



**Bob Sahota, Revolution Asset Management**

Bob is managing director and chief investment officer and one of the co-founders of Revolution. He is responsible for leading the strategy and managing the assets of the portfolio. Bob has held senior roles as head of direct lending at Kapstream Capital and head of fixed income at Challenger from 2005 to 2016.

He has led an investment team of 14 managing leveraged finance/private debt, real estate debt, ABS, investment grade corporate credit and alternatives portfolios on behalf of both Challenger and pre-eminent Australian superannuation funds. During his time at Challenger, funds under management increased from A\$1bn to A\$9bn.

# AUSTRALIAN PRIVATE DEBT (PART TWO)

## The Investment Opportunity for Institutional and Professional Investors

Bob Sahota

### Australian private debt

#### Current attractive sub-sectors

Across the spectrum of Australian private debt, there are a number of sub-sectors that have presented, and continue to present, stronger risk-adjusted returns (see Figure 9). These sub-sectors include:

- Leveraged buyout and private company debt;
- Private and public Asset-Backed Securities (ABS) to various commercial and consumer loan pools; and
- Loans to stabilised (non-construction/development) commercial real estate assets with underlying lease cashflow streams.

These sub-sectors are explained in detail below.

#### Senior real estate debt

This sub-sector is involved in providing loans to stabilised commercial (office, retail and industrial) properties and portfolios of properties. This lending is based on a combination of cash flows generated by the properties and the underlying value of the asset/s in question. This type of lending is viewed as relatively low risk due to the fact that the properties have long, stable tenant profiles (supporting cash

flow generation) and are generally geared to less than 70% providing a material equity cushion.

Real estate lending can itself be considered quite a broad category, with opportunities spanning everything from residential apartment development right through to stabilised properties with high occupancy, long Weighted Average Lease Expiry (WALE) and low gearing. While the former may offer double-digit returns in benign market conditions, this could rapidly change with a potentially high loss-given-default (consider, for example, the value of an off the plan apartment when banks are tightening their lending standards).

#### Private company debt and leveraged buyout

Leveraged buyout (LBO) debt is typically debt that is provided to private equity firms to facilitate the acquisition of a target company. The Australian private equity market contains numerous participants and includes names such as KKR, The Carlyle Group, TPG, Pacific Equity Partners, Blackstone, Affinity, CHAMP and Archer Capital. It has been reported that private equity had over \$5.8 billion of dry powder as at FY2017, with the recent \$2.3 billion capital raising by BGH resulting in over \$8.0 billion of dry powder available for invest-



### The quote

*The Australian leveraged/M&A loan and private company debt market is large, with an average of US\$15.4 billion of issuance per annum since 2012.*

ment today. Given that the typical LBO capital structure is circa 50% debt and 50% equity, this implies a significant pipeline of debt opportunities in the years ahead.

The LBO market has three key sub-categories: bank loans; term loan B (TLB); and unitranche. Some of the key characteristics of each of these categories is summarised in Table 5.

**Table 4. Typical transaction attributes – Senior real estate debt**

Senior real estate debt			
Senior secured loans			
Typically 3 years to maturity			
Typically 50-70% lvr (loan to value ratio)			
Hold to maturity			
Investment and non-investment grade			
Illustrative Pricing			
Upfront fee received	Initial spread	All-in spread*	All-in yield to maturity
0.75%	2.50%-3.50%	2.75%-3.75%	4.75%-5.75%

Source: Revolution Asset Management. \*Including upfront fees over a 5 year life.

**Table 5. Typical leveraged buyout financing structures**

	Bank Loans	Term Loan B	Unitranche
<b>Leverage</b>	4.0-5.0 x	4.0-5.0 x	5.0-6.5 x
<b>Tenor</b>	5 years	5-7 years	5 years
<b>Amortisation</b>	30% over loan tenor	1% pa	Nil
<b>Covenants</b>	Debt/EBITDA		
	Interest Coverage Ratio (ICR)	Cov-lite	Debt/EBITDA
	Debt-Service Coverage Ratio (DSCR)		
<b>Upfront fee received</b>	Up to 4.0%	1.0%	Up to 3.0%

Source: Macquarie, Revolution Asset Management.

As shown in Table 5, the key variables across the different categories include leverage, tenor and covenants, with Bank Loans typically exhibiting the lowest leverage, shortest tenor and full covenant packages.

LBO debt provides an attractive risk adjusted return with running yields (excluding any upfront fees) of currently around 3.75%-4.75%, with TLB and unitranche transactions typically pricing wider than this to compensate for the additional leverage, tenor and lack of covenants. Covenants should only be dispensed with for the most stable and robust credit profiles. In assessing TLB and unitranche transactions, investors should only be investing in these structures for the most attractive and defensive industries and underlying business profiles.

