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PRIVATE DEBT

Overview and focus on the Real Estate sector

BOCCONI STUDENTS for REAL ESTATE

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WHAT IS PRIVATE DEBT?

Private debt refers to the provision of credit to companies from funds, rather than banks, bank-led syndicates, or public markets. Private debt transactions involve borrowing and lending arrangements between private sector participants, such as corporations, private equity firms, and hedge funds. Unlike public debt, which traditionally involves standardized loans, this financial instrument allows unique contract terms which can fit the peculiar needs of the borrower.

Private debt instruments can take various forms but most commonly involves non-bank institutions making loans to private companies or buying those loans on the secondary market. Private debt transactions involve negotiated terms and conditions between the borrower and lender. These may include interest rates, maturity dates and covenants.

It is important to note that, compared to publicly traded securities, private debt instruments often have lower liquidity; nevertheless, the illiquidity is often compensated by potentially higher yields.

Private debt plays a crucial role in corporate finance, providing companies with an alternative source of funding beyond traditional bank loans. It is often used to finance acquisitions, capital expenditures, working capital needs, and other strategic initiatives.

INVESTOR PROFILE — SEEKING DIVERSIFICATION

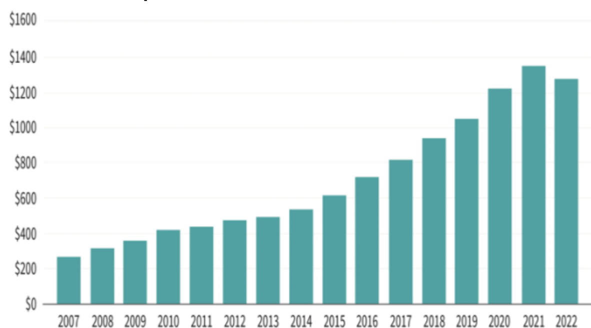
Private debt investors (lenders) provide capital to the issuers of private debt. These investors can include institutional investors such as pension funds, insurance companies, hedge funds and asset managers, as well as individual investors. They are drawn to the consistent cash flows and relatively higher returns offered by private debt funds, which can complement their existing portfolios of traditional investments.

PRIVATE DEBT AFTER THE GREAT RECESSION

Before the 2008 recession, the debt market was characterized by a period of robust growth and a relatively low-interest-rate environment: the years leading up to the Great Recession witnessed a boom in leveraged finance. This involved the issuance of high-yield or "junk" bonds and the use of leveraged loans to finance corporate acquisitions and leveraged buyouts (LBOs).

Furthermore, the market for collateralized debt obligations (CDOs) and mortgage-backed securities (MBS) expanded significantly. CDOs were complex financial instruments that bundled various types of debt into tranches with different levels of risk. These structured products were widely traded and held by financial institutions around the world. MBS, like CDOS, bundled residential mortgages as securities.

After the 2008 recession, the debt market underwent significant changes because of increased regulatory scrutiny and shifts in investor behavior. The Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, for example, introduced measures to regulate financial institutions, enhance transparency, and improve risk management. Banks and financial institutions became more cautious in extending credit lines without fully assessing borrowers' creditworthiness and the underlying risks associated with loans. Moreover, the Basel Accords, specifically Basel III, set strict capital requirements, obliging banks to hold high quality liquid assets and reducing leverage. These regulations decreased the capacity commercial banks had to lend to many small and medium businesses; as a result, non-bank lenders, such as private debt funds, filled that void: private funds, which must respect fewer regulations, took the place of banks in extending credit lines, and this increased the volume of private debt.



TYPES OF PRIVATE DEBT

The majority of private debt investments are in unlisted private debt funds. To access the private debt asset class, investors can choose among a range of different funds, with specific strategies and characteristics, and varying risk/return profiles. The main types of private debt are described in the following sections.

DIRECT LENDING

In this form of financing, specialized private debt funds issue loans directly to small and medium enterprises (SMEs). Direct lending strategies may be appealing as they normally invest in the senior part of a company's capital structure, which may provide steady current income with relatively lower risk. Among the different types of PD, Direct Lending is the most used for Infrastructure debt and Real Estate debt, respectively to invest in infrastructures, or to purchase and develop residential and commercial properties. Generally, these sub-categories guarantee stability and a low-risk profile.

