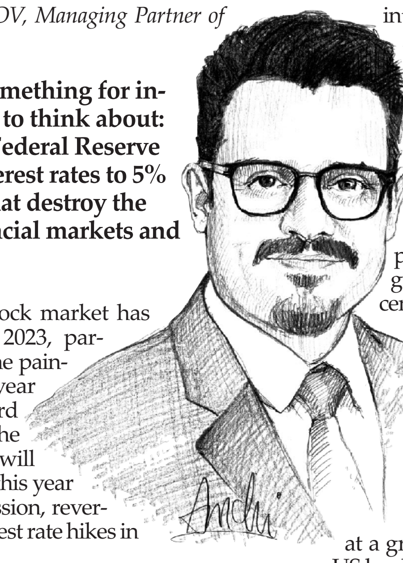
Would the markets afford interest rates of 5% and how investment funds are financing the lack of investors?

By Ivaylo MARKOV, Managing Partner of Thales Capital



Here's something for investors to think about: as the Federal Reserve (Fed) raises interest rates to 5% or more, will that destroy the economy, financial markets and stock prices?

The American stock market has revived to start 2023, parlaying much of the painful losses of a year ago. The upward tone is tied to the view that the Fed will need to cut rates this year to prevent a recession, reversing one of its fastest rate hikes in history to day.

Investors who warn of the coming of the "Doomsday", including hedge fund billionaire Paul Singer, have long spoken of this outcome. Singer believes that a credit pizza and a deep recession may be necessary to clear dangerous levels of froth in the markets after an era of near-zero interest rates. Another scenario could be one of little change: credit markets could tolerate the interest rates that prevailed before 2008. The Federal Reserve's interest rate could rise a bit from its current range of 5% and stay there for a while.

"An interest rate of 5% is not going to break the bank," said Ben Sneider, managing director and U.S. portfolio manager at Goldman Sachs Asset Management, in a telephone interview for MarketWatch. Sneider has seen many mortgage companies that, like most U.S. homebuilders, have taken on debt during the pandemic, reducing spending and borrowed to almost overnight low levels. "They continue to fall on the wrong side," he said.

The profit margin is in focus

"Yes, the Fed can hold the funds," Snaider said. "The economy can continue to contract." The Fed and other global central banks have virtually raised interest rates since the pandemic to fight inflation caused by tighter demand for goods and services, a reason for hatching policies of public authorities.

Fed Board Member Christopher Waller predicted at the end of the appeal that he could force interest rates to rise even more than savings currently expect, to limit the cost of living as measured by the consumer price index, at 5% annually, as per March figures, above the usual annual target of the central bank of 2%.

The sudden increase in interest rates has led to significant losses in stock and bond portfolios through 2022. Higher interest rates also affected the fields in the Silicon Valley Bank two months ago, since the bank has sold safe but interest-rate-sensitive bonds at a great loss. This has caused problems in the US banking system and potential credit losses.

"The interest rate is higher than it was a year ago and higher than it has been in the last decade," said David Del Vecchio, co-head of the corporate bonds team at PIMG Fixed Income in the US. "But if you look at longer periods of time, they don't make that much noise.

"When investors buy corporate bonds, they accept to concentrate on the potential weak link in whole equation and see what they can do to prevent the total loss of their investment, including the coupon. For this purpose, Del Vecchio's team sees corporate loan sources to be used on a longer term, inflation is expected to remain above target, but there are also encouraging signs that many inflation-targeting companies will start from the target position, if the recession occurs and perpetuate in the near future.

"Profit margins are falling, but coming off peak levels," said Del Vecchio. "So they're still very, very strong and they're going down. It's probably going to go down through the current quarter. "It's not hard to come up with reasons why stocks could still fall in 2023, sick stocks or payment issues with the real estate transactions, that will bring the economy into a recession. Sneider's team at Goldman Sachs Asset Management expects the S&P 500 to end the year at around 4,000, or about 2.5% below recent bullish levels.

