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# Private Credit vs. Public Debt

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*There are a plethora of factors to consider when comparing the distinctions between private and public debt, and between middle market loans and their broadly syndicated counterparts.*

Yield is just one of them. Others include interest rate risk, credit risk, liquidity, volatility relative to market moves, security, and duration risk.

Let's begin with interest rates. The vast majority of active fund managers have operated in an almost entirely bond-friendly rate environment. Hard to imagine that in April 1980 (three months before this author launched his banking career), the prime rate hit 20%. Eighteen months later, 30-year Treasuries reached a high of

14.7%. Today those rates stand at 4.75% and 3.13%, respectively.

Will the next thirty years mirror the post-1980 period, with rates rising back to double-digits, or will structural changes in our economy, as well as nationalist trends globally, dampen growth and rates for years to come?

Regardless, it's doubtful that fixed income instruments will benefit from the same tailwinds they've enjoyed since the Carter Administration. That's one of the reasons institutional investors have jumped into floating rate assets, particularly as the Fed seems to be moving towards a more hawkish tone on rate hikes.

Another element influencing loan vs. bond decisions is where we are in the business cycle. The Trump trade may have pushed a potential recession off a bit further, but it also may have raised the height from which the economy could eventually fall. That worry has motivated funds who seek more safety at the top of the capital stack. Leveraged loans, as we know, are secured by the assets of the issuer, while high-yield bonds are unsecured and in a subordinated position.

Default rates across loans and bonds have eased as energy-related issuers have either restructured or healed with last year's uptick of

oil prices. But experienced investors know that losses incurred by unsecured bond holders tend to be higher than for secured loan holders. The only question is when a downturn will begin.

That’s why, amid the multitude of unknowns investors face over the next several years, it’s helpful to focus on the known characteristics of private and public credit alternatives.

## YIELDS EXAMINED

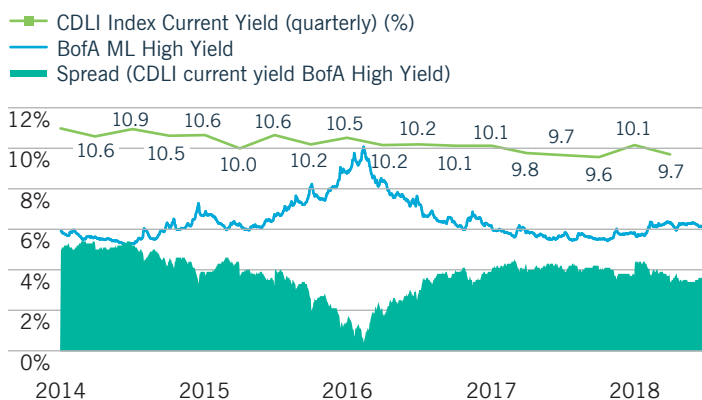
Now we turn to relative yields.

This example shows, since 2016 there’s been a steady increase in the differential between junk yields (as measured by the BofA ML HY Index) and middle market loans (per the CDLI Index).

### Relative value<sup>1</sup>

*The attractiveness of the middle-market loan asset class is highlighted by its consistent premium over traditional high yield bonds.*

#### High Yield vs. Middle Market debt held by BDCs<sup>2</sup>



Sources: DebtWire, Cliffwater LLC

\* As of 31 December 2017, the CDLI index includes USD 91bn in assets, with more than 6000 loans – approximately 61% senior debt, 25% subordinate debt, 9% equity and 5% other. BDC<sup>2</sup> eligibility to be included in the Index is at least 75% of total assets represented by direct loans as of the Index valuation date. All the yields are unlevered. CDLI Index yield is total interest income of all BDCs<sup>2</sup> covered, divided by their total assets, reported quarterly (10.1% as of 31 December 2017). CDLI data is quarterly while BofA Merrill Lynch HY Effective Yield is daily.

Besides pointing to the stable returns of senior secured credit, it demonstrates how bond yields fluctuate with market sentiment.

Investors were spooked in early 2016 by fears that anemic economic growth would slow to a recession. That sent junk bond yields soaring and prices dropping. Equilibrium was regained

as the year went on, but fixed income accounts were buffeted in the event. Private credit funds weren’t as severely affected by those same influences.

