Alternative credit at a time of uncertainty

In mid-March, **Tell Media Group**, in co-operation with **Aberdeen Standard Investments**, **BlackRock** and **BMO Global Asset Management**, organised a discussion about investments in alternative credit with three invited Danish participants. **Caroline Liinanki**, editor of Nordic Fund Selection Journal, and **Niklas Tell**, founder of Tell Media Group, moderated the roundtable.

By: Niklas Tell Photo: Christer Salling

The discussion, which was held at Hotel D'Angleterre in central Copenhagen, started with Caroline Liinanki asking the investors how their portfolios have changed over the years and what their current allocation looks like.

JIMMY LUNDBY: "When we got out of the financial crisis around 2010, it was all about taking on risk. We tried to gain exposure to instruments that had the potential of delivering high returns. At that time, we saw that companies would be able to grow their top-line and would also be able to grow into their capital structures and de-lever over time. That was the strategy back then. What we're seeing right now is the opposite. We're reducing risk and we try to focus more on asset-backed securities. We're essentially trying to be a bit more robust."

BERTIL FROM: "If we go back to the financial crisis, we also had risk on and in 2012 our exposure to credit topped at around 25 per cent. Today, we're at some 15 per cent. As we have an absolute return target, we've actually increased the risk profile. With falling interest rates and falling spreads, we simply need to take on more risk. What we've done is to reduce the allocation but what we have is more risky. We're only in high yield today and more into alternatives. We split credit into performing and distressed and we've had exposure to distressed debt since 2007 and it performed exceptionally well in 2008 and 2009. What I like from a portfolio perspective is that it will perform well if we're hit with a recession. The allocation today is smaller than it used to be but it will likely increase if there is a recession."

JESPER KIRSTEIN: "If we look at Nordic investors, some five years ago the allocations to private credit were very much ad hoc. In the last three years, we've seen investors moving into this area in a large scale. The Finns were early but we see big moves in Denmark as well. What we see now is a systematic move into private credit where investors are carefully considering what segments they want exposure to."

NIKLAS TELL: DO YOU SEE THE SAME TRENDS WHEN TALKING TO EXISTING CLIENTS AND PROSPECTS?

BARRY FRICKE: "I very much agree that direct lending has been an attractive place to be for many years. But as we enter the later stages of the cycle, there's a recognition that you might want to be a bit more defensive. Investors are moving into asset-backed areas such as infrastructure debt and real estate debt, which should perform better in a downturn and should provide better recovery rates. There's now more focus among investors on correlation with the economic cycle."

DAVID SCHMUCK: "From our perspective, our private debt offering is a bit more conservative and for a long time that was considered to be negative. Today, we're beginning to see more interest in what we do."

JAMES TURNER: "A driving force for investors de-risking is, of course, that people are thinking that we're approaching the end of the cycle and they want to be prepared for that. What concerns me is that investors are moving from liquid markets to illiquid markets, which doesn't mean less risky. They could still experience credit losses – it will just take more time before it shows. There has also been a fear of rising interest rates and we saw a shift from high yield to loans and then a shift from loans to private credit to avoid mark-to-market risk."

JESPER KIRSTEIN: "You're talking about shifts in risk appetite but what we've seen is more of an explosion of interest from clients over the last five years. Is that a picture that you recognise?"

JAMES TURNER: "Yes. With rates looking like they will stay low for a long time, clients need to find returns somewhere."

NIKLAS TELL: DO YOU THINK OF ALTERNATIVE CREDIT AS AN ALTERNATIVE INVESTMENT OR AS PART OF THE FIXED INCOME PORTFOLIO?

BERTIL FROM: "When we increased our allocation to 25 per cent, the money came from ordinary fixed income. That was a way of getting higher expected returns and compensate for falling interest rates. As a foundation, I don't have to worry too much about mark-to-market since I'm not regulated. I've been able to benefit from this hunger for yield trend that we have seen for a long time now. The big question is, of course, how this will play out going forward."

DAVID SCHMUCK: "I think one of the lessons has been that some of the liquid assets weren't as liquid as you thought. That has been one of the things that drove people into private debt."

JESPER KIRSTEIN: "I do understand the journey from high yield to senior loans to private credit. That's been an easy journey. The question is if you're compensated enough today in private credit. And I don't see it as an alternative asset class – this is fixed income."

