REVOLUTION
ASSET MANAGEMENT

ARE THE RIPPLES BECOMING WAVES?

A closer look at the impacts of inflation on private debt

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With rising global inflationary pressures mounting, a range of factors are converging to create a new inflationary era. From the demand distortions and supply dislocations associated with the COVID-19 pandemic to geopolitical risks, these factors are expected to increase volatility across financial markets in 2022.

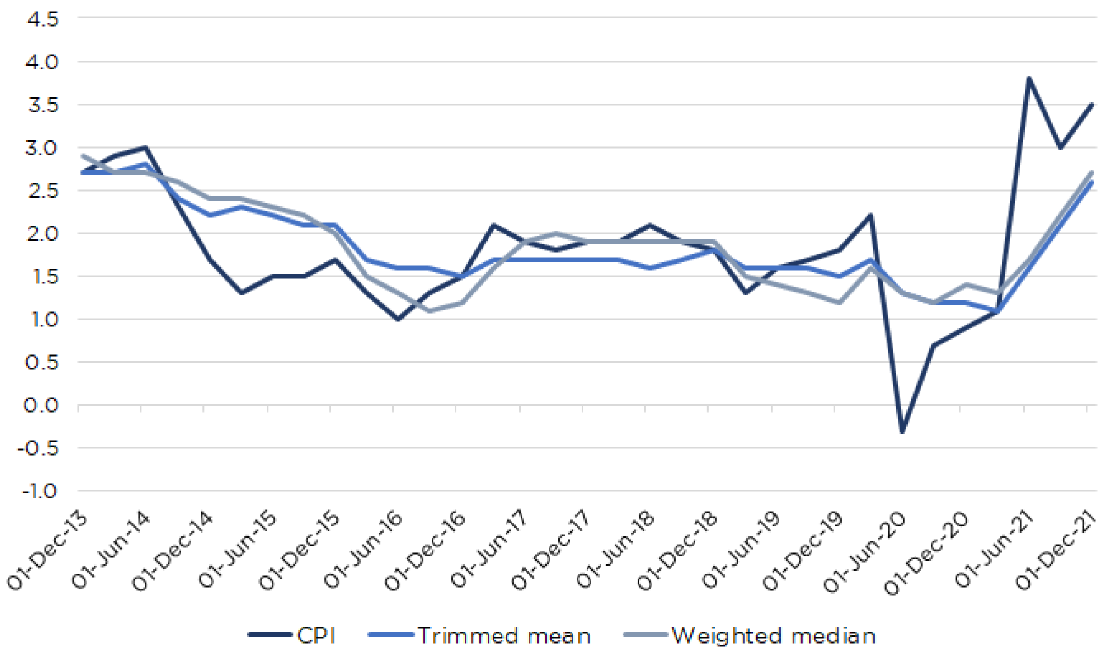
David Saija, Senior Portfolio Manager at Revolution Asset Management provides his insights on the impacts of inflation on private debt for investors as they evaluate the next phase of the economic cycle. Understanding the inflationary outcomes and how they may feed into the global economy will be key to defending investor portfolios.

Australian summers are great. As an island nation, we have over 30,000 kilometres of coastline, which spoils us for choice in terms of visiting some of our lovely beaches as well as the vast array of activities one can engage in such as kayaking, paddle boarding or boating, to name a few.

What does this have to do with inflation?

Well, inflation in Australia has been quite subdued for the best part of the last decade, and up until early 2021, was trending well below the central bank's 2-3% annual inflation target.

Australian Inflation - Annual Movement %



Source: Reserve Bank of Australia.

This can be likened to paddle boarding – occasionally dealing with some ripples from passing boats – sometimes you lose your balance and fall in, but most of the time you're able to deal with the choppiness and remain standing. However, with inflation, more and more ripples are now occuring, with 2021 seeing the inflation rate in Australia increase quite rapidly.

What does this mean from a private debt perspective?

