

Some Thoughts on Private Debt

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Overview

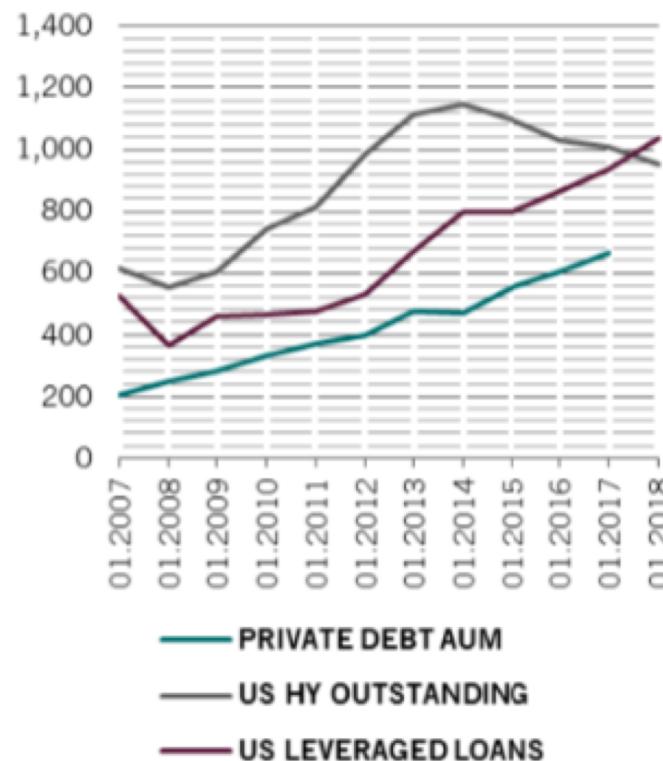
- What is private debt?
- Some facts re private capital, private equity (PE) and private debt.
- Some interesting questions?

What is Private Debt?

- What is it not?
 - Not traditional bank debt.
 - Not traditional bonds.
- Somewhat opaque. Different definitions in different places.
- What does it include?
 - CLOs / Large Leveraged Loan Market.
 - » Primarily syndicated loans to large corporations.
 - Direct Lending Funds (DLFs), Business Development Corps. (BDCs), Mezzanine Debt, Distressed Debt and Venture Debt.

High Yield Bonds have declined while Leveraged Loans and Private Debt have risen.

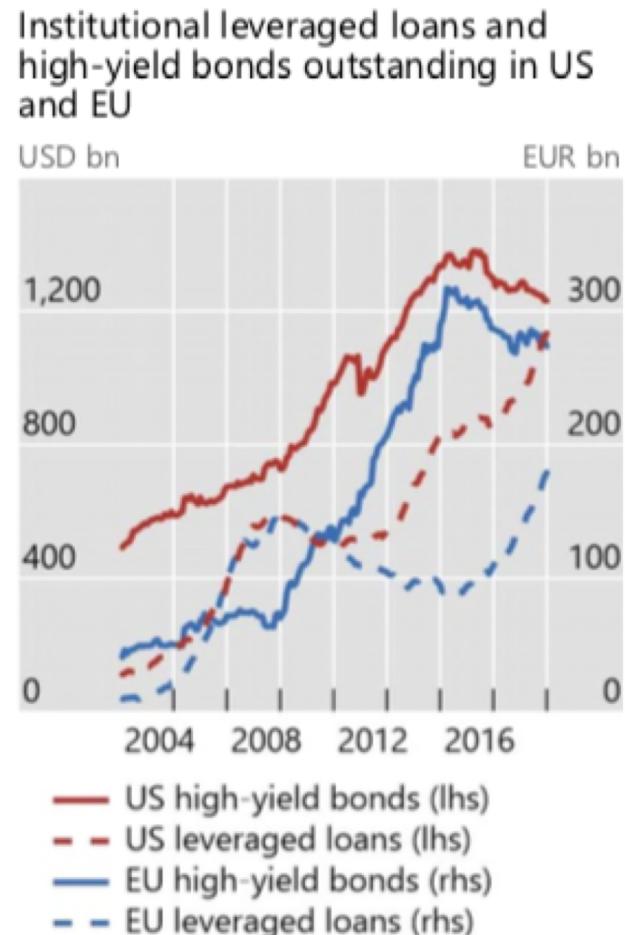
Figure 2: Institutional AUM by asset class



Source: Prequin, Dealogic, S&P/LSTA, Pictet

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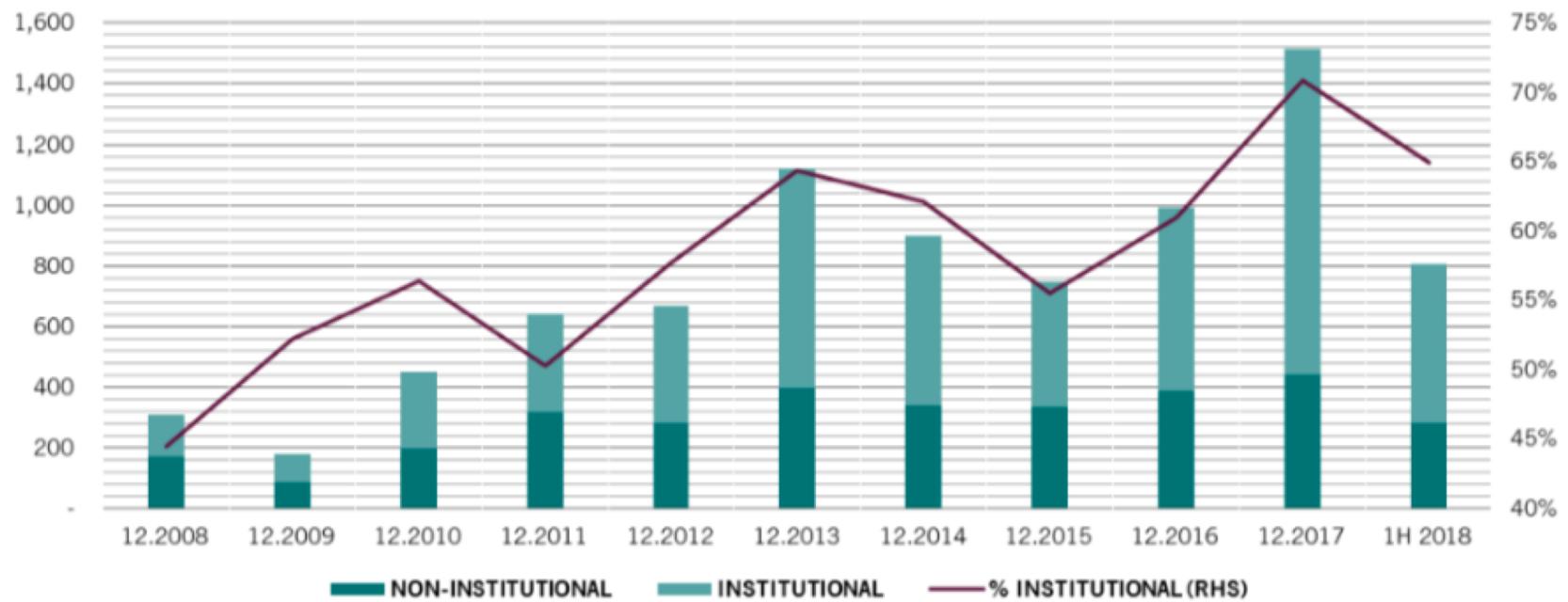
US and Europe



