M&G INSTITUTIONAL

A guide to illiquid credit: New opportunities for investors

For Investment Professionals only

M&G INVESTMENTS

Welcome

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As investment banks have retreated from the provision of finance to large swathes of the economy so the opportunity for long-term investors has grown. They are taking this opportunity by investing in private and illiquid credit.

While much has been written about the concept of illiquidity, a lot less has been written about the types of instrument that make up this asset class. This is understandable given that so many of the loans that constitute the illiquid credit market have been locked away in bank vaults for so long.

'Illiquid assets' has become a shorthand for bespoke, private assets that are not generally available to investors. The illiquidity premium has become shorthand for the various premia that should attach to an asset that is bespoke and non-standard.

This guide aims to unearth more detail about these assets, explain the benefits they can bring to investors who do not need liquidity across their entire portfolio and set out some of the pros and cons of illiquid credit investing.

The value of investments will fluctuate, which will cause asset prices to fall as well as rise and you may not get back the original amount you invested.

M&G Investments has been investing in private and illiquid debt since 1997. In 2017 it was ranked as Europe's first and the world's second largest manager of private debt by Private Debt Investor magazine.

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Illiquidity, introduced

Private, illiquid credit is an area of growing interest for investors in Europe.

It is most simply defined as assets that do not have an active secondary market in which they can be traded. However, this rather sweeping definition covers a wide range of debt securities with very different characteristics and purposes.

Illiquid credit assets can be long term, such as 25-year leases on commercial property, or shorter dated, such as directly arranged corporate loans or supply chain finance.

Banks used to be the pre-eminent lenders of this type of debt to the majority of European borrowers. As the investment banks have retreated since the global financial crisis, the capital markets have changed significantly. Previously, it was in the interest of the banking sector to expend huge efforts to package up debt for the public markets and long-term investors in a relatively simple format. The availability of cheap capital and the homogeneity of the packages that they produced meant that they were able to offer investors liquidity.

Today, pressured by regulatory and commercial considerations, banks are finding many such loans either too expensive or too unattractive to renew, and are pulling back from vast swathes of the market. Furthermore, there is no incentive for them to package assets for investors and it is significantly more expensive for them to offer liquidity.

At the same time, governments are taking steps to encourage a broader range of finance providers to extend these loans.

For long-term investors, this means that illiquid credit is emerging as an attractive set of investment opportunities. It takes the familiar principles of debt or bond investing – the lending of money in return for regular interest payments – into less standardised areas such as private debt. Many companies and projects are now coming directly to investors for financing and the burden of packaging and structuring assets is falling on the investor. It does mean that these assets will not be liquid because there is no reason for the banks to offer liquidity if they are not making fees from packaging and structuring.

Investing in these assets can provide a long-term investor with an income stream in excess of that from corporate bonds, from credits not available in public bond markets.

This excess return is derived from the inherent complexity and illiquidity of the assets. In simple terms, investors want to be paid more to hold things that can be difficult to understand and hard to sell.

Illiquid assets also provide opportunities to generate specific kinds of regular cashflows for investors. Many offer floating rate or inflation-linked coupons, which can protect investors from rises in interest rates or from inflation.

There are broadly three types of illiquid credit: long dated; five- to seven-year maturity investments; and unique, specialist opportunities that can offer attractive risk-adjusted returns.

