Private Equity Domain

*Mill Creek Capital Advisors' quarterly publication, **Private Equity Domain**, focuses each time on a specific aspect within one of the four major sub-segments in private equity – Buyout Funds, Venture Capital, Debt/Credit Funds, or Real Estate/Real Asset Funds.*

Claire B. Kendrick, Ph.D.
Managing Director
Alternative Investments & Research

Loans versus Bonds. In private equity, Debt/Credit Funds represent one of the main sub-groups; yet the range of strategies within this segment is enormous. We distinguish between debt funds and credit funds – with debt funds buying existing corporate or government debt, whereas credit funds are extending new borrowings.

This discussion focuses on Debt Funds, which we categorize into three separate groups: (1) trading-focused, (2) control-oriented, and (3) influence-seeking.

Trading-Focused. The Fund Managers or General Partners of a fund will purchase existing debt vehicles (bonds, loans, or other obligatory instruments) in anticipation of a catalyst or specific event that will revalue the debt hopefully to the upside. For instance, a Fund Manager buys the debt of ABC Tool Company in anticipation of a beneficial merger; or buys the debt of XYZ Drug Company in expectation of a positive change to insurance reimbursement rules. The goal is to buy the debt of out-of-favor or unloved companies at a discount, before the catalyst event. Following the event, the Fund Manager will resell or "trade" the debt instruments after they have moved-up in price. The Fund Manager generally has a short-term investment horizon of 3 to 18 months. The Fund Manager does not need, and usually does not seek, to take control of the underlying companies. Rather, the Fund Manager is looking for a time arbitrage (price today versus price at a future date). Some funds trade dozen of positions daily, while others take more concentrated positions in a handful of companies and trade their fewer positions infrequently.

Debt trading-focused firms are not unique to private equity. In fact, the majority of debt-trading firms are publicly-traded mutual funds and hedge funds (called contrarian investors, or event-driven funds, respectively). Because private equity firms usually have 8 to 12 years of contractual access to investors' money, they have a longer-term investment horizon and can take a more active role when purchasing companies' debt.

Buying the debt of a company prior to an expected beneficial catalyst can take several forms, but the most common strategies are to buy publicly-traded bonds, or bank-arranged loans (which are not publicly traded), or both. Given their short-term investment horizon, most trade-focused funds buy publicly-traded corporate or government bonds. Although publicly-traded bonds are not nearly as liquid as publicly-traded stocks, they are the most liquid of the debt instruments, there is a public market, and there are rules and regulations surrounding public disclosures of financial information, the calculation of earnings, and the release of information to the public. Because of the non-public nature of bank-arranged loans, buying and selling these loans is a much longer process that can take months or years, and therefore most trading-focused funds stick with publicly-traded bonds to match their shorter-term investment horizon.

Control-Oriented. The Fund Manager seeks to buy a substantial portion of a company's outstanding debt, and then force a restructuring. The restructuring is usually brought about by triggering a bankruptcy or by the threat of a bankruptcy (called a near-bankruptcy). The Fund Manager buys the debt of a financially distressed company, triggers a bankruptcy, and through a court-mandated financial restructuring the Fund Manager exchanges the debt it holds for new equity – thereby becoming the majority shareholder of the newly recapitalized or post-bankruptcy company (shares held by previous shareholders are eliminated). As the now- controlling shareholder, the Fund Manager can rebuild the company through changes in management, operational improvements, and changes to the capital structure (i.e., a reduced debt load), such that the company can resume growth and prosper. This strategy is often called "distressed debt investing" or "distressed for control investing". Note that this is not same as taking control (through the debt or equity) of a company and then breaking the company up into parts and selling off the parts – which is known as corporate raiding.

If the Fund Manager tries to take control by amassing a large portion of a company's publicly-traded bonds, it is hard not to signal that intent to the market. Once the market gets wind of it, competitors may start buying the debt and/or the prices of the bonds rise, making it difficult to buy the debt cheaply. The Fund Manager could wait for the company to miss an interest or principal payment – but by then, the company will have sullied its reputation with vendors, customers, bankers, and the stock market, making it very hard to rebuild the company. However, if the Fund Manager amasses its debt position through buying bank-arranged loans, usually there are loan covenants that are violated or breached long before a company reaches insolvency (an early warning system). The covenants in the bank-arranged loans give the Fund Manager tools to force a bankruptcy or restructuring, whereas with publicly-traded bonds there are generally no covenants by which to orchestrate an orderly bankruptcy (i.e., a bankruptcy that is approved by the bankruptcy courts in a timely manner and not highly contested). Bankruptcies themselves are rarely quick and a company can easily sit in bankruptcy protection for 12 to 36 months. Turning the company around can take another year to five years. Thus, the Fund Manager has to have time to buy the debt, go through bankruptcy, rebuild the company, and sell the new equity – a multi-year undertaking. With time on their hands, this strategy is well-suited for the private equity structure, but not generally for hedge funds or mutual funds.

Given the extra rights that come with bank covenants, most private equity firms will pursue distress for control investing through bank-arranged loans, rather than publicly-traded bonds. Covenants not only help the Fund Manager orchestrate an orderly bankruptcy, but the covenants provide the debt holder with superior access to company level information. Bank loan covenants give the lender access to management, books and records, customers, and vendors. A publicly-traded bond does not provide for any of that, and bondholders have access only to the publicly-filed financial statements (the same as are available to stock holders). Bank loan covenants, therefore, provide the Fund Manager with significantly more rights and information, compared to owning a bond – this information asymmetry is important and often critical to a Fund Manager's ability to successfully return a company to profitability. Major differences between a publicly-traded high yield bond of a distressed company and a "leveraged loan" (a bank-arranged loan to a below investment grade company) are in Diagram 1.

