US ROUNDTABLE

PRIVATE DEBT INVESTOR ROUNDTABLE | NOVEMBER 2013

Plugging holes in US balance sheets

Europe's banks don't sell, according to the five experts we brought together for a frank exchange in New York recently. So if you're serious about deploying private debt capital, the US is where the action is. But even there getting things done is hard – the increasingly emboldened banks compete hard for deals, and pricing risk is what everyone is in danger of getting wrong. **Sam Sutton** reports.

Banks scaled back their lending operations, creating a financing gap that non-traditional lenders and private funds rushed to fill. This piqued the interest of institutional investors, who continue to search for yield in a low interest rate environment. That same environment prompted many private companies to refinance through the high yield and leveraged loan markets, which in turn led retail investors to dedicate record amounts of capital to those strategies. Through it all, new players of different sizes, structures and strategic approach began to engage the market, challenging conceptions of who is best suited to fill the financing gap.

All of the above is apparent if you've observed the US private debt market over the last few years. But it doesn't leave much room for nuance and, as the expression goes, the devil lies in the details.

Private Debt Investor hosted its first US roundtable in November, drawing on the perspectives of five private debt industry veterans to explore how investors, managers and companies view the private debt market today. As the participants convened in a conference room in CIFC Asset Management's midtown Manhattan office, it quickly became apparent that although the opportunities for investors remain, finding the best way to access those opportunities is still a challenge.

One thing is certain, however: the ebbs and flows of the banking sector continue to dictate how firms can put their capital to work.

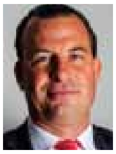
"That's the nature of our business, trying to assess the hundreds of billions of dollars that are on banks' balance sheets," says Ivan Zinn of Atalaya Capital Management. "It's still an abnormally high level to where it would have been pre-'08, so it's less than it was at the peak - around half a trillion. Now it's around $300 to $400 billion, depending on how you do that math."

Zinn's firm specialises in the

WHO'S WHO

LOU SALVATORE, GSO CAPITAL PARTNERS

Lou Salvatore is a senior managing director and head of portfolio management at GSO, where he is responsible for coordinating investment committee and managing the firm's investments in public and private opportunities. Prior to joining GSO in 2005, Salvatore was a principal at DLJ Investors, where he focused on the mezzanine universe. He worked for Kidder Peabody prior to DLJ.



OLIVER WRIEDT, CIFC ASSET MANAGEMENT

Oliver Wriedt is the head of capital markets and distribution at CIFC Asset Management, where he has a seat on the firm's management committee. Wriedt joined CIFC from Providence Equity Partners' capital markets group. He has also been the co-head of marketing and structured products at GoldenTree Asset Management. CIFC had approximately $12.3 billion in corporate loan products under management as of 30 September.

IVAN ZINN, ATALAYA CAPITAL MANAGEMENT

Ivan Zinn is a founding partner and chief investment of Atalaya Capital Management, which specialises in acquiring loans and credit assets from financial institutions, as well as loan origination. Prior to the 2006 launch of Atalaya, Zinn was responsible for origination corporate and real estate loans and other special situation investments at HBK. Before joining HBK, Zinn managed Highbridge/Zwirn Capital Management's European investment effort.

CHRIS ACITO, GAPSTOW

Chris Acito is the chief executive officer and chief executive officer at Gapstow, a credit investment advisor with $800 million under management. Acito manages Gapstow's investment funds, which invest in traditional corporate credit and other traditional and non-traditional credit strategies. Before he launched Gapstow in 2009, Acito had been global chief operating officer for Investcorp's hedge fund group.

JOHN HARRISON, HARBERT MEZZANINE PARTNERS

John Harrison is a senior managing director at Harbert, where he manages the firm's mezzanine investment team. He also chairs Harbert's Australian private equity investment committee. Prior to joining Harbert, Harrison was a vice president and eastern regional manager at Finova Mezzanine Capital. Previously, he worked as a vice president of Sirrom Capital Corporation. Harbert's mezzanine strategy typically invests $3 million to $15 million in subordinated debt in lower mid-market companies.

acquisition of mid-market and lower mid-market assets from banks, a practice that was (until recently) unique to the US.