	Assets	Description	Nature of cashflows
Long term	Infrastructure debt	Debt provided to a variety of infrastructure sub-sectors including renewable energy and economic infrastructure. Finances new projects and refinances existing ones.	Fixed rate, inflation-linked or floating rate
	Income strips	Long-term lease arrangements secured on property; rental payments are inflation-linked. Property returned to tenant at end of lease. Often development financing.	Usually inflation-linked
Short to medium term	Direct lending to companies	Floating-rate loans provided directly to mid-sized businesses.	Floating rate
	Private placements	A private alternative to the public bond markets to raise capital by mid-sized and larger companies with a select number of accredited lenders.	Usually fixed rate
	Leasing	Financing for companies which provide leasing of hard assets such as heavy machinery (eg forklift trucks).	Fixed rate
	Leveraged loans	Syndicated loans to large companies, typically to finance mergers and acquisitions or leveraged buyouts by private equity sponsors.	Floating rate
	Trade receivables	Short-term supply chain financing for smaller companies buying the right to receive payments due to the company.	Fixed rate (short term)
	Commercial mortgages	Private loans secured against commercial property.	Usually floating rate
Higher-yielding mixed term	Distressed debt	Investment in credit of fundamentally sound companies that are undergoing debt restructuring.	Fixed or floating rate
	Regulatory capital trades	Purchase of junior portions of banks' corporate loan books; banks gain regulatory capital relief from the sale.	Floating rate

The origins of illiquid credit: 4,000 years of funding business

Companies have long used credit to help them to supply goods and services to the economy. The practices of paying a fee to borrow land or equipment, or exchanging unpaid invoices for upfront cash, have existed for thousands of years.

Leasing, for instance, is believed to have begun in ancient Sumer in Mesopotamia (modern-day Iraq) at around 2000 BC, where records show people renting land, cattle and farming tools. At about the same time, merchants were starting to buy up outstanding promises of payment from agents for cash. This type of supply chain finance, known as factoring, was well-established in Britain by medieval times and helped to develop the cloth and corn trades.

Today, credit is an integral part of companies' activity. An estimated 80% of UK business-to-business transactions take place on credit (ACCA, 2014) while 55% of the UK's commercial property, worth a combined £486 billion, is rented rather than owned by occupiers (PIA Property Data Report 2017).

For decades, finance of this nature has been provided primarily by banks, which have forged close relationships with companies and arranged credit through one-to-one contracts.

This brings us to the starting point for any understanding of illiquid credit investing: these debt instruments do not have a functioning secondary market, so are usually held until maturity.

The lack of a secondary market is important for two reasons.

First, many of the corporate loans, leasing agreements and property-related debt now collectively known as illiquid credit are bespoke, created for the benefit of lender and borrower alone, and there has traditionally been little need, nor indeed much opportunity, to materially alter an arrangement during the life of a loan. When the agreement came to an end the borrower might refinance it, but there was never any intention of it being traded.

Second, this means there has been no way for other parties, such as long-term investors, to gain access to these loans. With such lending squirrelled away by the sell-side, how would a buy-side institution have any access to it? Until recently there was never any window on them.

Of course fund managers, pension funds and insurance companies played an indirect role by providing the funding to banks that ultimately financed such lending. For many years banks would raise capital cheaply through the sale of corporate bonds and other debt securities in capital markets.

Banks would then lend to their clients at a higher interest rate, pocketing the difference.

This provision of finance to longer-term borrowers, set against short-term liabilities, proved a long-standing and lucrative business model. But all this changed in 2008, and from that time investors started to prise the system apart.

Notes on data: £486 billion figure is calculated: 55% of value of commercial property of £883 billion. PIA = Property Industry Alliance

Banks' secession from some credit markets: a new market norm emerges

In 2008, the banks' funding model inverted, as illustrated below.

The inversion was triggered by the simple fact that many bond investors recognised that bank balance sheets are not as straightforward as they previously looked.

