PRIVATE DEBT IS BECOMING A STAPLE OF PORTFOLIO ALLOCATION

- Thierry Vallière & Thierry de Vergnes, **Amundi**

In Europe, 2017 saw loan emissions exceed those of high-yield bonds and 2018 now starts with a strong message to the finance sector. Following in the footsteps of post-crisis US regulation, new European rule now requires banks to implement soft caps on maximum leverage – net debt/ EBITDA. This will certainly influence how the most ambitious bank financings are structured and will also impact the overall private debt market. In this context, asset managers will have a crucial part to play, as ***Thierry Vallière****, Global Head of Private Debt Group, and* ***Thierry de Vergnes****, Head of Acquisition Debt Funds, at Amundi explain.*

Ryan Flanders: **The private debt segment is experiencing significant growth. Will this last?**
Thierry Vallière: There is a combination of factors which are creating a complex macroeconomic environment. Unconventional monetary policies and low rates have had a significant impact on all asset classes. As return opportunities get scarcer, investors are led to focus their attention on the same assets, which, in turn, become more expensive and less liquid. In addition, new risks emerge, linked to portfolio concentration, increased correlation and lower volatility.

Today, private debt attracts investors as it shelters them from some of these issues, which we know will not go away. Even if unconventional policies start to recede, they will probably not totally disappear, and interest rates are not likely to rise sharply in the near future.

Thierry de Vergnes: The growth of the private debt segment is driven by structural, not cyclical, evolutions. As a matter of fact, the 2008 crisis has led political leaders and regulators to massively modify financial regulations, especially for banking activities. Rising capital costs have pushed banks to adopt an "originate to distribute" model, which changes things on the financing market. In contrast, by providing institutional investors with easier access to private debt, national and international regulators have contributed to entrusting them and asset managers, rather than banks, with the role of financing the economy. In the US, more than 70% of the financing market is now disintermediated, as opposed to only 20% in Europe. We will not get close to the American model any time soon, but we see a similar trend in Europe and there is significant room for increased disintermediation.

RF: **In this new environment, is supply within the private debt market in line with demand?**
Thierry Vallière: Developed countries are entering a cycle of economic recovery, and companies are looking for financing. Naturally, they increasingly turn to institutional investors, as banks can only offer limited opportunities. So we see increasing convergence between what issuers want and what investors need.

Thierry de Vergnes: Institutional investors are, indeed, having a hard time finding assets and returns to balance their liabilities. Private debt appears as a fitting solution. In addition, fundraising has reached all-time highs over the last few years, which provides ample amounts of money to invest. European issuers should certainly benefit from this, and asset managers should also as they will have more choice for their portfolios.

RF: **How can private debt meet investors' needs?**
Thierry de Vergnes: There are multiple advantages of private debt. First, it helps reduce the concentration of fixed income portfolios, thus mitigating their credit risk as well as the risks linked to rising interest rates. It also provides additional asset diversification. Rather than just focusing on traditional corporates, which are already part of their bond allocations, investment grades or high-yield portfolios, private debt will enable investors to access up-to-now inaccessible corporates. These include, for instance, corporates which are under private equity, and funded by loans. The private debt segment also enables investors to gain exposure to infrastructure or real estate debt. So it does open the door to a broad range of issuers, to which they had no access before.

On top of this, it is worth mentioning that most private debt assets are backed by a Euribor and margin-based coupon, which in the event of a rise in interest rates provides an interesting defensive feature.

Thierry Vallière: Private debt enables the capturing of premiums of various types, which come from the difficulty of sourcing assets, but can also be linked to asset sizes or to structuration complexity. Finally, in most cases, private debt benefits from tight legal documentation and asset guarantee.

RF: **What is the right amount of private debt in a portfolio allocation?**
Thierry Vallière: Private debt has become a staple of any portfolio, and the size of the private debt market makes it impossible to ignore. These assets are part of a global fixed income strategy, without replacing traditional bonds. Private debt helps capture additional premiums and other correlations that traditional fixed income cannot offer. It is all the more essential in a diversified portfolio that it is not strongly correlated to traditional assets.

However, the amounts available for investment in this asset class are such that they call for a high degree of caution in the selection of assets. Private debt is not immune to decreasing returns and weakening legal structures and documentation.

