INVESTMENT INSIGHTS BLUE PAPER | MARCH 2021

Investing in post-Covid-19 European private debt markets: focus on selection

Confidence must be earned

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Dear client,

Private debt markets have grown rapidly since the Great Financial Crisis (GFC), with global assets under management (AuM) tripling, from $275bn in 2009 to over $850bn in 2019. The European market accounts for about a third of these assets.

The Covid-19 crisis has had a significant impact across private debt markets, with fundraising and deal making having been affected from early 2020. While the onset of this crisis was unexpected, concerns were already being raised about late-cycle conditions in private debt markets related to underlying economic conditions and to emerging risks associated with demand-supply imbalances, tightening spreads, and looser credit standards which showed up in the prevalence of covenant-lite transactions, increased EBITDA adjustments, and rising leverage. All this led to a challenging year for private debt markets in 2020.

However, prospects are improving for 2021. As the crisis' peak is probably behind us, this year, the focus will be on new opportunities which should be plentiful based on lower financing from banks that will leave the door open to private debt funds to cover issuers' financing needs. These needs will include servicing the extra debt that corporates have incurred and the requirement to step up their investment expenditure to adapt to the new challenges brought about by the crisis, such as the need to have short and straight-forward supply chains and efficient digital infrastructure.

A key trend on the supply side in 2021 should see markets moving from large underwriting towards a more 'clubby' direction, with room for private debt funds to subscribe to those transactions in terms of club deals. This market environment will be investor-friendly, as private debt funds will have more power and leeway to negotiate the legal documentation underpinning each transaction.

On the demand side, there could be opportunities in M&A and consolidation, but stringent selectivity will be paramount on both geographical and sector bases in order to avoid those areas that have been hit hard by the crisis and could experience a spike in defaults.

From an investor standpoint, private debt is an established, systemically and complementary asset class that could be included in strategic allocation analysis, as we also highlight in our recent long-term expected returns publication. Historically, it has delivered diversification, stable income streams, and consistent premium returns over liquid and traditional debt with modest drawdowns over the long term. Additionally, it has been a systemically important contributor to economic growth, thanks to the support it provides to the real economy, as the contribution of banks faded after the GFC due to more stringent regulation.

Private debt encompasses a wide range of opportunities (e.g., senior debt, direct lending, distressed debt, etc) which have different goals, underlying dynamics, and risk-return profiles. In 2021, investors could focus on safer strategies at the top of the capital structure where risk-adjusted returns are attractive, resulting in a key test arising for some limited partners (LPs) and general partners (GPs). Some GPs might even exit the market.

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The case for investing at the top of the capital structure

From an investment perspective, which trends do you envisage for private debt markets in 2021?

"A key trend we foresee on the supply side in 2021 is that markets will move from large underwriting in a more 'clubby' direction".

Market trends appear favourable for the asset class on both the supply and the demand side. On the supply side, banks and large asset managers played a key role at the height of the Covid-19 crisis, helping to prevent the health and economic crisis from evolving into a financial and liquidity one. In many European countries, they were in charge of providing state-backed liquidity to companies (e.g., guaranteed loans), together with evolving credit lines and granting covenant holidays to help corporates weather the storm. In France, they have granted €128bn – some 4% of GDP – of financing since the start of the Covid-19 crisis. The ECB's TLTRO scheme will help to lighten the burden on bank balance sheets. It is estimated that about 60% of corporates made a waiver request so far during the Covid-19 crisis. We have also seen a repricing of risk and an increase in provisions from banks, up 50-100bps, on average. This year, banks will be busy refinancing these guaranteed loans and we expect that any additional liquidity provision will be more difficult.

Another key trend we foresee on the supply side in 2021 is that **markets will move from large underwriting in a more 'clubby' direction.** Companies with weaker balance sheets, higher indebtness, lower profitability, and low visibility should find it more difficult to operate in such a context. To some extent, there will be room for private debt funds to participate and subscribe to those transactions in terms of 'club' deals. Liquidity provided by debt funds will be even more critical going forward.

On the demand side, there will be opportunities for **M&A and consolidation** in the coming year, as companies will have to rein in the additional debt they have incurred during the crisis and may do this through asset disposal. Alternatively, at some point, they will need to refinance or reschedule this debt. The funds that are providing such funding could be seen as an interesting tool for those companies. We will also see some acceleration in **investment trends** to strengthen local supply chains, as Covid-19 has highlighted the length and complexity of global supply chains. We could also see some **digital investment** to strengthen the digital infrastructure and tools in light of the new consumer trends that have emerged from the Covid-19 crisis.

Finally, regarding the investment perspective, we foresee a more lender-friendly market this year, as private debt funds will have more power and leeway to negotiate legal documentation. It will be a challenge to find the right companies to invest in, but private debt funds will have more negotiating power. **The investment perspective for 2021 appears challenging, but overall transactions should be of good quality.**

Which sectors have been hit hardest by the Covid-19 crisis, and which could benefit from it?

"The hardest hit sectors will recover only in 2022-23, on average, while investors could consider investing in the less affected sectors".

As has been the case for public markets, within the private debt market, the most hard hit sectors by the Covid-19 crisis have been travel, leisure, hospitality and aviation. On the other hand, the sectors that have benefitted from the crisis – or that have been less impacted – are healthcare, telecommunication, media, and technology (TMT), information technology (IT), food, agriculture and finance. We think that **the hardest hit sectors will recover only in 2022-23, on average, while investors could consider investing in the second group of sectors.** This trend is not specific to the private debt market, but could extend to every asset class, including for public markets.

"In 2021, investors might favour less risky strategies, as these still provide some interesting pick-up compared to what they could get in public markets".

What will be the impacts of the Covid-19 crisis on the quality of assets and on portfolio management?

The Covid-19 crisis is different from previous ones, as central banks have been quicker and bolder in their policy responses. In addition, the private debt market is currently much larger than it was in 2008, even though it remains relatively immature. There is much dry powder and it is easier to get capital today than it was after the GFC. The issue will be how to invest it wisely. In the aftermath of the crisis, markets could see a '**flight to quality**', with investors buying less risky strategies which still offer attractive returns (excess return is at 50-200bps) despite the recent price increases – we note that prices have almost returned to their pre-Covid levels.

As such, in 2021, investors might favour less risky strategies, as these still provide some interesting pick-up compared to what they could get in public markets. It will be key for investors **to diversify broadly across geographies and sectors and to invest only at the top of the capital structure – preferably secured deals – which offer attractive risk-adjusted returns.**

In addition, it will be paramount to structure transactions to mitigate the risks identified during the due-diligence process, considering local insolvency regimes and security-package enforcement. **Investors should seize short-term opportunities while sticking to the sustainable long-term strategy developed over the years.** From 2022, there could be appealing investment opportunities on **distressed debt,** as liquidity provided by central banks should be less ample.

Over the coming months, it will be key to differentiate between new investments and portfolio investments. For new investments, the legal documentation required will be more lender-friendly. With regard to portfolio management, we could see two phases: at the beginning of the Covid-19 crisis, everyone was supporting the companies they were investing in. In 2021, we will enter a new phase, with investors becoming more demanding, asking for more documentation and the repricing of risk to a level that is in line with the actual corporate risk, which has increased during the crisis alongside the general rise in corporate indebtness. Alternatively, investors might ask for more stringent limitations on dividends, additional covenant on minimum cash requirements, or for extra information undertakings. Despite such repricing, in 2022, we expect to see many waivers remain still in place for existing portfolios.

What do you expect regarding default rates?

Default rate projections have been revised down over the past few months. **At the height of the Covid-19 crisis, they spiked to 8-10%; now, most estimates are around 6%, on average, though dynamics will differ critically among sectors.** Those sectors that have been impacted heavily by the crisis should experience higher default rates, together with SMEs and companies with poor governance. **Risks to such an outlook will hinge critically on possible multiple waves of the virus and on a double-dip recession in 2021.** Active investors should try to avoid the sectors that were most impacted by the crisis.

