Growing demand for alternative credit amongst Australasian investors

According to Dennis Mothoneos of Sydney-based Clearway Capital Solutions, these range from relatively liquid non-investment grade credit such as high yield, emerging market debt and bank loans; and more recently, relatively illiquid alternative private credit including distressed control and non-control credit, real estate and infrastructure debt and mezzanine private equity debt.

One of the underlying factors driving this shift has been the burgeoning number of retirees; and, reflecting this, the increasing need for more income relative to growth. Consequently, investors have expanded the size of their debt portfolios either by reducing allocations to other asset classes or by creating stand-alone pension pools with their own asset allocations and manager configurations.

The demand for income generating investments has also resulted in alternative credit being funded within real estate, infrastructure and private equity. A sizeable number of institutional investors are dispensing with traditional asset class categories and creating new ones, such as defensive and growth alternatives, to accommodate these products and strategies. A smaller number are increasing their risk budget allocations to alternative credit as dictated by risk parity driven approaches.

The drivers of this change are not only demographic. Despite Australian reference interest rates being comparatively high; in order to diversify, investors have sought opportunities elsewhere as most domestic markets lack depth and diversification across industry sectors and quality. However, institutions have invested in domestic real estate senior and subordinated debt (and, to a lesser extent, infrastructure) due to the availability of opportunities locally. In particular, subordinated debt on fully or partially leased A-grade property became very attractive when spreads widened considerably after 2008.

Furthermore, the current low yields and fiscal and current account imbalances of many developed countries suggest an asymmetric risk for return trade-off in sovereign debt compared to credit. Loose monetary policy and quantitative easing by many central banks has also heightened concerns about rising inflation. Consequently, bank loans, infrastructure debt and European mezzanine debt have been attracting serious consideration as their coupons reset with changes in interest rates. Also, subordinated infrastructure debt is typically of shorter duration.

Certain alternative credit strategies are also becoming attractive because many growth-orientated investors, particularly the remaining defined benefit funds, are of the view that economic growth will be poor over the next five to ten years and returns from equity will be relatively low. In contrast, they believe alternative credit may provide relatively stable returns with lower risk. For example, bank loans and mezzanine debt usually have tighter covenants, hierarchy within the capital structure and are often secured by collateral; albeit on a second ranking basis, thereby contributing to high recovery rates.

In addition, real estate subordinated debt is often collateralised on a second mortgage basis by the underlying real estate or the stock of the development company; whilst infrastructure debt generates cash flows predicated on a regulated or semi-regulated user pays monopoly. These factors help to constrain credit rating volatility and maintain above average recovery levels. The compounding effect of high and steady coupon income also reduces volatility.

Both income and growth investors are seeking alternative forms of credit because of perceived diversification benefits over the long term, including during bullish and bearish markets. Infrastructure, real estate and mezzanine debt are less reliant on the economic cycle to generate returns as they are often used by sponsors to bridge a gap in time or in financing.

Additionally, a few industry and government sponsored funds with relatively mature private equity programs have had to deal with J-curve issues as a result of the crisis in 2008. Therefore, the returns of European mezzanine debt - comprising cash coupons, arrangement fees and non-call provisions - generate income earlier than buyout, where total returns are more dependent on capital appreciation. The so-called funding gap, albeit declining as valuations rise, also represents an opportunity impending maturities can be renegotiated with higher contractual coupons.

Finally, a smaller number of investors are attempting to opportunistically capture the outsize returns that are available in certain types of private credit during periods of dislocation. Those investors are primarily seeking exposure in distressed for control and non-control instruments and strategies.

Some investors are cautious about committing to certain forms of alternative credit. Despite signals indicating many developed economies are on slower but stable growth trajectories, there remains the possibility of another recession. A steep downturn could lead to an increased number of defaults. In addition, many alternative private credit strategies invest in relatively illiquid instruments or are housed in illiquid product structures such as limited partnerships. Some investors are reluctant to lock away their funds for many years; particularly, as volatility reduces their ability to meet their objectives or exploit opportunities that arise in liquid asset classes. The challenge for managers and LPs is for liquidity to more closely match the underlying instruments.

For investment managers and general partners, whether alternative credit is funded from investor's debt or more growth orientated portfolios will have important consequences regarding their engagement with investors. Prior investment beliefs, return expectations and risk tolerances (including towards liquidity) may differ markedly. For example, there is a belief that management costs and the misalignment of incentives between investors and agents should be reduced. However, funding these strategies from fixed income allocations might be even less forgiving.

The funding source will also determine how the due diligence is conducted; valuations would come under even greater scrutiny as any growth assumptions would be discounted and claims of requisite credit analysis skills might be met with cynicism. Lastly, managers need to convince investors alternative private credit is not simply just another way to divide the portfolio and create unwanted governance costs rather than meaningful diversification and risk/return benefits.