

For Professional and Wholesale investors only



Is private debt
ready for
recession?

December 2022



Introduction

Private debt: Looking ahead with the changing face of markets

As we have seen in 2022, uncertainty has weighed heavily on markets and generated extreme volatility across asset classes. As the market headwinds shift from soaring inflation and rising interest rates to recession fears, investors need to rethink their allocations as we enter uncharted territory.

With the increased interest in private debt and the challenging economic period ahead, we provide this short paper – Is private debt ready for recession? The Revolution Asset Management investment team explores the impacts of inflation, rising interest rates and widening credit spreads on the Australian and New Zealand private debt market and highlight the specific characteristics of leveraged buyout loans, real estate debt and asset-backed securities – the sub-sectors of private debt that have demonstrated the ability to withstand multiple market cycles. It is more important than ever to understand what's under the hood of a private debt allocation as the period ahead will see huge dispersion of performance of private debt funds, depending on the focus of the respective strategies.

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The authors





Part 1 – Not all private debt is the same. Why investors shouldn't overlook this enticing alternative asset class

Senior Portfolio Manager, David Saija and Portfolio Manager, Lucie Bielczykova provide insight on the impacts of inflation, rising interest rates and widening credit spreads on Australian and New Zealand private debt as they evaluate the next phase of the economic cycle. Given the timing and shape of the recovery still remains unknown, investors shouldn't overlook this alternative asset class which can provide much needed capital preservation during these uncertain times.

In the current environment of surging inflation, rising rates, widening credit spreads, and volatile financial markets, there is little doubt that the orchestrated slowdown of developed market economies by Central Banks will cause businesses and consumers to come under increasing pressure. The risk of a global recession is now increasing as a result.

In these periods of challenging economic conditions, the key attributes of Australian and New Zealand private debt have proven to be very attractive and can offer investors a level of protection, namely due to:

1. Floating rate

As base interest rates have risen the yield of the portfolio has risen, thereby insulating performance against inflationary forces;

2. Secured nature of loans

All loans in Revolution's portfolios are secured (over the underlying assets or assets of the business) which provides strong protection in periods of macroeconomic downturn;

3. Diversification and low correlation

Private debt offers the ability to invest in industries and sectors that are not easily accessed through liquid markets. Moreover, the low correlation to volatile liquid markets and traditional asset classes is also attractive to investors, as private debt provides capital stability in an investor's portfolio while delivering a steady income stream.

Looking ahead, asset allocators have been asking about the stability of the private debt sector during economic turbulence, the fundamental health of underlying borrowers and the ability of borrowers to continue to service and repay what was taken out as cheap debt.



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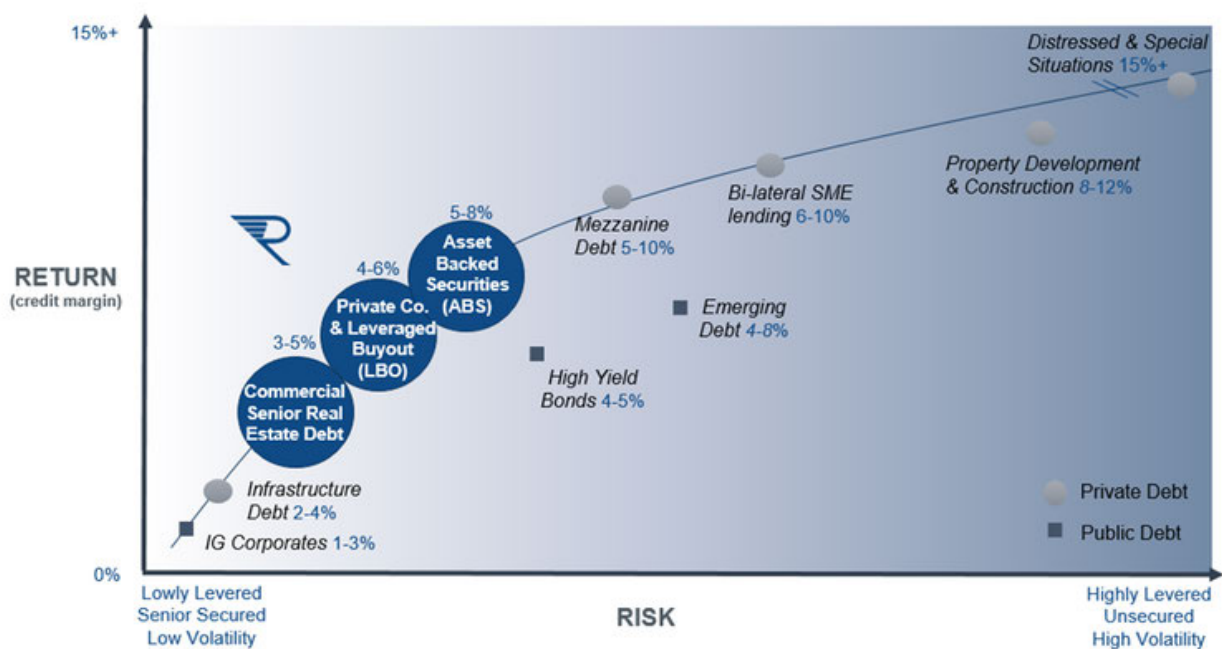
Over the last decade and the past couple of years in particular, the market has benefited from very low interest rates. This meant cheap funding, easy serviceability, little or no inflation, and very low default rates observed in the market.

In the period ahead, the market is now expecting to experience weakening credit fundamentals, particularly interest coverage metrics and serviceability, as well as increasing default rates as borrowers attempt to adapt to the new economic environment.

While it is important to note that we are coming off a relatively benign period where companies are generally in much better shape compared to the pre-GFC period - with more conservative balance sheets and less leverage in the capital structure, there will be borrowers that can withstand and adapt to the changing environment, and there will be pockets of the market and strategies that will find it increasingly difficult to navigate this period.

As such, it is more important than ever for investors to understand what's under the hood of their private debt allocation, as there is no doubt the period ahead will see huge dispersion of performance of private debt funds, depending on the focus of the respective strategies and underlying exposures.

The sub-sectors of private debt



Source: Revolution Asset Management.



Partnering with the right manager – asset selection and credit discipline key to success

While the investable universe of private debt is broad, Revolution focuses on three key areas being Commercial senior real estate debt, Private company and leveraged buyout debt (LBO) and asset-backed securities (ABS). Revolution believes these segments offer the best risk-adjusted returns when compared to other segments in the private debt universe.

Similar to the broader market, investors have repeatedly asked about the ability of Revolution to be able to navigate through what appears to be a challenging period over the next 12-18 months.

Revolution's strategy has always been focused on capital preservation throughout economic cycles. As such, focusing on the downside risk for all loans that are advanced is the core of Revolution's investment process. It has always been an imperative to ensure that there is demonstrated serviceability and repayment of all loans through any macro-economic downturn or recession.

The current state of the portfolio is robust, as a direct result of Revolution's investment philosophy. Revolution avoids cyclical industries and focuses on those industries that are best able to navigate through a more volatile period – industries such as healthcare, mission critical software and consumer staples.

Within those industries, Revolution targets market leading players with strong ability to maintain margins throughout the cycle. Furthermore, ABS are predominantly secured against prime borrowers with higher underlying credit scores, with these borrowers having a much better ability to deal with challenging economic conditions than weaker borrowers.

Whilst the future remains uncertain, the investment team at Revolution has the benefit of receiving very timely private side information on all portfolio loans, to assess how they are performing, coupled with stringent third-party oversight for asset performance and valuations.

All assets are independently reviewed by a specialist valuation firm that utilises all available private side information on a monthly basis to confirm if loans are performing. Since inception of the Revolution private debt strategy in December 2018, Revolution has had no defaults in its portfolio of loans.

Overall, Revolution's private debt strategy offers many features that are very appealing in the prevailing market for clients as diverse as large superannuation funds, not-for profits and foundations, family offices, endowments and high net worth investors. The combination of capital stability, high income component with low correlation to traditional fixed income and risk assets across a diversified pool of loans is an attractive strategy to minimise interest rate sensitivity and guard against inflation risk as we enter a period of continued market and economic volatility.



