

A black and white photograph of a person standing on a small, narrow boat or paddleboard, navigating through a calm body of water. The background is filled with tall, slender palm trees that are partially obscured by a thick mist or fog, creating a serene and somewhat mysterious atmosphere. The water reflects the light from the sky and the silhouettes of the trees.

WHITE | PAPER
SEPTEMBER 2016

PRIVATE DEBT

Part II
Private Debt Revisited:
A Global Perspective

PRIVATE DEBT REVISITED

In the years following the global financial crisis, increased bank regulation and innovative technology have transformed the landscape of private debt investing. **Bayshore Capital Advisors** made its first allocation to a private debt specialist in 2009 and has since maintained a dedicated research effort to new and niche private lending strategies. Bayshore has invested across the universe of alternative assets since 2001.

In 2015, Bayshore published a private debt whitepaper, "[10 Questions: The Landscape and Post-Crisis Opportunities Explained](#)", to provide investors with research and insight into this new space. A continuing global search for alternative sources of income has attracted even more investor capital into private credit and contributed to the maturation of the market (see figure 1). Not only do investors now have more options within the investment opportunity, but they can also access the strategies through more creative and flexible structures. There will certainly be winners and losers, and managing risk remains important, but Bayshore believes the asset class will continue to evolve and provide a compelling yield alternative for individual and institutional investors.

Investors' views on how the size of the private debt market will change over the next five years. >>

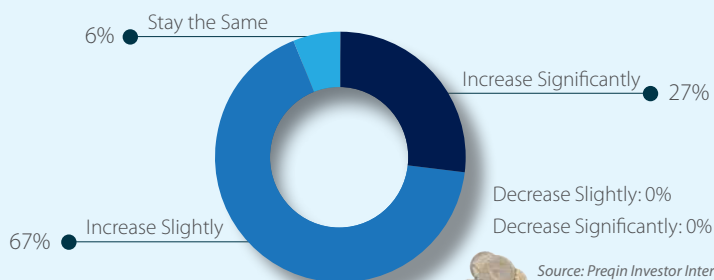
THE PROBLEM

The world is running out of options for safe, yielding investments. A 30-year bull market for traditional fixed income investments is extended, and the return outlook is highly unattractive. Investors must now consider allocating to alternative strategies that can provide both income and portfolio protection.

A NEW ASSET CLASS IS PART OF THE SOLUTION

Private Debt (PD) is a rapidly growing asset class driven by structural changes in the financial services industry and the success of the leveraged lending market in the US. With a risk profile similar to traditional fixed income investments, PD is now spreading into many areas of global finance. In exchange for short-term liquidity, investments in PD can deliver a significant yield premium and better downside protection than high yield bonds. PD also offers substantially lower interest rate sensitivity than traditional sources of yield, a potentially important characteristic if the global economy normalizes over the coming years.

FIGURE 1. INVESTOR SENTIMENT REGARDING SIZE OF PRIVATE DEBT MARKET



TRADITIONAL FIXED INCOME HAS LOST ITS “SAFE” CHARACTERISTIC

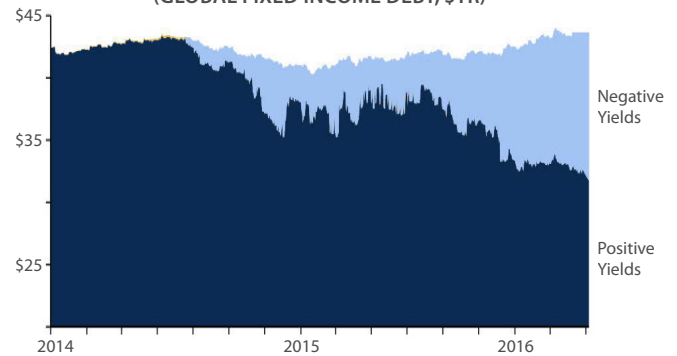
Return-free risk

Since inflation and interest rates peaked in the early 1980s, fixed income has been a phenomenal investment, able to provide consistently strong returns. With low volatility and a negative correlation to equities, fixed income has also provided investors with portfolio management benefits. However, after a spectacular run fueled in large part by post-crisis central bank policies, this bull market is likely to be in its final stage. Today, traditional fixed income securities face an asymmetric risk proposition with rates likely to normalize in the coming years. Other income-producing assets have also followed bond prices higher, and investors can find very little value in investment grade credit, high yield credit, or dividend equities.

