Private Debt and Investing in the Real Economy

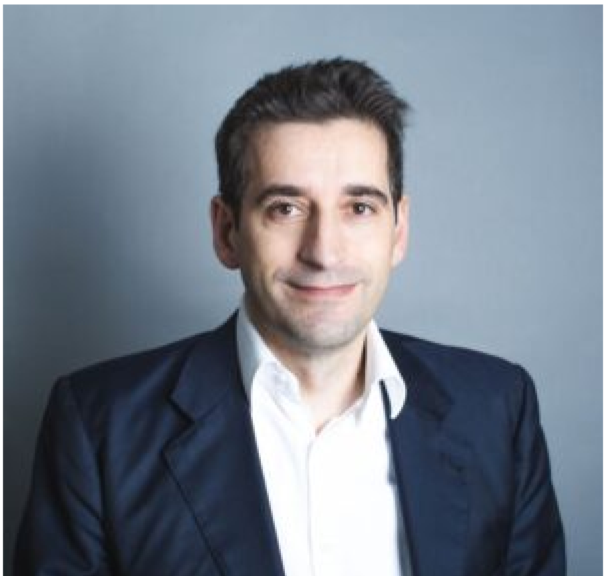
Stockholm (HedgeNordic) – We caught up with Nina Jahanbin, Head of Nordics at Union Bancaire Privée (UBP), Colin Greene, Head of Private Debt at UBP, and Francesco Filia, CIO and CEO of Fasanara Capital.

Private debt assets under management have more than doubled over the past decade to USD 848 billion (including dry powder) as at the end of 2020 and are forecast to grow by 11.4% annually to USD 1.46 trillion by the end of 2025, according to Preqin, the financial data provider. Private debt allocations are growing, and have reached 12% of consultant-led allocations, according to Private Credit Fund Intelligence.

Private credit not only offers a yield pickup – and, sometimes, stronger covenants and collateralisation – but also makes a strong contribution to the real economy by helping to plug market gaps in areas such as financing smaller companies or social and affordable housing. These are also growth markets where substantial capital can be deployed in scalable strategies.

Factoring

European factoring – i.e. buying invoices at a discount from suppliers in the real economy – is worth EUR 1.8 trillion or 11% of EU GDP, representing a key source of financing from 260,000 private companies (Source: FCI, 2020). For over seven years, Fasanara Capital has been pursuing a direct, super-diversified, non-recourse factoring strategy that uses fintech to originate and underwrite invoices and other types of trade receivables. Returns in recent years of around 6% gross in euros carry virtually no duration risk, as a portfolio turnover of 4–5 times per year means that the average duration of deals is just a few months. The credit risk is effectively investment grade: although Fasanara sources the invoices from small companies that may not have any credit rating, the debtors are much larger and investment grade, including giant multinationals.


Francesco Filia, CEO – Fasanara Capital

Default risk is relatively low, with historical losses due to defaults on the overall European factoring market being below 1%. “We aim to minimise losses through the use of fintech to help carry out due diligence, which includes AML, KYC, financial statements, and verification, to minimise the risk of fabricated invoices or multiple advances on the same invoice. So far, investment-grade mandates have shown zero losses, partly because deals in this segment have significant over-collateralisation and additional recourse or guarantees. The strategy is also highly diversified, with a typical portfolio comprising over 10,000 debtors, 5,000 suppliers, 70 originators, 30 sectors and 50 countries. With the exceptions of the fintech-friendly UK, US and Germany, country weights are capped at 10%, while emerging and frontier markets are a small part of the portfolio," says Francesco Filia, CIO and CEO of Fasanara Capital.

"We aim to minimise losses through the use of fintech to help carry out due diligence."

Factoring is not immune to yield-compression pressures. Returns in euros on the Fasanara strategy have come down from 9–11% in 2015–2017, to a range of 5–6% in 2019 and 2020 as more capital has flowed into the strategy and technology has improved efficiency. "2020 was something of a special case because two risk mitigants reduced returns. Prudentially holding more cash than usual resulted in higher-than-normal drag, while a higher recourse to credit insurance also reduced returns on some deals. Going forward, the strategy is to seek full deployment of assets in 2021, which currently stand at EUR 1.5 billion. We expect stable yields for at least five years, but also expect that technology will eventually bring in efficiencies that reduce yields," says Filia.

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The investor base includes insurance companies, banks, family offices and the European Investment Fund (EIF), which is invested in the strategy as a cornerstone investor in a separate, closed-end fund, vehicle that runs pari passu. The EIF had been pursuing ESG and impact investing as part of its mandate for many years before these became more widely fashionable. Fasanara's ESG policies include some upstream sectorial exclusions as they are signatories to the UNPRI, TCFD and CA100+, with funds complying with Article 8 of the EU SFDR and avoiding predatory or distressed lending.

