

ANALYSIS

PERFORMANCE

The art of benchmarking

The private debt industry's relative youth makes benchmarking difficult given the scarcity of historical data. This hasn't stopped investors committing to the asset class in search of yield, however. **Anna Devine** explores how they go about selecting managers.

Experienced investors in both the fixed-income and private equity markets are becoming increasingly interested in private debt. With interest rates at record lows and private debt – in its many guises – offering attractive risk / return profiles, market sources suggest LPs are reallocating capital away from traditional fixed income and even private equity into credit funds.

Yet selecting managers to back can be tricky, not least because it's a relatively young asset class.

Oliver Huber, head of private debt at fund of funds **Golding Capital Partners**, says: "It's not always easy, particularly in Europe, where the market is still developing with many first-time funds.

"If comparing the private debt industry to private equity it is certainly more challenging due to the lack of available databases that track the asset class," he says.

Jim Strang, managing director of the European fund investment team at investment advisor **Hamilton Lane**, says: "Private debt is an enormously broad area. The easiest way to think about it is in terms of risk and return, starting at the riskiest end of the spectrum, distress-for- control. Executing this strategy is challenging but returns are also the highest, at around 20 percent or higher.

"At the other end you have direct lending, which is a relatively new feature of the private debt market, especially in Europe. Returns are typically in the single digits and the corresponding risk should be relatively low.

"In the middle of these strategies you have the active non-control space. Here investors



"IT'S NOT ENOUGH TO JUST LOOK AT NUMBERS PROVIDED IN THE TRACK RECORD. YOU ALWAYS HAVE TO FORM YOUR OWN VIEW AND MAKE A JUDGEMENT WHETHER THIS MANAGER WILL CONTINUE TO BE SUCCESSFUL IN THE FUTURE"

Oliver Huber,
Golding Capital Partners

are looking to buy into loans or obligations at less than their original face value and are looking for an element of 'pull-to-par,' some form of coupon on yield and potentially further upside through a restructuring. Returns here are somewhere in the teens," he adds.

Strang adds that in Europe distressed investing for control has been around about twenty years, but that primary lending from debt funds emerged only in the last six to seven years since the crisis. "In aggregate, the European private debt market is a lot less mature than the equivalent US market," he says.

AN ART, AND A SCIENCE

Huber says returns are just one piece of the puzzle when selecting a fund, however. Like many LPs, **Golding** uses a third-party database. It tracks around 270 mezzanine funds and around 170 distressed fund segmented by the US and Europe.

"What's also important – and this is where it becomes more of an art than a science – is that you have to understand the fund manager on a deeper level – how the investment strategy is differentiated; the capability of its platform to source and select the right transactions as well as how credits are managed in work-out situations.

"You've got to meet as many managers as possible and try to see everyone who is in the market raising a fund," Huber says.

"Most crucial is how capable they are in work-outs when things go bad. Do they have the skills and also the passion to manage and work hard with a company in a downturn? There are managers in the private debt space with a more passive approach – their only option is to try and sell, which is very difficult in this illiquid asset class, particularly in a market crash. We want to see teams that can manage through a downturn and fight hard to get the money back in restructuring situations," Huber says.

A DEARTH OF DATA

Industry data on returns is most comprehensive in the distressed and mezzanine fund segment of the market.

"If you look at mezzanine, net returns are on average around 10 percent. For distressed debt funds they are around 14

ANALYSIS

PERFORMANCE

percent over a period of around 20 years,” Huber says.

Huber thinks “positive bias” might also skew reported returns by between 100 and 200 basis points above what actual market returns are, as managers are more likely to report if they can show strong returns rather than if they underperform the market, he explains.

There are geographical differences in returns as you might expect too.

“In general the US market has performed better than Europe – probably around 200 bps better in returns throughout the last cycle. Part of that is that in the difficult 06/07 vintages, the US funds did significantly better as they had the tailwind of a relatively much stronger economy in recent years coming out of the dip in 2008. In consequence, they had lower default rates as well as stronger repayments / exits. Whether this outperformance of the US market will continue through the current cycle over the next five to seven years remains to be seen,” he says.