Well, there are a few angles to examine, including the impacts from a portfolio perspective as well as from an individual borrower level. Are these just ripples from passing boats, or are these ripples something to be concerned about and can the paddle boards hold up, or do you need something bigger and better to deal with the inevitable rougher seas?

The Fixed Income Portfolio Perspective

Portfolio construction can be complex at the best of times, let alone when you add an inflationary overlay, where traditional sources of growth (for example, through growth stocks) and income (through fixed rate bonds) can come under pressure. This has seen investors shift to alternative asset classes, with a pronounced shift to private assets, including private debt.

When looking at a fixed income portfolio, it is important to understand how inflation (and interest rates) can impact the broader return achieved by the portfolio. In a traditional fixed income portfolio (containing fixed rate bonds), as inflation and interest rates begin to rise, the fixed coupon on the bonds do not, resulting in the price or the capital value of the underlying bonds actually declining, resulting in capital losses. This is the inverse relationship between fixed rate bond/loan prices and interest rates – as interest rates rise, bond prices fall, and vice versa.

The nature of private debt however, differs from traditional fixed income assets. Being a floating rate asset means the interest is based on a floating interest rate (called the base rate) plus a margin for the term of the underlying loan. This provides protection against inflation, as when interest rates rise, so does the floating base rate, resulting in investors receiving higher income and protecting them from inflation.

In turn, the private debt principal remains protected (price doesn't fall as is the case with traditional bonds) and overall yield actually increases.

Let's demonstrate this principle with an example:

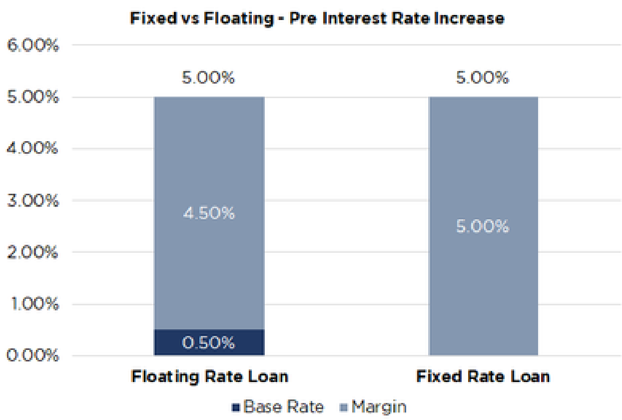
Assume there are two loans – Loan A, a floating rate loan (representing private debt), and Loan B, a fixed rate loan (representing traditional fixed income).

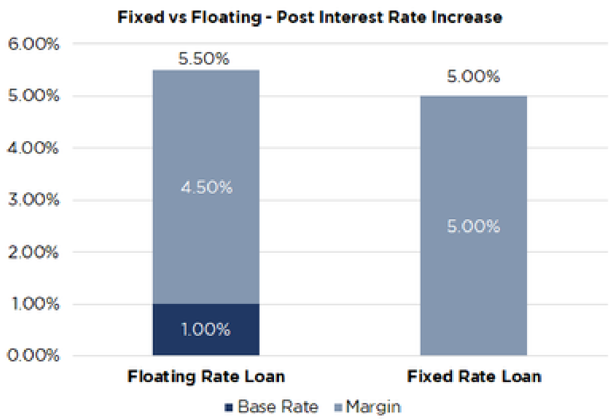
Loan A is priced off a floating base rate, which is currently at 0.5%, plus a margin of 4.5%, resulting in a total interest rate of 5.0%.

Loan B is a fixed rate loan with a fixed interest rate of 5.0%. Both investments initially generate the same interest income of 5%.

If interest rates were to increase by 0.5% (due to higher inflation), the resulting base rate for Loan A would be 1.0% – leading to investors receiving a higher interest income of 5.5% (being the 1% base rate plus the 4.5% margin). Conversely, the interest rate on Loan B remains fixed at 5%, and given the aforementioned inverse relationship between the fixed rate loan price and interest rates, this would also result in a capital value reduction (assuming a 5 year loan – this could be as high as a c.2.5% decline in the capital value!).

