

Why now is the time to consider investing in private debt

November 2020



Marketing material for professional investors and advisers only

Schroders

Executive summary

While the future of traditional fixed income investing may look gloomy, we believe private debt can help investors meet their income needs at a time when it is harder than ever to find real returns.

The market has become increasingly challenging with equity dividends deferred or depressed and bonds offering minimal or even negative returns. Private debt can help fill the gap however given the complexity, it is our view that experience is the key to successful investing to avoid any potential pitfalls. A specialist manager can help to navigate these risks.

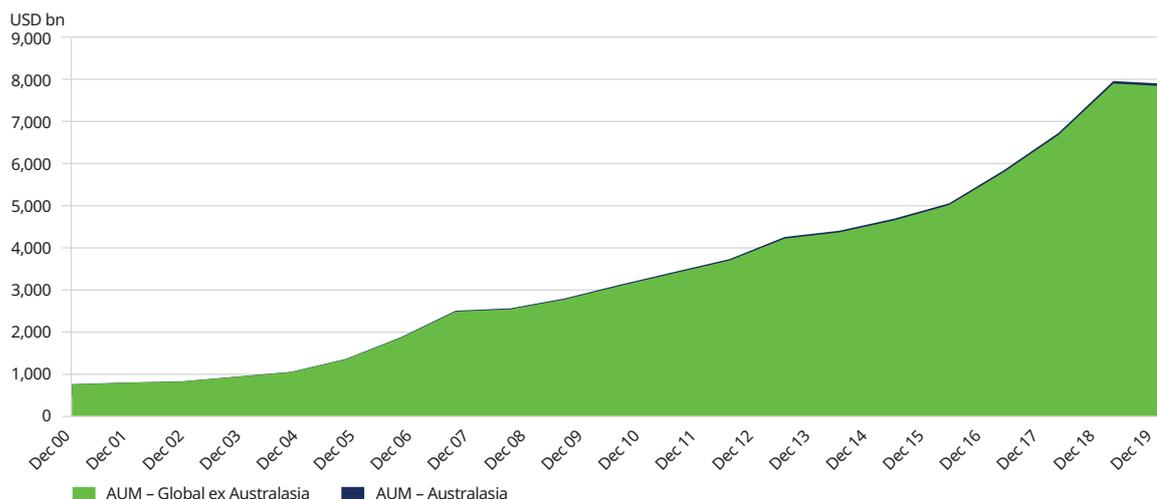
The benefits of investing in private debt include diversification, a reduction in volatility, potential for superior risk-adjusted returns, and access to a range of duration profiles all with stable underlying income characteristics that have low or no correlation to more volatile listed markets. The complexity and illiquidity of this asset class gives rise to a premium not afforded to other asset classes within this sector.

Why now?

Private debt as an asset class is not new, with global assets under management (AUM) standing at almost USD 8 trillion as at March 2020¹. **Figure 1** shows the AUM globally, with Australasian AUM standing at only USD 60 billion as at March 2020, representing less than 1% of the global AUM.

So why hasn't private debt flourished in Australia when it has in other markets offshore?

Figure 1: Private debt AUM



Source: Schroders, Preqin, October 2020.

Regulatory changes

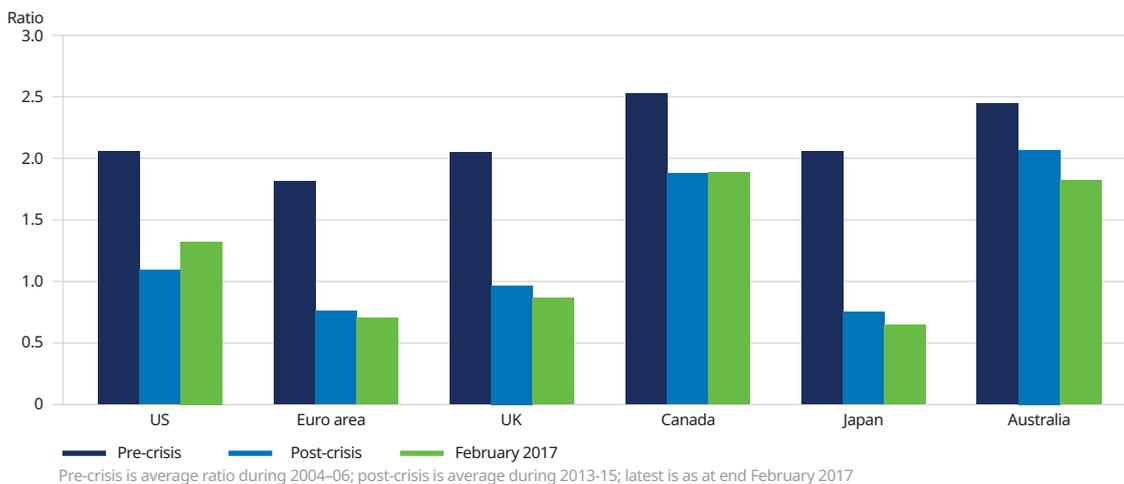
Since the Global Financial Crisis (GFC), banks have been required to hold progressively higher levels of regulatory capital to address the vulnerabilities that led to the crisis itself. Holding this capital is costly, and often comes at a trade-off to shareholder returns. The challenge is to minimise the amount of capital they need to hold on their balance sheets (in order to provide the highest possible returns for their shareholders) whilst trying to maintain market share.

In Europe and the US, the GFC and these subsequent changes presented an opportunity for the private debt market to flourish. The GFC hit offshore banks much harder than Australian banks, forcing them to change their lending criteria and as a result shift more credit risk off balance sheet. As Figure 1 shows, the private debt market ramped up significantly after the 08/09 period.

Australia, in contrast to the rest of the world, fared very well through the GFC. Australian banks had little exposure to the US housing market and subprime mortgages which were the major cause of the crisis, however they did have a strong reliance on the wholesale funding markets. The Australian government announced a range of measures that provided stability to the market, all of which meant the flow-on impacts to corporates were substantially lessened.

¹Source: Preqin database; private debt assets under management as at October 2020.

