HEIRLOOM
INVESTING

CONSIDERATIONS FOR INVESTING IN PRIVATE CREDIT

Heirloom Breakfast Seminar – November 2019

On November 7th, Heirloom hosted a breakfast seminar exploring Private Credit investment considerations in this late stage of the market cycle. We were pleased that the participants were again engaged and interactive and used this forum to discuss and share their investment strategies and ideas as well as network with their family office peers.

Below is a summary of the general topics discussed.

A CHALLENGING ENVIRONMENT FOR PUBLIC CREDIT

The Fixed Income asset class has been evolving under a unique set of circumstances since the 2008 Financial Crisis. An era of global quantitative easing has pushed the rate of income from these securities to historic lows while magnifying the underlying risks of these assets.

The yield on the 2-year U.S. Treasury, for example, is currently hovering at a 50-year low. In fact, since 2009, the yield on this government bond is lower than the dividend yield of the nation's benchmark stock index, the S&P 500.[i]

The situation is even bleaker in the rest of the world with yields now negative in many places. The volume of worldwide debt with negative rates has been steadily surging over the past decade and is currently worth $16.4 trillion.[ii]

Meanwhile, Fixed Income credit spreads have been compressed to multi-year lows in the U.S. and Europe. At the same time, the risks have been covertly magnified by the reduction in covenants and the rising magnitude of embedded leverage in leveraged loans, collateralized loan obligation (CLO) and collateralized debt obligation (CDO) structures.

As a result, family offices are generally finding the Public Credit market less attractive and are looking for other investment opportunities, which often include the private markets.

THE RISE OF PRIVATE CREDIT

Private market investment is currently experiencing impressive, sustained growth. Private market AUM climbed 12% from 2017 to 2018 and is currently worth $5.8 trillion, according to data from Preqin. Private Credit comprised 13% of this total, and is anticipated to reach $1 trillion by 2020, as allocations shift further.[iii]

This shift, however, has not just been generated by the lack of yield and heightened risk in the public market. Since traditional banks have minimized lending to small and medium enterprises, the SME market has experienced an acute gap of funding. In our opinion, this lack of funding has created an attractive opportunity for investors.

A confluence of these factors has pushed private capital to bridge the gap to such an extent that non-bank loans now account for over 40% of all U.S. loans.[iv] Despite this flood of capital, however, the yield on private debt (10% on average since 2008) has held its value, indicating further demand and investor opportunity[v].

CONSIDERATIONS FOR PRIVATE CREDIT

While Private Credit is a promising asset class, these investments can be complex and difficult to access. Investors should be aware of the potential risks and downsides of Private Credit investments. A list of some considerations we examined are outlined briefly below:

PRIVATE CREDIT BENEFITS:	PRIVATE CREDIT CAUTIONS:
• Higher Potential Risk-Adjusted Returns • Reliable Income Stream • Medium Duration • Lower Correlation to Traditional Asset Classes • Hedging Potential • Asset Security	• Difficult to Originate • Low Secondary Market Liquidity • Investment Complexity • "Set It and Forget It" • Tax Considerations • Short Timeframes for Funding

PRIVATE CREDIT INVESTMENT TYPES

There are different types of Private Credit instruments and they offer varied opportunities and present unique risks. A short summary follows of the types we discussed:

- Trade Finance and Factoring are short-term floating rate instruments with medium returns and lower risks. We find this an attractive segment of the class and are actively invested. Higher returns can be achieved for firms specializing in certain offbeat sectors or geographies.

- CLOs/CDOs can offer greater diversity and higher-than-average returns. We are avoiding the majority of these, however, as they suffer the most from the covenant-lite and high underlying leverage issues in our opinion.

- Asset-backed loans offer risk-return profiles that hinge on the underlying asset. The asset backing lessens the need for specialist credit adjudication and the recapture process is generally simple (in select jurisdictions). These loans have been the biggest part of our credit allocation for over 10 years. We have invested with some managers but have found that we can source these opportunities ourselves.

- Cash flow loans also offer security via the company's cash flows. We have done some of these directly, but these require another level of credit adjudication, monitoring and willingness to step in and take control of a business. In general, Heirloom uses managers for these allocations, though we have found the risk-adjusted return to be superior in Asset-Backed lending and so have focused most of our allocations there.

- Peer-to-peer lending offers direct lending opportunities via online services and have become quite popular with families. It is something we consider to be exceptionally crowded, however, and exceptionally risky. There is high correlation between these borrowers, it is very costly and administratively burdensome to attempt to recover on defaulted loans, and the majority of the organizers/providers of these loans are suffering losses at an unsustainable rate.

OUR INVESTMENT APPROACH

Based on our capital preservation investment approach, we have narrowed our Private Credit focus to low-to-medium risk Private Credit instruments that offer medium-high return and medium liquidity.

We believe that asset-backed loans have been overlooked by most investors and traditional banks, offering attractive valuations and plenty of opportunity. Typically, our focus is on smaller loan sizes ($2-$10 million), which are commonly needed by companies of $5-$50mm in revenue. These companies are stable and abundant but they often have difficulty securing bank debt due to banking regulations making smaller loans more costly to service. To invest, our strategy is a combination of direct lending and investing in and beside managers.

