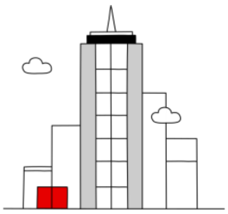
IPM monthly blog

Our monthly insights into private markets – **September 2023**

Real estate



US economists unclear on recession

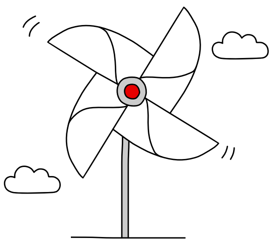
Higher interest rates led to capital values declines across most markets and sectors over the past 18 months. The UK led the pricing correction, followed by the rest of Europe. Now, the UK appears to be stabilizing with Europe likely to bottom out later this year. US pricing declines lagged and are expected to continue into early 2024. Japan has been an outlier with interest rates on hold and capital values remaining steady.

Stricter lending standards and higher debt costs make it harder to refinance existing debt and to source debt for new investments. Workouts are happening for underperforming loans.

Commercial real estate income is holding up, except in the office sector. In the US, economists are split on whether the economy will contract or not. If recession happens in early 2024, commercial real estate (CRE) should reprice quickly, which often precedes bounce-back. If there is no recession, repricing and rebound will be likely to remain gradual.

Fundamentals remain strong for the industrial and logistics sectors. The retail sector is holding up better than other sectors, as it did not experience as much cap rate compression following the GFC and pandemic crises. Housing shortages drive long-term optimism for the residential sector. Offices face the most downside risk due to the impact of hybrid working and capex expenditure needed to make older offices more competitive and energy efficient.

Infrastructure



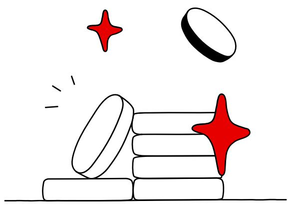
Silver linings emerging

Some silver linings are beginning to emerge around the sentiment for private infrastructure fundraising, despite a lackluster year so far. Infrastructure Investor reported in August that nearly half of all institutional investors are under-allocated to private infrastructure, based on a database on 2,900 investor profiles.

Preqin's 2H23 investor outlook showed that 41% of investors surveyed are looking to commit more capital to private infrastructure in the next 12 months, vs. 35% in the 1H23 survey. Despite concerns around inflation and interest rates, private infrastructure was up 2.8% in 1Q23 according to Burgiss' preliminary data.

UBS

Private credit



A deep dive into direct lending

The direct lending space, an area of top investor interest, has grown rapidly over the last 10 years, both in size and proliferation of strategy types. With an increasingly diverse ecosystem, the space may be daunting for new investors. With that in mind, we have outlined key characteristics to consider when assessing direct lending strategies, their importance, and how they may differ across strategies.

– Loan structure: Loans are typically structured with floating interest rates and may have additional sources of returns, such as entry / exit fees, prepayment fees, original issue discount (OID), and equity participation. With all these potential levers to pull, direct lenders can currently seek to generate unlevered Internal Rate of Returns (IRRs) of 10-14%.

  - *Weighted average spread (WA)*: Loan interest rates are typically structured as a floating rate consisting of a spread over a benchmark base rate such as Secured Overnight Financing Rate (e.g., SOFR + 600bps). Perceived as a measure of credit risk, the spread usually increases as managers invest in incrementally riskier borrowers. In the middle market today weighted average spreads may range from as low as 4.5% to up to 10% for first lien credit, with the average coming in at ~6%.

  - *Entry / exit fees*: Managers may charge borrowers a fee to enter or exit the loan (1-3% typically), fees for early prepayments (typically set up as a 103 of principal in year one, 102 in year two and 101 in year three), or amendment / modification fees for restructuring or extending loans. These additional fees may serve as additional return generators and act as distinguishing characteristics in how managers structure their loans and ultimately generate returns.