How can investors discriminate among investment opportunities in order to be selective?

"Investors should seize short-term opportunities while continuing to follow the sustainable long-term strategy developed over the years".

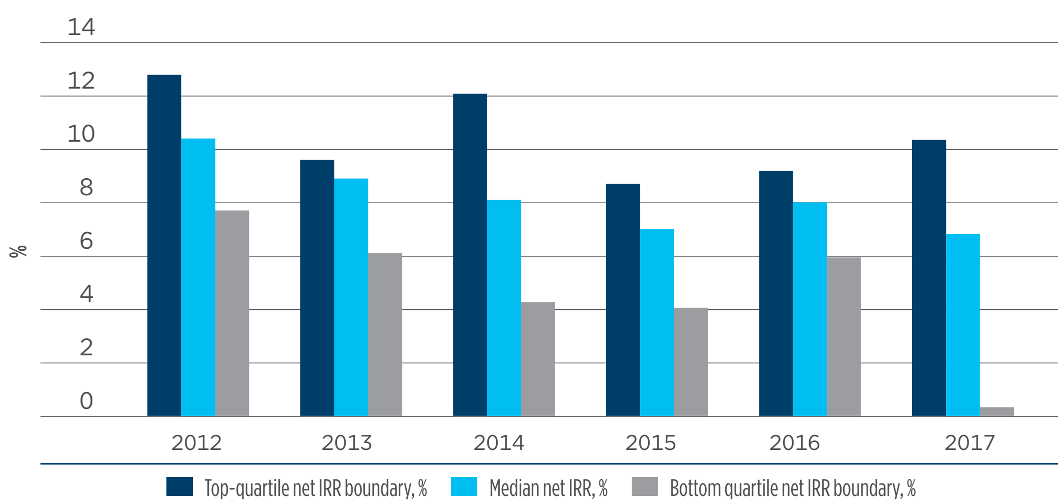
In order to be selective, investors should adopt the same practices they used before the Covid-19 crisis. Fundamental analysis will remain key to understanding a company's business model and its drivers. **Financial analysis** will also be critical to assessing a corporate's ability to generate cash flow and to service debt. With this information available – possibly gathered during the due diligence process – investors could have a solid basis in the legal documentation to define their investment's value. **Factors that were important before the crisis will remain critical. What may change is that some sectors may prove more resilient than others and investors should focus on them**. The focus will continue to be on sector allocation and diversification.

Those funds that survived the GFC managed to outperform in terms of internal rate of return (IRR). Do you expect this to be the case for the Covid-19 crisis as well?

Historically, median returns for Europe-focused private debt funds have been 7-10%. Higher yields have been associated with economic distress while lower yields have been associated with economic growth. Since 2012, returns have trended lower as a result of:

- A decline in LIBOR rates;
- Yield-spread compression; and
- Growth of senior loans relative to mezzanine, distressed debt, and special situations (within the Cliffwater Direct Lending Index, the share of senior loans increased from 38% at end-2009 to 71% at end-2020).

Figure 1. Europe-focused private debt funds, internal rate of return

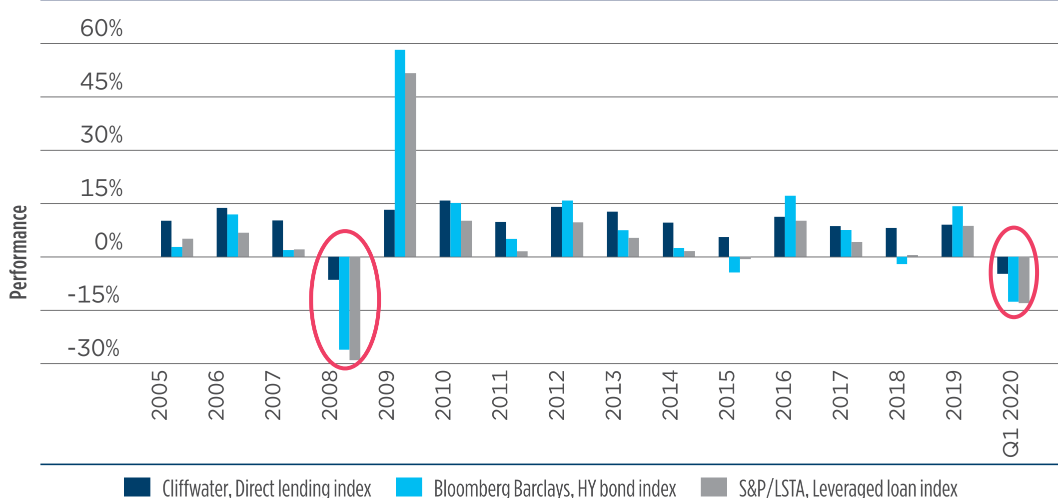


Source: Preqin Pro, Amundi. Data as of 30 September 2020.

"Private debt funds have proved more resilient than both the high-yield and the leveraged-loan markets during the GFC and the Covid-19 crisis".

While more resilient, European direct lending also experienced a downshift in direct lending margins, from 7-8% in 2017 to 6-7% in 2019, according to Proskauer. Over 500 direct lending deals were completed in 2019 for an overall size of around €50bn. Despite this downtrend in returns over time, **private debt funds proved more resilient than both the high-yield and the leveraged-loan market during the GFC and the Covid-19 crisis.**

Figure 2. Resilience during a crisis



Source: Cliffwater, Bloomberg Barclays and S&P Capital IQ. Data as of 17 February 2021.

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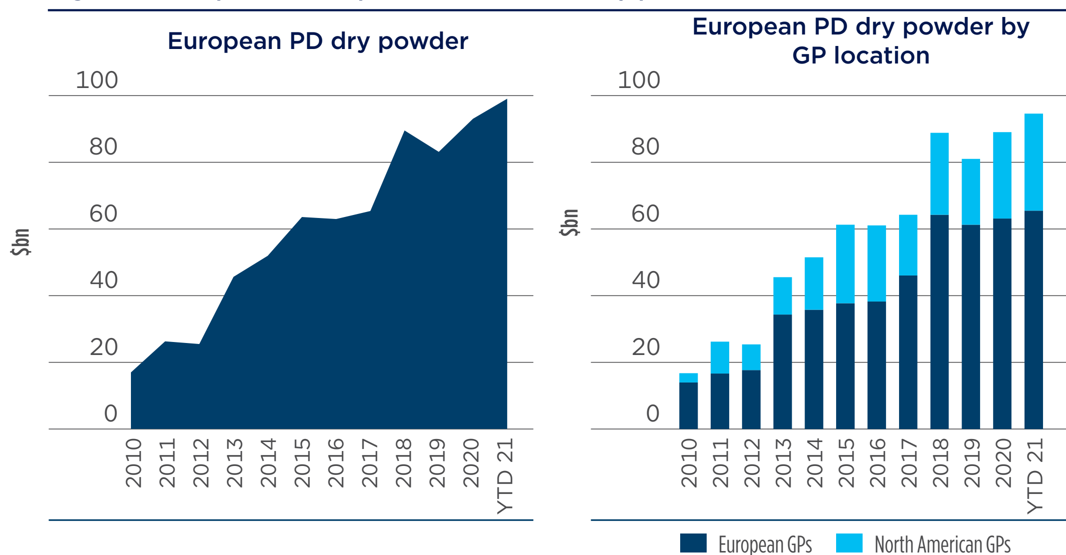
Despite this similarity, investors should bear in mind that the GFC and the Covid-19 crisis are different in nature. The former originated from the financial system and saw banks retreat from the market, so funds that were able to fill that gap, enjoying many opportunities. Today, the banking industry is in better shape, funds have dry powder, and clients are more familiar with turnaround or restructuring situations. In addition, there is more competition. **As such, post-Covid-19 vintages may not be as good as the post-GFC ones.** As dry powder is ample, investors should be able to adapt and invest more quickly than was the case after the GFC.