Sources: Federal Reserve Y-9C Reports; Bloomberg Finance LP.; LCD, an offering of S&P Global Market Intelligence, and BoE calculations. ECB calculations using AFME and SIFMA data. FSB Report.

Leveraged Loans have become more institutional / less bank driven.

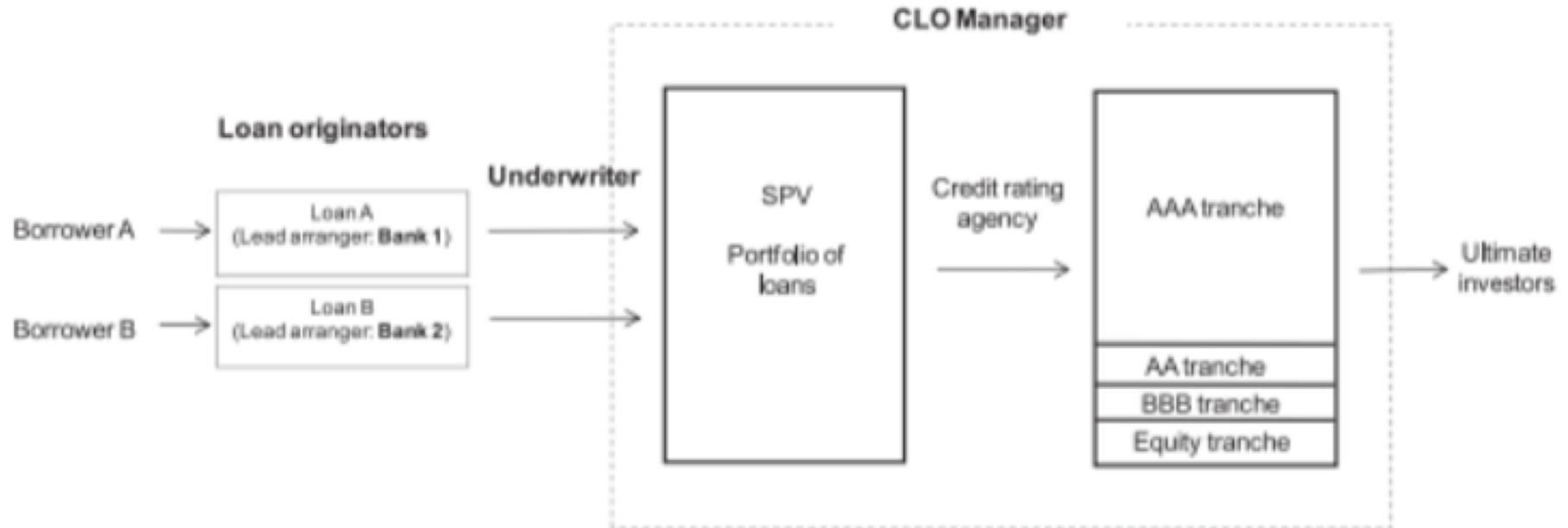
Figure 3: US issuance of leveraged loans, banks and institutional, USD billion