  - *Equity / warrant participation*: To further increase the portfolio's risk profile or generate equity-like returns, some managers may also secure some form of equity participation typically via warrants, plain equity or hybrid securities. For managers with this approach, 2-5% equity participation via warrants is a typical structure.

  - *Original Issue Discount (OID)*: Providing loans with an original issue discount is also a common approach to generating additional returns, where loans will be issued with 1-3 percentage points at discount to par.

– Portfolio risk measures: Direct lending investors focus on some key portfolio characteristics when assessing strategies to provide them with some indication of the portfolio's risk profile. This includes weighted average Loan to Value (LTV) interest coverage ratio, weighted average Debt / EBITDA ratio, sponsor / non-sponsor exposure, and capital structure exposure. These measures provide investors with some indication of a portfolio's expected risk profile.

  - *Loan to value (LTV)*: is the ratio of the size of the loan relative to the value of the collateral. Direct lenders typically seek to lend at LTVs below 75%. In the middle market, LTVs generally vary in parallel with the market capitalization of the company. In the lower middle market, which is considered higher risk, LTVs are generally at the lower end (60% or less). As investors progress up in the middle market, LTVs increase as larger companies are considered less risky as going concerns, and managers generally have less bargaining power in structuring loans to their benefit. In the current environment with tightening credit underwriting and retrenchment of traditional lenders, direct lenders have considerable bargaining power and are securing attractive LTVs ranging from 35-60%.

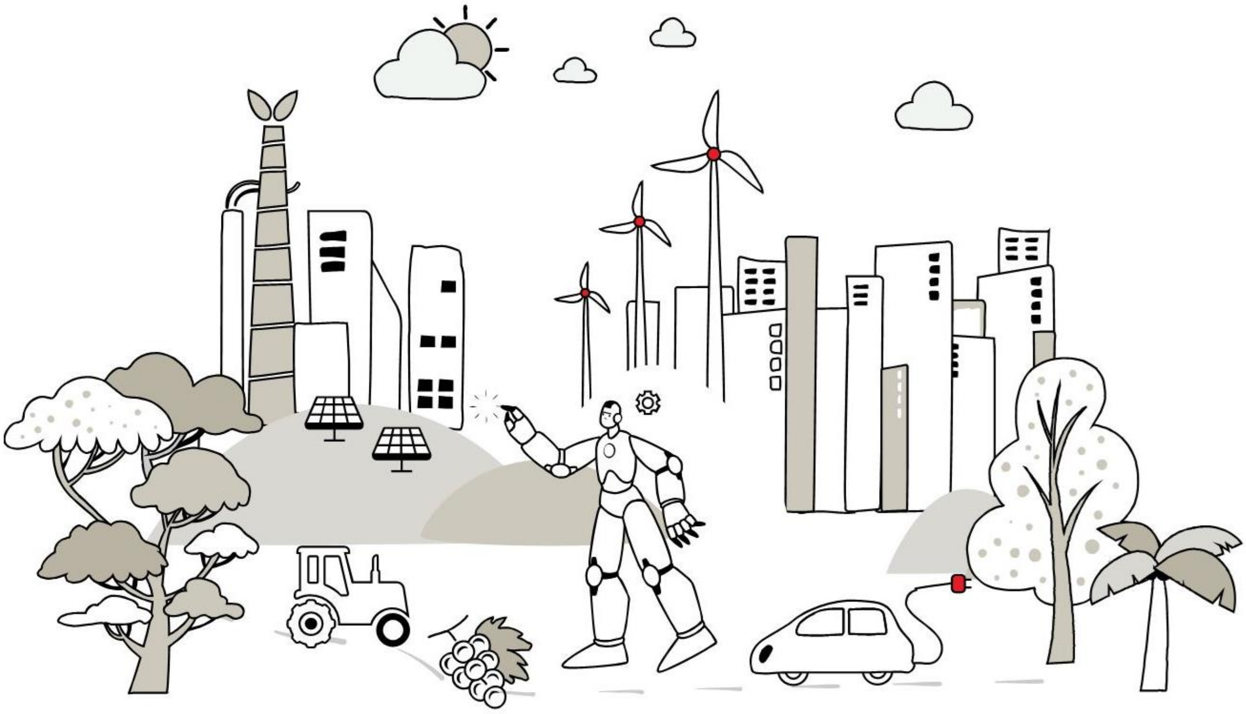
- *Capital structure*: Capital structure exposure will vary by strategy, reflecting the type of risk in focus (senior debt, junior debt, equity). Traditional direct lenders typically focus exclusively on first lien senior secured loans and remain at the top of the capital structure. More hybrid or junior strategies looking to generate enhanced returns may include varying amounts of uni-tranche or junior / mezzanine debt, as well as equity exposure in their strategy. While adding junior or equity exposure will increase expected returns, it also adds additional risk in the form of subordinated or unsecured risk, or equity risk.

