PRIVATE DEBT IN 2023

ASSESSING THE CURRENT STATE OF THE PRIVATE DEBT MARKET IN CANADA AND ACROSS THE GLOBE

NINEPOINT ALTERNATIVE INCOME GROUP

MAY 2023

ninepoint PARTNERS

Private Debt in 2023

Assessing the Current State of the Private Debt Market in Canada and Across the Globe

Contents

Introduction........2

The State of the Canadian Private Debt Market........2

The State of the Global Private Debt Market........3

In Conclusion........6

Introduction

Private debt appears to be experiencing its golden moment. Higher interest rates and spreads coupled with a pullback in banking activity are helping private debt become more 'mainstream' and less 'alternative' even in larger deals traditionally financed by banks. Recently, many private equity players have taken the plunge by raising large private debt funds and financing debt in their own private equity deals. In this report, we intend to delve into the factors behind these trends both in Canada and around the world.

The State of the Canadian Private Debt Market

As the global private debt market continues to grow, it is important to examine the unique dynamics influencing private debt investing and allocation trends within the Canadian market. Despite numerous tailwinds in the sector, Canadian investment in alternatives, including private debt, continues to significantly lag the broader global market.

1. **Private Debt Filling the Funding Gap:** The current inflation-induced, high-interest-rate environment has created a liquidity crunch in the highly regulated Canadian credit market. Even though data around Canadian private debt activity is scarce, we have observed that Canadian private debt funds are enjoying healthy pipelines of loan deals, including borrowers traditionally financed by banks. The lack of a Canadian secondaries market across loan types (senior secured, mezzanine and junior) creates a unique opportunity for private debt incumbents in this country.
2. **Smart Money Endorsement:** The most sophisticated investors in the country have been steadily increasing their allocations to private debt on behalf of Canadians. CPP Investment Board, the country's largest pension fund, for example, had $44.4 billion invested in private debt as of Dec. 31, 2022, a 25% increase since the end of its fiscal year 2021, and a more than 770% increase since 2011.[1]
3. **Canadians Are Significantly Underinvested in Alternatives:** Globally, it is estimated that over 30% of investors hold alternative assets in their portfolios.[2] In Canada, that number is significantly lower. The Alternative Investment Management Association estimates that the average Canadian wealth advisor has an allocation to alternatives of just 4%, of which private debt is only a subset.[3] While private debt funds have lesser transparency and liquidity relative to public funds, some of the factors behind the abovementioned disparity are that Canadian investment dealers tend to rate alternatives as higher risk without regard to a fund's historical risk-adjusted return.[4] In addition, a regulator-endorsed KYP ("Know Your Product") requirement limits the practical number of investment products Canadian dealers are willing to sell. The unintended consequence is that, arguably, Canadian investors often have less diversified portfolios relative to the rest of the high-net-worth world.[5]

"Through this recent period of banking turmoil, Canadian markets have experienced overall tightening. However, the degree of tightening has not been as severe as in the U.S., owing largely to the absence of regional banks in Canada. On the private debt front, the opportunity to diversify a portfolio with strong risk-adjusted returns continues to drive growth from sophisticated investors focused on portfolio construction and a longer term view."

–Ramesh Kashyap, Managing Director & Head of Alternative Investment Group at Ninepoint Partners and Co-Chair, AIMA Credit Council

4. **Banking Sector Less Fragmented and Less Vulnerable:** The Canadian credit market differs from the U.S. market both in size and the overall structure. As a smaller market, Canada has not been materially affected by recent headwinds in the U.S. banking sector. This is largely due to the difference in the depth of the banking sector between the two markets. The Canadian credit market is largely funded by loans distributed by the five largest banks versus a highly competitive and fragmented banking market in U.S., where regional banks have a large share of the small- and medium-size business loan market.[6] There is also an absence of an established secondaries market in Canada unlike in the U.S., where regional banks and Savings & Loans institutions can execute secondary deals and take the exposure off larger banks' balance sheets. This gap is filled by the private debt industry in Canada.

5. **Legacy Issues Continue to Drag on Retail Participation:** Many Canadian retail investors have remained on the sidelines due to ongoing legacy issues arising from the collapse of a large Canadian private debt fund that was put into receivership due to fraud. The confusion this has created in the market has had a negative impact on more-established, long-tenured private lenders in Canada, despite their established histories of delivering steady, risk-adjusted returns. With highly liquid instruments like High-Interest Savings Accounts or GICs offering ~5% annual returns, some retail investors have also opted to park their capital in these sorts of investments while pulling out from both private and public markets. In our view, such allocations work against the principle of portfolio diversification, as cash and GICs are essentially fixed income vehicles.

