Alternative Credit: A Primer

What Is Alternative Credit?

Alternative credit is a broad term that we at First Eagle use to describe non-investment-grade debt facilities, both public and private, outside the scope of core US fixed income, including direct lending (both single-lender and middle-market "club" loans), syndicated loans and high yield bonds. The asset class historically has offered yields in excess of those available in traditional fixed income markets in exchange for additional risks such as liquidity, credit and/or complexity.

What Assets Comprise the Alternative Credit Universe?

A wide array of credit assets can be considered "alternative credit," and investment managers in the space all having their own definitions and areas of specialization. For the purposes of this discussion, we'll focus on the characteristics of four key segments of alternative credit: direct lending, middle-market club loans, syndicated loans and high yield bonds.

Direct Lending and Middle-Market Club Loans

Private debt markets have grown rapidly in recent years in terms of both supply and demand. Persistently low interest rates have driven a proliferation of private equity-backed leveraged buyouts, while concurrent regulatory changes have made certain commercial bank activities—including financing such buyouts—prohibitively expensive, accelerating banks' retreat from middle-market lending and enticing nonbank lenders to fill the void.

Direct lending typically refers to the origination of loans by nonbank lenders—typically asset managers, business-development companies (BDCs), collateralized loan obligations (CLOs), hedge funds, insurers and other institutional investors—to mid-sized companies that generally are too big for commercial bank loans but too small to tap the capital markets for their financing needs. These highly customized financing solutions can be originated by a single lender or by a small group of unaffiliated nonbank lenders through a **middle market "club" loan**. From First Eagle's perspective, direct lending targets include companies with annual EBITDA[1] of $10–40 million, while club loans involve borrowers in the $25–75 million EBITDA range.

Though private lending opportunities, each with its own risk-return profile, are available across the debt stack, senior-secured loans are the most popular. Paying a floating-rate coupon and having a typical maturity of five to seven years, these unrated loans offer a spread premium to public debt securities in exchange for reduced liquidity and exposure to relatively smaller borrowers. Since they are usually held to maturity (or a refinancing event), direct loans offer little opportunity for capital appreciation, though an upfront fee or discount to par at issuance can boost total return.

Direct lenders partner with borrowers to create customized financing solutions that meet the borrower's needs and timeline. In exchange, lenders typically have greater influence over the loan's structure and its protective covenants as well as greater access to management teams, which helps support more comprehensive due diligence. This dynamic has allowed direct lenders to apply more rigorous underwriting discipline than those providing financing through the more liquid public bond markets, which historically has resulted in lower default rates and higher recovery rates.

The opportunity in this space is significant; the nearly 200,000 companies in the US middle market contribute approximately one-third of the country's annual private sector GDP and employment.[2] Borrowers in search of capital from nonbank lenders may be either sponsored—that is, owned by a private equity firm—or not. Sponsored transactions usually occur concurrently with a leveraged buyout (LBO); a private equity firm will seek out debt financing for an asset it is purchasing, with that debt being recorded as a liability on the balance sheet of the acquired company. Non-sponsored loans, in contrast, typically are revolving credit facilities used by borrowers to fund ongoing operations. Extending credit in the middle-market space is very much a relationship-driven business, and it's not unusual to see a private equity sponsor complete multiple transactions with the same lender over the years.

1. Earnings before interest, taxes, depreciation and amortization.
2. Source: National Center for the Middle Market (NCMM); data as of November 20, 2020. Note that the NCMM defines the middle market as US companies with annual revenues from $10 million to $1 billion.

Though there are many similarities between single-lender direct lending and middle-market club loans, there also are a few distinctions to take note of. While single-lender direct loans give the lender full control over negotiating loan terms with the borrower and 100% of the deal's economic interest, they require a significant capital commitment, which—depending on the size of the fund—may hamper efforts to build a diversified portfolio of loans. Club loans, in contrast, tend to require a smaller capital commitment from each lender, which enables lenders to do participate in a greater volume of loans—including loans to larger businesses with larger financing needs than would be feasible through a direct loan. In exchange, however, club lenders must surrender some degree of control over the deal's terms and share its economics with their partners.

Syndicated Loans and High Yield Bonds

Though distinct financing instruments, syndicated loans and high yield bonds share a target customer of very large non-investment-grade companies. Borrowers in this space may include prominent companies with strong earnings. Many corporate capital structures contain both syndicated loans and high yield bonds, with companies seeking a blend of financing alternatives based on their current needs and market conditions.

Syndicated loans—also known as "broadly syndicated loans," "senior loans," "leveraged loans, "bank loans," and "floating-rate loans," among other names—are extensions of credit to non-investment grade companies arranged and administered by large banks, who facilitate participation in the deal by a range of institutional investors including mutual funds and structured vehicles like collateralized loan obligations (CLOs). **High yield bonds** are debt securities issued by non-investment grade companies in an investment-bank-led bond offering process no different than that for investment grade companies.

