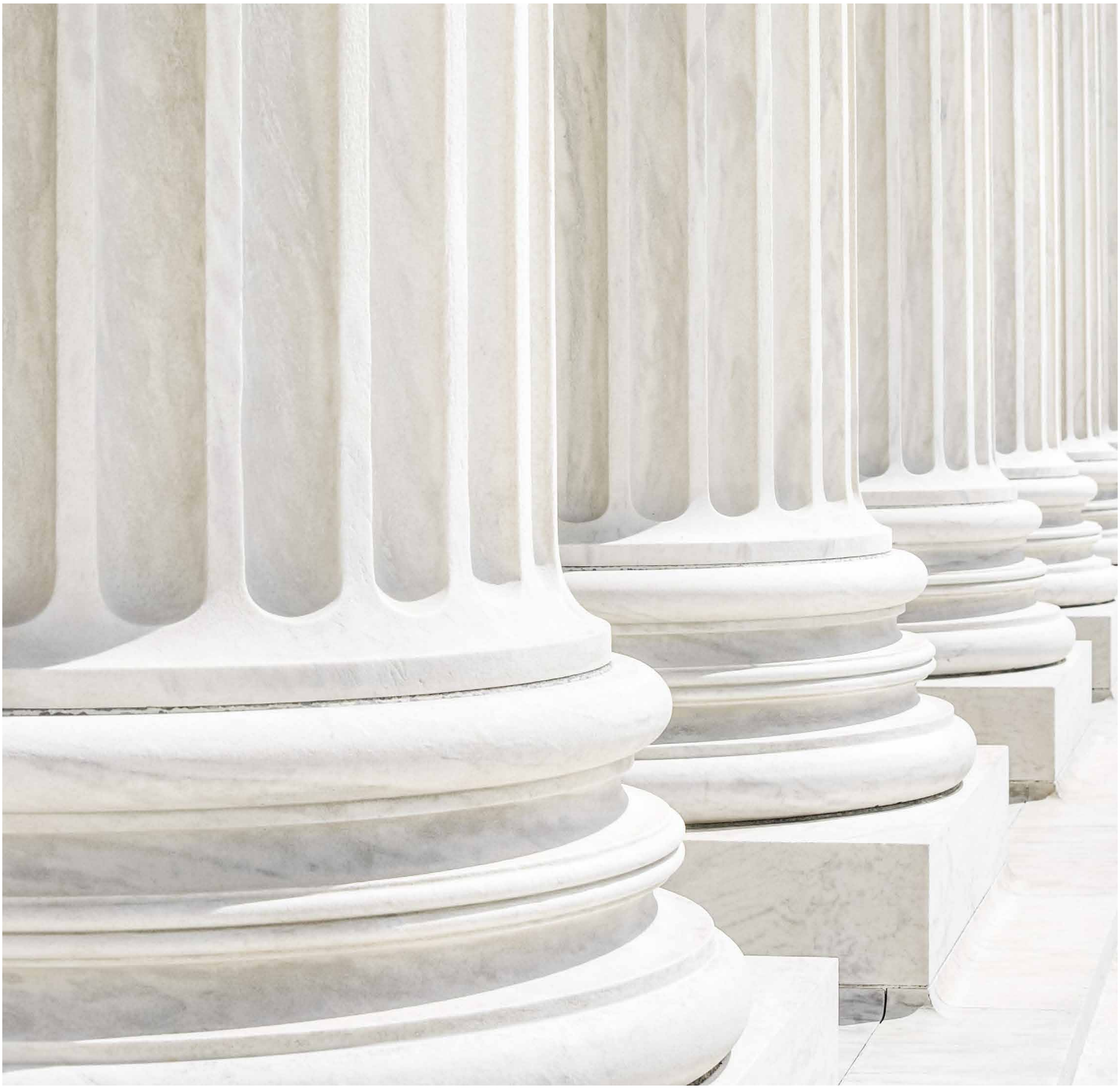
Asset management
Professional clients only

Private First Class

An overview of the sustainable opportunity in private credit



Overview

- Regulatory-driven reduction in bank lending and broader need for corporate capital creating a compelling long-term opportunity in private credit

- Demand/supply dynamics, compensation for illiquidity and complexity leading to attractive risk-adjusted returns potential for providers of capital