Figure 3. Europe-focused private debt funds, dry powder, $bn



Source: Preqin Pro, Amundi. Data as of 31 December 2020.

"We believe that economies of scale and building the right infrastructure will be key themes going forward".

However, there is no direct correlation between the capital raised and the investment opportunity. **We believe that economies of scale and building the right infrastructure will be key themes going forward.** We could see some consolidation among the largest players that have established, long-term relationships with large LPs. Some GPs might exit the market.

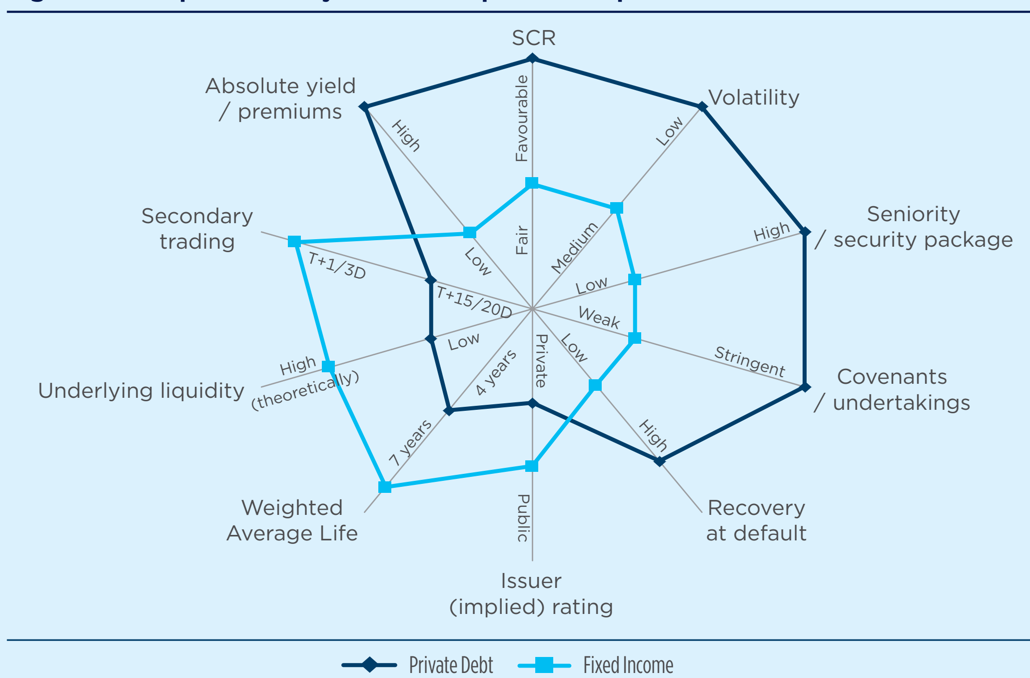
Private debt in investor portfolios

Private debt vs. public fixed income markets

Private and public debt markets exhibit complementary features. The former offers higher average yields than the public fixed-income market, with lower volatility and shorter average debt lives: four years compared to seven for public fixed income. This will make private alternatives attractive for issuers. At the same time, the solvency capital requirement is more favourable for private debt markets, covenants are more stringent, and seniority packages are higher. Unlike for issuers of public fixed income securities, usually a rating is not available for private debt issuers even though typically it is equivalent to speculative grade. Generally, private-debt issuers are low- to mid-sized, with an enterprise value ranging between €50m and €1bn. Private debt securities are negotiated on the primary market and not broadly syndicated to a large group of investors (club deal approach). Trading private debt securities on the secondary market will require longer settlement times, at 15-20 days, on average, compared to one to three days for public markets. As such, private debt markets are less liquid than public markets, but enjoy better prospects of recovery at default. Finally, private debt funds are typically closed-end, in limited partnership with defined investment and harvest periods.

"Private debt has different features from public debt, that can make it complementary in an investor's portfolio".

Figure 4. Complementarity features of public and private debt markets



Source: Amundi as of 13 February 2021 SCR=Solvency II capital ratio.

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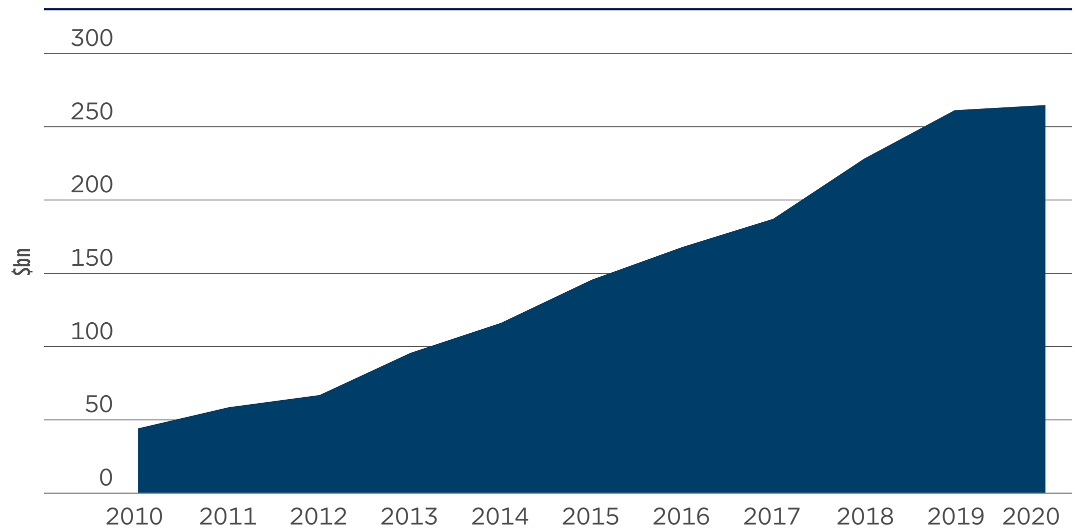
Investor trends: a growing and transforming market

Patrizia ANTONINI
Amundi Strategy – Business Intelligence

Market growth and dry powder resurgence

The **European private debt market has been growing rapidly since the GFC. It reached an overall size of $264bn as of December 2020.** European fund managers (general partners, GPs) control 72% of the assets under management (AuM), with North American players managing the remaining 28%.

Figure 5. Europe-focused private debt, AuM, $ billion



Source: Preqin Pro, Amundi. Data as of 31 December 2020.

Market growth has been exceptionally strong over the past five years, recording double-digit three-year growth rates. This trend should continue over the mid/long term. According to a Preqin investor survey for the second half of 2020, 48% of investors anticipated to maintain or increase their allocation to private debt in the short term.

"Dry powder has reached almost $99bn in 2020, recovering from the slowdown experienced over the first half of 2020, but the capital has been concentrated in the hands of a few GPs with recognised brands."

At the same time, the shift from public to private is continuing and there are many unvested funds (dry powder) to be put to work. **Dry powder has reached almost $99bn in 2020,** recovering from the slowdown experienced over the first half of 2020, but the capital has been concentrated in the hands of a few GPs with recognised brands. Once markets normalise, GPs with significant dry powder should be able to capture good opportunities at competitive prices, as some of the best investments get done during periods of downturn and then recovery. European GPs can be the main beneficiaries of this growth, as they manage 75% of the European private debt dry powder pool, while American GPs cover 25% of the market.

Covid-19 impact on European PD: short-term challenges followed by a likely long-term reversal

The **Covid-19 pandemic has impacted negatively the asset class.** Despite the huge amount of capital at work, there has been a significant short-term slowdown in all activity: distribution of capital to limited partners (LPs), fundraising, and deals. **The distribution of capital to LPs has been declining in the short term,** a scenario that investors have not experienced for a long time. LPs' capital calls have not stopped yet because the calls are not primarily driven by new deals. Instead, there has been a shift

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in financing arrangements. GPs have learned lessons from the last crisis and are trying to make their capital calls now, before LPs start asking them not to do so. Europe-based fund managers are fully adopting this behaviour.