Part 2 – Reaching for resilience as we take a closer look at leveraged loans

Falling markets are largely seen as a challenge for traditional asset class investors, though the interest in private market investments, such as leveraged buyout loans (LBOs) is rising. Senior Portfolio Manager David Saija and Portfolio Manager, Lucie Bielczykova weigh in on the momentum of LBOs for investors and where opportunities lie in generating stable and predictable income.

What do surging inflation, rising rates, widening credit spreads, volatile financial markets and a potential recession waiting around the corner all mean for LBOs?

First, it is helpful to establish Revolution's focus within the private company and leveraged buyout segment of the private debt market. The private company and leveraged buyout debt market is wide and can range from conservative bank-type lending that involves lending to large and established companies, through to bi-lateral and Small Medium Enterprise (SME) lending that involves lending to small companies and SMEs as a sole lender, all the way to distressed and special situation debt where lenders take equity-like positions with a view to turn around a company that is facing challenging conditions or requires a complete restructuring or recapitalisation.

Revolution focuses on the larger, broadly syndicated transactions, which usually involve top tier private equity firms (such as KKR, PEP, TPG, EQT, Apollo for example) acquiring large, well-established and market-leading businesses.

Example borrowers in Revolution's strategy



Revolution is a senior secured lender to these businesses. Seniority refers to investors' relevant position in the capital structure. Senior lenders rank at the top of the capital structure and receive priority repayment of cash flows, meaning that any principal and/or interest on senior instruments are paid before junior debt and equity holders. A typical LBO capital structure has ~50-60% equity and/or junior debt buffer, which provides a significant amount of buffer and protection.

Revolution holds first ranking security over the company's assets and operations. Security (also known as a lien), is legally documented in loan contracts and allows lenders to have rights over the borrower's assets should they be unable to meet their repayment obligations. Together with seniority and security, covenants and loan terms provide further structural protections, which combine to mitigate risk.

Being floating rate in nature, private debt has embedded protection against inflation and changes in interest rates. The yield of floating rate assets is anchored to short-term interest rates. Therefore, as interest rates rise, the cash yield on private debt assets will also increase without any negative impact on the value of principal (as opposed to traditional fixed rate bonds which incur capital losses when interest rates increase). From the borrower's perspective, this means that the cost of debt servicing can increase significantly.



Is private debt ready for recession?



Source: Revolution Asset Management.

While Revolution expects to see some deterioration in coverage metrics for LBO assets with increasing interest rates flowing to borrowing costs, it should be noted that they are coming off a very low starting point with rates having been near zero for a long time. On an absolute basis, cost of funding remains relatively cheap. It is also notable that most Australian borrowers at least partially hedge their interest costs, and therefore Revolution does not expect them to fully feel the impact of rising rates from a servicing perspective. From an overall fundamental standpoint, borrowers are generally in good shape with sound balance sheets and manageable leverage.

Revolution's strategy focuses on lending to large, well-established businesses in stable, non-cyclical industries, that hold a leading market position, with a strong and experienced management team, strong profitability, and stable margins. These factors all work together to ensure that cash flows remain stable throughout economic cycles, with ample liquidity to service and repay debt.

"There are a number of factors that determine how a particular business can deal with inflationary pressure and recessionary environment. Some of these factors include industry, business size and market position, basis of competition and if they have a sustainable competitive advantage, who has the balance of power in terms of relationships with customers and suppliers, the quality and experience of the management team as well as profitability, margins and cash flow generation, to name a few." David Saija – Senior Portfolio Manager



Non-cyclical industries

Revolution favours industries such as healthcare, mission-critical software and consumer staples. Demand drivers in these industries tend to be quite stable given the importance of the products/services offered. Further, demand in these industries tends to be relatively price inelastic (not sensitive to increases in price), which enables businesses to better manage margins in times of inflationary pressure, as is the case at the moment.

Large well established market-leading businesses

Larger businesses typically have a longer track record, with a well-established and diversified client base as well as deeper, stronger, and more sophisticated management teams. Having a strong market position also means that the barriers to entry make it difficult for competitors to enter the market or existing competitors to compete against the dominant player. As such, the dominant position provides them with more flexibility to manage their top line and cost base. Combined with inelastic demand, market leading businesses are able to manage input cost pressures to increase their sale prices without a corresponding decrease in volumes, ceteris paribus, allowing revenue to increase to offset any cost pressures.