- *Debt / EBITDA ratio*: Debt / EBITDA measures a firm's ability to potentially service its debt with earnings and provides insight into how leveraged a company is. In the middle market, typical debt / EBITDA ratios may range from as low as 3.5x to as high as 7x. Direct lenders typically seek to invest in companies with less leverage. Like LTV ratios, debt / EBITDA ratios typically grow as investors move up market. Investors are generally more comfortable with larger companies taking on additional leverage. Again, managers also have less bargaining power to negotiate more conservative leverage levels in this regard with larger companies.

- *Interest coverage ratio*: a similar measure of risk that measures a company's ability to service debt payments, and looks at the ratio of its earnings relative to its interest payments over a period. Typically, direct lenders look for significant interest rate coverage over 1x, signifying that the company is properly equipped to service payments and is generating positive cashflow. It is important to note that as most loans have floating interest rates interest coverage ratio is sensitive to rising interest rates. For instance, as base interest rates increase, companies will likely see their interest coverage ratios deteriorate. During recessions, companies may be squeezed on both sides of the ratio, as a recession may result in lower revenue and EBITDA, while interest rate increases would increase their interest payments.

- *Sponsor exposure* refers to whether borrower companies have funding by private equity firms ('sponsors'). Sponsor-backed companies are typically considered to present less risky investments. These sponsors may also be willing to inject additional capital into their portfolio companies in the event of business deterioration, providing additional comfort for lenders. Non-sponsor companies are typically considered to be riskier, given the lack of a potential backstop with an equity investor, and direct lenders can secure a pricing premium for financing them. Traditional direct lending strategies usually focus on exclusively investing in sponsor-backed strategies, while some managers focus on a combination of sponsor and non-sponsor deals to generate enhanced returns. Sponsor involvement is more prevalent in the upper middle market, while lower middle market companies considered to be riskier, generally have less PE involvements. While one may assume that non-sponsor companies would exhibit a higher default rate, this may not necessarily be the case. Some investors have found that with proper structuring and underwriting, non-sponsor strategies can secure additional premium without taking additional credit risk, given better negotiating power in the lower middle market.

Covenants: As part of extending financing, lenders will require certain conditions to be met throughout the life of the loan. Covenants may be financial or non-financial and may include maintaining certain minimum ratios such as debt-to-assets, cash reserves, interest coverage, EBITDA leverage, etc. As managers lend to increasingly larger companies, they have less bargaining power to negotiate strong covenants with borrowers. Traditional direct lending strategies typically avoid cov-lite loans and focus on providing loans with strong covenants to protect from borrowers poorly operating the business, protecting their claims in the capital structure and collateral, and their ability to potentially control the business in the event of a default or workout. Over the past 15 years, there has been a proliferation of covenant-lite ('cov-lite') loans with loose documentation that provides less structural protections for lenders. Note that the majority of loans issued in the syndicated market are cov-lite loans.



For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)

sh-am-private-markets-research@ubs.com

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