. Our conclusion was that some of the managers with the largest inflows are doing twice the number of deals per employee compared to others, the question you then need to ask is whether they then can keep the same investment discipline and credit quality.