Indeed, commentators suggest that with equities riding at record levels, volatility is poised to make a comeback. Currently the VIX is around 14.12, having settled down since its near-term peak of 22.5 just before the November election. As we highlighted in The Lead Left’s 2017 outlook, any number of global surprises could trigger a VIX uptick.

Note also that the current loan yield is generated by assets held by BDCs<sup>2</sup>. The dividend requirements of those vehicles tend to prod their managers towards higher coupon loans. But otherwise the CDLI Index is an excellent proxy for private credit. (See the Lead Left Spotlight for our interview with Cliffwater’s CEO Steve Nesbitt for more).

What’s a more normalized yield expectation for middle market senior debt? Thomson Reuters LPC (Loan Pricing Corporation) reports leveraged yields for first-lien term loans weighed in around 6.7% for the quarter ended Jan. 31. S&P LCD (Leveraged Commentary & Data) data shows a similar yield of 6.6% (90-day rolling as of March 2).

Second lien observations for smaller deals are few and far between, but S&P pegs those yields somewhere around 11.69%. Unitranche, also a tough bird for which to get good metrics, is generally found to be in the Libor (L)+550-600 range, or all-in of 7.5-8.0%.

Compare that with the “public” loan equivalent of high-yield bonds – the broadly syndicated loan market. This is effectively public debt because many borrowers are so-called cross-over bond issuers, and/or carry public debt ratings. The debt is also widely traded with tranches over \$500 million. Recent LPC and LCD yields for large, liquid loans are 5.7% and 5.62%, respectively.

That represents a major discount to the middle market, thanks to the “illiquidity premium” placed on smaller loans by institutional investors. And as our Spotlight guest points out, middle market lenders can deliver real value by having direct influence on deal structures and

pricing – something you can't manage from a Bloomberg terminal.

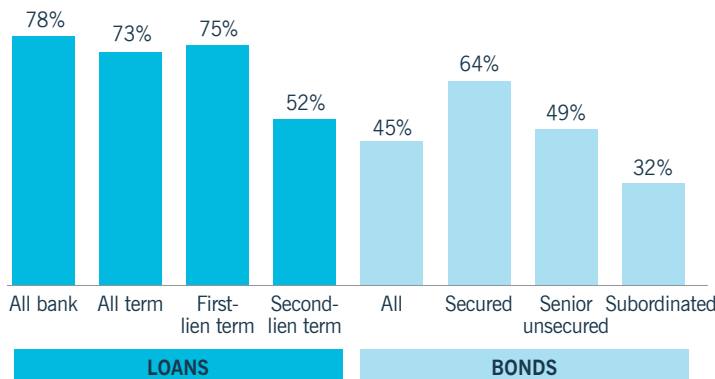
### THE CAPITAL STACK

The fundamental thesis governing credit risk for high yield bond holders relative to loan holders is that the latter is advantaged by the seniority and secured position in the issuer's capital stack.

### Par bonds underperformed during negative periods

*The lower on the capital stack a debt investor's position is, the more challenged the recovery.*

#### Bank Loan vs. Bond Recoveries



Sources: S&P Global LossStats

As shown above, these two elements work together to give loan investors the best chance for the highest recovery in case of a default.

All things being equal, the weaker position held by bonds is offset by the higher coupons of those instruments. However, as we stated above, supply/demand technicals often play a larger role in relative yields than structural fundamentals.

Another factor to consider besides seniority is the type of cushion below you. Having unsecured and truly subordinated debt, along with the sponsor's cash equity, under your senior secured loan provides additional capital to protect you in a liquidation.

S&P LCD data bears this out. For facilities with a greater than 50% capital cushion below them, the average discounted recovery is 85%. When

the cushion drops below 50%, the recovery also drops, down to 50%.

Beyond capital structure, the mere size of financings can sway credit risk. For example, the preponderance of energy-related credit is owned by large institutional (rather than middle market) investors. Saying we're in the ninth year of an economic recovery is quaint for companies in the oil patch. Since the price of crude plummeted from \$107/bbl in June 2014 to \$46 in January 2015 (eventually hitting bottom at just under \$30 in February 2016), the energy sector has been in its own sustained recession. It will be interesting to see how the latest run-up in prices will impact the sector.