Figure 2: Banks' share price to book ratios²



Sources: Bloomberg, RBA

Banks, however, generally began to pull back loan tenors and corporates were forced to issue equity to create a buffer. Despite all this, the institutional loan market failed to develop like it had in other parts of the world, perhaps because the banks were able to maintain their dominant position. There was simply little alternative source of capital available to borrowers.

Despite these headwinds, disintermediation is now occurring as a variety of financial institutions have emerged to meet changing consumer needs; including digital banks (aka neobanks), buy now/pay later companies and private direct lenders. Banks continue to dominate the corporate loan market but the landscape is changing, driven in part by ongoing developments in the regulatory regime governing banks.

These regulatory requirements have driven Australian banks to adopt a different perspective on returns from a pure revenue focus, to a focus on forging a return on economic or (more recently) regulatory capital. The Australian Prudential Regulatory Authority (APRA) is the governing body for Australia's financial system, and it manages the level of regulatory capital required

by banks and insurance companies to provide enough financial cushion to absorb losses from unexpected financial events.

Corporates who found their lenders less than supportive during the GFC may have broadened their audience of bank lenders, but the demand/supply dynamic still favoured strong bank participation in syndicates and clubs.

Interest rates

Compared to some offshore markets, Australia has enjoyed much higher rates of interest as shown in **Figure 3**, and a higher dividend yield (not to mention the high level of imputation credits available) as shown in **Figure 4**, meaning the illiquidity premium offered by private debt hasn't been as high, relative to total yield, as in those other markets. Now that Australia has been pulled into the world of lower rates and less secure dividends, investors will have to consider broader sources of income and may be willing to exchange some liquidity for the illiquidity premium private debt can offer.

Figure 3: EUR, USD and AUD 3 month reference rates

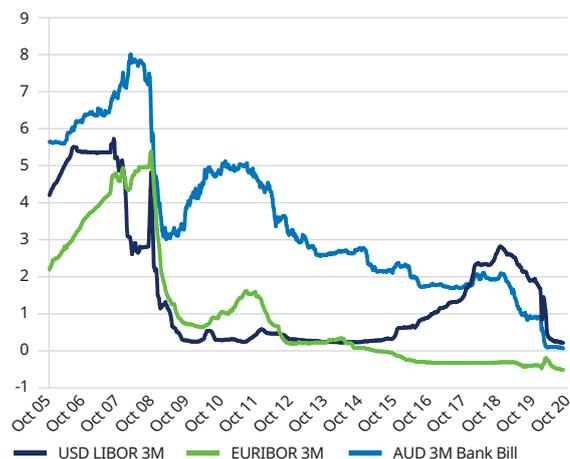
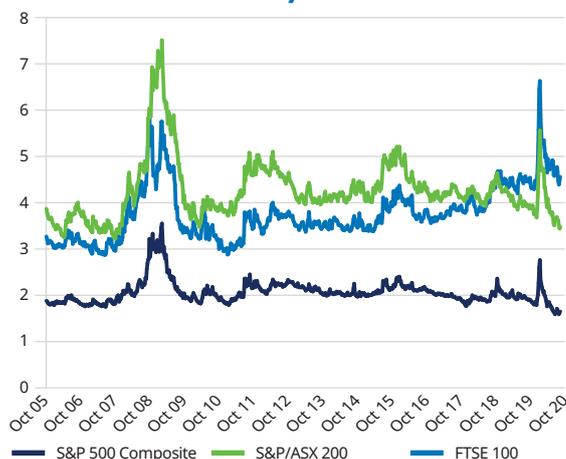


Figure 4: S&P/ASX200, S&P500 and FTSE100 dividend yields



²Reserve Bank of Australia: Bulletin – March Quarter 2017. Returns on Equity, Cost of Equity and the Implications for Banks.

Private debt is quite simply a way to earn additional yield by trading off liquidity. This has been viewed as a good trade-off in Europe and the US where real rates have been low for a long time. However, in Australia the private debt market hasn't grown at the same pace. More recently, the early release of super during COVID has seen some superannuation trustees focus on liquidity. Now that things have settled somewhat, and the impacts of COVID have been less than many expected, investors can resume the emphasis on returns over liquidity.

Further support for consideration of private debt as a source of regular income are the recent reduction in rates in Australia and the decline in dividend forecasts partly driven by regulator intervention - for example, APRA requesting banks to halve their dividends³.

Retirement capital

Australia's unique superannuation market has historically focused on growth assets, whereas defined benefit (DB) schemes have been more focused on income producing assets, particularly in recent years as the DB market is maturing and schemes don't have the luxury of time to help them through cycles. Many UK DB schemes are now cashflow negative, meaning if they hold equities, they need to sell them to meet pension payments. By holding income assets, like private debt, they can use the income source to meet liabilities rather than deplete the capital, which significantly reduces the risk and the reliance on stable equity prices.

As the Australian superannuation model matures, we think investors will increasingly look to private debt to provide a secure and stable income stream approaching and throughout retirement.

Why is bank capital relevant and why is it creating an opportunity for private debt?

Banks hold capital relative to the riskiness of the underlying asset (loan), and the measure of the amount of capital held by a bank is its Capital Adequacy Ratio (CAR) which is capital base (CB)/risk weighted assets (RWA) where:

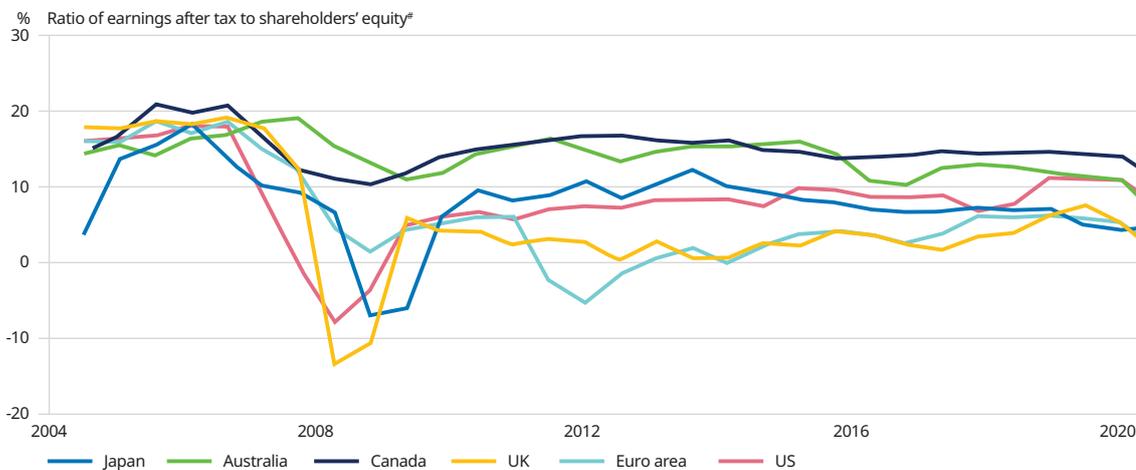
CB = Equity capital + retained earnings + other qualifying capital (such as Common Equity Tier 1 Capital)

