International Private Credit: A Differentiated Source of High Income

In the years following the financial crisis, global investors have been penalized with low bond yields and limited opportunities to generate higher income. Over this same period, a steady stream of banking regulations has considerably reduced the capital that traditional lenders can deploy to deserving borrowers. While lending constraints have somewhat alleviated in the U.S., conditions remain particularly challenging across European and Asian markets. As a result of this supply-demand imbalance, a robust international private credit market has developed. This credit market is supported by specialty lending businesses with local market knowledge and relationships as well as sophisticated sourcing, underwriting, and asset management capabilities. These private lenders provide productive capital when traditional lenders cannot participate and thus are compensated with potentially higher returns on their investments when compared with public markets debt.

We interviewed BlueArc Capital, a specialty alternative investment firm, to discuss their findings on the international private credit markets, the key benefits offered to investors in this market, and how investors can access this opportunity set via established and experienced private lending teams.

What is International Private Credit?

Broadly speaking and similar to the U.S., international private credit provides a source of capital to corporations, financial sponsors, and small enterprises with restricted or underserved access to traditional lending sources. Private credit can take a variety of formats but is often characterized by highly negotiated lender protections, structured cash flows, and higher income potential when compared with the publicly listed and broadly syndicated loan markets. A few examples of different types of private lending are as follows:

Direct Lending	Real Estate Lending	Bank Risk Sharing / Regulatory Capital Relief	Opportunistic Corporate Debt
• Middle-Market corporate borrowers • Primarily Senior, 1st lien, and floating rate • Collateralized by Cash Flows or Hard Assets	• Senior, 1st lien debt • Mezzanine debt • Structured securities or portfolios of loans • Often backed by cash flowing assets	• Loans to small / medium size entities (SME) • Loans to large corporate borrowers • Consumer loan portfolios • Trade finance • Helps banks optimize ROE	• Controlling fulcrum securities • Special situations • Restructuring opportunities

Investors Demanding Higher Yields

Even 10 years beyond the financial crisis, investors remain yield-starved due to artificially suppressed interest rates. Global government bond yields remain paltry, and often negative, as of early February 2019 (Figure 1). International private credit may provide relief to income constrained portfolios.

Country	5 Year Yield	10 Year Yield	30 Year Yield
U.S.	2.49%	2.68%	3.03%
Japan	-0.16%	-0.01%	0.60%
Germany	-0.34%	0.16%	0.77%
U.K.	0.87%	1.22%	1.72%
France	-0.52%	0.58%	--
Italy	1.72%	2.87%	3.65%

Figure 1: Global Investors Yield Starved | Source: TradingEconomics.com

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Key Benefits and Return Potential of International Private Credit

- Strong potential for higher income than available in traditional public debt markets
- A low correlation to public markets
- A limited duration profile
- Transparent risks
- Accessible collateral often secured by cash flows

From a total return perspective, international private credit offers the potential to capture high single-digit to low double-digit net returns largely from senior, secured debt risk with moderate use of leverage.

Why Consider International vs. U.S.?

Coupled with a reduction in traditional bank lending, the private credit market has grown since the financial crisis and continues to provide a robust opportunity set for investors due to its income potential, strong lender protections, and low correlation to traditional markets. As compared to the U.S., however, European and Asian credit markets remain historically underserved *(Figure 2)* and are arguably in an earlier stage of an opportunistic investment cycle *(Figure 3)*. These less developed and more fragmented private lending markets in Europe and Asia may provide for greater return potential and structural protections.