- Growing and diversified opportunity set across asset-backed, real estate and direct corporate loans – and across the debt capital structure

- Proprietary multi-channel deal sourcing network critical to sustainably strong risk-adjusted returns potential as asset class attracts increasing interest

The changing world of borrowing

The world of traditional banking in the developed world was never likely to survive the financial crisis untouched. Under the impetus of the Basel Committee on Banking Supervision, banking's global regulator, G20 countries committed to a set of actions laid out in the Committee's Basel III Accord designed to ensure a more stable financial sector. At the core of the new framework were stronger capital requirements, both on an absolute basis via lower leverage and on a risk-adjusted basis using new asset risk weightings. Higher liquidity standards complete the triple pillars of a more robust regulatory backdrop.

Banks have responded in obvious ways: by raising equity capital and by shrinking loan books. However, while the broader impact of deleveraging has been to leave a large and growing lending gap, at the individual sector level the impact of these regulatory changes has not been equal. In particular, the new risk-weighted asset framework requires banks to hold significantly larger amounts of higher quality capital as a risk buffer against certain categories of loans than ever before, while other categories remain unaffected.

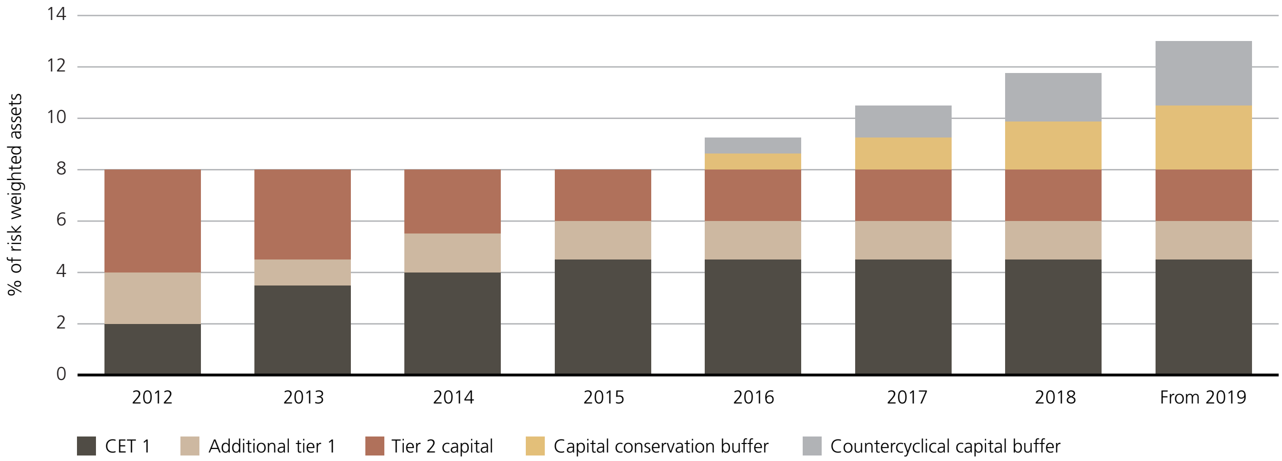
Unsurprisingly therefore, banks are not only shrinking but reshaping their loan books, stepping away from areas hit by higher risk categorisation to focus on more capital efficient business lines. In the process, borrowers in other areas including project finance, commercial real estate and longer-term corporate debt have been left to seek out alternative sources of funding.

Importantly, this exercise in balance sheet deleveraging is on-going, as Basel III's tougher capital requirements are phased in over a number of years. According to estimates by Deloitte, European banks are still carrying some USD 2.4tn of non-core loans that need to be divested.

But there are other drivers that are likely to sustain the growth in non-bank lending aside from the changing regulatory backdrop. One of the most important is that non-banks are generally able to offer more tailored loan terms and covenants – something that benefits both lender and borrower. For idiosyncratic borrowers or distressed situations, we believe that alternative lenders simply make more sense than banks. We therefore see the growth in private credit as a structural rather than cyclical development.

With an evolving lending gap, this lack of balance sheet availability within the banking sector is creating inefficiencies and dislocation across private credit markets. The potentially attractive returns and diversification potential relative to traditional publicly traded asset classes have not escaped investors' notice at a time of generally low government bond yields. Private credit also offers a potential cashflow profile that is, in our view, well suited to many pension and annuity funds where illiquidity of assets held is often less of a concern.