"A fundraising slowdown is affecting all strategies, with different levels of intensity."

The **Covid-19 pandemic has created challenges for fundraising in the short term,** with a quick drop in the amount of capital raised by GPs, as investor behaviour changed in reaction to the Covid-19 pandemic. The majority of LPs adopted a wait-and-see approach and have been rebalancing, most redirecting capital allocation towards larger, more established funds. In the short term, few have been changing commitments to the asset class, reducing the number of funds or cutting the size of commitments.

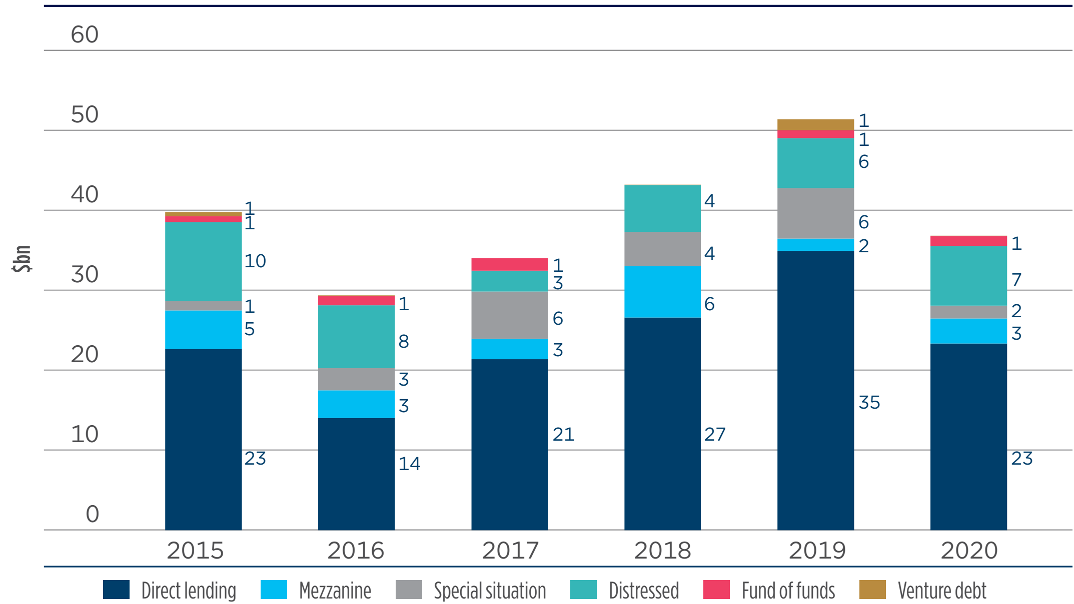
Despite this, GPs agree that such trend should revert over the mid/ term. The rationales behind this thinking are robust:

- Liquidity is abundant and fundraising will be supported by this liquidity.
- Good returns will be available in just a few markets, with private debt being one.
- LPs have realised that private debt plays a key role in financing the real economy.
- During the Covid-19 crisis, GPs have also granted payment facilities or deferred interest payments to avoid liquidity crises and to support government measures so they are happy to invest.

As a consequence, the shift towards private debt continues, even if fundraising and performance have been impacted negatively by the crisis.

A **fundraising slowdown has been affecting all strategies, with different levels of intensity.** European direct lending, distressed and mezzanine funds have continued to raise capital, while special situations are seen as an opportunistic option. Venture and private debt fund of funds (FOFs) are not judged a priority.

Figure 6. Europe-focused private debt funds fundraising by strategy, $ billion



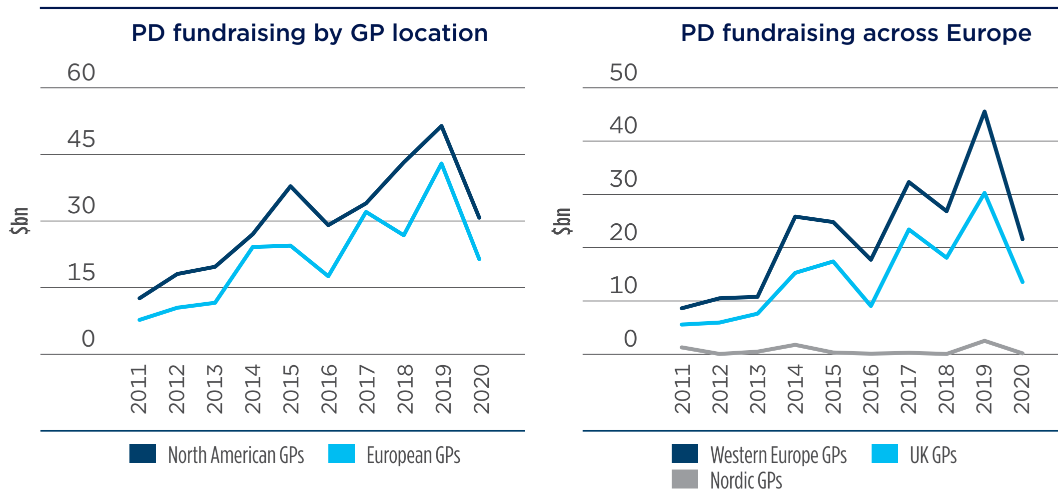
Source: Preqin Pro, Amundi. Data as of 31 December 2020.

"The fundraising slowdown has been impacting European GPs more than North American ones."

The fundraising slowdown has been impacting European GPs more than North American ones. American GPs collected 42% of the fundraising pool, while European GPs captured 58%. Among European GPs, those based in the United Kingdom and Western Europe have been most active.

"North American GPs have a strong focus on direct lending and distressed debt, while they have abandoned mezzanine and special situation, and do not cover venture debt and fund of funds."

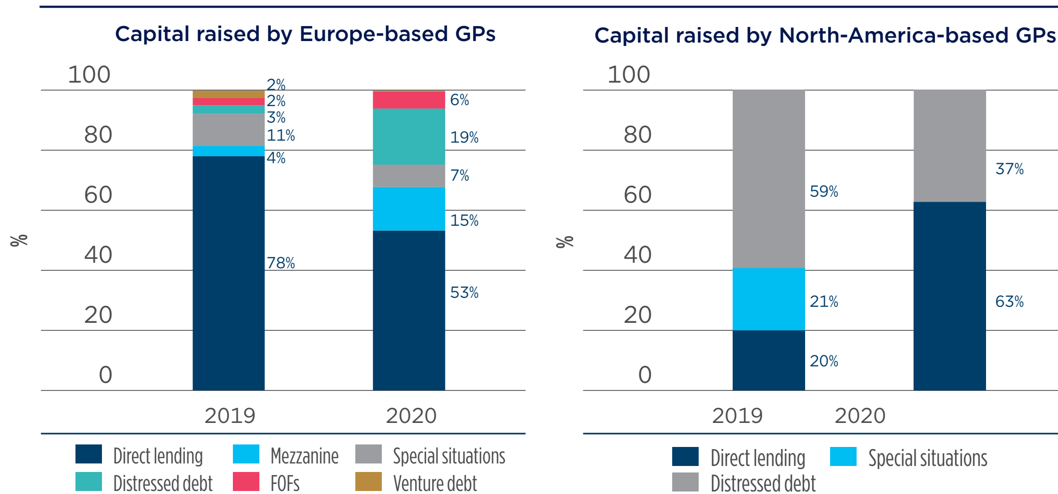
Figure 7. Europe-focused private debt funds fundraising by GP location, $bn



Source: Preqin Pro, Amundi. Data as of 31 December 2020.

North American GPs have a strong focus on direct lending and distressed debt, while they have abandoned mezzanine and special situation, and do not cover venture debt and fund of funds. **European GPs** privilege direct lending, mezzanine, special situations, and recently have been adding into distressed debt and, marginally, on fund of funds.

