Chris Rust

Episode 192: Filling the Gap: The Case for Non-Sponsored Direct Lending

GUEST Q & A

Stewart: My name's Stewart Foley. I'll be your host. Today's topic is called Filling the Gap, the case for non-sponsored direct lending. And we're joined by Chris Rust, who's the co-head of European Credit Opportunities with 25 years in the industry with Ninety One. Chris, welcome. Thanks for taking the time to be on with us today.

Chris: Thank you very much, Stewart. Pleasure to join you.

Stewart: It's going to be fun, it's a beautiful day here in Chicago, and so the sun's actually out today and we've got no snow on the ground, so I'll take it. But before we get going too far, can you tell us where you grew up? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

Chris: I grew up in France, Germany, and New Jersey. We moved around a bit as a family, so I had that peripatetic background, as it were.

Stewart: The triad of culture.

Chris: Exactly. The triad of culture, indeed, indeed. So my first job that I'm fond of and remember keenly was a job I had in Germany in my teens working for the town garden and cemetery department, whereby I spent the summer essentially maintaining the local cemeteries and public gardens. And it was actually a wonderful experience, I really enjoyed it.

Stewart: That's cool. And how about insurance asset management? What do you think makes insurance asset management so cool?

Chris: I think what makes fascinating is that there's such a diverse set of considerations around insurance management, especially in the current world and market environment where there is such a broad range of emerging strategies, especially in the alternatives market that can serve a role for insurance asset managers to meet their needs. And so it's a very innovative, active, rapidly evolving space, which I think makes it really fun and interesting.

Stewart: Yeah, I agree. I think it's really... it's white hot right now, for sure. We're thrilled to be part of that activity as well. I think it's fair to start with, some investors are worried that there's a bubble brewing in private credit. What is your take on that?

Chris: That's a great question and clearly there has been a lot of discussion around this point, rightly so. My view on it is that a lot of capital has indeed come into the private credit space over the last decade. And to our minds and my mind, there is a bubble of sorts, if you will, certainly in the sponsor focused direct lending space. But what's important to bear in mind is that all this capital that has come into the private credit market has not been uniformly distributed across the various segments of the private credit market. And so whilst there has been an increase in competition and competitiveness in the direct lending market, which in turn has led to pricing pressure and arguably erosion of terms, such as covenants, et cetera, and increased leverage.

By contrast, there are other areas of the private credit world where there has been less competition. For instance, the market which we focus on, I.E., the lower mid-market, non-sponsored borrowers. To our mind, that actually remains relatively uncrowded because it's a market that is much harder to access. In summary, yes, a lot of capitalists come in,

yes, there's some heat in the space, but it's important to distinguish where that heat resides within the overall private credit market because it's very broad.

Stewart: I think that's a great point and well put. Let's talk more specifically about your focus on European mid-markets. Can you paint a picture of that space and maybe help us dispel any common misconceptions there?

Chris: I think the first point to make is that the European mid-market is a very large market. Indeed, one of the ways in which it is distinct from the US market is the preponderance of small and medium-sized businesses as a percentage of the total economy. So specifically, small and medium-sized enterprises, or SMEs, make up over 90% of all companies in Europe, which is a significantly larger percentage than it does in the US. And secondly, there is a very large funding gap facing these so-called SMEs in Europe. Indeed, there have been numerous estimates that point to a funding gap of nearly half a trillion Euros, which is about 3% of the European GDP.

So this funding gap reflects the amount of borrowings that these SMEs would like to take, but cannot. And that is the case because the banks in Europe have been retrenching and continue to retrench, which means that, simply put, these businesses do not have the same access to capital from banks anyways that they used to have. And they're crying out for capital, especially when it comes to capital that is more flexible and bespoke. So that's the second observation on the European mid-market. And the third one is that there are some fantastic companies in the European mid-market and lower mid-market. So to our mind, there's a very rich opportunity set to meet an unfilled funding need in this market.

Stewart: So I've got a little bit, well, not a little bit, I got a lot of skin in the game here because I'm a small business and we seek finance, and when we have people come on and they're always about doing sponsored deals. And the argument is a powerful one, you go, well, it's private equity and they got money to back it up in case something goes wrong and so on and so forth. And it's like, yeah, but there's a lot of very good companies that need funding that aren't necessarily owned by private equity, which is where you're focused. So that preamble gets me to this. What is the appeal to lending to sponsorless borrowers?

Chris: That's a great question, Stewart. Look, the answer to that is the following. First and foremost, in contrast to a private equity owned or sponsor backed borrowers, non-sponsored borrowers, or sponsorless borrowers, often tend to be less well-served by direct lending funds because their mandate is to focus on sponsored borrowers. And what that means is that for managers who are able to originate opportunities to lend to non-sponsored borrowers and structure and manage the loans to them.