BARRY FRICKE: "As people view this more and more as mainstream fixed income, there are more relative value assessments being made, for example between private and public credit and then among the different areas within private credit."

JAMES TURNER: "It's also a case of a growing market. In the past, it was all about the dollar market but today Europe can finance its own transactions. This is creating bigger markets for people to invest in and that creates better liquidity, which in turn makes people more comfortable."

NIKLAS TELL: "WHERE DO YOU SEE THE BIGGEST OPPORTUNITIES TODAY?

JESPER KIRSTEIN: "I was recently in London talking to managers that do both senior loans and private credit. What they said was that if you invest in a well-diversified portfolio of senior loans today, you might get close to 5 per cent. What can you get from private credit in Europe today? Some 7 per cent after fees?"

JAMES TURNER: "Yes, there's probably going to be more dispersion between good and bad managers in private credit compared to loans. I think it's easier to say what you're likely to get in loans than in private credit. I would also like to add

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BERTIL FROM
The Lundbeck Foundation
Chief financial officer of the Lundbeck Foundation since 2009. Before joining the foundation in 2006 as chief investment officer, he spent about nine years at Danske Bank. He has previously also worked at the Danish central bank.

JIMMY LUNDBY
Pensam
Senior portfolio manager and responsible for the illiquid credit portfolio at the pension company Pensam, with a focus on investments within real estate, infrastructure and corporate credit. Prior to joining Pensam, he worked at Nykredit within acquisition & leveraged finance.

that private credit has changed as a concept as well. The whole idea of private lending back in 2010 was that funds were established because banks couldn't lend to corporates. That was the concept of direct lending – to take the place of the banks. Today, that's not the case at all as it's more about financing private equity deals."

CAROLINE LIINANKI: WHY HAS THAT CHANGE BEEN TAKING PLACE?

JAMES TURNER: "Because banks don't really have any trouble lending to corporates as they have been getting a massive help from the ECB. People thought that that banks might have difficulty lending in the wake of the financial crisis but they really didn't."

BARRY FRICKE: "We often associate private credit with mid-market lending but it's important to remember that it's broader than that. Mid-market lending is a core part of it but if we debate whether there's currently value in private credit, we must remember that there's also infrastructure debt, real estate debt, aviation finance, trade and receivables finance, among many other areas."

CAROLINE LIINANKI: SO WHERE SHOULD INVESTORS GO FROM HERE?

JIMMY LUNDBY: "For the foreseeable future, I think we will continue to focus on more secure instruments but the idea behind our thinking is to have our risk appetite correlating with how the market evolves. So when we get another downturn, that's when we will be looking to bring risk on again.

BERTIL FROM: "At the beginning of the year, our strategy was to increase our credit exposure because it looked very attractive at the beginning of January. Now, I'm not that certain any longer and it's very difficult to talk about the future as prices are moving so quickly. I would still like to change my allocation a little bit from equities into credit but I would like to wait until we see some turmoil."

BARRY FRICKE: "If you're not a Solvency II insurance company, you should try very hard to avoid assets that are appealing to Solvency II insurance companies. You should also try to avoid assets that are appealing to banks under Basel III. Another good idea is to stay a bit under the radar. Smaller deals of around EUR 30 to 70 million per investments will not be as appealing to investors that need to deploy in bulk but the terms are likely to be better and focusing on this area will open up a bigger universe from which to select."

BERTIL FROM: "As you said James, banks have capacity. You can't compete with them because their cost of capital is much lower compared to what investors would require. A lot of new funds are visiting us saying that they are looking to buy some of the assets that banks don't want to hold. From a risk perspective – is that what you would like to own? It might be senior but if the banks don't want to hold it, there might be something bad there. We don't have a huge direct lending portfolio but what we see is that private equity sponsored deals are very much covenant light – we basically have no rights. We've avoided it so far because investing in junior debt with no rights makes no sense. In general, you don't get paid for the risk you take. Even in liquid markets, there tend to be situations where you can buy cheaply. We saw it in December and with new regulation, banks are not there to hold their hand under the market. We didn't buy enough in December but we bought some. As an investor, it's important that you keep some dry powder. It's, of course, tricky because we didn't know if it was a new crisis that started in December or if it was just another blip."

