CANADIAN ASSOCIATION OF ALTERNATIVE STRATEGIES & ASSETS

PRIVATE CREDIT IN THE 2020s: AN ASSET FOR A CHALLENGING TIME

How this age-old investment option has adapted to recent market and industry trends to deliver returns to investors and needed credit to borrowers

We would like to thank the following CAASA members for helping to make this paper possible:

apcapital.ca

cameronstephens.com

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About CAASA & This Paper

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is inclusive in that it welcomes participation from all companies active in the space (375+ members in 2023) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very active, organizing numerous conferences, webinars, socials, and podcasts throughout the year. Pan-alternative, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

As with all our papers, we use an external writer to draft it from interviews with participating members and it represents, in the end, our views and not necessarily that of every participating member.

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Foreword

“It’s always something - if it’s not one thing, it’s another,” was the refrain of Roseanne Rosannadanna, played by Gilda Radner on Saturday Night Live. While firmly in the world of satire, it could be the mantra of any investor over the last, say 2,000 years. Or course, modern economic memory ranges from a few decades to a few minutes in the past - but the notion retains its applicability: there is always something to worry about and keep one from investing.

Over the last 15 years, the world has lived (somehow) through the Great Financial Crisis, COVID-19, and a precipitous uptick in inflation and interest rates around the globe. These three regime changes have produced inflection points for many investments and asset classes, and private lending is one that has taken advantage of these so-called crises and stepped up to the challenge.

The GFC redefined how banks go about their business of lending to many sectors of the economy – private lending stepped in to fill the gap. COVID-19 further challenged lenders’ ability to adjudicate credit and put much-needed capital into the financial system – and nimble lenders were able to adapt their processes to keep the financing flowing. Now inflation (see our previous papers on the back cover) has created further buffeting headwinds to investor portfolios – and private lending’s predominantly floating-rate and short term (low duration, thanks to higher yields) features have enabled the industry to continue to deliver to both investors and lenders.

This paper will delve into these topics and highlight some areas of specialization that investors can take advantage of. Enjoy!

James Burron, CAIA
Co-Founder & Partner, CAASA

Overview

The practice of lending is as old as finance itself. Loans and debt instruments, typically called ‘fixed income’ securities, make up a significant component of many investors’ portfolios, with 40% of the traditional 60/40 portfolio allocated to bonds purchased on the public markets.

The primary lending institutions remain the traditional banks who issue loans and mortgages to organizations and individuals. However, as banks look to reduce their exposure to risk, and as governments tighten regulations in order to, in their view, safeguard the financial system against crashes, loans and fixed-income investments purchased outside the public markets, so-called ‘private credit’ or ‘private debt’, has come into its own.

What is private credit?

Just like private equity is a type of equity investment made off the public markets, private credit is a type of debt investment made off the public markets. And just like private equity, private credit investments can be hugely varied, with loans tailored to the circumstances of the sector, the market, or even the specific borrower.

Investing in private credit could mean investing in mortgages, or investing in a loan to a real estate developer. It could mean investing in a strong and successful organization that simply requires a tailored borrowing solution, or it could mean investing in a loan to a distressed organization.

Corporate private debt and real estate continue to be the predominant private credit strategies, but there are now many niches, such as litigation financing, trade finance, royalty financing, or asset-backed lending.

The appropriate private credit solution will depend on a specific investor’s risk tolerance, and investment objectives.

From crisis to crisis

Private credit solutions have existed for as long as human beings have lent money to each other – but like many alternatives, “private credit” as an asset class truly came to the fore after the Great Financial Crisis (GFC).

During the GFC, the risks borne by lenders due to so-called “subprime” borrowers became the subject of a significant amount of public scrutiny. To reduce this risk, regulators and banks began tightening the rules around lending money, narrowing what an “acceptable” borrower might look like, and requiring extensive documentation, like proof of income, to secure a loan.

Capital charges levied against banks also increased, making it more expensive for banks to hold longer-term debt, and constraining them in terms of the type of lending solutions they could provide.

