Alternative Financing with Private Debt

Private Debt investments reached an all-time high in 2017 and the number of Private Debt funds has quadrupled over the past decade. With institutional investors planning to increase their allocation towards Private Debt, the popularity of Private Debt in Europe is stronger than ever. Recent developments fostered a dynamic and thriving market environment for Private Debt with the potential to seriously challenge the role of banks in lending. In a market traditionally dominated by banks, the funding gap caused by a growing demand for financing and decreasing capacities of banks to lend can be filled by Private Debt managers.

Private Debt market development

Over the last years, the market demand for Private Debt investments in Europe has experienced rapid growth. According to a survey conducted by Preqin in 2018, Private Debt is among the most sought-after asset classes within alternative investments (Preqin Global Private Debt Report 2018). Going forward, 42% of those investors surveyed are planning to commit more capital to Private Debt funds within the next twelve months.

In 2017, global Private Debt fundraising surpassed USD 100bn. At the same time, global assets under management in Private Debt reached an all-time high of USD 638bn. Consequently, the last year has accentuated the increase of capital allocated to Private Debt and has proven that Private Debt managers are facing a larger investor base with increasing allocations toward alternative investments. Currently, the interest in Private Debt as an alternative asset class is stronger than ever.

Underdeveloped European market with great potential

Compared to the US, Private Debt has still a large growth potential in Europe. Traditionally, Continental Europe has a highly banking-oriented financial system, where traditional financial institutions are involved in 50% of all financing transactions. In the US, 75% of all financing transactions are done by non-bank institutions, and only 25% by credit institutions like banks.

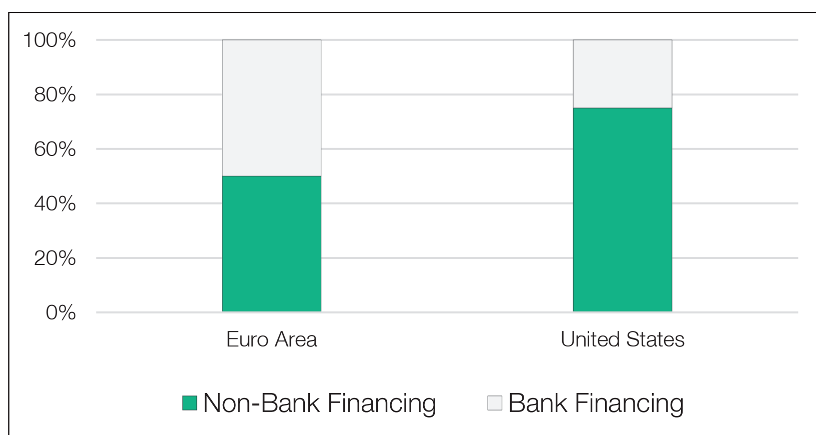

Figure 1: Share of bank & non-bank financing in total non-financial corporation financing in the Euro Area & the United States.
Source: ECB, Federal Reserve System, ECB Economic Bulletin, Issue 5 / 2016.

Against this background of a comparatively underdeveloped European market, market players like Vicenda Asset Management with its multiple Private Debt investment vehicles (such as its single transactions securitization vehicle Thalos Investment Platform S.A., the Daneo Private Debt Fund and the Swiss SME Loan investment opportunity) are stepping in to close this financing gap, offering investors attractive investment opportunities in a growing asset class to further diversify their portfolio.

Drivers of the continuous advance of Private Debt

The uptick in growth for the asset class of Private Debt can be attributed to two main drivers:

1. **Increasing regulation including higher capital requirements have reduced banks' lending capacities**

The adoption of an increasingly stringent regulatory framework can be traced back to the years following the 2008 global financial crisis. Tighter banking regulations like the new Capital Requirements Directive IV under the Basel III framework have curtailed banks' lending to SMEs, to large corporates and in special situations generally. Furthermore, entirely new ratio requirements (such as the net stable funding ratio (NSFR) and the liquidity coverage ratio (LCR) have been implemented. This results in higher capital requirements for banks to cover for short-term liquidity disruption and reduces the appetite of banks to lend. These capital requirements imposed on Swiss and European credit institutions have significantly reduced banks' lending activities and have rendered several types of banks' business activities economically unviable.