**Table 6. Typical transaction attributes – Private company and leveraged buyout debt**

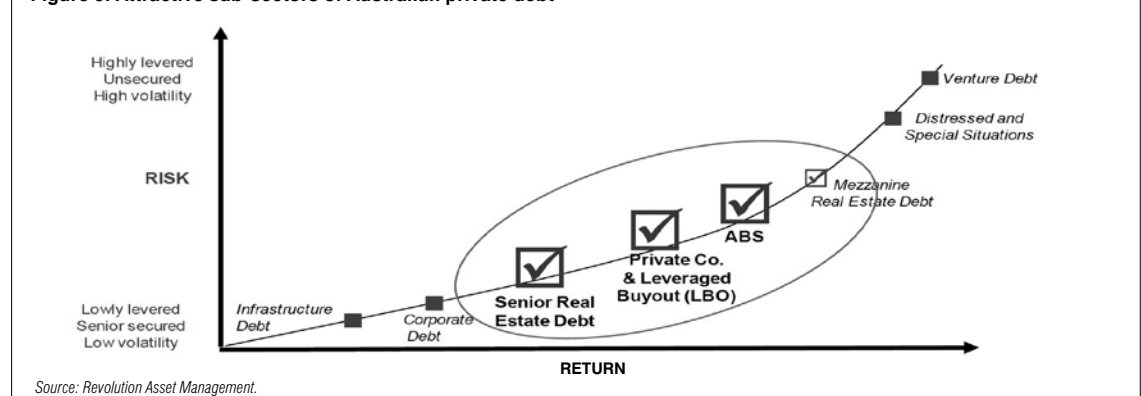
Private company and leveraged buyout debt			
Senior secured loans and some bonds			
Typically 5 years to maturity			
Floating interest rate			
Hold to maturity			
Non-investment grade			
Illustrative Pricing			
Upfront fee received	Initial spread	All-in spread*	All-in yield to maturity
Up to 4%	3.75%-4.75%	3.95%-5.55%	5.95%-7.55%

Source: Revolution Asset Management. \*Including upfront fees over a 5 year life.

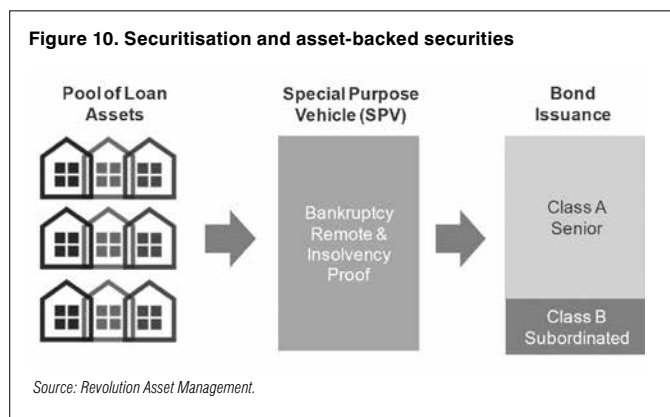
### Asset-backed securities (private and public)

Securitisation is the act of creating asset-backed securities (ABS) from pools of underlying loans. It begins with the formation of a special purpose vehicle (SPV), which is a company whose specific purpose is to acquire assets and issue debt secured by those assets. ABS are the preferred way for smaller banks and specialty finance companies to finance pools of familiar asset types, such

**Figure 9. Attractive sub-sectors of Australian private debt**



as auto loans, credit card receivables, mortgages, and business loans. Each underlying loan in a pool is a contractual obligation to pay. Figure 10 illustrates this.



Since ABS debt is extended to an SPV and secured by an identified pool of assets, it is typically non-recourse to the originating company.

**Table 7. Typical transaction attributes – Private / public consumer and commercial ABS**

Private / public consumer ABS		Private / public commercial ABS	
Auto loans, Residential Mortgages, Credit card receivables, Personal Loans		Equipment leases, Corporate Loans, Small business loans, Accounts receivable, Aircraft	
Floating interest rate		Floating interest rate	
Hold to maturity		Hold to maturity	
Investment and non-investment grade		Investment and non-investment grade	
Illustrative Pricing			
Upfront fee received	Initial spread	All-in spread*	All-in yield to maturity
Up to 1%	3.00%-8.00%	3.00%-8.20%	5.00%-10.20%

Source: Revolution Asset Management. \*Including upfront fees over a 5 year life.