Loan A (floating rate) and Loan B (fixed rate) – pre and post interest rate increases





Source: Revolution Asset Management.

"In periods of higher inflation, private debt offers investors protection with the underlying yield increasing as inflation and interest rates increase. This can be seen as a nice thick and wide paddle board, providing stability when seas get a little choppy." David Saija – Senior Portfolio Manager

What is in the Private Debt portfolio? And how will it respond?

While inflationary impacts on a portfolio basis are now well understood, it is important to understand the impacts inflation can have on underlying borrowers. Afterall, a private debt portfolio is comprised of several underlying loans and borrowers. Let's take a look at these key segments and understand how inflation can affect them.

At Revolution Asset Management, the key focus is on three key segments of the market:

- Private company and leveraged buyout debt;
- Real estate debt; and
- Asset Backed Securities (ABS).

Private Company and Leveraged Buyout Debt

When looking at private company and leveraged buyout (LBO) transactions, Revolution focuses on the larger, broadly syndicated transactions, which usually involve top tier private equity firms acquiring large, well-established and market-leading businesses.

There are a number of factors that determine how a particular business can deal with inflationary pressure such as industry, business size and market position, basis of competition and if it has a sustainable competitive advantage, who has the balance of power in terms of relationships with customers and suppliers, the quality and experience of the management team as well as profitability, margins and cash flow generation.

Revolution tends to favour lending to large, well-established businesses in stable, non-cyclical industries, that hold a leading market position, with a strong and experienced management team, strong profitability with stable margins and solid cash flows.

These factors all work together to ensure that cash flows remain as stable as possible with minimal volatility, noting that volatile cash flows could significantly impact liquidity and adversely affect their ability to service outstanding debt. So, this naturally leads us to favour industries that tend to be more stable, such as healthcare, mission-critical software and consumer staples.

These types of businesses and industries are generally better able to control input costs, while demand drivers also tend to be quite stable given the importance of the products/services offered with demand also being rather inelastic. This last point is quite important, as this allows businesses that do see input cost pressure to increase their sale prices without a corresponding decrease in volumes, ceteris paribus, allowing revenue to increase to offset any cost pressures, and keeping profitability, margins and cash flows in check.

Business size and market position are also important factors to consider. Larger businesses usually have a longer track record, with a well-established and diversified client base as well as deeper, stronger, and more sophisticated management teams allowing them to better control their margins and cash flows.

This is also why Revolution favours lending to businesses with strong market positions – the barriers to entry make it difficult for competitors to enter the market while their dominant position provides them with more flexibility to manage their top line and cost base.

The basis of competition and having a sustainable competitive advantage are also key to managing inflationary impacts. If the business is one that competes predominantly on price (that is, the service or product offered is largely homogenous), it may become difficult for them to pass on price increases as less levered competitors, or those with different cost base compositions, would have more flexibility.

Similarly, who holds the balance of power in a relationship can also play a role in protecting against inflation. Imagine the situation where the borrower is a small or medium-sized business and its major suppliers and customers are very large and powerful businesses. There is the potential for the supplier to increase prices, while the customer refuses to accept the increase and threatens to take its business to a competitor. The balance of power clearly lies with the suppliers and customers, resulting in the potential for margins to get squeezed, and highlighting the absence or weakness of a competitive advantage.

While these reasons are critical to business in managing inflationary pressures, they also highlight why Revolution focuses on larger, broadly syndicated deals rather than smaller bilateral loans.

Larger businesses are generally important (in terms of their role in the industry - providing employment as well broader economic contribution) and have very long track records with established customers contributing to their strong profitability and cash flow generation. Contrast that to a small and medium-sized enterprise that is smaller in size, may not have a long history, will likely see weaker barriers to entry and consequently weaker profitability and more volatile cash flows. A very different proposition indeed, highlighting the fact that not all private debt transactions are created equally.

An example best demonstrates how these aforementioned factors contribute to a business's ability to deal with inflationary pressure.