In Europe, there have been three waves of private debt fundraising since the crisis, Strang says. “The first wave came in 2008, the second around 2011 and 2014 is the third wave. In the first wave, debt funds performed well and probably beat initial expectations around returns. Generally returns from the second wave are playing

out close to expectations. It is still early for a number of these funds but returns are solid, if not as strong as in the first wave. We have yet to see how the third wave of funds will fare.”

TECHNIQUE

Golding also has its own in-house benchmarking tools but it’s thought many LPs rely solely on third party databases.

“Not all [LPs] are set up with their own dedicated private debt teams,” Huber says. “It is a broad LP investor base and it is my understanding that many just rely on [external] databases when picking a manager or pursue a more opportunistic approach to investing with the few relationships they have in the market,” Huber believes.

Ben Schryber, director of private equity and credit in the US at placement agent FirstAvenue, shares that view and voices concerns about the private equity approach to benchmarking.

“The private equity approach of benchmarking funds focuses on alpha generation and upside,” he says.

“With private debt, downside protection is equally if not more important than upside,” he says, adding, “Benchmarking the default and recovery rates of private loan portfolios against each other and against similar quality public debt is a good way to evaluate downside protection.”

“Some LPs are agnostic regarding geography [US versus Europe], strategy [sponsored versus non-sponsored] and capital structure [senior versus subordinated]. From my experience, these investors tend to favour funds targeting the highest returns rather than funds with the most attractive risk / award profile,” he says.

Schryber highlights the perils of over-reliance on third-party data providers: “Comparing performing credit funds is more difficult than comparing funds within just about any other asset class,” he says.

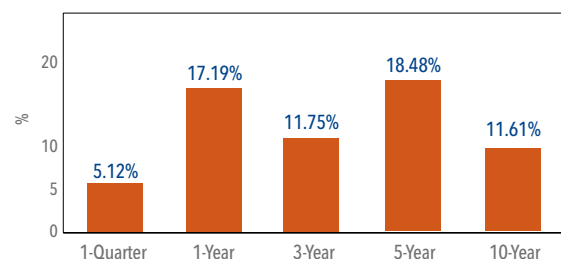
“Some third party data providers aggregate all performing private credit funds together for benchmarking purposes. It is dangerous to use these benchmarks to make investment decisions, as performing private debt encompasses a very wide range of sub-strategies,” he says.

When looking at variation in returns between debt funds, Huber has a similar thought process.

“Volatility [in private debt] is much lower than in private equity, yet it’s still about 10 to 15 percent for mezzanine between the top funds and the underperformers but it’s hard to quantify further when there is limited data for individual vintages. For segments such as distressed debt, mezzanine and senior loans, you need to look at each fund vs their relative peer group. Slicing and dicing just in terms of

CAMBRIDGE ASSOCIATES: DISTRESSED SECURITIES INDEX

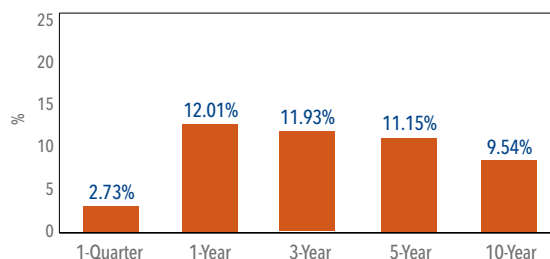
The Index shows end-to-end pooled returns (net of fees, expenses and carried interest) to LPs as of 31 December 2013, and is based on data compiled from 252 distressed securities funds, including fully liquidated partnerships, formed between 1987 and 2013.



Source: Cambridge Associates

CAMBRIDGE ASSOCIATES: GLOBAL MEZZANINE INDEX

The Index shows end-to-end pooled returns (net of fees, expenses and carried interest) to LPs as of 31 December 2013, and is based on data compiled from 142 global (123 US and 19 ex US) mezzanine funds, including fully liquidated partnerships, formed between 1986 and 2013.



Source: Cambridge Associates

ANALYSIS

PERFORMANCE

quartile is not a good enough comparison,” Huber says.