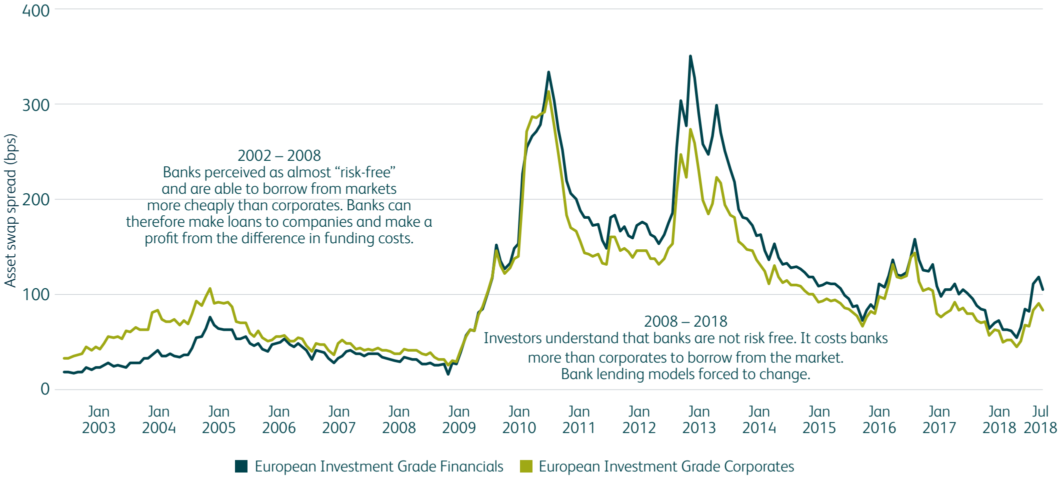
As the financial crisis unfolded, investors grew increasingly concerned that banks were exposed to risky, non-traditional assets but could pledge safe, traditional assets, such as residential mortgages, to access cheap funding, removing them from the pool of assets available to repay corporate bonds should a bank default. In addition, the proliferation of off balance sheet funding and complex structures inside banks made it harder to quantify the risks of lending to them. It seemed remarkably difficult to evaluate the chance of a bank defaulting, or estimate the recovery rate following a default.

Viewed through this prism, a company's financial position is much simpler to understand, and this is now reflected in perceptions of risk and in funding costs. Banks today experience a higher cost of funding from capital markets compared with their non-financial corporate bedfellows.

However, these commercial considerations only partly explain the bank withdrawal from illiquid credit. The other chapter in this story is regulatory.

The financial crisis highlighted the shortcomings of a banking system that matched short-dated liabilities with long-dated assets, prompting regulators to act. A number of measures have since been introduced that aim to make banks better capitalised and load their balance sheets with liquid assets such as cash.

Financial credit borrowing costs versus the wider corporate bond market



Source: M&G, Bloomberg (Merrill Lynch, EB03 ER03), as at 31 July 2018

This has distorted some markets, as banks have become reluctant to provide loans that would require them to tie up a lot of capital to comply with the new rules. They are not renewing loans in certain sectors as they reach maturity, or are stepping back entirely from asset classes such as leasing or social housing.

Equally, banks appear less and less suited to being the primary provider of some types of credit. So, as loans come to be renewed or replaced and banks stop doing so, a gap in the market is created for institutional investors.

Importantly, these regulatory headwinds are not going to change, which means this market promises to be sustainable and permanent rather than a short-term opening for opportunistic investment. Illiquid credit should become increasingly mainstream business for investors.

The net stable funding ratio (NSFR) and the liquidity coverage ratio (LCR)

While it is well known that banks are grappling with new capital requirements, it is perhaps less understood that the Basel III regulatory framework harbours two unprecedented initiatives that take aim at the issue of liquidity, rather than just capital.

Both measures are direct responses to the freeze in the short-term interbank lending markets in 2007 that left banks, from Northern Rock to Lehman Brothers, relying on a paltry array of liquid assets to back a gargantuan set of short-term obligations.

The NSFR looks at how much of a bank's long-term assets (defined as having a maturity greater than one year) are funded by long-term finance, short-term finance, customer deposits or equity.

Importantly, short-term wholesale funding – such as certificates of deposit, commercial paper or overnight deposits from other banks – is completely excluded from this breakdown.

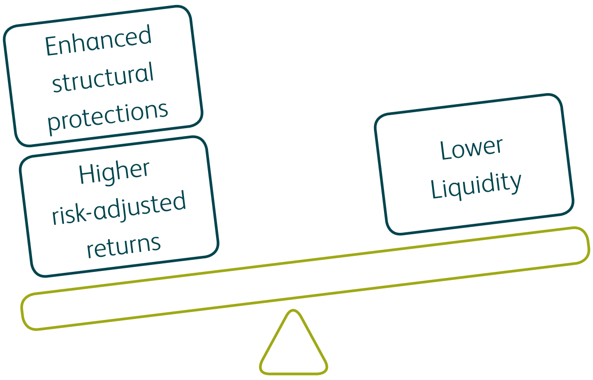
Meanwhile, the LCR measures the level of highly liquid assets, such as government debt, the bank has on hand to meet its average 30-day obligations.