MEZZANINE DEBT

Mezzanine Debt provides borrowers with subordinated debt, ranked between equity and debt in the capital structure. This kind of instrument, a hybrid of debt and equity, is not secured by assets and ranks below more senior loans for repayment in the event of a default or bankruptcy. It often comes with equity "kickers", which are incentives that can support attractive total returns – often on par with equities – still being a debt claim in the payment waterfall. Mezzanine debt has conversion rights to an equity interest in the company in case of default, generally after senior

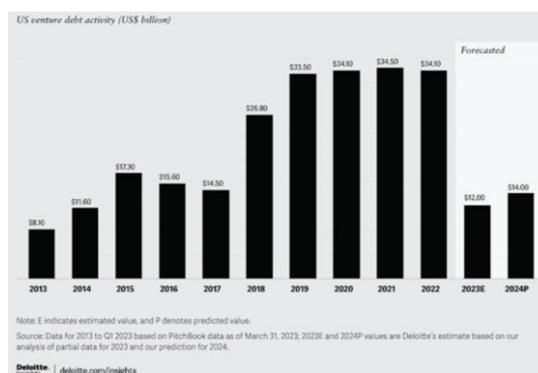
lenders are paid. Compared to direct lending, mezzanine debt has a higher interest rate, but also involves a higher risk for the investor. Mezzanine capital is typically used to provide additional financing for specific purposes. These include acquisitions, growth investments, capital increases or corporate restructuring, and leveraged buyouts (LBOs). More generally, it is used in situations where traditional bank loans are unavailable or insufficient.

DISTRESSED DEBT

A distressed debt fund is similar to direct lending, but only targets distressed opportunities: it refers to acquiring debt securities of companies experiencing some type of financial or operational difficulty (in most cases they are insolvent). Lenders take on a higher level of risk in exchange for lower prices and potentially high returns: distressed debt investors usually purchase debt securities at a significant discount to face value, expecting companies to improve their prospects through operational turnaround, with the goal of gaining profit selling the debt once the financial problems are overcome and the company has recovered. Distressed debt often involves the purchase of securities in the secondary market, rather than new origination of debt. The debt issued tends to be senior, and therefore high in the capital structure, due to the substantial threat of liquidation. The prevalence of opportunities with this strategy tends to coincide with economic downturns and periods of credit tightness.

VENTURE DEBT

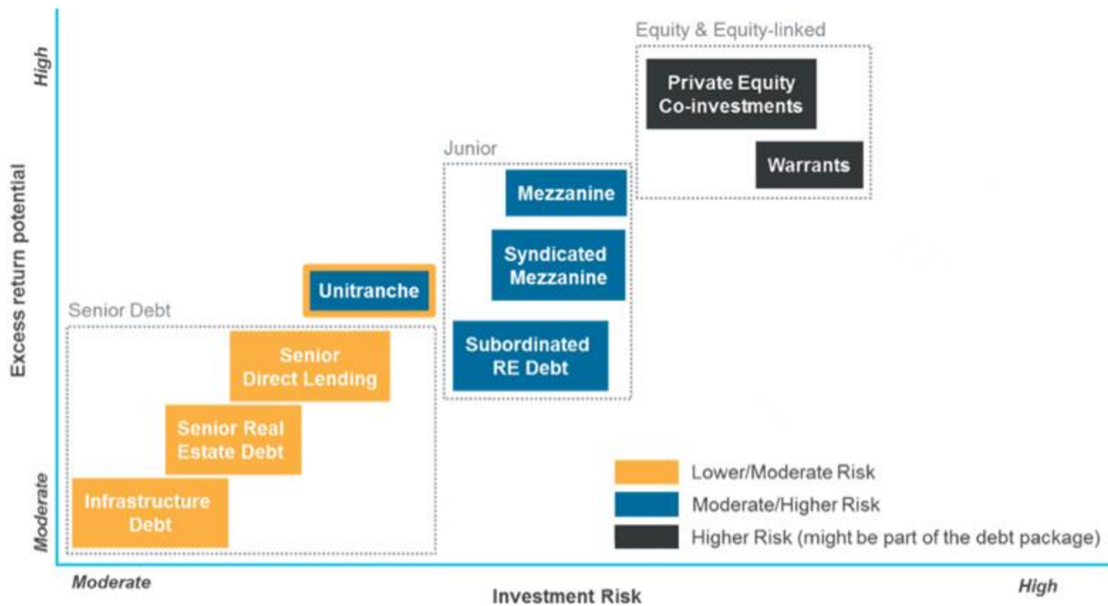
Venture debt refers to a specific form of financing in which venture capital companies or start-ups raise additional debt to support their growth – usually in tandem with equity arrangements. Unlike traditional debt financing, venture debt is specifically targeted at early stage or growth stage companies. These are typically supported by venture capitalists. That of venture debt is a growing market in the current environment as an increasing number of later stage venture-backed companies are turning to venture debt to extend their cash runways. Interest rates on this type of loan can be between 10% and 20% and often include warrants for shares.