The new senior secured debt lending market remains untested too, Schryber notes. The dilemma is that with the market as young as it is, “It’s really difficult to [benchmark performance] without seeing how these funds perform under financial stress.

“The majority of direct lending funds in the market today were formed post financial crisis, a period of relatively stable economic growth characterised by low overall default rates and high recovery rates. It is therefore difficult to determine how much of a fund’s performance can be attributed to true alpha generation versus market beta. For funds that do have pre-and post- financial crisis track records, the pre-crisis performance tends to be a much better indication of a manager’s credit skill-sets than their post-crisis performance,” Schryber adds.

Schryber does see improvements in LPs’ understanding of the new asset class however: “LPs have become more sophisticated with benchmarking private credit funds in the last year or two. Many LPs and consultants are starting to track key portfolio-level metrics and are using the data to compare risk between different managers,” he says.

“If you look up some of the US public pension funds, they too have compiled their own data. The way to do it is to dig pretty deep when you meet a manager,” Huber says.

RELIABLE REPORTING

Robust reporting will also help with the understanding of the market. “Around eight out of ten [managers] provide a good reporting standard, where we do not need to ask further questions,” Huber says.

“Since the crisis a lot of things have improved in the relationship between LPs and GPs. Investors are more demanding and many GPs have adapted their reporting standards. Reporting practices are now relatively close to each other in terms of the quality of data you get,” he says.

“COMPARING PERFORMING CREDIT FUNDS IS MORE DIFFICULT THAN COMPARING FUNDS WITHIN JUST ABOUT ANY OTHER ASSET CLASS”

Ben Schryber, FirstAvenue

“What almost everybody provides are unaudited quarterly balance sheets, income statements and valuations on the individual investments. Some go one step further. The best in class have operating performance data and development of net debt position on an individual company basis as well as qualitative comments on the portfolio companies,” he says.

Strang also believes the reporting is good: “A lot of people [in the private debt markets] have their DNA in hedge funds so generally they are quite good at reporting.”

FIGHTING FOR (LOWER) FEES

Managers have seemingly responded to pressure from investors regarding fees, too. “There is a clear trend in the industry that management fees are paid on invested capital and not on committed capital as was the standard a few years ago,” Huber says, suggesting around 60 percent of managers in the private debt space now draw fees on invested capital.

“There is also a general trend towards overall lower fee levels. While previously annual management fees were in the range of 1.5 to 2.0 percent, they are now around 1.0 to 1.5 percent, sometimes for senior loan funds as low as 0.6 percent,” he says.

“While the trend towards lower fees is generally a good thing for LPs as it increases expected net returns, you have to also make sure that the team is well paid and can afford to attract and retain the best people.”

He also explains that “another positive effect of a management fee structure paid on invested capital is, that there is positive

net income even after the first quarter of the fund life. You don’t have to go through a J-curve. A lot of investors like that.”

When asked whether some fund managers might be incentivised to pick credits which could be considered less than credit-worthy just for the sake of increasing assets under management and related fee income, Huber says it is a valid concern but contends that managers typically put a lot of their own money into their funds – typically around 2 to 4 percent of the overall fund volume.

A LOOK FORWARD

A report from fund of funds manager Unigestion at the start of the year highlighted that distressed debt had outperformed equity on a five year rolling basis since 1995 (except for the dotcom bubble) and recommended the strategy as “a prudent way to gain exposure to market beta.” It forecast returns in the region of 8 to 30 percent, citing three different scenarios, and is bound to whet the appetite of LPs further.

And despite a lack of data, with every new fund, it is set to improve.

Strang says: “The problem you can have is that you need access to a lot of primary data to get rigorous benchmarking. It’s not bad but it’s not perfect. The quality of data will improve over time.”

Huber notes that looking at the past can’t always give you a good picture of the future anyway:

“It’s not enough to just look at numbers provided in the track record. You always have to form your own view and make a judgement whether this manager will continue to be successful in the future. Questions regarding the team and organisation are very important, in particular how the key people in a team are incentivised and what drives them.

“It’s not only the historic track record you need to look at but if the setup will be stable for the next eight to ten years as you will be relying on that team for the future if you invest with that manager.” ■