The Heterogeneity of Private Debt

Stockholm (HedgeNordic) – Born out of the ashes of the global financial crisis, the private debt industry evolved into one of the largest and fastest-growing private market asset classes. Private debt has emerged as a viable asset class for investors before the coronavirus pandemic and even more so during the pandemic. "With private debt becoming a major asset class, it is normal for investors to have a private debt allocation," Jussi Tanninen *(pictured)*, Head of Alternatives at Finnish insurer Mandatum Life, tells HedgeNordic. "For an institutional investor, it is actually more active decision not to invest in private debt than to invest," he argues.

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Strong demand for yield in today's zero-return environment has made private debt an attractive asset class for many investors. "Obviously one needs to find additional sources of returns in today's low-yielding environment, so investors are turning all the rocks to find those additional sources of income and returns," says Tanninen. "I suppose everybody likes good risk-adjusted returns and private debt can offer just that."

Just the Tip of the Iceberg

Matias Hauru, portfolio manager responsible for private debt at Mandatum Life

The good risk-return profile of private debt is just one of the many reasons to invest in the space, according to Matias Hauru, portfolio manager responsible for private debt at Mandatum Life. "Indeed, the illiquidity premium is probably one of the key reasons to invest in this space," Hauru corroborates Tanninen's argument. Whereas the illiquid profile of private debt does not suit every investor, according to Hauru, "if one does not have significant limits on the portion of illiquid assets in a portfolio, then investing in private debt is a natural way to achieve better risk-adjusted returns over public debt."

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Another advantage of private debt over public debt is the floating-rate nature of most private debt loans, argues Hauru. "This basically means that there is low duration risk in a portfolio of private debt loans." Hauru goes on to argue that private debt transactions also exhibit less information asymmetries than public transactions. “Being on the private side of things, you often get access to better financial information when doing a transaction, which allows you to do more rigorous due diligence,” argues Hauru. “In the public space, you need to rely on publicly available information.”

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Private debt transactions also carry significant downside protection. “When it comes to the downside protection in these privately-negotiated transactions, you can get better terms in loan documentation, covenants and other terms,” points out Hauru. Should things get difficult for a borrower, for example because of the coronavirus-induced socio-economic challenges, privately-negotiated loan deals offer a better venue for finding solutions. “One key aspect is that there are less counterparties and stakeholders in these transactions,” says Hauru. “You do not have to negotiate with hundreds of bondholders or stockholders to find solutions, which allows you to find better solutions for everyone involved.”

Mandatum’s Private Debt Programme

Mandatum Life has been running a private debt investment programme that is part of the firm’s wealth management services. The private debt programme is a good example of successful co-investing, where the insurer pools capital and joins forces with its customers to make larger investments on more favourable terms. “You could call it a fund-of-fund type of program,” explains Hauru. “It is not technically a fund of funds, but the approach is very similar.”

Almost on a yearly basis, Mandatum Life launches a new investment programme to create a “fund-of-fund type of vintages focused on private debt.” According to Hauru, “each of these funds of funds consists of eight to ten private debt funds, covering a wide range of different strategies within the private debt space that range from traditional direct lending to more opportunistic strategies.” With the private debt industry representing a very heterogeneous space, Mandatum Life can invest in “anything that in our view represents a good risk-adjusted return strategy across the private debt space.” Hauru points out that “our mandate is pretty wide, but especially in private credit, we believe that diversification in terms of risk and return is essential.”

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Mandatum Life is currently raising capital for its fourth Private Debt investment basket, having invested over €1.5 billion in the private debt space since 2016. “We have been offering this type of product since 2016,” Tanninen tells HedgeNordic. “But from balance sheet money we have invested in private debt funds since 2008,” he emphasizes. “We have the existing relationships, we have the “information bank” and our 12-year experience to successfully run this private debt investment programme,” continues Tanninen. “12 years of experience in this space is quite a long time for a European investor.”

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“The programme that we have built is basically an allocation tool to private debt for our clients,” explains Hauru. “The programme allows our clients to field institutional grade, private debt allocation in their portfolios with smaller tickets.” Most of the capital raised for Mandatum Life’s private debt programme comes from “so-called programme investors who invest in each of our vintages and use it as an allocation tool for private credit.” This co-investing brings increased scale “that allows us to get better terms for our investments, including lower management fees or performance fees, or other terms in the documentation.”

Manager Selection Process

“We do not think that there is such a thing as a private debt market as one homogenous group,” Tanninen says. “Therefore, we feel that diversification, obviously between external managers, but even more importantly between strategies, is very important.” Mandatum Life’s private debt team meets over 100 private debt managers a year “to find the ones offering the best risk-return combination in our view.”

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“Our manager selection process and portfolio construction rely on a bottom-up approach," explains Hauru. "When it comes to selecting managers, we first aim to understand very thoroughly the deals that they had done and especially evaluate the risk related to these deals." Whereas Mandatum Life does not have predefined allocations to specific geographies and strategies, "we make sure the portfolios are diversified and balanced."

One common characteristic of all managers selected for Mandatum Life's private debt investment programme is "the presence of a competitive edge that is very difficult to replicate," according to Hauru. One of these competitive edges could involve economies of scale. "Having a €10 billion-fund allows managers to participate in deals that face less competition," says Hauru. "The competitive edges can also relate to the scale of the platform and resources, deal-sourcing capabilities or some country-specific local knowledge."

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A manager's ability to protect against a permanent loss of capital is also put under the microscope. "As these are fixed-income investments, it is obviously key not to lose money in these deals as the upside is typically very limited at least in direct lending strategies," says Hauru. "One of the key parts of our due diligence is to analyse the manager's ability to protect the downside in these investments," he continues. "If there are challenging situations, are they able to go through them and for example, go through a restructuring if needed?"

Returns and COVID Impact

Hauru says that "there is a lot of variance between strategies." Mandatum Life's private debt investment programme features "opportunistic strategies that can generate private equity-type returns between 12 percent and 15 percent net of fees." The safest, lowest-returning strategies, however, yield about six percent per year. "And then we have everything in between."

The coronavirus pandemic represents the first "real" test for the private debt market and its investors. "While there is still some uncertainty about how the pre-pandemic private debt deals will turn out, part of the asset class has proven itself during the crisis, proving that it is actually able to benefit from crisis situations," argues Tanninen. "We do not know yet whether defaults will pick up, but one thing that we can say is that the asset class was able to deploy capital in stressed market conditions," he continues. "In private equity, even if you had all the dry powder in the world, that did not help much in the second quarter of 2020 because nobody was selling anything."

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"The market environment has improved in most of the sub-segments of the private debt market since the COVID crisis hit," points out Hauru. "In opportunistic strategies, which include distressed, stressed, special sits and those kinds of strategies, one could argue that the market opportunity for new investments is probably the best since the global financial crisis," he continues. However, the private debt team at Mandatum Life "do not want to make bets on just selecting some strategies within each vintage," according to Hauru. "Our philosophy is to build a balanced portfolio regardless of the market situation."

Pictures by Tomi Parkkonen.