Of course, we are in unprecedented economic territory (see figure 2), and it is possible that bond prices will continue to climb if yields drop even lower. This scenario is likely if the global economy drops into a recession. On the other hand, with any normalization of the economic picture, investors in traditional fixed income, and yield surrogates such as MLPs and REITs, will face a long period of very low or even negative returns.

Fitch recently calculated that if yield curves were to quickly reset to 2011 levels, global government bonds would lose 10%, while Eurozone bonds would incur a 21% loss (up to 44% for long bonds)¹. In any case, the risk and reward characteristics of traditional fixed income are no longer what they were. Investors must now pause to consider all risks embedded in their current fixed income portfolios. ¹Fitch Ratings: fitchratings.com/site/pr/1009833

FIGURE 2. NEGATIVE YIELDS ON THE RISE
(GLOBAL FIXED INCOME DEBT, \$TR)



Source: GFIM Bond Index.

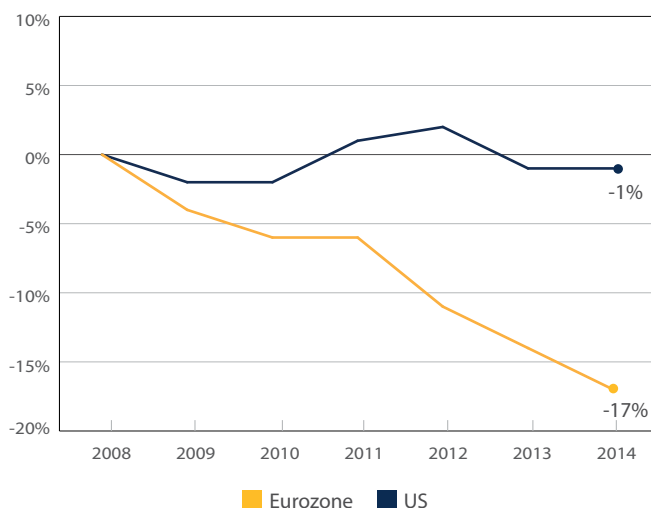
MEANWHILE, A QUIET FINANCIAL REVOLUTION

Banks retreat

Broad government response to the great financial crisis, together with technological innovation, has accelerated a quiet revolution in the financial services industry. At the heart of this transformation is a wave of tighter bank supervision designed to de-risk the industry and avoid another near-collapse of the banking system. Global regulations (Dodd Frank, Basel III/IV, and many others) are forcing larger banks to move toward a “utilities model”, one that emphasizes larger capital cushions, less leverage, greater disclosure, stricter operational guidelines, and a lot more oversight (these same banks paid over \$200 billion in fines for improper conduct over the past decade²). As a result, many banks globally have abandoned business activities that are too risky from a compliance perspective or simply too burdensome under the new regulatory rules. This is particularly evident in Europe today where, according to the Financial Stability Board, banks’ share of Eurozone financial assets has fallen almost 20% since 2008 (see figure 3). Even in the European corporate lending market where banks have historically dominated, they have lost share to non-bank lenders (see figure 4). Ironically, in a world with record low interest rates and excess liquidity, many credit-worthy borrowers can only obtain credit at very high costs, if at all. Banks have refocused on their largest lending relationships in their core markets and continue to transfer non-core assets from their balance sheets to alternative asset managers and private investors.

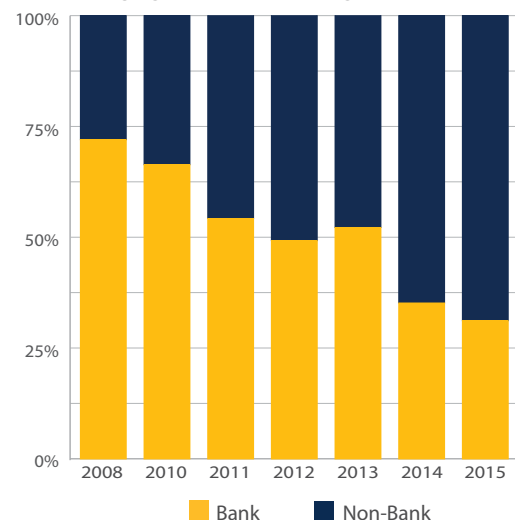
²The Economist, August 13, 2016

FIGURE 3. BANKS’ SHARE OF TOTAL FINANCIAL ASSETS (INDEXED CHANGE)



Source: Financial Stability Board's Global Shadow Banking Monitoring Report 2015.

