A PRIVATE DEBT MARKET FOR A SUSTAINABLE AOTEAROA NEW ZEALAND

CEFGroup Report

2nd Mar 2023

Contents

Authors

Renzhu ZHANG
Strategic Postdoctoral Fellow, CEFGroup

Paul CARMAN
Founder and CEO, Private Capital Group

Ivan DIAZ-RAINEY
Professor of Finance, Griffith University
Honorary Professor, University of Otago

Greg PEACOCK
Principal, MyFiduciary

Amanda SIM
Master of Finance Student, CEFGroup

Note: The results presented in this report are generated from Ms. Sim's Master of Finance thesis, in collaboration with MyFiduciary and Private Capital Group. A more in-depth analysis of the survey results will soon be published in a CEFGroup working paper.

KEY TAKEAWAYS

- There is increasing interest in private debt (PD) among both PD and non-PD investors. PD is poised to grow further in the near future.
- PD investors have had a good experience to date, and most are optimistic about PD's growth potential.
- In New Zealand (NZ), PD is an under-utilised investment asset relative to the scope to invest.
- Main reasons for not investing in PD, among NZ respondents, are lack of experience, lack of liquidity and size of the market.
- Compared to the UK, PD market in NZ is still in its infancy, with many investors yet to make their first commitments to the asset class.
- NZ respondents prefer more conservative PD instruments characterised by lower risk.
- PD investors, on average, are greater advocates of responsible investing.
- Respondents, especially those that have had PD investments, think that it is a lot easier to achieve ESG and impact goals in private markets than in public markets.

ABOUT PRIVATE DEBT

Private debt, also known as private credit, is a form of debt financing provided by alternative sources of capital such as closed or open ended debt funds and institutional investors, as opposed to traditional sources such as banks or public markets. It includes various forms of debt financing such as direct lending, mezzanine funds, distressed debt and special situations, and is commonly used for buyouts, expansion capital, working capital, real estate development, and acquisitions. It differs from the more traditional public debt market, otherwise known as fixed income or bonds in a number of important ways. PD provides access to greater levels of due diligence and reporting given the private nature of each loan, is typically structured on a secured basis and as such represents a legally enforceable first claim on the company, and pays interest as a margin over a floating rate of return rather than a fixed coupon as is standard in the fixed income market. The combination of these elements has helped to create a market which represents USD 1 trillion of capital, according to **Preqin**.

ABOUT THE SURVEY

Early 2022, **Bloomberg Intelligence** predicted dramatic growth in the ESG debt market in the next few years, from 4 trillion to 15 trillion US dollars by 2025. The growth in ESG debt is expected to be driven by not only the massive influx of bank loans into sustainable businesses, but also the creation of new sustainable PD. In search of higher risk-adjusted returns and lower volatility, especially during periods of economic uncertainties, institutional investors are now stepping up their PD allocation (**Shi, 2022**). Globally, the PD market has grown tenfold from 2010 to 2020 (**Gunter et al., 2021**), and has become the second fastest growing alternative investment asset (**Preqin, 2022**).

Despite the significant growth in PD globally, the trend does not seem to have extended to Aotearoa New Zealand. That said, the new capital adequacy framework imposed by the Reserve Bank of New Zealand (RBNZ) on registered banks, effective July 2022, creates an opportunity for the development of PD in NZ.

Figure 1: *Geographic Location of Respondents*

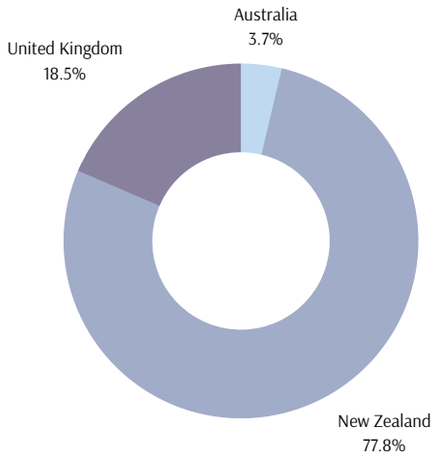
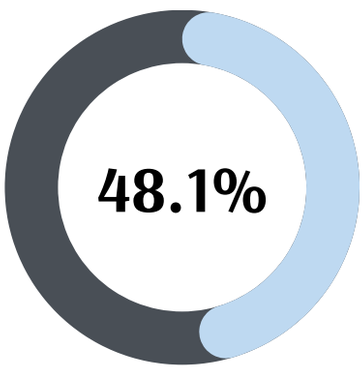


Figure 2: *% PD Investors Among Respondents*



The aim of this report is to understand the opportunities and barriers associated with developing a PD market in NZ, and to elicit respondents' views on how PD can support the transition toward sustainability. To do this, the research team surveyed institutional investors that have PD investments, or might be interested in investing in PD. The survey took place from October 2022 to November 2022 and resulted in 27 usable responses, representing a high response rate of 17.9%.