CAROLINE LIINANKI: IS DISTRESSED DEBT INTERESTING TODAY?

JIMMY LUNDBY: "It could be but I think we see that asset class more as a hedge. We're potentially looking to do something in that space. That would be to offset losses that we might see in other parts of our portfolio."

DAVID SCHMUCK: "I do think there are opportunities if you pay attention to the underlying fundamentals and that's where your distressed portfolio comes into play. If you understand the fundamentals of something that falls to 90 cents on the dollar, it would be perfect for that portfolio but you have to pick and choose."

JESPER KIRSTEIN: "There's a reason why the direct lending market in the Nordic region has stopped and that is because we are over-banked. There are a lot of banks chasing these loans. I would never select a manager that's investing in Nordic direct lending. Talking about covenants – yes, they can be light in many segments of the market and that's why we recommend you look at the lower middle market in the US where covenants are still ok.

BARRY FRICKE: "There's a slightly worrying trend where investors seek out a certain yield without enough recognition of the market context. Consider the journey since the financial crisis. First, investors reallocated from investment grade to high yield. Then, as public spreads got compressed, they looked to trade away liquidity to capture an illiquidity premium and moved into core mid-market lending. And now it's the lower mid-market as the core market has become crowded. I don't disagree that there are interesting opportunities in the lower mid-market but investors are taking on more risk than perhaps they intend. It's remarkable how that has been normalised over the last couple of years."

DAVID SCHMUCK: "Our experience in the US market is that there's a difference between sponsored and non-sponsored owned companies. Over the years, we've done both and generally our experience was better with sponsored owned companies. They have real capital at risk and they have an incentive to help that company if there is a bump in the road. They don't put good money after bad, but they're active and they have a reason for making it work. Today, it's part of the strategy to focus on sponsored-owned companies."

JIMMY LUNDBY: "I think you must distinguish between the US and the European market when it comes to smaller companies. The institutional debt market in the US is much more mature compared to Europe where banks are more active. The price for obtaining debt in the US is probably a bit higher compared to Europe because if banks want something, they're able to offer very attractive rates."

CAROLINE LIINANKI: WHICH MARKET IS MORE INTERESTING – EUROPE OR THE US?

JESPER KIRSTEIN: "Would you like to have a manager that has been through a crisis or one that has only done 20 deals? I think the answer to that is clear. I'm not predicting where we are in the cycle but we will eventually run into more difficult times and at that point in time, I would prefer a manager that has been there before. Most of the managers in Europe haven't as most funds were set up after the financial crisis and times have been fantastic. We haven't had any defaults and they haven't had to take over the keys to the company."

BARRY FRICKE: "Yes, investors' jobs are much harder when it comes to European managers for exactly that reason. Most of the managers worth their salt in Europe have been through many crises before. However, this experience has often not been within the asset management environment. Investors' due diligence challenge is therefore much harder because they can't look at track record of the manager. They need to look at the history of each individual and what experience they have. Often they have experience from banks but it's harder to objectively assess."

JESPER KIRSTEIN
Kirstein Holding
CEO of Kirstein Agg. Holding, which is the owner of Kirstein, a company that advises asset managers on investment and strategy, and Spektrum, an investment management company. Before setting up Kirstein in 1992, he worked as CEO at several Danish banks.

JAMES TURNER
BlackRock
Head of European leveraged finance at BlackRock, overseeing investment strategies across European high yield, long/short credit, leveraged loans and the European fundamental credit research team. He joined the firm last year after more than 16 years at Oaktree Capital Management.

BERTIL FROM: "I agree fully with Jesper. It's so important that you can prove that you have worked with restructurings and so on. Whether you're in private debt or a high yield manager – don't fool yourself. Sooner or later you will run into problems and I would much rather have a manager admitting the problems they have run into and have them explain how they dealt with them. If you have a manager that says they never had any problems, it's because they sold at 10 cents on the dollar rather than working hard to get 30. Sourcing of deals is another important factor to look at. If you're sitting in your office and waiting for sponsors to knock on the door, then you're probably the last one they ask. Do they have a good network and can they prove to you that they can source good deals? That's very important."

