Andrew Lockhart, Metrics Credit Partners

Andrew Lockhart is a managing partner at Metrics Credit Partners. He has more than 30 years' experience specialising in leverage and acquisition finance, corporate and institutional lending, and origination and portfolio risk management of large, diversified and complex loan portfolios, including corporate restructurings. Andrew holds a Bachelor of Business and Masters of Business Administration.

The corporate loan market

A fixed income asset for turbulent times

Andrew Lockhart

Australian investors are currently facing a conundrum when it comes to their asset allocation. With low rates and persistently low growth, finding reliable sources of return is becoming an increasingly difficult task.

Australia is in the lowest interest rate environment in history, with the official cash rate now at 0.25%. Reserve Bank of Australia rhetoric indicates that investors should prepare for an extended period of low rates, driven by stagnant wage growth, low inflation and high levels of household debt.

Against this backdrop, 10-year government bonds are trading very close to 1%, and the returns from cash and term deposits are insufficient for most investors—given the official inflation rate.

This low-rate environment means many investors are losing money on their fixed income holdings. This creates a challenge for those seeking to grow their assets and for those who are relying on their investments to generate an income, such as retirees.

As a result, many investors are looking beyond traditional fixed income for growth and income.

Investigating other types of fixed income

In times of market uncertainty, increasing portfolio allocations to defensive investments such as fixed income is a popular strategy for both preserving capital and generating income. This is because fixed income assets typically have a low correlation to growth assets such as equities and property, meaning they generally perform better in down markets.

The most well-known types of fixed income are government bonds and corporate bonds—debt securities issued by governments and corporations and sold to investors.

However, there is also a larger but lesser-known subsector of fixed income—corporate loans.

Corporate loans are loans provided to companies for various purposes, such as funding working capital requirements, expanding and purchasing assets, completing specific projects or for commercial property acquisition or development purposes.

These types of loans were traditionally provided to companies by the banks. However, this has changed as regulation has driven up the cost of bank funding, providing opportunities for non-bank lenders to fill the void. This is just one change in the wider transformation of Australia's banking sector brought about by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry and a myriad of other global other changes.

The big four banks and their subsidiaries suffered a 10-percentage-point drop in market share in business lending and equipment finance over 2018/19 as their market share slid from 77% to 67%, while non-major lenders grew their share from 23% to 33%, mortgage aggregator FAST found in its 2019 *Business Lending Index Report*.

Further, total loans from the major bank lenders declined 12.5% from $4.07 billion in 2018 to $3.56 billion, while non-major lenders increased 42.4 % year-on-year to $1.77 billion. This trend is expected to continue, as businesses still need to borrow money despite the banks' pullback.

In contrast, non-bank corporate loan growth here is echoing what is playing out across the broader Asian region. This growth is similar to what has happened in the residential mortgage market, has opened opportunities for non-bank lenders to disrupt the market, and is creating opportunities for investors.

In short, it means investors can now invest like the big banks do. In addition to providing mortgages to home buyers, Australia's big banks also lend to companies, although companies are charged more than mortgagees because they are seen as slightly higher risk.

Though, corporate loans are lower risk than growth assets such as equities and property because they come with a range of embedded protections. Loans are generally secured by the borrower's assets, and lenders are paid before equity holders in the unlikely event of business insolvency. In addition, returns are linked to inflation.

While non-bank lending in Australia has developed to the point where it is competing with the bank sector, it is also complementing it, with non-banks investing alongside the major banks for the same loans.

Example 1. Banks and non-banks working in tandem

On property deals, banks often finance the senior land acquisition, with non-banks financing the mezzanine debt.

How corporate loans can benefit a portfolio

For investors, the growth of the non-bank corporate loan market is creating opportunities to participate in an exciting subsector of the fixed income market.

From a return perspective, investing in a diversified portfolio of corporate loans has enabled investors to earn 4–10% above the cash rate, which is much needed in a low-interest-rate environment.

Returns also have a low correlation to other major asset classes including equities, government bonds, hybrids and term deposits; providing an excellent source of portfolio diversification for investors.

Lenders in the market typically undertake rigorous due diligence before lending, and ongoing engagement with borrowers is maintained throughout the loan term to assess risks.

Another key benefit of the corporate loan market is its size and diversity. Opportunities range from lower-risk senior unsecured investment-grade debt investments all the way through to secured loans to sub-investment-grade borrowers or higher-risk investments such as subordinated or mezzanine loans that offer the potential for higher yields.

Given where debt sits within the capital structure of a company, all such debt transactions present a lower-risk investment compared with direct equity investment.

According the Australian Bureau of Statistics (ABS), corporate loans currently make up 77% of the Australian corporate debt market, meaning there are ample opportunities for investors to tap into the current high demand for non-bank funding.

According to a recent Acuris report, *Direct lending in Asia Pacific: a study on Asian middle market private credit opportunities,* approximately eight in 10 (82%) mid-market firms in the Asia Pacific region said they would seek financing from non-bank lenders in 2020, while around two-thirds (68%) said this source of financing is critical to their business.

This trend has certainly been evident in Australia. According to the ABS, the corporate loan market is already over 20 times the size of the domestic corporate bond market, at around $963 billion.

Accessing the market

Traditionally, corporate loans were only available to wholesale investors. However, in recent years, select opportunities have become available to investors such as retail or self-managed superannuation fund investors in the Australian market.

Today, accessing the direct corporate and property developer loan market has never been easier for retail investors, who can now invest in the sector through Australian Securities Exchange-listed vehicles, providing for daily liquidity, compared with term deposits which require locking away cash for fixed terms.

Potential traps in the hunt for yield

When looking at the corporate loan market, investors have a range of products from which to choose, but it is important to be aware that they are not all the same.

Example 2. Potential drawbacks of international offerings

Some offerings include international bonds to take advantage of higher interest rates or yields and to diversify their holdings. However, the potentially higher rate of return is accompanied by increased risk arising from adverse currency fluctuations, which can cause investment volatility and ultimately impact returns.

In contrast, investing in Australian assets removes foreign exchange risk from the equation, and investors are also protected by Australia's strong corporate insolvency laws. Australian law is focused on giving priority to the interests of creditors, especially secured lenders

The quote

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compared with other developed nations such as the US and UK, which are now perceived to be much more focused on the rights of the debtor companies.

Some credit markets are now also at a point in the cycle where risks are becoming more apparent.

Over the past 10 years, businesses across the globe have loaded up on debt, credit quality is deteriorating, and compensation for credit risk has declined as yields have collapsed. In short, global credit investors now face a lot more risk, for a lot less return.

Corporate loss rates in Australia are low. Further, selecting local diversified funds helps to manage downside risks by spreading funding across a range of sectors, risk profiles, loan types and borrowers with different maturity profiles.

Before investing in corporate loans, it is important to seek out an experienced manager who can generate a pipeline of sufficient high-quality transactions and mitigate risks by appropriately vetting and pricing individual transactions.

With diversification and the right management, the corporate loan market is well worth considering for investors seeking sources of regular income in a low-growth and low-interest-rate environment. **FS**