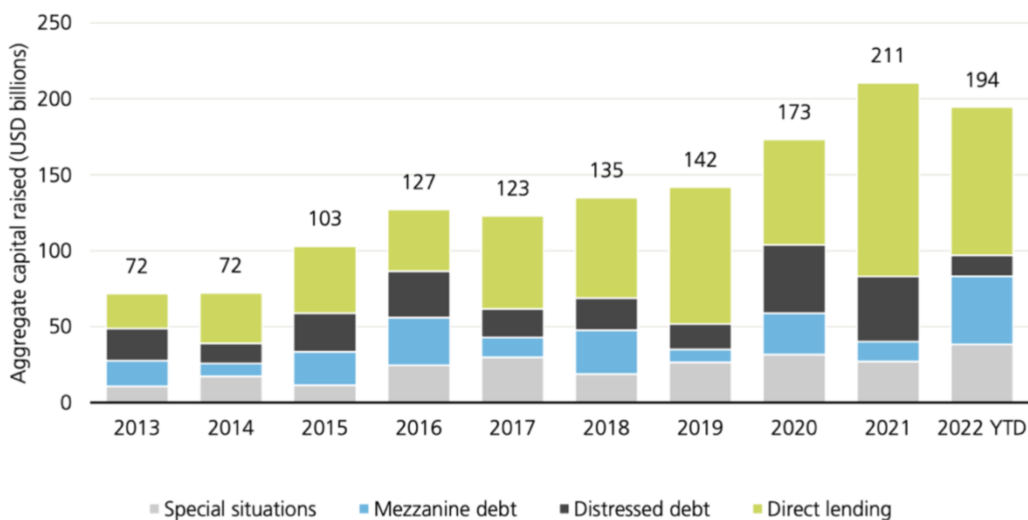


SPECIAL SITUATIONS

Private debt funds that specialize in so-called "special situations" look for opportunities to provide capital and help companies overcome specific issues. Generally, special situations can mean any

variety of non-traditional corporate event that requires a high degree of customization and complexity. The potential occasions for special situations investments can be many and varied. Examples include companies undergoing M&A transactions, divestitures or spinoffs, litigations, or other capital events which require specific financing solutions. Special situations lenders typically buy debt securities well below par, looking to profit from a positive resolution to any issues affecting the company.





PRIVATE DEBT RISKS

As with all forms of investment, private debt does not come without risk. It is important for both the borrower and the lender to be conscious of these risks to better judge the soundness of an investment, its potential yield and the integrity of the operation. A clear understanding of the potential risks and rewards will greatly help investors and investments perform better in the long run. The most common risks associated with private debt are expanded upon below:

CREDIT RISK

Lenders often lend money to firms that have a relatively weak credit rating, or a less established credit history. As such, the risk of default is higher, as any significant negative changes in the borrower's firm or market may lead to the firm being unable to honor its agreement. This could be due to the firm itself, poor management or products of low quality, or could be due to macroeconomic factors outside of the firm's hands, such as severe changes in consumer interest in the firm, or on consumers disposable income. Therefore, it is necessary to perform thorough due diligence before approving a loan. However, firms that aren't publicly traded may be reluctant to disclose their financial statements, making it harder for lenders to estimate the creditworthiness of the firm, and then approving the loan.

LIQUIDITY RISK

Liquidity risk in private debt stems from the difficulty of quickly selling or converting investments into cash at a fair price. Unlike publicly traded securities, private debt lacks a centralized market, making it challenging to find buyers or sellers easily. Lock-up periods and complex terms restrict the ability to sell, and valuing these investments becomes ambiguous due to infrequent market pricing. Moreover, the broader market conditions and economic uncertainties directly impact the availability of buyers, potentially leading to significant discounts or losses if a quick sale is necessary.

