Observations on Debt & Alternatives Markets

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Frontier Advisors Pty Ltd

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture.

Our research team

Allison Hill and Joey Alcock of our Debt and Alternatives Research team travelled to Edinburgh, London and Zurich in April 2013, meeting with more than 30 fund managers. The meetings covered numerous asset classes and investment strategies including private equity, currency, traditional and alternative fixed interest, multi-asset managers, global macro, and volatility managers. While much time was spent discussing and assessing the capabilities of the managers themselves, discussions were held with a wide spectrum of investment professionals to enable analysis of a series of market views to compare and contrast.

Allison Hill

Joey Alcock

The rise of institutional capital

The behavioural consequences of the low real yield environment appear to have hit the illiquid credit market in Europe, with managers commenting on a notable change in market dynamics that occurred towards the end of 2013 and which continues today. The balance between the supply of capital and the opportunity set now appears distorted.

For investments being sold in open, intermediated auctions (typically via investment banks), it is reportedly not unusual to have up to 50 investor groups reviewing offering documentation.

The mix of investors may include a variety of private equity funds as well as hedge funds (who are willing to take the liquidity mis-match risk) but also asset owners like sovereign wealth funds with their own internal investment teams.

Many fund managers Frontier met with simply no longer review these deals unless they have an informational or operational edge that will allow them to enter a competitive bid, with the pricing of many deals being extremely tight. For example, it was reported by one fund manager that the National Asset Management Agency (NAMA), the Irish "bad" bank, recently sold a portfolio of assets that was so heavily bid the return of the winning bid as estimated by the fund manager from the known cash flows will be 0%.

This indicated a very aggressive assumption had been used by the winning bidder with respect to future growth of earnings to get to a suitable return on the investment. This was but one of a number of manager anecdotes pointing to uncomfortably elevated competition in this space.

While competition is significant, the volume of problem assets remaining in Europe is also large. With European banks returning to modest levels of profitability, they now have greater scope to take some losses on such assets. Strong demand for almost any yield-bearing assets also means the losses are less likely to be large.

These combined impacts mean opportunities are likely to continue flowing steadily to the market. For those managers offering strong proprietary sourcing networks, and/or who are able to offer innovative or structured solutions, Frontier believes investments with suitable rates of return given the risks can still be achieved.

This environment however, requires exceptionally strong confidence in a manager's ability to extract alpha.

Leverage is back baby!

Due to the dynamics just mentioned, managers indicated many deals are being underwritten by investors on increasingly tight margins, and in order to make these deals economic, these investors are increasingly applying (cheap) leverage.

While the use of leverage to meet investment return hurdles is not new, the pace at which leverage levels appear to be rising does speak to a market where pressures are reappearing in a pattern observed all too well before the crisis.

With strong indications from central banks that stimulatory policies may well still be in place for some time to come, risks around leverage may well be manageable for the time being but Frontier continues to closely monitor this dynamic. What might bring the dance to a halt this time?

How much is enough?

Many managers feel investor return expectations are increasingly moderating in today's environment of low real yields.

Managers who previously would have underwritten private equity-like investments to a gross 20% IRR (or higher) return, now see investors happy with a mid-teens gross return or even lower in some cases for ostensibly the same level of risk.

One manager highlighted an example where they were recently asked to build a multi-asset mandate which would target a 4% p.a. real return with 12% p.a. volatility!

These types of investor responses may seem unusual to Australian institutional investors, who have experienced strong equity market returns and meaningful positive real yields over recent years.

Internationally however, the experience is different and has curbed expectations, potentially highlighting an increasing divide between the investment objectives of large foreign investors and Australian superannuation funds.

The consequential impact of this for pricing and competition for deals is something that needs to be held front of mind for Australian investors.

Roll on banks, roll on …

It appears European banks are also in the lending game once again - a necessary pre-determinant for investors to obtain leverage - after a few years in the wilderness.

There was a dispersion of views among fund managers as to the precise nature of the increase in bank activity. Several managers said their phones are ringing again with offers for (cheap) financing on deals.

Others indicated that while banks are providing financing, it's only in a facilitation role (which would align well with the goals of central banks and governments). That is, a debt package will be structured up by the bank and sold off to other investors from the bank's balance sheet quickly.

This is making the environment difficult for direct lending and mezzanine debt providers. Even so, it does pose risks for the banks as well should they fail to move all of these assets off their books.

Some participants highlighted however, that while the banks still have bad assets, they continue to need to grow revenue, with shareholders intolerant of declining profits.

Therefore, as assets mature and roll off balance sheets, they need to again acquire assets to maintain a revenue base.

In a competitive environment, some fund managers believe quality standards around assets being acquired are being compromised, seeding potential future issues for these banks.

Anecdotally, banks are maintaining credit checks for exposures they continue to hold, and have a preference for "investment grade" pools of assets (even if the pools of assets are "loosely" defined as investment grade, such as a pool of credit card receivables).

The most aggressive behaviour is from those banks who can "afford" to be so, with some German banks being noteworthy as well as those that were supported by government bailouts like Lloyds and RBS.

However, even those not in positions as strong, need to be active in the market to maintain revenues. With competition increasing in the market, we again need to monitor credit worthiness and lending standards.

Oops, they're doing it again …

With investor demand so high for interest bearing securities, we observed a notable trend of increased issuance of high yield (albeit from a low base relative to the US) and bank debt in the European market.