Influence-Seeking. This category sits between "trading-focused" and control-oriented". The Fund Manager wants to bring about a major managerial shift or operational change in order to improve the profitability of the target company, and thereby increase the price of the company's bonds, loans, stock, and other investment instruments. Although influence-seeking involves a longer investment horizon compared with trading-focused strategies, it is designed to take less time than that required for control-oriented strategies. The Fund Manager often buys meaningful positions in both the debt and equity of a target company, so that the company is nudged or encouraged into making the changes sought. For example, the Fund Manager may be seeking to replace the company's management team or Board of Directors (managerial changes). The Fund Manager might want the company to sell assets, divest certain business lines, or agree to a certain merger (operational changes). Since much of the gain from such activities will be an increase in stock price (stock prices are often more sensitive to small and medium range changes in profitability), the Fund Manager is encouraged to own both the debt and the equity. As such, influence-seeking generally involves publicly-traded companies, since it is difficult, if not impossible, to buy the stocks of privately-held companies. Since this strategy usually entails owning the publicly-traded debt and equity, it is more common to see this strategy among hedge funds and mutual funds (often called activist funds).

Conclusions. Structural differences between publicly-traded bonds and non-public bank-arranged loans help define the strategy variations we see among the three debt-buying groups. Trading-focused funds are more common in the hedge fund and mutual fund arenas, with a shorter investment horizon and an emphasis on publicly-traded bonds. Control-oriented funds are more common in the private equity universe, where the funds have 8 to 12 years to effect a change and they can use that time to amass the debt, restructure the target company through bankruptcy, and rebuild the company. These funds tend to buy bank-arranged loans that are not publicly traded, so that they will face less competition in buying the debt, have greater information and access to the target company, and the loan covenants can be used to trigger a more orderly bankruptcy. Influence-seeking strategies, utilizing a medium-term investment horizon, are more common among hedge funds and mutual funds, with the funds buying both debt and stock, leading to an emphasis on publicly-traded companies and therefore publicly-traded bonds.

Investment gains generated by the three types of debt funds vary widely and are impacted by skill, gyrations in the public markets, banking cycles and regulations, and changes taking place in the industry sector(s) of the target companies. However, if those variables were to be consistent across all three debt purchasing categories, we would expect the control-oriented funds to out-perform the other two for several reasons:

- The ability to buy more cheaply, since portions of the leveraged loan market are less competitive (i.e., less efficient due to their private nature)
- The longer investment horizon (greater illiquid), which gives the control-oriented funds greater flexibility regarding when and how to buy, rebuild, and sell the target companies
- The larger amount of information and access to the target company, as afforded by the loan covenants. Further, loans are senior to bonds, and have a superior claim to assets in bankruptcy, therefore reducing the chance of a loss and increasing the likelihood of recovering some capital even in the event of a loss.
- The quarterly amortization of loans (quarterly payment of interest and some principal) reduces the chance of losses, relative to the bullet maturity on bonds (all principal paid in one lump sum at maturity). The floating rate structure of loans also protects the loan-holder more over the long term, relative to the fixed-rate nature of publicly-traded bonds, since floating rate debt suffers less erosion from rising inflation.

Diagram 1: Major Differences

Characteristic	Leveraged Loans	High Yield Bonds
Credit rating	Below Investment Grade	Below Investment Grade
Hierarchy	Senior Secured, secured by a lien on all assets of the borrowing entity and its US subsidiaries	Senior Unsecured, backed by the earning power of the company, but subordinated to senior secured obligations
Contract governing the lending agreement	Loan Agreement or Credit Agreement	Bond Indenture
Financial Statements	Balance sheet, income statement, funds flow statement	Balance sheet, income statement, funds flow statement
Contractual Rights	Direct access to the books of the company management; private information and projections; inspection of property, plant, and equipment	None
Covenants	Affirmative and negative covenants, plus rigorous and explicit financial covenants	None
Interest rate/coupon	Floating rate	Fixed rate
Pricing	Tied to Libor or the prime rate	Credit spread over the same-dated US Treasury security
Average life to maturity	Six years	Ten years
Amortization	Required quarterly principal payment	Bullet principal payment at maturity
Callability	Prepayable at par without penalty	Call protected for a portion of its life
Structures	Term loan facilities, revolving credit facilities, and possibly pre-funded letters of credit	Term obligation full funded at the issuance of the bonds
Syndication	Large loan syndicates to a number of banks (the bank syndicate). Syndicate members are responsible for holding some subset of the total loan amount, selling the rest onto investors.	Bonds are syndicated to several investment banks (the bond syndicate). Syndicate members sell their portions to investors
Buyers	Commercial banks, CLOs, prime bank mutual funds, insurance companies, private equity & hedge funds	High yield bond mutual funds, pension plans, insurance companies, hedge funds, CDOs, and private equity funds
Liquidity (tradability)	A limited secondary market and more restrictive covenants create a less liquid secondary market	Robust secondary market creates greater liquidity
Minimum issuance size	No minimum. Banks have internally set minimums, smaller banks have smaller minimums. Loans under $10 million are less likely to be syndicated and are often held by a single bank.	Usually $200 million, but at times $100 million
Regulator	US banking regulators (federal and state)	Securities and Exchange Commission (SEC)
Size of market	$960 billion (3/31/2016)	$1.6 trillion (3/31/16)

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