Due diligence

Revolution performs significant due diligence on the business, industry and historical financials, as well as stress testing and scenario modelling for each individual loan to determine how the business would perform should identified risk factors materialise or the economy weaken. It is for this reason that Revolution avoids transactions in cyclical sectors which can experience volatile demand throughout economic cycles, as well as bilateral SME loans,

which are typically smaller in size and are significantly more sensitive to changes in the macroeconomic backdrop such as changes in demand, the rising cost of labour, input cost inflation and increasing cost of debt.

This all leads to Revolution managing a “sleep at night” portfolio of stable, non-cyclical businesses which is at the very core of its investment philosophy and a function of its disciplined approach to lending. Revolution is comfortable with the ability of its corporate borrowers to withstand economic weakness. This is due to the focus of its investment strategy being on well-established market leading companies within stable non-cyclical industries with strong barriers to entry.

As it relates to the broader market, Revolution expects some pain to be felt in certain pockets of the market during a potential recession, particularly in cyclical industries with variable demand, sectors linked to discretionary consumer spending (such as retail, hospitality, consumer discretionary), and smaller companies that could see their margins squeezed.

Where will pressure likely emerge?

In Revolution’s view, areas that are likely to experience pressure are:

- **Cyclical sectors**

Such as retail, hospitality, consumer discretionary which are linked to consumer health and demand and will likely come under pressure as consumers manage their increasing costs of living and mortgages and rein in their discretionary spending.

- **Highly leveraged capital structures**

Revolution considers the appropriate capital structure is dependent on the business as well as the industry the business operates in.



The leverage multiple can quickly escalate, particularly for cyclical businesses and industries.

- **Small companies**

SMEs and smaller market players are more likely to come under pressure as they may not be able to pass on the increasing input costs to their customers to the extent large companies and market leading players can. As a result, these companies could see their margins contract as they are forced to absorb increasing costs, resulting in declining profitability.

The winners

On the other hand, defensive strategies will be the winners. Defensive strategies such as Revolution's that focus on high quality businesses and sectors, that demonstrate stable demand and generate stable and predictable cash flows, regardless of economic conditions, will be able to withstand the economic turbulence.

Later in the cycle, distressed and special situations strategies may also become potentially attractive, as they will be able to capitalise on the opportunities that this environment will create. Revolution does not participate in these opportunities as it is outside the investment strategy of the firm.

Conclusion

There are a number of factors that determine how a particular business can deal with inflationary pressure and recessionary environment. While Revolution expects to see some deterioration with respect to fundamentals and coverage metrics across the LBO market, Revolution expects little impact to its portfolio which benefits from stringent due diligence and strategy focus on strong, stable, market leading businesses in stable industries which are able to produce sound cash flows regardless of the cycle. Revolution will continue to focus on identifying and capturing real value opportunities across businesses that can withstand volatile economic conditions.



Part 3 – Considerations when investing in real estate debt

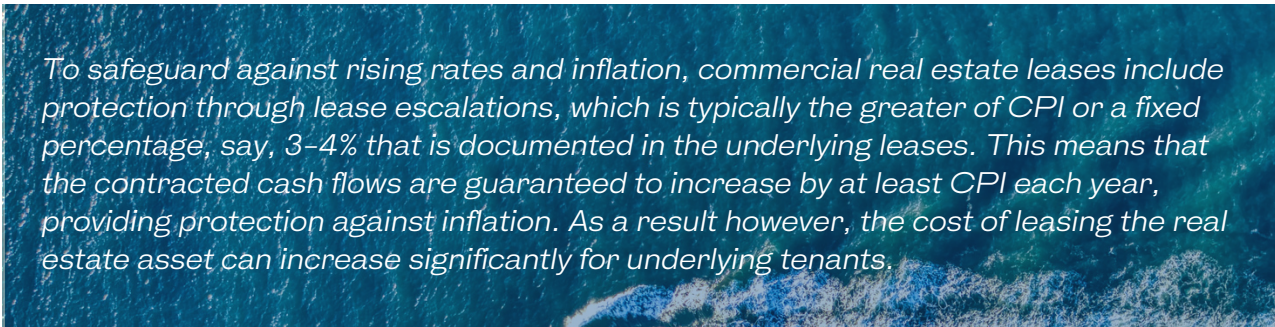
In the current economic environment, there are a number of factors that investors need to contemplate when considering real estate debt opportunities. Senior Portfolio Manager, David Saija and Portfolio Manager, Lucie Bielczykova discuss the impact of rising inflation on real estate debt and where the pressures are to be seen for investors.

The spectrum of lending opportunities to real estate is quite wide, ranging from low Loan to Value Ratio (LVR) lending to stabilised commercial properties with strong tenants and long leases at one end of the spectrum, right through to large-scale residential development loans, which are typically highly leveraged, have no underlying cash flows to service the debt with lending based on an assumed future value of the property.

Similar to leveraged loans, Revolution focuses its real estate attention on the more conservative end of the spectrum. Any loan Revolution will advance needs to demonstrate that it can be serviced via cash flows generated by the property, with the asset value (in terms of being able to sell the asset to recover any outstanding debt) being secondary in nature. As such, Revolution favours lending to well established retail, industrial and office assets, with high quality tenants on long leases that generate a recurring cash flow and income stream to the asset owner.

Revolution is also quite conservative with leverage in its real estate debt transactions, with typical LVR of around 60–70% which provides a significant equity buffer and safeguards against the value of the property falling below the loan amount. There are also covenants which impose restrictions on borrowers such as a maximum LVR (which is typically subject to an annual external valuation to ensure compliance) or minimum interest cover ratios (or ICR), which must be complied with by the borrower, and may trigger a breach of the covenant and an event of default, enabling the lender to demand full repayment of the loan.

Similar to corporate borrowers, rising interest rates and inflation result in the cost of debt increasing for real estate borrowers. Further, a recessionary environment can weigh on the underlying tenants and their ability to pay their leases, while at the same time it has the potential to trigger a decline in property valuation which lenders take security over.



To safeguard against rising rates and inflation, commercial real estate leases include protection through lease escalations, which is typically the greater of CPI or a fixed percentage, say, 3–4% that is documented in the underlying leases. This means that the contracted cash flows are guaranteed to increase by at least CPI each year, providing protection against inflation. As a result however, the cost of leasing the real estate asset can increase significantly for underlying tenants.



As such, strong tenants are also key in the equation. Revolution pays significant attention to, and conducts in depth credit analysis on, the underlying tenants to ensure serviceability throughout the cycle. Using a retail asset as an example, Revolution favours assets that rely on non-discretionary spending with large, grocery-based anchor tenants such as Coles or Woolworths, with long leases in place that not only tend to generate a stable cash flow, but also draw foot traffic to the centre.

Where is pressure being seen or likely to be seen?

The impacts of the current economic environment are unmistakable in the real estate sector, with various high-profile developers facing significant pressure and demand for residential development projects also declining due to reduced borrowing capacity and lower consumer confidence.

In Revolution's view, areas that have or are likely to experience pressure are:

- **Development or construction loans**

These types of transactions carry significantly higher risk, with no tenants or cash flow producing leases and rely on the value (or future value) of the asset to sell the property and repay the outstanding debt. For example – the development of an apartment tower is a common private debt transaction that Revolution avoids, where lenders make loans on the basis that the apartments will be sold on completion of the development and the proceeds would repay the loan. There are several risks with these types of loans in an environment of rising inflation, interest rates and overall macroeconomic weakness, including rising building cost pressures (particularly when utilising fixed price contracts), labour shortages, demand for the apartments as consumers grapple with declining

borrowing capacity and rising costs of living, and the potential for the overall property value to fall below the amount of the outstanding liabilities. Revolution avoids residential real estate, construction or any kind of development projects.

- **Highly leveraged assets**

These assets have a thin equity buffer to account for any valuation declines, which could result in the value of the underlying asset declining to the point where it is less than the loan outstanding.

