A question of scale

Momentum behind the private-debt market is growing as investors widen their search for higher-yielding assets within credit allocations. Specialists in Australia say developments are leading their sector closer to the robust markets developed in the US and Europe after the financial crisis, including more transparent valuation and liquidity.

BY CHRIS RICH

The Australian savings industry's investment allocation to fixed income, and even more so to credit, has historically been significantly smaller than most other developed nations.

The first generation of superannuation savers ushered in by the introduction of compulsory superannuation in 1992 are only starting to reach retirement age. Even when they get there, the long-expected reweighting of funds toward low-capital-risk, income-providing assets could be in question given the persistence of low yield in the traditional fixed-income sector.

With increasingly unappealing yield in mainstream fixed income and only limited expectations of interest-rate rises in the medium term, how super funds – and other investors – can generate adequate return to provide for members' retirement is an increasingly pressing question.

At the same time, there is a sharpening focus at policymaker level on ensuring reasonably priced credit is available to entities that are widely viewed as primary drivers of economic growth – that is, to SMEs and the mid-market. A range of specialist lenders has emerged seeking to fill a space that has become less appealing to banks, and these lenders need reliable sources of funding.

Private debt, in the broadest sense, has become a notable option for superannuation funds seeking to generate higher yield from their fixed-income allocation. It is not a homogenous asset class, however: private debt is often used as a catch-all term for a number of private financing formats including large infrastructure projects and public-private partnerships (PPPs), unrated corporate bonds, institutional term loans and structured-finance vehicles.

Most of this type of lending is still provided by Australia's major banks supplemented by international banks, with just a small slice available to asset managers. Regulatory bank-capital changes over the past few years have diminished authorised deposit-taking institution capacity to lend in this space, however. Private-debt opportunities should be proliferating for institutional investors that are willing to wrestle with challenges such as illiquidity and opaque valuation. The same story is emerging in New Zealand (see box on p56).

These challenges raise the question of scalability – in other words, even if private debt represents a theoretically enormous opportunity set, whether it is one the bulk of institutional funds will be able to access.

VALUATION AND LIQUIDITY

The primary consideration is that most sectors of the private-debt market are not readily substitutable even for other OTC credit asset classes – by virtue of the lack of reliable liquidity or transparent valuation in private debt. Australian corporate credit, to take one example, often does not see substantial day-by-day secondary activity – but it is not hard to mark bonds to market and most positions can be unwound under normal trading conditions.

By contrast, private debt historically does not offer even the conditional flexibility of traded credit. Large assets like PPPs are all but untradeable, while even smaller ticket-size items like term loans and privately-placed bonds lack the valuation visibility of the public market. At the smaller end of the market, the underlying diversity of SMEs makes it difficult to create a homogenous product suitable to become a staple of capital markets.

One option for at least some asset types is aggregation. For instance, multiple initiatives are afoot to cultivate SME

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PETER GRAF ARES SSG

lending as a segment of the Australian securitisation market. For example, the Australian Business Securitisation Fund seeks to create cost-efficient funding through securitisation for lenders that can be passed on to SME borrowers. Meanwhile, an Australian Securitisation Forum working group is developing a reporting template to deliver standardisation across a diverse range of SME lenders to lay the foundations for a public asset-backed securities market.

There are positive signs, most recently including a debut public securitisation from SME specialist lender Prospa that launched in August. Bob Sahota, founder and chief investment officer at Revolution Asset Management in Sydney, says the mechanics of securitisation mean this type of funding lends itself well to the aggregation of SME loans. "The securitised format has the benefits of granular pools and strong cash flows, with nonbank lenders also taking the first loss," Sahota explains. "The cheap funding afforded by the triple-A tranche means investors receive quite a lot of excess spread in the other tranches."

Taking a wider view of the private-debt landscape, a key factor for specialist lenders to grow in the private-debt space is digitalisation for more agile and efficient operations – according to Joe Millward, Sydney-based founding partner at Epsilon Direct Lending.

The issue is not so much lack of data but the challenges of organising the abundance of data borrowers hold into something useful for portfolio management and that can then be used to reassure end-investors.

Marianne Antonicelli, director, private markets and loans at IHS Markit in Sydney, says: "There is a lot of data in the private-debt space that is very unstructured. This applies to everything from financial and income statements to KPIs."

Using technology to bring all the data into a standardised format allows private-debt asset managers to extract information for their reporting back to end-investors. This should help enhance end-investor comfort with an otherwise-opaque asset class and, in turn, assist with the institutionalisation of the sector as a whole.

It does not, however, solve the issue of valuation. With no consistent secondary market for private debt in Australia it is hard to establish reliable mark-to-market pricing. Lack of asset-valuation clarity makes many investors wary and is exacerbated in stressed scenarios.

The nightmare scenario is that of forced sale – when investors need to realise cash for unreliably priced assets with little or no established secondary market. This came into focus during the period of superannuation stress caused by the early withdrawal scheme designed to ease financial pressure in the early weeks of the pandemic. Super funds were forced to shore up liquidity as three million members withdrew more than A$36 billion (US$26.4 billion) from their accounts.

Most of this came from the most liquid assets – but it still had an impact on private debt. Falling asset prices in public markets fuelled concern that net-asset values could be arbitraged, according to Chris Pashley, Sydney-based managing director at IHS Markit.