**Warehouse securitisations or private ABS/RMBS**

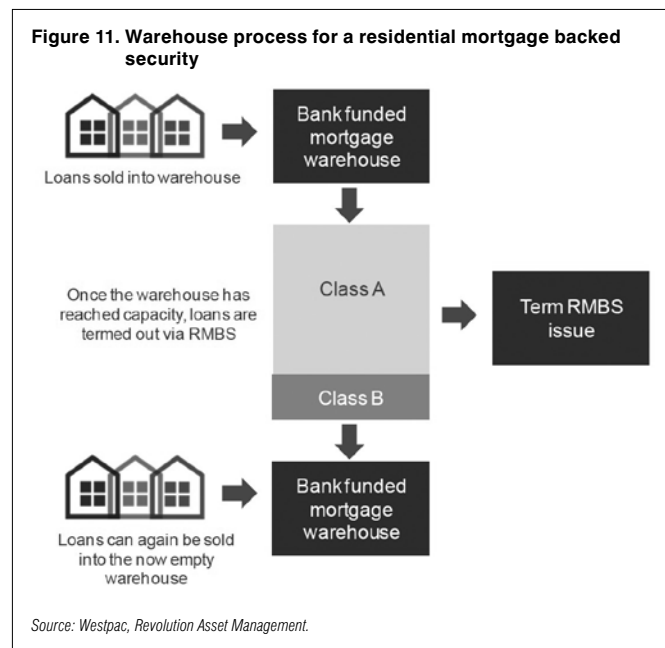
The initial few underlying loans are always originated into a warehouse securitisation or private ABS, which is a revolving funding facility with a maximum overall commitment size. As more and more loans are originated into the warehouse, the size of the asset pool grows and becomes more seasoned and diversified. As the size of the pool approaches the maximum commitment size, the originating company normally term funds the asset pool by issuing bonds into the public ABS market.

Since warehouse securitisations are revolving facilities, they typically include features to mitigate potential risks associated with a dynamic pool of underlying loans. Specifically these include features such as eligibility criteria for loans that can be included in securitised pools after closing and portfolio parameters to protect against deterioration in the quality or performance of the underlying loans. If such criteria or parameters are breached, or performance dete-

riorates, then the loans must be removed and funded outside of the warehouse or else the revolving period ends and the underlying loan pool becomes static or fixed.

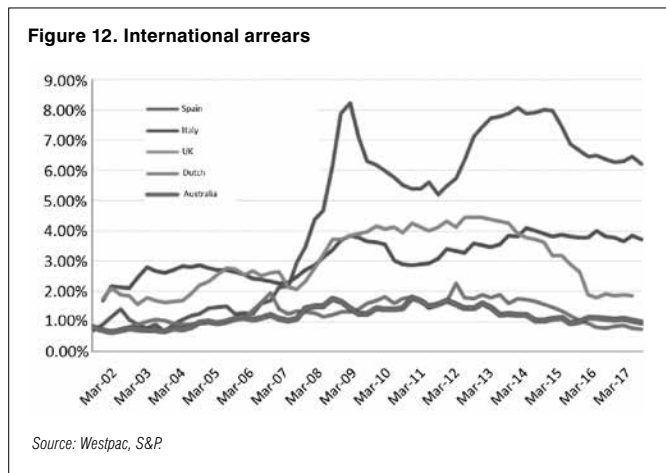
Usually the senior funding for a warehouse securitisation is provided by a larger bank and the first loss equity is provided by the originating company to demonstrate alignment. The originating company can also bring in mezzanine funders to partially reduce the amount of equity capital tied up inside of one warehouse, so that it can be recycled and used to open further warehouses with greater overall capacity. Prior to January 2018, a considerable portion of the mezzanine funding was provided by banks. However, APRA has recently changed the capital rules for securitisation (known as APS120) such that it is only viable, from a return on equity perspective, to provide or invest in the senior tranches of private and public ABS, which are usually AAA credit rated. The regulated removal of banks as investors in mezzanine ABS tranches has created compelling investment opportunities for non-bank investors such as private debt funds and insurers.

Figure 11 illustrates how the warehouse process works for a residential mortgage backed security (RMBS), which is a specific instance of an ABS where the underlying pool of loans consists of residential mortgages.



The principal job of ABS investors is to analyse the cash flows from the pool of underlying assets to assess value and the possibility of loss, rather than relying on current market prices or an external credit rating. From a historical perspective, the performance of Australian RMBS and ABS has been strong, with Standard & Poors (S&P) confirming that in the 30 plus year history of the market, all gross losses to date have been covered by lenders' mortgage insurance (LMI) claims paid and by excess spread in the underlying pools. The strong performance can be attributed to the quality of credit underwriting and the strong alignment of interest for loan originators through them being the first to suffer from any credit losses.