FIGURE 4. BANKS’ SHARE OF EUROPEAN PRIMARY LOAN MARKET

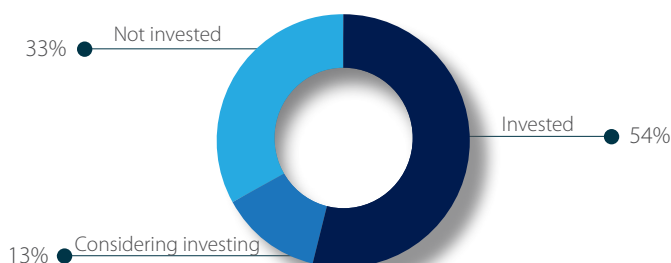


Source: TIAA Global Asset Management. S&P Capital IQ. 2009 data not meaningful.

AS BANKS RETREAT, INVESTORS STEP IN

The disintermediation of banks began well over a decade ago in the US, where non-bank lenders are the dominant source of funding for private companies with higher debt burdens. This more traditional private lending (also known as mid-market or direct lending) is funded by institutional and retail capital through Collateralized Loan Obligations (CLOs) and Business Development Corporations (BDCs), respectively. As shown in figures 3 and 4, Europe is now following suit.

FIGURE 5. INSTITUTIONAL INTEREST IN PRIVATE DEBT



Source: Preqin Investor Interviews, 2015.

As the private debt market expands, alternative asset managers have developed the expertise to internally source and underwrite transactions. Their ability to capture origination fees and increase returns for investors has also contributed to growth in the asset class. Today, there is no shortage of high quality specialists providing access to a variety of private debt investments. Interestingly, many “startup” alternative asset managers consist entirely of experienced teams lifted out of banks that have shuttered lending activities for all but their largest clients.

As a result, institutional allocations to private debt are becoming more mainstream (see figure 5). Now that these strategies have matured, many institutions no longer consider private debt as a private equity or hedge fund allocation. Instead, they have begun to shift a portion of their traditional fixed income allocations into a new “alternative income/credit” bucket.

THE BENEFITS OF PRIVATE DEBT

Attractive yields and low volatility

Private debt is an appealing alternative, offering stable, fairly predictable returns without exposure to public market volatility. Most alternative asset managers collect income from their borrowers and pass that directly to their investors. These strategies provide loans with interest rates ranging from mid-single digits to high teens. Some managers also add origination fees, prepayment penalties, extension penalties, warrants, and fund leverage to obtain additional security and/or increase returns.

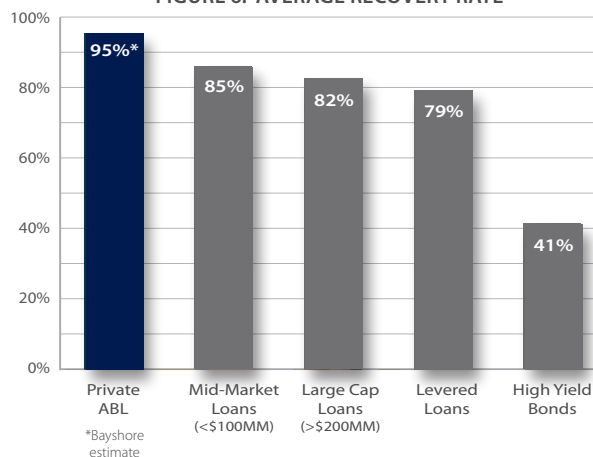
Interest rate protection

Arguably, the biggest risk to traditional fixed income investors today is duration risk (negative price impact faced if rates rise). An important characteristic of private debt in the current ultra-low interest rate environment is the prevalence of floating-rate loans, allowing investors to benefit from a potential rise in interest rates. However, even with fixed coupons, the short to medium term for PD loans enables alternative asset managers to raise interest rates on new issues and deliver higher yields to investors. In contrast, many traditional fixed income investors, who are assuming this duration risk, would suffer mark-to-market losses with any rate increase.

