Blain's Alternative Asset Outlook

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STOCK MARKET MELTDOWN! BOND MARKET CATACLYSM!


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October through November gave us perfect headlines to support the "Alternative Assets" thesis… Bond and Equities tumbled as markets wobbled. Off-market investments offering broader, stable, more effective, better aligned risk, diversified and uncorrelated investment returns performed best. Listed bond and stock markets are proving less transparent and suffer chronic illiquidity following the distortions of QE and the breakdown of traditional market making due to regulatory overkill….

Welcome to this first **Alternative Asset Monthly** from **Shard Capital**.

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ALTERNATIVES –TIME FOR SOMETHING NEW?


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> ***a market isn't a market until someone has been hurt.***

Recent research and market polling states Alternatives and Private equity are the most popular asset classes fund manager seek exposure to. Secured Real Assets offering "dull, boring, predictable" returns are at the top of fund managers' Christmas wish lists. More and more managers are looking for suitable off-grid deals and funds to boost returns and stabilise returns.

Investors realise they can't survive on volatile listed stocks distorted by QE and buy-backs, or a corporate bond market where downgrade threats, decreased covenant protection, and rising fundamental risk don't produce returns to justify the investment.

Just a few years ago most mainstream funds would not look at unrated debt, non-listed stocks, or cash flow secured deals. Now, most large investment groups have teams looking at stuff that's "different": private placements, direct lending, club deals, venture capital, and anything else that goes into the "special situations" bucket..

On the other hand, a market isn't a market until someone has been hurt. Bloomberg is warning about the limited illiquidity of direct lending deals. A major credit fund was trounced by illiquid alternative assets and forced into a summer fire-sale to cover nervous investor redemptions.

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Doubts have been expressed about just how diligent non-bank investment teams can be analysing new unfamiliar asset classes. The risk transfer from banks to non-banks since 2008 is seen as weakness by many market pundits. Critics warn benchmarking doesn't work when there is nothing to benchmark against. Compliance officers don't like Alternatives because they don't fit convenient investment checklists. Investment committees don't like stuff they can't immediately understand.

Many investors are still struggling to invest – looking for deals that look, smell and feel like Alternative Assets, but can be booked and invested in as if they were standard listed security transactions. Some are choosing funds, letting others handle the management issues. Others look for deals that have been sliced and diced into recognisable equity, mezz, junior and senior debt – which doesn't always suit the deal!

The bottom line is Alternatives are Alternative – they won't perform like safe bonds or volatile equity, and they don't come neatly wrapped as listed securities. There is no point trying to squeeze square deals into round transaction buckets. They require imagination, knowledge, expertise and diligence to understand and fully value. As such, the Alternative sector is a perfect asset class for the new Age of Rational Investment we believe is coming.

SHARD CAPITAL IN THE ALTERNATIVES SECTOR

We've got ideas to address in the Alternatives sector:

- How can we make the alternative sector more open, transparent and investible?
- What kind of alternative assets are we working on?
- What service can we offer clients?

As yet, there is no standardised definition of an "Alternative Asset".

We'd include anything that's non-standard, including private equity, venture capital and debt, infrastructure and transport financing, direct lending and private placements of debt, quasi-equity and equity – anything in the "Special Situations" space.

If it's not conventionally listed – it counts. We aren't concerned if it's rated or not – some say ratings are just expensive opinions given by analysts with no real financial stake in the deal!

"Typically, we like deals that are structured on the back of predictable cash flows from leases or contracts."

Alternatives: Due Dilligence, Openness, Transparency and Liquidity

No investor should assume an Alternative Investment is going to be liquid. There is always a price – but that doesn't mean complex assets can only be sold at distressed levels.

A major fund discovered through the summer that alternative investments can prove extremely illiquid. It doesn't help when the assets are difficult to define, the underlying covenants are unclear or difficult to set out, due diligence is difficult to complete, and the deals look generally "murky".

Structuring deals in a clear manner, ensuring supporting information and evidence is clear, available and independent, and documenting deals clearly not only improves the likelihood of closure, but can promote their future re-saleability.

On issue is the lack of market momentum. The graduates with 3-5 years experience on the execution desks of major investment firms often lack the expertise, ambition or knowledge to sell complex deals – preferring to focus on listed product their compliance officers can get comfortable with because its "UCITS", "MiFID", and generally "EBSD" compliant.

Here at Shard Capital, our teams have the expertise and market tenure to clearly explain and market complex deals, and the experience to market them to relationship clients across the developing alternative investment biosphere. This enables us not only to place new deals, but create liquidity across assets thought to be unsellable. There is always a price – and it doesn't need to be a bad one.

There is a dearth of freely available information on what is going on across the Alternatives Sector – it's a staggeringly large market covering multiple asset classes and commercial sectors. Many issuers want deals kept under the radar (so as not to compromise themselves by revealing business plans), while a large number of the deals never get to market.

We're hoping to be able to set out more deals in broad context, and to broaden knowledge of the market, we invite our partners and colleagues in the Alternatives Sector to provide information and copy for this Monthly Alternative Outlook.

