An aerial photograph of a rugged mountain range. The terrain is covered in patches of snow and ice, with several large, vibrant turquoise lakes scattered throughout the valleys and cirques. The lighting creates strong shadows, emphasizing the steep slopes and jagged peaks of the mountains.

# Finding value in private debt

Adoption of private debt is widespread, but we believe many are failing to exploit the full breadth of the asset class.





## From a brand new opportunity to a core asset class

In 2015 Willis Towers Watson highlighted the opportunity to play the role of “good bank” in private debt markets in the article “Illiquid credit – playing the role of a (good) bank.”<sup>1</sup> Until this point, adoption by institutional investors had been fairly muted. Fast forward to 2018 and we believe investors are now increasingly familiar with private debt, with adoption more widespread – as illustrated by record levels of new fundraising. According to Preqin,<sup>2</sup> assets under management were \$638 billion by June 2017, up from \$205 billion at year-end December 2007, making it a significant part of the credit landscape. We feel the asset class is simply too big and too important to ignore.

However, with the market increasingly diverse and growing rapidly, it is not easy to understand its complexities. This is why we believe the majority of institutional investors have concentrated their activities in mid-market corporate direct lending. We feel this approach is much too constraining.

## Corporate direct lending was a sensible first step into the asset class, but can better value now be found elsewhere?

We continue to advocate for an approach that looks to exploit the full breadth of private debt markets and is sufficiently flexible to direct capital towards areas seeking to offer the most attractive risk-adjusted returns. With mid-market direct lending now demonstrating signs of material deterioration in credit underwriting and future return potential, we anticipate that greater diversity and a keen focus on finding value will be the key determinants of success or failure over the coming years.

At its simplest, we are looking to identify borrowers in private debt markets with a genuine and credit-positive need for our clients’ capital. And, in addition, we are seeking situations where there are greater barriers to entry for providers of debt capital like us.

This paper explores key principles we believe should guide investors when looking to make attractive returns in private debt and also shares investment examples.

## Value-seeking themes

In reflecting on our investments over the last few years, we found four common themes: 1) we liked the assets we lent against; 2) the borrowers needed our capital; 3) there were barriers to entry for new market entrants; and 4) we made sure the investment warranted sacrificing liquidity. What do these mean in practice?

### 1. Like the assets you lend against

We bias our private debt investments towards lending in markets with positive market dynamics that support asset prices. Simply put, we believe assets that are both strongly underpinned and have a good chance of growing in value are much more likely to ensure you’ll get your money back. Clearly there will be exceptions (e.g., lending to stressed companies or assets with exceptional yields that appropriately compensate for the risk taken). However, for the core of our clients’ portfolios, we want to lend to creditworthy borrowers and assets.

So when trying to filter through opportunities, we believe it is important to understand the market fundamentals for the assets you lend against. Lending in a market that you believe is trading at questionable valuations should give you pause for thought. By way of example, our research colleagues in private markets have a negative view on valuations in large-cap private equity and, consequently, we are biasing capital towards lending in other areas.

<sup>1</sup>“Illiquid credit – playing the role of a (good) bank”. [www.towerswatson.com/en/Insights/IC-Types/Ad-hoc-Point-of-View/Perspectives/2015/Illiquid-credit](http://www.towerswatson.com/en/Insights/IC-Types/Ad-hoc-Point-of-View/Perspectives/2015/Illiquid-credit)

<sup>2</sup>2018 Preqin Global Alternative Reports

## 2. Lend where your money is genuinely needed

To state the obvious, it makes sense to identify where regulation and other impediments have diminished credit availability. We believe the most attractive returns are likely found where these forces are most extreme and the supply and demand of capital are unbalanced.

We continue to advocate for an approach that looks to exploit the full breadth of private debt markets and is sufficiently flexible to direct capital towards areas seeking to offer the most attractive risk-adjusted returns.

Speaking first to regulation, “bank disintermediation”<sup>3</sup> has driven the growth of private debt since 2010. Some eight years later we feel regulation continues to inhibit traditional lenders. In all the opportunities we have committed capital to, regulation has been a key driver in creating the opportunity for institutional investors.

It is not just regulation that impedes capital flows into a market. Complexity, illiquidity and the absence of a long track record in an institutional setting can also be inhibiting factors. We have found that many investors are unwilling to be a first mover back into markets that have experienced performance issues in the past, even if the dynamics in that market have changed substantially. For those willing to bear these risks, we believe the rewards can be substantial.