- **Weak tenants**

Property tenants generate the cash flow that is used to repay debt. Accordingly, having a weak tenant base could result in tenants facing financial difficulties, not paying the rent on time and eventually vacating the property, creating a vacancy and a hole in the cash flows of the property.

The winners

In challenging economic times, Revolution believes the winners will be those who maintain their discipline and focus on the underlying property fundamentals with conservative lending against quality properties, in good locations, with strong tenants that generate strong, recurring cash flows.

As a result of its strict lending criteria, Revolution currently has very limited direct real estate debt exposure in the portfolio, as senior secured lending to established commercial real estate has been dominated by banks to date.



Is private debt ready for recession?

Conclusion

Rising interest rates and inflation are set to increase the cost of debt servicing for real estate borrowers, while a recessionary environment may also drive a decline in property valuations (lenders security) and weigh on the underlying tenants' ability to pay their leases (key source of cash flow for the property). As such, certain areas of the market could come under pressure and strong credit discipline will prove vital in the period ahead.



Part 4 – A closer look at asset-backed securities

Senior Portfolio Manager, Dr Simon Petris and Portfolio Manager, Steve Sutinen examine asset-backed securities (ABS) which are focused on providing funding to established non-bank lenders with strong underwriting processes, high credit quality customers, profitable track records and adequate access to debt funding and equity capital to support their business growth.

Example borrowers in Revolution’s strategy

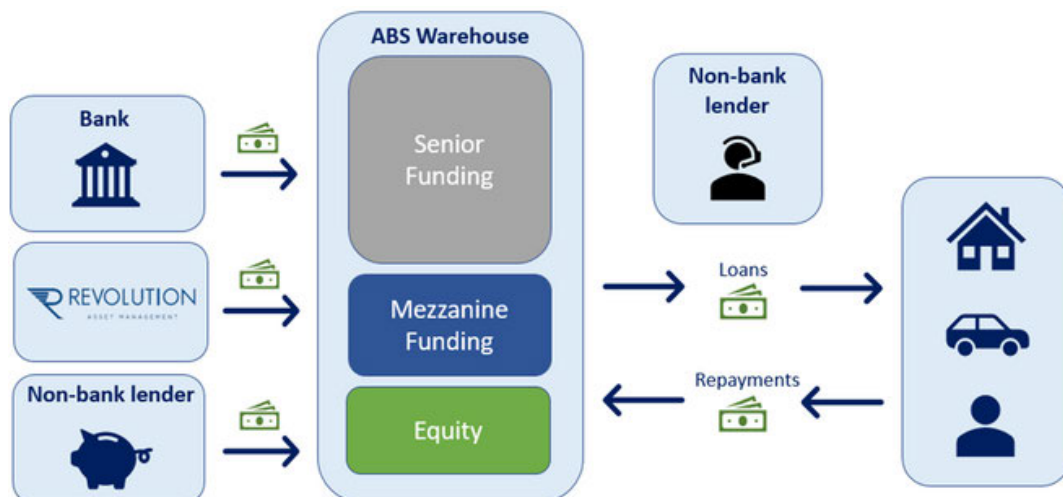


Revolution typically provides funding directly to the non-bank lender’s funding warehouse and not to the non-bank lender themselves. A warehouse is simply a bankruptcy remote special purpose vehicle from which the non-bank lender makes loans to its customers, like residential mortgages or motor vehicle loans. Lending directly to the warehouse ensures that Revolution has security over the portfolio of loans within the warehouse which provides protection from any financial difficulties that the non-bank lender may incur.

Revolution primarily provides mezzanine funding to these private ABS warehouses. The mezzanine funding ranks ahead of the non-bank lender’s own equity but behind a major bank’s senior funding, meaning that losses from any of the underlying loans would first need to deplete the non-bank lender’s equity entirely before any loss can be incurred by the mezzanine investor. This provides a significant layer of protection for Revolution’s invested capital.

Revolution targets its ABS exposures towards consumer loans provided to prime and higher credit quality borrowers with underlying asset security, for example residential mortgages and motor vehicle loans.

Security over physical assets allows the lender to repossess and sell the relevant asset should a borrower become delinquent on their loan.



Source: Revolution Asset Management.