Figure 12 compares residential mortgages in Australia versus different European countries, and illustrates the outstanding long term performance of the Australian market in a global context.



The US mortgage market is not shown in the chart above because it is unique compared to all others. The vast majority of US conforming mortgages ultimately end up being funded via one of the three major government agencies (Ginnie Mae, Fannie Mae and Freddie Mac). The agencies guarantee the credit risk of all the underlying loans which makes US RMBS essentially an interest rate product because the underlying loans are all fixed rate and pre-payable. The US subprime mortgage market was the epicentre of the GFC. It was a niche sub-sector of the US mortgage market outside of the government agencies, targeting very high risk borrowers with poor credit histories and low incomes. US subprime is only a fraction of the size it was before the GFC and its problems can be traced back to extremely poor underwriting of credit risk as a result of poor alignment of interest with the loan originators who were incentivised by volume alone.

#### Size of the investable and attractive sub-sectors

While the size of the Australian private debt market is very large at over A\$2.8 trillion, it has historically been the domain of banks and consequently, they will continue to be actively involved in the key segments that remain economic for them following the various changes to capital rules and risk weighted assets.

As previously detailed, the more attractive sub-sectors of the Australian private debt market exhibiting strong relative value are also large markets in their own right. The size of the opportunity in each of these three key market sub-segments are discussed in more detail below.

#### Leveraged loans and private company debt

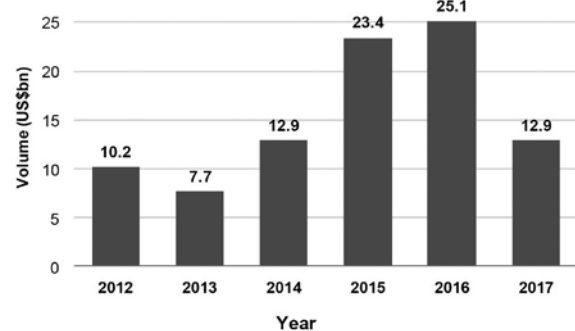
The Australian leveraged/M&A loan and private company debt market is large, with an average of US\$15.4 billion of issuance per annum since 2012. It should be noted, issuance in 2017 was lower than 2015 and 2016 at US\$12.9 billion, which was driven by less M&A activity over the year. However, with over A\$8.0 billion of dry powder held by private equity firms, the expectation is that 2018 and 2019 should see further activity, which should support leveraged loan issuance in the period ahead for participants in this space (such as private debt managers and strategies) to actively take part in.

**Table 8. Size of attractive sub-sectors of Australian private debt**

Asset Class	Sponsor	Arranger	Total Market
Private Company and Leveraged Buyout Debt (Bank loans, Term Loan B, Unitranche)	KKR, TPG, Bain, Carlyle, PEP, Affinity, CHAMP, BGH, Partners Group, Blackstone	GS, Barclays, Nomura, Citi, ANZ, WBC, CBA, NAB, Investec	\$15-30 billion p.a.
Public ABS	La Trobe/Blackstone, Pepper/KKR, Eclix	ANZ, WBC, CBA, NAB, DB, BAML, Citi	\$45 billion p.a.
Private ABS	Flexi, Resimac, Latitude, Think Tank, Bluestone/Cerberus	JPMorgan, MUFG, PWC, KPMG	\$90 billion p.a.
Commercial Property Loans (Office, Retail and Industrial)	Brookfield, GIC, Goodman, Stockland, Blackstone, Lend Lease	ANZ, WBC, CBA, NAB, Grant Samuel, PWC, KPMG, Stamford Capital	\$30 billion p.a.
TOTAL			\$180 billion - \$195 billion p.a.

Source: Revolution Asset Management, APRA, Macquarie Group, Westpac, RBA and Thomson Reuters LPC.

**Figure 13. Australasia M&A loan market**



#### Public and private ABS

Public ABS issuance has been growing strongly since the GFC, with issuance reaching A\$45 billion in 2017 – the largest year since 2007 (as shown in Figure 14). While issuance in the public market has been dominated by RMBS, other ABS and Commercial Mortgage Backed Securities (CMBS) have been growing, albeit off a small base.