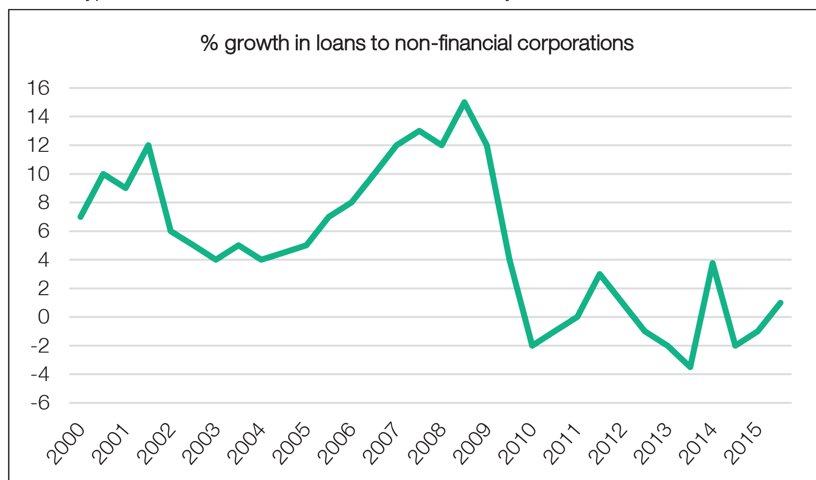

Figure 2: % of growth in loans to non-financial corporations in Euro area
Source: ECB and Bundesbank calculations; Deutsche Bundesbank Monthly Report, September 2015

Therefore, the importance of banks within Europe's credit system has already started to decrease significantly. This trend does not only apply to lending to SMEs, but also to extending loans to large corporates and private individuals.

2. **Central banks' expansionary monetary policy has caused a low yield environment, making it difficult for institutional and private investors to achieve their target returns in fixed income**

While regulation has caused a decrease in banks' lending activities, central bank interventions like quantitative easing have created a low-yield environment for investors. Facing difficulties to achieve their target returns in such a setting, investors have shown increasing interest in alternative fixed income investments such as Private Debt.

Private Debt as an asset class

Private Debt transactions can be described as privately negotiated loans extended to non-public companies. These loans are not publicly traded and often have no rating. As there is typically no liquid secondary market for Private Debt loans, investors are rewarded with an illiquidity premium. Typical investors are institutional investors, such as pension funds and insurance companies, as well as family offices, UHNWs and treasury departments.

Private Debt funds typically have a fixed tenor of 3 to 5 years. Depending on the specifics and the risk/return profile of the trade, typical Private Debt transactions generate returns between 5% and 15% p.a. in CHF. Very often, such transactions also feature a comprehensive security package to improve the underlying risk profile.

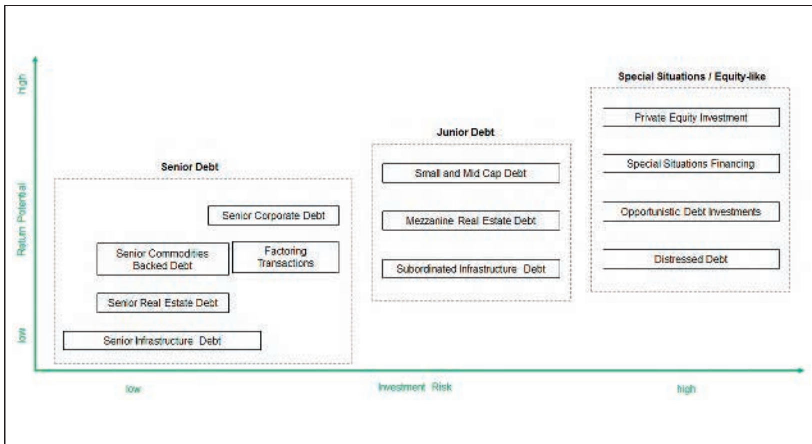

Figure 3: Spectrum of Private Debt transactions
Source: Vicenda Asset Management

The spectrum of Private Debt transactions is wide and includes senior debt, junior debt, special situations and even equity-like transactions. Thereby, these transactions are structured and executed via a variety of different vehicles and platforms, reaching from peer-to-peer lending marketplaces to more classical fund formats.

Matching interests of borrowers and investors

The various alternative investment strategies and their applications are endless.

On the borrower side, Private Debt financing can be utilized as an efficient way to increase working capital or to finance growth and acquisitions. Furthermore, these transactions can be used to improve balance sheet ratios and to optimize a company's capital structure through capital relief transactions.

From an investor's perspective, Private Debt investments offer access to a new attractive asset class, which diversifies the investor's overall portfolio construction. Through the illiquidity premium and flexible negotiation of the deal documentation (loan and security agreements), investors can achieve superior risk/reward profiles compared to other debt instruments and alternative investments.

The fact that only a few parties are involved (e.g. the borrower and lender) offers an opportunity to structure tailor-made financing solutions that cater to the distinct and sophisticated needs of borrowers as well as of investors. The key features of such transactions are an efficient negotiation and highly flexible terms (such as defining specific covenants), the inclusion of credit enhancement features and the speed of execution. Given these characteristics, Private Debt investment opportunities significantly outperform unsecured corporate bonds by offering an overall superior risk/return profile.

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