Australian investors embrace private debt opportunity

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Private debt is gaining in popularity as investors look for higher yields and stable returns, but they must also consider the risks including illiquidity and impairment of capital.

"Private debt has unique characteristics that we think are attractive and really well aligned to the objectives of long-term investors and right now, in the current low yield environment, that attractiveness is even further accentuated," Frontier Principal Consultant, Andrew Kemp, said.

IFM Investors Executive Director, Lillian Nunez, said private debt is still an emerging asset class in Australia compared to the US and Europe. “There is potentially about 100 to 200 basis points spread premium between Australian assets and northern hemisphere assets due to Australian private debt being really in early stages and being an inefficient market at the moment," she said.

However, the debt is not rated by rating agencies and most investors hold private debt until maturity (4-7 years) given its low liquidity. Nunez said there are financial and non-financial covenants in place to manage risks if a business is stressed.

"This means that, in addition to caps on leverage ratios or minimum interest cover ratios, the company must come back to the lender to seek consent for adding debt, acquiring assets, disposing of assets, changing strategy, changing executive team, even to provide distributions to equity, and this gives the lender additional control."

Barings' Global Private Head of Portfolio Management, Terry Harris, said it saw high deal volume and wider spreads following the pandemic in late-2020 to early-2021 although spreads have since tightened.

"If you compare all in spreads over the base rate for middle market loans even in the US as a more competitive market, they still remain well over 200 basis points wider than broadly syndicated loans, so you're still getting compensated really well for the illiquidity."

The direct lending market performed well despite the pandemic, according to Harris.

"Private equity sponsors were pursuing opportunities to acquire businesses that demonstrated the ability to weather the pandemic. Private equity sponsors were also investing a substantial amount of cash equity behind the debt, so in most deals today we're seeing at least 50% equity capitalisation below the debt."

Frontier Advisors Senior Consultant, Nam Tran, said that most direct lending strategies were exposed to non-cyclical industries compared to the tradable leveraged loan market, and these stable industry exposures have helped keep losses low over time.

“Despite lending to smaller businesses, the risk of loss to investors in direct lending strategies ~~is~~ might actually end up being lower compared to the risk of loss in ~~in~~ for leveraged loans investors for example."

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