**Figure 14. Total securitisation issuance 2004-2018**

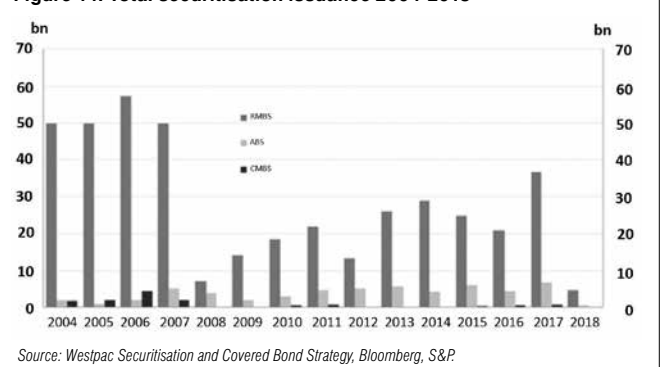
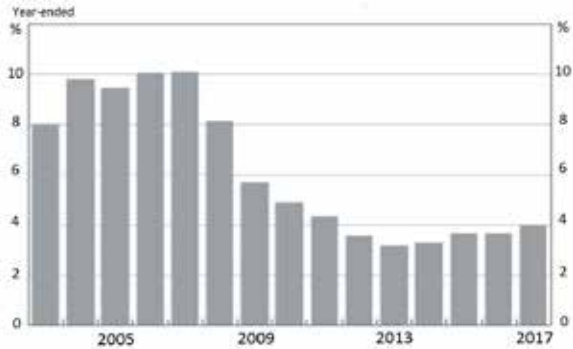


Figure 15. Estimated non-ADI share of housing credit



Source: APRA, RBA.

The private ABS market is significantly larger than the public market, with Revolution Asset Management estimating around A\$90 billion of transactions in 2017 – approximately double that of the public ABS market. This market is expected to continue to see strong transaction flow in the coming years, largely supported by several large private equity funds investing into non-bank originators. These non-bank lenders will be armed with large amounts of equity capital to fund their growth ambitions. At the same time banks will face increased regulatory pressure in the form of higher risk weights, limits on investor and interest only loans and the recommendations from the recent Royal Commission (Misconduct in the Banking, Superannuation and Financial Services Industry). Overall, these factors are likely to see market share of housing credit shift from banks to non-bank lenders, as they seek to regain the market share they lost following the GFC.

**Commercial real estate debt**

The debt market for commercial real estate in Australia is material; with APRA figures as at 31 December 2017 showing that authorised deposit-taking institutions (ADIs) had circa A\$200 billion of office, retail, and industrial property debt exposure. While commercial real estate loans are generally three to seven years in tenor, this could see \$30-70 billion in existing loans maturing each year. Additionally, there are other opportunities such as new transactions that will require funding, as well as the aforementioned impacts of increasing risk weights and capital charges on banks. This will likely result in the banks lending on a lower loan to value ratio basis or, in some instances, not being willing to refinance a loan and consequently requiring a third party to provide funding. Accordingly, it is conservatively estimated that any given year will see around A\$30 billion of commercial real estate debt opportunities.

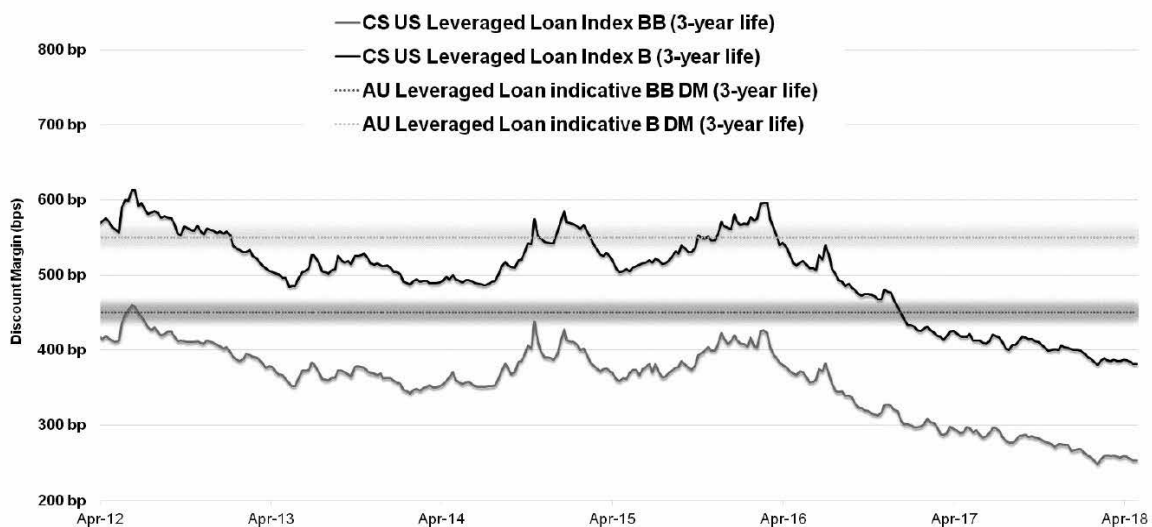
Overall, one can see that the markets for the most attractive sub-sectors of the Australian private debt market are significant, with an aggregate size of approximately A\$180-195 billion of issuance per annum. In this regard, manager selection remains critical to ensure deep and wide origination networks to take advantage of transactions that display the best risk-adjusted returns, while maintaining credit discipline.

**Relative value vs global equivalents**

The relative attraction to the aforementioned sub-sectors is further supported by the relative value they currently offer when compared to their offshore equivalents.

Figure 16 shows the US BB and B credit rated leveraged loan spreads versus the equivalent indicative Australian loan spreads. Some of the key features highlighted here include the volatility of the US market, especially when compared to the Australian market, and the spread comparison, noting that the US B-rated index is currently tighter than Australian BB-rated indicative spreads.

Figure 16. Credit Suisse US Leveraged Loan Index – BB and B spreads

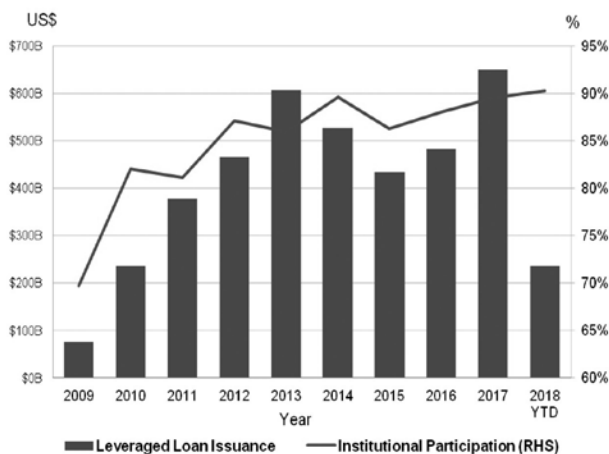


Source: Credit-Suisse, Loan Connector.

As can be seen in Figure 16, spreads in the Australian private debt market have been remarkably stable over a long period of time. This has been largely driven by two main factors:

1. The Australian leveraged loan market remains very much bank dominated with very low institutional investor participation. This has allowed banks to maintain pricing discipline for given credit risk over time. It is important to remember that banks are ultimately leveraged investors via the ongoing regulatory capital framework, so their conservatism locally with respect to credit risk is understandable. In other markets such as the US and Europe, participation is dominated by institutional investors (see Figure 17) and banks play more of an intermediary role. The intense competition for loan assets overseas has seen credit spreads fall sharply coupled with the increasing sacrifice of structural protections for loan investors in the form of lending covenants (see Figure 18).
2. New institutional and banking participants such as CLO managers and retail loan funds have not sought to compete on pricing but instead focus on providing the borrower with additional flexibility to gain higher allocations in primary market transactions. The fact that Australian loans are not eligible collateral for CLO managers to include in new products has meant that there has not been the level of competition seen in other developed markets such as the US and Europe.

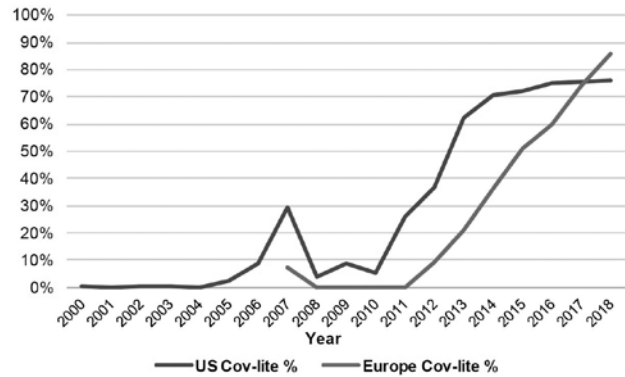
**Figure 17. US Leveraged loan issuance (USD) and non-bank investor participation**



Source: S&P Leveraged Commentary and Data.

