How private debt could help investors meet their return and impact goals

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

KARTESIA

About the author

Frantz Paulus

Head of Investor Relations, Kartesia

Frantz is responsible for fundraising and investor relations. When joining Kartesia in 2016, Frantz had over 9 years of experience in private equity and 7 in audit and transaction services. Prior to joining Kartesia, Frantz set up and headed the equity co-investment activity of Crédit Agricole Private Equity, where he invested in buyout and growth capital transactions across Europe. Previously, Frantz worked in a family office specialized in the healthcare sector. He started his career as an auditor with PwC in London before joining their Transaction Services department in Paris, where he conducted due diligence assignments for corporations and private equity funds.

How private debt could help investors meet their return and impact goals

Private debt is a form of financing that – unlike many traditional fixed income investments – is not listed on exchanges. It is provided to companies not by banks, but by alternative lenders such as specialist private debt managers investing on behalf of institutions such as pension funds.

The asset class has quickly become established as an important component of many institutional investors' allocations in recent years thanks to the compelling benefits that it provides in terms of risk-return potential.

And by choosing to work with a specialist manager, it's also a vehicle through which investors can achieve an additional goal: making a positive impact on society and the planet.

Filling a void: one of the quickest-growing asset classes

The European private debt market has grown rapidly in recent years, primarily due to regulatory capital requirement compelling banks to massively reduce their lending activity in the wake of the great financial crisis.

Bank lending tends to fund the activities of larger companies, which the banks deem less risky. The financing needs of companies that are too small to access the public debt markets have been going unmet, resulting in a huge potential opportunity.

This void has been filled in part by private debt managers. The private debt market has grown rapidly, and is now estimated at **USD 1,045 billion** in 2020[1].

Private debt has also become an increasingly popular investment over the past decade, as institutional investors have reallocated funds from their traditional fixed income allocation towards this asset class. This seems set to continue -- data provider and forecaster Preqin predicts an impressive **11.4% annual growth rate through 2025!**

1 Preqin

A low-yield world? Not for private debt investors

Private debt provides **three advantages** that make it difficult for institutional investors to ignore.

- First, historically it has provided **returns above 9.4%**[2] for over 15 years. With much of the public bond markets providing yields close to zero today, this makes private debt hugely attractive.

- Second, the returns on private debt have a **low correlation**[3] with those of other major asset classes, making it a great source of diversification within a balanced portfolio.

- Third, private debt usually **offers floating rates**, helping protect investors against potential increases in interest rates down the line. This could be attractive when inflation expectations are in flux.

Locked up

There are few free lunches in the world of investments. This applies to private debt, which involves one major catch to its high returns -- it is **illiquid**.

Once an investor has committed to a private debt fund, their assets are essentially locked up for **six to eight** years. This could be an issue for some – if they need their cash back quickly, they can't get it.

But for investors able to accept the illiquidity, the returns can be substantial.

2 CDLI: Cliffwater Direct Lending Index. Data since inception in September 2004, Annualized returns through 30 June 2021. See www.CliffwaterDirectLendingIndex.com for further information on the CDLI.
3 CDLI correlation <0.7 with Global Equities (MSCI ACWI) and <0 with Global Bonds (J.P. Morgan GBI US Unhedged LO)

Don’t forget Sustainability: a vital consideration in private debt

The world is changing. Today there is a huge focus on environmental issues such as climate change and biodiversity, and social matters like workers’ rights, permeating almost every aspect of our lives. There’s also been a surge in the attention paid to sustainability issues by the investment industry.

Despite this trend, private debt managers have been relatively slow to incorporate ESG criteria in their processes. This is beginning to change as pressure from investors increases. Regulation, such as the Sustainable Finance Disclosure Regulation, should also result in rapid developments on this front.

That said, **incorporating ESG is still a differentiating factor** among private debt managers, even though any manager who doesn’t take into account ESG today is at a clear disadvantage.

Making a positive impact: the natural next step for private debt investors

In its early days, ESG was all about excluding investments in firms involved in controversial practices such as weapons manufacturing. More recently, ESG investors have been analyzing a firm’s positive practices and how they could drive investment returns. Investors are increasingly allocating to firms making a measurable positive impact on the environment or society.

This trend has been accelerated by the development of the United Nations Sustainable Development Goals, a collection of 17 interlinked global goals that are intended to be met by 2030. Ten or twenty years from now, it seems likely that **making a positive impact** will be a requirement of all investment funds – their managers will have to explain to clients how they seek to make a positive impact rather than just trying to achieve a positive financial return.

To date, however, impact investing remains uncommon among private debt managers.

Regardless of regulation and investor preferences, it makes sense to incorporate ESG factors in private debt investment processes.

For example, consider a firm with poor social practices, such as unfair treatment of its workers. In today's transparent world, its employees can immediately go to job websites and post a bad review of the company. Prospective employees can look at these reviews and decide not to work for the firm. The company would have to increase salaries to entice new employees, directly affecting its profitability.

Meanwhile, consider a private debt manager that doesn't look into how much the companies it lends to pollute their environment. After it lends there is a major pollution incident at one of its facilities, resulting in huge costs to the company – either directly in terms of paying to clean up the pollution, or indirectly through damage to its reputation. This could permanently impair the value of the debt investment.

But it's not just about risk management – embracing ESG can also considerably increase firms' return potential, and some companies even put ESG at the core of their business strategy. Veja, a French firm making sports shoes from organic, fair-trade materials is a good example. Its products are extremely popular and it has grown rapidly thanks to its focus on sustainability.

What should investors look for in a private debt manager?

Private debt is a complex and heterogeneous asset class. This has two main implications: first, investors need to find a manager able to deal with this complexity; and second, there's considerable scope for talented managers to outperform the broad private debt universe.

But how should investors choose their private debt manager? At Kartesia we believe they should look for a number of attributes.

- The first is a stable, well-resourced investment team.
- Another is experience: many private debt managers have appeared over the past few years, but few have experience spanning decades and the range of challenging environments that have arisen over the long term.
- The third is a solid track record demonstrating the manager's ability to consistently add value to companies they lend to in a range of economic conditions over the long term. This is achieved through a good diversification of the portfolio companies -- sectoral, geographical, level of development of the funded companies.

One might also add the ability of the investment company to deploy new funds; this should be assessed over time to and across market conditions. It is important to assess the quality of the reporting and the transparency of the manager. Finally, it is our conviction that having sound and robust ESG policies for investments, as well as Corporate Social Responsibility policies for their own business, will allow managers to **outperform in the long term**.

€150 B
AUM as of
30 June 2021

570
Experienced and
committed professionals

25 years
Leading the way in
sustainable investing

KARTESIA

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY