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Searching for yield – a role for junior capital

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The search for yield has always been a focal point of the fixed income investor, but today's investors must look far and wide to find it. U.S. 10-year Treasuries have not seen the top side of 4.0% since the end of the global financial crisis and are currently priced to yield less than 2.0%. While the Federal Reserve has indicated that it may begin tapering its quantitative easing program later this year, it is our expectation that long-term U.S. Treasury yields will remain low by historical standards.

In this paper, we consider the characteristics of private subordinated capital – commonly referred to as junior capital – which could help investors in their search for yield.

As few investors are familiar with the specifics of junior capital, they can perhaps be best understood by discussing some of the similarities and differences with high yield (HY) bonds, which are often favored by investors in low-yielding markets.

HIGH YIELD BONDS

Unlike junior capital, HY bonds are well-known to most investors. They are publicly traded investments, covering a large opportunity set – in 2020, approximately \$440 billion of HY bonds were issued¹. They are non-investment grade, fixed-rate, public debt securities, offering higher return potential compared with investment grade debt, albeit with higher default risk. Historically, HY portfolios have returned between 6.0% and 7.0%², which is a marked premium over other liquid fixed income alternatives. Two factors have mainly driven this performance: 1) the lower credit quality (and therefore higher yield) compared to investment grade debt, and 2) their usual subordination in the capital structure to other, more senior debt.

JUNIOR CAPITAL

Junior capital also offers opportunities to enhance yield, but it differs from HY in a number of ways. It can take on multiple variations such as subordinated notes (fixed rate) and second lien term loans (floating rate), but they all share a few underlying characteristics: 1) subordination or junior in right of payment to a senior secured term loan as part of a capital structure used by a private equity firm in a leveraged buyout, 2) most commonly, return is all or mostly cash pay with a small paid-in-kind element and 3) average all-in pricing is between 10.0% and 12.0%.³

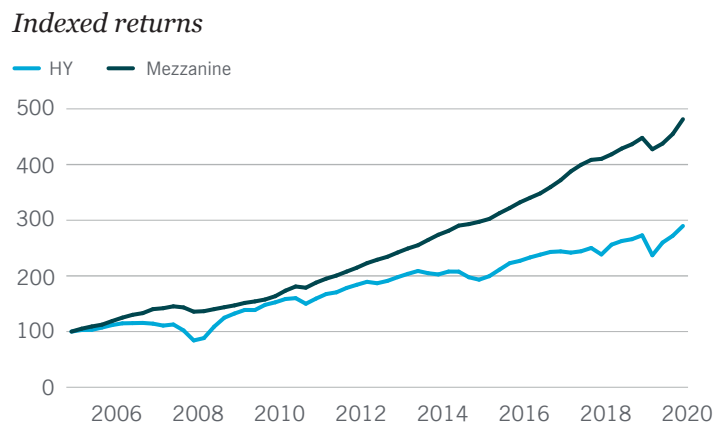
RISK-ADJUSTED RETURNS

Junior capital has the potential for higher returns than HY. Over the last ten years, average annual returns for junior capital have been almost double those of HY, at 11.0% and 6.4%, respectively.⁴ Returns were superior even when incorporating the global financial crisis into the analysis. Over the last 15 years, average annual returns for junior capital and HY were 11.0% and 7.3%, respectively.⁴ The difference is consistent, meaningful and can be explained by several factors:

1. **Size:** HY bonds occupy a higher end of the market than junior capital – typically EBITDA of \$50 million and above. Larger businesses are generally regarded as safer, more stable platforms, so a size discount is incorporated into HY returns. Junior capital often occupies the part of the market for borrowers under \$50 million of EBITDA and is priced with more risk. However, we believe that risk can be mitigated with superior access to information, as we discuss in the next section.
2. **Liquidity:** HY bond investors reap the benefits of investing in public securities, namely a high level of liquidity and the ability to be a short- or long-term investor. Junior capital investors are compensated for illiquidity with higher yield but must be committed to a longer-term investment strategy (typically three to five years of duration).

3. **Market dynamics:** As public securities, HY bonds are traded and priced with a high degree of transparency. Information is available to all participants in the marketplace which establishes a price equilibrium among buyers and sellers of the notes. Alternatively, junior capital is issued in a private, imperfect marketplace with transactions between one buyer and one seller. While providers of junior capital financing must contend with the threat of competitive pressure from other lenders, pricing is determined more by negotiation than the dynamic pricing of public markets.
4. **Equity enhancement:** In some cases, junior capital investors receive strips of common equity alongside their debt investments, which, if chosen carefully, can boost returns.

