Direct Lending. Recession Proof?

Stockholm (HedgeNordic) – Despite not yet being tested in times of an economic recession, **Scandinavian Credit Fund**, the first and so far only Nordic alternative fund solely focused on short-term senior secured direct loans, appears to represent a decent all-weather investing alternative. The direct lending hedge fund has delivered 37 consecutive months of positive returns not correlated to other asset classes.

Bank Lending and Competition

European businesses rely more heavily on traditional bank lending than their counterparts in the United States. Increased regulation, however, has been weakening the lending activity of European banks to smaller entities. As banks are not lending to small businesses anymore, a gap for players such as Scandinavian Credit Fund opened. And the gap is not likely to go away any time soon. “We have the so-called Basel IV reforms coming up that will make corporate lending even more expensive for banks,” reckons Fredrik Sjöstrand *(pictured)*, the CIO of Scandinavian Credit Fund.

Commenting on the future role of banks in corporate lending, Sjöstrand predicts “banks will go intermediary-only, where entities like us do the direct lending.” Europeans are following in the footsteps of their American counterparts. “Europe and Scandinavia have embarked on the same development that has gone significantly further in the United States,” remarks Sjöstrand. “We will have more banks go broker-only here as well.”

Whereas bank lending is dwindling, there is now increasing concern of too much money in the hands of direct lenders chasing limited opportunities. The increased demand for direct lenders is allegedly driving down returns and eroding lending standards by offering borrowers more options. Sjöstrand reasons that the dilution or weakening of covenants is prevalent predominantly in the area targeted by bigger sharks, large direct lenders on big tickets between €20 to €50 million.

Targeting Less Competitive Waters

“Our typical tickets are between SEK 20 and SEK 300 million, so we mainly focus on smaller and mid-sized companies in Scandinavia,” explains Sjöstrand. “The competition is less aggressive in the segment we operate.” Although covenant-light loans have become more prevalent recently, Scandinavian Credit Fund and their team of six debt capital market (DCM) originators have become stricter when giving out loans. “Our lending is always senior secured,” emphasizes Sjöstrand.

“We have a standard package of covenants and, on top of that, we seek to identify tangible assets that can be pledged as collateral,” tells Sjöstrand. Having tangible assets as collateral is a key element in the direct lending activities performed by Scandinavian Credit Fund, as Sjöstrand and his team have been reluctant to offer loans to platform-based or asset-light businesses. “We said ‘no’ to everything so far in that area for the simple reason that we do not see any assets we could use as collateral in these types of companies,” says the fund’s CIO.

It is not enough for a business to be cash flow positive and revenue-generating to land a loan from Scandinavian Credit Fund. “If we find some collateral around the business, a guarantee from another company, a personal guarantee from ownership or something else that is tangible, then we can consider,” elaborates Sjöstrand. “If a borrower goes belly up, there should be something we can hunt.”

Correlation and Uncorrelated in Rising (and Downward-Spiralling) Markets

Scandinavian Credit Fund, only three years ago celebrated as the “Rookie of the year” at the Nordic Hedge Award, aims to offer between six to eight percent return to investors, net-of-fees, every year and the team running the fund has successfully delivered on its promises so far. The direct lending hedge fund earned an average compounded return of 7.4 percent since launching at the beginning of 2016. More importantly, however, the fund is currently enjoying a 37-month streak of positive monthly gains, with the annualized volatility in returns standing at a mere 0.69 percent. The fund’s Sharpe ratio stands at an outrageous 10.2, unmatched by any Nordic hedge fund.

HedgeNordic statistics show that Scandinavian Credit Fund’s returns are uncorrelated to traditional asset classes such as equities and fixed income. The correlation coefficient between the fund’s monthly returns and those of the Standard and Poor’s 500 stands at a mere 0.18, whereas the correlation with the Vanguard Total Bond Market Index equals a negative 0.33. “We are of course correlated with bond markets when they go up, but we are basically zero-correlated with all other asset classes,” reckons Sjöstrand. Whether correlations with other asset classes increase in the event of a recession remains to be tested, acknowledges Sjöstrand.

“We may get hit with credit events, especially in times of recession, but we have the collateral if a company goes bust,” says the CIO. “If we are delivering negative returns and the rest do the same, of course, correlations will go up,” he continues. But as long as the team running Scandinavian Credit Fund does its due diligence on borrowers, the likelihood of returns diminishing and correlations increasing is minimal. “The main risk our investors face is that for some reason we do not do our homework in a proper way when it comes to credit analysis,” acknowledges Sjöstrand. “The risk stems from overseeing something when making an investment.”

Each transaction performed by Scandinavian Credit Fund relies on an independent analysis, with the fund manifesting no industry focus. Since the Swedish economy is tied to the real estate market because of its sheer size, real estate accounts for one-fourth of the direct lending fund’s loan portfolio. “We have decreased our exposure to real estate quite significantly over the past year” in an attempt to improve the correlation or, better say uncorrelation, characteristics of the fund.

Although not yet proven as a recession-proof investment product, Scandinavian Credit Fund most certainly represents a proven market-craze-proof alternative. “We have already proved that we are uncorrelated to all other asset classes,” says Sjöstrand. “Adding our vehicle in a traditional portfolio will definitely improve all risk and return metrics if we continue to deliver on our promises as we have done so far,” he concludes.