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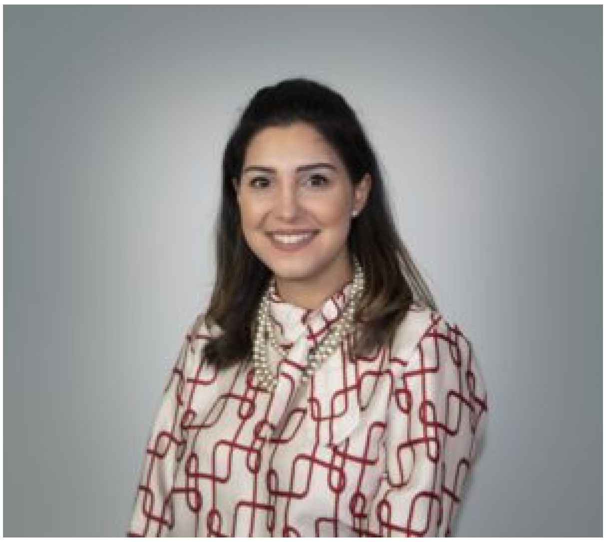
Nina Jahanbin, Head of Nordics – Union Bancaire Privée (UBP)

"The strategy has generated a lot of interest from the Nordic investor base, especially because of its impact on the real economy. In a context of negative yields and expensive valuations, investors have been looking for alternative income and diversification away from traditional credit and rate exposures. Unlike structured or private credit, Fasanara's factoring funds can provide significant, uncorrelated, reliable income with relatively low risk and accessible liquidity.

In short, Fasanara has managed to digitalise and disintermediate an established banking trade that is now opening up for institutional investors, exploiting fintech, e-commerce and e-invoicing secular trends." says Nina Jahanbin, Head of Nordics at UBP.

Social and Affordable Housing


Colin Greene, Head of Private Debt – Union Bancaire Privée (UBP)

Factoring is reasonably liquid and investors who can accommodate multi-year liquidity of six or more years may get slightly higher returns – a target of 6–7% – from private debt that is used to finance social and affordable housing, student housing, and care homes.

"The shortage of social and affordable housing has grown over the past 10–20 years as house prices have risen much faster than wages," says Colin Greene, Head of Private Debt at UBP. For instance, since 2000 the UK House Price Index is up 182%, compared with an around 85% rise in average weekly earnings according to the UK's Office for National Statistics (ONS). To put it another way, the ratio of median house prices to median pre-tax earnings has reached an all-time high of 8 times in 2018, up from 5.1 times in 2002, according to the ONS.

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"Increasing the stock of available housing is really high impact; it's the S in ESG. The National Housing Federation estimates that 3.8 million people in England are in need of social housing, while the Children's Commissioner for England has found that 124,000 children are living in temporary accommodation. Government policy in England is to build 300,000 new homes per year, but over the past decade only between 125,000 and 244,000 were built per year, according to the House of Commons Library Briefing Paper, Tackling the under-supply of housing in England," says Greene.

Not only is there an undersupply of housing, but new housing must help with decarbonisation. "Some 22% of UK carbon emissions come from heating houses. The strategy therefore pays careful attention to energy efficiency, insulation and heating in light of revised building standards," says Greene.

High Volume of Financing Required

The social need to address the undersupply of housing is facing headwinds from the cost of addressing legacy problems in the existing housing stock. In May 2021, the Financial Times reported that, according to four of England's largest housing associations (Clarion Housing Group, L&Q, Network Homes and Peabody), fire safety remediation work following the Grenfell Tower fire could reduce construction of new affordable homes. L&Q separately said in March 2021 that its own housebuilding target could be cut by 70%.

Meanwhile, the costs of retrofitting housing to meet decarbonisation targets are mounting. Inside Housing estimates the cost of retrofitting all social homes in the UK to zero carbon could reach GBP 100 billion, although there may be grants to fund or part-fund legacy costs. Even so, a very high volume of financing will be required to meet housing needs in an energy efficient manner, so there is room for many funding types, including private debt.

Covid-19 Has Exacerbated the Housing Need

COVID-19 constrained the housing supply in 2020. Moreover, while many individuals lost out economically, many others had their incomes underpinned by furlough schemes. Unlike during and following the global financial crisis when house prices fell, UK house prices in February 2021 were up 8.6% year on year. This is not just a UK phenomenon: the Financial Times reports that in Q1 2021 house prices across the 37 economies of the OECD accelerated at the fastest rate since 1990.

Despite the need for more housing, financing is constrained. "The balance of bank lending to construction firms in the UK has been trending down for eight years," says Greene. Private debt can fill some of this gap.

"Student housing is relevant to the broader housing shortage, since housing students in purpose-built properties helps to reduce pressure on the housing stock by releasing more homes for families. We see this as a hugely scalable 10-year investment theme."

UBP's private debt strategies focus on two main segments: affordable housing, and those sectors for which there is strong institutional demand, including student housing and care homes. There is a common thread to these, "student housing is relevant to the broader housing shortage, since housing students in purpose-built properties helps to reduce pressure on the housing stock by releasing more homes for families," says Greene. "We see this as a hugely scalable 10-year investment theme," he concludes.

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