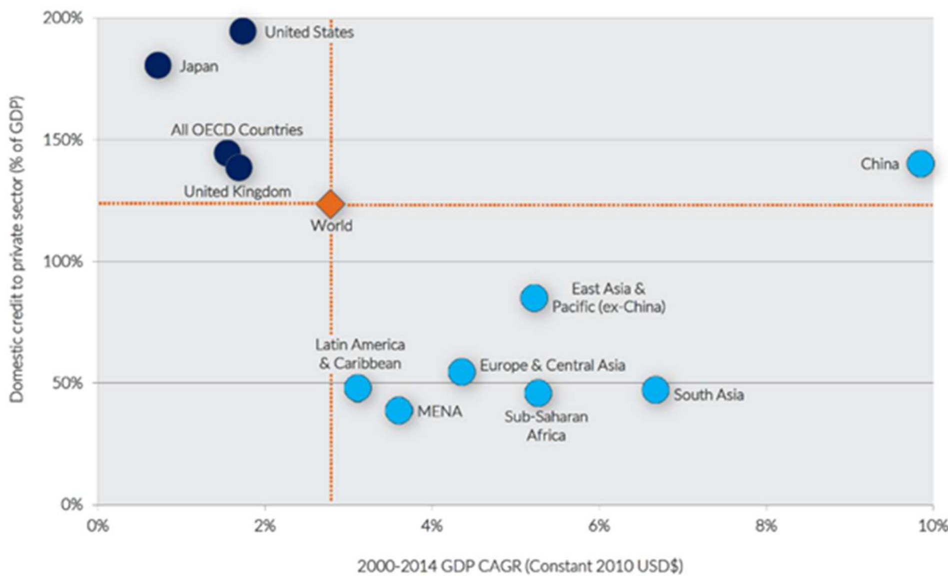

Figure 2: Credit Structurally Undersupplied Across Europe & Asia
Source: World Bank

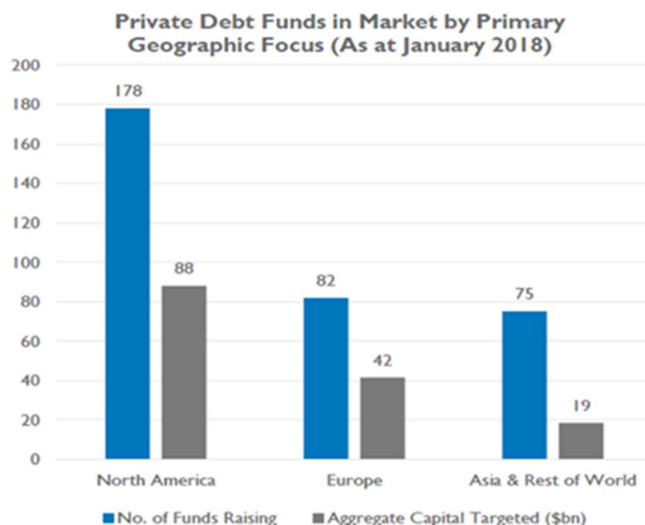

Figure 3: Capital Raised for Private Credit Investments
Source: 2018 Preqin Global Private Debt Report

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Growing International Opportunity Set

The main driver of this growth has been due to strong demand from borrowers following the retrenchment of banks from some lending markets. This borrowing demand, coupled with undersupply of traditional bank capital has resulted in the emergence of alternative lenders who can provide flexible and highly structured credit solutions via streamlined and institutional quality processes. In addition to the less crowded nature of European and Asian credit markets, there are two primary tailwinds which make the developing nature of the opportunity set timely to the current environment.

Regulatory Constraints

Regulation has either forced some lenders entirely out of the market or significantly reduced such activity since the financial crisis. The curtailment of bank 'prop' activity due to various legislation continues to have a material impact on credit availability across Europe and Asia. Bank balance sheets across Europe also remain more leveraged when compared to U.S. counterparts (*Figure 4*) and have come under pressure due to ever more restrictive requirements from the enactments of Basel III (2014), Basel IV (2019) (*Figure 5*) and new IFRS 9 accounting standards.

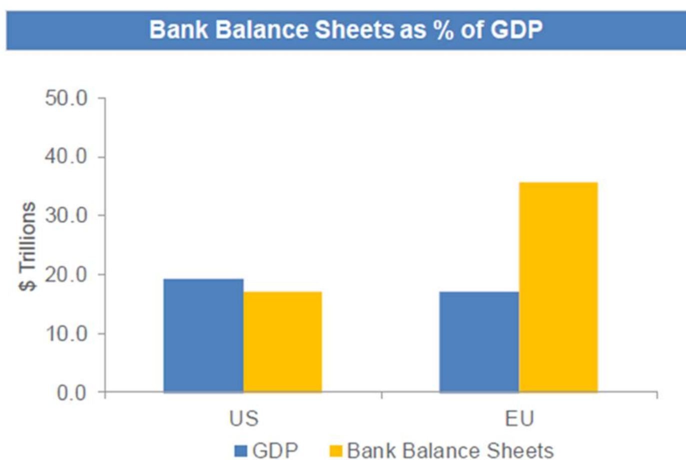

Figure 4: European Balance Sheets Under Pressure
Source: Bloomberg for FDIC (Bank Balance Sheet) as of 30 June 2017 and US (GDP) as of 30 September 2017. IMF for Europe as of 10 October 2017 (GDP). ECB for ECB as of 30 June 2017 (Bank Balance Sheet).