"European banks don't sell," Zinn says, prompting chuckles from the other participants. "I ran around Europe a few years ago when everyone thought Basel II would present opportunity. And there wasn't a lot to do there then, and I do think now it's different. Obviously, we don't traffic in Europe on a frequent basis right now, but I do think now is different. For a large firm like GSO and others, they have nice flags there ready to buy things. And occasionally they'll get nice trades. But the nature of the US banking system is that it has been one that sells loans."

That sell-off hasn't trickled down to the community bank level, however, where Chris Acito of Gapstow believes many institutions are re-entering the market after a lengthy fallow period: "Many smaller banks are beginning to re-build their loan portfolios. Holding common equity positions provides exposure to small business loans, sometimes priced below book value."

"Do you think that community banks are a good business?" Zinn asks. "I've sat on boards of small banks. That business is just worse than it used to be. You can't make the ROE, the cost of the regulatory burden is really high. I'd argue it's a much worse business in general."

"In aggregate, yes," Acito says. "But the business isn't going away. Lending is ticking up a little bit. In the community banking sector, there are clearly emerging haves, not-so-haves and have-nots."

"I wouldn't say it's a case of, 'Go out and buy the index', but there is a cadre of banks right now whose biggest strategic issue is plugging holes in their balance sheets. They can't raise capital quickly enough to support all the loan growth that's in front of them," Acito adds.

That has been true at the higher end of the market as well, argues Lou Salvatore of GSO Capital Partners. Although banks are not seeking to acquire risky assets – thanks largely to a stricter regulatory regime – they are still extremely active. They can't resist the combination of readily available financing capital and strong demand from borrowers.

"I think in today's world, where there's a ton of liquidity and there's a search for yield where all the different pockets of credit are taking in money, banks are emboldened. They're not in the business of owning risk but to the extent that they can set up deals and syndicate those, they'll do that all day long. And with the markets the way they are, I think banks are fairly emboldened to bring deals and they're able to get them done," he says.

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Lou Salvatore, GSO

That confidence isn't reserved for situations that call for an agent. According to Salvatore, the banks still feel relatively confident putting their balance sheet to work as well.

"They'll commit to deals because they have a lot of confidence that they can syndicate them. I think when they lose that confidence they'll pull back quicker. They're not in the business of owning anything on balance sheet. But they're aggressive with their commitments today because they haven't had many problems in the way of selling paper."

PRICING RISK

The banks' willingness to put capital to work at the larger end of the market has certainly created opportunities for firms to invest through syndications, however, it's unclear whether the illiquidity risk the firms must undertake for access is being priced appropriately, says Oliver Wriedt, who heads CIFC's capital markets and distributions segment.

"As we look at the syndicated market and the club market where either a bank or finance company works as agent, we find that we're not getting paid particularly well for illiquidity, particularly at this stage in the credit cycle, given the bid that's out there for senior secured US bank loans," Wriedt says, adding that his firm has found a "sweet spot" investing in sub-$1 billion enterprise value companies that support $300 to $500 million of senior secured bank debt. CIFC finds it to be a market segment that is generally overlooked by large mutual fund complexes.

Accessing those deals may be problematic however, particularly at the pricing offered by the syndicates.

"Oftentimes they require sort of an invitation from the sponsor to get involved, particularly in the more interesting transactions. That's where we found better relative value vis-à-vis the syndicated mid-market, where the increment might be 100 basis points. We don't think that that really justifies the illiquidity associated with that instrument in anything but today's market," he says.

"So if 100's the wrong premium to get paid for the illiquidity, what's the right premium?" Zinn asks the group. "If 100's not right, is it 500? Something in between, where the grey area starts show up?"

It's a very good question – one that leads to plenty of back-and-forth amongst the panelists. To Gapstow's Chris Acito, it is the "the number one question investors are asking right now", particularly given the amount of money that has been raised through more liquid credit instruments.

"Private credit has become hot and people are interested in it. But, relative to the more liquid opportunities, you have to be honest and ask, 'What is the extra bump in return?' Also, is it really worth fighting that wall of capital raised to invest in certain illiquid strategies? It's probably the number one debate we're having at our firm."

Wriedt compares the current environment to the one that existed in the years leading up to the global financial crisis.