"It wouldn't be a bull market," Sneider said. "It's not as bad as expect many investors. "Highly leveraged companies that have debt maturities in the near future will struggle and may even struggle to stay afloat," said Austin Graff, Chief Investment Officer at Oral Sarital. And the economy is still not likely to "enter in a recession with a bang", he said. "There will be a slow slide to recession, as companies tighten their belts and cut back on jobs, which will have a ripple effect throughout the economy.

"However, Graff also sees the benefit of higher interest rates in the big banks, which better leverage the interest rates in their bond portfolios. "Banks can be much more profitable in today's interest rate reality," he said, referring to the high end banks that usually offer 0.25%-1% to all customer deposits, but they can give loans of around 4%-5% and more. "The amount of money that banks are making in the current climate is incredible," Graff said, signing with J.P. Morgan Chase & Co., citing methods that include an estimated interest income of USD 81 billion net for this year, which is an increase of about USD 7 billion from last year.

Del Vecchio from PGIM said that he is expecting a short and shallow recession, if it comes at all. Recession could arrive as a non-synchronized one and the crash could ripple large parts of the economy, instead of an equal hard impact to all sectors at once. The US housing market has seen a sharp slowdown over the past year as mortgage lending has slowed, but positive signs are emerging as travels, house renting and tourism sectors are still doing well," PGIM stated.

How are the investment funds impacted

Investments funds in Europe and US are struggling at a certain extent to attract the right investors since the beginning of the war in Ukraine and even before that. Well renown asset managers did not afford the lack of interest to their new fund initiatives and failed to raise the required seed capital. The Private Equity sunny days of one-and-done fundraising processes doubled with heavy oversubscriptions is way behind us. Very few asset managers may feel immune to private equity's fundraising failure, having a serious quantity of LPs sending cheques and GPs attracting new investors onboard, promising sometimes the impossible dream.

The Carlyle Group is a clear example with their Carlyle Asia Partners Growth II Fund, for which they have collected USD 950 million versus USD 1 billion planned. "While we believe that we will attract a significant amount of capital for our next vintage of buyout funds, we no longer expect these funds in the aggregate to be the same size as their predecessors", CFO Curt Buser said on the firm's first quarter earnings call beginning of May. But what's happening with lower players and firms, if even Carlyle Group struggles?

Some GPs have turned their head to another direction. And what if the debt at a reasonable price was the partial solution for the missing or incomplete fundraisings? Attractive loans appeared here and there at interesting rates of 2, 3 or 4% of interest rate per year, as banks clearly refuse to play the game for the time being, especially in Europe. Investment firms and asset managers are playing substitutes with a certain success we have to say, using Middle East banking institutions. A GP instigated loan to the fund may respond to questions number four and five in each investor's agenda.

Here are the famous "FIVE WHATs" that each investor investing into a fund raises:
- What is the risk for me?
- What is the earning?
- What is the cost?
- What are the committed investments already?
- What amount did the GP put inside?

The first three questions are directly or indirectly linked to the fund structuring entity or the GP's capacity to create the right strategy, find the right partners, select the right investments. Questions number four and five could be responded by a hybrid mixture of debt and equity in which the second does not exceed 2/3 of the whole assets under management. Otherwise, the model is biased and a real risk of over-indebtedness watches around the corner. The question is would the investors entering the fund accept that a debt allowed the fund to launched as a fundraising process failed? The game is worth the candle, a famous saying stipulates, but do not burn the candle at both ends.

Debt capacity of Luxembourg companies: yet another headache for investment managers?

By Dinko DINEV, Partner and Oleg TUPCHII, Senior Manager, Transfer Pricing at Deloitte Luxembourg

For fund managers, inter-company debt has always been a preferred way to structure capital injections into Luxembourg Special Purposes Vehicles (SPVs) because it provides a fast and efficient way to move cash across the investment platform.

However, SPV debt financing must comply with anti-abuse and anti-simulation principles in Tax Adaptation Law[1] as well as debt-to-equity ratio of related party borrowers, such as transfer pricing (TP) rules. These principles also apply to companies engaged in holding activities.