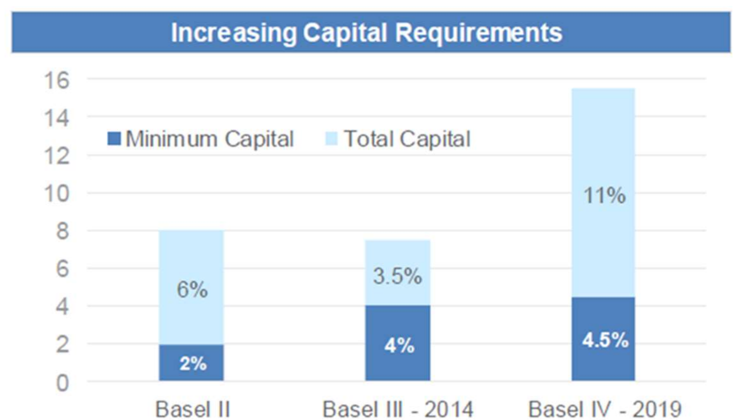

Figure 5: Incremental Regulatory Pressures
Source: PWC Portfolio Advisory Group, 'Capitalising on the acceleration in the bank restructuring' 2016.

Structural Shifts:

When compared with the U.S., the European market has historically relied much more on banks for the financing of SMEs and Middle Market Companies. With headwinds relating to regulatory challenges and low GDP growth, alternative/private lenders have a greater opportunity for capital disintermediation going forward in our view *(Figure 6)*.

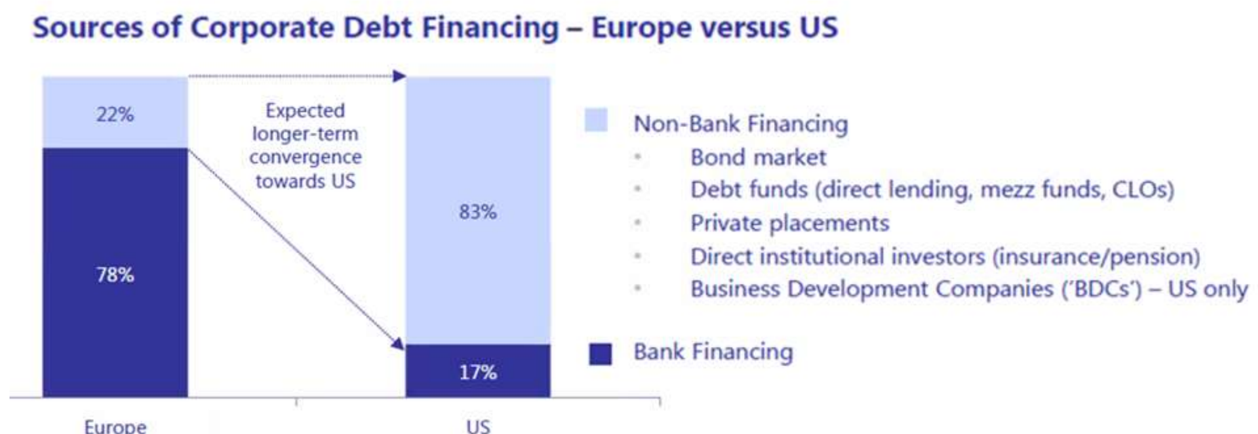

Figure 6: European Corporate Non-Bank Debt Financing Expected To Increase Considerably
Source: Cheyne

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In Asia, borrowers also frequently face an under-developed/low penetration local bank-lending market that is unable to tailor solutions beyond plain 'vanilla' structures. An under-developed high yield market, a lack of middle-market CLOs, and a lack of listed / permanent capital vehicles has contributed to the opportunity set for private capital to provide solutions via direct middle-market lending, alternative real estate credit, and other asset backed financing.

Why Invest in International Private Credit?

- Yield-starved market environment - difficult to find compelling sources of yield in traditional capital markets
- Diversification of income as compared with traditional higher yielding fixed income strategies
- Total return potential commensurate with public equities but provides senior positioning in capital structures
- Complementary to private equity exposures accessing underserved and fragmented markets
- Seeks to capture illiquidity premium available from private markets

How to Invest?

International private credit has historically been difficult to invest in due to localized knowledge/geographic barriers as well as the substantial resources and skills required to deploy capital effectively. As a result, most investors choose to allocate to established investment management firms with long-standing local banking and advisory relationships, specialized structuring expertise, and well-resourced teams focused on underwriting, structuring, and managing assets. In order to deploy capital with confidence, this allocation methodology requires an investor to source a variety of private credit specialists, develop an opinion on a wide array of strategies, perform detailed due diligence on firms/private funds, and monitor these investment managers on an ongoing basis. If an investor cannot incur the costs associated with these efforts, then partnering with a specialized advisor that covers the asset class or offers a diversified investment vehicle targeting this opportunity set can be an efficient and cost-effective means to incorporate the benefits of international private credit into a portfolio.

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