Figure 1
Basel III Minimum Capital Requirements Evolution

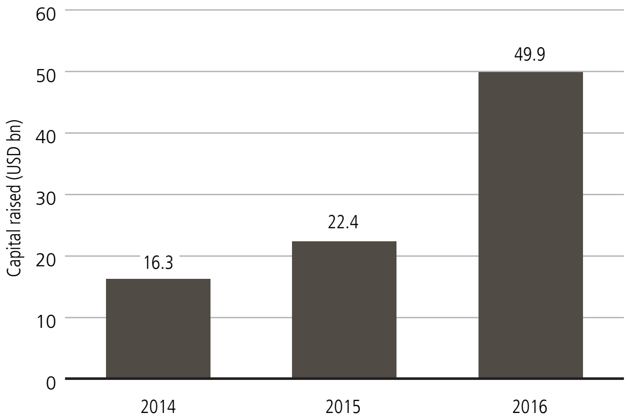


Source: Bank of International Settlements

Attractive returns potential with built-in protections

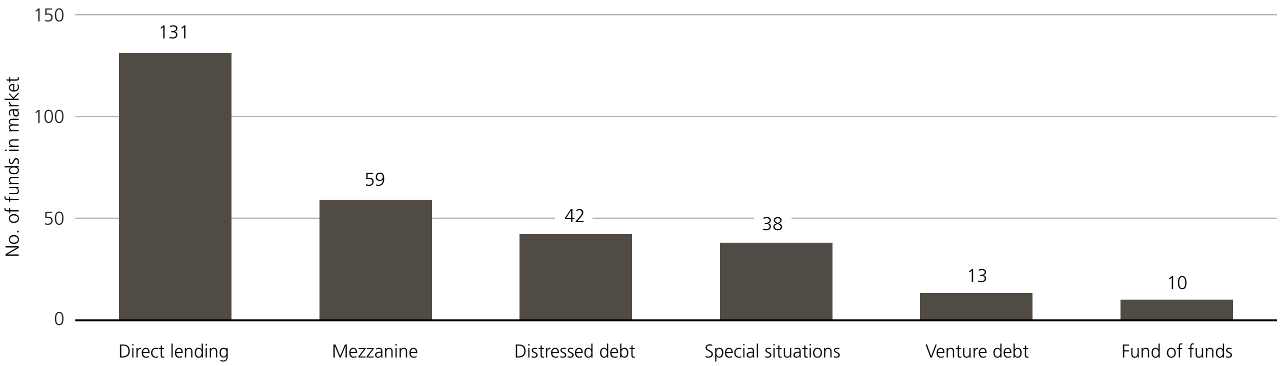
Given these characteristics, private credit is receiving ever greater attention from institutional investors and there has been significant fund raising in recent years. However, much of the fund raising in private credit has been focused on midmarket direct corporate lending. Unsurprisingly, yields in this area are starting to come under pressure as the asset class becomes more mainstream.

Figure 2
Direct lending/middle market fundraising
As of 31 December 2016 (USD bn)



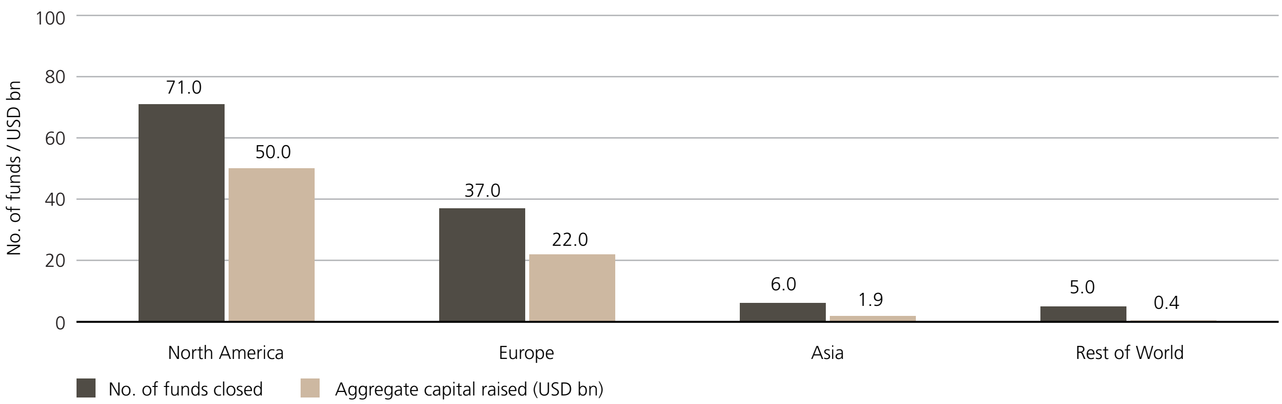
Source: Thomson Reuters LPC and Wells Fargo Securities, LLC