HEIRLOOM'S IDEAS:

Heirloom has been shifting its clients' portfolios towards Private Credit for 10+ years. During the breakfast, we discussed specific examples of how Heirloom is undertaking Private Credit investments, such as the following:

INVESTMENT THEME	HEIRLOOM'S STRATEGY
CANADIAN LIFE SETTLEMENTS • Responding to the changing demographics, investing in life insurance policies from the insured policy owners and collecting the death benefit when the insured passes away.	• Lending against life insurance policies, earning similar returns to owning US based life insurance policies outright, but with LTVs providing substantially greater security.
DRY BULK SHIPPING: • Dry bulk shipping involves transporting iron ore, coal, agricultural goods, etc., but not finished goods (containers) or oil/gas. • Global trade and cyclical trends make acquiring and chartering dry bulk vessels and investment, providing stable cash flow and vessel price appreciation.	• Financing the acquisition of dry bulk maritime vessels, providing loans secured by vessels. Values are currently below replacement levels and LTVs are low, with a moderately liquid resale market.
NICHE ASIAN LITIGATION FINANCE: • As society becomes more litigious, and legal cases more complex, litigation finance has become an important vehicle to fund a plaintiff's lawsuit in return for a portion of the settlement if successful.	• Lending against contingent litigation case claims sourced/evaluated by the leading team in their specific niche. • Focusing on the niche of construction and insolvency claims in ex-Australia Asia-Pacific (mainly Singapore, Hong Kong, New Zealand), which offer strong return profiles but are too small for the mega funds.
US LAW FIRMS TAKING CONTINGENT CASES: • Many US law firms take case work (especially Plaintiff) on contingency, effectively replacing the role of the Litigation Funder in the value chain. • These firms have particular insight into the cases and therefore credit quality, and are in a unique position to steer the outcomes towards settlements that are good for lenders.	• Lending to smaller US law firms, secured against a portfolio (maximum exposure to any one case type is 20%) of contingent case billings (max LTV 30%), and personally guaranteed by the assets of the Equity Partners of the law firms (albeit typically this is not enough to cover the debt in full).

HELICOPTER FINANCING: • Helicopters, for use primarily by hospitals, police forces, infrastructure monitoring firms and oil rig worker shuttle operators require financing.	• Financing packages of Helicopters, which are in turn leased out on long-term leases to users such as hospitals (air ambulance), police forces, infrastructure companies and oil rig operators. • The leases offer strong protection, as does an active secondary market – specialty helicopter residual values are fairly reliable.
LONDON PROPERTY: • Special situation with slightly higher than average LTV on a property mortgage, but very low LTV when other assets included. These kinds of special situations are often ignored if they are of this size and are not "standard". This creates a lot of opportunity for small, nimble managers/family offices.	• Financing a GBP 6mm loan to support the purchase of a Central London Flat. The Loan is additionally secured by distributions from a Trust worth 10x Loan Value.
MUSIC ROYALTIES: • Music royalty streams produce fairly reliable cash flows and have stable / predictable asset values. Their revenue is based on number of plays (live, radio, streaming, etc.) and is split between the songwriters and artists/musicians.	• Financing the acquisition of music royalty catalogues in the $8-12mm range that are considered AAA for their content.

Many of the above strategies are complex, have a degree of illiquidity, and require specialized expertise to understand and invest in. However, spending the effort and resources to shift your portfolio to even a few of them could add to your expected return, while reducing your portfolio risk.

Heirloom, has spent extensive time and effort researching and understanding the nuances of each of these initiatives. If you would like to speak with someone at Heirloom to discuss or learn more about any of these above-mentioned alternatives, please let Beth at beth.hirshfeld@heirloominvesting.com know.

ABOUT HEIRLOOM

Originally the in-house investment management function for a Canadian single family office, Heirloom offers flexible institutional-quality investment solutions designed specifically to help family offices and high net worth individuals achieve their goals. Its services include advisory over the entire portfolio as a full Outsourced Chief Investment Officer, to offering advice or managing investments in specific themes or asset classes, to offering co-investment opportunities in specific opportunities or themes.

Heirloom's macro-thematic investment strategy invests across assets classes and geographies, focusing on *allocating capital to long-term trends and market dislocations with a heavy focus on risk understanding and control.*

Its approach has been used by leading pension plans and sovereign wealth funds for 20+ years. This strategy is supported by extensive academic research and has been advocated by McKinsey as how all investors should manage their money to generate the best risk-adjusted returns over the long-term.[vi]

DISCLAIMER:

This document is for information purposes only and is not intended as an offer or solicitation to invest. The material in this document is intended only as a reference and should not be relied upon as investment advice or for any other disclosure purposes. This is intended for investors in Ontario, Quebec, Alberta, Manitoba and BC only. Past performance is not indicative of future results and there can be no guarantee that this strategy will achieve its investment objective.

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Any investment involves a degree of risk, including the risk of total loss. The risk information presented herein endeavours to capture some but not all risks associated with an investment strategy or product.

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[i] Bianco Research. 2018
[ii] Associated Press. ICE Data Indices LLC. 2019
[iii] IPE 2018
[iv] Bank of America
[v] McKinsey & Co. 2019
[vi] McKinsey & Co. "From Big to Great"