Downside protection

In the case of default, private debt strategies also have a strong track record of recovering principal (see figure 6). Most loans are either high in the capital structure (1st lien) or collateralized by assets of the borrower (typical loan-to-value ratios are 50-85%). Because privately issued loans are between two parties, the lender can obtain maximum security with tight covenants and heavy collateral protection. Further, in the case of a repayment delay or default, PD strategies typically involve a direct bilateral restructuring, much simpler than a bond or bank loan default, impacting multiple parties and interests.

FIGURE 6. AVERAGE RECOVERY RATE



Sources: S&P CreditPro, MGG/J.P. Morgan. Ultimate recovery rate from 1995 – Q2 2014.

A NEW GLOBAL OPPORTUNITY

Bayshore divides the investable universe of private debt into six areas.



Direct Leveraged Lending

Mature funding market for debt to corporates with high financial leverage (debt/EBITDA); often in conjunction with private equity sponsors.

Asset-Based Lending

Line of credit or term loan based on value and liquidity of collateral (loan-to-value/LTV).



Specialty Finance

Structured transactions of increased complexity, balance sheet facilities, risk transfer transactions, factoring, leasing, complex or niche collateral transactions.

Trade Finance

Short-term loans to finance international trade.



Marketplace Lending

Technology-supported small-balance lending to mostly unsecured borrowers.

Asset Transfers

Secondary market purchases of private loans, both performing and non-performing, often from banks.

STRATEGY CHARACTERISTICS

● Good ◐ Moderate ○ Poor

To date, Bayshore has sourced and evaluated over 250 private debt opportunities offered by managers on five continents. This asset class includes a range of liquidity structures, from quarterly withdrawals to 10-year terms. In addition to liquidity, the quality of the borrower's credit, presence of collateral, duration of the underlying loans, and whether the strategy employs leverage to deliver higher returns are important factors in strategy selection.

		Return Range*	Credit	Collateral	Duration Protection	Leverage (good=low)	Liquidity**
Direct Leveraged Lending	Senior	4 - 8%	●	●	●	◐	○
Direct Leveraged Lending	Mezzanine	10 - 14%	●	○	●	○	○
Asset-Based Lending	Traditional	8 - 12%	◐	●	●	●	◐
Asset-Based Lending	Distressed/Special Sits	12% +	◐	◐	◐	◐	○
Specialty Finance		10 - 14%	◐	●	●	●	◐
Trade Finance		4 - 8%	◐	●	●	●	●
Marketplace Lending		7 - 9%	◐	○	◐	◐	◐
Asset Transfers	Performing	9 - 11%	●	●	●	◐	○
Asset Transfers	Non-Performing	15% +	○	◐	◐	●	○

*Loss adjusted net return before applying fund-level leverage. **Rating based on average term of underlying loans.

PRIVATE DEBT IN DETAIL

typical investment life // collateral

Direct Leveraged Lending

Direct leveraged lending in the US is poised to continue its growth, taking additional share of the private debt market as regulators scrutinize banks' involvement in leveraged finance. Leveraged lending in Europe is also growing, complementing more restricted bank lending on the continent. Capital markets in Asia and Africa are less developed and therefore offer the highest yielding (but riskiest) opportunities for leveraged lending.

3 - 7 years // borrower's future cash flows and equity

Asset-Based Lending

The US, with its deep capital markets, is home to the majority of private **asset-based lending** (ABL) strategies. However, a lack of competition in some non-US markets (such as Latin America and Europe) makes them more appealing on a risk/return basis. Lending against tangible assets (inventory, real estate, equipment, ships, planes, trains) or financial assets (accounts receivable, royalties, tax credits, legal claims) often provides for shorter-dated, lower risk opportunities. ABL managers often use their underwriting speed and flexibility to provide borrowers with expensive bridge loans which are repaid when banks eventually process and approve the borrowers' traditional financing.

6 months - 5 years // tangible or financial assets

Specialty Finance

Specialty finance is a more complex version of ABL, often involving more structured solutions which may include an array of niche or exotic collateral and securities, senior leverage facilities, and factoring transactions with some implied credit risk.