RWA = Loans and other assets of the bank weighted according to their relative risk (often by an internally developed credit scoring metric) and various other risk parameters largely adopted via the internationally accepted Basel capital framework.

Figure 5 shows that in 2020, Australian banks' return on equity has fallen below GFC levels, whereas banks in other major markets have begun to improve upon some of these GFC lows.

The result? Banks are demonstrably moving away from their previous model of take-and-hold large tickets of loans, and adopting a focus on holding capital where there is a reasonable return on that capital, be that via other non-lending opportunities such as transactional banking, M&A advisory or equity capital markets. Loans that don't make the grade are either declined or held at lower ticket sizes. Post-COVID, many companies have been re-rated and have higher capital weights, so banks are seeking to lighten up balance sheets through secondary sales, or reducing commitments when they can (for example, during refinancing).

Figure 5: Large banks' return on equity*⁴



*Number of banks: Australia (4), Canada (6), Euro area (39), Japan (4), UK (4) and US (12). *Excludes minority interests; reporting periods vary

Sources: APRA; RBA; S&P Global Market Intelligence

³<https://www.apra.gov.au/news-and-publications/apra-updates-guidance-on-capital-management-for-banks-and-insurers>, July 2020

⁴<https://www.rba.gov.au/publications/fsr/2020/oct/pdf/financial-stability-review-2020-10.pdf>

A new era

Welcome to the dislocation of the Australian loan markets. Where banks, who once dominated the landscape with their size and scale, are grappling with ever-increasing regulatory oversight and a heightened focus on returns on economic and regulatory capital. Borrowers on the other hand, are continuing to look for competitively priced debt.

The consequential gap between supply and demand can be elegantly filled with institutional capital and provide much needed diversification to the Australian loan markets. We are seeing this with the shift towards structures that meet the needs of institutional debt. This provides greater opportunity for those who are on a quest to find diversified sources of income to make a strategic allocation to this newer asset class.

Characteristics of private debt

There are several basic characteristics of a private debt instrument in the Australian market.

- 1 Privately held** – the debt instruments are private, but the borrower need not be. For example, many listed entities in Australia have syndicated loans or bilateral/direct loans alongside listed or unlisted bonds. Borrowers may be from any sector and may be an operating company or a holding company, depending on the opportunity. They must all have one thing in common– the ability to generate a multiple of sufficient cashflows to service their debt requirements in addition to their operating costs.
- 2 Illiquidity** – these loans are illiquid, and therefore can be attractive to investors for many reasons; not the least of which is the inherent **premium** for this illiquidity. Those with patient capital and an ability to balance risk/reward can benefit. In Australia we have a relatively immature secondary market, so most strategies must rely on a hold-to-maturity assumption.
- 3 Tenor** – generally limited to a term not greater than 5 years, except for some sectors (like infrastructure) where due to the nature of the asset we may see longer tenors.
- 4 Pricing** – mostly floating rate (base rate + spread) where the spread can be static (i.e. same spread for the life of the loan) or dynamic (grid-based, where for example pricing could reflect movements in risk profile). Pricing is also a function of demand/supply dynamics in the market. The higher the demand for a borrower's debt, the tighter pricing may be. Pricing is also heavily impacted by other factors such as the sector, size of the deal, security (and therefore probability of default), and leverage.
- 5 Structural protections** – financial and information covenants most often form part of the structural protections giving comfort to lenders. These structural protections are more advantageous to lenders in Australia, versus say, European or US deals. Australian deals generally enjoy tighter covenant headroom, maintenance rather than springing⁵ covenants (except for Term Loan B, as outlined on the following page), and leverage is moderated. Whilst covenant-lite loans are a relatively new part of the Australian debt landscape, they became more popular before the onset of COVID, but we now expect only the more compelling transactions with strong underlying characteristics will adopt this structure.

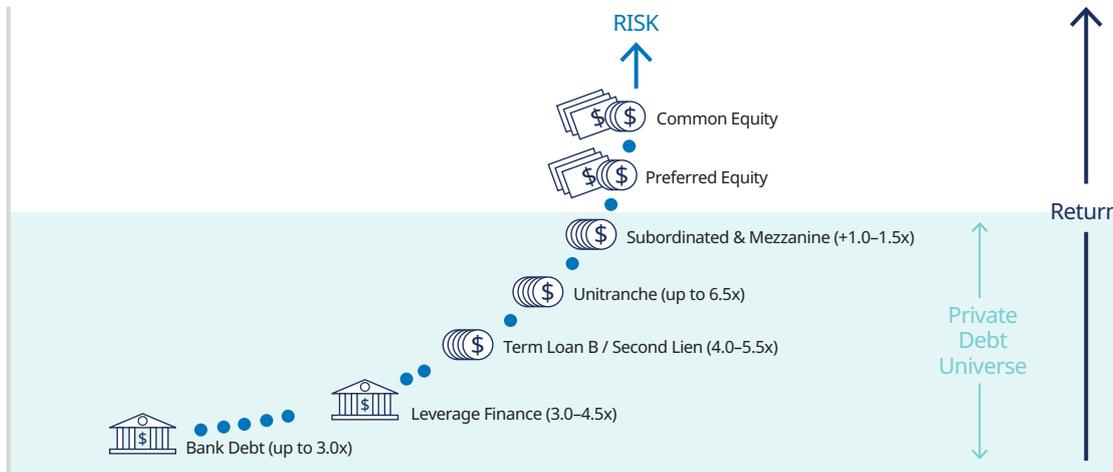
⁵Maintenance covenants are covenants that are always to be complied with. Springing covenants are required to be complied with upon occurrence of a certain future event, like the raising of additional indebtedness, or the usage of revolving credit facilities above a certain threshold. Springing covenants are often only for the benefit of a certain class of lenders (like the RCF providers), and other debtholders can be subject to the decision by those lenders to waive events of default.