JAMES TURNER: "I agree that sourcing is important but sometimes that gets too much attention relative to the actual investment side. When I look at teams, I sometimes see that it's all sourcing people and not enough experienced investment people. Another thing about having experience from restructuring is that you must be flexible and sometimes you must be able to put additional cash into a position in order to protect your stake and not be pushed out."

JIMMY LUNDBY: "I agree that you need experienced investment staff and not just sourcing. It's also important for us that the manager has enough resources to take on restructurings because if we get such a wave, it will be more than one company and that's very time consuming."

BARRY FRICKE: "In Europe, even if you're able to find managers that individually have experience with workouts, it's different to work in a bank compared to an asset manager. At a bank, you often have different teams for sourcing, underwriting and ongoing management but at an asset manager, the different roles are often combined. Because the European market is much newer, it's also harder to differentiate between good and bad managers. There will be a shake-out when the markets turn and some managers will struggle."

CAROLINE LIINANKI: IF YOU ONLY WANT MANAGERS WITH EXPERIENCE GOING BACK TO THE FINANCIAL CRISIS, WHAT DOES THAT MEAN FOR EUROPEAN MANAGERS?

JIMMY LUNDBY: "For our European managers, we had to go back and look at what the individuals had done in the past. Where they worked, what they did there and whether they did any workouts, so really trying to understand their past. We needed to do that because the firm record wasn't there. We also looked at the size of the teams to understand if they have the ability to act if something goes wrong."

JAMES TURNER: "Aside from sourcing, I think if you have someone with a lot of experience from the leveraged loan market or from high yield, then they will have the skills to pick good credits and they will understand the documentation. It's not materially different to what you want from someone investing in direct lending."

BARRY FRICKE: "You will also see managers coming from the equity side, for example those that have done a lot of infrastructure investing and now have switched over to infrastructure debt. That's often valuable and relevant experience since if you underwrite the project, you assess it in its entirety. Yes, you're at different points in the capital structure and your approach to a workout will be different but you have seen the situations before."

CAROLINE LIINANKI: WHAT ARE SOME OF THE KEY LESSONS LEARNT AT THE LUNDBECK FOUNDATION AND PENSAM, WHICH HAVE INVESTED IN THE ASSET CLASS FOR A LONG TIME?

ROUNDTABLE – ALTERNATIVE CREDIT, COPENHAGEN

JIMMY LUNDBY: "I think for us, it's important to understand that even if private credit is illiquid, you can and should be a bit tactical and decide if you want to be in junior or senior debt at specific points in time. Just because you're in private debt doesn't mean you're immune to volatility or economic downturns - you still need to reposition yourself from time to time. Eight years ago, we focused on junior debt and now we focus more on senior debt."

BERTIL FROM: "I think there are a lot of lessons learnt. First of all, you have to be agile, which Jimmy referred to. The market is changing rapidly and just after the financial crisis, we could buy senior secured debt very cheaply, which we can't do today. You need to be able to change your strategy. One important lesson is that when you pick a manager, you need to pick one that's agile and what they're allowed to do must be broad. If it's too narrow, you either end up with a strategy where there's too much capital for a small opportunity or the terms will be very bad. I'm constantly amazed by how quickly the market is changing and where opportunities appear. Another thing – think about what other people don't like, especially the banks. If there's something they don't like, you might get the right price."

CAROLINE LIINANKI: ISN'T GIVING BROAD MANDATES A BIT RISKY? DO YOU REALLY WANT TO GIVE THE MANAGERS THAT MUCH FREEDOM?

BERTIL FROM: "It's a balance. Currently, we only have distressed debt managers and an old mezzanine manager but what I typically hear from managers is that there's a specific market opportunity right now that they want to explore. However, when I look at the documentation, they're usually asking for a very broad mandate and I think that's wise. Right now, there's a lot of talk about banks needing to divest some of their portfolios due to new regulation. Yes, there might be a window but it will be very short and it's important that you don't end up with a manager that's unable to invest the money you're allocating to them."

NIKLAS TELL: JIMMY, WOULD YOU AGREE ON BROAD MANDATES?

JIMMY LUNDBY: "No. We really want to know exactly what we're getting. We would rather have a situation where the manager is not able to deploy capital instead of ending up with other assets than we thought. It may also come back to the fact that you, Bertil, have more flexibility. We must invest and manage our portfolio in accordance with the financial regulation and guidelines from the Danish FSA. To do that, we really need to understand the specific risks we're taking. We also see documentation where the mandate is fairly broad and then we negotiate to get to a point where we're comfortable. If we're unable to get there, we will simply have to walk away."