Residential mortgage-backed securities are a great example of this behavioral bias. It took a significant period of time for this market to rebound post-crisis from negative investor sentiment, despite what we believed to be improving economic fundamentals that resulted in performance on an outright and risk-adjusted basis for those brave enough to reenter the asset class early.

## 3. The easier it is to scale, the less attractive it is likely to be

We believe institutional investor demand is often heavily influenced by visibility. More visible investment ideas are more likely to be considered by institutional investors. Asset managers, particularly the larger ones, play an influential role in creating and improving visibility. These asset managers will often focus on ideas that are simple to raise, scalable and profitable to run, which means they tend to crowd towards similar opportunities. As mid-market direct lending or, indeed, private equity illustrate, large capital flows can create downward pressure on returns and upward pressure on risk.

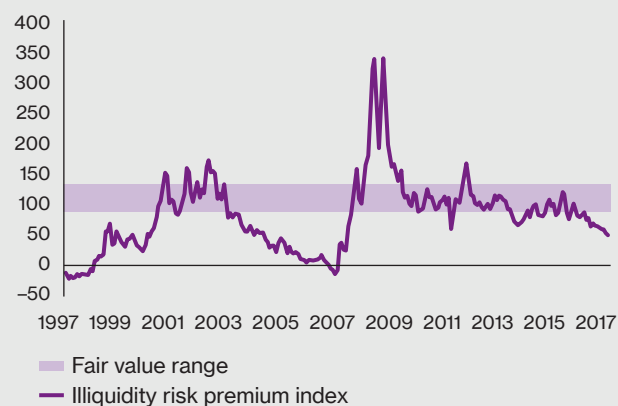
As such, we spend much of our time looking for opportunities too small for others to want to compete. This can occur either via specialists, often smaller asset managers, or by encouraging a larger asset manager to create a smaller, targeted fund around an opportunity that currently sits within a much broader fund. We believe this bias towards a smaller specialist is particularly well rewarded in periods of market complacency and higher valuations, characteristics we observe in most credit markets today.

## 4. Help ensure market returns are fair or better than the risks warrant

You should only invest in private debt if you believe the returns warrant giving up liquidity. This is not always the case, as we believe at various points in the cycle the illiquidity premium may be smaller or greater, and investors should always aim to compare illiquid opportunities against a liquid comparable. Willis Towers Watson measures this via an illiquidity premium index, shown in *Figure 1*. As the index illustrates, we believe the illiquidity premium today is low, suffering from a market flush with liquidity and yield-starved investors. We are therefore very selective in the new investments we make.

Figure 1. Willis Towers Watson illiquidity premium

Central bank liquidity has compressed the illiquidity risk premium



Source: Willis Towers Watson, Bloomberg, S&P, MSCI, PMA, Thomson Reuters, The Federal Reserve Board, Merrill Lynch

[www.towerswatson.com/en-US/Insights/IC-Types/Ad-hoc-Point-of-View/2016/05/Understanding-and-measuring-the-illiquidity-risk-premium](http://www.towerswatson.com/en-US/Insights/IC-Types/Ad-hoc-Point-of-View/2016/05/Understanding-and-measuring-the-illiquidity-risk-premium)

<sup>3</sup>Bank disintermediation is a commonly used phrase that describes how institutional investors replace bank lending when regulations make it harder for banks to lend.

Finally, we have purposely used the phrase “market returns” here to highlight that market participants cannot sustainably charge borrowers more than the market. So rather than rely solely on manager outperformance, we look to find markets where the supply and demand of capital are identifiably mismatched, creating attractive market returns.

### How to find value in surprising places

It’s a challenge to find opportunities that meet all these requirements. However, using them as a framework has helped us find value in surprising places.