As shown in **Figure 1**, among the 27 respondents, 77.8% are based in NZ, 18.5% are based in the United Kingdom (UK), and 3.7% are based in Australia. This diverse geographical representation allows for interesting comparisons between NZ, which has a relatively nascent PD market, and the UK, whose PD market is much more developed.

Further, we had a good balance of respondents, with 48.1% identifying as PD investors and 51.9% identifying as non-PD investors (see **Figure 2**). This not only allows us to examine the perspectives of those who have invested in PD, but also helps us delve into the reasons why some participants have yet to invest in this market. This diversity in perspectives can provide valuable insights into the potential barriers or concerns that may be preventing wider adoption of PD investments in NZ.

This project is undertaken by a collaboration of researchers from the **Climate and Energy Finance Group (CEFGroup)** at the **University of Otago** and **Griffith University**, in partnership with **MyFiduciary Ltd** and **Private Capital Group (PCG)**.

CHARACTERISTICS & CURRENT STATUS OF THE NZ PRIVATE DEBT MARKET

[1] Yield-Oriented Assets: IPS-Permitted vs Actual Investment

As illustrated in **Figure 3** and **Figure 4**, in NZ, less than half of the respondents who are permitted to invest in PD did invest in PD. Whereas in the UK, where the market is more mature, eligible investors tend to allocate their money into various forms of yield-generating assets that they are permitted to invest in.

Of allowable asset classes, PD among NZ respondents is the most underutilised asset class (**Figure 3**). Our results indicate that there may be a gap in understanding or awareness about the potential benefits of PD among NZ investors. Note that as we sent the survey to a list of specialist operators of PD in the UK, having zero allocation to fixed interest (see **Figure 4**) may not be indicative of the broader UK market, nor is a higher allocation to private than public debt. It does highlight that in markets where PD is more mature, this has led to the development of more dedicated players.

Figure 3: Yield-Oriented Assets - Permitted vs Actual Investments (NZ)

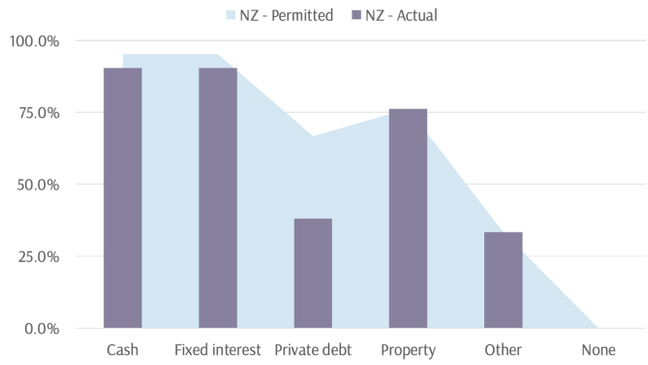


Figure 4: Yield-Oriented Assets - Permitted vs Actual Investments (UK)

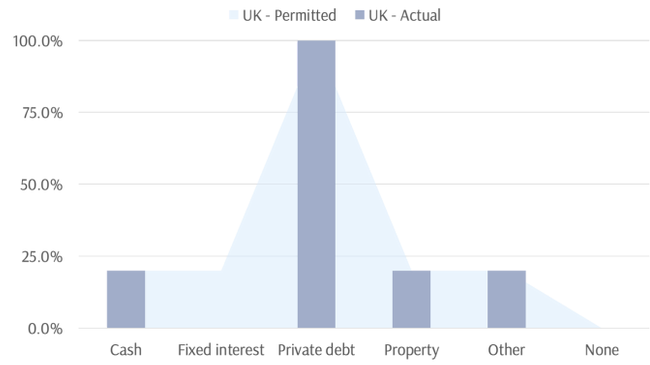


Figure 5 takes a deep dive into NZ and UK respondents' attitudes towards PD and fixed interest. NZ respondents tend to favour fixed interest due to their organisations' investment policies (47.6%), their familiarity with the asset class (47.6%), and the higher liquidity offered by fixed interest investments (47.6%). In contrast, respondents from the UK prefer PD for its relatively low volatility (100.0%) and potential for high returns (60.0%). A similar pattern can be observed among PD and non-PD investors (see **Figure 6**).

