MIND THE GAP

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The term "funding gap" must be one of the most popular to be found in asset managers' marketing presentations, especially since the global financial crisis. The opportunity to supply capital where there is less competition is intuitively appealing, but investors should heed the warning they announce on the London Underground to "mind the gap". Funding gaps, like the gaps between the trains and the platform, both open and close, and now is the time for asset managers marketing presentations to become far more specific in their use of the term.

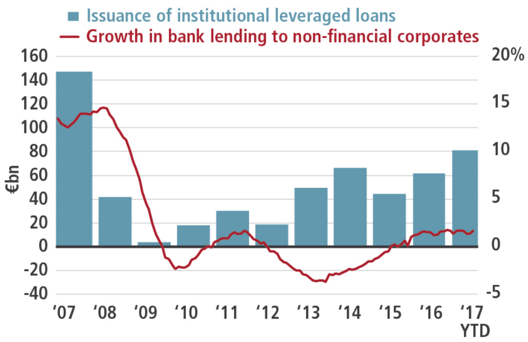
In the aftermath of the financial crisis, banks did retrench from lending in many sectors, initially as they focused on bolstering capital, and subsequently as they adjusted to a wave of re-regulation. This provided opportunities for asset managers to raise capital to make private loans. The sweet spot was private corporate credit, where investor familiarity and lower barriers to entry made both raising and deploying capital easier. Very few asset managers sought to recreate a bank-type network of lending offices, given they could simply pick up the phone to their friends at private equity firms and offer to finance their deals, quickly, flexibly and competitively.

Contrast that with the real estate and consumer finance sectors. The fact that they had been at the epicenter of the crisis deterred many investors, while accessing mortgage or consumer loan originations forces asset managers to take on operational complexity and regulatory compliance. As a result, funding gaps in these sectors are closing far more slowly than in corporate lending, where banks resumed growing their lending books several years ago.

With these traditional sources of funding for companies wide open, and the first half of 2017 representing a record year of fund raising for European corporate direct lending funds*, it is now hard to justify the use of the term funding gap. Quite the opposite, it is unquestionably a borrowers' market. Leverage is rising, covenants are eroding and earnings adjustments proliferating, all while lending margins compress.

Under pressure to deploy the capital they have raised, private corporate debt managers are typically responding by taking greater risk, shifting lower in the capital structure, either by selling on less risky senior tranches or taking on more equity type risk, whether explicitly through preferred equity or implicitly through mezzanine debt.

INCREASED LENDING TO EUROPEAN COMPANIES BY BOTH BANKS AND INSTITUTIONAL INVESTORS



Source: ECB/Haver Analytics, S&P LCD

TIME FOR A CONTRARIAN APPROACH

Perhaps it is time to think contrarian thoughts in corporate credit? Distressed and special situation investing is the ultimate form of value investing, but disciplined scale and patient deployment is key when the absolute cost of borrowing and thereby defaults remain low. It probably doesn't count as contrarian but, when it is cheap to borrow, borrow. Now is a fine time to lock in low cost liabilities in a collateralized loan obligation (CLO), creating a valuable long-dated option to reinvest if asset spreads widen, but to pivot to debt tranches if expectations of defaults rise. Those options will prove especially valuable in navigating any turn in the credit cycle.

Away from corporate credit, the traditional bank and insurance lenders have firmly rediscovered their appetite for commercial real estate debt. Lending against fully refurbished and leased, well located properties that are described as "core" certainly sounds low risk, but sadly offers commensurately low yields. But with added complexity in the form of elements of vacancy, development, tenant profile or secondary locations, which often fail to conform to rigid underwriting templates, competition to lend thins out rapidly. At the same time, those borrowers tend to be focused on securing financing that facilitates their strategy to add value to a property, hence lending margins can be achievable that are often attractive versus the economic risk.

That raises another contrarian thought, embrace complexity. Complexity is often a superior compass for locating premium returns than illiquidity ("illiquidity premium" being perhaps the second most popular term in private debt marketing!). Banks are expert at packaging complex loan pools into simple, rated securities, with just enough incremental yield to find buyers. But as those securities season, exposures become more concentrated and potential price paths more dispersed. Faced with greater uncertainty and/or hands-on management they frequently look to sell at steep discounts. Essentially, the previously suppressed complexity premium re-expands.

Navigating the later stages of the credit cycle is neither simple nor easy. Sitting in cash has an absolute as well as an opportunity cost for many European investors, and while PIMCO's most recent cyclical outlook is titled "As Good As it Gets", it could stay good for a while longer. In the meantime, we suggest focusing on sectors with barriers to entry, on sub-sectors with less competitive dynamics, on securities where complexity is already exposed and on strategies designed for flexibility. When the London Underground platforms become crowded, it's often better to head above ground, take a breath of fresh air and traverse the UK's capital nimbly on foot.

AVOIDING THE CROWDS

LOW RISK ← risk spectrum → HIGHER RISK

Trade finance	Specialty finance	Mezzanine corporate loans	Rescue finance
Collateralized Loan Obligation (CLO) debt	Direct corporate loans`	Regulatory capital relief	Distressed
Core Commercial Real Estate (CRE) Loans	Non-conforming residential mortgage loans	Value-add Commercial Real Estate (CRE) loans	Mezzanine Commercial Real Estate (CRE) loans
Infrastructure loans	Seasoned loan pool securities	Consumer finance	Collateralized Loan Obligation (CLO) Equity

Colour coding Crowded Medium Uncrowded

SOURCE: PIMCO. As of 30 September 2017.

**Deloitte Alternative Lender Deal Tracker Q2 2017*

PIMCO