Deals we're working on:

Typically, we like deals that are structured on the back of predictable cash flows from leases or contracts. Deals don't come to market until they've been tested and back-tested – and can be justified in terms of contracts, supply and demand, IP and the many other factors required.

At the moment we're looking at potential deals in Shipping, Aviation, Renewables (Waste-to-Energy), Agribusiness, Property Development, Affordable Residential Property initiatives, plus we're always marketing our own funds; Shard Credit Partners (which provides alternative finance to SMEs) and Suir Valley Ventures (which invests in early stage tech companies).

We're looking for new deals in commercial logistical property, aviation and direct corporate lending (private placements and direct lending!)

DECEMBER FOCUS: AVIATION

The past few years has seen a renaissance in aircraft financing. The Fed, the Bank of England and the ECB kept interest rates artificially low through Quantitative Easing, while smart investors realised aircraft were real assets (just like mortgages, houses and car loans), producing attractively dull, boring, predictable and less risky real returns than bond markets.

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What's not to like about aircraft when demand is rising in line with the expanding global middle class who want to travel and the continued expansion of global commerce? Or that planes remain in short-supply as manufacturers delivery times lengthen? (On the downside: a single aircraft is a very expensive depreciating asset which conventional structured finance professionals dismiss as "lacking granularity".)

But even as single discrete asset, a single aircraft carries a host of financing possibilities through its life time. Typically they are bought directly by airlines, or by leasing companies who then rent them to airlines. When first launched a planes requires the payment to the manufacturer which may be met through a mix of senior debt, mezz, and equity.

It's not usual for aircraft to be sold a number of times through their lives, raising further financing opportunities. Repayments on debt can be financed from lease payments or directly from the aircraft/airline's revenue streams. Even when they've flown for the last time, aircraft provide income from recycling and reusing parts and engines can prove surprisingly valuable.

> ***"It's not usual for aircraft to be sold a number of times through their lives, raising further financing opportunities."***

Non-bank financial firms like insurance companies, pension and hedge funds have become increasingly keen to replace banks as "direct lenders" into the Aviation space. As new post crisis regulations meant banks became less able to lend, and these new non-bank direct lenders took the opportunity to replace them. New lenders have piled into aircraft back senior debt, mezz and equity – perhaps not always understanding all the underlying risks and details of the market. Senior aviation debt has tightened dramatically.

Now the Fed is hiking rates and bond market yields are increasing. The yield on corporate bonds issued by well know names look relatively more attractive. Investors are starting to worry about how liquid their aviation assets might be, and just how risky they might be. Some are starting to worry about what they've bought and own.

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The travails of the A380 Super-Jumbo put some of these issues into perspective. Expectations the Airbus Superjumbo would prove a highly desirable second-hand mid-life asset have proved… "optimistic" meaning aircraft aren't being sold and re-leased to repay early investors. The glib assumptions made 10-years ago about future values look embarrassing now. Early investors in some deals are likely to find they'll only get a portion of their principal back.

However, even A380 deals are cash positive – through the life of the deals investors have received regular coupon payments and even if the final project values are lower, investors in these "bad" deals will still get a sizable portion of their redemption back.

I have no idea how aircraft fly, but the cashflows underling them are predictable and therefore financeable. It all depends on the quality and availability of the information to fully analyse and price the risk accordingly.


Photo credit: Depositphotos

"Expectations the Airbus Superjumbo would prove a highly desirable second-hand mid-life asset have proved… "optimistic""

There are four main risks:

1. The **Credit Risk** in aviation is the underlying user of the plane. How likely are they to keep up the payments on using it? Credit analysis is a well established market discipline guiding investors on who is likely to be around and making payments over the life of any loan. There is always going to be long-term lending risk when the health of airlines is correlated to factors like oil prices, growth and prosperity. Oil prices – and not just what Saudi is doing – are always a factor.

2. The **Structure Risk** of the deal – how well it's been constructed, and the cashflows defined and captured, segregated and overseen to make sure investors receive their principal and interest is critical. Most deals are well-established and documented – but they need checked!

3. The third and most unfamiliar risk is the **Metal Risk –** what will a plane be worth when it's time to refinance or if the airline using it goes bust? Investors need to question everything an aircraft owner says to justify the asset it's trying to finance. There are lots of positives to emphasise about superjumbos, mid-life widebodies, freighters or part-outs, but investors have to be diligent, persistent and demand answers to questions about the negatives. Understanding what happens and how long payments can be delayed following an airline default is critical.

4. A final risk is **liquidity**. Aviation assets are never going to trade like liquid stocks. It's a negotiated market. They don't need to be buy-and-hold to maturity, but if investors need to sell Aviation assets, they need to exhibit patience to achieve the best price.

There are further risk concerns to layer on top – for instance the lack of transparency about aircraft values when much of what happens (and is traded) across the aviation industry remains obscure. Valuation agents can provide good guidance, but I've heard more than one investor worried about the glib assumptions that aircraft can be sold at the end of their leases to repay principal as akin to a Ponzi scheme. They are wrong, but the need to understand exactly how deals work, and where assets are pricing, is paramount.

At the moment we're working on a number of aviation deals and can show a number of possible aviation-linked investments yielding between 6.5-10% on various aviation assets. Call for a chat to discuss.

Best regards,

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