Together, these phenomena created a gap in the market. Certainly, there were borrowers who, after the reforms, did not qualify for bank loans due to financial instability. But there were other borrowers who, despite being perfectly able to support a loan, would be turned away under new rules. These borrowers might include self-employed individuals, business owners who write down their income for tax purposes, or newcomers without a local credit history.

Following the GFC, private lenders began to fill this gap left by traditional lending institutions. Investors, in turn, began to allocate capital to them, drawn by an attractive risk-adjusted return, and by private credit’s lack of correlation to volatile financial markets.

What was previously the domain of progressive investors, such as high-net-worth individuals or family offices, began to attract institutional capital.

In 2023, the value proposition that made itself clear during the GFC has once again come to the fore: rising interest rates and slowing economic growth have put many borrowers outside the lending criteria of traditional banks, not only because of income requirements but also because of the rise of self-employed and gig workers. Investors, again seeking refuge from volatile financial markets, allocate to private credit for an attractive risk-adjusted return.

This year, and going forward, private credit deserves serious consideration for inclusion in any investor’s portfolio.

“The Canadian market is far less crowded with private debt players than in the U.S. In Canada, we compete primarily with the banks. In light of increased capital charges, the banks are highly constrained in providing flexible, more creative, more patient capital. We can provide that capital. These developments have allowed us to win more transactions and access a larger opportunity set.”

Theresa Shutt
Head of Corporate Debt
Fiera Capital

“If you look after the Global Financial Crisis, you have all these private debt funds that really took off, and they’ve certainly multiplied. This is equally true in real estate lending, where private lenders’ business began to accelerate substantially. The traditional lenders pulled back and so they had to defend their balance sheets – they were under stress. Simultaneously, the economy began to recover rather nicely and rather rapidly, and so the demand for housing and industrial and commercial properties continued to rise. And so, you had a mismatch between the demand for real estate and the availability of credit.”

Daniel Marchand
Managing Director, Capital Markets
Cameron Stephens Mortgage Capital

"When the banks tighten, they tighten because of regulatory requirements, from the federal regulator, OSFI. We're regulated differently. Our regulation tends to fall more in the provincial side, and we don't have to follow the same rigid underwriting practices that the large banks do. So oftentimes when banks get constricted, it pushes borrowers into our space and we end up getting an onslaught."

Ches Hagen
Chief Executive Officer
AP Capital MIC

The value proposition to borrowers

Private credit's flexibility allows it to deliver an attractive value proposition to borrowers. The specific value proposition will change from borrower to borrower, and from sector to sector. Some of the more common use cases are given below:

- Mortgage holders and homebuyers may benefit from private lending opportunities if they would not otherwise qualify for a bank loan. This is not necessarily because they are subprime borrowers. They may have substantial income that cannot be reported in a way that a bank recognizes. They may also require credit for other reasons, like a so-called "bridge loan", to help them purchase a new home while they wait for their old home to sell.

  These loans can be provided by alternative lenders, such as Mortgage Investment Corporations (MICs). The terms of these mortgages vary, but can be quite short-term, delivering a needed loan to the borrower and an attractive yield to the investor.
- Organizations can look to private lenders for tailored solutions that fit the needs of their industry. The term of the loan, and other parameters, can be customized. Banks are also frequently constrained with respect to the amount they can lend as a percentage of the whole project (loan-to-value). Construction firms looking for simplified capital solutions can go to alternative lenders instead, who can provide a much higher loan-to-value – with a much quicker speed of execution.
- Unique approaches to lending and financing like trade finance can reduce the risk associated with purchasing goods in bulk. A supplier may ask a purchaser for payment up-front before shipping a product. But this presents a risk. Trade finance eliminates this risk by issuing

credit to the buyer and assuming the responsibility of paying the seller. Trade finance has applications in international trade, but also in riskier domestic sectors like cannabis.

"We've been engaged with a distillery who just needs an operating line of credit. They went to a commercial bank who offered them an 18% interest line of credit. This is a distillery that's producing over $50 million worth of revenue and product every year with a fairly decent track record. So instead of actually going the traditional approach and paying 18%, they're asking, why don't I actually issue a security token and fund my operation in that way against the aging whiskey that's actually tied up in a warehouse?"