RF: Can liquidity hinder investment?
Thierry Vallière: What we have seen, after the crisis and the ensuing tightening of regulations, is a reduction in liquidity across all asset classes. Investors have increasingly grown used to this, and have, over the years, turned to new markets in order to find returns. They went from investment grade to high yield and now look favourably at emerging markets. This is a trend that favours our asset classes, which instantly reward relative illiquidity. The lack of liquidity is even less of a problem as some institutional investors hold long- or very long-term liabilities, and do not need their portfolios to be instantly monetized.

Thierry de Vergnes: With private debt, investors accept to trade in a lower level of liquidity for other advantages. Absolute return is higher than on the public debt market, especially because access to private debt is more restricted. In terms of risk profiles, private debt assets also fare better than their public counterparts. This is due, in particular, to the private market's stringent requirements in terms of transparency and legal documentation. As such, they often provide stringent contractual protection; private debt provides investors with added security on the issuers' assets, which is not always the case in public debt markets.

RF: You said thorough selection of assets is key. How do you do this?
Thierry Vallière: In a fast-growing market, we are convinced thorough selection is the key to success. It is essential to discriminate when choosing and to look for diversification. Our hit ratio for corporate private debt activities is only 1 in 20. Being a sizeable player with strong visibility gives us good knowledge of what is going on in the market.

Amundi is Europe's premier fixed income platform. We rely on an exceptional infrastructure, with a dedicated team of 15 highly qualified experts for private debt only. Publications and sources of information on private debt are rarer than for traditional asset classes, which makes the quality of credit analysis even more crucial. In addition to managing sourcing, credit analysis and documentation, our team also manages asset structuration and monitoring.

Thierry de Vergnes: In terms of leveraged loans, Amundi boasts an excellent deal flow. On the one hand, we are reaping the benefits of our investment program in buyout funds – €3bn invested across 200 funds. On the other hand, we take advantage of the good relationships our position as Europe's largest fixed income asset manager allows us to build with investment banks.

Thanks to this exceptional deal flow, we can be very selective when choosing LBO debt investments. Our portfolios are built on both the primary and secondary markets, to capture market opportunities and also for diversification purposes. We apply a rigorous diversified approach to sectors and issuers, which helps minimize volatility.

Our leveraged loans portfolio is truly European, while corporate private debt portfolios are c. 75% French.

Thierry Vallière: Being generalists is also a plus. Amundi is an integrated organization, and we are challenged on the relative value of our investments. Several traditional fixed income professionals, including our Group Head of Credit Research, are members of our Investment Committee. We have the scope and teams to deal with complex private debt assets. However, for each operation, we strive to show the premium's relative value and the protection and diversification bonuses the asset will provide in the framework of a global investment strategy.

AMUNDI
Amundi is Europe's largest asset manager by assets under management and ranks in the top 10[1] globally. Following the integration of Pioneer Investments, it now manages over €1.4tn of assets[2] across six investment hubs based in 37 countries. In 2016, Amundi launched a platform dedicated to real and alternative assets to provide easier access to unlisted investments. Bringing together capabilities in real estate, private debt, private equity and infrastructure (green energy), this platform has a headcount of 200 people for AUM of €38bn[3], and offers solutions through single funds, club deals, and multi-management funds, including two innovative and ambitious partnerships with EDF and CEA.

As part of this new platform, the Private Debt division Group has a dedicated team of experienced professionals in asset management who leverage Amundi's Fixed Income extensive capabilities: N°.1 European bond manager with €700bn+ of assets and 150 dedicated professionals including 10 in-house research experts and 20 sector analysts.

THIERRY VALLIERE
Thierry Valliere is Global Head of Private Debt Group. He oversees all private debt activities and is co-chairman of the Investment Committee for the asset class. Thierry holds a postgraduate diploma in Corporate Finance and Financial Engineering (with honors) from Paris-Dauphine University.

THIERRY DE VERGNES
Thierry de Vergnes is part of the Private Debt Group. He is Head of Acquisitions Debt Funds and is running liquid leveraged loans activity in Europe. Thierry has a degree in Mining Engineering, an MBA from the Institut Français du Petrole and is registered with the FCA.

real-assets.amundi.com

[1]Source IPE "Top 400 asset managers" published in June 2017 and based on AUM as of end December 2016.
[2]Data combined for Amundi and Pioneer Investments at 30 June 2017 prior to harmonization of accounting methods for AuM.
[3]Figures as of 30 September 2017.