Figure 8. Europe-focused PD funds, fundraising by strategy and GP location



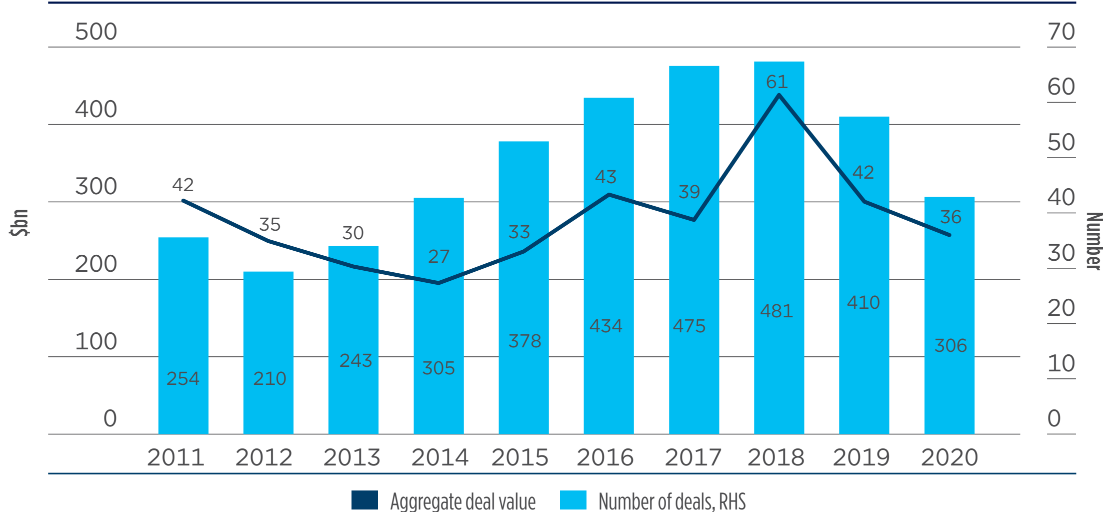
Source: Preqin Pro, Amundi. Data as of 31 December 2020.

"The Covid-19 crisis has accelerated trends that were already present in the market: now it is more difficult for a fund to reach the closing."

The Covid-19 crisis has accelerated trends that were already present in the market: **now it is more difficult for a fund to reach the closing.** GPs based in Europe needed more time (21 months) for closing a fund than American GPs (15 months), as of December 2020. **The number of funds in the market has been rising, as has their average size.** As of December 2020, there were 130 funds for an aggregate target size of $97bn. The majority of the funds (88%) is managed by GPs based in Europe, with only 11% in the hands of North American GPs. The latter search for economy of scale, as shown by the fact that the average fund size is up $2.2bn, corresponding to almost three times that of European funds ($0.8bn).

A **significant slowdown has occurred in the number of deals and aggregate deal values.** In the short term, most deals at an advanced stage should go ahead, but they will take more time to complete. Given the difficulty of valuing businesses at present, **GPs seem to be adopting a wait-and-see** approach. As the economy recovers, deal activity is expected to rebound sharply.

Figure 9. Europe-focused PD funds, aggregate number of deals and value



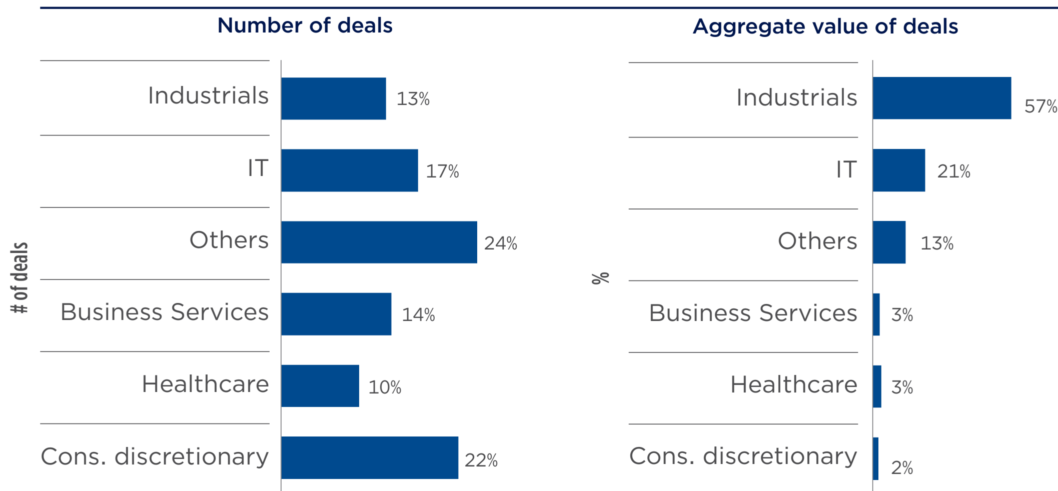
Source: Preqin Pro, Amundi. Data as of 31 December 2020.

"Given the difficulty of valuing businesses at present, GPs seem to be adopting a wait-and-see approach. As the economy recovers, deal activity is expected to rebound sharply."

Investment selection opportunities amid sector divergences

The activity slowdown has been affecting sectors unevenly. It has exacerbated long-term trends and driven the investment selection on challenges and opportunities. Given the current uncertainty, private debt GPs will need to be cautious. In 2020, the majority of deals were concentrated in few **key sectors, including industrials, information technology, healthcare and business services. Key vertical deals** have occurred in manufacturing, cloud computing, e-commerce, mobile apps, healthcare technology, and virtual reality.

Figure 10. Europe-focused PD funds, number of deals and value by sector



Source: Preqin Pro, Amundi. Data as of 31 December 2020.

Performances and multiples should fall in the short term. LPs and GPs alike recognise that returns on existing portfolios will decline as a result of the impact of Covid-19. However, they are not seeing a reduction in targeted returns for new investments because there should be attractive investments to be made in the aftermath of the crisis.

"In 2020, the majority of deals were concentrated in few key sectors, including industrials, information technology, healthcare and business services."

LPs and GPs are bullish about medium- to long-term plans, with a continued trend towards higher allocations. All GPs agree that, in the short term, the best opportunities are in distressed debt, special situations, and direct lending. Geographically, they find the most appealing opportunities in the United States, Western Europe ex-United Kingdom, and the Nordics. All GPs agree that, over the mid/long term, direct lending should be the most secure and appealing strategy for Europe-based investors. To sum up, **European private debt markets remain attractive, despite the negative impact of the Covid-19 crisis on the short-term outlook.**

Who is investing in European private debt?

What is the investor profile?

The number of investors in European private debt is growing quickly, moving from 1,000 in 2015 to 2,243 over the last five years. **The trend is expected to continue.** One-third of LPs expect to increase commitments to private debt in the coming year, highlighting their confidence in the market and knowledge that funds that have invested through downturns and recessions have historically provided the best returns. **LPs' intentions point to further growth over the medium term for the asset class, with a 2% median current allocation vs. a 3-4% target.**

The most active segments in the European private debt space are **pension funds, foundations and insurance companies.** They represent 63% of the aggregate investor pool. Among Europe-based investors, banks, wealth managers and family offices seem to be more active than foundations. Unsurprisingly, **the majority of investors** subscribing to European private debt **have headquarters in North America (57%) and Europe (31%),** mainly in the United Kingdom, Germany, Italy, France, and Switzerland. Institutional and wealth managers based in Asia and Rest of World (RoW, 12%) invest marginally in the asset class.

Why are they investing in private debt?

Private debt offers LPs a wide spectrum of investment solutions with different risk/return and liquidity profiles from direct lending, mezzanine, distressed debt and special situations to venture debt. Investors accept liquidity constraints for the duration of their investment in exchange for major benefits, which include:

- Private credit strategies that offer **better downside protection**;
- Less volatility than traditional fixed debt (both investment grade, IG, and high yield, HY); and
- **Alternative premiums.**

"LPs and GPs are bullish about medium- to long-term plans, with a continued trend towards higher allocations."