Figure 6: Summary of loan characteristics across different loan types
(please refer to the Glossary on pages 12-14 for definitions)

	Bank loans	A\$ Term Loan B	Unitranche
Typical leverage	Up to 3.0x (non-leveraged loans) 3.0-4.5x (leveraged loans)	4.0-5.0x	Up to 6.0x-6.5x
Tenor	Up to 5 years	5-7 years	5 years
Covenants	Often 2 maintenance: Cashflow – Interest Cover Ratio (ICR) or Debt Service Cover Ratio (DSCR) and Gearing – debt to EBITDA For real estate: Loan to Value Ratio (LVR) is common	Covenant-lite Covenants may apply only to Revolving Credit Facilities (RCF), and be springing in nature	Usually only a gearing covenant such as debt to EBITDA
Amortisation	Term Loan A – 30% of total amortising Looking to bring end leverage down to 3.0-3.5x No call protection for senior. Available for mezzanine	Negligible (~1%pa.) Hard or soft call protection may be on offer	N/A Hard or soft call protection
Security	Fixed & floating charge	Fixed & floating charge	Fixed & floating charge
Arranged?	Club or underwritten	Best efforts arranging/underwritten	Club/underwritten/best efforts
Other	<ul style="list-style-type: none"> - Capex limits and other spending “buckets” - Restrictive accordion/incremental facilities - Other restrictions, neg undertakings etc. - Could be combined with a traditional mezzanine piece - EBITDA cure usually goes to debt reduction 	<ul style="list-style-type: none"> - Only RCF lenders have the benefit of a leverage ratio (but cross defaults would provide protection if accelerated) - Equity cures are to EBITDA (meaning less \$ required to cure) - Freebie basket 0.5-1.0x - No restrictions on use of incremental proceeds, can be pari passu or any junior ranking 	<ul style="list-style-type: none"> - RCF/working capital provided super senior by banks, governed by intercreditor documentation - Mostly interest payable throughout the term, but could also include Payment-In-Kind (PIK) (i.e. interest deferral) or Toggle (meaning borrower can choose to cash pay or defer (PIK) interest)

Where does private debt sit on the risk spectrum?

Figure 7: The private debt risk spectrum

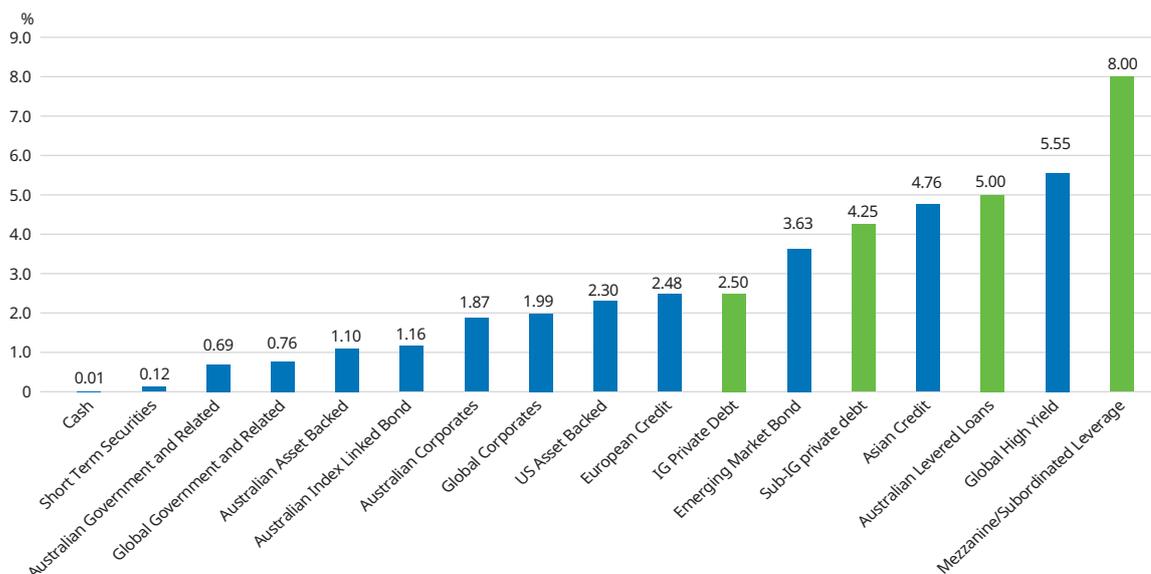


Private debt is a broad asset class that offers a spectrum of potential returns depending on risk (which generally varies depending on rating, security, tenor and leverage).

In the Australian Syndicated Loan Market, and generally speaking (as at October 2020), investment grade opportunity is in the sub 2.5% all-in⁶ range;

non-investment grade, non-leveraged corporates are in the 3.25%-5% all-in range, and leveraged loans are in the 3.75%-6+% all-in range with the range being determined by the sector and size of the opportunity⁷. Subordinated and mezzanine deals offer a premium to senior loans, as compensation for being lower priority in the cashflow and repayment waterfall.

Figure 8: Private debt within the fixed income market



Source: Schroders, October 2020. Figures shown are representations of typical return expectations for the asset classes shown. These figures are not forecasts and Schroders makes no guarantee or representation that any particular asset or asset class will generate any particular rate of return.

⁶All-in includes the annualised effect of any borrower paid additional fees.

⁷Figures stated are representations of Schroders' view of typical return expectations in the Australian syndicated loan market. These figures are not forecasts and Schroders makes no guarantee or representation that any particular loan or type of loan will generate any particular rate of return.