"If we go back to 2006-2007, we saw a very similar compression in the basis between broadly syndicated loans and those distributed in the clubbed or lightly-syndicated mid-market. In that era, we saw a lot of these things built specifically for CLOs. Because you couldn't make the CLO arbitrage work, you needed to buy these loans to drive your arb. For most managers that didn't end well.

"Now from a price perspective, those loans didn't drop as much as much as the large syndicated loans back in 2008. But obviously, the credit experience was

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different – it was worse. It was clearly worse. So from that perspective, we're wary of this basis. In '06-'07, those deals were more aggressively levered than today. Spreads in the absolute were lower. So in that respect we're not where we ended up in late '07 but we think there needs to be more of a premium. So where I think it gets to be interesting is in that 200-250 basis point pick-up for a solid $25-$35 million EBITDA business with good structure."

Deal availability, and thus pricing, improves as you move down market, according to Harbert Mezzanine Partners' senior managing director John Harrison. Unlike GSO and CIFC, which specialise in what some may label the upper mid-market, Harrison's firm typically provides $3 million to $15 million in mezzanine financing to companies with enterprise values that fall below $100 million, a space that puts them well within the confines of the lower mid-market.

"The good thing about our market is, pre-recession we saw a lot of CLOs buying small company private debt. We saw the national footprint finance companies in our market and a lot of hedge funds were lending directly to pretty small businesses. Pretty much all of that has gone away. Pre-recession, I had a CLO manager tell me, 'I can do it a lot cheaper than you can because I can just leverage more'," Harrison says. "Yeah, well that didn't work out real well."

THE RISE OF THE BDC

The question of leverage and access at the lower end of the mid-market leads the participants into a discussion surrounding the types of deals being pursued by business development companies (BDCs), a market segment that – though small – has grown significantly over the last few years.

Some, such as the Financial Industry Regulatory Authority, still consider BDCs risky assets for their exposure to highly leveraged illiquid portfolios. Even so, BDC structures allow for an evergreen pool of capital, and many have demonstrated an ability to consistently deliver 8 to 10 percent annualised returns. That

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combination may prove an enticing proposition for limited partners.

"As an outsider looking in, it does seem like the BDC vehicle today is the most attractive format to hold illiquid private debt," Wriedt says. "Considering the nature and relative ease with which BDC operators have been able to raise secured debt, unsecured debt, convertible debt and equity, they really have been managing the liability side of their balance sheet exceptionally well. The little guys have been doing their baby bonds, the bigger guys all have investment grade rated debt. It's not quite what the REIT market is, but it certainly seems to be heading that way. That's a very enviable position to be in. The growth has been, certainly for the big guys, nothing short of amazing."

That growth becomes all the more amazing when considered within the context of how BDCs tend to be perceived by other participants in the market. Several roundtable participants characterised BDCs and their management teams as being somewhat sub-par, though still capable of delivering returns.

"We'd argue that [BDCs] couldn't raise institutional capital. So now they're out raising retail money and yet we look like the dummies because they have a several billion dollar BDC now," notes Zinn.

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>
> **Oliver Wriedt, CIFC**

Although a large portion of BDCs' capital comes from retail sources, the returns they've managed to generate over the last few years will likely prompt larger institutional investors to pursue yield through that type of fund structure.

"It's simple," explains Salvatore. "They're basically able to do secure deals – again whether it's unitranche or the entire capital structure, clubbed up senior deal in that LIBOR plus 700-900 range. It's a structured product, it's floating rate, it's got a healthy spread and it's pretty good paper on a relative basis in this market. And then they apply some leverage to it and get a nice return that's worked well for their investor base. But I think that institutional investors are also going to come to the realization that that's very good, over time."

Even so, the fact that BDCs generally operate as publicly traded vehicles creates different incentives for growth, which could prove problematic for certain types of investment, says Harrison.

"You know, I came out of a BDC. The BDC market requires a lot of growth, and I think more likely you'll see the BDCs with similar assets under management as our fund in the small, sponsored, private equity market deals. Which really don't have the pricing we want," Harrison says. "You have to chase the growth to maintain the stock price and the dividends. We do primarily unsponsored transactions and most likely I am the capital or, at least, all of the junior capital."