Typically, it means they are at a less competitive and a less crowded market, and so one of the appeals of lending to non-sponsored borrowers is precisely that, namely it's a less crowded, less competitive market, which means that you're not competing just on cost of capital or how few covenants you have in your loan document. So that's one appeal. The second is that it's a very large market, at least in Europe. I already mentioned the structure of the market whereby SMEs make up the majority of companies and the four to 500 billion funding gap.

The other appeal of lending to non-sponsored borrowers is that because the market is less crowded, there is the potential to generate attractive risk returns. So in our market, we view opportunities whereby we can lend on a secure and asset backed basis, with target net returns to investors in the double-digits. So that's really compelling to have that risk profile of potential double-digit net returns with good downside protection, including in borrowers that arguably the loans to which should be arguably less correlated to a lot of other asset classes.

Stewart: And you've kind of led me right to my next question, which is you have chosen to pursue an asset-backed private credit strategy rather than a cashflow lending strategy. Can you talk a little bit about why that is and just sort of the difference?

Chris: You're absolutely right, Stewart, that we have deliberately chosen to pursue an asset backed lending strategy for the simple reason that, in the main, the downside protection is greater in asset backed loans than in cashflow loans, at least in our mind. Defaults will happen over time in any strategy, most likely. It's very hard to avoid them over a long period of time.

Defaults themselves are drag on returns. However, the big drag on returns is the loss given default. And if you look at statistics, for instance, the high yield and leveraged loan markets over the last 25 years, the recoveries on defaults for high

yields and leveraged loans over the last 25 years has ranged, if I'm not mistaken, from roughly 40 cents to 60 cents. And these are cashflow loans in the main.

By contrast, asset-backed loans, if these are well-structured, have the potential to recover higher amounts, maybe even par. And certainly that is our aim. When we underwrite, we stress test the assumptions to see what our recovery would be on our loan, and we aim for investments where that recovery is near par. And that's the reason for the asset backing, it's really around downside protection because that's clearly one of the propositions of that strategy.

Stewart: When we look at the European non-sponsored market, what are the keys to success there? Is it in the origination? I mean, you mentioned the 90% SMEs, obviously there's a great deal of companies that would be in your target market. Talk to us about what are the keys to success.

Chris: I think there are two keys to success. You mentioned one of them, which is origination. I'll come to that in just a moment. And secondly, it's the skillset that includes not just good credit skills, but crucially also private equity and workout skills. Because in the absence of a sponsor, a private equity sponsor, behind these borrowers, it falls on people like us as the private credit provider to the non-sponsored borrower to assume the roles, if you will, of that sponsor as these roles relate to the underwriting, but also the management of the loan, including particularly in the event there is an underperformance or a default. So that's a key success factor. The manager should have those three skills, workouts, PE skills and credit.

And in terms of the origination, the way to originate these opportunities is not by having a network of relationships with the private equity funds definitionally, nor is it, for that matter, by having relationships with the distressed broker dealer desks of the banks in London. Rather, in order to access these non-sponsored borrowers, it is essential to have relationships with their advisors. And typically those advisors tend to be smaller advisors and very local markets. It might be the law firm, the accounting firm, could even be the owner's wealth advisor. It might be a two person advisory boutique. And whilst they may be in the capital cities like London or Paris or Frankfurt, oftentimes they're in so-called secondary cities like maybe a Rotterdam or Stuttgart or Birmingham. And it takes time to build up the origination contacts in those locations throughout Europe in order to access this market opportunity.

Stewart: Yeah, I can see how that would take time to amass that network.

Chris: And that's what, Stewart, this is what creates those barriers to entry to this market. A lot of investors rightly ask us, well, guys, I mean, you're painting a really interesting picture here. It sounds like what you're saying anyways is there's scope and potential to generate double-digit net returns to investors, but with really good downside of risk management. And how is this possible if this market is so attractive, surely should be more crowded? Well, we explain that. That's a great question. It just so happens that it is not easy to access. It's quite a labor-intensive strategy because of this origination model, but also because of the need to have this broad range of skillset.

Stewart: Yeah, that's really interesting. When you think about a US insurer, why would they add European private credit to their global private credit portfolio, and what role, in your mind, would it play?

Chris: I think adding exposure to strategy such as ours, which is to say lower mid-market, non-sponsored European lending, can have the potential benefits of, one, adding diversification to asset owners' portfolios, and in doing so, reducing correlation within their portfolios. Secondly, what we think it has the potential to offer is potentially attractive risk adjusted returns because the market in which we operate in Europe is not very efficient and this is really what's generating that attractive risk return potential. Thirdly, these loans have the potential to offer high absolute returns. We talk about double-digit net return targets of 12% or more. That also has the potential to be of appeal to asset owners. So there's a few things there really that can be of interest.