As a result, banks simply have no choice but to hold a greater volume of liquid securities against the risky assets on their balance sheets – reducing their capacity to provide more capital intensive or longer-term lending.

Illiquid credit's appeal to long-term investors

Most illiquid assets derive their value almost entirely from their cashflows, rather than a perceived future market appreciation (beta), so are well suited to long-term investors looking for regular income. And as banks are increasingly compelled to pull back from these assets, long-term investors are perfectly positioned to step forward and pick them up.

Illiquid credit investing is a simple trade-off: what is lost in liquidity is gained in higher risk-adjusted returns and structural protections that can be far superior to those offered by public bonds.



For example, in a direct lending investment, covenants typically require the borrower to maintain debt ratios within set limits, and will hold talks with the lender should the business come close to breaching any of them. In these cases, the lender can be compensated by the company for amending or waiving the covenants giving additional returns to the investor. Covenants give the lender the right to negotiate directly with the company with the aim of ensuring that the company recovers or achieves a higher recovery – than, for example, unsecured corporate bonds, which don't have covenants – should the worst happen.

> "Illiquid credit derives its value almost entirely from cashflows that are well suited to long-term investors looking for regular income."

Another advantage is that many illiquid assets pay floating rate cashflows that increase accordingly in a rising rate environment, or have regular inflation-linked uplifts to their payment stream. Both of these types of contractual cashflows can perform specific tasks for investors looking for regular income over the long term.

In the cases where illiquid assets do pay fixed rates, the spread, or difference between the interest rate paid and the 'risk-free' government bond yield, can still be very attractive.

The truth behind the fabled 'illiquidity premium'

'Illiquid assets' has become a shorthand term for bespoke, private assets that are not generally available across the investor base. 'Illiquidity premium' is the label classically used to describe the difference between the returns of liquid and illiquid assets and has become shorthand for the various premia that should attach to an asset that is bespoke and non-standard. But, contrary to popular belief, there is no such thing as a fixed illiquidity premium. Any return premium is subject to change, and some illiquid credit assets are still so sought after that their supposed illiquidity "premium" is actually negative.

It is also wrong to suggest that this premium reflects illiquidity alone. Complexity is sometimes a bigger contributor to excess pricing.

Giving complexity its due

The lack of uniformity across and within illiquid credit makes it difficult for investors to understand and evaluate assets. In many cases, potential buyers need to find and source the assets themselves, which can be a resource-intensive, intricate and convoluted process. This essentially places many assets out-of-bounds for all but the most tenacious investors.

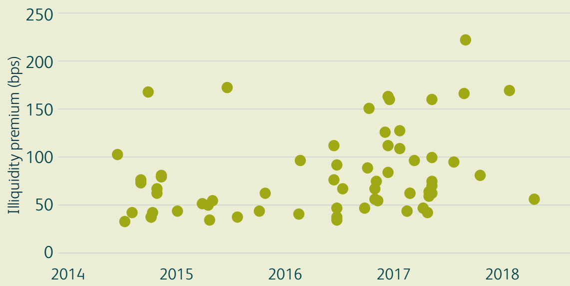
A relatively limited supply of potential buyers with sufficient skills to approach these situations has the effect of lowering overall demand. All other things being equal, this manifests itself in higher returns than from comparable, more popular liquid assets.

This excess return in numbers

The premium (measured in basis points) over comparable public bonds that is paid on illiquid credit assets varies significantly. The chart on the right hand side reflects a selection of transactions conducted by M&G since mid-2014.