Historically in Luxembourg, investment managers could rely on certain rule-of-thumb debt leverage ratios, such as the 85/15 ratio for financing participations, which were widely accepted as standard market practice. These ratios, however, have lost relevance with the arrival of Chapter X of the OECD TP Guidelines[2] in February 2020.

Currently, taxpayers are expected to conduct a transfer pricing analysis to justify that their debt leverage is not excessive from an arm's length perspective (within their debt capacity).

What does such analysis entail? Does it significantly limit the ability of SPVs to absorb inter-company debt, compared to historically applied debt-to-equity ratios? How should one handle the TP analysis efficiently when there are multiple borrowing SPVs across the investment platform? How often should debt capacity analysis be refreshed?

This article briefly addresses these questions and demonstrates that solutions exist for investment managers to ensure compliance with TP rules in a pragmatic manner consistent with their business objectives.

What does a debt capacity analysis entail?

It involves observing the debt leverage of peer entities in the market (peer analysis). Alternatively, financial modeling can be used to assess the ability of the tested borrower to service its debt based on its own economic parameters, such as balance sheet strength and cash flow projections.

The nature of a debt capacity study can vary greatly. For example, in private equity deals, acquisitions vehicles are evaluated using Debt-to-EBITDA as the industry established indebtedness metric, based on leveraged buy-out (LBO) market data. For real estate investment SPVs, however, the maximum Loan-to-Value (LTV) and Interest Cover Ratio (ICR) observed in the relevant property markets usually define their debt capacity.

Do debt capacity studies restrict the amount of inter-company debt, compared to previous practices?

Historically applied debt leverage ratios in Luxembourg, such as the 85/15 ratio for financing participations or the 1/99 ratio for financing debt investments tend to be generous regarding the amount of inter-company debt allowed.

Nevertheless, conducting a debt capacity study does not necessarily result in lower amount of allowable inter-company debt. An SPV with a strong balance sheet, expected cash flows or operating in a market where high debt leverage is the norm, is usually assessed for its capacity to borrow, which often exceeds the historically applied ratios.

How should one handle multiple borrowing entities across the investment platform?

Performing individual debt capacity studies for each SPV that borrows inter-company debt within the investment structures managed by fund managers can be time-consuming and expensive.

Fortunately, SPVs with a similar investment profile can often be grouped together and subjected to a single debt capacity study, but the way in which the results of the study are applied to cover entities may vary. Depending on the particularities of the investment structure, it may be appropriate to apply the results on a consolidated and individual entity basis.

Another solution for effectively managing the debt-to-equity TP requirement of SPVs is to adopt a debt capacity policy. It outlines the applicable ratios upfront, grouped by investment scenarios (or use cases), and includes future SPVs (forward-looking approach).

To illustrate, a real estate debt capacity TP policy could establish applicable LTVs depending on their underlying asset (office, residential, retail, etc.). Equipped with such a policy, fund managers can determine the debt-to-equity ratio they should follow whenever they structure the fund flows for an investment.

When should a debt capacity study be refreshed?

A debt capacity study covering an SPV (or group of SPVs) does not need to be updated if the funding structure subject to the study remains unchanged. When a TP Policy is used, it needs to be updated periodically to remain relevant for any new SPVs subject to the policy.

Conclusion

Current TP rules require a debt capacity analysis to support the debt-to-equity ratio of SPVs borrowing inter-company debt. This can impose numerous complexities for fund managers, particularly when managing multiple SPVs. Pragmatic solutions like debt capacity TP policies can help minimize delays and costs associated with the TP regulations.

On 13 June 2023, Deloitte Luxembourg will discuss debt capacity among other key topics during its annual TP Talks conference. For more information on the event, please refer to the following link: https://www.deloitte.com/lu/tp-talks.

1) Para. 5, 6 Steueranpassungsgesetz vom 16 Oktober 1934
2) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris