Perspectives

Illiquid Credit

Playing the role of a (good) bank

TOWERS WATSON

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Many credit markets have historically been dominated by banks and largely inaccessible to institutional investors, particularly in Europe. Instead, investors have looked to private equity, real estate, infrastructure and hedge funds to access alternative risk premia, including the illiquidity risk premium, to help diversify the sources of return. The available opportunity set is changing rapidly as strict regulation of the financial sector has led to a loss of bank lending capacity, and as such created an opportunity for institutional investors to step in and provide capital in illiquid credit.

Institutional investor appetite for illiquid credit has grown since the global financial crisis, attracted by the higher return potential versus traditional credit and the opportunity created by reduced bank lending capacity. However, in the context of the size of illiquid credit markets (for example, approximately 70% of corporate lending in Europe is done by banks) and the capital vacuum being created by the retrenchment of banks, take-up remains relatively muted. We believe there is significantly greater scope for investors to consider illiquid credit as a meaningful part of both low-risk and return-seeking portfolios, indeed we view this as an excellent opportunity for clients with a tolerance for illiquidity and a desire to improve overall portfolio efficiency.

There are several compelling reasons to consider illiquid credit:

- Tailwinds for the asset class remain compelling
- Access to often under- or poorly utilised return sources (illiquidity, skill and complexity premia) and associated improvement in portfolio diversity
- Diversifying sources of credit risk (something we believe is critical at this point in the cycle)

What is illiquid credit?

Illiquid credit (or private debt) represents part of the broader alternative credit space, referring to those non traditional asset classes where there is limited ability to sell prior to maturity. The illiquidity risk premium represents an important driver of performance, with investors needing to forego other investment opportunities and rely on liquidity sources elsewhere.

Figure 01. Alternative credit – more sources of return

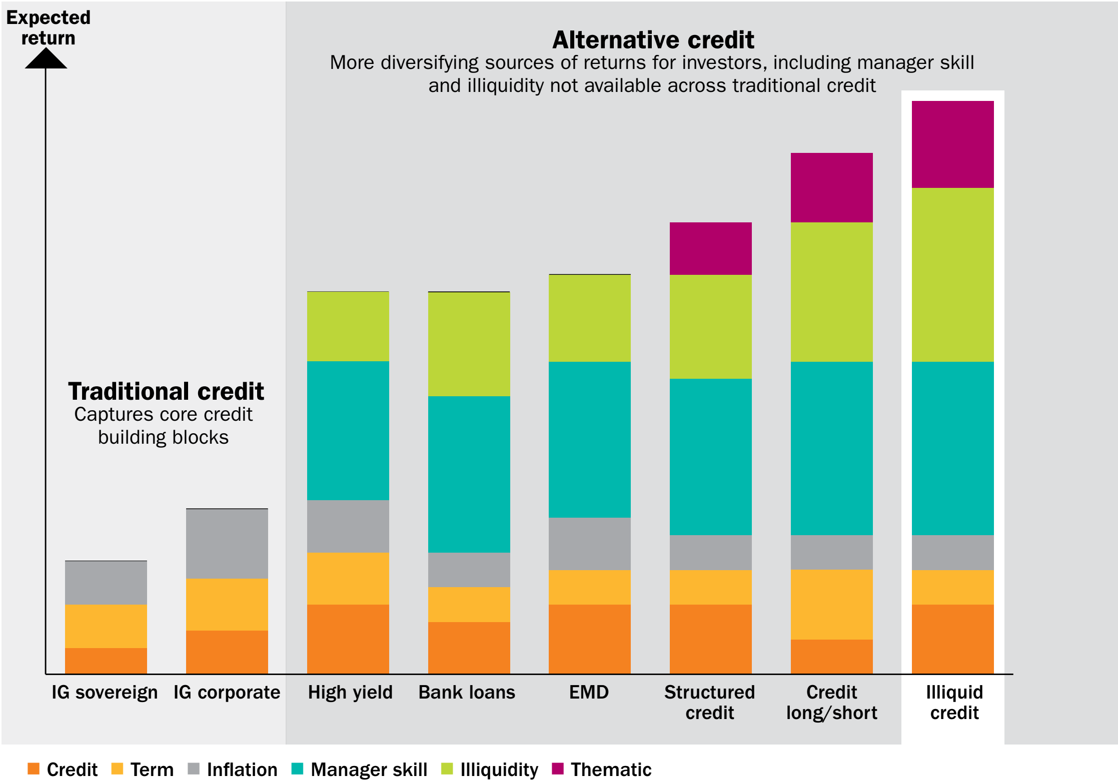

Figure 01 details the composition of different credit asset classes by their underlying risk premia. The far right bar represents a higher risk segment within the illiquid credit universe, with associated higher expected returns. The illiquidity risk premium and manager skill represent important drivers of returns. As detailed below, amongst illiquid credit sub-asset classes there are opportunities offering a range of different risk and return characteristics to satisfy different portfolio roles.

A means to improve diversity of portfolios

Many credit portfolios are substantially invested in investment grade corporates and sovereigns, in addition to having substantial equity allocations. Consequently, we observe that portfolios are typically dominated by the term, credit and equity risk premia, and furthermore the underlying exposures are typically to large corporates and sovereigns. As detailed in "Alternative Credit – Credit for the modern investor", alternative credit presents an opportunity to improve portfolio diversity, introducing different risk premia and improving the overall mix.

The more liquid segments of Alternative Credit are primarily about accessing less efficient asset classes and different borrower types, typically helping to boost returns and improve the chance of success when deploying active management. However, the underlying strategies still tend to be focused on larger asset classes, with heavy representation from large corporates and sovereigns; securitised credit is perhaps an exception insomuch that residential mortgage-backed credit provides direct exposure to the household borrower.

Illiquid credit also represents a less efficient asset class where active management is more likely to be well rewarded. However, it provides access to a far broader range of credit risk, for example, middle market corporates, consumer credit, commercial real estate and infrastructure, as well as niche and difficult-to-access credit risk such as non-performing loans or niche lending activities.

Figure 02 demonstrates the breadth of opportunities that fall under illiquid credit. The opportunities are broadly grouped based on their risk/return characteristics, with the headings illustrating the different roles illiquid credit can play in a portfolio. For example, at one end of the spectrum, infrastructure debt represents an alternative to traditional investment grade credit, deliver a secure, long-duration cash-flow stream that can be incorporated into the liability-matching program of a pension fund or insurance company. At the other end of the spectrum, we see opportunities such as distressed debt, seeking to deliver a return target akin to (or indeed above) that of equities, and thus would likely sit alongside and perhaps compete for capital with private equity.

Figure 02. Summary overview of the breadth of opportunities available within this broad asset class

Opportunities exist across the risk and return spectrum	**Investment grade alternatives**	**Loan/High-yield alternatives**	**Higher-risk performing credit**	**Equity-like credit**
	Trade finance	Niche-focused direct lending	Real asset leasing	Distressed for control
	New issue mortgages	Mezzanine	Royalties	Distressed debt
	Infrastructure senior debt	Unitranche	Specialty finance	Rescue finance
	CRE senior debt	Real estate whole loans	US RPLs	CLO equity/risk-retention
	AAA CLO debt	Middle-market direct lending	Regulatory capital	NPLs
Characteristics				
Net return range (over reference rate)	1.5%–5%	5–8%	8–12%	12%+
Income generating	Yes	Yes	Yes	Mix
Risk profile	Low	Medium	Medium-high	High
Reasons to consider	Diversification	Illiquidity premium	High carry	Alternative source of equity-like returns
	Low-risk source of yield	Skill	Illiquidity premium	Illiquidity premium
		Diversity of alternative credit risk	Skill	Skill

Still benefitting from compelling tailwinds…..

The effects of the global financial crisis of 2008 continue apace, notably the ongoing application of stricter regulations designed to reduce (systemic) risk and build confidence in the banking system. The heavy regulatory burden is forcing banks to divest certain assets and business lines, and/or to identify alternative providers of capital to partner with them such that they can maintain profitable business lines while meeting with new (Tier 1) capital requirements.

For example, the historic and ongoing future scale of the opportunity from European bank asset sales is significant, with PwC estimating in excess of €100 billion in likely activity in 2015 (versus approximately €80 billion in 2014)[1]. There is an opportunity for institutional investors to acquire these assets, offering high levels of cash-flow generation and (possibly) lower sensitivity to the credit cycle.

More broadly, the retrenchment of banks and the associated capital vacuum provides compelling tailwinds for (largely) unregulated institutional investors looking to exploit the illiquid credit space. This is reflected in an elevated illiquidity premium in some asset classes. Due to the structural competitive advantage (versus the broader market) of institutional investors' typically longer-term capital, we see an excellent opportunity and rewards for those wanting to fully utilise their investment horizon and tolerance for illiquidity.

Of course, there is a cost. Illiquid credit presents a challenge (and opportunity) of less familiarity, greater complexity and the associated governance required in order to successfully be an early mover. This is covered in the implementation section.

….although it is harder to identify value currently, and investors should be wary of cycle risk

A combination of accommodative central bank policy and excess global liquidity, since the financial crisis, has driven down yields across asset classes. Consequently, the return prospects for the majority of credit asset classes are likely to be modest versus long-term history. This is pushing investors to 'search for yield', often pushing them to assume greater illiquidity, greater complexity and often greater risk.

We believe investors should be cautious about assuming greater risk when the cycle is mature, with our central expectations that the current benign default environment is unlikely to persist over the medium term. We have spoken to our clients about the concept of 'battening down the hatches' for tougher times ahead when thinking about portfolio construction, noting that illiquid credit can be part of the solution.