Stewart: So it would be helpful, I think, if we could walk through an example of the kind of deals that you're looking at. And you've talked a little bit about how you originate, but how you evaluate and so forth. Is there an example that you could share with us without revealing the recipe to the secret sauce?

Chris: Yeah, absolutely. There are a few that come to mind, but I'll choose one, which is the following. We lent around 25 million Swiss Francs to a Swiss borrower this past year, which basically was looking for funding to grow a venture of theirs in a consumer space in the oral hygiene space. Specifically, they were looking originally to raise equity to fund this growth.

Now, the cost of growth equity is pretty high. I mean, over sort of 3, 4, 5 year period, most growth equity investors expect a return of, I don't know, 4, 5, 6 times, if not more, on their investment.

We sourced this opportunity through a two person boutique we know. They put us in touch directly with the two owners. And when we met them, we said, "Look, we're not growth equity investors and unfortunately we cannot lend to this business of yours because it's too early stage. However, are you open to a loan deal, and if so, do you have any assets that you could pledge?" And these entrepreneurs said, "That's a great question. We hadn't thought about this. But yes, we are open to a loan deal and it so happens we do own assets. Indeed, we own a portfolio of residential real estate in Switzerland. Now, it is encumbered because you shouldn't be surprised. We have borrowings against it from Swiss banks, however, it's actually moderately levered. So there's actually a lot of residual value or equity value in this portfolio."

And it turned out that based on this discussion, we collaborated with them to arrive at a loan structure whereby our loan has a three-year tenor, a target net return to investors in the mid-teens in Euros. This return comes from a combination of cash interest and capitalized interest paid out at maturity. And from a security perspective, we have charges over the real estate of this portfolio. So we have second ranking liens, we have recourse to the venture whose growth we're funding, and we also have personal guarantees from the owners, who are very wealthy owners with a lot of other assets.

And I described this deal because it's an example of, firstly, how we source, which is through small advisors, as I mentioned. In this case, a two person boutique. This opportunity was off market. Secondly, how we like to create solutions for borrowers that are an attractive alternative to equity. Oftentimes we are competing not with other loans, we may be, but oftentimes it's against equity. And whilst our loans are not cheap in the sense of standard loan terms, certainly they are cheaper than most forms of equity, as is certainly the case here.

And it also illustrates how we like to include asset backing into deals. So here we have a loan that is effectively a corporate real estate hybrid, and it has all the hallmarks of our strategy and is reflective of the opportunity set in Europe and the benefits that can be offered to investors. Such as in this case, you have a loan that has a double-digit target net returns with asset backing and good downside protection because the loan to value is around 65% maximum.

Stewart: That's really helpful, and that's a great example of... and again, that's not particularly a straightforward deal. That requires some innovation in your part, some creativity, but it sounds like a terrific structure and a terrific result all around, so.

Chris: That's right, and the owners, they told us themselves, Stewart, they said, "Listen guys, we know what you're lending us is not cheap, but equally, genuinely we're pleased because we've kept full control of this business, we don't have an intrusive dilutive minority shareholder, and we can repay you in two years. You have a two-year non call. That's fair enough. But we like that because with equity it's much harder to get rid of an equity investors. So thank you for that flexibility and we're happy because we got a really nice structured loan with good risk return targets."

Stewart: Yeah, that's terrific. I really appreciate it. I've learned so much today, Chris, and thanks so much for being on. I want to leave you with a couple of fun ones out the door. What's a good piece of advice that you've gotten over the course of your career that you'd like to share, and who would you most like to have lunch with, alive or dead?

Chris: Look, in terms of advice, one of the pieces of advice that I've always treasured is just to never give up. Just keep going. Life throws things at all of us, and what's really essential is just to try to roll with those punches, which inevitably will come. That's the nature of life. Pick yourself up and keep going. That's not to say it's easy, but it's important to have that mentality of just persistence, tenacity, picking yourself up. So that's on the advice side of things.

As to somebody I'd love to have a meal with, I spent some time with, is actually someone who recently passed away and I know many people are fond of him, but certainly I would find it fascinating to sit down with Charlie Munger. Seems such a remarkable individual, so well-read and well-rounded. Clearly, very thoughtful. Witty as well. And I just love his philosophy around life and business and investing in so far as it includes this multiple models, if you will, of looking at life and investing and business. I think that's a very rich, fascinating mindset. So I'd love to sit down with him.

Stewart: That's fantastic. I really appreciate you being on today, Chris. Thanks for taking the time and thanks for all the education today.

Chris: Fantastic. Likewise. Thank you so much, Stewart. It's been a pleasure.

Stewart: It's been terrific. We've been joined today by Chris Rust, co-head of European Credit Opportunities with 25 years in the industry with Ninety One. Thanks for listening. If you have ideas for podcasts, please shoot me a note at podcast@insuranceaum.com. Please rate us, like us and review us on Apple Podcasts, Spotify, Google Play, Amazon, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.

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