Source: Bloomberg, Pictet

What is Private Debt? CLOs

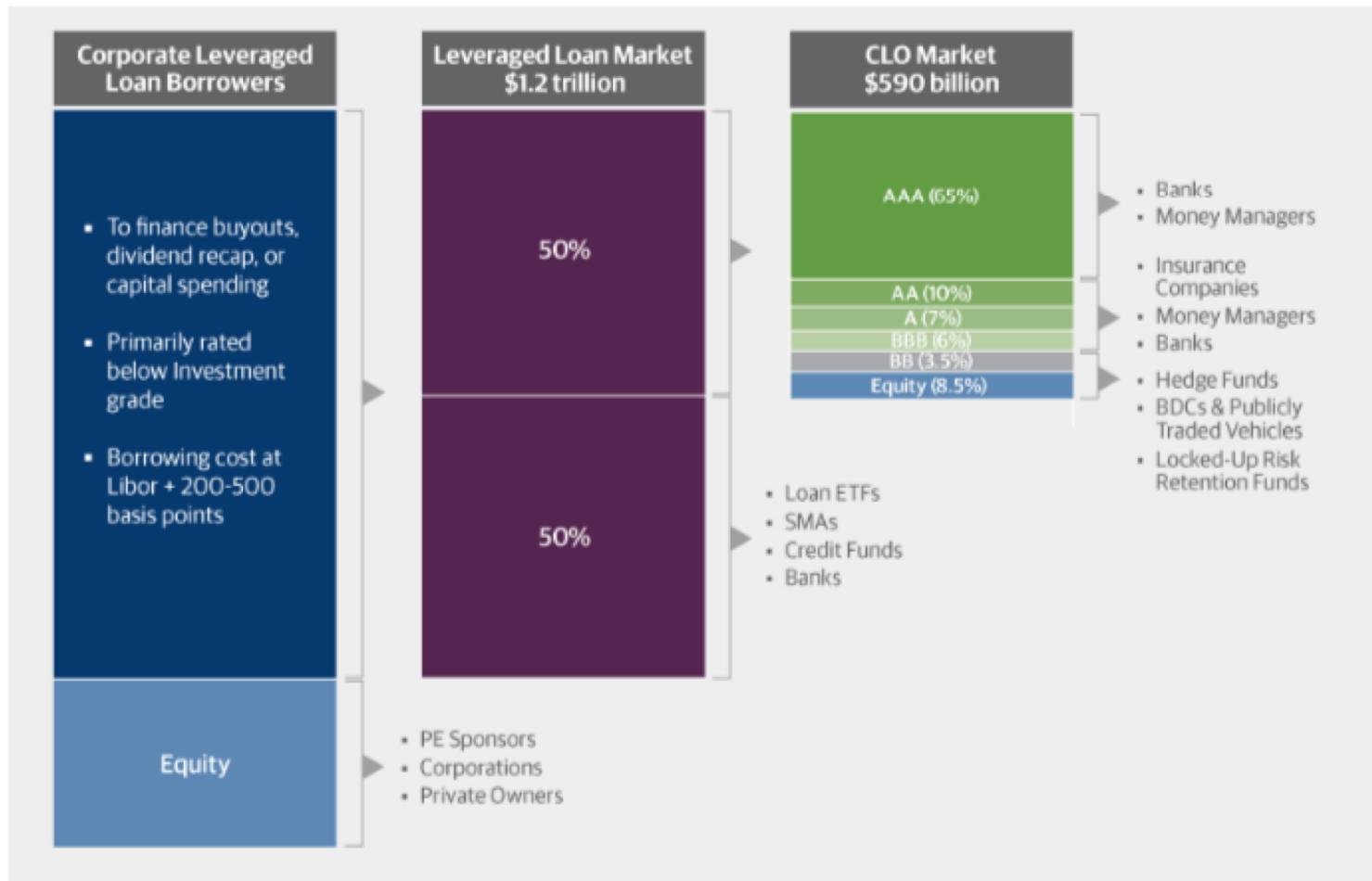
Figure 4: Typical CLO structuring



Source: Benmelech et al. (2012)

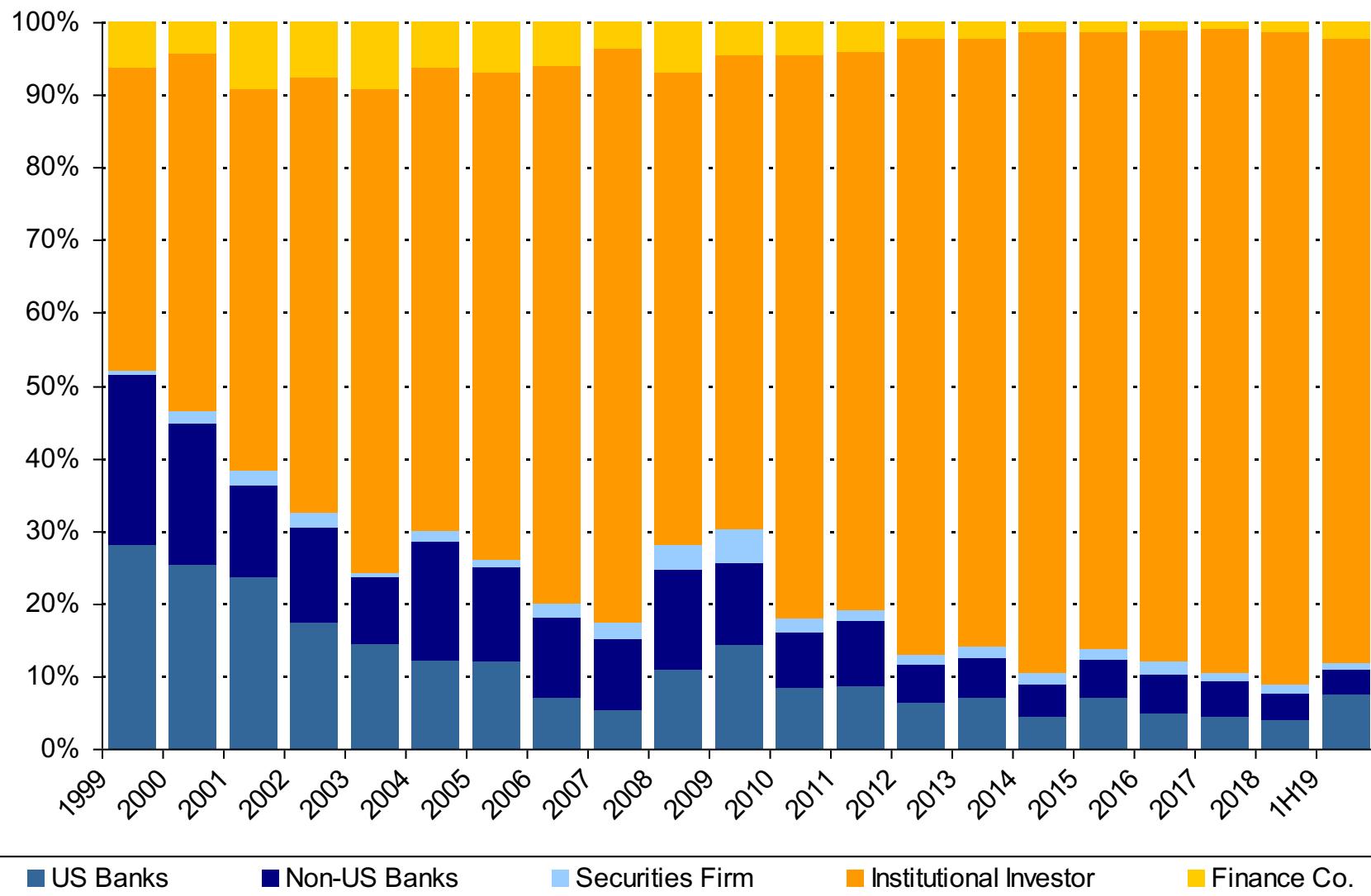
What is Private Debt?

Figure 6: Leveraged Loan and CLO Markets Capital Flow



Source: Guggenheim Investments, S&P Global Market Intelligence, Wells Fargo. Data as of 3.31.2019.

Primary Investor Market: Broad Type



■ US Banks

■ Non-US Banks

■ Securities Firm

■ Institutional Investor

■ Finance Co.