IHS Markit conducts proxy "observable" price activity of like assets, independently valuing more than 6,000 private-debt instruments on a regular basis. Pashley says: "Some Australian investors have pushed back on observable price proxying based on expectations it would adversely affect their Sharpe ratios. However, we have seen that fair value of private assets remains critical both for performance reporting and asset-allocation decisions during testing times."

LOCAL EVOLUTION

The Australian private-debt market is clearly still in an evolutionary phase – in market infrastructure as well as scale. Nonetheless, Peter Graf, managing director at Ares SSG in Sydney, tells *KangaNews* it could develop along a similar trajectory seen in Europe and the US. As recently as 10 years ago just a handful of large institutional lenders serviced the mid-market in the US and Europe, where now borrowers can call on several dozen.

According to Graf, the keys to developing the domestic market are twofold. One is local fund managers building specialist teams capable of picking the right companies to lend to – which requires a different mindset from valuing and assessing investment-grade credit. The other, which may be easier to deliver, is the increasing presence of global private-debt investors in the Australian market.

"Large global lenders from the US and Europe are looking for new areas of opportunity and are coming to Asia and Australia to use their skills in assessing mid-market companies and providing them credit," Graf suggests. "This means the path Australia takes to establish robust institutional lending in the mid-market space could well be quicker than other jurisdictions."

There are clear signs of investment expertise being deployed in Australia, with a direct through-line to banks' retreat from the

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OPPORTUNITIES IN NEW ZEALAND

Like Australia, capital regulation in New Zealand in the years since the financial crisis has created an opportunity for specialist lenders to fill a void left by banks.

The four Australian major banks have a tight grip on market share for commercial lending in New Zealand through their local offshoots. In fact, the lending market is arguably more concentrated than in Australia as fewer international banks have established a significant balance-sheet presence in the smaller jurisdiction.

However, Reserve Bank of New Zealand (RBNZ) capital requirements for domestic banks published in December 2019 could be a game changer. These increased the minimum required total capital ratio for domestic systemically important banks to 18 per cent of risk-weighted assets, from 10.5 per cent. Some market participants expect one of the consequences of the new rules is that the major banks will be forced to retreat from lending that becomes less capital-efficient – specifically in the subinvestment-grade space.

Effectively, subinvestment-grade companies will have to generate implausible returns for banks to justify the extra capital impost, Paul Carman, founder at Private Capital Group New Zealand (PCG) in Queenstown, tells *KangaNews*.

"The direction of travel is clear," he says. "Capital changes will create a regulatory arbitrage disadvantage for banks in lending to subinvestment-grade companies and will reinforce capital allocation to investment-grade credit."

There is significant opportunity for specialist lenders to fill the gap. Set up in late 2019, PCG plans to launch its first fund in September with roughly NZ$400 million (US$280.4 million) in assets under management. It expects to launch its domestic-portfolio investment entity a few months later, having been in extensive discussions with domestic investors over the past year, Carman says.

However, the New Zealand institutional market's unfamiliarity with the private-debt asset class – specifically the lack of visibility about liquidity and valuation – is a significant hurdle to attracting investment.

While the New Zealand private-debt market is in its infancy – Carman estimates it is more than five years behind where the Australian market has developed to – there are green shoots and change is happening faster than this timeline suggests. "Comfort with the asset class will come to investors once they make the first allocation with a preferred asset manager. We are in an embryonic stage with domestic investors, but it is all happening now. I think it will accelerate in the next 12-18 months rather than 3-5 years."

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PAUL CARMAN PRIVATE CAPITAL GROUP

space. Epsilon is an Australian-based nonbank corporate lender and private-markets investment manager founded in 2019 to provide financing to middle-market companies. The company's three founders left the leveraged-finance area of a major bank as they found it increasingly difficult to meet customer needs, Millward tells *KangaNews*.

Opportunities for this type of investment abound in the current environment. Sahota says there is a long pipeline of opportunities in the private-debt space based on the growth aspirations of many mid-market companies and, especially, the prevalence of M&A activity in this sector. "Any of these large acquisitions will need in the order of 50 per cent debt financing," he says.

However, one of the salient challenges for Australian private-debt asset managers is to produce a product offering that is a good fit with the scale and other requirements of the institutional end of the superannuation market.

Millward says Australian superannuation funds often have ongoing allocations to private debt offshore and these are helpful in laying the groundwork for more active domestic engagement. Even so, he adds, local knowledge of the sector is currently something of a mixed bag.

"Some large institutional investors in Australia have little to no exposure to private credit or direct-lending strategies, offshore or domestically," he tells *KangaNews*. "With corporate loans, the historically dominant position of the banks means developing an understanding of measuring credit risk across various private-credit strategies is in its early stages. There are also really quite mixed views on liquidity risk in private credit."

Millward believes the Australian market can grow to rival offshore peers, but it will take time. "The reason is that investors have to learn about the asset class. They will dip their toes in the water first, then watch the performance and track record – which could involve trial and error," he says.

Graf, meanwhile, says development should in time prove to be a virtuous circle. He comments: "More institutional lenders are providing options and companies are getting comfortable that they are receiving a competitive deal, which means they are more likely to execute on the financing. It is a snowball effect where successful deals will result in more successful deals." •