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Corporate Credit: Public vs. Private

Joint Research Project

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Objectives

- ☐ Review credit in PRIT Fund
- ☐ Evaluate credit market risk/return
- ☐ Apply framework to credit investing options



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Summary of Findings & Investment Recommendation

Summary of Findings

- ❑ Evidence of high dispersion amongst distressed debt strategies, but manager needs to beat public high yield index.
- ❑ Data show that unless managers time the market well, they don't beat the index net of fees.
 - Distressed debt strategies add 200 – 250 bps of alpha from timing of their investments vs. straight-line PME.
- ❑ Distressed opportunities are episodic. Lose ground to public index unless big dislocation (contraction).

So What?

- ❑ Research results raise the bar for mezzanine and distressed debt strategies:
 - **Mezzanine:** may not be able to meet our expectations (doesn't outperform HY, low dispersion, no alpha from timing, price takers, pro-cyclical, fees eat all alpha).
- **Private distressed debt:**
 - We can likely find a number of managers with skill here, but need to see significant timing or selection skill.
 - Focus on non-control distressed, de-emphasize distressed-for-control (really private equity).
 - Explore more favorable terms:
 - Bigger relationships (fee breaks).
 - Negotiate no fee on capital committed but not yet called (Oaktree structure).
 - Negotiate carry hurdle > high yield CCC.

Potential Next Steps

- **Credit Hedge Funds:**
 - Continue research to evaluate where Credit Hedge Funds fit in the credit investment spectrum.



Private Debt Opportunity Set

☐ Distressed Debt

- HY credit trading at distressed levels (eg. 50-60 cents on the \$).
- Manager buys subordinated debt (lower on cap structure), because impaired creditor drives restructuring.
- Restructure debt to equity.
- Distressed debt typically closely held, so usually can work out credit issues even though more covenants than public markets.
- Recovery rate better than public markets because lots have financial sponsor who would do unnatural things to save equity ("PE put").
- Some hedge funds do this.
- Late in cycle, want to invest higher in stack; early in cycle, want to invest lower in stack.
- Distressed is cyclical, episodic. Positive correlation with equities. Rips in recovery, dips in contraction.
- Very sensitive to timing of investment.

☐ Direct Lending/Mezzanine

- Junior unsecured/second lien.
- Borrower can't access syndicate, so mezz lenders bridge gap between bank loans and equity in cap stack.
- Borrower typically LBO sponsors, small HY issuers, acquisitions, recaps, later-stage growth financing, project finance.
- Stated coupon represents majority of return, with equity upside potential.