Figure 5: *Preference Private Debt versus Fixed Interest (NZ vs UK)*

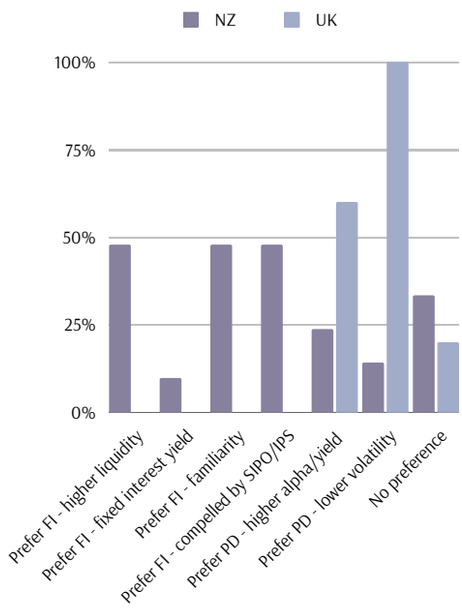


Figure 6: *Preference Private Debt versus Fixed Interest (PD vs Non-PD)*

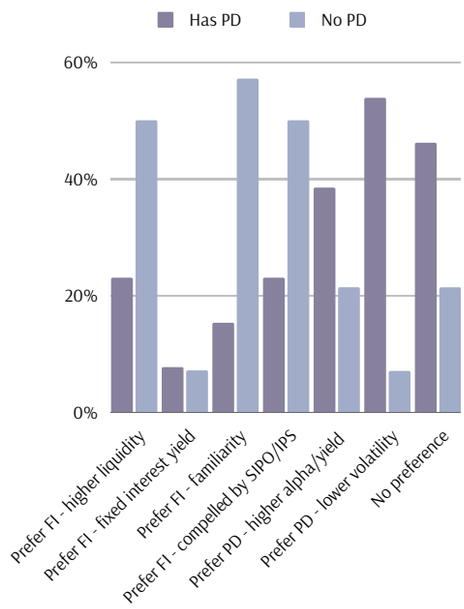
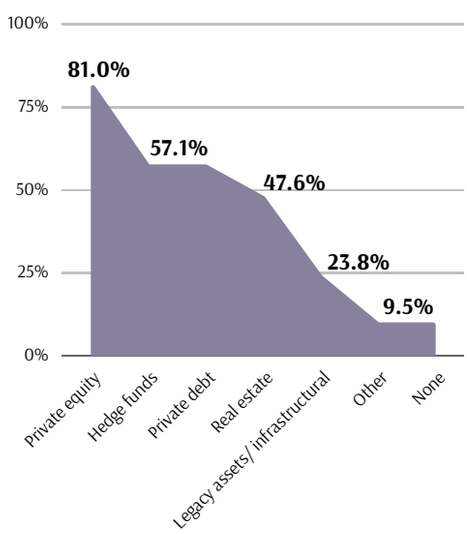


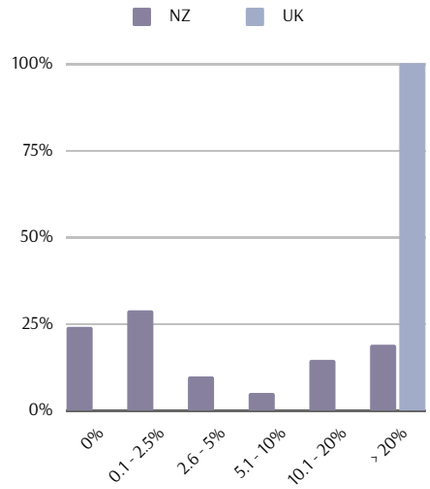
Figure 7: *Private Markets that NZ Respondents Have Investment Experience with*



The most prevalent private market instrument, among NZ respondents, is private equity (PE) (81.0%), followed by hedge funds (57.1%) and PD (57.1%) (see **Figure 7**). The much lower percentage of NZ respondents that have invested in PD relative to PE is mainly due to familiarity and availability reasons.

[2] AUM in Alternative Markets: Private Market vs Private Debt Market

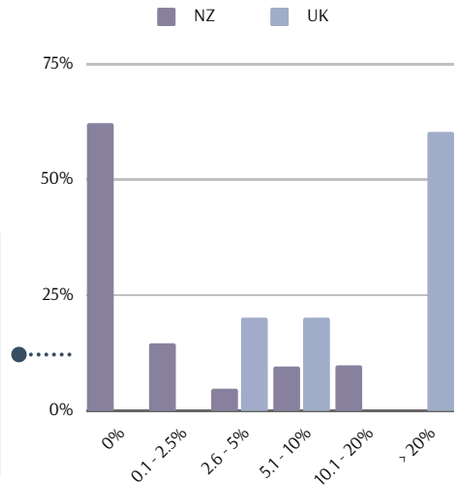
Figure 8: *AUM Invested in the Private Market (%)*



Compared to the UK, NZ respondents invest a lower percentage of AUM in the private market (including both PE and PD). [1]

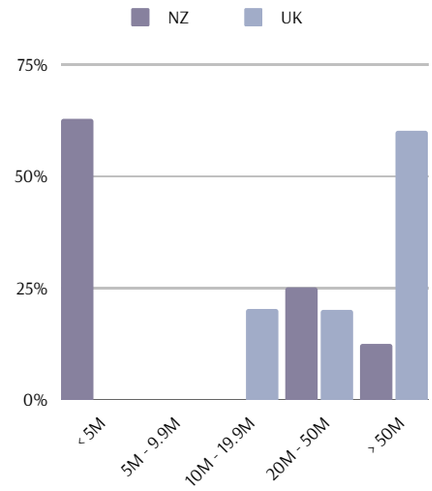
The divergence between NZ and UK is more apparent for the PD market. This can be attributed to a number of factors, such as the smaller size of the NZ economy and a more conservative investment culture in NZ, which may result in a lower appetite for risk and a preference for more traditional investment options. [1]