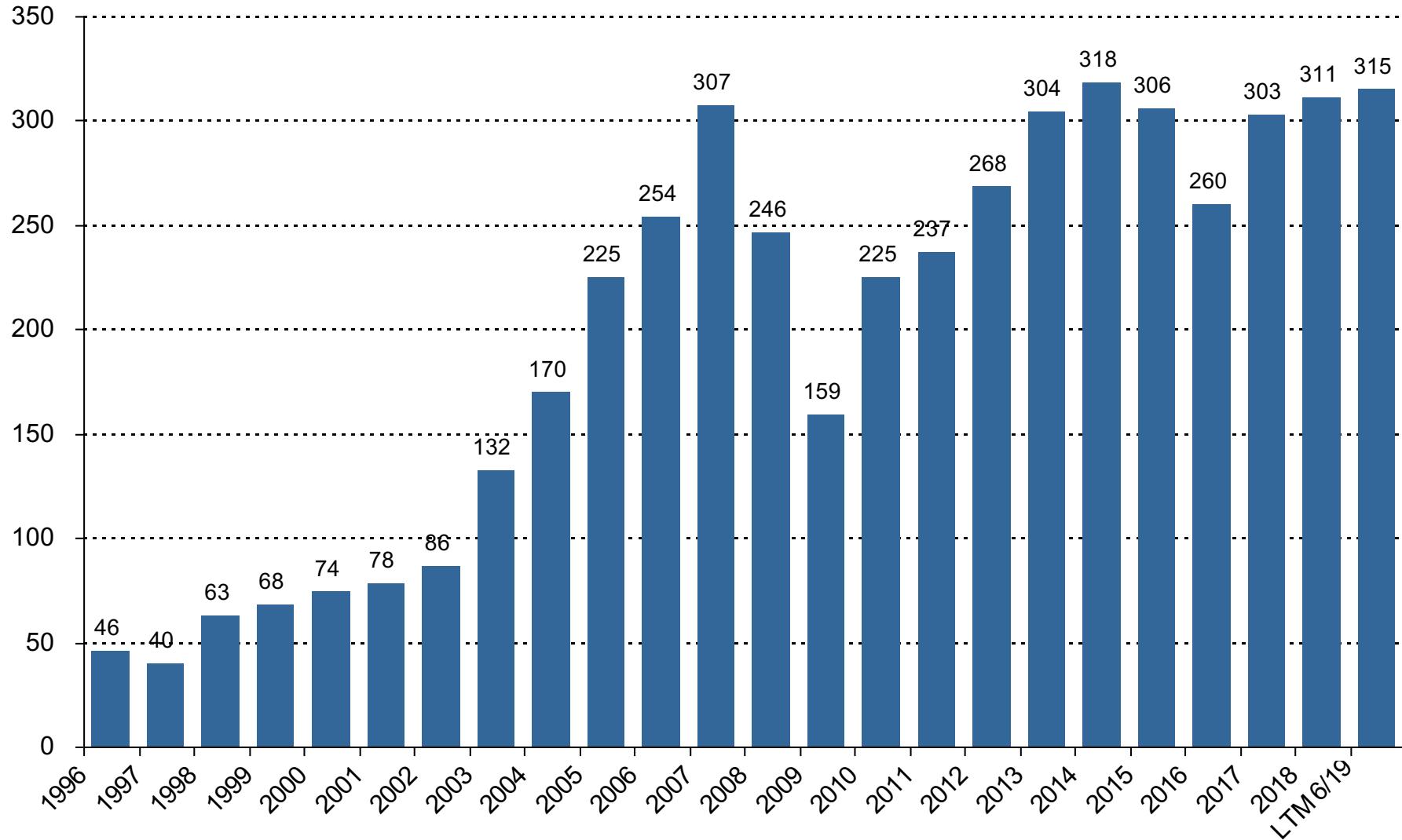
Highly leveraged loans only (pre-1996: L+250 and Higher; 1996 to date: L+225 and higher).

Excludes left and right agent commitments (including administrative, syndication, and documentation agents, as well as arranger).

Excludes RQonly ABLs.

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Primary Investor Market: Total Institutional Loan Groups & Portfolios

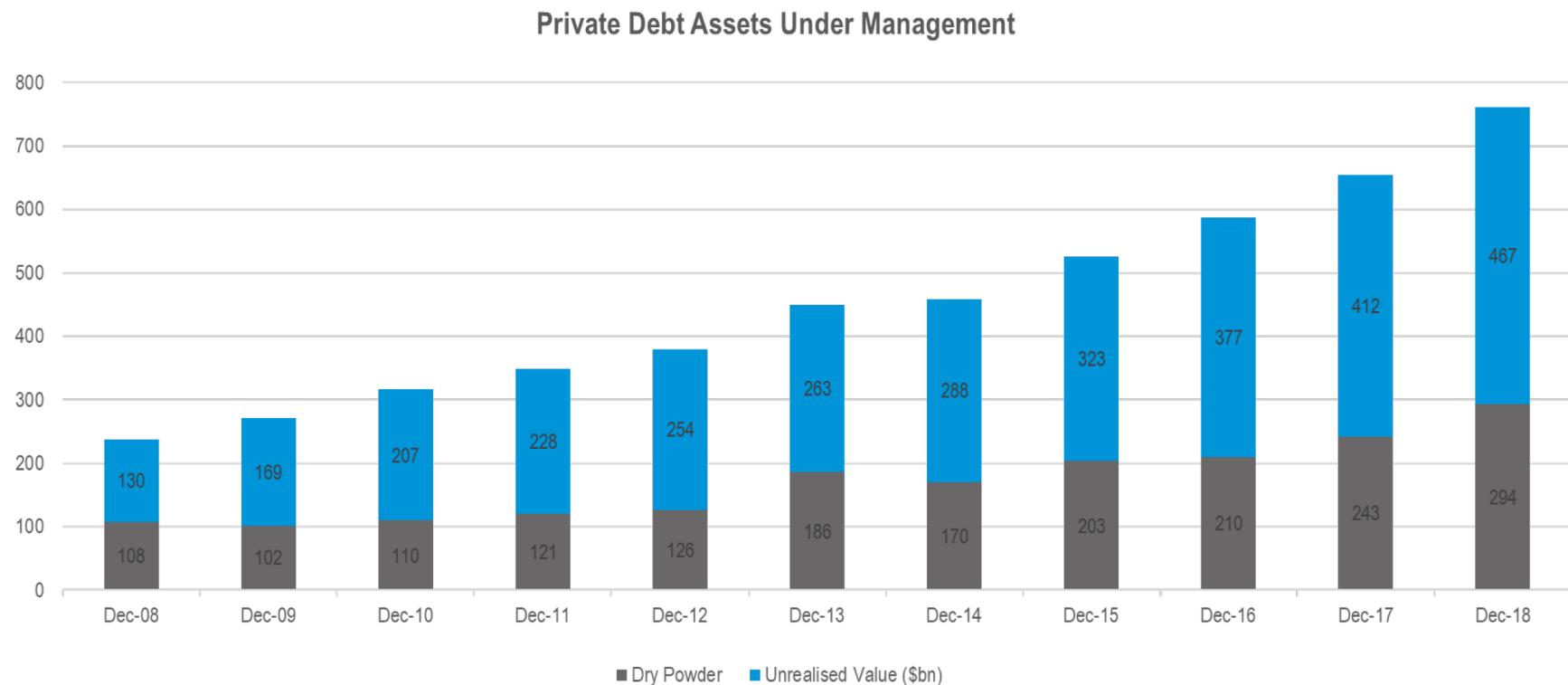


Highly leveraged loans only (pre-1996: L+250 and Higher; 1996 to date: L+225 and higher).
Groups that either participated in 3 or more loans, or made \$10 million of commitments.