INTEREST RATE RISKS

Changes in the interest rate can impact the cost of debt for borrowers and the total returns for the lenders. Variable rate debt instruments are particularly at risk to interest rate changes, as too great of a fall in the reference rate may completely wipe out the lenders profit margin from the debt. Furthermore, if interest rates climb too high, economic activity will slow down, whilst the firms interest coverage will rise, which may lead to a higher default risk as a firm is unable to cover its interest costs whilst having a slower revenue stream.

REGULATORY RISKS

Regulatory and legal risks in private debt stem from potential changes in regulations impacting debt agreements, compliance challenges, and uncertainties in legal interpretations. If proper care isn't taken in ensuring that contracts follow existing and likely regulations, it may lead to complexities in complying with new rules, potential disputes

due to intricate contractual terms, and difficulties in enforcing agreements across different jurisdictions. Managing these risks involves staying updated on regulatory shifts, conducting thorough legal due diligence, and ensuring clear, transparent, and well-defined contractual agreements to mitigate uncertainties and potential disputes.

Mitigating risks in private debt involves diversifying investments across various sectors, borrowers, and regions to minimize the impact of defaults. Crafting clear and comprehensive contractual terms ensures legal clarity and reduces the potential for disputes. Continuous monitoring of borrower performance allows for proactive measures, while incorporating risk premiums helps balance potential returns against risk exposure. Developing well-defined exit strategies, considering lock-up periods and secondary markets, facilitates planned exits and liquidity management when required. These strategies collectively work to enhance risk management and resilience within the private debt market.

FOCUS ON REAL ESTATE PRIVATE DEBT

Private debt funds lend to a diverse range of borrowers across the real estate spectrum, that utilize private debt financing to purchase or develop any residential or commercial property.

Private debt funding in the real estate sector has seen a steady increase since the 2008 financial crisis. Banks and public debt providers have become more risk averse, as well as having heavier restrictions and regulations placed on them by governments, leading to more reserved loans. This has made private debt funds more competitive, as it gives real estate developers easily accessible and customizable loans. These loans and financial operations can be used at different stages of project development to achieve distinct goals, making real estate development easier and more lucrative for both parties.

Bridge loans are short term high interest loans that provide immediate cash flow to the real estate developer. They are typically used to bridge the gap between purchasing the property and finding permanent financing at more favorable rates. They can also be used for renovating existing properties and buildings before they are either sold or refinanced.

Construction loans typically come after bridge loans and are used to finance the construction or renovation of the project. They are longer term loans at lower interest rates compared to bridge loans. They can either be paid off by selling the property, or can be refinanced once construction is completed.

Separate from funding its construction, private debt funds can opt to invest in failing or distressed debt tied up in real estate assets. They can then aim to restructure the debt, foreclose the property, or attempt to reorganize and restructure the property/project to reach its potential value.

This method requires more resources on the funds side, as they need to be able to correctly manage and optimize the property/project, otherwise they will struggle to make a profit off of the purchase.

Property developers and owners may also choose to perform a Sale-Leaseback Transaction, where they sell their property to a debt fund, and immediately secure a lease for the use of the property. This gives developers access to large amounts of previously tied up capital, whilst giving them the long-term use of the property. They are also less at risk from any depreciation in property value or utility, that risk shifts over to the private debt fund.

Such funding methods give developers more flexibility compared to regular bank loans and allow for faster and more targeted terms and conditions. It is also a higher risk but higher reward method for investors who are looking for higher yields when compared to typical investment streams.

EXEMPLES

BLACKSTONE REAL ESTATE DEBT STRATEGIES FUND (BREDS)

Blackstone Real Estate Debt Strategies Fund is a series of closed-end, commingled funds managed by Blackstone Real Estate Debt Strategies, a platform within Blackstone. It focuses on investing in senior and mezzanine debt across the capital structure of global real estate.

The fund employs a variety of investment strategies, including:

- Origination: BREDS sources debt financing directly to borrowers, providing them with capital for acquisitions, developments, and refinancings.
- Acquisition of existing loans: The fund also purchases existing loans from banks and other lenders, often at a discount to par value.
- Special situations: BREDS invests in complex or unique situations where its expertise can unlock value, such as turnarounds, restructurings, and bankruptcies.