Key differences between syndicated loans and high yield bonds include the following:

- **Coupons.** Syndicated loans pay investors a floating-rate coupon (subject to Libor floors), which mitigates their interest rate sensitivity relative to fixed-rate securities. High yield bonds pay a fixed coupon.
- **Capital structure.** Syndicated loans are secured by the borrower's assets and are senior in the capital structure. High yield bonds are unsecured and subordinate to syndicated loans, but above mezzanine debt and equity, in a capital structure. Because of their senior-secured status, syndicated loans historically have enjoyed lower default rates than high yield bonds and higher recovery rates.
- **Callability.** Syndicated loans typically are callable at par soon after issuance, which limits price upside. High yield bonds tend to have better call protections.
- **Liquidity.** Though syndicated loans have a relatively active secondary market through which investors can access liquidity, their idiosyncratic nature limits liquidity relative to bonds, including high yield bonds.
- **Covenants.** Syndicated loans traditionally carried significant covenants that regulated what borrowers must and cannot do and financial positions they must maintain. As investor demand for loans has increased, however, "covenant-lite" loans, which more closely resemble the lax restrictions of high yield bond indentures, have become the norm.
- **Transparency.** High yield bonds are subject to stringent reporting requirements. Syndicated loans face less regulation, and ongoing monitoring can be more difficult.

On balance, the interest rate on a syndicated loan tends to be less than that for a high yield bond issue with a similar credit profile, due largely to the loans' senior secured position in the borrower's capital structure. That said, the pricing of leveraged loans and high yield bonds is highly influenced by market technicals; since the investment banks that arrange the loans and bond issues tend not to hold the debt on their balance sheets, market supply and demand has an outsized influence on loan terms.

Surveying the Alternative Credit Market

LESS LIQUID/HIGHER YIELD ⟷ MORE LIQUID/LESS YIELD

	Direct Lending	Middle-Market Club Loans	Syndicated Loans	High Yield Bonds
Borrower Annual EBITDA	$10–40 million	$25–75 million	<$75 million	<$75 million
Loan/Issue Size		$20–200 million	<$250 million	<$250 million
Market	Private	Private	Public	Public
Place in Capital Structure	Senior secured	Senior secured	Senior secured	Subordinated
Interest Rate	Floating rate	Floating rate	Floating rate	Fixed rate
Liquidity	Limited	Some	Trade OTC	Trade OTC
Term			5–9 years	7–10 years

Source: First Eagle Investment Management.
For illustrative purposes only.

What Are the Key Considerations for Alternative Credit Investing Today?

- The low interest rates and narrow risk spreads that have characterized the years since the global financial crisis, which seem likely to persist, have made it difficult to generate material real income and attractive total returns from traditional credit instruments or portfolios benchmarked to popular indexes like the Bloomberg Barclays US Aggregate Index.
- Alternative credit yields haven't been immune to the low interest rate environment, but these assets have offered more attractive yields, adjusted for risk, than core fixed income investments. A portfolio composed of both public and private alternative credit assets may be able to take advantage of relative value opportunities both among and within these markets to efficiently capture risk premia over time while managing liquidity considerations, serving as an attractive option for those seeking consistent income over time.
- The expertise required to navigate alternative credit suggests that experienced, research-driven managers may be able to exploit information inefficiencies and pursue above-market returns through careful security selection and industry and sector allocation.
- While alternative credit in general is less liquid than more traditional fixed income exposures, illiquidity varies across assets. For long-term investors, reduced liquidity may not present much of an obstacle given the yield pickup. Further, early-2020 dynamics are a good reminder that the liquidity of traditional fixed income markets may not be as plentiful as it seems.
- The interval fund structure gives portfolio managers greater flexibility to invest in less-liquid alternative income-generating assets while still offering investors periodic liquidity opportunities, and is available broadly with generally no requirements that investors be accredited or qualified.

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Before you invest in an interval fund, you should be aware of the various risks. Please see the offering document for a complete discussion of the risks.

Alternative Investment Risks

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

Loss of all or a substantial portion of the investment;

Lack of liquidity in that there may be no secondary market for interest in the strategy and none is expected to develop;

Volatility of returns;

Interest rate risk;

Restrictions on transferring interests in a private investment strategy;

Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;

Absence of information regarding valuations and pricing;

Complex tax structures and delays in tax reporting and

Less regulation and higher fees than mutual funds.

Use of leverage which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy.

Carried interest which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements.

Below investment-grade loans which may default and adversely affect returns.

All investments involve the risk of loss of principal.

Bloomberg Barclays US Aggregate Bond Index is a broad based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. This includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and collateralized mortgage-backed securities.

Indices are unmanaged, one can not invest directly in an index.

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