Figure 9: *AUM Invested in Non-Bank Private Debt (%)*



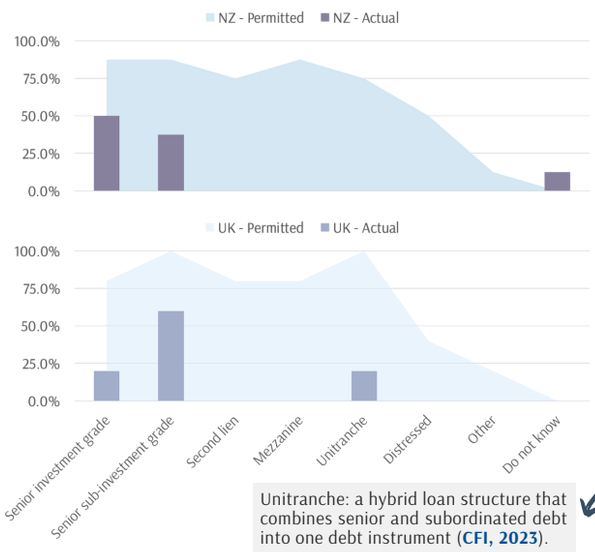
The typical size of investment in PD funds by UK investors stands at over 50 million NZD, with 60.0% of respondents indicating such investments. On the other hand, 65.0% of NZ PD investors allocate less than 5 million NZD in the PD market (see **Figure 10**). This disparity can be attributed to the larger funds under management (FUM) held by UK respondents, as well as a more developed and mature PD market in the UK compared to NZ. The dominance of the banking sector in the NZ market and the absence of specialised PD funds for non-property investments has also played a role in this discrepancy. Additionally, a lack of access to PD products, the potential currency risks associated with offshore investments, limited understanding of PD's benefits, misconceptions regarding its complexity and risk, and limited information and resources may have hindered the willingness and ability of New Zealand investors to invest significant amounts in the PD market.

Figure 10: *Typical Investments in Private Debt (NZD)*



[3] Risk and Return Preferences

Figure 11: Debt Instruments NZ/UK Respondents Used in the Private Debt Market - Permitted vs Most Used



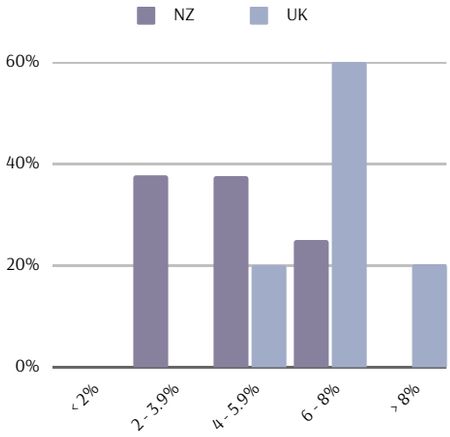
Unitranche: a hybrid loan structure that combines senior and subordinated debt into one debt instrument (**CFI, 2023**).

As shown in **Figure 11**, given the ability to invest, senior investment grade debt instruments are the most popular among NZ respondents (50.0%) due to lower perceived risks. This suggests that NZ respondents, on average, are risk averse. This is understandable given the immaturity of the NZ PD market, investors' lack of experience (see **Figure 7**) and potentially also that wider spreads are available on PD in NZ, meaning that less risk needs to be taken to achieve target returns.

Compared to NZ respondents, UK respondents are more willing to take on risks in the PD market. More specifically, 60.0% and 20.0% of the UK respondents invest a majority of their PD funds in senior sub-investment grade and unitranche debt instruments, respectively. These instruments typically have a higher default risk and thus offer a higher yield compared to the senior investment grade.

[1] Given the nature of our sample, some caution should be attached to the statement.

Figure 12: *Target Spread of Private Debt over Cash Rates*



80.0% of the UK survey respondents expect a spread of 6% and above, whereas most NZ-based survey respondents are comfortable with a spread of 6% and below (**Figure 12**). The disparities in target spread expectations for PD over cash rate can be attributed to a number of factors, including the differences in the maturity of the PD market and investors' risk appetite between the two countries. The PD market is more established in the UK, providing investors with more investment opportunities with higher returns. Additionally, institutional investors in NZ may have less knowledge about the potential returns on PD investments, or may prioritise safety over returns, whereas UK investors may have had positive return and default experiences and are thus more willing to take on greater risks in the PD market. This is in line with our previous observation that compared to their UK counterparts, NZ investors tend to prefer more conservative PD instruments characterised by lower returns and lower risks.