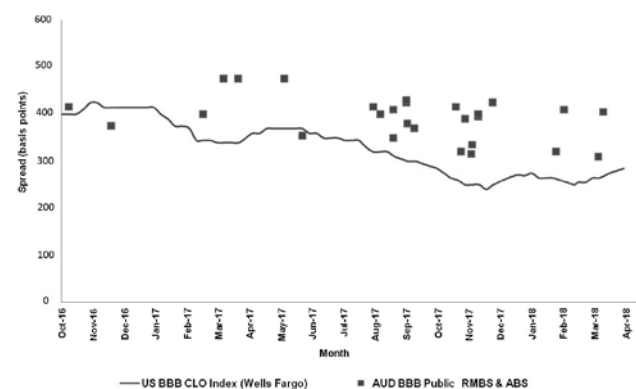
This relative value is also evident in Australian ABS as illustrated in Figure 19. When compared to US BBB rated CLOs (which offer the greatest credit margin for global ABS), Australian public market BBB rated ABS are currently trading 50-125 basis points wider (at a spread of around 325 basis points to 400 basis points). The Australian and New Zealand private ABS warehouse market is generally another 100 basis points wider again (150-225 basis points wider than US BBB-rated CLOs) with a much shorter maturity. This represents outstanding global relative value given the exceptional long term performance of the underlying pools.

**Figure 18. Covenant-lite issuance – US and Europe**



Source: S&P Leveraged Commentary and Data.

**Figure 19. Global asset-backed securities (ABS) relative value**



Source: Westpac, National Australia Bank, Wells Fargo.

## Barriers to entry

### Local market attributes

While it has already been recognised that the Australian private debt market is large and well-established, there have been several barriers that have resulted in this asset class experiencing a low level of institutional participation. These are explained in detail below.

### Mandates

Being a largely illiquid asset class, market participants must be able to tolerate this key feature and have a specific illiquid mandate in order to exploit the opportunities currently available in the local market. This has resulted in more traditional fixed income managers, which usually promote the liquid feature of their product, not being able to participate. Additionally, most traditional fixed income products typically require an external credit rating from a credit rating agency such as Standard & Poor's, Moody's or Fitch. With the Australian private debt market typically consisting of unrated transactions, most traditional fixed income managers are unable to explore opportunities that have not been rated by an external credit rating agency, limiting their ability to participate in the private debt market.

### Relationships – Origination

Relationships are critical when it comes to markets that are private in nature, due to transactions being sourced from these key relationships. In this instance, participants require relationships with a number of firms such as:

- Sponsors: typically includes private equity firms for leveraged loans and non-bank lenders for ABS transactions;
- Banks: this would include the banks that arrange and syndicate transactions; and
- Advisory firms: this includes a number of firms that are involved in debt advisory. These firms typically have unique client bases that would require private debt solutions.

These relationships are built over many years and many transactions, making it difficult for new participants to be able to enter the market successfully.

### Expertise – Track record

Private debt requires a high level of relevant expertise. This expertise is required across every facet of originating a transaction such as negotiating key terms and conditions, as well as conducting the underlying credit analysis and monitoring individual transactions. This is particularly relevant to offshore participants looking at entering Australia, with local industries often displaying different regulations and structures compared to their offshore equivalents, making it more difficult for offshore based analysts/portfolio managers to properly analyse and scenario model illiquid Australian industries and companies.

### Local industry knowledge

Whilst many leveraged loan managers in offshore jurisdictions have strong and deep credit teams to enable assessment of loans and ABS, the knowledge and experience that these teams possess is not always relevant in the Australian market. An example of this would be healthcare. The Australian healthcare industry has its own regulations and nuances and is unique hence a US healthcare industry expert would have little or no familiarity with how the industry operates in an Australian context. A company specific example of local industry knowledge would be where we have a dominant player in an industry such as ‘Boost Juice’ where this company has effectively created its own category for fresh juices and smoothies in the local market. When comparing the scale of this franchise operation versus a US franchise model it would seem as though Boost Juice would appear more like a small start-up, rather than a leading player, however it represents an attractive risk adjusted local opportunity nonetheless. In this way local knowledge and familiarity with companies operating in Australia is a distinct advantage to local managers over foreign domiciled fund managers looking to enter the Australian market.

### Hedging

Foreign participants would typically require the AUD currency risk to be hedged, to ensure their return is not adversely impacted by fluctuations in the Australian dollar. Given that Australian private debt instruments are typically callable in nature and often include contracted amortisation and excess cash flow sweeps, the cash flows from the underlying instrument are variable, making them difficult to hedge, unlike a daily traded liquid bond, which does not include amortisation or cash flow sweeps.

### The role in a ‘late cycle’ phase

As previously addressed, private debt affords portfolios a number of structural protections through seniority, security and covenants, which combine to manage the risk of the investment and improve recoveries should the borrower face distress. This is particularly important given the stage in the current credit cycle. As can be seen in Table 9, Revolution Asset Management has done a comparison across bonds (domestic and offshore, HY and IG), US leveraged loans and CLOs, and Australian private debt.

