Finding Compelling Risk/Reward in Private Debt

Stockholm (HedgeNordic) – Allianz Global Investors has been expanding its private markets footprint for over a decade and is now one of the largest players in the space. Some EUR 81 billion or 14% of assets of EUR 582 billion is in alternatives (as of December 2020), of which 94% is in private markets. The offering includes infrastructure debt and equity, including renewables, and private equity as well as private debt, which includes direct lending. The latest strategy launches have been trade finance, impact investing, and two multi-manager products focused on external managers: a fund of private debt funds (which was profiled by HedgeNordic in 2020) and a fund of private equity funds.

"We have expanded into areas where our local presence, knowledge, network and investor base are aligned. We are open minded about new strategies and would only be likely to avoid niche markets that cannot be scaled up," says Emmanuel Deblanc, Head of Private Markets, Allianz Global Investors.

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Allianz is exposed to nearly all strategies it offers externally to a greater or lesser extent. "Internal and external clients naturally need to be treated fairly. Larger or earlier investors may get better terms on fees, whether they are Allianz or third parties. Investment vehicles can be comingled and pooled or could be dedicated to single investors for larger allocations," says Deblanc. The client base is institutional and includes substantial allocations from insurance companies and pension funds, where credit ratings and transparency can be important under Solvency II.

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Private credit spans a wide spectrum of risk and reward, with return targets ranging from about 1% to 15%, and credit ratings including investment grade, non-investment grade and some non-rated exposures. It includes strategies where few if any borrowers have credit ratings, though equivalent ratings can be mapped, based on metrics such as leverage multiples. Portfolio transparency also aims to offer look-through reporting, which can be useful for obtaining lower Solvency II capital charges. "Whether investors could use the portfolio reporting and mapped credit ratings for Solvency II purposes would depend on their internal models," says Deblanc.

Allianz has exposure to developed markets mainly in the US and Europe, and also emerging markets including infrastructure debt in Latin America, and blended finance deals in Africa in conjunction with development finance institutions. Currently, Asian private credit, which combines some developed markets such as Australia and some emerging markets such as India, may offer the most compelling value in either developed or emerging markets – in absolute and relative terms.

Yield Pickup

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In absolute terms, Asia (excluding China) can generate gross yields of 9% in senior secured lending while direct lending can go as high as 15% (the net return targets are about 20% below this after typical management and performance fees). This is in USD after some deals in Australian Dollar, New Zealand Dollar or Indian Rupee have been hedged back. In relative terms, this represents a yield pickup of between 250 and 450 basis points over broadly comparable risks in the US and Europe. (The mapped credit ratings are 'BB' equivalent for the senior secured strategy and 'B' equivalent for direct lending). The legal risk framework is similar. Private credit covenants are generally stronger than in public markets, including in Asia. Legal documentation is predominantly in English law, and other legal systems, such as Singapore, Hong Kong, Australia, and India, which are based on English law. "Finance security can use local law and Allianz has a strong influence on terms and packages," says Deblanc.

Clean EBITDA Growth and Strong Governance

On a risk-adjusted basis, the yield pickup might even be more attractive because the metrics used to calculate leverage multiples can be much cleaner. "EBITDA adjustments, which can mean true leverage is much higher than the headline figures, are widespread in the US and Europe, but are much rarer in Asia where definitions are much tighter," says Deblanc. Therefore, typical multiples of 3.5 times EBITDA for senior secured lending and 4.5 times EBITDA for direct lending, are meaningful.

And if the starting point for leverage may be lower, it gets better over time. "Asia's stronger economic growth allows the strategy to deleverage, and also makes credit attractive to entrepreneurs who want to avoid the dilution that could be entailed in public or private equity. They would rather not prematurely give up equity when they could make a much more lucrative exit in a few years' time," says Deblanc. (Allianz does occasionally take equity kickers such as warrants on the direct lending side when equity value could be disproportionate relative to its capital).

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Though these individuals are independent minded, they will also consent to reasonably intrusive governance rights, such as board observer rights, board seats and cash monitoring on the direct lending side.

Relationships, Origination, Defaults and Workouts

This is a relationship-based business where Allianz's team have originated 75% of their own dealflow, mainly from founders though there can be some financial sponsors. Most deals are bilateral though the largest ones are sometimes syndicated with other institutions or banks. The uses of finance include growth, acquisition and refinancing, with an approximately even split amongst the three: for senior secured and direct lending, the splits are: 41/32/27 and for direct lending, they are 34/37/29, respectively. The senior secured lending strategy would not lend to the same borrowers as the direct lending strategy, as that could create a potential conflict.

Whereas some Allianz strategies, such as senior investment grade debt, have a zero loss underwriting philosophy, and have had no defaults for over a decade, Asian private credit has historically seen some occasional defaults and small losses. Of 88 deals that the team invested in since 2010, five had restructuring issues, with the worst return was an IRR of minus 5%. The reasons for losses have tended to be negative sector dynamics such as a new competitor driving down margins. There has not been any fraud.

Growth Sectors and ESG

The sector focus on software, data centres, healthcare, education, packaging, pharmaceuticals, real estate, food/food retail, telecom, and waste management is essentially investing in secular growth and defensive sectors, which are often asset heavy and have strong cashflows. The strategy avoids cyclical sectors such as apparel, autos OEMS and suppliers, consumer durables, travel and leisure, retail, and shipping.

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"ESG is also influencing sector choices, as some deals are driven by energy transition and renewables. For instance, most new generation in India comes from renewables, which also requires reinforcement of networks to handle intermittency," says Deblanc. European investors have growing ESG reporting needs, such as carbon footprints and SFDR (Sustainable Finance Disclosure Requirement), which is being phased in between now and 2023, and Deblanc is confident that their borrowers will provide enough transparency: "medium sized companies in Asia should increasingly be willing to disclose enough data because they need to do this to access finance."

Yield Compression?

"The covid crisis initially increased yields, between March and October 2020. Yields have now reverted to pre-Covid levels, especially in more mature markets such as Australia and New Zealand, but we do not see signs of further yield compression," observes Deblanc in May 2021. There are structural reasons for yields in the Asia Pacific region remaining higher, at least outside China, where Allianz do not see the same supply/demand imbalances.

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On the demand side, high growth generates a strong demand for credit. On the supply side, Asian public markets cater mainly for larger borrowers; Asia is under-banked and does not have the structured credit collateralised loan obligations (CLOs) or Business Development Companies (BDCs) and various other vehicles that provide credit for smaller companies in the US and parts of Europe. There may also be a complexity premium: "Asia has many different countries and geographies and is not a homogeneous market like the US," says Deblanc.

For more information on Allianz Global Investors private markets capabilities visit nordic.allianzgi.com

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