With deals in all parts of the capital spectrum and throughout the market, it can be more challenging to find relative value in the large corporate space. One source of value, however, is the middle market, where EBITDA ranges from \$20-50m. Big banks have appetite here, but deals are often not particularly big and thus less attractive to syndicate. The solution is smaller, bespoke, clubs. Margins can often be more generous, reflecting an even higher illiquidity premium.

The key here is careful asset selection accompanied by significant financial downside analysis and we would look to defensive sectors with solid structures to ensure that borrowers can survive periods of shock (such as the current COVID crisis).

Overall, the loan market compares favourably to other market alternatives in an environment of near-zero base rates, depressed or deferred equity dividends and bonds offering minimal or even negative yields.

Careful asset selection remains crucial

Part of the art of careful asset selection is experience. The COVID crisis has demonstrated the importance of focusing on credit fundamentals, in particular, understanding how businesses can react to unforeseen and sustained shocks to revenue. This shows the importance of choosing an asset manager that has managed through the good times, when lending is vastly easier, as well as the more challenging times.

Private debt is not dynamically priced, and terms and conditions are set at financial close, so the two most important items to be undertaken before deciding to make a loan are:

- 1 Knowing your borrower.** Your manager must undertake comprehensive due diligence, understanding all relevant risks and their (potential) mitigants as debt contracts are often negotiated directly and highly customised; and
- 2 Modelling the downsides.** A thorough understanding of downside risk ultimately protects both sides from potential future headaches and enables you to stress-test your portfolio when macro events cause concern. Stress the cashflows to determine under what circumstances the structure breaks and ensure the protections are sufficient to enable an orderly refinancing or you revert to your exit analysis.

Chasing yield – Risk vs reward

Chasing yield in this space inevitably means giving up something, perhaps it's a covenant (or two), or risk in terms of higher leverage. When the best you can hope for is getting your principal and interest back, these types of trade-offs should be reserved only for the stronger and more defensive sectors where businesses with demonstrated strong and resilient underlying cashflows and clear market presence reside. We believe that covenant-lite opportunities should be subjected to heavier diligence and understanding of the downside risks, and an understanding of who holds the cards in a lender vote (and thus who will drive outcomes).

In short, any fund with a heavier focus on the newer unitranche and cov-lite structures (particularly those written pre-COVID) will inevitably come with a much higher probability of default than a post-COVID deal, or a more moderated bank deal with maintenance covenants. The mitigant to this risk is a well-diversified portfolio, both in sector type, geographical exposure, rating and security type.

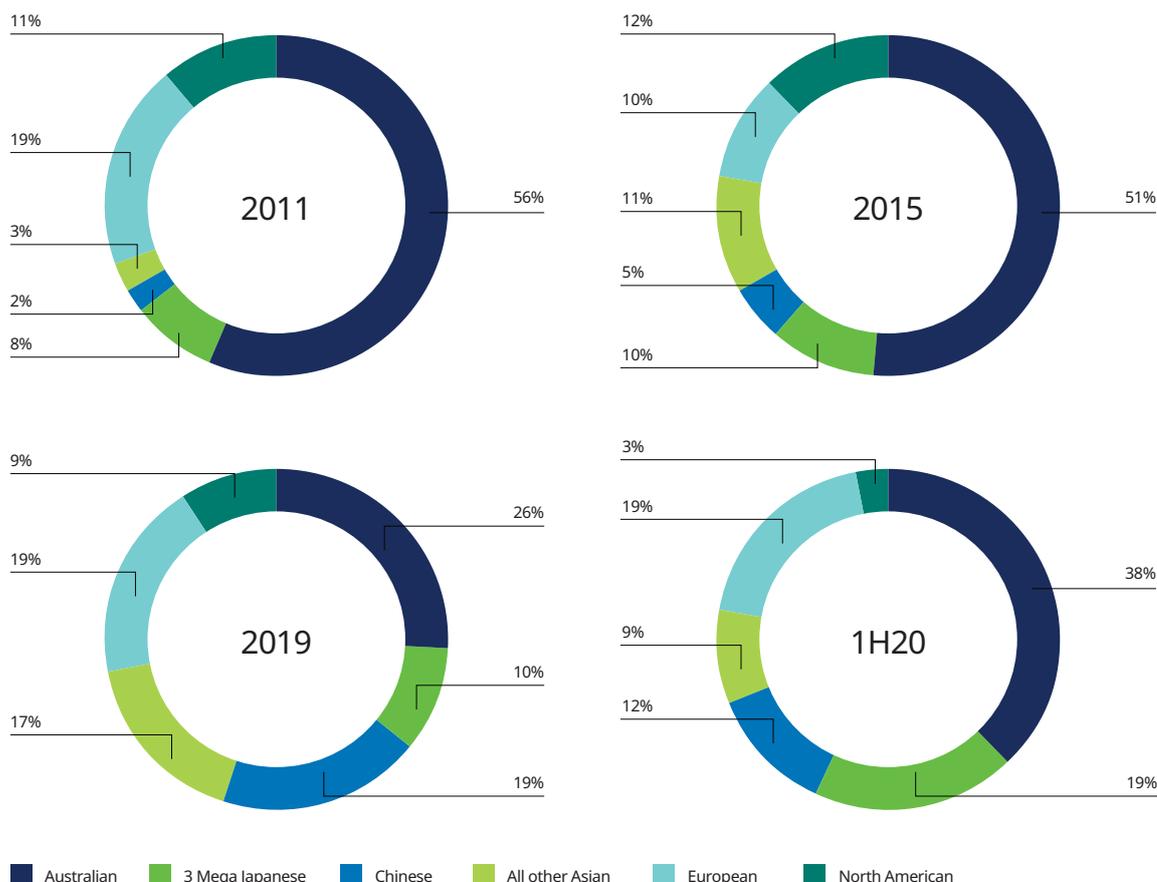
The impacts of COVID and where to from here?

COVID has undoubtedly changed the way we all do business. The first weeks of the COVID crisis in March 2020 saw banks grappling with short-term funding costs whilst trying to ensure availability of funding lines to their clients. New clients or new monies often had to be deferred or met with more limited support. We saw very few true new money deals come to market for several months.

