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PEMBERTON
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Pemberton Perspectives

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Discussing some key investment themes in European private debt

The Year Ahead for Private Debt, 2018

As investors return to their desks following the holidays, the positive market tone seen at the end of last year shows little sign of abating. The US tax reform news last month has been reinforced by positive data coming out of Europe and China, pushing global equity and commodity markets higher.

The IMF is projecting global GDP growth to increase from 3.6% in 2017 to 3.7% in 2018[1]. They also predict European GDP growth of 2.0% in 2018[2], supported by a robust economy in Germany, where unemployment is at an all-time low and the debt-clock has started reducing for the first time in 20 years[3].

So the bull-run looks set to continue, providing a supportive backdrop for further M&A activity. Headline GDP growth numbers, however, mask both the risks and opportunities that potentially confront investors in 2018.

Aside from various geo-political risks (continued conflict in the Middle East, nuclear tension on the Korean peninsula, Brexit, or the daily Trump tweet-fest), on a macro-level, we believe that certain asset classes including equities, commodities, foreign exchange and interest rates all have the potential to trigger volatility. We also believe that industrial and technological evolution will lead to irrevocable changes in certain sectors that will make the roles of specific companies redundant.

For commodities, oil is centre stage, with the potential supply disruptions triggered by unrest in Iran, Saudi Arabia, and Yemen all having the potential to push oil prices even higher than their current levels. This can have knock-on impacts on global growth and fuel-dependent sectors such as aviation and logistics.

Foreign exchange fluctuations, whether they are linked to Brexit or otherwise, will need to be managed or hedged. Those sectors in the UK that are dependent on low-cost overseas labour, such as agriculture, construction, and food service sectors, may well continue to struggle in 2018 as employees see greater earning potential back in their domestic markets. Against that, and despite the uncertainty caused by Brexit, we believe there will be investment opportunities to support strongly performing niche companies if other capital providers pull-back during uncertain times. Many UK based businesses have strong overseas cash flows to mitigate weaker growth in the UK.

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Regarding interest rates, we believe this is more of an issue for investors rather than borrowers at the moment. The global 10-year rate outlook is benign, with Bunds at 0.42%, Japan at 0.06%, and the US at 2.5%[4]. In the US, despite the fact that near-term Fed hikes are expected (and baked-in to the 2-year, which stands at 2%[5]), the longer-term outlook is very flat, with the 10-year at 2.5%[6]. For those with interest-rate concerns, the floating-rate loans that underpin the Direct Lending market are less exposed to rising interest rates; they should, therefore, be less exposed than the European high yield bond market, which saw 5 weeks of outflows at the end of 2017[7], potentially triggered by concerns over rising interest rates.

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Future-proofing investments will be an on-going challenge for 2018 and beyond. Whilst we do not believe that Bitcoin will replace reserve currencies (Euro or the Dollar) in any meaningful way, it highlights the need to be constantly aware of technological advances. The auto-sector, which accounts for 4% of European GDP per the EC[8], looks set to provide a great case study for the impact of change. Will an auto-parts supplier that manufactures engine parts for combustion engines still generate that same cash flows in 2020 if people move to hybrids, electric cars, and car-pooling? To protect against this, we believe sectors such as elderly care, pharmaceuticals, and food production can offer long-term, stable investments.

Political risk is always hard to predict and manage. Even the people with their 'fingers on the button' don't appear able to set out a clear road-map for the year ahead. A summary of our view on political risk is (i) it is uncertain, (ii) material risks appear unlikely, (iii) markets have shown amazing resilience at bouncing back from down-turns in the long-run, and (iv) we would rather be positioned in secured loans than equities if material downside risks do occur.

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In addition to all of this, forewarned is forearmed. As one of our Portfolio Managers often says, "you are rarely hit by the bus you are looking for." Pemberton has invested in a series of early warning systems, rating tools, and restructuring expertise to ensure that, if the unexpected happens, we are in a good position to manage risk pro-actively.

In conclusion, we believe that Direct Lenders, and Pemberton in particular, are well placed for 2018. The benign macro backdrop is projected to continue and will likely support continued M&A activity. Potential volatility from commodities, FX, and interest rates can be sensitized for and managed. Rigorous due diligence, using the help of specialist sector expertise, can help to future-proof investment decisions. If the outlier political risks emerge, we will hopefully have a material equity buffer with which to protect our LP's returns. On a relative value basis, we would prefer to be in private senior secured loans with IRRs of 6.0–10.0% than earning 3.0–4.0% in the public high yield bond and leveraged loan markets[9].

1 Source: IMF World Economic Outlook October 2017 www.imf.org
2 Source: IMF DataMapper World Economic Outlook October 2017 www.imf.org
3 Source: German Debt Clock, Financial Times 4th January 2018
4-6 Source: Financial Times www.markets.ft.com/data 8th January 2018
7 Source: S&P LCD Data December 2017
8 Source: European Commission www.ec.europa.eu/growth/sectors/automotive 8th January 2018
9 Source: Credit Suisse Western Europe Leveraged Loan Index 15th December 2017

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These are just a few of our thoughts based on our view of the market.

We'd love to hear your views for our Pemberton Perspectives Series. So please feel free to contact our Head of Investor Relations, Mike Anderson on +44 (0)20 7993 9311 or mike.anderson@pembertonam.com with any questions or comments.