Figure 1: Comparing returns



Source: ICE BofA US High Yield Index Total Return Index and Refinitiv Eikon – Cambridge Associates Database of Private Subordinated Capital Funds

The return spread between junior capital and HY becomes even more interesting when adjusted for risk. We can examine relative risk by using return volatility as a proxy. The table below shows the Sharpe ratio calculated for both HY and junior capital. The Sharpe ratio measures risk-adjusted return; essentially, the ratio of return over a period of time to volatility. A higher ratio implies greater risk-adjusted return. From March 31, 2006 to December 31, 2020, we calculated a junior capital Sharpe ratio of 2.50 vs. a HY Sharpe ratio of 0.55. The implication of Figure 2’s data is that junior capital offers higher relative returns per unit of risk.

Figure 2 – Comparing risk-adjusted returns

Risk and return metrics

	Junior capital	HY bonds
Annualized return	11.0%	7.3%
Annualized excess return	10.0%	6.3%
Annualized excess standard deviation	4.0%	11.4%
Sharpe ratio	2.50	0.55

Source: ICE BofA US High Yield Index Total Return Index and Refinitiv Eikon – Cambridge Associates Database of Private Subordinated Capital Funds. Returns from 1Q 2006 to 4Q 2020.

Note: Returns are calculated on a quarterly basis for both Junior Capital and HY Bond metrics

As discussed above, because HY bonds are fixed-rate securities trading in a public marketplace, these assets are subject to daily price movement. The most influential variable is credit spread volatility but other factors also contribute to price fluctuations, such as interest rate volatility. Junior capital’s exposure to these risk factors is very different. As it is an illiquid asset, junior capital is rarely traded. Its value is not subject to daily fluctuations of interest rates or of the supply-and-demand pressures of a public market. It is a buy-and-hold security, the value of which is determined almost entirely by the underlying credit quality of the borrower.

AN INFORMATION ADVANTAGE

This brings us to the heart of the matter. Junior capital lenders enjoy one more key advantage: quality of information.

A properly staffed and resourced junior capital lending team can gain an edge through the quality and scope of the information they can access. By definition, publicly traded securities are required by regulation to make their financial information uniformly available to the public. On the other hand, junior capital lenders can benefit from direct access to borrowers in a private marketplace. And our experience suggests that this information advantage can perhaps be the critical edge that private lending teams can use to excel. Rather than relying solely on pre-prepared marketing documents, lenders complete a deep dive into borrower data, financials, key business model drivers and customer trends based on proprietary diligence requests. They receive one-on-one calls with management addressing diligence criteria, including detailed financial projections. Often, the lender is working alongside the private equity sponsor and can leverage the full scope of its buy-side diligence. This access to information typically allows for more informed decision making. And it does not stop with underwriting. Junior capital lenders remain in the data flow throughout the duration of the investment, with frequent calls with management or even board observation rights. Furthermore, junior capital lenders almost always receive financial covenants on their investments. Typically, these are in the form of a leverage covenant. These guardrails on company performance provide lenders with leverage against borrowers if financials turn soft.



Junior capital offers higher relative returns per unit of risk, according to our analysis

CONCLUSION

Fixed income investors who are comfortable with illiquid securities and a medium-term investment horizon should consider junior capital. Our analysis shows that, historically, junior capital has offered a premium to reflect these risk exposures, rewarding investors able and willing to exploit the asset class' structural market and information advantages. A well-constructed portfolio can generate significant annual returns with minimal losses.

Choosing the right partner is important – the junior capital market is large with many participants, and despite its overall stability, pitfalls await the undiscerning lender. Constructing a portfolio is an active process that requires product and market expertise, as well as strong and tenured relationships with borrowers. A quality manager should have a track record that is extensive, durable and accessible. However, with the right manager, junior capital can play a very important role in the search for yield.

What to look for in a junior capital manager:

- Product and market expertise
- Strong and tenured relationships with borrowers
- Extensive, durable and accessible track record

For more information, please visit our website, nuveen.com/churchill.

Endnotes

- 1 Source: S&P Global Leveraged Commentary & Data
- 2 Source: ICE BofA US High Yield Index Total Return Index as of December 31, 2020
- 3 Source: Churchill portfolio, 2013 to present
- 4 Source: ICE BofA US High Yield Index Total Return Index and Refinitiv Eikon – Cambridge Associates Database of Private Subordinated Capital Funds as of December 31, 2020

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A word on risk

Junior capital investments are subject to certain risks. Please consider all risks carefully prior to investing in any particular strategy. These investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk. Market forecasts are subject to uncertainty and may change based on varying market condition, political, and economic developments.

Investments in below investment grade or **high yield securities** are subject to liquidity risk and heightened credit risk.