[4] Sector Preferences

NZ respondents consider healthcare and life sciences (61.9%) to be the most attractive sector for PD investments, followed by industrial and manufacturing (47.6%), and energy and utilities (42.9%) (**Figure 13**). Firms operating in the healthcare and utilities sectors are considered "defensive", as they provide essential goods and services that are not subject to significant changes in demand, regardless of economic conditions. The performance of the industrial and manufacturing sector is also considered to only have a moderate correlation with business cycles. This aligns with our earlier findings in the previous section, where we show that NZ institutional investors tend to be relatively risk averse. Further, our results suggest that NZ respondents may see PD as a form of asset-backed finance, and therefore prefer tangible assets (e.g., energy and utilities, industrials, and property) over intangible assets (e.g., high-tech and agriculture and horticulture), even though the latter plays a critical role in driving economic growth in NZ (**Infometrics, n.d.**).

Concerning the different sector preferences among PD and non-PD investors, PD investors find high-tech – a major driver of economic growth – attractive, whereas non-PD investors favour consumer products due to familiarity of the brands (**Figure 14**).

Again, the above findings indicate that (1) UK respondents are more experienced and specialised than NZ investors, weighing cash flow coverage above asset coverage, and (2) PD investors are generally more focused on sectors with secular growth and demonstrate a lower focus on name familiarity or recognition than non-PD investors.

Figure 13: Sector Preferences (NZ vs UK)

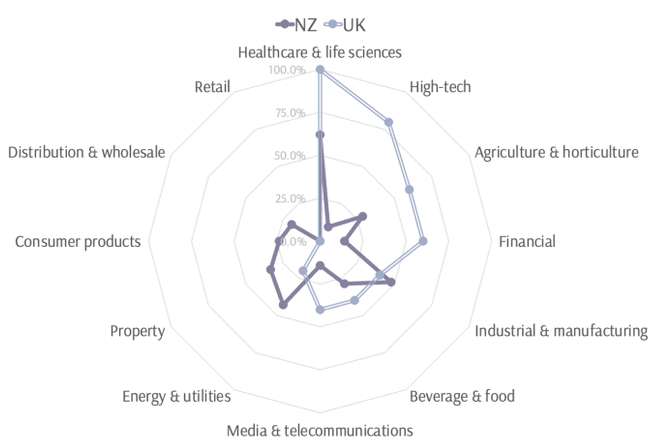
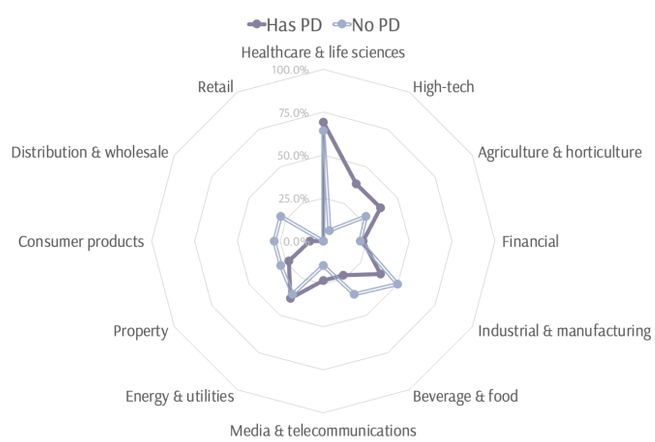


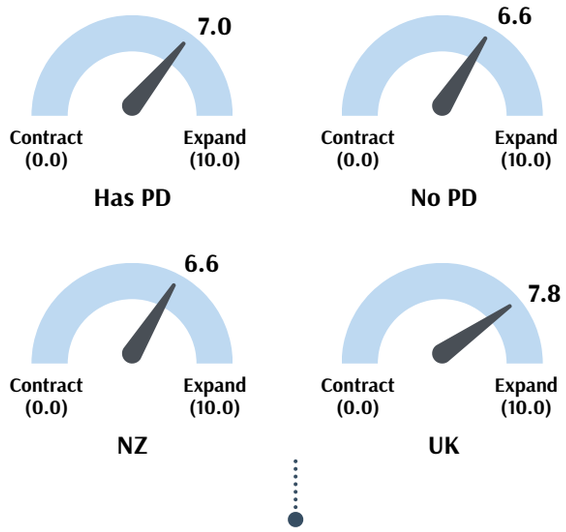
Figure 14: Sector Preferences (PD vs Non-PD)



FUTURE DEVELOPMENTS OF THE PRIVATE DEBT MARKET

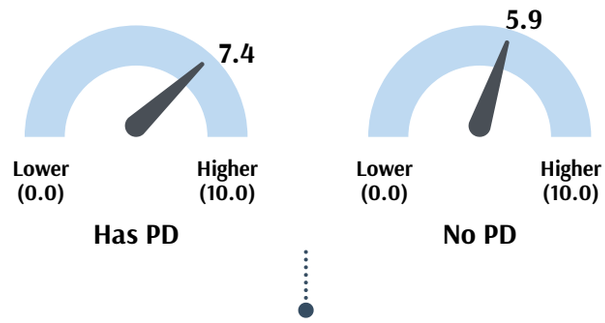
[1] Expectations

Figure 15: *Expectation of the Development of PD over the Next 12 Months (PD vs Non-PD and NZ vs UK)*