What is Private Debt? DLFs and BDCs.

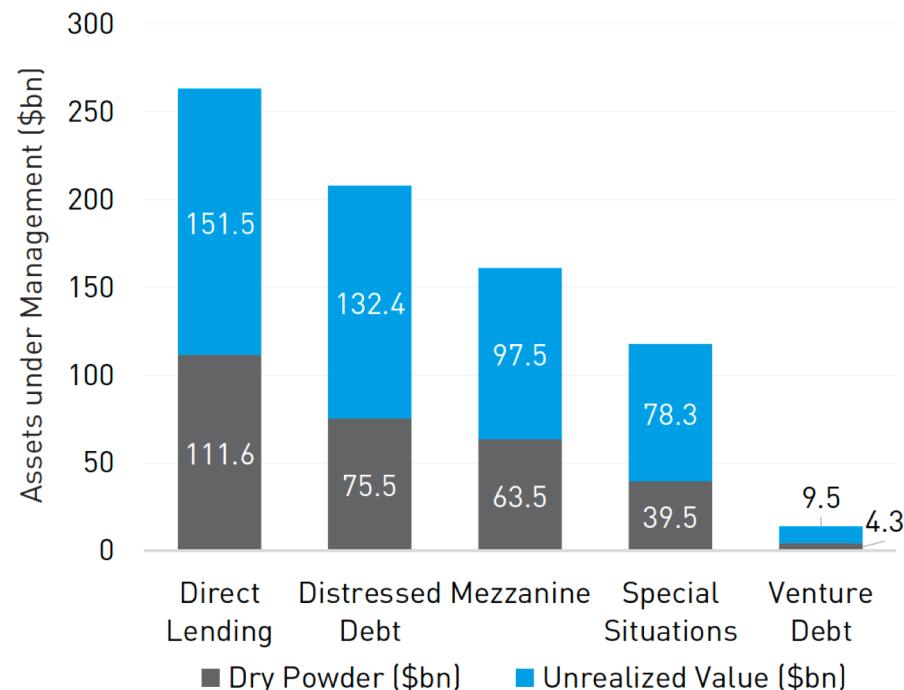
- Invest largely in senior loans of middle market companies.
- U.S. Middle Market. Companies with
 - Sales between \$10 million and \$1 billion.
 - EBITDA usually below \$100 M.
- “Private” refers to instrument rather than borrower:
 - Public companies can borrow using private debt.
 - » See “NonBank Lending,” Chernenko, Erel and Prilmeier, 2019.
 - But, typically extended to private middle-market companies.
- Large fraction of loans come from private equity deals.
- Funds tend to be leveraged from 0.5:1 to 2:1.

AUM has Increased Three-Fold over Past Decade



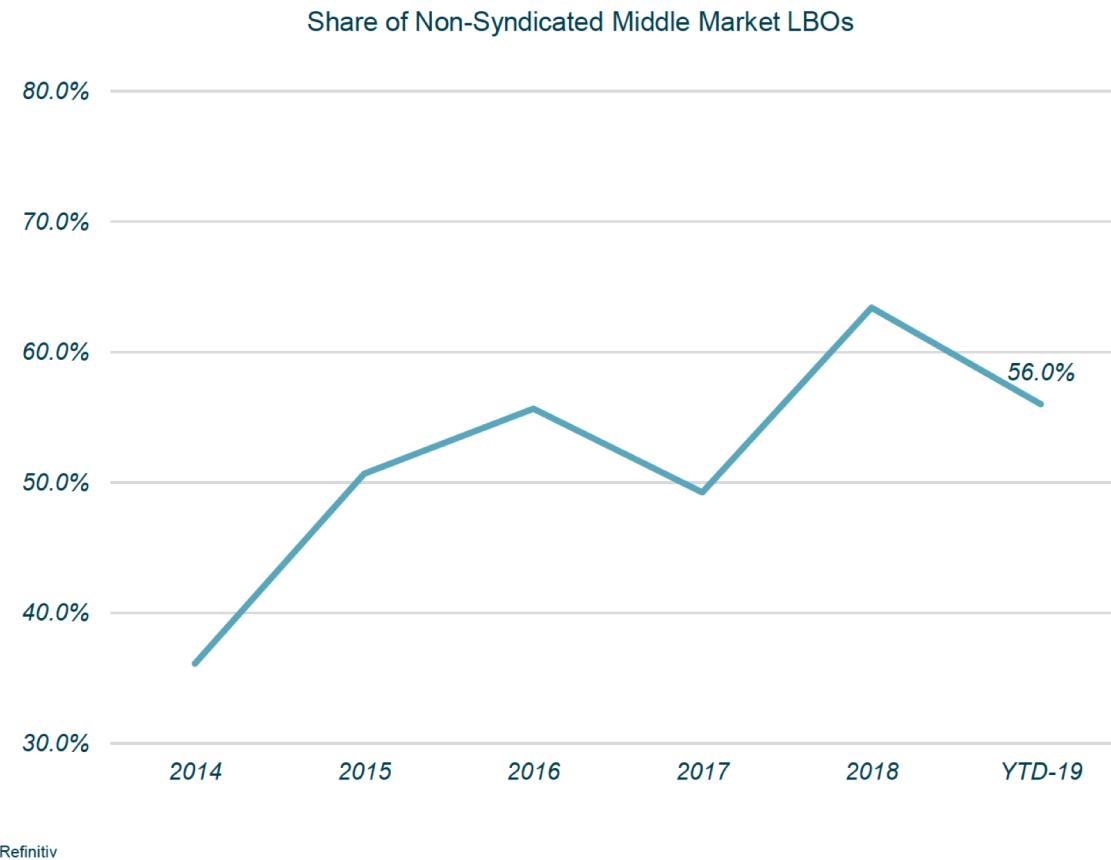
Private Debt AUM

Fig. 12: Private Debt: Assets under Management by Fund Type



Source: Preqin Pro. Data as of December 2018

DLFs increasing share of Middle Market LBOs



BDCs?