"It'll be interesting to see," says Acito. "As you know, many of our worlds are shifting rapidly. Clients are increasingly not the family office, but the big, big pension plans. What does a pension plan that wants to build a big allocation to private credit do? What are the options? You wonder if there's a creative pension out there that could almost replicate what a BDC does without all those mechanics, to create a quasi-committed or permanent capital [solution]."

THE EVOLUTION OF DEMAND

As LPs develop greater interest in private debt as an asset class, it will be up to fund managers and advisors to craft products that best meet their needs and demands.

"I think that perhaps some of the biggest impediments to pensions getting more interested in private credit is just addressing credit in a comprehensive manner as opposed to just one-off trades that a lot of people make over time. Few pensions have a standing allocation to credit. Credit investments are sprinkled among the private equity, hedge fund, and fixed income allocations," Acito argues. "It'll be interesting as soon as that 'opportunistic' word gets dropped from credit investing, and it changes to a systematic credit allocation."

The issue at present is that private debt commitments don't really fit within the typical buckets large institutional investors set for their investment allocations. It's too illiquid for fixed income, but its return profile doesn't match what many investors demand of their highly illiquidi private equity portfolios.

Some institutions – such as the New Jersey Division of Investment and the California Public Employees' Retirement System – have found a way to adapt, tapping The Blackstone Group and others to set up broad, opportunistic mandates that allow for investment across a firm's entire platform.

"There's clearly also a desire – a lot of the pension fund managers are farther up the curve on this – to be able to come to institutions like Blackstone and look across the broader platform and have a single managed account or an opportunistic account that can reach across bigger organizations and have money go to where the best opportunities are," Salvatore muses. "To the extent you can find mezzanine or private credit deals with mid-teens returns, they want as much of that as they can get. We've seen a lot of folks get very sophisticated and be opportunistic about co-investment and drive to what types of investments programs suit their needs."

That sort of opportunity is only available to those with access to capital, however, something that leaves smaller investors in the dust.

"Those are obviously the largest pension funds, who are also the smartest. New Jersey giving you all money for your tactical opportunities fund. That's very unique propositioning because New Jersey can write a $500 million check and not recall that they did it," says Zinn. "As opposed to most folks, who aren't able to say, 'Here's exactly what I want, here's how I want it. Now build a diversified portfolio'. In other words, I just don't think there's that many sophisticated pension fund investors who are going out to ask for that," he adds, a point echoed by Harrison.

THE SMALLER PLANS ARE OFTEN LESS CERTAIN WHERE PRIVATE DEBT FITS WITHIN THEIR ASSET ALLOCATION

John Harrison, Harbert

"It seems the majority of plans with more resources are more likely to understand the private debt market than small or medium sized plans. The smaller plans are often less certain where private debt fits within their asset allocation," Harrison says.

Of course, many of those smaller pensions rely on the advice of their investment consultants, some of whom have dedicated a commendable amount of time and energy to the advancement of the asset class. As more consultants expand their network within the ever-broadening private debt world, it's likely that we'll begin to see greater involvement from smaller institutional investors.

This has already been the case for certain California pension systems, Wriedt observes, where pensions between $1 billion and $2 billion in size have set up allocations.

"I think a lot of it is consultant driven, and a smart CIO that recognises if they were able to deliver 10-12 net, it would be an absolute home run given the risk profile and, more importantly, in the absolute. They have some certainty around that return. It certainly promises to be a positive return which is not something that they can say about all assets that they traffic in," Wriedt continues.

"We've been really surprised at how broad the acceptance of private debt strategies has been. And it's not where we want it to be, but it's in the right direction and if it works for the big guys it works even better for the small guys."

LPs will ultimately have to determine how best to approach the asset class on their own. While some may feel most comfortable with establishing a separate account, others will have to accept a more gradual process, much like the one many undertook years ago with their private equity allocations.

"You can't invest with one fund. You have to think that this is a systematic program that will eventually grow to something that is meaningful in size and thoughtful and that can react over time. That's going to take several years to develop. Yet again, another reason I believe it's beneficial for folks to think about credit comprehensively, as opposed to, 'That's a great one off trade'," Acito says.

"If you want to build the systematic exposure while at the same time maintaining opportunistic views, you have to have that program and capital allocation always out there so you can move from sector to sector to sector as ideas evolve."

After all, if anything's certain in private debt, it's that the asset class will continue to change, develop, and grow. ■