While the group of deals in late 2017 appears to include a relatively healthy premium, there is no guarantee that this will continue to be replicated. Investors simply need to be prepared to act when value presents itself.

Illiquidity premia on recent illiquid credit investments



Source: M&G Investments, June 2018.

Illiquidity myths busted

The illiquidity premium is universal and can be quantified

No: In credit investing, illiquidity and complexity differ from opportunity to opportunity. Any premium paid is often more reflective of the complexity or structure of the deal than illiquidity. Being appropriately rewarded for all of the risks taken – including illiquidity – is more important.

Illiquid credit investments are long dated

No: While some illiquid debt lasts for decades, many assets have maturities of five to seven years or sometimes less. The key to making assets useful for long-term investors is to group them by common characteristics, such as medium term, floating rate returns or longer-dated, inflation-linked coupons, to create products suited to their needs.

Once you've invested in an illiquid asset, you're stuck with it

No: Selling is rare, and there is no established secondary market, but it is possible with the right expertise and a little patience to find a willing buyer for these attractive assets. As more non-bank investors enter this market it would be reasonable to expect more instances of selling.

This investment opportunity will only be available for a short time

No: The fundamental shifts in the regulatory and commercial landscapes mean that banks are gently pulling away from large swathes of the medium- and longer-term financing market on a permanent basis. While they are not usually selling large books of their existing assets, they are choosing not to renew on maturity which is gradually increasing the available pool of assets for investors to buy as time progresses.

How to approach illiquid credit

As new opportunities to invest in illiquid assets emerge from pipelines that can be difficult to anticipate, experienced investors have come to expect a dynamic and developing market.

Investors that are new to this market must consider a number of factors.

Pricing

Prices of different assets evolve in different ways, in response to demand and supply metrics that are primarily a result of the changing environment for banks, but which are also influenced by new entrants into the non-bank investor group with a strong motivation to buy almost regardless of price. Whereas highly liquid assets such as blue-chip equities experience almost instantaneous price changes as a consequence of changing supply and demand, it is perhaps no surprise that things are more complicated in the world of illiquid credit. The lack of a developed secondary market makes it much harder to price these non-standard assets and a constant view of asset flow is crucial to ensure that the price at purchase exhibits good value.

Since the height of the financial crisis, there has been downward pressure on spreads (the difference between the yield of a risky security and 'risk-free' government bond) across the entire illiquid credit market. However, the spreads of different illiquid assets have contracted at different rates. This makes some highly attractive at present, while others may become so in future.

As any given asset class reaches a viable scale it will attract greater interest from prospective buyers, an increase in demand that will typically cause its pricing advantage to begin to ebb away again. The essential rule is that first movers get the best assets for the best prices.

Cashflows

The stream of contractual cash coupons generated by a debt security is its primary source of value to investors, and the price of that security is theoretically derived from the sum of all its future cashflows. This is true of all credit but especially illiquid assets, which have no price conferred on them by a market and are almost always held until they mature, so an investor has no chance to profit from the appreciation of their value over time.

They are therefore best viewed as a source of reliable, predictable cash income rather than being a bet on future market price appreciation and its consequent requirement to generate performance by a well-timed sale of the asset. For long-term investors, illiquid credit can provide a regular and stable cash stream to help them to provide regular income.

"For long-term investors, illiquid credit can provide a regular and stable cash stream."

Flexibility, discipline and patience

Taking an open-minded, unconstrained approach to this market can enable a long-term investor to identify and exploit value from the myriad of differently shaped and sized opportunities as and when they are available and attractive.

Of course, such a 'lumpy' market can throw up disappointment, as a once-attractive asset class may suddenly display poor pricing or structures. In such circumstances an investor would be well-advised to step away and focus on other parts of the market.

As the regulatory environment for banks continues to transform, new opportunities for institutional investors, such as M&G, will emerge. However, the pace of change may be slow, as lenders can take a long time to retreat from asset classes in which they have traditionally been dominant.

Patience is also required for the careful negotiations with the borrower or the originating bank to secure the right price, structure and protections for a given investment opportunity. Private transactions tend to be negotiated over weeks or months (and, on the odd occasion, years).