- Subject to regulatory requirements:
 - Must invest at least 70% of assets in domestic operating cos. not publicly listed, or exchange-listed with less than \$250 in mk. cap.
 - Quarterly disclosure on asset-level performance.
 - Most BDCs treated as regulated investment cos. (RICs) for tax purposes – no corporate income taxes if distribute > 90% of taxable investment cash flow as dividends to their shareholders.
- Many BDCs are publicly traded on exchanges.
- Some are related to PE firms – Apollo, Ares, New Mountain, TPG
- Can be leveraged 2:1 (up from 1:1).
 - Small Business Credit Availability Act lowered 200% asset coverage (1:1 debt-to-equity) to 150% (2:1 debt-to-equity).

BDCs

Figure 20: Number of and total assets held by BDCs



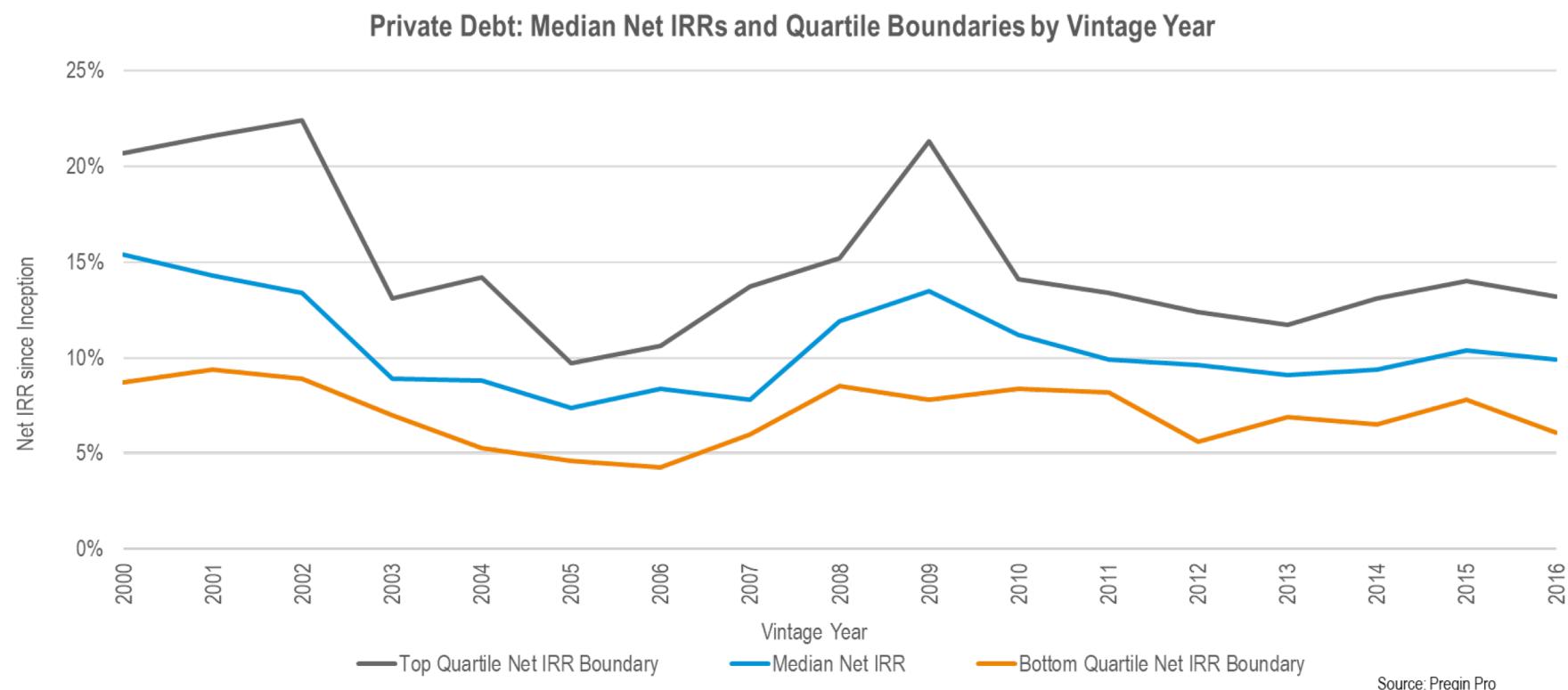
Source: Preqin.

Why the Increase in Private Debt?

Why the Increase in Private Debt?

- Ares:
 - Floating rate.
 - High current yields.
 - Attractive long term yield and risk-adjusted returns.
 - Greater lender protections.
 - Low volatility / correlation with other assets.
 - Bank consolidation.
 - Increased capital and risk standards on banks for illiquid assets.
- Banks better off lending to private debt funds than to companies directly.
 - Better regulatory treatment?
 - Lower capital charge?