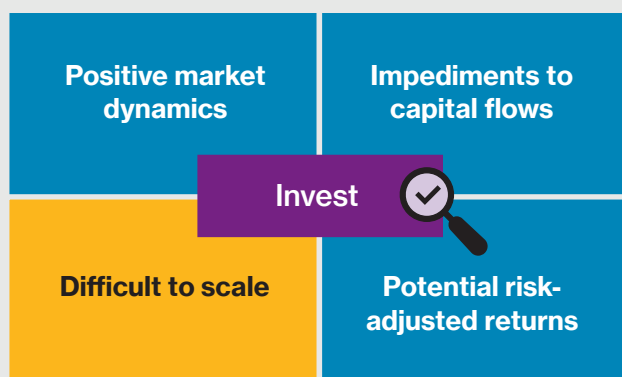
### Opportunities to support poorly served borrowers in the U.S. residential mortgage market

The U.S. residential mortgage market is one of the largest and best-followed credit markets globally, so it seems difficult to believe there are poorly served borrowers. It is a market we view positively (*Figure 2*), with asset values supported by the prosperity of the U.S. consumer, positive demographic trends, improving economic fundamentals and the slow recovery of new residential construction post-crisis. Additionally, we believe poor pre-crisis lending practices have caused distress for many legacy lenders in this market, and all have faced meaningful increases in regulation.

We are particularly attracted to the nonqualified mortgage segment. A qualified mortgage is one that meets specific U.S. federal government standards and is presumed to have met the “ability to repay” rule. We believe there is ample capital for this type of mortgage financing. For those unable to achieve qualified mortgage status, mortgage providers have tightened credit standards dramatically, and availability has been greatly reduced, as illustrated by the decline in product risk in *Figure 3*.

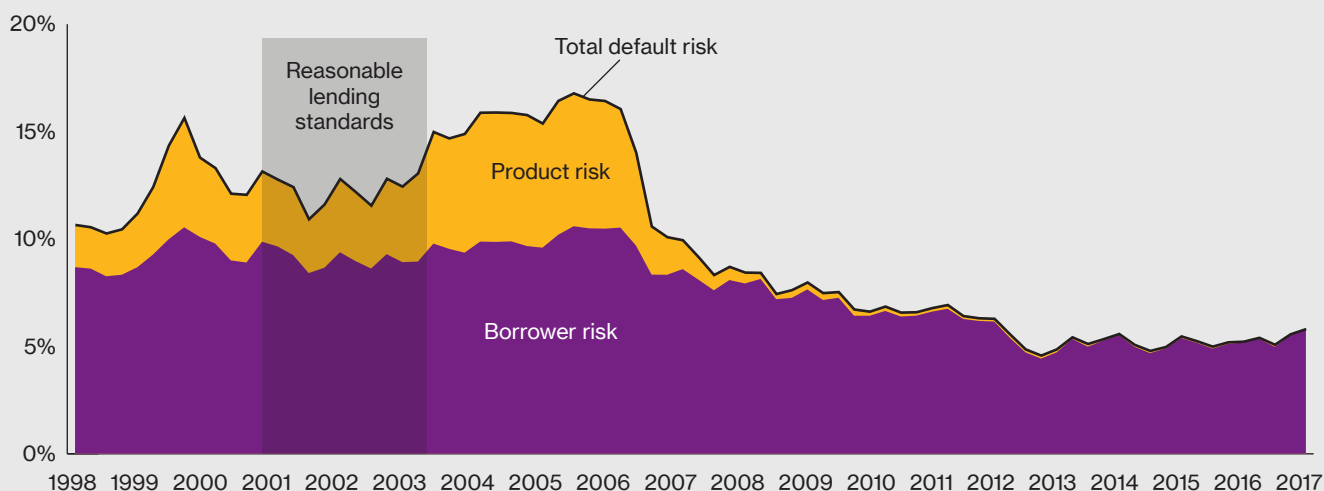
In all the opportunities we have committed capital to, regulation has been a key driver in creating the opportunity for institutional investors.

Figure 2. U.S. residential mortgage market



For illustrative purposes only

Figure 3. Default risk taken by the mortgage market, 1998Q1 – 2017Q3



Sources: eMBS, CoreLogic, HMDA, IMF, and Urban Institute.

We feel the opportunity exists in distinguishing credit-starved borrowers that are genuinely deserving, for example, those that are self-employed, may be of lower (but improving) credit quality or those that have missed a mortgage payment historically but subsequently improved their credit profile. For these borrowers, we are simply looking to fill a need created by the borrower's inability to get a regular bank or agency mortgage.

To be clear, there is risk associated with nonqualifying mortgages. However, we believe they do not represent the reincarnation of the 2006 – 2008 subprime mortgage market. Rather, nonqualifying mortgages may present an opportunity for a highly discerning buyer to potentially achieve attractive risk-adjusted returns, with positive tailwinds for the U.S. mortgage market and regulatory-linked barriers to entry.