BREDS invests in a variety of real estate asset classes: Office, Industrial, Residential, Hospitality, Retail, Performance.

The fund has a strong track record of performance, with its funds generating gross returns of over 10% per year on average since inception.

OAKTREE REAL ESTATE DEBT FUND

OAKTREE

Oaktree Real Estate Debt Fund is not just one fund, but rather a series of funds managed by Oaktree Capital Management focusing on real estate debt investments. Here is a summary of the latest iteration:

Oaktree Real Estate Debt Fund III (REDF III)

- Size: Closed in December 2021 with $3 billion in committed capital, exceeding its predecessor fund by 34%.
- Investment strategy: Targets a variety of debt positions on the risk spectrum, including senior, mezzanine, and distressed debt.
- Target assets: Invests across various real estate asset classes like office, multi-family, and retail.
- Performance: Data for REDF III specifically is not publicly available yet, but Oaktree's Real Estate Debt strategy has a strong track record.
- Fees: Charges a 1.5% management fee and a performance fee based on profits exceeding a specific hurdle rate.
- Investors: Available to qualified institutional investors.

GENERALI ASSET MANAGEMENT — PRIVATE DEBT FUND

With a long track record of managing private debt portfolios, their private debt strategies aim to help investors achieve investment goals while contributing to the real economy.

Generali PD Fund offers long-term direct and indirect private debt strategies. For example, their direct corporate credit strategy adopts a buy and hold approach to support the expansion of European SMEs looking to improve their ESG profiles. Meanwhile, their fund-of-funds range targets private debt global asset managers and diversified strategies.

Sustainability is integral to the private debt offering at Generali Asset Management, and ESG is embedded throughout the investment lifecycle, with a commitment to supporting the real economy and private SMEs in Europe.

Main aspects:

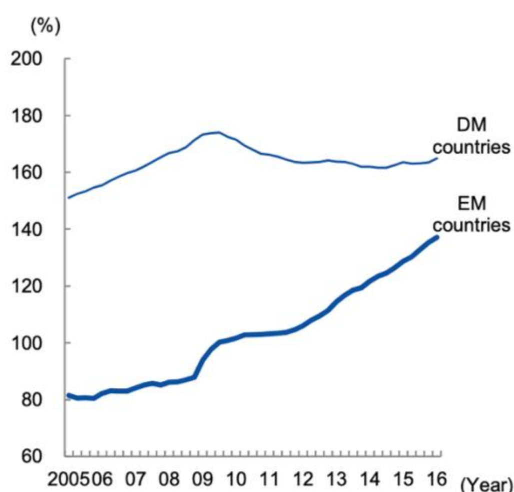
- Direct lending
- Special situations
- EU recovery
- ESG
- Funds-of-funds

PRIVATE DEBT IN EMERGING MARKETS

Although the phenomenon of private debt is far more prominent in the developed markets (DMs), it’s also a growing asset class in emerging markets (EMs).

As said, since the 2008 financial crisis, private credit has grown to become a relevant asset class. To date, much of the activity of private debt funds has been concentrated in developed markets, in particular the U.S. The emerging market economies, though, have been a driving force behind global economic recovery, as various economic measures implemented since the 2008 financial crisis took effect and boosted private demand. Consequently, private debt’s appeal has started to extend to EMs due to increasingly favorable long-term structural shifts and

changing market dynamics. From 2009 to 2019, private credit fundraising in EMs tripled, from about $2.4bn to more than $8bn per year. The post-pandemic world accelerated the process, given the high inflation rates and the potential for a global economic recession. EM private credit, in absolute terms, still remains a small asset class relative to private credit in developed markets. In 2021, private credit fundraising in North America and Europe touched $180.1bn compared to $11.9bn across all EMs. Private debt share to nominal GDP in the overall emerging market countries rose from 88% at the end of December 2008 to 136% at the end of June 2016, coming closer to the level of developed market countries, which has been kept flat at 160%.



There are reasons to believe that private credit will continue to grow, especially in EMs, given the uncertain and peculiar interest rates environment. EMs are predicted to grow faster than DMs due to favorable demographics, fewer supply-side constraints, industrialization, access to resources, political reforms, and infrastructure development. Furthermore, authorities improved regulatory changes which support the maturation of EM private debt.