JAMES TURNER: "I would, of course, like a broader mandate but it also has to be within my area of expertise. If you have a slightly broader mandate, there are areas where you can add value not only from picking credits but also from switching between different parts of the market. One example would be European credits last summer when we saw big differences in spreads between loans versus bonds. If you had a portfolio where you could tilt between the two, you could exploit that. If your mandate was too narrow, you would never get permission in time to do that."

CAROLINE LIINANKI: WHAT ARE YOUR VIEWS ON ESG INTEGRATION IN THIS SPACE? JIMMY, YOU'VE RATED ALL OF YOUR EXTERNAL MANAGERS FROM AN ESG PERSPECTIVE.

BARRY FRICKE
Aberdeen Standard Investments
Global head of private credit, product strategy & solutions at Aberdeen Standard Investments. Prior to joining the firm in 2017, he was an executive director at Goldman Sachs for eight years.

DAVID SCHMUCK
BMO Global Asset Management
Portfolio manager at BMO Global Asset Management. He joined the company in 2012 from Pangaea Asset Management to co-manage an initiative focused on private debt products and separate accounts. He has more than 20 years of experience in the leveraged loan market.

JIMMY LUNDBY: "They did rather well and I would say it turned out better than expected. This is something that has become more of a focus area for managers as well and a lot of managers already have their own policies in place. A lot of managers are also signatories to the PRI."

BARRY FRICKE: "We integrate ESG into every deal we do and each deal is assigned an ESG risk rating. What this measures is the likelihood of an ESG risk negatively impacting the credit fundamentals. In public markets, you're sometimes paid handsomely for taking on ESG risk and at least have the flexibility of being able to sell. Generally in private markets, you need to hold these investments to maturity and our tolerance for ESG risk is therefore much lower."

DAVID SCHMUCK: "Our team integrates ESG in their process. We also have a responsible investment team in London that are specialists and we collaborate with them as well on ESG issues. A lot of investments that could be questionable from an ESG perspective were never really interesting to us in the first place. Sectors such as oil, gas and mining didn't work for us from a cash flow volatility point of view.

NIKLAS TELL: WOULD YOU SAY THAT ESG HAS BEEN INTEGRATED FOR A LONG TIME, EVEN IF IT WASN'T LABELLED AS SUCH?

BARRY FRICKE: "A number of years ago when we first formally integrated ESG risk assessment into our investment process, the question from many in the team was how the ESG assessment differs from what we already do, which is to evaluate how risk might impact the credit fundamentals. We might call it ESG risk now but it's really not very different from what we've always done. However, what has changed over the last couple of years is that ESG risks have become much more pronounced."

CAROLINE LIINANKI: HOW BIG OF A CONCERN IS REPUTATIONAL OR HEADLINE RISK WHEN YOU INVEST IN THINGS SUCH AS DISTRESSED DEBT?

DAVID SCHMUCK: "Reputational risk is absolutely something you pay attention to in every transaction. As a big organisation, it's critical."

JIMMY LUNDBY: "We also try to make sure that the managers we team up with will not do anything that will come back and reflect badly on us. It's really about behaving in the right way. You need to behave decently, also in distressed debt."

BARRY FRICKE: "I think part of the risk in distressed, which we currently don't do, is that you're much more likely to go through workouts. And in workouts, tough decisions needs to be made as you take control of a company. That could create reputational risks. It's true for any debt investment but in the distressed space, workouts are typically more frequent."

JAMES TURNER: "I know from observation of past restructurings that you can end up in the media for taking decisions in workouts that are not popular."

BERTIL FROM: "I think this is very important and it's something that we think a lot about. If I look at the foundation, our investment portfolio is some 25 per cent of our total assets and if we do something wrong there, that hits our big corporate holdings and then we can lose much more. This is also a consideration when we decide if we are to use an external manager or do it in-house. If we use an external manager, we can point to them, which we can't do if we do it ourselves. The good thing about doing things internally is that we will think twice before making an investment. I would say that reputational risk has always been important and it's only becoming more important."