The often slow pace at which opportunities emerge means it is not uncommon for an investor to keep an illiquid credit asset class under review for a number of years. However, once assets become available and attractively priced, the investor should be able to move quickly and capitalise on the buying opportunity.

A word of caution

While illiquid credit has much in common with public bond market investing, these assets still lie outside the mainstream of fixed income. They are private debt investments that do not offer the relative comforts of public credit ratings and public pricing information. The usual rules of thumb for private debt investing most certainly apply here.

Firstly, individual credit or deal selection trumps all other cards. The nature of this market makes it impractical to approach with an asset allocation strategy (dedicating a certain amount of investment to illiquid credit regardless of the availability of good opportunities). The only approach is to originate and value each individual investment.

Secondly, it is crucial for a would-be investor to maintain strong relationships with the right market participants: brokers, bankers and corporate finance advisers. Maintaining relationships with a large number of different market participants reaps rewards in the number and quality of investment opportunities made available to an institutional investor, such as M&G. The quality of the relationship with the broker or bank and other participants will also have a direct bearing on the final agreement on the terms of the loan.

Thirdly, when investing in an illiquid asset, it is important for the institution to be sure that it can recover as much of the loan provided as possible should things go wrong. Monitoring the investment, having absolute clarity on the lender's rights and obligations and putting in place specialised resources to fight for what is owed can mean the difference between success and failure.

Illiquid credit – 'fixed income' or 'alternatives'?

When it comes to non-mainstream assets, investors often come up against the question of how to classify them and, consequently, which investment 'bucket' to assign them to. In such situations, the application of first principles should always apply: what risks and returns does the investment deliver? And what problem does it solve?

Illiquid credit bears all the classic hallmarks of traditional fixed income investing. The main considerations for investors are the delivery of steady cash income and the credit spread at the point of purchase, rather than the expectation of future capital gains.

Going back through time, it was high-quality income rather than the potential for capital appreciation that bolstered the popularity of the earliest bonds, issued by the Venetian government in 1157 to fund a war with Constantinople.

Illiquid credit embodies all the qualities that investors have sought from fixed income since then, and M&G believes that these assets should reside firmly within fixed income allocations.

Case studies

M&G direct loans to Capital on Tap

Capital on Tap is an online lender to small businesses, founded in 2012 and has provided over £500 million in funding to more than 40,000 businesses in the UK to date.

M&G initially provided Capital on Tap with £25 million of senior debt financing in 2016. This has subsequently grown to circa £45 million across senior and mezzanine debt, which forms part of a wider funding package of £130 million secured in August 2018. The funding will allow the company to accelerate growth in the UK and launch in other countries across Europe.

This deal brings much needed cashflow to small businesses and is expected to generate attractive risk-adjusted returns for our long-term clients.

Assets	Conditions to meet	
Direct lending to medium-sized companies	Illiquidity	✓
	Predictability of cashflows	✓
	Availability	✓
	Compensation for risk	✓
	Structural protections	✓

Neoen harnesses wind and solar power

In 2015, French renewable energy producer Neoen obtained long-term financing for a portfolio of wind and solar projects located in France and Portugal. The nine solar parks and four onshore wind farms have a combined peak capacity of 100MW and receive secure, government-backed revenue streams for their power through feed-in tariffs.

M&G and Sequoia, a UK infrastructure fund, provided a total of €40 million fixed rate secured debt. This was validated as a 'green bond' since the transaction meets environmental, social and governance requirements. The bond amortises (repays) over its life. The long-term nature of the finance is possible due to the predictable cashflows generated by the renewable energy assets.

The deal provides an attractive risk-adjusted return for our clients while the capital enables Neoen to further expand its asset base.

Assets	Conditions to meet	
Renewable energy finance	Illiquidity	✓
	Predictability of cashflows	✓
	Availability	✓
	Compensation for risk	✓
	Structural protections	✓

Glossary of terms

Asset-backed securities: a debt instrument secured against a pool of assets such as mortgages, loans, receivables or bonds.