To illustrate the effect of this industry downturn on issuers of debt, consider the corporate default rate. According to S&P, that rate fell to 4.4% in February 2017 (from 5% in January). Embedded in that number was an almost 25% default rate for the energy/resources sector. Strip that out and the overall rate drops to only 2.1%.

This impact is also evident when comparing default rates for tranches greater than \$350 million with those less than \$350 million. According to the S&P LCD, over each of the past fifty months, the default rate for the large loans has exceeded that of smaller loans in all but four instances.

Finally, experienced managers know that no single factor contributes more to greater credit risk than excess borrower leverage. High-yield bonds historically carry higher leverage, in part because bonds are typically refinanced, not amortized from cash flow.

Recent S&P data show Leveraged Buyout (LBO) bonds with total debt to ebitda of almost 6.5x. Compare that with broadly syndicated loan leverage of 6.3x (per Thomson Reuters LPC most recent data) and middle market loan leverage of 6.2x.

Interestingly, LPC's metrics gleaned from private club (i.e. non-syndicated) senior debt deals show even lower leverage of 4.77x. That's a telling statistic for investors considering the relative credit risk proposition between private credit and public debt.

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## DURATION RISK

Let's turn our attention to duration risk and how well these instruments meet the long-term goals of their constituents.

Bonds are by definition long-term investments, typically ten years for non-investment grade issuers, and up to a century for the highest quality corporates. They may also contain non-call provisions protecting investors from refinance risk. But depending on the rate environment and outlook, locking up your money that long can be a boon or a bear.

Leveraged loans carry less rate protection for the investor, but also make it easier to get your money out. Maturities are generally limited to seven years. Unlike bonds there are few non-calls (though occasional "soft" calls allow the company to refinance without penalty for M&A events), and loans on average are refinanced for other reasons after three or four years.

Of course being floating rate, with the issuer adjusting its Libor rate every few months, these loans have a duration risk that's effectively zero.

As Steve Nesbitt, the CEO of investment advisory firm Cliffwater, points out, institutions such as pensions, endowments, and foundations require 7% returns. High-yield bonds right now yield a shade over 7.1%, according to the LevFin Insights.

Compare that to 6.21% where middle market loans are priced today, per Thomson Reuters' latest numbers. Which would you rather be, unsecured, fixed-rate, and junior? Or secured, floating-rate, and senior?

Not to mention the relative loss rates. In a recent report UBS analysts estimated US high-yield bonds had a twenty-year average annual loss rate of 2.8%, while leveraged loans weighed in at 1.3%, less than half that of bonds. Regardless of loan and bond features, it all comes down to having the right manager. To quote Mr. Nesbitt, "The better managers have better underwriting skills and sourcing capabilities. As an investor we expect to pick up spread and manager alpha."

**For more information, contact your Global Investment Advisory Services representative, or visit us at [www.tiaa.org/public/assetmanagement](http://www.tiaa.org/public/assetmanagement).**

1 The green line in the chart is the \*Cliffwater Direct Lending Index (CDLI) current yield, which is based on the investment income of the underlying assets held by public and private BDCs<sup>2</sup>. BDCs<sup>2</sup> invest in middle market companies, and the Index comprises of more than 6000 middle market loans – with 59% senior debt, 27% subordinate debt and 9% equity. The blue line displays the BofA Merrill Lynch US High Yield, which tracks the performance of USD denominated below investment grade corporate debt publicly issued in the US. Increase in high yield depicts dislocations in market, pricing in higher risk. The spread of CDLI current yield minus BofA ML HY (shaded area in teal) shows the premium of middle-market loans over traditional High Yield, gauging attractiveness of the asset class. The higher premium for middle-market, to some extent, depicts the illiquidity for private loans and credit risk associated with smaller companies. Following a steady surge in the spread in 2016, which stabilized in 2017, but remains relatively attractive, with a 306-basis points differential, as of 13 June 2018.

2 BDCs: Business Development Companies

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