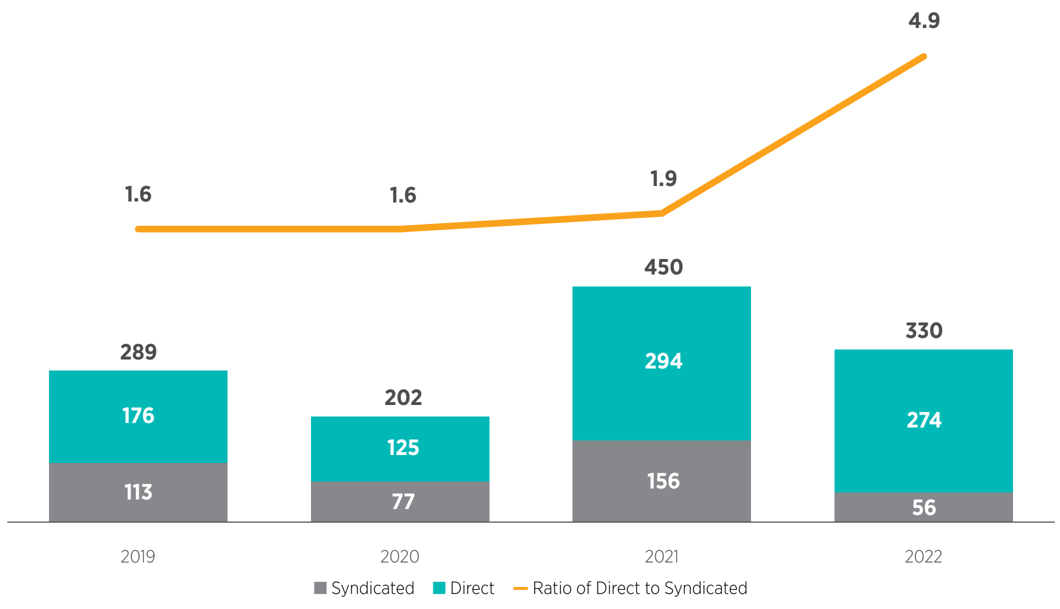
The State of the Global Private Debt Market

While the current banking crisis has had a ripple effect across countless industries, the timing of it could not have been better for the established global private debt industry, which remains well-positioned to continue to thrive with large stockpiles of cash chasing good deals.

There are five key dynamics that are setting the stage for the continued growth of the private debt asset class across the globe:

1. **Slowdown in the Broadly Syndicated Loan Market:** Private debt is increasingly winning market share from the syndicated loan market. In 2022, there were roughly five times more deals financed through private debt versus broadly syndicated loans, compared to an average of 1.7 times in the previous three years (Table 1).

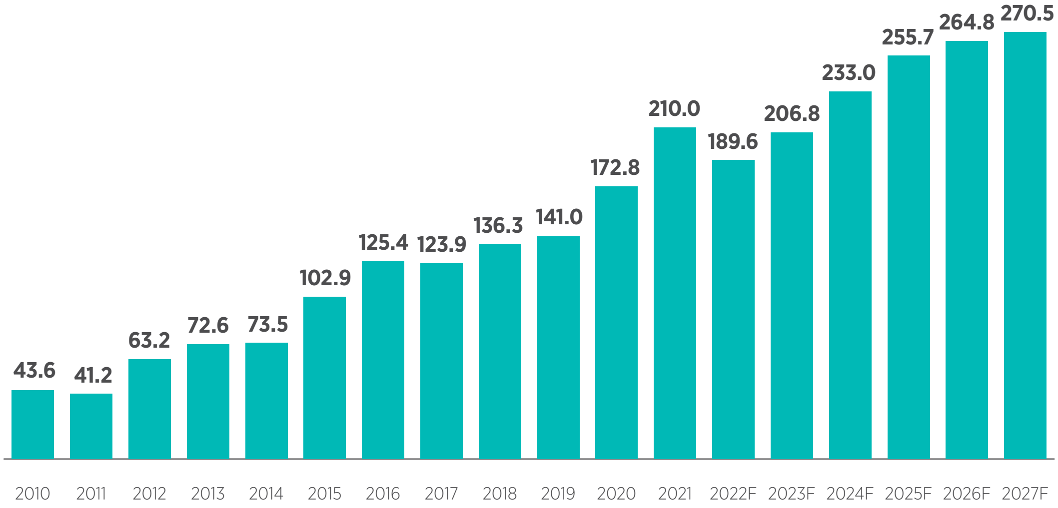
Table 1: Ratio of U.S. Syndicated Loans 2019-2022



Source: Leveraged Commentary & Data (LCD).