As short-term funding costs began to stabilise following government intervention, and the market regularising to a newer routine, new money deals returned, but not as many as we would have expected in a non-COVID 2020.

Foreign banks have pulled back from the market in Australia since the beginning of March, presumably because they have been concentrating on their home markets. According to LoanConnector, North American banks' participation in the Australian Syndicated Loan Market dropped from 9% to 3% from 2019 to 1H 2020, and Asian banks (excluding 3 mega Japanese and Chinese banks) dropped from 17% to 9% over the same period. Australian banks increased their market share in 1H 2020, likely due to their strong relationships with borrowers and being the natural port-of-call for COVID-driven liquidity.

Figure 9: Bank composition of the Australian Syndicated Loan Market over time



Source: LoanConnector, ANZ

Structural impacts

Other impacts of the crisis are a pullback in leverage and a tightening of terms and conditions from those pre-COVID levels where we were starting to see more and more unitranche and cov-lite solutions in this part of the world, and a heating up of the leverage held within companies. In our opinion, only the most desirable borrowers can now command these terms, and the market is unlikely to engage in a significant downward shift in risk and return to pre-pandemic heat.

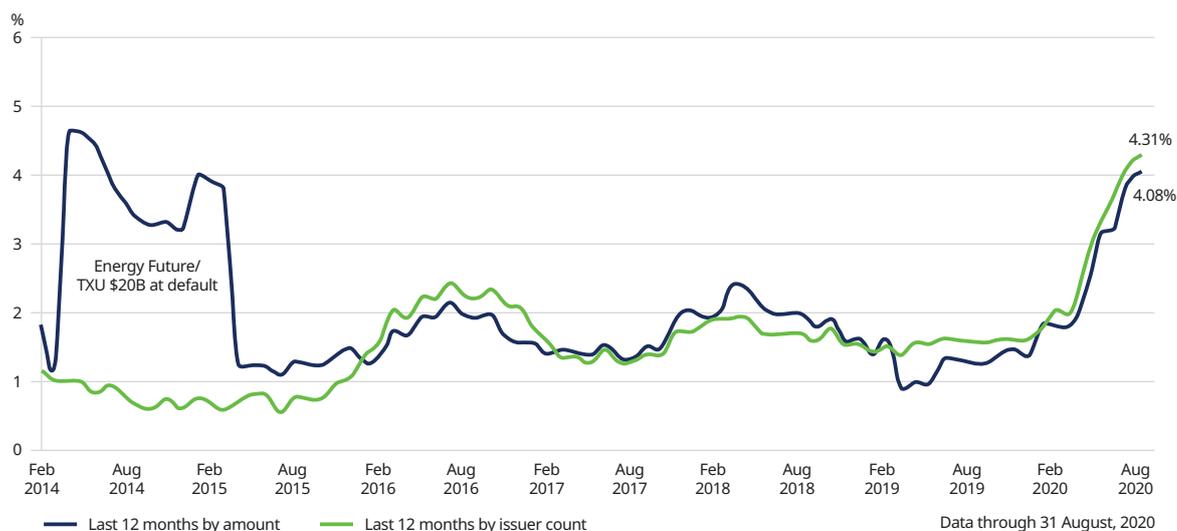
If COVID has taught us nothing else, it is to be prepared. Only a few businesses survived lockdown looking better than before (supermarkets, data centres, technology disrupters, for example). Nearly every business needed to rethink the way they engage with their customers, and how to manage their employees. COVID also became the mother of invention in a way that shows the resilience of our small-to-mid enterprise (SME) sector. For example, gin distilleries began to manufacture hand sanitiser and stage prop makers turned their hands to making desks. For the middle market, focusing on alternative business opportunities can assist with exit analysis in the event primary business becomes paralysed.

This all comes down to appetite for risk. The M&A market will inevitably return looking for distressed opportunities ripe for turnaround or consolidation, to revive deals waylaid at the beginning of lockdown, or indeed simply to invest the vast bank of monies raised over the past few years where capital needs to be deployed by a certain date. This is likely to lead to more competition at the larger end of town (bigger tickets to deploy), more leverage and less structural protections than smaller, middle market club deals.

We also need to be prepared for the impacts of COVID to translate to increased default experience in the next 6-12 months for existing loans. Standard & Poor's (S&P) reports that the default rate of the S&P/LSTA Leveraged Loan index hit 4.08% in August due to pandemic impacts. This is a trailing 12-month calculation, which peaked with the August actual rate of 4.31% - the highest since September 2010.

Whilst the Australian market is less risky in terms of total leverage and terms, the trend does need to be monitored. The Australian government's temporary changes to insolvency laws have now been extended to 31 December 2020. We believe these changes may improve stressed businesses' ability to manoeuvre out of a challenging situation in a more orderly manner as our economy begins to reopen, but consequently an enhanced lens must be applied to any new investments made during this period.

Figure 10 – US leveraged loan default rate

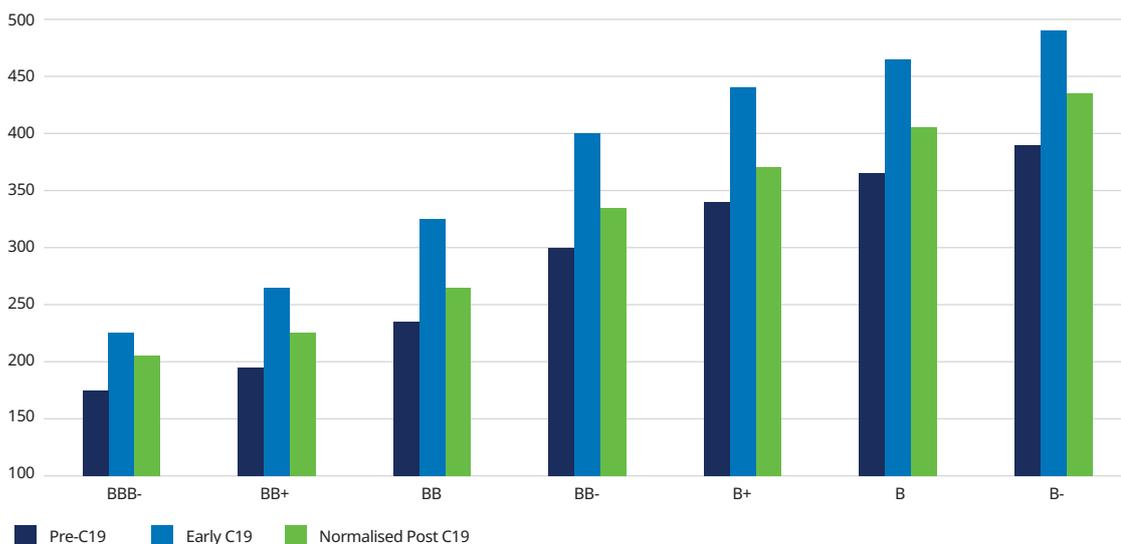


Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index.