Net IRRs vs. Vintage Year – PD Delivered Consistent Performance



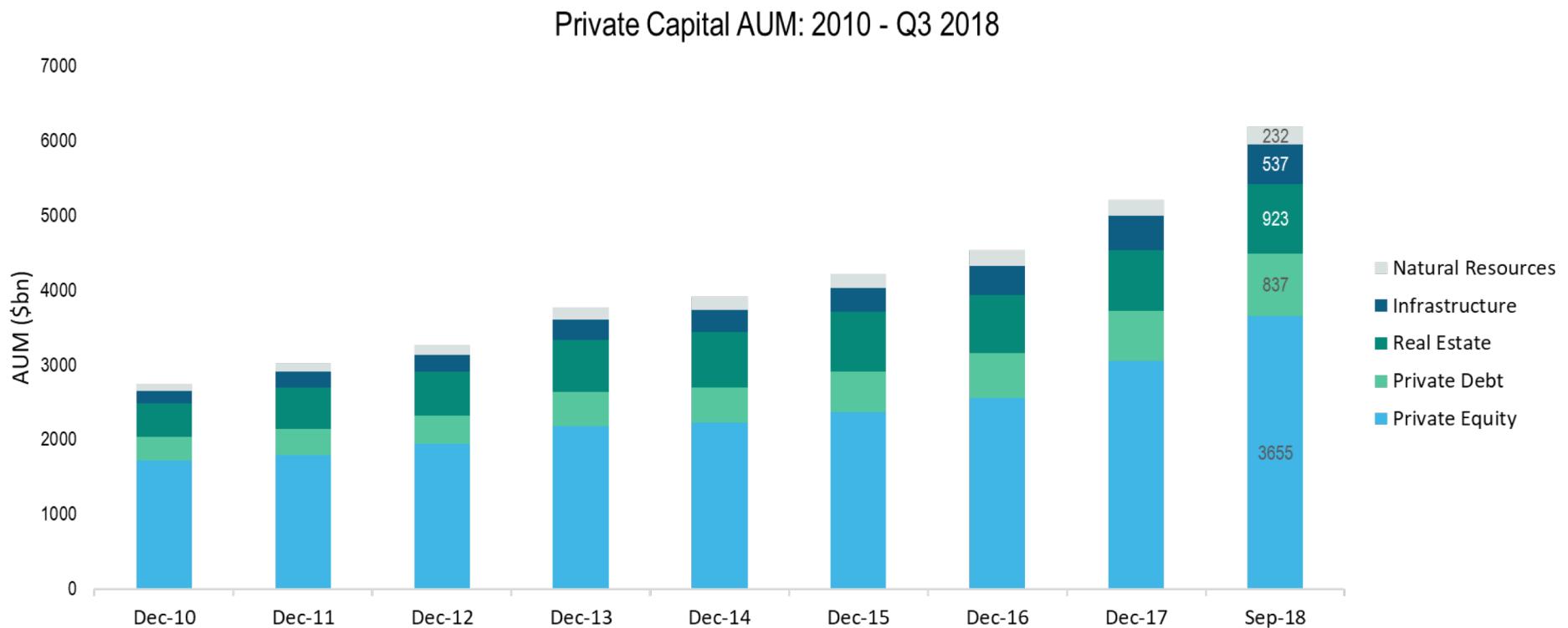
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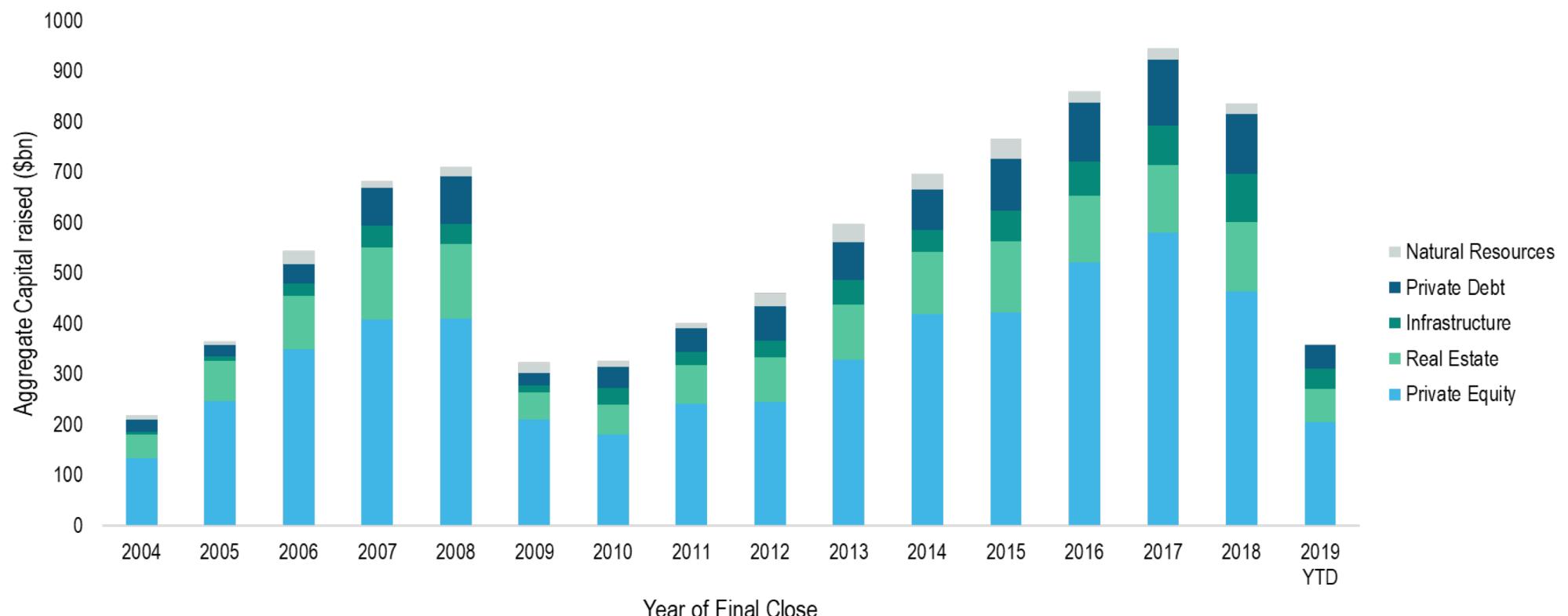
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Private Capital Markets are large and growing