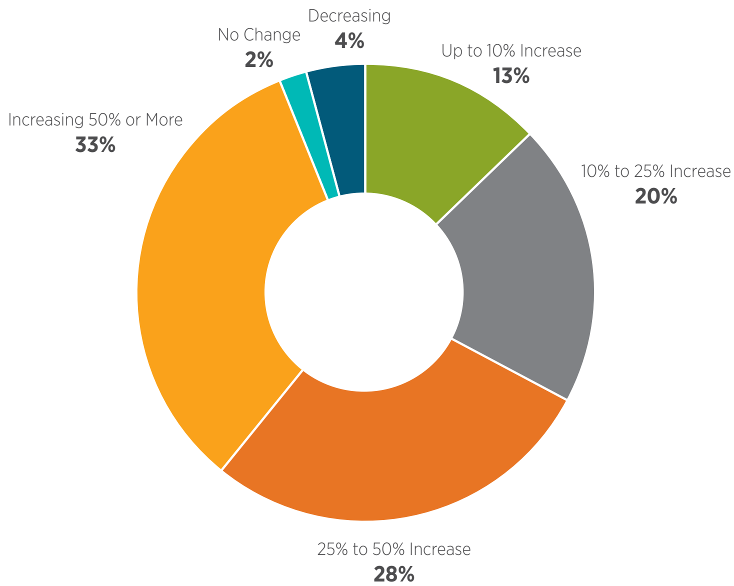
2. **Higher Yields Attracting Investors to Private Debt:** The near double-digit yields produced by private debt funds in recent years[7] have helped create a significant build-up of dry powder (Table 2). Most recent studies have shown an increased interest in allocating to private debt, even from more conservative family office investors with investment objectives that include capital preservation and portfolio income (Table 3).

Table 2: Private Debt Fund Raising (US$B)



Source: Preqin 2022.

Table 3: Private Debt Allocations – Family Offices



Source: Ocorian 2022.

3. **Larger Deals Funded Entirely by Private Debt:** U.S. middle market companies have traditionally been the main target segment for private debt players (Table 4). The leverage ratios of 4-5 times had resulted in private debt deals that were primarily in the US$40 million to US$400 million range and, further, that private debt was not known as a reliable source of funds for multi-billion-dollar deals. This has changed recently with the emergence of loan syndication amongst private debt players, enabling the financing of larger deals while limiting the risk of a fund depending too heavily on fewer, larger loans (concentration risk).

Table 4: PE-led take-private deals in US announced since July 1, 2022[8]

Announcement Month (2022)	**Company**	**Acquirer(s)**	**Loan Type**	**Deal Size** ($B)
December	Maxar Tech	Advent International	**Private Debt**	6.4
December	Coupa	Thoma Bravo	**Private Debt**	8.0
October	UserTesting	Sunstone Partners, Thoma Bravo	Equity Only	1.3
October	Weber Inc.	BDT & Company	**Private Debt**	0.2
October	Agrofresh Solutions	Paine Schwartz Partners	Non-Bank	0.2
October	KnowBe4	Vista Equity Partners	**Private Debt**	4.6
October	ForgeRock	Thoma Bravo	Equity Only	2.3
September	Billtrust	EQT AB	**Private Debt**	1.7
September	ChannelAdvisor	CommerceHub, Insight Partners	**Private Debt**	0.8
August	Computer Services	Bridgeport Partners, Centerbridge	Non-bank	1.6
August	Avalara	Vista Equity Partners	**Private Debt**	0.8
August	Atlas Air Worldwide	Apollo Global Management	**Private Debt**	2.9
August	Ping Identity	Thoma Bravo	**Private Debt**	2.8
July	Hanger	Patient Square Capital	**Private Debt**	1.3
July	Sharps Compliance	Aurora Capital Partners	**Private Debt**	0.2