COVID has led to a rather basic shift in price for risk – on average over the last 7 months this was 20-30bps higher than pre-COVID levels according to our dialogue with key market participants.

Those that refinanced or priced debt during the March to May 2020 period may disagree, as they would have experienced a greater COVID-tax on their margin. We expect this relatively expensive debt to be refinanced in the next 6-12 months creating more opportunity for a rebalancing of syndicates.

Figure 11: Australian non-leveraged corporate spreads pre-COVID, early COVID and post-COVID



Source: Survey of key market participants by Schroders, September 2020, averages applied, illustrative only. Pricing can depend on multiple factors including size of deal/syndicate, activity (i.e. M&A), and security provided. Upfront fees attributable to a refinancing of existing debt (not a new deal).

Summary

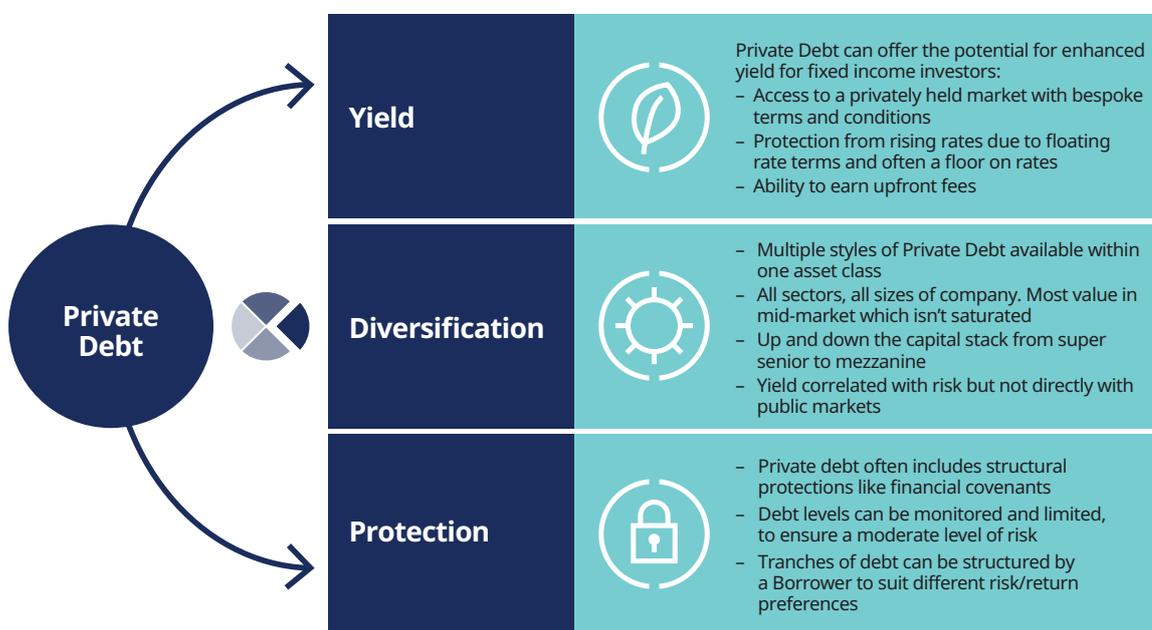
The impetus to consider investing in private debt in 2020 can be a search for higher yield (in the absence of other alternatives), diversification, or a combination of both.

The post-COVID private debt space offers an additional benefit – now is the time to access well structured, and more moderately leveraged debt, benefiting from being set at the beginning of one of those well-worn and dependable economic cycles. Private debt can offer a comparatively generous and stable income profile, and with an experienced manager, default risk can be appropriately managed.

The Australian private debt market can provide greater stability of cashflows, where credit-focused managers can help to improve the diversity and depth of this embryonic market diversifying away from the increasingly risk-averse bank sector.

In summary, an allocation to this asset class can provide additional diversification in portfolios which may be customised to risk tolerance, and a yield that is not directly subjected to the volatility experienced in listed markets.

Figure 12: Summary of private debt features



Glossary

Accordion	An accordion feature in a loan document allows a lender to increase its facilities in anticipation of future needs, often for expansion. Borrowers pay a premium for the right to use it. If unused, the option expires with no penalty.
APRA	Australian Prudential Regulatory Authority – the prudential regulator for Australian banks, credit unions, building societies, insurance, reinsurance and superannuation funds.
AUM	Assets Under Management.
Bank Share Price to Book Ratio	The price to book (P/B) ratio is used to compare a company's market cap to its book value. This provides a comparison of share price to assets and liabilities rather than earnings, which can fluctuate more often, particularly through trading activities.
Basel Capital Framework	Also known as the Basel Framework or often referred to as Basel I/II or III. The Basel Framework is the full set of standards of the Basel Committee on Banking Supervision which sets global standards for the prudential regulation of Banks.
Best Efforts	Where an arranger commits to do their best to sell a loan but does not underwrite the loan.
CAR	Capital Adequacy Ratio. The ratio of a bank's available capital in relation to its risk weighted credit exposures.
Call Protection	Hard (or absolute) – a provision in a loan whereby the loan cannot be repaid before a certain date, thus protecting the right to income from the loan for that time. Soft – a provision in a loan that provides that a premium must be paid if a loan is repaid early.
Capex	Capital Expenditure. Money spent by a business to buy or maintain fixed assets
Cashflow Waterfall	The ranking of payments showing the priority of each cashflow and outflow.
CB	Capital Base – the amount of regulatory capital required to be held by a bank. The measure of financial cushion available to an institution to enable it to withstand losses.
Club Deal	A group of lenders collaborate to provide a loan to a borrower with no subsequent sell down.
Covenant	In the private debt context, a covenant is a promise by a lender to do (or not do) certain things or to meet certain thresholds.
Covenant-Lite or Cov-Lite	Fewer restrictions on the borrower and fewer protections for the lender. Typical for a leveraged buyout or sponsor buyout/private equity transaction.
Cross Default	A provision in a loan document under which a default is taken to occur under the loan document upon the borrower committing a default of an obligation under a different document.
DB	Defined benefit. A type of pension scheme where a specific payment is promised to an individual upon retirement, often indexed to inflation. Generally calculated by reference to a formula based upon earnings history, how long the employee worked for and age.
DSCR	Debt Service Coverage Ratio – a measure of cashflow available to meet debt service requirements.

