The Case For Private Lending

An Attractive Fixed Income Solution

PRIVATE LENDING OVERVIEW

Private lending/debt is simply described as private loans that occur outside the traditional bank networks. Although private lending has existed for thousands of years, post the financial crisis of 2008/2009, regulatory changes such as Dodd-Frank and Basel III, changing sentiment, among numerous other circumstances, have substantially shifted the global lending landscape. This has expanded the opportunity set for non-bank lenders to increase their presence and fill a void that has been left behind.

Alongside this, an extended period of low-interest rates has caused many investors to seek alternatives to their low yielding tradition fixed income investments – private lending being one of them. This thirst for yield from investors, along with the need for capital from non-bank lenders, has allowed the sector to emerge and flourish, creating a sister alternative asset class to private equity – private debt – one which can provide end-investors with attractive returns with low levels of volatility.

THE BENEFITS OF PRIVATE LENDING

Private lending fund assets have increased significantly over the past decade. Investors rationale for attraction to the area are numerous and include:

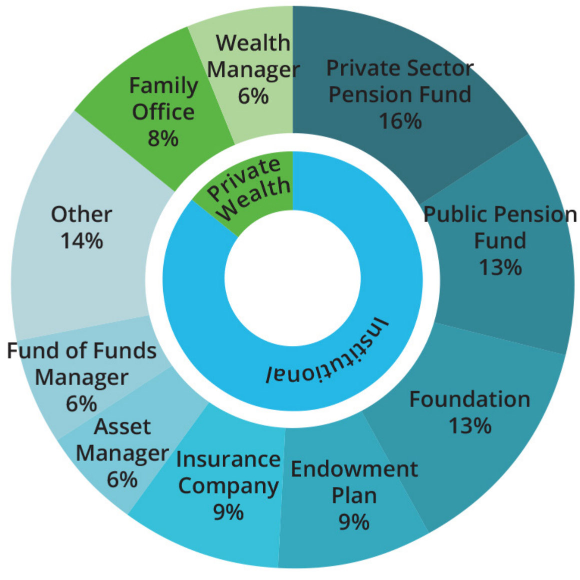
- Strong historical return and cash flow characteristics relative to other fixed-income vehicles
- Focus on capital preservation
- Low historical correlation to traditional fixed income and equity markets
- Low historical volatility relative to traditional fixed-income investments
- Historical consistency of returns

WHO INVESTS IN PRIVATE LENDING?

Private Lending has been broadly adopted by Institutional investors within Canada. Canada Pension Plan Investment Board ("CPPIB"), Public Sector Pension ("PSP"), and Ontario Teacher's Pension Plan ("Ontario Teacher's") to name a few, have all increased contributions to private debt within their portfolios. Since 2005, the nation's biggest pension manager CPPIB has increased its private debt allocation from $0-$20.4B as of 2018 (CPP Investment Board, 2018 Annual Report). Other Canadian investment goliaths like the PSP and Ontario Teacher's followed suit, with PSP increasing its private debt allocation by 15% between March 2018-2019 (Public Sector Pension Investment Board, 2019 Annual Report) and Ontario Teacher's by almost 5% from 2017-2018 (Ontario Teacher's Pension Plan, 2018 Annual Report).

Predictions by AIMA Canada forecast the Private Debt market reaching $1 Trillion by 2020 as investor sentiment and expectations towards private debt remain strong and consistent (AIMA Canada Handbook 2019: A Report on the Canadian Alternative Investment Landscape). Globally, North America will account for more than 50% of the world's private debt assets and investors (2018 Preqin Global Private Debt Report). So as this asset class continues to gain traction among Canadian institutional investors, ultra-high net-worth and family offices, those within the Canadian retail market aware of this shift, can either enter or increase their allocations to private debt as a way to capitalize on their participation.

Breakdown of the Investor Base of Private Lending by Type



Source: Preqin Private Debt Online 2018

WHERE DOES PRIVATE LENDING FIT WITHIN A PORTFOLIO?

With many funds offering investors different risk/reward profiles that broadly look attractive relative to traditional fixed income options, private lending funds have increasingly made their mark on institutional and retail portfolios alike. Being able to provide investors with more secured positions in the capital stack in addition to other forms of private debt that may have more risk (such as junior unsecured debt), have made private lending an increasingly attractive option for portfolio diversification and varying return potential.

HIGHEST SECURITY
Senior Secured Bonds
Junior Secured Bonds
Senior Unsecured Bonds
Junior Unsecured Bonds
Preferred Equity (Preferred Stock)
Equity (Common Stock)
LOWEST SECURITY

In times of economic uncertainty, such as today's current environment, downside protection is a key investment metric – with traditional yields being low, investing in companies that are able to survive a downturn in the credit cycle remains imperative. Knowledge about the collateral backing investment assets, understanding the rigorous processes of monitoring and having the underwriting expertise, are all critical to distinguishing the long-term private debt winners from the opportunists.

While private lending can indeed offer attractive return, risk and diversification characteristics, choosing the appropriate alternative private lending investment vehicle for a specific portfolio's risk profile is paramount.

IMPORTANT NOTES

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