Consider a business that creates mission-critical software. This could be accounting software, or legal or healthcare practice management software. This software is critical to overall business management and the annual cost is typically only very small relative to its total cost base. Furthermore, prices for subscriptions to these applications commonly increase in the order of 3-5% p.a., allowing its top line to grow annually, ceteris paribus. The overall importance of this software, coupled with its relatively low cost, results in clients being willing and able to pay, resulting in demand generally being inelastic. These are the types of businesses that tend to meet Revolution’s strict investment criteria, as they have strong barriers to entry, an entrenched client base that has very high switching costs, and demand which is relatively inelastic, resulting in stable profitability and cash flows.

These types of business will find that they are better able to navigate inflationary pressures than those that are lacking one or more of the key attributes highlighted.

In summary, there are many factors involved in determining how well a business is able to handle inflationary pressures that require an extensive amount of due diligence to ensure the business is in a strong position to navigate a volatile economic environment. Stability is what we look for at Revolution, and having a strong business that scores highly in the factors mentioned above will ensure demand, profitability and cash flows will remain sound, regardless of the economic climate.

Revolution bases its lending decisions on cash flow, rather than the real estate value, or in some cases, the “expected” value of an asset. When looking at commercial real estate lending, it is important to understand the underlying cash flows the property generates. Specifically, commercial real estate leases include protection through lease escalations, which is the greater of the Consumer Price Index (CPI) or a fixed percentage, say, 3-4%. This means that the contracted cash flows are guaranteed to increase by at least CPI each year, providing protection against inflation.

The Revolution investment philosophy is based on old-fashioned credit analysis where the cashflows from the underlying leases form the basis of the investment decision, with the asset value (in terms of being able to sell the asset to recover any outstanding debt) being secondary in nature.

Real Estate Debt

When it comes to real estate, Revolution has a very clear definition of what fits within the investment strategy. It does not include residential, construction or any kind of development project. The types of real estate assets that Revolution seeks to fund include retail, industrial and office assets, with high quality tenants that generate a recurring cash flow and income stream to the asset owner.

Using a retail asset as an example, Revolution requires strong anchor tenants such as Coles or Woolworths, with long leases in place that not only generate a stable cash flow, but also draw foot traffic to the centre.

These types of deals appeal to Revolution – good quality commercial real estate with a strong tenant base generating stable inflation-adjusted cash flows.

Contrast the above to other types of real estate debt that are often marketed under the label of private debt, perhaps lending to a property developer to construct residential apartments. There are no existing tenants generating a stable inflation-adjusted cash flow to repay the loan (the building hasn’t even been built yet!). In this case, lenders would be lending on the basis that the apartments would be sold and the proceeds would repay the loan.

What happens when inflation and interest rates start to rise?

This can be examined from two sides – what happens to demand for these apartments and what happens to the building costs for the developer?

In general terms, rising interest rates results in individuals experiencing a reduction in the amount they can borrow (due to serviceability constraints), resulting in the residential property market slowing and prices softening. This makes it more difficult for people to commit to off the plan purchases as their borrowing capacity will reduce as rates increase.

At the same time, you have the property developer facing higher building and labour costs as well as having to pay a higher interest rate on the loan they have taken out to build the apartments, limiting their propensity to pay the higher costs. Here, the borrower (property developer) could come under pressure as demand for property softens while at the same time facing higher costs, resulting in margins being squeezed. Inflation has the potential to materially weaken the borrower, while the underlying collateral could experience value declines. Will lenders in this situation get their money back? Possibly, but a lot will depend on just how much inflation affects the borrower as well as the value that was assigned to the unbuilt apartments.

Asset Backed Securities

Revolution occupies a critical place in the Asset Backed Securities (ABS) market where it is one of the largest, out of only a few players in the market, that can invest in pre-term warehouses.

Revolution's capabilities span multiple sub-segments of the ABS market and include mortgages, consumer (such as credit cards and personal loans) as well as vehicle finance across Australia and New Zealand. These warehouses generate cash flows from the underlying pool of loans which generally provide security over the underlying assets being funded in the pool. The underlying loans within ABS pools can be either fixed or floating, with mortgages typically being floating while consumer and auto loans are fixed. Looking at the underlying loans that form these pools, it is important to understand how these fixed and floating rates can impact the borrower, the cash flows and the key credit metrics within the pools.