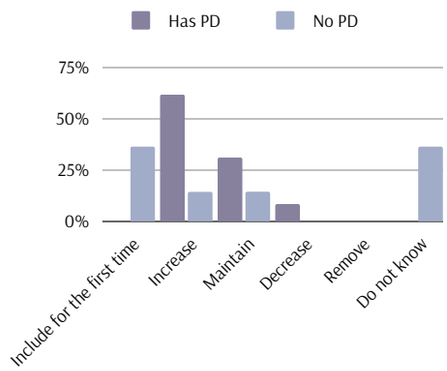
On average, respondents anticipate growth in the PD market within their respective jurisdiction/country over the next 12 months. This is especially true for UK respondents and those who have invested in PD.

Figure 16: Perception of Risk-Adjusted Return on Private Debt vs Other Yield-Oriented Assets *(PD vs Non-PD)*



Survey respondents' positive attitude towards the future development of PD could be attributed to its steady track record of performance. As depicted in **Figure 16**, regardless of their prior experience with private debt, respondents generally perceive a higher risk-adjusted return from PD compared to other forms of yield-oriented assets. PD investors, on average, share a more favourable view towards PD's risk-adjusted performance, indicating that they have had a positive return experience.

Figure 17: *Expected % Allocation to PD Over the Next 1-3 Years*

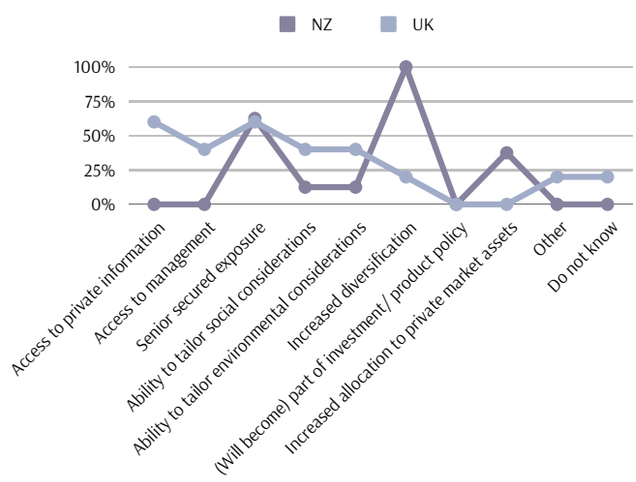


As shown in **Figure 17**, of those who have invested in PD, 61.5% plan to increase their PD allocation in the next 1-3 years and 30.8% plan to maintain their current level, indicating positive experiences and optimism for future growth and returns. Further, half of those who currently do not have any PD investments are interested in adding it to their portfolio within the next 1-3 years. Overall, we have noted increasing interest in PD among both current and potential investors. We anticipate that the PD market will continue to expand in the coming years.

[2] Motivations

Beyond pure financial return expectations, NZ respondents are motivated to invest in PD for the diversification benefits it offers to their portfolio (100.0%), the senior secured exposure it provides (62.5%), and the increased allocation to private markets (37.5%). In sharp contrast however, UK respondents are more driven by the ability to access private information (60.0%) and management (40.0%) through PD investments (**Figure 18**). These results are influenced by both the relative maturity of each jurisdiction and the nature of the respondents to some degree. NZ respondents tend to have broader asset allocation roles with limited PD experience, whereas UK respondents are more likely to be specialists in the field.

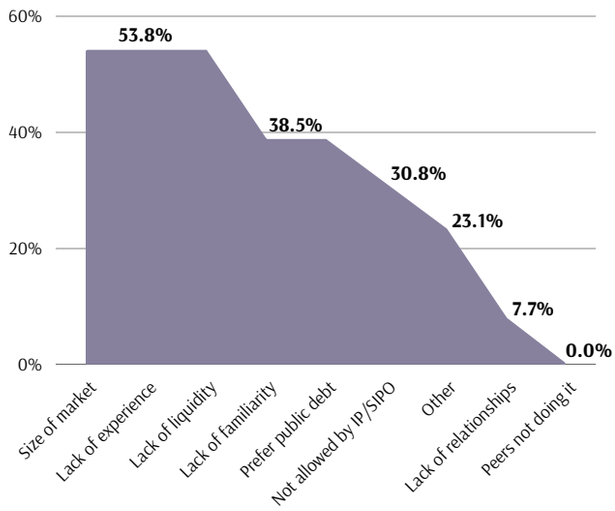
Figure 18: *Motivations for Investing in Private Debt*



Further, most NZ respondents do not view PD as an opportunity for responsible investing, whereas 40.0% of the UK respondents see it as a way to incorporate environmental and social considerations. The UK data highlights what is crucial (e.g., access to information and management) to generate returns once the decision to diversify and allocate to private markets has been made, whereas the NZ data pertains more to the more fundamental decision to create an allocation to PD.