Figure 3
Private credit funds in market by fund type



Source: Preqin as at 3 January 2017

Figure 4
Private credit fundraising in 2016 by primary geographic focus



Source: Preqin

However, outside of standard direct lending, a shortage of capital means that suppliers of credit are in a strong position with regard to yields, returns and deal structuring. Although they can vary widely depending on the borrower, asset backing, deal structure and position in the capital structure, coupons are typically Libor + 10% to 15%.[1]

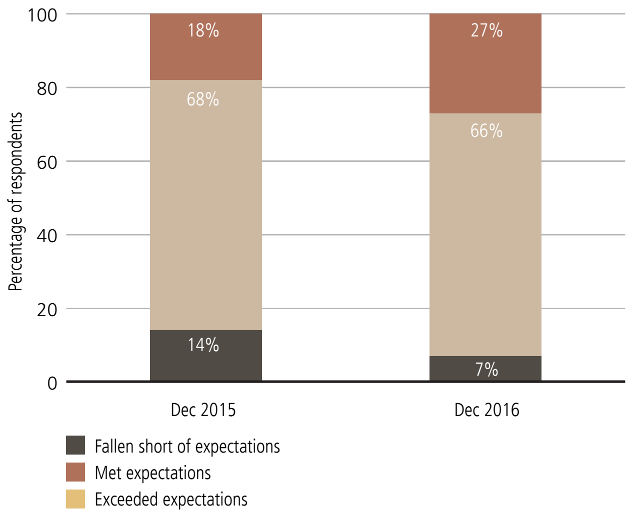
The shortage of capital also means that deals are structured with more favourable terms and greater protections to the lender than is typically the case in covenant-light conventional bonds. These protections include a clear charge over the assets of a company and seniority in the capital structure. Such protections are further and materially enhanced by the detailed due diligence process that is undertaken prior to parting with capital. In a rising rate environment it is also worth noting that the majority of private credit is issued with floating rate returns.

And as an asset class private credit appears to be delivering. According to a recent survey by specialist alternatives data provider Preqin, 93% of investors feel that their private credit investments either met or exceeded expectations in 2016. In 2015, that figure was 86%. It is unlikely to be a co-incidence given this experience that, in the same survey, some 62% of investors with existing private credit exposures revealed that they were intending to increase allocations to private credit over the long-term.

Longer-term returns have also been attractive in both an absolute and relative context. According to market data compiled by Preqin, private credit average net return figures were positive for every annual vintage in the sample stretching back over two decades from 2011. Among the individual private sub-sectors, distressed debt delivered IRRs greater than 10% in over 83% of vintages (19 out of 23) with a median average IRR of 14.4% over the same time period[2].

According to a recent survey by specialist alternatives data provider Preqin, 93% of investors feel that their private credit investments either met or exceeded expectations in 2016.

Figure 5
Proportion of investors that feel their private credit investments have lived up to expectations over the past 12 months, 2015 *vs* 2016



Source: Preqin

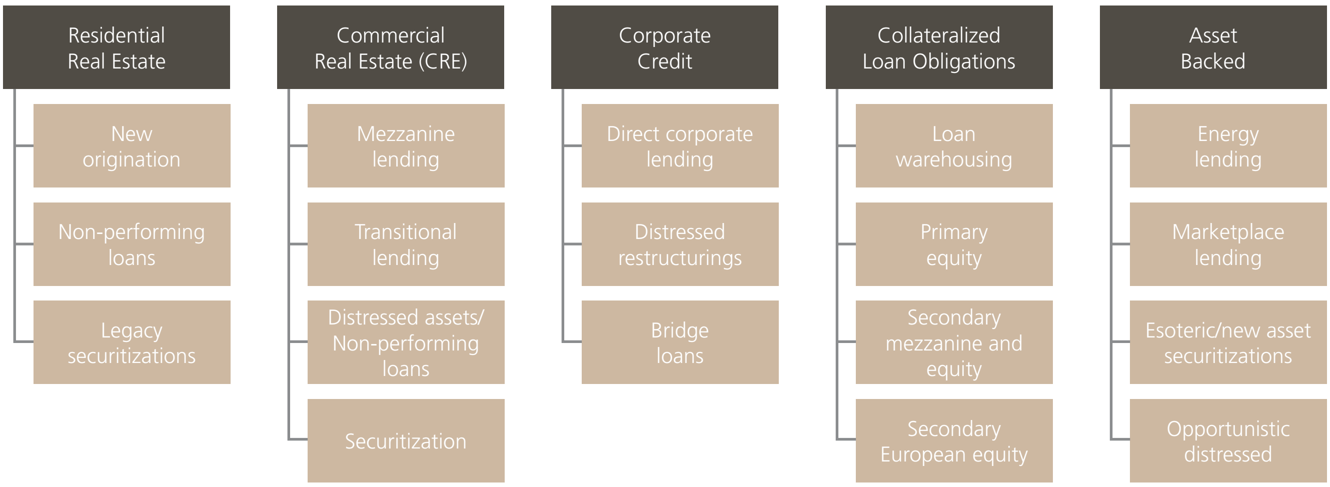
1 Please note these figures quoted are based on the current market environment and may vary.
2 IRR's are only shown for realized investments of over 12 months. IRRs presented are solely for the purpose of detailing the anticipated risk and reward characteristics of an investment in order to facilitate comparisons with other investments. The IRRs presented are not a prediction, projection, expectation or guarantee of future returns. The IRRs presented are gross of expenses, fees and applicable taxes, which may materially adversely affect returns. The IRRs are based on assumptions regarding future events and situations that may not prove to be accurate or may not materialize. There can be no assurance that any of the investments will achieve returns comparable to those presented herein, and accordingly, IRRs should not be relied upon in any way for an investor's decision to invest. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS**.

An increasingly diversified universe

The private credit universe covers an increasingly broad range of illiquid debt instruments across a number of economic sectors. They are further differentiated by loan length, asset backing and position within the corporate capital structure. All of which provides investors with an attractive and growing opportunity set with strong diversification potential at the individual security level.

Geographically, the private credit universe also continues to broaden. Non-bank lending is well established in the US. But the private credit market is increasingly global in nature. Historically, differences in legal structuring across the European Union's 28 members has hindered private credit growth in Europe. But investors are now addressing these issues and Europe has become an attractive source of deal flow as banks deleverage.

Figure 6
Selected Private Credit Sectors and Sub-Sectors



Source: UBS Asset Management

Assessing and accessing private credit opportunities

The breadth of the private credit investment universe means expertise in a number of areas is required covering both macro sensitivity and borrower analysis.

At the macro level investors assess factors including but not limited to:

- Business cycle
- Interest rates and inflation
- Macroeconomic factors
- Industry trends and competition
- Cyclicality and seasonality
- Regulation
- Relative values
- Market technicals

At the borrower level the due diligence analysis is wide ranging and runs across four distinct areas:

Asset Analysis
- Nature of asset: hard or financial
- Asset value and net asset yield
- Asset foreclosure and liquidation process
- Regulatory and licensing considerations
- Transaction/market comparables

Management & Operations
- Meetings and calls with owners, management and advisors
- Assess business model and identify profitability drivers and stability
- Nature of product/service: commoditised or differentiated
- Customer/supplier diversification
- Competitor/comparable analysis
- Third-party expert reports

Financial
- Financial due diligence
- Capital structure
- Costs and capex analysis
- Cashflow and scenario modelling
- Size and cost of financing
- Sources and uses of cash and financing proceeds

Risk & Legal
- Legal review of key operating documents
- Regulatory risk
- Reputational risk
- Control and/or agent role
- Risks, market volatility and downside analysis
- Exits for the investment

In our view, it is a rigorous and repeatable process which is key to attracting new borrowers in the first place and when seeking to generate more consistent long-term returns. By definition, private credit is not open to all and this is a market where scale and reputation matter. The ability to source a diversified pipeline of opportunities globally on an on-going basis is absolutely fundamental to risk-adjusted returns. We believe therefore that private credit as a market favours strong global networks with proprietary sourcing channels and strong market connections.