Losing their asset, and potentially incurring a capital loss, acts as a significant deterrent to borrowers defaulting on their loan in the first instance. If a borrower does default, the asset security then also helps to limit any loss on the loan. For example, a residential mortgage which has accumulated equity from the borrower's initial deposit, loan repayments and house price growth, could be sold at a large discount to the market price and the lender would still not suffer any loss on their loan.

Revolution actively avoids non-bank lenders which operate riskier business models including lending to lower credit quality borrowers, residential mortgage products which allow high loan-to-value (LVR) ratios or loans secured by recently constructed high rise residential apartments. It is Revolution's view that these sub-sectors of the consumer loan market are most likely to experience stress in a high interest rate environment.

Due Diligence

Before committing to any new ABS investment, Revolution conducts intensive on-site due diligence reviewing each non-bank lender's underwriting processes including customer identification, income verification, borrower repayment capacity, arrears management and collections. Revolution performs a detailed review of individually selected customer loan files to ensure that the originator is prudently providing finance to stronger credit quality borrowers.

Once a non-bank lender's business model has been assessed, Revolution constructs a detailed cashflow model to analyse significant stress testing scenarios which simulate weakening economic conditions and rising unemployment. These scenarios, which can be many multiples of the 'stress tests' which APRA imposes on banks, determine the amount of equity which Revolution requires the non-bank lender to contribute to the warehouse. Given the limited number of suppliers of ABS mezzanine funding in the Australian market, Revolution has a very strong negotiating position to demand adequate equity capital in each transaction to meet its modelled stress scenarios.

Following investment, Revolution receives detailed performance reporting from every private ABS warehouse on a monthly basis. Real-time reporting combined with a strong negotiating position gives Revolution the ability to demand that the non-bank lender take remediating actions, like adding additional equity into the warehouse, at the earliest sign of any deterioration in the underlying loan portfolio.

Attractive defensive returns through the cycle

Investments in ABS transactions are all made on a floating rate basis therefore as market interest rates rise the yield on these investments will also increase. For a warehouse to be able to withstand this increased cost of borrowing, non-bank lenders have the ability to pass through rate increases to the underlying borrowers. Increasing customer interest rates may lead to an increase in customer arrears and potential defaults however Revolution's stress test modelling gives comfort that any increased defaults would be adequately absorbed by the originators equity.



Where will pressure likely emerge?

Whilst current economic data continues to show strong consumer health with historically low levels of arrears, it is Revolution's view that the areas that are likely to experience financial pressure in the medium term are:

- **Unsecured consumer lending to lower quality borrowers**

Lower quality borrowers are likely to experience stretched cashflow from higher living costs and increased mortgage payments which may lead to increased arrears and defaults.

- **High LVR residential lending**

Strong residential property markets in recent years have likely resulted in some borrowers over-extending themselves to buy property at historically high prices. As property markets cool and interest rates increase, marginal borrowers could face unaffordable loan repayments combined with negative equity resulting in losses on forced property sales.

- **Recession risk leading to increased unemployment**

Unemployment in Australia remains at historically low levels however this will rise in a recessionary environment. Increased unemployment will lead to increased consumer lending arrears and defaults particularly for those working in cyclical industries for example retail and hospitality.

The winners

Well capitalised consumer finance lenders with conservative underwriting policies will be the winners in the ABS market. Revolution's investment process specifically targets ABS originators which will be able to withstand economic turbulence and avoids originators with riskier business models.

Conclusion: An unsettled market brings opportunities for private debt

Globally we are facing a market environment of soaring inflation, rising interest rates and significant economic uncertainty.

Throughout this series we have highlighted specific characteristics which make private debt particularly suited to provide investors with protection against these macroeconomic headwinds and deliver attractive risk adjusted returns.

Private debt is a floating rate, cash flow generating asset class, meaning that the investment yields will increase in line with interest rates. Private debt provides capital protection through its secured loan structures and Revolution's asset selection targeting stable, non-cyclical industries should limit the impacts of a looming recessionary environment.

Overall, manager selection and the construction of investment portfolios that remain resilient through more challenging conditions expected over the next 12-18 months, will ensure that investors in private debt strategies will achieve their stated objectives.

For more information

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