[3] Obstacles

Figure 19: *Main Reasons for Not Investing in Private Debt*



As presented in **Figure 19**, one of the main reasons that NZ respondents cite for not investing in PD is a lack of experience with this new asset class (53.8%). Additionally, the market for PD in NZ is small (53.8%) and lacks liquidity (38.5%), which can make it difficult for investors to buy and sell these assets.

"Lack of liquidity" as one of the key obstacles is consistent with the **S&P Global 2021 report**, which identified illiquidity and lack of transparency as key risks in the growing PD market. Indeed, PD instruments are often less transparent and less standardised than other types of yield-oriented assets, making the valuation of them rather difficult. In addition, the secondary market for both assets and funds (including PD) is still at its infancy in NZ with fewer investors participating than in more established markets like the UK, further exacerbating liquidity concerns.

[4] Elements Helpful for the Development of Private Debt

Factors which affect the development of the PD market are divergent between NZ and UK (see **Table 1**). NZ investors' major concerns seem to be more market-oriented and related to the asset class itself, whereas in the UK, respondents' concerns are more around legislative or structural risks. Specifically, NZ respondents cite the involvement of highly experienced PD funds (76.2%), large-scale PD funds (61.9%) and pension funds as investors (61.9%) as key drivers for the growth of PD in NZ, whereas UK respondents are more focused on bankruptcy rules (60.0%), supporting tax systems (40.0%), regulatory framework (40.0%), unfavourable economic conditions (40.0%), and cultural attitudes towards PD (40.0%). Similarly, non-PD investors tend to prioritise the involvement of highly experienced PD funds and corporate investors over structural considerations when it comes to the development of the PD market in their respective jurisdictions/countries.

Table 1: *Most Important Elements for the Development of Private Debt*

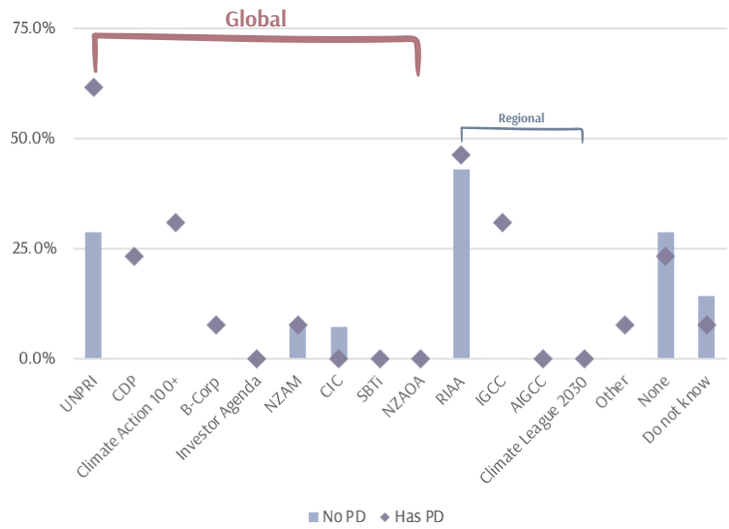
	All	NZ	UK	Has PD	No PD
Private debt market integration across borders	7.4%	4.8%	0.0%	7.7%	7.1%
Supporting tax systems	22.2%	19.0%	40.0%	23.1%	21.4%
Regulatory framework	22.2%	19.0%	40.0%	30.8%	14.3%
Attractive public funding opportunities	14.8%	19.0%	0.0%	7.7%	21.4%
Large-scale private debt funds	55.6%	61.9%	40.0%	61.5%	50.0%
Highly experienced private debt funds	63.0%	76.2%	20.0%	46.2%	78.6%
Involvement of corporate investors	25.9%	28.6%	20.0%	15.4%	35.7%
Involvement of pension funds	51.9%	61.9%	20.0%	46.2%	57.1%
Involvement of insurance companies	14.8%	14.3%	20.0%	15.4%	14.3%
Uni endowments, foundations & family offices	18.5%	19.0%	20.0%	23.1%	14.3%
Bankruptcy rules	14.8%	4.8%	60.0%	23.1%	7.1%
Cultural attitudes towards private debt	37.0%	38.1%	40.0%	38.5%	35.7%
Unfavourable general economic conditions	14.8%	9.5%	40.0%	23.1%	7.1%
Other	3.7%	4.8%	0.0%	0.0%	7.1%
Do not know	3.7%	0.0%	0.0%	0.0%	7.1%

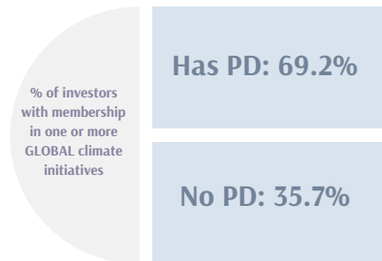
PRIVATE DEBT IN THE ESG CONTEXT

[1] Climate Initiative Signatories

As suggested by **Figure 20**, PD investors are much more likely to become signatories of a global climate initiative (e.g., Climate Action 100+, CDP, UNPRI) than non-PD investors (69.2% vs 35.7%).