Examples were provided where small companies, who previously couldn't have dreamed of accessing liquid capital markets have now been able to.

For example, GHD (makers of hair straighteners) is a single product line company in a non-essential good with $30 million EBITDA. It recently issued a high yield bond for $150 million which was significantly oversubscribed, in order to fully refinance an existing term loan, despite being a first time issuer. In this instance, the coupon on the bond was the same as the interest rate on the loan (reflecting the demand for the issuance), but the refinancing of course released the company from its covenant obligations under the loan terms.

These issues concern Frontier and as a result of these observations, we will be undertaking an updated review of the bank loans market to assess the balance of the return being received for risk undertaken.

It was also noted by private equity managers we met, the initial public offering (IPO) market remains hot for new deals, although trade/strategic buyers are not averse to paying up for some companies either.

As the IPO window reopened over a year ago, private equity-backed exits were typically the first and second tier companies in an industry.

More recently however, managers believe companies with potentially less merit will now be readied for exit to capitalise on this ample liquidity.

In addition, while offers for IPO and/or secondary or co-investments were being readied, trade buyers were coming in and "blowing others (i.e. financial buyers) out of the water".

While strategic imperatives may account for some of this, the lingering concern is that cheap and readily available debt may encourage poor behaviour at the corporate level.

Market data certainly sees debt and entry multiples creeping up to, or beyond pre-GFC levels in the private equity universe.

It was these trends that saw Frontier introduce a negative "half-bar" for international private equity in our last Quarterly Asset Allocation Review and Outlook.

Europe – a continent divided?

Perhaps one of the most interesting conundrums we discussed with all parties was that of economic conditions in Europe.

Consensus held that there was real economic growth in Europe, albeit at a sub-par level (about 1% on average). It was also felt inflation (or disinflation) was not yet an issue.

The remaining story however saw many divergent views from managers. Two managers with whom we met held the view the Eurozone will not be able to withstand ongoing economic pressures and break up.

One, somewhat tongue-in-cheek comment from a manager highlighted that Germany, as a result of the Treaty of Versailles, was required to pay out the equivalent of 3% of its GDP in reparations to Allied nations following World War I. The stress this placed on Germany was a driving factor in causing World War II. In the estimates of the manager, Germany is now in the position where it will have to transfer away the equivalent of around 8% of its GDP in perpetuity to help finance the recovery of weaker Euro-member nations.

Ultimately this manager believed the net present value of this equation wouldn't be tolerated by Germany, and despite some initial pain from a currency perspective (i.e. a "new Deutschmark") the breakup of the Euro would be the end result.

Other managers were marginally more moderate in their outlook believing that the ECB would hold its course and "jawbone" the confidence of the market, but ultimately there would be no material action as Germany wouldn't allow it (being not directly in its interest).

Given this, if the market "calls Draghi's bluff", there could be material economic instability.

Yet another group of managers was far more constructive, believing the ECB would take action, whether it is rate cuts, or bond purchases, to ensure the value of the Euro does not rise too much further and peripheral European countries' interest rates moderate to stimulate economic growth and allow Europe to trade through the crisis.

In general, the market seems to be trading towards the latter view, so any information to the contrary, including poorly worded commentary by central bankers, could see considerable market volatility.

Of course, the future of Europe is likely to be as much politically determined as it will be by economic influences, so we continue to highlight the importance of acknowledging both of these forces.

The alpha bet

With volatility across most asset classes at low levels, and with investment strategies reliant on market directional plays struggling for clarity over recent periods (witness the poor returns from most hedge funds over 2014 to date, and in particular the trend followers), many of the managers we spoke with emphasised the attractiveness of relative value bets and “alpha-seeking” in the current environment.

Broadly speaking, their focus has turned more to identifying ways to make money from security selection within market segments and/or using “active management” to extract value from deals rather than rely on broader market movements.

It is all well and good for managers to espouse active management strategies as a way to continue generating returns when yields are low and there appears to be evidence some securities are behaving more in line with fundamentals of their intrinsic risk characteristics (that is, increased cross-sectional volatility).

However, we encourage continuing vigilance with respect to identifying what are genuine alpha strategies versus what may only appear to be so, on the surface (for example, where managers state they are more comfortable using greater leverage on deals than before because “risk has declined”).

Even so, Frontier continues to advocate active management when we have high conviction in a manager’s team, strategy, investment process and “edge”.

Conclusions

Our European-focused research trip has sparked further research in several areas, including an updating of our view on the bank loans market.

Frontier believes there are a number of emerging risks for clients to monitor when making asset allocation decisions. These risks include “underlying” risks like covenants and investor aggressiveness, which are, based on risk and return measures, less easy to observe in a real time manner.

Investors also need to consider what rates of return they are prepared to accept going forward, noting returns across many asset classes are broadly being bid down by the international investor community.

The increased disparity in the global economic landscape, (e.g. rates likely to go up in the US, and possibly the UK, while Europe and Japan may undertake further easing), as well as currently low base rate yields, leads Frontier towards having a preference for active “alpha” strategies where manager skill can generate appropriate returns net of fees.

We therefore apply a high hurdle on these opportunities and have identified a select number of managers on this trip that we believe are of interest and on which we will conduct further research.

Naturally, we would be pleased to speak to you to share more information on these managers and ideas.

Level 16, 222 Exhibition Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

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