Private credit strategies deliver **reliable income** due to recurring cash flows. **Private debt strategies can help achieve better portfolio diversification due to the low correlation with other asset classes.** In the current environment, private credit strategies offer clients the embedded **option of restructuring pricing and terms or the option to exit at (or least at) par.**

Private debt can **finance the real economy and SMEs.** During the Covid-19 crisis, we have seen some sovereign wealth funds partnering with GPs to set up Europe-focused direct lending platforms (e.g., Mubadala Investment Company has partnered with Baring) or governments promoting private debt vehicles (e.g., the Italian government is pushing the new PIR, or individual savings plans) to support the real economy.

"LPs' intentions point to further growth over the medium term for the asset class, with a 2% median current allocation vs. a 3-4% target."

Which are their main concerns?

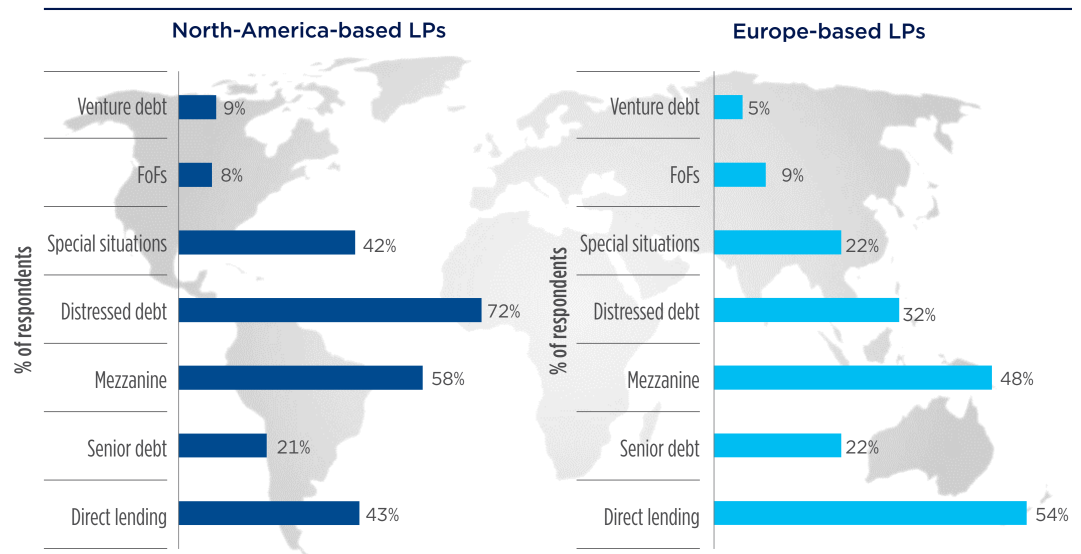
Investors are concerned about the **credit profiles of companies** and about the impact of **credit spreads**. These have seen widening trends throughout 2020, as lenders have grown more worried about the economic outlook and the ability of borrowers to service their debt.

What are the investor preferences?

Investor preferences depend on the LP's location and on the time horizon. The majority of the **LPs based in North America** invest in European distressed debt and mezzanine. They approach special situation strategies opportunistically to benefit from the Covid-19 fallout. Direct lending is moderately popular, while venture debt and fund of funds are marginal.

Europe-based investors are cautious, privilege direct lending, mainly senior debt and mezzanine, being moderately positive on distressed debt and on special situations. Fund of funds business makes sense in Western Europe while venture debt is at early stages everywhere. **Short term,** the outlook is positive, with the majority of the investors thinking the best opportunities over the next twelve months will be in developed markets and in the **United States, Western Europe ex-United Kingdom, the Nordics** and in **distressed debt and special situations.**

Figure 11. Investors by region and strategy, as a share of respondents



Source: Preqin Pro, Amundi. Data as of 30 September 2020.

"Europe-based investors are cautious, privilege direct lending, mainly senior debt and mezzanine, being moderately positive on distressed debt and on special situations."

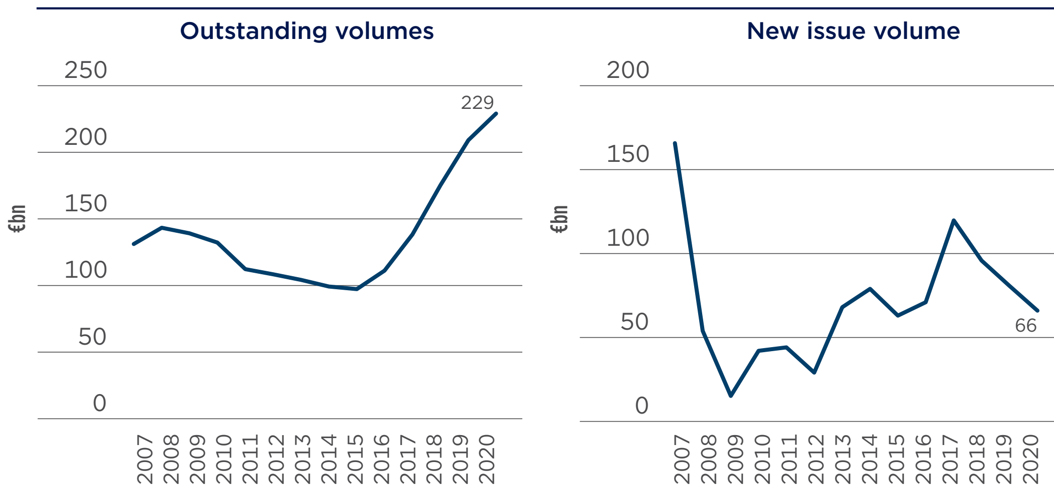
The majority of investors (69%) seek **diversified strategies, with a multi-country** and **multi-sector focus.** Given the current uncertainty, private debt investors have been more cautious: since the beginning of the Covid-19 crisis, the focus has been on technology, industrials, healthcare, business services and food. Investors have accessed the asset class through several vehicles, with up to 59% preferring private closed funds and 16% separate accounts, while 25% appreciate co-investments, which proved particularly popular among European investors.

Leveraged loans: key trends ahead

What is going on in the European leveraged loans market?

The outstanding volume for European leveraged loans reached €229bn as of end-2020, compared with over €400bn for the European HY bonds market. The market is dynamic, with double-digit growth over the last three years (18.4%). The Covid-19 crisis has accelerated this trend. **New issuances** reached €66bn as of end-2020, **resulting in a setback** in 2020 (-18.1% YoY). Fund managers agree the trend should reverse in the short term.

Figure 12. S&P European Leveraged Loans Index (ELLI), € billion

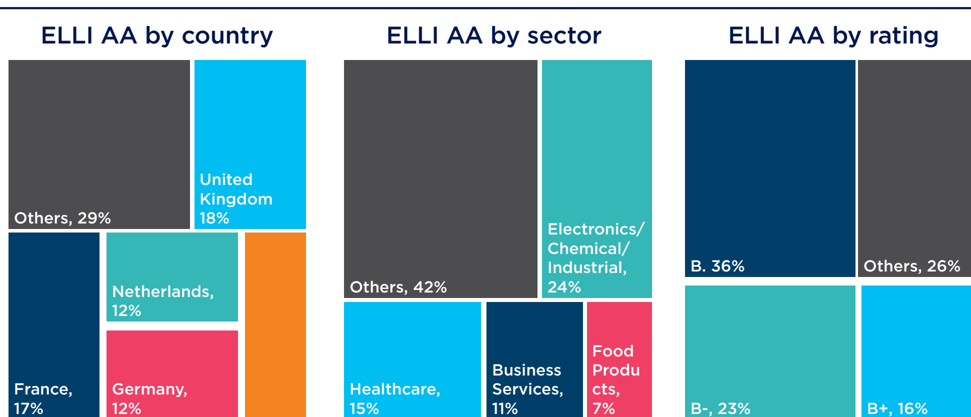


Source: Standard & Poor's, Amundi. Data as 30 September 2020.