EBITDA	Earnings Before Interest Tax Depreciation and Amortisation.
EBITDA Cure	Aka equity cure – the right for a borrower to inject EBITDA in such a manner that, if a ratio was breached and retested, it would no longer breach.
First Ranking	The right to the first proceeds from the sale of any security or proceeds in a cashflow waterfall.
Fixed & Floating Charge	A charge that covers both fixed (easily identifiable) and floating (ever-changing) assets.
Freebie Basket	A free and clear term loan or debt basket also called a “freebie basket”, which could be used by companies to take on more debt over time without having to face certain restrictions such as debt incurrence tests.
Gearing	The amount of debt a company holds relative to its assets or levels of activity. Common measures are LTV or debt to EBITDA.
GFC	Global Financial Crisis – the period of extreme banking stress during mid-2007 to early 2009; the catalyst of which was a collapse in the US housing market. It led to the failure of several financial firms and a significant disruption to global financial systems and economies.
ICR	Interest Coverage Ratio – a ratio used to determine how easily (or not) a company can repay debt. Equal to earnings before interest and taxed divided by the company’s interest payments due during the same period.
IG	Investment Grade – an instrument rated BBB-/Baa3 or better by one of the major rating houses.
Institutional Capital/ Institutional Debt	Debt or capital intended to be invested in by institutional clients, such as superannuation funds, insurance companies or endowments.
Intercreditor	An Intercreditor Agreement or Deed is a document signed between two or more creditors, stipulating in advance how their competing interests are resolved and how to work in tandem in service to their mutual borrower.
Junior Debt	Debt which ranks junior to another instrument. Cash will always go to pay the interest and principal on the senior debt tranche before paying the junior debt.
Leveraged Loan	A leveraged loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. Lenders consider leveraged loans to carry a higher risk of default, and as a result, a leveraged loan is more costly to the borrower. Leveraged loans for companies or individuals with debt tend to have higher interest rates than typical loans. These rates reflect the higher level of risk involved in issuing the loans.
LSTA	The Loan Syndications and Trading Association is a financial services trade group which exists to enhance the development and running of the North American syndicated loan market.
LTM	Last 12 months
M&A	Mergers & Acquisitions – market activity whereby one company joins or takes over another company.
Maintenance Covenant	A maintenance covenant requires the borrower to maintain a certain level of activity at all times, for example a certain Interest Coverage Ratio or debt to EBITDA level.
Mezzanine Debt	Debt which ranks junior to another instrument. Cash will always go to pay the interest and principal on the senior debt tranche before paying the mezzanine debt.

Neobank	A type of bank that operates exclusively online without any physical branch networks.
NIG or Non-IG	A debt instrument that is rated BB-/Ba1 or lower.
Pari or Pari Passu	Meaning debt is equally ranking, so in the case of default, the two tranches of debt are repaid in equal proportion.
PIK	Payment-in-Kind – this feature allows the borrower to pay interest with additional debt, rather than cash. In other words, the interest will accrue on the original loan size, increasing the amount due to be repaid at maturity above the original loan amount.
Private Debt	Debt that is privately placed and cannot be traded on an exchange.
RCF	Revolving credit facility – debt that can be repaid and redrawn up to a specified limit at the borrower’s discretion.
Regulatory Capital	The amount of capital a financial institution needs to hold, as determined by the guidelines imposed by the regulator.
S&P	Standard & Poor’s – one of the main rating agencies who will privately or publicly rate companies and debt instruments.
Second Ranking	Debt that ranks behind another financial instrument. Cash will always go to pay the interest and principal on the first ranking instrument before paying the second ranking instrument.
Senior Debt	Debt that ranks senior to all other financial instruments. This debt will receive all cashflows as a first priority to pay the interest and principal on this debt instrument. NB. beware instruments which rank super senior!
Springing Covenant	A covenant (as defined above) which only becomes binding on the borrower if the revolving credit facility is drawn.
Subordinated Debt	Debt that ranks behind a senior debt tranche. Cash will always go to pay the interest and principal on the senior debt tranche before paying the subordinated debt.
Sub Prime	A loan for which the borrower would not be deemed investment grade, or “prime” in nature.
Tenor	The length or term of a loan or debt instrument.
TLA/TLB	Term Loan A/Term Loan B – loans which rank pari passu, but with different repayment structures depending on investor preference. E.g. Term Loan A may be a revolving line of credit, and Term Loan B a fixed rate for a longer tenor.
Toggle	A toggle instrument is a type of payment-in-kind (PIK) bond in which the issuer has the option to defer an interest payment by agreeing to pay an increased coupon in the future. With toggle notes, all deferred payments must be settled by the bond’s maturity.
Underwritten Deal	A deal is underwritten by a bank when the bank agrees to take on the entire debt piece. The bank may then look to sell all or a proportion of the debt to other counterparties prior to or after settlement.
Wholesale funding market	Wholesale money refers to the large sums of money lent by financial institutions in the money markets. This wholesale banking encompasses the market for tradable securities, such as Treasury bills, commercial paper, bankers’ acceptances, foreign or brokered deposits, certificates of deposit, bills of exchange, repo agreements, federal funds and short-lived mortgage and asset-backed securities.

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