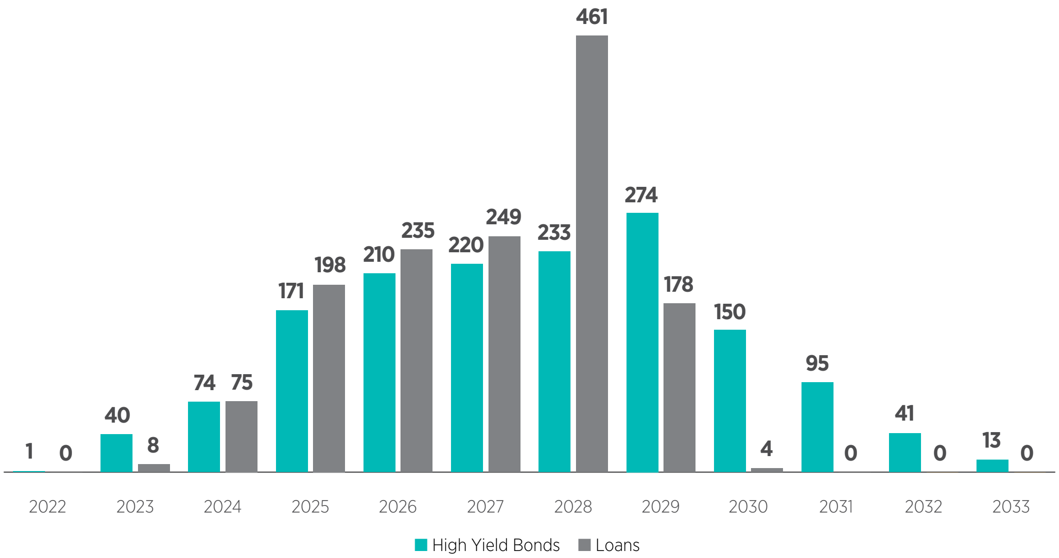
4. **Favorable Deal Terms and Higher Equity Cushion:** In a tight-liquidity environment, increased demand for financing has ensured that private debt players have a greater ability to command better deal terms, including lower leverage ratios (Debt/EBITDA) and better debt coverage metrics (loan security). Average leverage multiples have come down and formerly popular covenant-light structures are off the table (Table 5). Consequently, private debt deals now enjoy higher equity cushions in private equity-led deals.

Table 5: Comparison of a Buyout Deal in January 2022 vs. January 2023[9]

	January 2022	**Today**
EV/EBITDA	12.5x	12.5x
Debt/EBITDA	6.5x	5.0x
Equity/EBITDA	6.0x	7.5x
Debt/Cost	5.0%	11.5%

5. **Upcoming Maturities of High Yield and Leveraged Loans Create Opportunity:** With high levels of leveraged debt and high yield bonds maturing in the next 4-5 years (Table 6) – in the face of more limited refinancing possibilities – combined with the fact that banks remain busy clearing the deal backlog from the last couple of years, we believe there is a unique opportunity for private debt to step in and fill the financing gap.

Table 6: Maturity Profile in US$B



Source: S&P/LCD and BofA Global Research, as of 12/31/21. The loan market is represented by the S&P/LSTA Leveraged Loan index, the high yield bond market is represented by BofA/ML High Yield Corporate index. Default rates are by par amount. Investors cannot invest directly in an index.

In Conclusion

Although Canadian investors are currently standing on the sidelines as it relates to private debt, overall favorable dynamics in both the U.S. and Canada, against the backdrop of a U.S. banking crisis, are translating into bullish tailwinds for the private debt industry. The movement of good quality borrowers from a bank's loan book to senior secured assets of private debt players is highly attractive from a risk-return standpoint and remains our key focus through our multiple offerings in the space. Overall, we believe allocating 5% to 20% of assets to private debt with a long-term horizon can help investors generate income and help to better diversify their portfolios.

ninepoint.com

FOOTNOTES

1 CPP Investment Board, 2022.
2 https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/wealth-and-asset-management/ey-2021-global-wealth-research-report-optimized-for-web-v2.pdf.
3 https://www.wealthprofessional.ca/investments/alternative-investments/we-are-heading-toward-a-golden-age-for-alternatives/371304.
4 Ibid.
5 Ibid.
6 https://www.brookings.edu/research/the-regional-banks-the-evolution-of-the-financial-sector-part-ii.
7 https://www.cliffwaterdirectlendingindex.com.
8 PitchBook Data.
9 Deal terms for illustrative purposes only. Source: Adams Street Partners.

DISCLAIMERS