Accessing finance in emerging markets can be challenging; however private credit represents a critical component of the capital structure for borrowers in these markets. It plays a crucial role with respect to the financing of small and medium-sized enterprises (SMEs). SMEs are often the engine of growth in EMs, contributing for nearly 50% of GDP. However, many SMEs struggle to get access the financing needed to grow and expand their business. Private credit can help fill this gap providing financing to SMEs. With its non-dilutive and flexible character, private credit can help to meet capital needs in key EMs growing sectors such as infrastructure, agriculture, energy, digitalization, and sustainable economy.

It is worth mentioning, though, that there exist some risks related to private debt investments in EMs. Political instability can make private credit providers hesitant to lend, due to the less stable and predictable legal and regulatory environment they will be operating within and the risk of non-payment from borrowers. Even though, as we said, there have been important reforms across the EMs, the lack of effective legal systems persists in some countries. Moreover, local currencies can be volatile at times, and this makes credit providers hesitant to lend, as their ability to profit from lending is impacted by fluctuations in the exchange rate.

In conclusion, private credit can bring many benefits to EMs, including filling the financing gap, offering diverse funding sources and customized financing options. However, private credit in EMs differs from DMs due to higher risk and peculiar legal and regulatory environments.

THE INDIAN EXAMPLE

Private credit is rapidly evolving in the Indian context. As India's economy develops and grows, private credit is growing with it. Entrepreneurs and firms need capital that traditional banks are not able to provide. In this context private credit is in a unique position to offer flexible capital to firms without seeking dilution of equity. Indeed, between 2018 and 2023 India attracted the largest private credit volume (9.5 billion) of all Asian markets. The local regulator SEBI in January 2023 allowed alternative investment funds to participate in credit default swap transactions, advancing the option to hedge the risk associated with the bond market. The Indian market represents a perfect example of an emerging market where investors can enjoy attractive returns with private credit strategies.

Notable Private Credit Investment in Asia, 2022

INVESTOR(S)	COMPANY	DEAL TYPE	COUNTRY	SECTOR	TRANSACTION VALUE (USDM)	INVESTMENT DATE
Exor, G2S2 Capital, JC Flowers	YES Bank NPL	NPL Pool/Portfolio	India	Diversified Financial Services & Holding Companies	1,353.9	Dec-22
Apollo Global Management	Mumbai International Airport	Senior Loan	India	Transportation Infrastructure	750.0	May-22
PAG	iQiyi	Senior Loan	China	Media & Entertainment	500.0	Dec-22
Cerberus Capital Management	Subic Bay Shipyard	Distress/ Restructuring	Philippines	Marine Transportation	300.0	Apr-22
Allianz Global Investors, BlackRock, Indonesia Investment Authority, Orion Capital Asia	Traveloka	Venture Debt	Indonesia	Travel, Leisure & Mobility	300.0	Sep-22
Cypress Capital, Goldman Sachs, Integrated Alternative Credit Fund	FundPark	Venture Debt	China	Non-Bank Lending & Specialty Finance	250.0	Apr-22
Global Emerging Markets Group	Smartron India	Senior Loan	India	Consumer Electronics	200.0	Jan-22
Fasanara Capital	Stashfin	Venture Debt	India	Consumer Finance	200.0	Jun-22
Victory Park Capital	Kredivo	Venture Debt	Indonesia	Consumer Finance	145.0	Mar-22
Bank SinoPac, BlackRock, BNP Paribas, Credit Agricole Corporate and Investment Bank, E.Sun Commercial Bank Ltd, Standard Chartered Bank	New Green Power	Senior Loan	Taiwan	Renewable Power	126.4	Nov-22
Värde Partners	Reliance Power	Distress/ Restructuring	India	Conventional Power	113.4	Oct-22
Boyu Capital, GGV Capital, Mirae Asset Global Investments, Temasek Holdings, True Global Ventures	Animoca Brands	Venture Debt	China	Media & Entertainment	110.0	Sep-22
Blue Torch Capital	Near	Senior Loan	Singapore	Media & Entertainment	100.0	Nov-22

Source: GPCA. Data as of 31 December 2022.

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