## U.K. real estate bridge lending

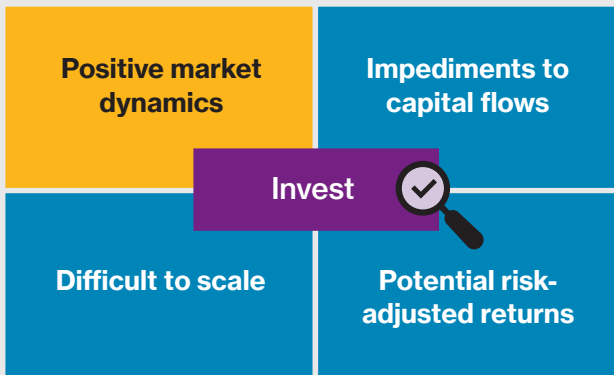
The U.K. commercial real estate market is also a large and well-followed market attracting substantial amounts of capital, particularly in London and the South East. While there are some potential headwinds, we believe regulation has created opportunities in two specific ways.

First, regulation has greatly increased the cost of capital for bank lending against property, encouraging them to reduce the loan-to-value ratios and reducing the incentive to lend against non-income producing property (*Figure 5*). Second, in 2013 the U.K. government introduced “permitted developments rights” that allowed for much more straightforward office-to-residential conversion approval and made this regulation permanent in 2015. This had the desired effect of encouraging office-to-residential conversion and, in the process, helped support commercial property valuations by taking supply off the market.

We believe these factors have created a highly attractive opportunity to provide short-term lending against non-income producing commercial real estate at a meaningful yield premium. While we are cognizant of the potential for market dislocation in London commercial real estate, the short maturity (less than 12 months) of these loans, the reasonable loan-to-value ratio and being the senior lender (first mortgage) on the underlying property all help limit the risk associated with a market correction.

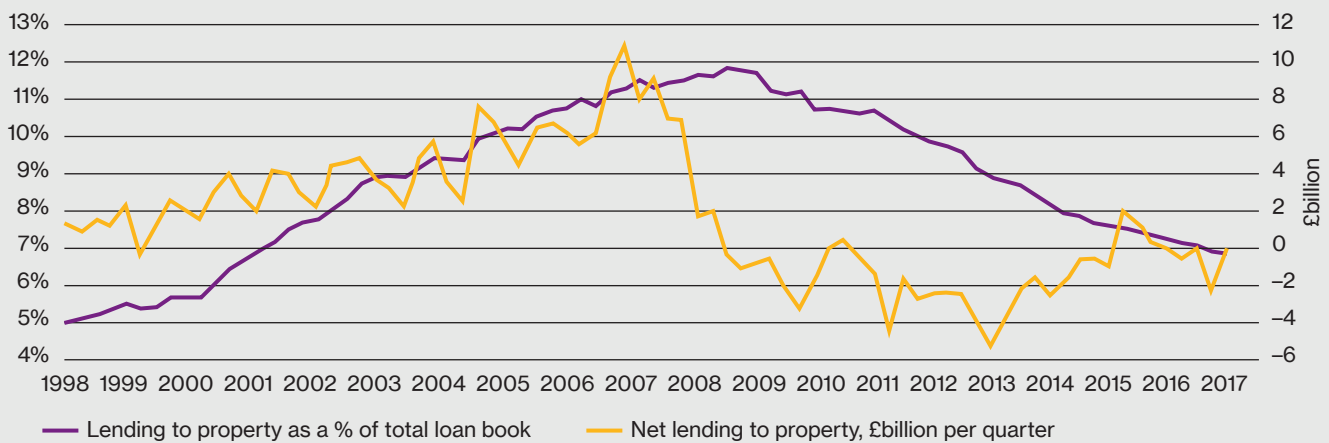
Private debt can play a valuable role in diversifying an investor's risk and accessing more uncorrelated sources of potential return.

Figure 4. U.K. commercial real estate market

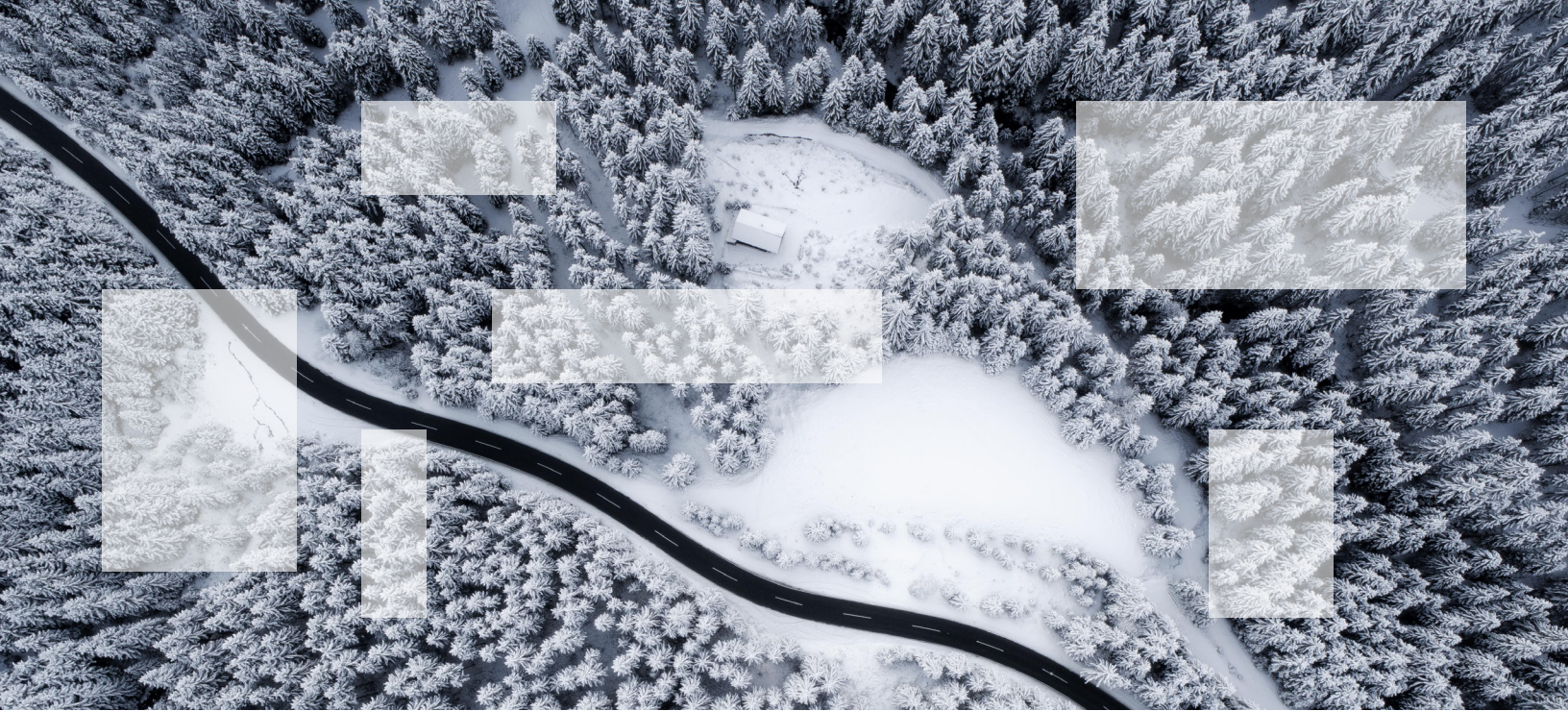


For illustrative purposes only

Figure 5. Reduction in commercial property lending by banks in the U.K.



Source: Bank of England Statistical Interactive Database



## Conclusions

We believe private debt continues to offer meaningful return pick up and strong value for risk taken for those investors willing and able to go the extra mile and unearth interesting opportunities. In recent years we believe meaningful investor capital has flowed into the private debt market, making it more challenging to find value today. However, we feel there is value to be found if investors remain selective, using their precious illiquidity budget to focus on opportunities where:

- The market has attractive tailwinds supporting asset prices
- There are regulatory and other impediments reducing capital inflows
- It is difficult to scale the opportunity, which reduces competition
- We feel the market appears to offer attractive compensation for the risk assumed, rather than relying on manager skill to compensate for an unattractive market beta
- As discussed in “Illiquid credit – playing the role of a (good) bank,”<sup>1</sup> we believe a focus on specialist managers is likely to be well rewarded as returns in core markets are eroded.

Keeping these principles in mind, we believe there are significant opportunities that remain for investors within the private debt market. As the search for yield continues in a low-interest-rate world (but with looming rate, policy and political risks on the horizon), we believe private debt can play a valuable role in diversifying an investor’s risk and accessing more attractive sources of potential return.

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