REYL

innovative banking

MARKET INSIGHT

MARCH - APRIL 2016

WEALTH MANAGEMENT

CORPORATE & FAMILY GOVERNANCE

CORPORATE ADVISORY & STRUCTURING

ASSET SERVICES

ASSET MANAGEMENT

Back to the roots. Private debt stages a comeback

Tight yields on corporate bonds, negative interest rates policies, clustering volatility and correlation on equity markets and omnipotent Central Banks created an extremely challenging environment for returns generation. In this context, private debt can offer an attractive alternative for patient investors. Why private debt is set for a comeback and what benefits can investors reap from this asset class?

Corporate financing outside the traditional capital markets channel has always existed, whether for newly created companies or, in general, for borrowers excluded from banks. But the 2008 crisis has led to the intensive development of this type of financing outside the traditional circuit. In the aftermath of the credit crunch, banks started to impose drastic measures in order to reduce risk on their balance sheets through the application of Dodd-Frank and Basel III rules. New players such as hedge funds and private debt funds took advantage of this situation to substitute for banks and to become key players in the lending space, offering investors a unique access to an extremely attractive risk premium.

that the collateral used in private debt deals is based on real and tangible assets, which provides a solid protection for the investor. Finally, in a world with close to zero or even negative interest rates, yield on private debt transactions is a major selling point.

The attractiveness of a private debt investment due to high returns and low volatility is undeniable. However, considering private debt as a homogeneous asset class is a shortcut. The diversity of available funding instruments can lead to considerably variable profiles of risk/return. Short-term financing, senior, mezzanine debt, or even unitranche are only part of the existing instruments available. Some funding facilities will only include fixed income characteristics, while other transactions will integrate call options on the issuer's equity. Another important aspect in evaluating an investment in private debt is in the nature of the collateral used to secure the financing. For instance, one company might have avalaible few tangible assets as collateral, while a more industrial-focused company will have real assets on its balance sheet whose valuation is less complex.

« Private debt is a true homecoming of banking »

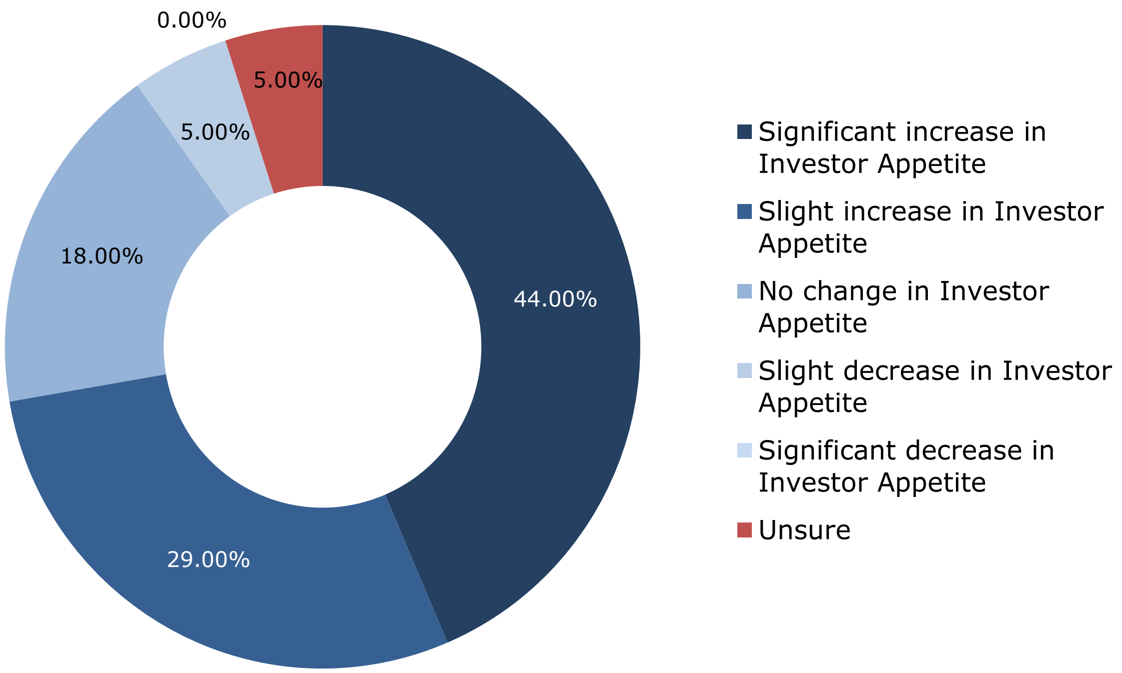
Nicolas Roth, Co-Head Alternative Investments, REYL & Cie Ltd

Private debt investments offer a number of benefits to a balanced allocation. As they are not quoted on financial markets, these instruments can significantly reduce the volatility of a diversified portfolio. Investing in private lending structures is part of a long-term approach, as private debt is held until maturity. Therefore, it is not subject to daily valuation, which is an important source of volatility in a portfolio. Unlike private equity investments and venture capital whose profits are usually returned to investors at the end of the life of the fund, private debt can be structured in a way to distribute interest payments during the life of the investment as well as principal repayment at maturity. Another key point is

Some transaction may be based on hardly tangible assets such as a patent on a new molecule candidate to obtain government approval for distribution. In this case, the returns offered will be much higher than for a much simpler and less risky asset, such as a commercial building. Hence, the structure of the financing but also the nature of the assets used as collateral will lead to different risk/return profiles from one transaction to another.

Finally, chosing the type of investment will mainly depend on the sophistication's degree of the investor. The use of specialist teams through funds is justified by the fact that this type of investment is not accessible to all, in opposition to public markets. Since these financing strategies are taking place privately, without public tender offer, it gives to this market a significant degree of opacity. Thus, closing of a financing structure requires enhanced due diligence work on the issuer in order to ensure its solvency capacity. A sophisticated legal process should also be established in order to document in detail the loan and to define precisely the collateral pledged. At the end, the documentation work needs to be systematically considered in extreme scenario, i.e. an issuer defaulting, since this event would result in enforcement and liquidation of assets. The thorough application of each of these steps being crucial to ensure an optimal financing structure, the use of teams with strong financial analysis and credit skills, but also well versed in legal analysis, is of utmost importance. Finally, private debt is a true homecoming of banking and a way to deploy capital in the real economy while adding to its portfolio this sought-after de-correlation effect.

Fund's manager view on how institutional investors appetite for private debt has evolved over the past 12 months:



Preqin Private Debt Fund Manager Outlook Q3 2015 innovative banking

www.reyl.com

IMPORTANT INFORMATION