Specialist loan servicing, restructuring and legal resources are all part and parcel of private credit. In part it is precisely this complexity and lack of uniformity that makes private credit illiquid and offers providers of capital such potentially attractive returns.

Yet the complexity and requirement for specialist expertise create barriers to entry in terms of both cost and knowledge that favour larger, well-resourced market players. They also suggest that returns in more opportunistic private credit are unlikely to be competed away in the medium-term.

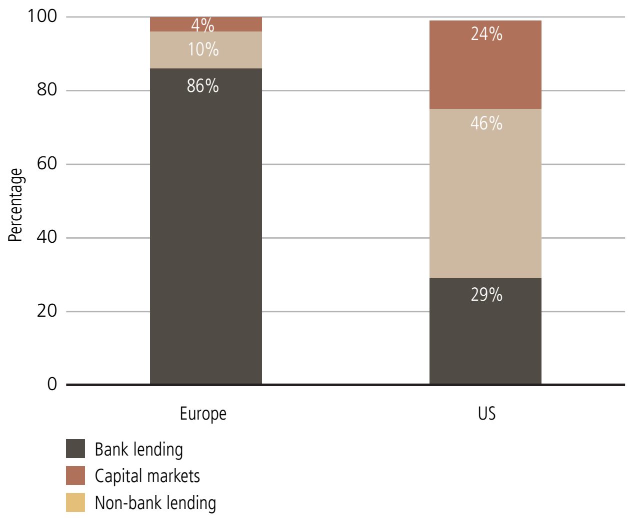
Once again we believe this sustainable market dynamic is a key attraction and a fundamental part of the overall investment rationale for private credit.

As we have seen, the private credit universe covers a broad array of different markets and opportunities. Consequently, private credit is one of very few markets where there are equally strong cases for both a direct access approach that makes the most of proprietary opportunities, and a potentially more diversified multi strategy approach to leverage specialist sourcing and operational expertise in specific sub-sectors. The optimal approach is clearly client-specific and depends on the end-investor's individual requirements and attitudes to risk.

Offering diversification across sectors, asset classes, products, maturities, geographies and capital structure position – and underpinned by the relative scarcity of capital, the illiquidity premium and, on an individual security basis by further complexity and urgency premia – private credit, in our view, offers a compelling risk/reward trade-off for long-term investors.

As an asset class we see it playing an increasingly key role in a broad variety of investors' portfolios going forward.

Figure 7
US v Europe: Sources of corporate financing



Source: JP Morgan

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Private Credit Q&A

Joe Sciortino, private credit portfolio manager at UBS Hedge Fund Solutions, and Baxter Wasson and Rodrigo Trelles, private credit portfolio managers at UBS O'Connor Capital Solutions, analyse the opportunities and sustainability of returns in an asset class that is receiving a great deal of investor attention.[1]

Q. What impact has recent fund raising had on the private credit market? Has any particular sub-sector been impacted more than others?

Baxter Wasson and Rodrigo Trelles
A lot of money is flowing into direct corporate lending. And there is still a significant amount of dry powder that is waiting to be invested. The majority of this money has been focused on private debt sectors where it can be invested relatively quickly – namely mainstream mid-market direct lending. As a consequence, yields in this particular part of the private debt universe have been compressed.

Joe Sciortino
A lot of the money is investing in corporate or direct lending. We believe the illiquidity premium the managers are touting as their investment rationale is questionable.

But the assertion that private credit is 'relatively attractive' misses the most important point when investing in private credit. The investment case for every individual credit investment, liquid or illiquid, needs to stand up on its own terms. There is little opportunity to change one's mind in private credit, and the attractiveness of an investment is therefore first and foremost about absolute value: are you as the lender being compensated sufficiently in absolute terms for the risks you are assuming?

And, after the drop in yields, the answer to the last question in direct corporate lending is usually no. We see much more attractive opportunities in other sectors we cover as part of the private credit universe.