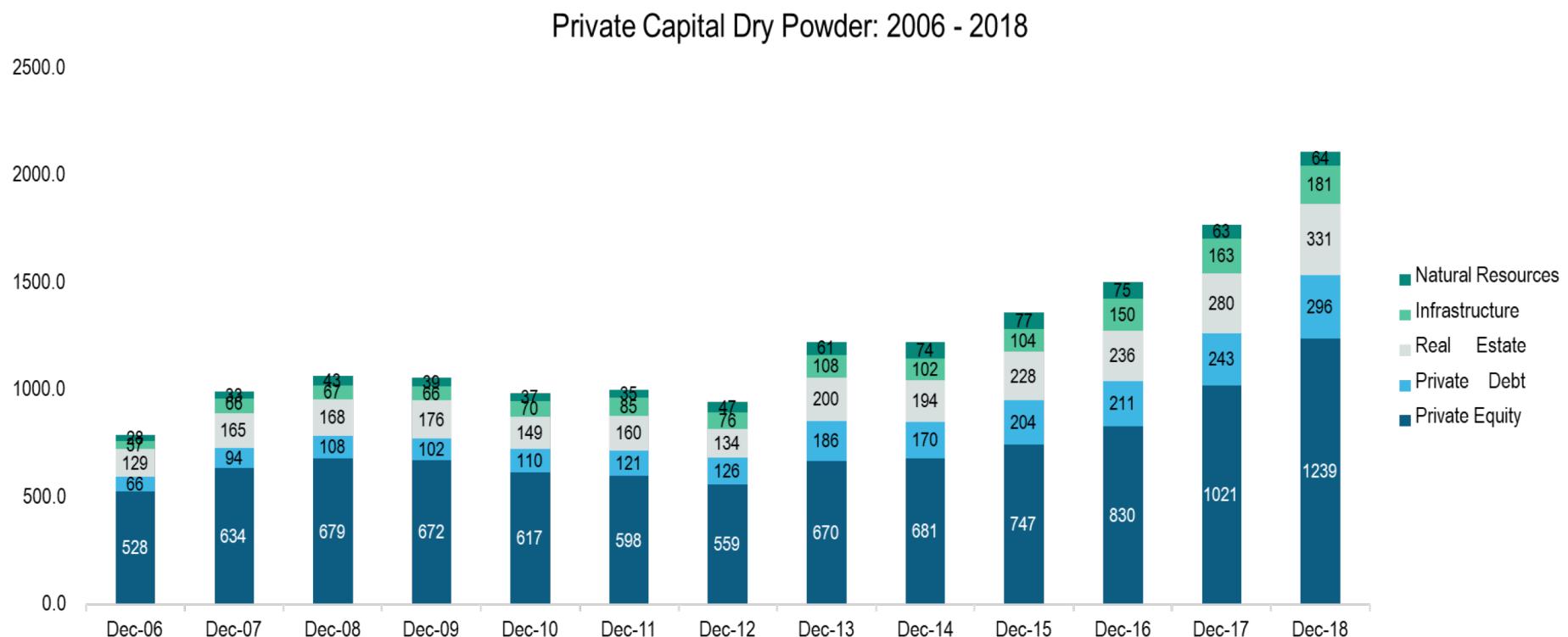
Private Debt has become a big piece



Private Capital Historical Fundraising, 2004 - 2019 YTD

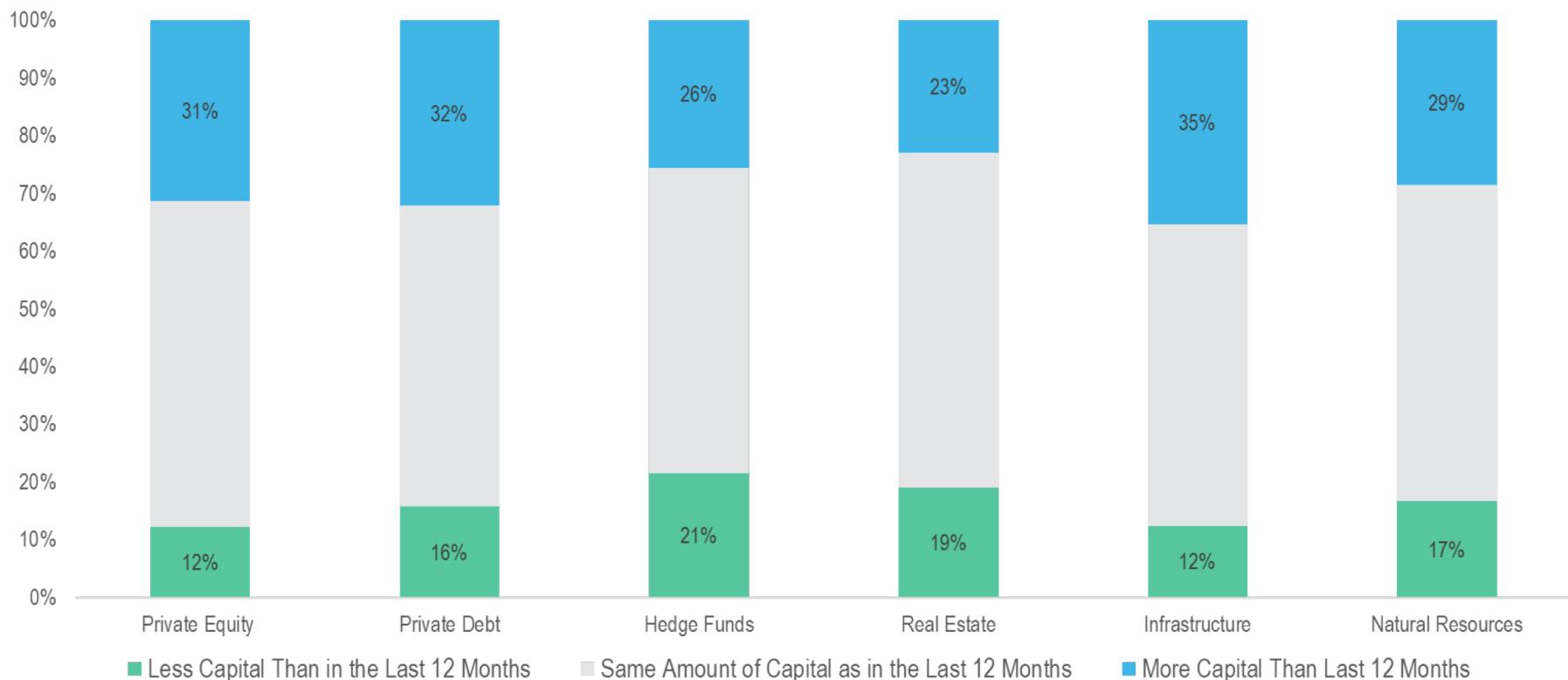


Private Capital Dry Powder at \$2.1tn



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Investors Intend to Increase Rather than Decrease Exposure to Alternatives in 2019



Questions

- What are actual AUMs for different groups? (AUM includes leverage).
 - CLOs, BDCs, DLFs, banks.
- Why have the different types of private debt replaced banks and the high yield bond market in leveraged lending?
 - Regulatory? Production function?
 - See Irani et al.
- Why have banks and CLOs ceded the middle market lending space to BDCs and DLFs?
 - Do BDCs and DLFs monitor better?
 - Are the loans too risky?
- What do BDCs and DLFs tell us about the specialness of banks?
- Do loan contracts from DLFs differ from other loan contracts? How?
 - vs. Banks? vs. Syndicated Loans?

Questions

- What covenants / terms are most heavily negotiated?
What determines variation in terms?
- Where do BDCs and DLFs get leverage from?'
 - If from banks, why don't bank lend directly to the companies?
 - Should we worry about leverage on leverage?
- How will CLOs, BDCs and DLFs perform in the next downturn?
 - FSB report makes the case for heightened risks.
- Are there conflicts between DLFs and PE funds?
 - How much do they rely on PE sponsorship for deal origination?
 - What does it mean that most of the PE firms have DLFs?

Some Relevant Papers

- Becker and Ivashina, "Covenant-light Contracts and Creditor Coordination," 2017.
- Benmelech, Dlugosz and Ivashina, "Securitization Without Adverse Selection: The Case of CLOs," 2012.
- Chernenko, Erel and Prilmeier, "NonBank Lending," 2019.
- Davydiuk, Marchuk and Rosen, "Direct Lending in the U.S. Middle Market," 2019.
- FSB, "Vulnerabilities associated with leveraged loans and collateralised loan obligations," 2019.
- Irani, Iyer, Meisenzahl and Peydro, "The Rise of Shadow Banking: Evidence from Capital Regulation," 2019.
- Loumioti, "Direct Lending: The Determinants, Characteristics and Performance of Direct Loans," 2019.
- Munday, Hu, True, and Zhang, "Performance of Private Credit Funds: A First Look," 2018.