Vince Kadar
Chief Executive Officer
Polymath

"When you look at what we call value-add lending, or "bridge lending" as it's sometimes called, it's a highly inefficient market. One of the reasons why borrowers go to specialist lenders is that this is all we do. We have a tremendous level of expertise in this. They can really engage with us, and we can customize a loan. We don't have off-the-shelf loan agreements, and we are able to customize the loan parameters to really suit their needs. So, when you think of a construction loan or a value-add home renovation loan, or even acquisition, we can adjust the term of the loan given their construction period or however long they would need that money."

Daniel Marchand
Managing Director, Capital Markets
Cameron Stephens Mortgage Capital

"These borrowers most often are borrowers who don't meet the traditional criteria. Oftentimes, they may have bad credit. That's one of the scenarios that people most often think of when they think private mortgage – they think bad borrowers, arrears, and powers of sale. That's actually not as common as one would think. Yes, there may be bad credit or debt consolidation needs. … But oftentimes, it's more of a self-employed borrower who, on paper, does not appear to be in a position to service the mortgage – but is in fact. Self-employed borrowers often write down their income for tax purposes. But banks are only looking at those tax slips, and they're not really looking at the full picture."

Elizabeth Wood
Executive Vice President
CMI Financial Group

The value proposition to investors

The value proposition of private credit is similar to the value proposition of public fixed income securities: they deliver a stable, predictable cash flow, and in the case of asset-backed lending or mortgages, are secured against an asset.

Like other private assets, they also deliver a return profile that is uncorrelated to the public markets, allowing investors fleeing volatility a safe port in a stormy economy. In a highly inflationary environment, they also offer a useful inflation hedge – their yield is superior to bonds purchased on the public markets, their interest rates are sometimes tied to central bank interest rates, and they are secured against an asset.

The flexibility of private credit also delivers advantages to investors. Loans can be structured so that they are at the top of the capital stack, meaning that investors in those loans will have preferred access to the income generated by that loan, and investors will enjoy increased security in the event of a default.

It is true that, unlike bonds purchased on public markets, private credit investments can be illiquid. Investors who expect to need access to their wealth must therefore take care before making a private credit investment.

But this illiquidity also confers a benefit: investors in private credit enjoy an "illiquidity premium", meaning that they enjoy a higher rate of return in exchange for losing access to their capital for a given time.

"When you're dealing in the public markets, you are always running the risk of the volatility of those public markets. And if there is an event that occurs around the globe, it can affect your investment immediately. When you're in the private markets, you're somewhat insulated from those radical, unpredictable, and volatile moves of the value in stock price or the value of the bond yields. So, the value proposition that many people find when they're considering private alternative investments like a mortgage investment corporation or a firm like AP Capital is that there's a consistency and a stability there."

Ches Hagen
Chief Executive Officer
AP Capital MIC

Finally, new innovations in private credit have democratized the private lending space, opening up investment opportunities to investors who would not have otherwise had access to them. New digital platforms have not only automated away much of the process associated with investment in private markets, but they have also granted individual accredited investors access to institutional-grade investment opportunities, such as investment in individual real estate developments.

By adopting blockchain technology, they also allow investors a degree of liquidity. By "tokenizing" a given investment, it can be traded on that platform's secondary market, allowing investors to liquidate their investment on a much shorter timeframe than they might have otherwise.

"The advantage to the type of financing we do, trade finance, isn't interest rates – it's safety. The risk of loss in the cannabis sector right now is so high because there's so much turmoil. Too much inventory, too many sales outlets and too many jurisdictions. We use our data to get comfortable with the vendor, to make sure that we can finance the vendor. But there's enough turmoil in the market that even the best lenders are going to pay a relatively high rate compared to other sectors."

David Goldstein
Chief Executive Officer
Stoke Inventory Partners

"[Investment on our platform] gets fractionalized. Once the funds are received, a security token is issued that represents the equity or debt, or the portion that's assigned to you. So, whether or not you have redemption rights, voting rights, distribution rights, or secondary market trading rights afterwards – all those elements are planned in there. It could be set up with a smart contract and a distribution going forward. … It's an optimization of how the existing markets work today."