Q. So where do you currently see the biggest opportunities?

Joe Sciortino
A multi strategy approach provides a broad universe of opportunities and the freedom to go wherever the risk/reward is most appealing. This involves the combination of top down research on sector and strategy opportunities and bottom up research focused on seeking to select the best managers to implement these strategies. The quality of managers' track records tend to persist in private investments. Experience counts and the best performing managers normally have access to proprietary origination networks and/or the best processes.

Currently we find opportunities in residential mortgages attractive. Non-standard mortgages are surprisingly hard to get, even for prime borrowers. If the loan is above a certain size or the borrower is not a US national then the normal Fannie Mae/Freddie Mac agency route is pretty much closed. We believe the underlying credit on these sorts of loans, backed by relatively conservative LTVs of circa 60%, represents attractive credit for the respective yields. Backed by a visible and easily valuable asset, these loans would need a significant housing market crash to lose money given the LTVs. With very good financing rates for the securitisation, total IRRs range from high single digit to low double digit depending on where you are in the capital structure.

1 Please note the opinions and information expressed in this report are applicable as of the date of the report, unless otherwise stated. The information contained herein is believed to be reliable but its accuracy cannot be guaranteed. All such information and opinions are subject to change without notice.

We also believe a focus on less commoditised areas of the market will offer significant opportunities. Special situations, distressed and transitional loans are all sub-sectors of Commercial Real Estate where banks once dominated the market and now have exited or continue to retreat. Coupled with new retention rules in Commercial Mortgage Backed Securities (CMBS) there is a significant shortage of capital for complicated situations. We are focused on identifying a small number of specialist 'best of breed' managers in these areas with access to exclusive opportunities to execute on these themes.

We also believe the regulatory bank balance sheet story is much stronger in Europe than in the US where more private capital has been raised. European banks have a large volume of performing, stressed and distressed loans to dispose of and this is creating a steady stream of attractive opportunities.

Baxter Wasson and Rodrigo Trelles
We see the premium for complexity, illiquidity and urgency as offering a much more attractive risk/reward trade-off than standardised corporate direct lending. In general, we see opportunities for proprietary loan deals where the borrower may have limited alternative financing options.

Q. How do you manage risk?

Baxter Wasson and Rodrigo Trelles
Our core risk management philosophy is captured in the phrase: "principal protection first". It is this underlying belief that really drives our attitude to risk and our investment decision making via thorough due diligence and fundamental analysis. All investment decisions are therefore built on the foundation of downside scenarios and seeking to protect against them. Experience is itself an important factor in managing risk in this market and any investment process should include assessments of a broad range of counterparty and economic risk factors and structural protections in the form of asset backing and conservative leverage. Furthermore, we believe any investment process should include relatively tight parameters on what the capital can be used for, collateral packages that can recover the principal even if the loan defaults, and "trapped" operational cash flows to ensure the loan can be serviced. In truth, having first access to ring fenced cash flows and collateral is the biggest risk mitigant available.

Joe Sciortino
The absolute return mindset that we spoke about earlier plays an important role in risk mitigation. It is the driving force behind manager due diligence that seeks to answer three critical questions:

– does the borrower have the ability to generate sufficient cashflow to pay the interest and repay the principal?
– what level and stability of asset backing or collateral supports the loan?
– finally, where are you in the capital structure in relation to those assets?

And by focusing mainly on proven managers in niche areas, we believe we can create a diversified portfolio of attractive IRRs backed by visible and proven cash flows and stable collateral.

Your global investment challenges answered

Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need.

At UBS Asset Management we take a connected approach.

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Our teams have distinct viewpoints and philosophies but they all share one goal: to provide you with access to the best ideas and superior investment performance.

Across markets
Our geographic reach means we can connect the parts of the investment world most relevant for you. That's what makes us different – we're on the ground locally with you and truly global.

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We focus on finding the answers you need – and this defines the way we think. We draw on the best of our capabilities and insights to deliver a solution that's right for you.

What we offer
We offer a comprehensive range of active and passive investment styles and capabilities, across both traditional and alternative asset classes. Our invested assets total CHF 656 billion[1] and we have over 3,500[2] employees in 22 countries.

Who we are
Backed by the strength of UBS, we are a leading fund house in Europe, the largest mutual fund manager in Switzerland and one of the largest fund of hedge funds and real estate managers in the world.

[1] Data as of 31 December 2016
[2] Thereof around 1,200 from Corporate Center. Data as of 31 December 2016

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