Starting with mortgages, which are largely floating rate, the return and cash flows generated by the pool increases as inflation and rates increase. This, however, also means that the underlying borrowers in the pool are having to pay higher interest costs as rates increase. It should be noted that when a typical mortgage is taken out, the borrower is assessed on borrowing costs that are up to 3% higher than prevailing market rates, providing a serviceability buffer which should allow borrowers to absorb the higher interest rates.

Additionally, the Reserve Bank of Australia has publicly stated that it is looking for sustained increases in wage growth before looking to increase the overnight cash rate. This results in underlying borrowers being better positioned to absorb the higher interest costs, while the pool generates higher cash flows for the noteholders.

With auto and consumer loans, which are typically fixed rate loans, the return and cash flows generated by the underlying loans will not increase as inflation and rates increase.

This means that the cashflows from the pool will not increase with inflation and higher interest rates, but it also means that the underlying borrower will not face the additional burden of higher interest costs, preserving their overall creditworthiness.

However, the notes that are backed by the pool are floating rate in nature, resulting in investors such as Revolution receiving a floating interest rate (that increases as inflation and interest rates increase), while the underlying borrowers do not face the added burden of higher interest rates.

The use of derivatives allows these non-bank originators to immunise the pool from a mismatch in the fixed rate they are receiving and the floating rate they are paying. Importantly however, investors in these types of securities receive a floating interest rate, protecting them from higher inflation.

What about Covenants?

Covenants are restrictions imposed on borrowers with the most common type of covenants being financial covenants, which impose financial restrictions on the borrower. Covenants are designed to offer a degree of protection for lenders and usually take the form of the borrower having to comply with some sort of ratio such as maintaining interest coverage (EBITDA/interest expenses) above a certain level or ensuring that leverage (Debt/EBITDA) remains below a certain level.

Covenants must be complied with by the borrower, or they can trigger a breach of the covenant and an event of default, enabling the lender to demand full repayment of the loan.

How these financial covenants are impacted by inflation is a key consideration. One of the key ratios to be affected is the interest coverage ratio, or ICR. This ratio measures how many times the interest cost is covered by EBITDA, with a higher ICR being preferred to a lower ICR. With private debt being a largely floating rate asset class, as described above, there is the situation where, as inflation and interest rates rise, interest costs will also increase, resulting in the ICR metric declining. This would certainly be the case for smaller and weaker businesses that haven't scored too highly in the factors discussed above.

We see these businesses as riding thin and narrow paddle boards – the type that can easily topple when the slightest of ripples appear on the surface. However, for strong businesses that scored highly in the aforementioned factors, they will likely see EBITDA (the numerator in the ICR calculation) increase at the same time as interest costs are increasing, usually resulting in the ICR remaining strong.

Conclusion

Globally, inflation has started to increase and financial market participants have been left to ponder the implications for portfolios, having come from a very long period devoid of inflation. Will it be just another passing boat, or will the ripples become waves and cause instability?

That depends on the vessel you are riding. At Revolution, we believe we are firmly steering our boat – remaining stable in choppy seas and importantly, staying on course to navigate the way and consistently delivering client value. With private debt being a floating rate asset class, it means that the portfolio yield will increase as inflation and interest rates rise, with the rising tide lifting all (floating rate) boats.

However, there are many things to take into consideration within each sub segment of private debt, all of which provide their own protection against inflation.

What is critical however, is the due diligence that is conducted to ensure loans are only advanced to strong, stable, dominant businesses/assets with strong management teams and barriers to entry, and stable cash flows, regardless of the cycle. The real question that needs to be addressed this year and beyond is: "How stable is the vessel you are riding, and can you deal with the rough sea when it inevitably arrives to reach your end destination with a pleasant journey along the way?"

For more information

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