"In the current environment, the asset allocation is skewed towards secured loans, secured countries, and the most resilient sectors."

In the current environment, the asset allocation is skewed towards **secured loans** (rated B+, B, and B-), **secured countries** (United States, United Kingdom, Germany, France, and the Netherlands), and the **most resilient sectors**, such as healthcare, electric/electronic, chemical/plastics, business services, industrials, and food. European leveraged loans' **yield to maturity** – 4.3% as of December 2020 -- is appealing to investors. It is higher than for both European HY and IG bonds. As rates remain near zero or even below in major countries, loan yields are beginning to attract new investors to the asset class.

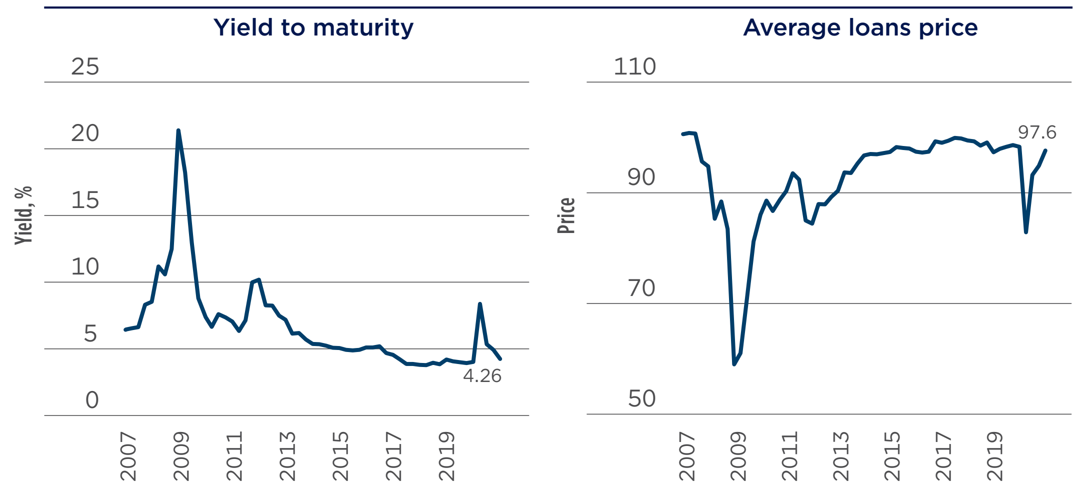
Figure 13. ELLI index asset allocation, end-2020



Source: Standard & Poor's, Amundi. Data as 31 December 2020.

The loans market is repricing and total return is recovering. As at end-2020, it stood at -0.75%, higher than HY at -2.6%. Price moves reflect optimism: aggregate prices now sit less than few points off February highs.

Figure 14. ELLI index, yield to maturity and total return trends



Source: Standard & Poor's, Amundi. Data as 31 December 2020.

"The outlook is positive: we would be constructive on loans. The time to invest is now."

We see **good signals** in the markets:

- **Leverage is decreasing,** with low interest rates and QE contributing to lowering fixed income yields and, in a domino effect, lowering financing costs of leveraged companies, as more investors compete to finance these issuers in a 'search for yield' strategy.
- **Defaults remain reasonably benign in European loans.** As of December 2020, the twelve-month default rate was 2.57% for ELLI based on par amount. It is difficult to see default rates falling from here, although expectations for default rates in 2021 have generally been revised down by most investment banks, as we have had more clarity on government support measures/monetary policy feeding into lower borrowing costs.
- **Loan contracts became more protective for lenders,** as shown by the impressive growth of the cove-lite contract volume. As a result, investors appear to prefer lower-rated loans to HY on better fundamentals and security packages.
- **Rise of buying opportunities.** In the short term, 'switches' from lower- to higher-rated paper have created a rating bifurcation of prices which can be a source of interesting buying opportunities over both the short and the long term.

The outlook is positive: we would be constructive on loans. The time to invest is now.

Do investors agree with this view?

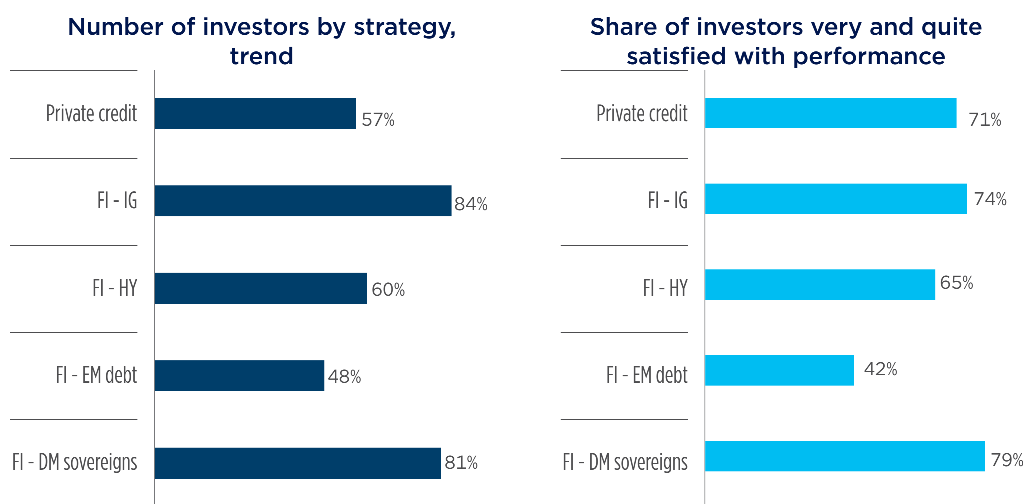
In the current crisis, many investors are adopting a wait-and-see approach, with most rebalancing but one in three changing asset allocation. A large portion of LPs recognise that their ALM profile is deteriorating and are searching for reliable income among credit strategies. According to a Bfinance asset owner survey, the majority of investors are satisfied with the performance of active fixed income strategies in developed markets. A large portion of institutional ones are **happy with IG strategies**. Most LPs are **moderately satisfied with HY** for high credit risk exposure, with many having concerns about emerging market debt. LPs that are searching for credit opportunities **appreciate** the performances delivered by **private credit strategies** and report a strong **interest in leveraged loans.**

"Leveraged loans as a hybrid solution between private and public markets, seem to be the right answer to investor income needs and downside risk protection."

Why the interest in leveraged loans?

Leveraged loans as a hybrid solution between private and public markets, seem to be the right answer to investor income needs and downside risk protection. The outlook over the next twelve months is positive for credit opportunities.

Figure 15. Asset owners' levels of satisfaction



Source: BFinance Asset Owner Survey 2H 2020, Amundi. Data as of September 2020. Note: the universe is composed of 368 investors representing $11tn in value, with 45% based in Europe, 34% in North America and 21% in Asia.

Focus on ESG reporting

"The majority of LPs consider responsible investing and ESG issues important to their investment strategies, but only 29% of investors in European private debt have an ESG programme in place or plan to institute one within the next twelve months for their private debt investments."

The discussion around environmental, social and governance (ESG) within private debt is lively. Investors -- conscious of the relevance of ESG investing -- are scrutinising funds to ensure they meet requirements in this area. Covid-19 raised investor awareness about responsible investing and ESG. The majority of LPs consider responsible investing and **ESG** issues important to their investment strategies, but only 29% of investors in European private debt have an ESG programme in place or plan to institute one within the next twelve months for their private debt investments. All agree ESG issues have become more important for the future because of the Covid-19 pandemic.

Fund managers are increasingly incorporating ESG principles into their investments. It is evident that ESG policies can have a significant influence on investor decision-making, but both investors and fund manager are not ready yet to adopt ESG principles across the board.