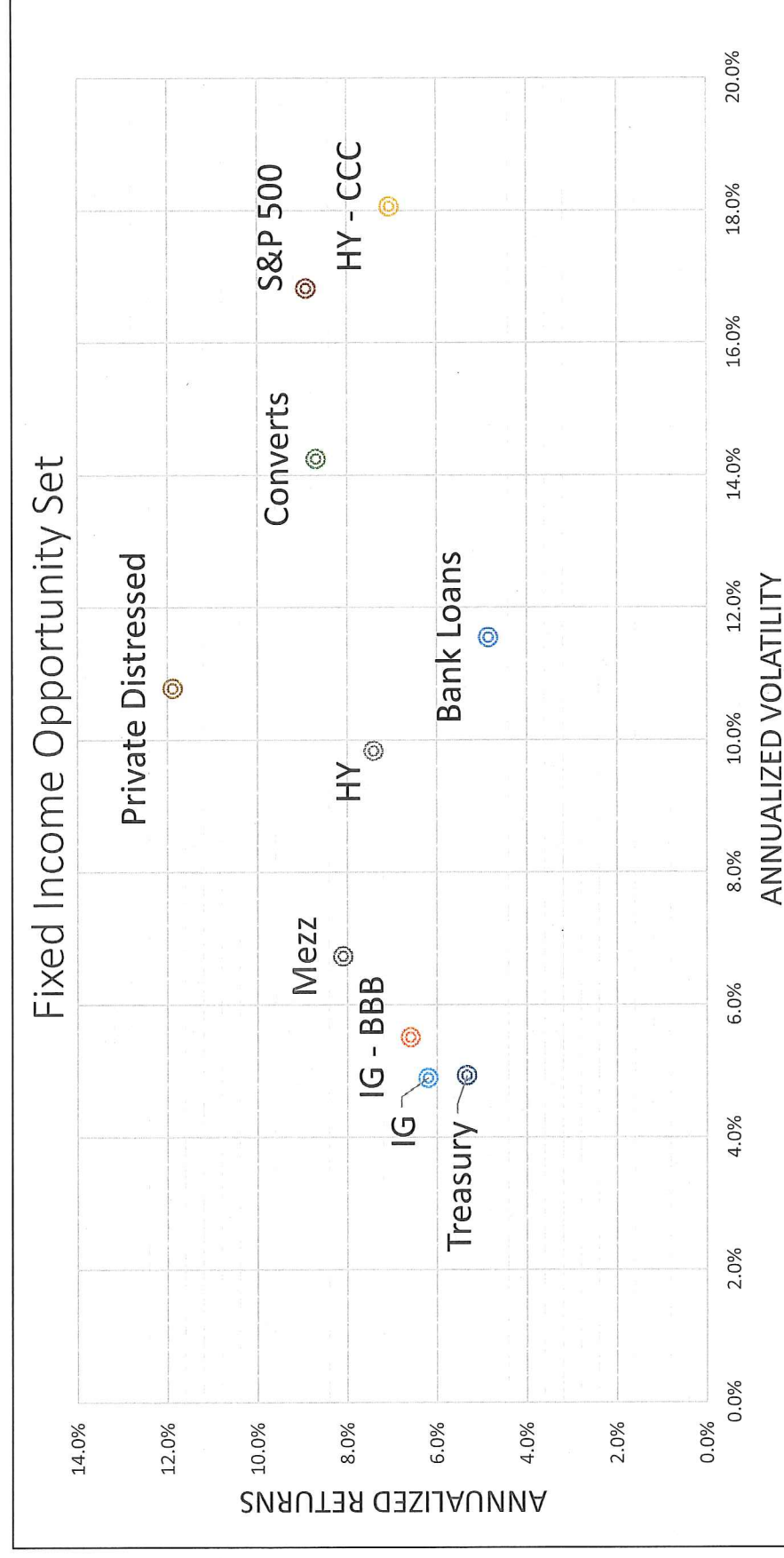
☐ Other Providers of Junior Capital

- Hedge funds.
- High yield market
- Second lien funds.



Risk vs. Return

- ❑ Distressed debt exhibits higher return and higher volatility than mezzanine debt.
- ❑ Private distressed debt return premium was generated in last market cycle (2000 – 2007), when it outperformed HY CCC's by 8% per year.
- ❑ Recent economic cycle: private distressed has not outperformed HY CCC.



Risk

- Investors must exercise care when using standard deviation of time-weighted returns as a measure of risk for private investments with drawdown structures.
- Risk will be understated due to smoothed returns, illiquidity, and marking practices.
- Volatility is unlikely to be less than the standard deviation, but is likely larger.
- Minimum volatilities: distressed debt 11%, mezzanine 7% (vs. 10% for HY and 18% HY CCC).
- Another measure of risk is the loss ratio. Distressed debt non-control exhibits a higher loss ratio than HY but a lower loss ratio than HY CCC. HOWEVER, this is baked into returns for both asset classes.

	Return (TWR, net)	Volatility (σ)	Median Loss Ratio*	Risk-Adjusted Return	PRIM View
Private Debt	11.9%	10.7%	6.7%	Return/ Volatility 1.1	Return/ Loss Ratio 1.8
Distressed – Control	9.8%	10%	18.5%	1.0	0.5
Distressed – Non-Control	10.5%	13%	6.5%	0.8	1.6
Hedge Fund Distressed Debt	9.1%	9.7%	n/a?	0.9	n/a?
Mezzanine	8.0%	6.7%	1.2%	1.2	6.7
Public HY	7.0%	9.8%	2.4%	0.7	3.1
Public HY CCC	7.0%	18.1%	12.5%	0.4	0.6

*Loss Ratio for Private Debt = ((total realized + unrealized losses) / invested capital). Loss Ratio for Public HY = average default rate x average (1-recovery rate). HY historical weighted average default rate 1978 – 2010 is 4.3%, recovery rate is 45%. HY CCC historical median default rate 1982 – 2007 is 21%, recovery rate is 53%.

Source: PRIM Staff, Altman paper (Defaults and Returns in the High-Yield Bond and Distressed Debt Market, 2010), Moody's Global Corporate Finance Paper pg. 22 and 29.

