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Investing in Growth Stage SMEs Through Private Debt

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Today, many small- and medium-size businesses have a hard time getting financing for operations and expansion because banks are applying ever-more-strict lending criteria to their loans.

At the same time, institutional and high-net-worth investors are challenged to find an investment to compensate for fixed income's shortcomings in an era of persistently low interest rates.

Fortunately, both SMEs and investors can benefit from private debt.

"Credit in Canada is primarily controlled by six chartered banks. If the bank perceives the risk to be too high, a bank is going to prefer to curtail the credit rather than to price it," explains Arif Bhalwani, CEO and Managing Director of Third Eye Capital, whose firm is the sub-advisor to the Ninepoint TEC Private Credit Fund. "It's easier for them to say no than for them to determine whether there's a clearing price that can offset potential losses."

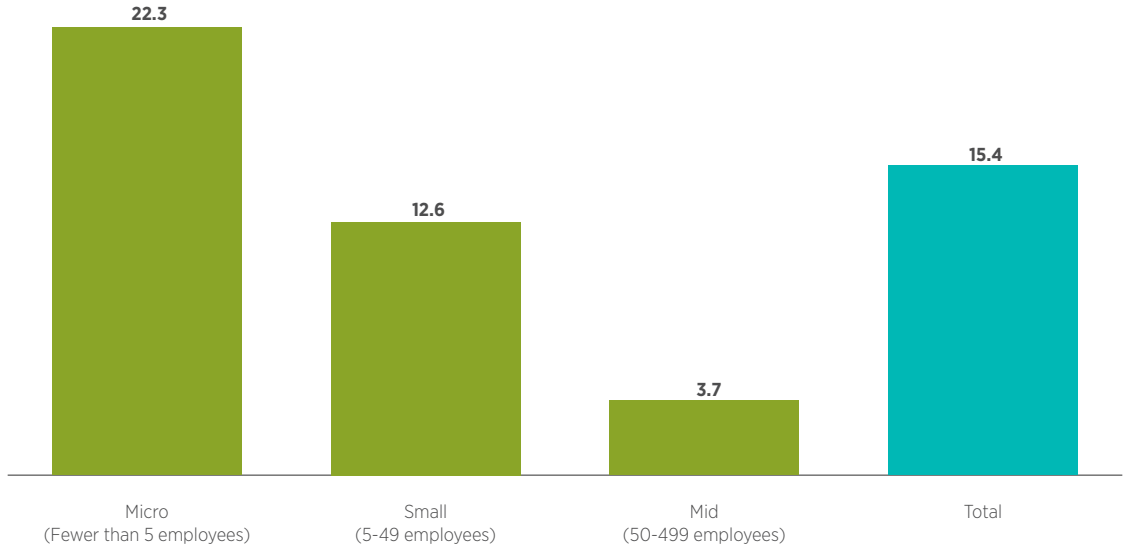
While this degree of conservative underwriting has contributed to a stable financial system in Canada, he says it's also impaired innovation. Canadian business formation rates are pretty much on par with that of the U.S., but there are huge differences when it comes to financing.

According to The Global Competitiveness Report 2019, published by the World Economic Forum, Canada ranks 27th in terms of financing for small and medium-sized enterprises (SMEs). That's not only lower than Finland (1st) and the United States (2nd), but also lower than Guinea (20th) and Azerbaijan (24th).[1]

In 2015, research from the Canadian Federation of Independent Business found that the overall loan rejection rate for SMEs was 15.4%. The smaller the company, the higher the rejection rate. Businesses with less than five employees had a rejection rate of 22.3% compared to 12.6% for companies with five to 49 workers and 3.7% for companies with 50 to 499 employees.[2]

Figure 1: Canadian SME Loan Rejection Rate (% response)

By Size of Business:



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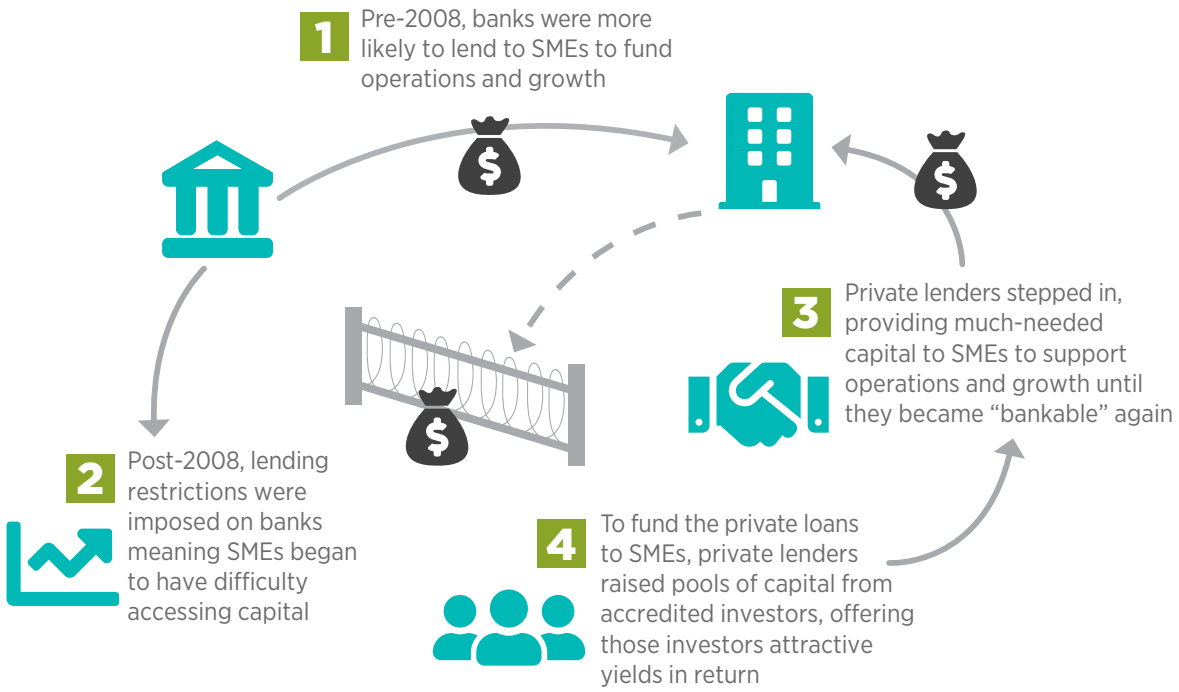
Canadian SMEs don't have many alternatives besides the big banks. Without an ability to get financing, their growth is handicapped and, in many cases, their ability to create employment for Canadian workers is similarly affected. Statistics Canada notes that SMEs made up 55% of Canada's gross domestic product in 2015[3] so, clearly, this situation does not contribute positively to Canada's overall economic growth.

The benefits of private debt investing

Private debt involves raising pools of capital from accredited investors, and using that capital to provide senior-secured loans to small- and medium-sized companies who meet strict loan criteria but who, since 2008, have had greater difficulties getting loans from banks who, as noted, have been motivated to tighten their lending criteria.

Figure 2: What is Private Debt



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For investors, private debt offers a number of benefits. It's low in volatility, the default and loss rates are lower than high-yield bonds, and it's typically collateralized by assets. Another advantage is it has a low or negative correlation to traditional asset classes, which provides greater portfolio diversification.

Of course, the returns are another benefit. U.S. middle-market direct lending investments produced a net return of more than 6% between January 2000 and 2018 while the standard deviation was about 5%, according to the Bloomberg Barclays and Standard & Poor's indexes. Over the same time period, the return was slightly higher than S&P 500 but the standard deviation (or volatility) was less than half.[4]

There's also an inclusive and proprietary nature around private debt, particularly direct lending. The loan is exclusive to the asset manager and its investors, and it won't be in any other portfolio. The firm can give investors more transparency and insights into what's happening with that borrower. If you compare that to an investment in a fund that's full of loans purchased in the public market, you won't find the same level of transactional transparency in the public market version.

Lender and Partner

In some cases, companies which receive a loan from a private lender get more than just funds to expand their business, they also get a partner. Bhalwani says Third Eye Capital considers itself to be more of a business problem solver than a lender. The firm builds a partnership with management teams and stakeholders, which helps build recurring business.

As soon as the firm extends a loan, it will add value by becoming involved in the company. "We'll augment management, provide strategic direction, bring our industry contacts to bear, help manage costs, and streamline the information systems management relies on."

Most companies aren't looking for a permanent partner that will own a stake in the business, they want someone that will help create value and are willing to share some of that value for a period of time.

Third Eye Capital typically invests $20 million to $200 million in a company with annual revenue of up to $1 billion. It's focused on established companies that have experienced an interruption in their business and need capital to nurse it back to health or rescue their underlying business. The firm will also look at companies wanting to expand or who are experiencing growth, but who have run-up against banks whose timelines and approval cycles are much slower than required.

The bottom line

In a world where investors are struggling to shore up the low yields offered by traditional fixed income investments, private debt presents a strong case for consideration within their portfolios.

Beyond offering the potential of strong yields and excellent portfolio diversification, private debt can play a role in helping Canadian SMEs grow and, in doing so, benefits all Canadians by supporting and encouraging innovation, employment, and global competitiveness. Everybody wins. ■

Listen to the **"Investing in Growth Stage SMEs with Arif Bhalwani"** podcast, featuring host Michael Hainsworth.

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FOOTNOTES

[1] The Global Competitiveness Report 2019, World Economic Forum.
[2] SME Financing Indicators, CFIB, October 2016.
[3] https://www.ic.gc.ca/eic/site/061.nsf/eng/h_03114.html
[4] https://www.benefitscanada.com/investments/asset-classes/are-investors-becoming-cautious-around-private-debt-111219

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