Basel III: a global regulatory framework developed by the Basel Committee on Banking Supervision requiring banks to hold a high level of capital against financial shocks. Was reinforced significantly after the financial crisis and now covers liquidity (see Net Stable Funding Ratio), risk management, governance and disclosure.

Bilateral: an agreement between a single lender and a borrower.

Bond: a tradeable debt instrument through which an entity borrows money for a fixed period and pays the lender interest at regular intervals, usually quarterly or semi-annually. The entire sum is repaid at the end of the contract (maturity).

Buy-side: investing institutions such as mutual funds, pension funds and insurers that buy and hold financial securities.

Commercial mortgages: private loans secured against commercial property.

Covenants: limits on a borrower's ability to behave in a way that is not in the interests of lenders such as a cap on the amount of debt relative to earnings the borrower can incur, how much cash it can distribute.

Credit analysis: the process of assessing the opportunity and risk associated with a company or debt security in the credit markets.

Credit rating: a system that assesses and categorises the credit risk of a company or debt instrument. The rating ranks the entity from most creditworthy (AAA) to least (D, signifying default).

Direct lending: bank-like loan financing extended directly to companies by non-bank investors on a private basis. Each loan is bespoke but typically a five to ten-year term with floating rate interest payments.

Distress: financial pressure on a company making it difficult for the entity to service its debt or fund its operations, so it faces insolvency. Can result in a debt restructuring.

Fixed rate: a coupon or interest rate on a debt instrument that is a fixed percentage of the principal amount.

Floating rate: interest structured as a margin over a floating base rate, usually Libor for sterling or US dollar denominated debt and Euribor for euro instruments. The margin is typically a flat percentage of principal.

Illiquid: not immediately convertible into cash. Illiquid assets have no secondary market in which they can be traded, are usually non-standard or created for one lender and borrower only, and held to maturity.

Lease: a contract in which the owner of a hard asset such as land, property or machinery agrees to rent the asset to another entity (lessee) for a fixed period in exchange for regular rent payments.

Loan: a private transaction in which a lender provides a borrower with an agreed sum of money for a fixed period, with the expectation of full repayment by the end of the period and payment of regular interest.

Liquidity: ability to convert assets into cash immediately or in a very short time. A market is liquid or has deep liquidity if there are many buyers and sellers able to facilitate a trade very quickly.

'Net Stable Funding Ratio': a rule of Basel III that requires banks to fund their operations with stable, reliable sources of finance. Aims to stop banks sourcing too much funding from the wholesale market.

Non-bank lending: all private debt financing not provided by banks; can include direct lending, private placements and leveraged loans.

Primary market: the initial sale of new financial securities, in which investors commit to purchase debt or equity that an entity is marketing for sale.

Private debt: non-listed debt instruments, including all non-bank lending. Instruments tend to be non-standard and change hands rarely in individually negotiated transactions.

Recovery rate: proportion of a debt that is repaid or recovered after an issuer defaults or debt is restructured.

Restructuring: a major change to a company's debt structure in which lenders can receive less than 100% of their money back.

Secondary market: marketplace for trading any financial security that was previously issued by an entity and which is now held by investors.

Sell-side: institutions such as investment banks that facilitate the sale of financial securities by acting as brokers, market makers, research providers, dealers and advisers.

Spread: difference between the yield of two bonds, typically a risky security and a 'risk-free' government bond. Also the difference between the bid price and ask price in bond trading.

Structural protections: terms and conditions of credit agreements that protect lenders, such as covenants or the provision of assets as collateral (security).

Supply chain finance: a way for companies to sell unpaid invoices to an investor, with a guarantee that the buyer of the goods or services will pay. The company receives the outstanding amount minus a discount as cash.

Syndicated: an agreement between a group or syndicate of lenders, and a borrower.

Trade receivables: money a business is owed by customers, which it has invoiced but not received payment. Can be sold or pledged to a third party for cash or a loan to release funds tied up in the business.

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