Vince Kadar
Chief Executive Officer
Polymath

Allocating to private credit

An investor who has decided to allocate capital to private credit will first need to decide how it will fit into their existing portfolio. A 60/40 investor may choose to allocate out of the "40" – that is to say, the fixed income portion of the portfolio. But an increasing number of investors are choosing to create a new bucket in the portfolio altogether – one for alternatives, reallocated out of debt and equity alike. Under this approach, private credit would sit in this alternative bucket.

This approach has advantages. As discussed, private credit is illiquid, so maintaining a significant portion of a portfolio as publicly traded securities allows an investor to mitigate the risks associated with illiquid investments.

For an investor who chooses to reallocate their capital, however, it is critical that they perform due diligence before they make any investment decisions.

This means looking beyond the simple yield of an investment and examining the underlying assets. In the modern lending environment, where interest rates have risen significantly, aggressively structured loans have become much more expensive to service. This will create strain on the borrowers, leading to risk. When debt service costs are laid atop other costs, such as upward wage pressures or increased cost of inputs, the risk to the borrowers – and, in turn, to investors in loans – becomes clear. Investors should ensure that they have a full understanding of the risks of a particular loan before deciding to invest.

When doing due diligence, investors should also consider the track record, and experience, of a given fund – examining how long they have been in business and also, how they have performed during good and bad economic times. Particularly for accredited investors, or family offices without large research teams, past behaviour may be the best indicator of future performance.

"In the current market environment, we expect more headwinds in private debt. As a result, investors really need to do their due diligence on the underlying loan structures. Many of these loans have been aggressively structured with higher leverage, minimal amortization and covenant-lite terms. As important, many of these loans have been structured as floating rate which has become very expensive for borrowers to service. With interest rates increasing 60%, borrowers now face a much higher debt burden, which combined with slowing demand, has put significant strain on these companies. While floating rate debt and higher yields may seem attractive from an investors point of view, we believe this is going to have a negative impact on the performance of these borrowers and their ability to repay debt."

Theresa Shutt
Head of Corporate Debt
Fiera Capital

"We target a breadth of private debt strategies, beyond direct lending, that aim to achieve mid-teen plus returns with an emphasis on downside protection. We are opportunistic and seek to benefit from illiquidity and complexity. We look for areas where complexity premium is rewarded, such as niche specialty finance, distressed and special situation strategies, or where there is less competition, in overlooked geographies and sectors."

Tarik Serri
Senior Director, Hedge Funds and Alternative Investments
Trans-Canada Capital

"Even if an investor can't evaluate our data because they don't have the industry expertise, they can see that we are experienced – the person with the least amount of experience on our team has spent 18 years as a professional. We've been around the block."

David Goldstein
Chief Executive Officer
Stoke Inventory Partners

An asset for a challenging time

The GFC remains the most challenging economic time in recent memory but in 2023, western economies faced substantial headwinds. Persistent inflation, low economic growth, and, in Canada, low productivity and soaring labour costs make for a challenging lending environment.

In the Great Financial Crisis, a challenging lending environment, and banks wary of risks, led to a population of underserviced borrowers, creating a gap that private lenders filled. In 2023, macro-trends, such as the rise of self-employment and the gig economy, are creating those conditions again. For investors willing to do their due diligence, private credit can offer an attractive risk-adjusted yield.

"You know, as the interest rates increase, and as the banks respond with additional tightening and restrictions, that entire segment of underserviced borrowers has just grown. Some of it is due to concerns with affordability, but a lot of what we're seeing is a significant increase in casual, seasonal, part-time workers, gig workers, freelancers or just people in business for themselves who simply do not have the income documentation that a bank would require. They are therefore forced to seek alternative opportunities. Business for self and gig workers have increased exponentially, outpacing employment growth year-over-year for the last two years."

Elizabeth Wood
Executive Vice President
CMI Financial Group

"We assess investment managers, funds, and assets as if we were at the end of an economic cycle and prioritize capital preservation and downside protection. We analyze how the manager handles downside risk, structuring, and macro-economic factors. We will therefore favor investment managers who have proven skills and experience in different credit cycles."

Tarik Serri
Senior Director, Hedge Funds and Alternative Investments
Trans-Canada Capital

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