The issue for fund managers is how to implement ESG considerations in the investment process and to track the impacts. Principles for Responsible Investment (PRI) offer same standards, and some European GPs -- mostly market leaders -- are adhering consistently to them. We analised the sustaibility reports of the top five GPs in Europe, published on an annual basis. The papers are made up of five sections that cover these topics:

- commitment to ESG;
- company profile and major ESG achievements;
- ESG list of material topics, governance, investment process and policy;
- a table with the ESG impacts at the company, asset class and fund level; and
- philanthropy, which is optional.

All GPs provide case studies – including at the single-fund level -- to show the impacts of their actions, as the market is showing no tolerance for 'greenwashing':

- The **first section** of the sustainable reports shows the **top management commitment to responsible investment and ESG**. There is a short description of a company's vision and the main ESG goals are reported, consistent with UN Sustainable Development Goals (SDGs). The strategic guidelines are optional -- only few players highlight them. It is compulsory to show the company's values, outlining their consistency with ESG goals. The history of ESG-SRI (socially responsible investing) integration underscores the progress in the field. The major initiatives reflect the seriousness of a company's commitment to sustainability.
- In the **second section** the company highlights the different sorts of expertise (i.e., private debt, infrastructure, etc), the major **ESG achievements at the corporate level and by expertise,** and tracks the **awards** from recognised international organisations, such as PRI rating and Woman Association.
- The **third section** shows the **ESG approach, reports the list of the material topics, and describes the governance, the investment process and policy.** It is not compulsory to highlight the scoring methodology. We notice that all GPs have set up **sustainability committees and dedicated teams**. Committees meet quarterly, provide input to the global strategy, and monitor progress. **Corporate and investment responsibility teams** are responsible for developing and implementing the strategy, for reporting results to the committees, and interacting with the investment teams. The **investment teams** implement and monitor responsible investing and ESG at the fund level, at the expertise level, and at the firm level. All GPs report about their **investment process** and **the sustainable investment policy, both customised by expertise (i.e., private debt).** We show an example of how to incorporate ESG issues into the private debt investment process.

"The issue for fund managers is how to implement ESG considerations in the investment process and to track the impacts."

Table 1. Private debt investment process, best practices

	Typical considerations for PD investment	ESG considerations	Engagement activity
Pre-deal cycle	Develop statement of investment principles Define investment universe (geography, sector, credit strenght, deal size etc...)	Develop responsible investment/ESG policy Define ESG screening criteria Educate external agents on RI policy Define ESG impact or thematic requirements (specialist funds only)	Not applicable
Pre-transaction			
Phase I **Origination and pre-assessment**	**Sourcing and origination:** generate investment ideas, identify investment opportunities, engage agents to source deals **Pre-assessment:** conduct high-level due diligence, identify any red flags for further consideration in due diligence process, take decision to proceed to due diligence phase	Apply negative ESG screens Identify any ESG red flags for consideration in due diligence process Consult ESG team or indipendent advisory committee Consider jurisdictional ESG issues such as local governance, legal systems, ESG policy and regulation	Engage senior management of prospective borrowers for disclosure of potential ESG risks
Phase II **Due diligence and investment approval**	Conduct credit analysis Conduct in-depth due diligence Appoint technical consultants Determine interest rate Write up investment memorandum Negotiate/finalise terms Take investment committee decision Transact	Conduct ESG due diligence Conduct ESG technical assessment Integrate ESG summary in investment memorandums Educate investment committee on relevant ESG considerations Include ESG reporting requirements for borrowers in terms Determine ESG monitoring needs	Request management changes relating to ESG (e.g., board independence) Arrange regular dialogue with borrower management Educate borrowers about investor ESG needs Define requests for ongoing monitoring of pertinent ESG criteria

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Post-transaction			
Phase III **Investment holding period**	Ensure ongoing borrower reporting and monitoring Address developments and incidents that pose risks/potential defaults Provide technical assistance Undertake restructuring process (common in distressed debt)	Carry out ongoing ESG monitoring Support improvements that address ESG risks Measure ESG outcomes linked to investment (mostly impact funds) Identify potential positive impact funds) Ensure manager ESG reporting to investors	Include ESG agenda itens in regular borrower meetings Manage ESG risks relating to potential defaults
Phase IV **Exit**	Consider possible refinance options Clouse out process	Undertake ESG impact assessment (impact funds) Facilitate manager ESG reporting to investors Consider internal close-out process including ESG lessons learnt	Consider close-out process with borrower, including ESG lessons learnt

Source: Unpri.org,Spotlight on responsible investment in private debt, 2018.

- In the **fourth section, ESG impacts** are tracked. **Data are quantitative;** key performance indicators (KPIs) are reported at the single-security level and are aggregated by fund, expertise and firm. We note a convergence to a set of KPI that are easy to track. The most common **environmental KPIs** are: CO_2 emissions avoided, amount of business travel avoided, reduction in paper consumption (%), percentage of waste treated or diverted, and reduction in consumption of water or electricity (%). The most significant **social KPIs** are: share of women in the company, on the board, in the management team, and in investment team. Also tracked are the number of hours training done in an academy or a millennial club, and the 'give days' offered for charity. The most relevant **governance KPIs** are: number of companies that implement compliance policies, anti-bribery policies and anti-corruption policies, as well as with diversity policies, healthy and safety policies, waste management policies, and environmental policies.
- The **fifth section** is optional. It refers to **philanthropy** and includes the main initiatives, the main achievements, and a link to no-profit associations created by GPs.

Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Bond ratings:** If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Closed-end fund:** In these funds, there is no internal mechanism for investors to redeem their subscriptions. Investors' subscriptions are tied up for the lifetime of the fund unless investors can find a buyer for their shares on the secondary market.
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in the opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Covenant:** It is a promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out or that certain thresholds will be met. Often they relate to terms in a financial contract -- such as a loan document or bond issue -- stating the limits at which the borrower can lend further.
- **Covenant-lite:** A covenant-lite loan is a type of financing that is issued with fewer restrictions on the borrower and fewer protections for the lender. By contrast, traditional loans generally have protective covenants built into the contract for the safety of the lender. On the other hand, covenant-lite loans are more flexible with regard to the borrower's collateral, level of income, and the loan's payment terms.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Default rate:** The share of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofA indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for corporate market are ICE BofA.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **Drawdown:** The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough.
- **Dry powder:** This refers to cash reserves kept on hand by a company, venture capital firm or individual to cover future obligations, purchase assets or make acquisitions. Securities considered dry powder could be Treasuries or other short-term fixed income investments that can be liquidated at short notice in order to provide emergency funding or allow an investor to purchase assets.
- **EBITDA:** Earnings before interest, taxes, depreciation, and amortisation.
- **GP:** General partner, a fund manager that raises capital from institutional investors through open-ended or closed-ended fund structures or non-fund vehicles with fund-like economics.
- **IRR:** Internal rate of return. This is a method of calculating an investment's rate of return. The term internal refers to the fact that the calculation excludes external factors, such as the risk-free rate, inflation, the cost of capital, or financial risk.
- **LIBOR rate:** The London Interbank Offered Rate (LIBOR) is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.
- **LP:** Limited partner, an institutional investor that commits capital to private funds through limited partnerships.

- **Market depth:** It is the market's ability to sustain relatively large market orders without impacting the price of the security.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Small and medium-sized enterprises (SMEs):** They are businesses whose personnel numbers fall below certain limits.
- **Solvency capital requirement (SCR):** A solvency capital requirement (SCR) is the total amount of funds that insurance and reinsurance companies in the EU are required to hold. SCR is a formula-based figure calibrated to ensure that all quantifiable risks are considered. The SCR covers existing business as well as new business expected over the course of twelve months.
- **Spread:** The difference between two prices or interest rates.
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period. They offer long-term funding at attractive conditions to banks to further ease private sector credit conditions and stimulate bank lending to the real economy.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Waiver:** It is a legally binding provision where either party in a contract agrees to forfeit voluntarily a claim without the other party being liable.

Important Information

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