**Table 9. Important characteristics in the late cycle phase**

	Global & Domestic High Yield & Investment Grade Bonds	US Leveraged Loans & CLOs	Australian Private Debt
Seniority	✓	✓	✓
Security	x	✓	✓
Covenants	x	x	✓
Protected from M&A risk	x	✓	✓
Protected from cash flow leakage	x	✓	✓
Relative value	x	x	✓

As illustrated in Table 9, Australian private debt offers the most complete package in terms of protection in this late cycle phase. Each of the key factors is addressed in more detail below.

### Seniority

Australian private debt is typically senior, with debt holder interests ranking before other creditors, entitling these debt holders to priority payment. In the case of traditional daily liquid bonds, seniority is the only structural protection available. Additionally, borrowers may issue debt in the future that subordinates bondholders, unless explicitly prohibited in existing debt documentation. Australian private debt documentation typically includes such provisions to ensure a senior position cannot be subordinated in the future.

### Security

Australian private debt is secured via the assets of the business being pledged as collateral, reducing risk and enhancing the recovery rate if a borrower defaults. Bonds (be they domestic or offshore, or high yield or investment grade) on the other hand, are typically unsecured in nature, which would likely see bond holders experience a lower recovery rate compared to the secured counterparts should the company default.

### Covenants

Australian private debt transactions typically include covenants, which provide an early warning sign in the event of any deterioration in creditworthiness. Importantly, covenants empower lenders (e.g. private debt managers) to be able to engage with the company efficiently to ensure any weak performance is rectified. This rectification could involve adjusting covenant levels to increase flexibil-

ity (typically in exchange for a fee and/or an increase in the interest rate) for temporary issues, or closer engagement with management to strengthen the balance sheet through a capital raising or asset disposals for more challenging or permanent issues the business may encounter. This is something that is generally not seen in the bond market or US leveraged loan market. In fact, around 80% of leveraged loan issuance in the US and Europe have actually been covenant-lite, resulting in no or minimal covenants to protect lenders. While this may be acceptable in a benign credit environment, more challenging times will result in lenders being unable to intervene, driving a lower recovery rate.

#### *M&A protection*

Loan documentation typically includes limits on permitted acquisitions, resulting in the borrower not being able to conduct M&A activity without the consent from the lending syndicate (which the private debt manager would be the leader of or play a key part). Additionally, the documentation typically contains change of control provisions, requiring all outstanding debt to be repaid should there be a change of control event. This protects creditors in the event the borrower becomes a target and becomes part of a more leveraged, less credit-worthy company. Either outcome could involve the consolidated entity holding materially more debt resulting in a weaker credit profile. Traditional daily traded bonds do not offer such a protection, with numerous examples of multi-notch downgrades which can impact bond prices following the announcement of M&A activity.

#### *Protection from cash flow leakage*

Cash flow leakage can occur in companies that issue daily liquid bonds, which may significantly affect their credit worthiness and value. Examples would include a company paying out large dividends, a special dividend or a share buyback. These are all equity-friendly initiatives which are considered credit negative for the owner of daily liquid bonds due to the cash no longer being available to pay debt holders. Australian public debt transactions typically trap all cash in the structure, resulting in dividends generally not being able to be

paid by the company, with any excess cash flow (that is, cash flow after meeting operating expenses, principal and interest payments and any capital expenditure) typically used to reduce outstanding debt. This is particularly important when looking at publicly traded bonds (where companies can pay large dividends or conduct share buy backs to the detriment of the company's credit profile) vs. the superior position in the capital structure of an investment via private debt.

#### *Relative value*

As outlined above, Australian private debt offers attractive relative value, particularly across the three sub-sectors identified, together with maintaining all the aforementioned protections.

The key factors identified above provide capital stability and security of income for investors via Australian private debt which in summary offers seniority in the capital structure, security and covenants, protection from M&A activity and cash flow leakage, as well as demonstrating attractive superior relative value when compared to offshore markets.

### **Conclusion**

Overall, Australian and New Zealand private debt offers a significant and immediate investment case in the late market cycle for investors. The local private debt asset class is substantial at over A\$2.8 trillion and is larger than the Bloomberg AusBond Composite Index and the S&P/ASX200 Index, and comparable in size to the total Australian superannuation savings pool.

There are also a number of tailwinds supporting the asset class, while offering a number of portfolio construction benefits such as low correlations to other asset classes together with diversification benefits, structural protections (which have now diminished in offshore markets), lower volatility, a steady income stream and inflation protection.

The investment universe is large with low levels of institutional investor participation, while offering strong relative value. Australian private debt provides investors today with a compelling investment opportunity. **FS**