6 months - 5 years // tangible or financial asset; structural security

Trade Finance

Trade finance provides short-term loans for international trade. This financing helps protect the interests of buyers and sellers in an international marketplace and assists in the completion of transactions that may involve multiple currencies. This source of capital is vital to the global economy, with 80-90% of global trade relying on this method of financing.

Trade finance activities are generally short in duration, providing the best liquidity within private debt, but also the lowest return. Trade finance also has had a stellar track record of avoiding losses, even during major market dislocations.

30 - 90 days // value of trading goods and other corporate assets/contracts

Marketplace Lending

Marketplace lending is where Silicon Valley meets Wall Street, usually providing unsecured small balance loans to consumers and businesses using technology-driven underwriting. The US is by far the largest market for marketplace lending, but some European markets are gaining more traction (e.g. UK). The combination of mobile connectivity, big data analytics, and new distribution channels has enabled technology start-ups to disrupt traditional banks in the consumer and small business lending space. Despite some recent growing pains, marketplace lending is here to stay.

1 - 5 years // excess spread over assumed loss rates

Asset Transfer

Asset transfer includes all PD opportunities that involve the purchase or structured risk-sharing of existing private debt – performing or non-performing – in a secondary market transaction. The typical seller is a bank that needs to part with the asset for a regulatory or capital management reason. Given their need for further deleveraging and balance sheet clean up, European banks will likely be the main source of such future transactions.

1 - 8 years // varies



“The optimal way to implement alternative credit is through a collection of specialists, allowing for the highest alpha potential in each sub-sector of the market. In an environment where credit spreads are at historically low levels, skill and differentiation in approach will be necessary to add value³. ”

- TowersWatson

A diversified portfolio of private credit strategies can target a blended net return of 8-12% with definable risk and a current income stream.

TAKE AWAYS

Before investors seek to take advantage of the higher yields available in private debt, they must fully understand the three main trade-offs in the various market segments.

Unlevered net return/yield targets

Unlevered net return/yield targets in private debt can range from 4-6% at the low-end via traditional trade finance and senior secured lending and can exceed 15% at the high-end through special situation asset-based lending and junior/mezzanine debt. In between, there is a full range of options accessible to investors. Managers in certain segments may also be able to capture a portion of their borrowers' upside through equity participation via warrants or preferred shares.

Principal protection

Principal protection should be the key concern for all debt investors. In private debt, a strong understanding of a strategy's expected defaults, recovery rates given default, and time to recovery is critical. A borrower's credit profile (on an unsecured basis) will largely drive default risk, while recovery rates will be contingent upon the strength of the collateral. Often, borrowers with both exceptional credit and collateral are able to secure more traditional financing. The best niche private debt managers specialize in lending to, and structuring transactions with, borrowers who possess one characteristic, but not both. A separate, but related, point when evaluating principal loss risk is the use of leverage by fund managers to "gear" returns. This is particularly common in the senior levered lending space, where managers frequently utilize 100% or more of leverage to increase returns. While this can work well in stable markets, investors must realize that they are effectively subordinating their capital to the leverage provider.

An illiquidity premium

Illiquidity is a large part of the reason that attractive yields in private debt are, in fact, achievable. While some lower returning strategies, such as trade finance, can offer quarterly liquidity, most private debt strategies require capital commitments between 3-8 years to match the duration of their underlying loans. Furthermore, the majority of private debt strategies are offered in closed-end private equity style commit-and-call structures, with managers often requiring 1-3 years to fully put investor capital to work. As the asset class continues to evolve however, Bayshore is now evaluating an increasing number of open-end, "evergreen" structures with sound asset liability management mechanisms and the ability to put capital to work quicker, providing investors with increased flexibility and choice.

In summary, Bayshore believes that private debt represents a structural opportunity for yield seeking and absolute return investors. Those who are willing to accept some illiquidity can participate in an asset class that offers compelling risk/return characteristics and current income. As the sector continues to attract more capital, partnering with an experienced allocator in the space will allow investors to access many niche opportunities via a research driven and thoughtfully constructed portfolio.

Bayshore first included private debt as part of a diversified portfolio in 2009 and has since successfully invested in 14 strategies in the asset class. Bayshore has an established global network of relationships in this unique area, as well as a proven track record of portfolio construction and strong performance.

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³TowersWatson Perspectives: Alternative Credit - Credit for the Modern Investor (September 2015)

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