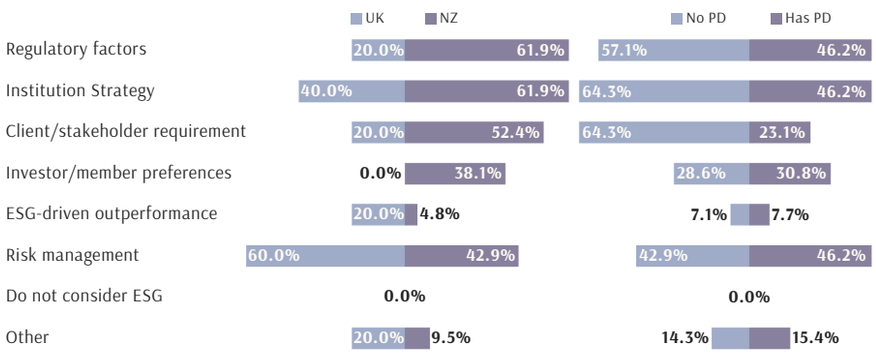
Figure 20: *Climate Initiative Signatories/Membership*





[2] ESG Motivations

Figure 21: *ESG Motivations (NZ vs UK and PD vs Non-PD)*



In NZ, ESG is often viewed as a compliance or business risk exercise, primarily driven by regulatory factors and the strategy of institutions, whereas in the UK, ESG is seen more as a risk management tool. This again hints that the UK respondents are more experienced PD investors with a more micro focus.

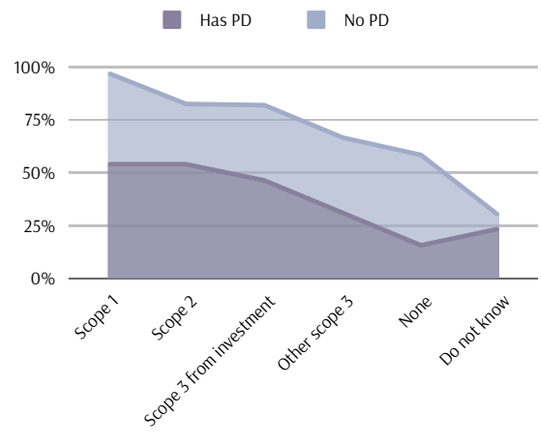
Similarly, non-PD investors are more likely to incorporate ESG into their investment decision-making process because they are told to do so by their organisations and/or clients/stakeholders, whereas a much smaller proportion of them consider ESG as a risk management tool or are motivated by ESG-driven outperformance.

[3] Scopes of Emissions Measured

40.0% of all respondents across countries measure emissions from downstream investment activities. The percentage looks low in an absolute sense but is still quite encouraging, given that there are no binding rules for scope 3 emissions disclosure, and measuring scope 3 has proven to be difficult with no clear guidance and the extensive data collection effort (**Nguyen et al., 2022**).

More PD than non-PD investors (46.2% vs 35.7%) measure scope 3 emissions derived from investment activities. Further, considerably fewer PD investors do not measure any scope of emissions compared to their non-PD counterparts (15.4% vs 42.9%) (**Figure 22**). This indicates that PD investors are more environmentally conscious and committed to ESG than non-PD investors.

Figure 22: *Scopes of Emissions Measured*

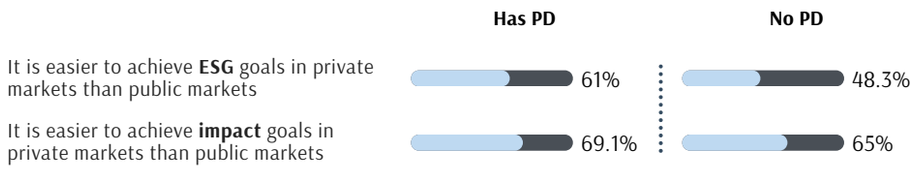


[4] Ease of Achieving ESG and Impact Goals: Public vs Private Markets

Respondents, especially PD investors, believe that it is a lot easier to achieve ESG and impact goals in private markets than in public markets (see **Figure 23**).

While it is not always easier to achieve ESG goals in private markets than in public markets, the greater control and flexibility offered by private instruments facilitates alignment of business practices and investment decisions with impact goals. Further, by definition, impact investing is more a primary market transaction than simply buying and selling securities in the secondary market. Therefore, public markets have limited ability in achieving impact goals.

Figure 23: *Ease of Achieving ESG and Impact Goals - Private vs Public Market*



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