Critically, not all illiquid credit investments are created equal and 'value' varies wildly across the myriad of different component asset classes. Despite the risks, certain illiquid credit asset classes offer compelling value for the risk being assumed and are consistent with Towers Watson's generally cautious stance.

1. Source: http://pwc.blogs.com/press_room/2015/08/european-banks-dispose-of-unwanted-loan-portfolios-at-record-rate.html

A case study in middle market direct lending

The magnitude of the required transfer in the provider of debt capital (from banks to other sources) to European middle market corporates and the significant barriers to entry associated with effectively underwriting and sourcing opportunities provides compelling tailwinds. This has largely shielded the asset class from the influence of quantitative easing and the glut of global liquidity. Consequently, investors are still able to secure attractive risk-adjusted returns, including a moderate illiquidity risk premium and, consistent with 'battening down the hatches', superior credit protections via bilaterally negotiated loan agreements.

Of course, this asset class will not be immune from a pick-up in corporate defaults and the 'search for yield' phenomenon that exists more broadly amongst the investment community, which is beginning to erode value in certain pockets of the markets. However, rather than undermine the case for investment, to our mind this highlights the importance of selecting managers with disciplined credit underwriting, patient capital and strong sourcing capabilities, in addition to equitable fees such that investors actually benefit from the embedded illiquidity risk premium and manager skill.

And there are also compelling opportunities in European real estate debt

Regulation has made it increasingly prohibitive for banks to lend against property that is in need of some level of repositioning, be it unlet whilst being upgraded, facing the need to re-lease in the near future or being completely redeveloped. We therefore believe lending into this space offers a meaningful opportunity for institutional investors to step into an asset class previously dominated by banks.

At this stage in the cycle we would focus predominately on Europe, as this area remains behind the UK in terms of its commercial real estate recovery and is starting to attract meaningful institutional interest as the economy stabilises. We believe whole loans offers a lower-risk way to capture this trend as there is often equity capital beneath the lender of approximately 25%–30%. This means it is somewhat less reliant on future cap rate compression and, of course, less reliant on the equity sponsor's business plan.

How should an institutional investor seek to implement?

In addition to the challenges of governance, complexity and lack of familiarity, implementation is also subject to certain challenges. In our view, the following represent key considerations when selecting the implementation option:

- **Aligning the liquidity of assets and liabilities** – The effective alignment of the liquidity terms of the investment vehicle (liabilities) and those of the underlying assets is critical for any investment strategy. For illiquid credit, this often means investing in private-equity style structures, with a fixed-term life and no interim liquidity. We are strongly supportive of tolerating fund illiquidity where appropriate, noting the industry is littered with the 'blow ups' of those attempting to offer liquidity where it does not exist.
- **Favouring a portfolio of specialists over a single multi-strategy manager** – While there are rare exceptions, illiquid credit typically represents a space where specialism is well rewarded. As noted previously, the most attractive market segments are subject to significant barriers to entry, often including the requirement to effectively source and underwrite credit risk typically handled by the large infrastructure and credit departments of banks. Investors must also be wary of the adverse selection challenges presented by banks naturally biasing away from those assets and businesses subject to more uncertainty and issues. We view this as a space where manager selection skill is crucial and hence typically favours specialists.
- **Utilising top-down informed view to help drive focus** – The breadth of the opportunity set and broad range of potential solutions makes an effective screening methodology a necessity. While we typically expect idiosyncratic manager alpha to represent an important driver of returns, the embedded beta exposures and inherent cyclicality should be key considerations. Consequently, exceptional manager research due diligence needs to be paired with top-down economics and capital markets research in order to successfully identify those ideas offering the most attractive total return potential, and indeed avoiding those suffering from macroeconomic and valuation headwinds.

Governance permitting, we believe implementation should be focussed, specialised, dynamic, and built with a strong appreciation for the broader portfolio. Illiquid credit exposure should be developed and maintained via investments in a series of closed-end vehicles selected on their future risk-adjusted total return prospects at the time of deployment, and derived using a blend of top-down and bottom-up inputs. An assessment of where the illiquidity premium is most attractively priced should represent an important determinant.

Conclusions

Regulation of the banking system has effectively created a set of new asset classes that can be accessed by the institutional investment community, with the benefits of increased portfolio diversity and potentially higher returns. An early mover advantage exists for those investors willing to overcome the additional governance and complexity associated with illiquid credit and to play the role of a good bank. These asset classes remain largely untapped by institutional investors and yet compelling tailwinds remain present.

But investors must not lose sight of cyclical headwinds associated with a mature credit cycle and compressed valuations in those markets segments already influenced by quantitative easing and investor search for yield. Only through discipline, selectivity and skill will the benefits of illiquid credit be successfully exploited.

Further information

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