Chenavari's Loïc Fery

Embracing the European credit revolution

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Tomorrow's Titans 2010 to 2016: Revisited

Chenavari is one of the most astute and eclectic credit managers in Europe. It manages a seasoned multi-strategy credit hedge fund that has a proven ability to navigate the ups and downs of the market. It also manages one of the top performing liquid alternative credit UCITS strategies in 2017, on the Lyxor platform; two London Stock Exchange-listed vehicles with strong performance and yields; and a growing spectrum of illiquid credit strategies encompassing a wide range of European private credit investments (consumer finance, specialty finance, trade finance, and direct lending) as well as structured credit, distressed (Chenavari has been quietly acquiring ships at the bottom of the cycle), risk retention and risk transfer transactions.

As a young banker at Société Générale in Hong Kong in the 1990s, Chenavari founder, Loïc Fery, was thrown in at the deep end, dealing with pivotal and existential issues at Asian banks. In May 1998, while working on the balance sheet restructuring of one of the leading banks of the country, he spent a week confined to a hotel room in Jakarta, when the city was over-run with tanks. The fall of President Suharto soon ensued. Indonesia, Thailand and Malaysia in the late 1990s had turbulent politics and their banking systems were undergoing radical transformation: addressing bad debts and solvency issues, restructuring and raising capital.

Fast forward 20 years and "Europe today is very different, but every bank has to adapt to a new environment. There are new regulations such as Basel III, Basel IV, many other new rules, and ECB supervision," Fery points out. Disruptive technology forces such as digitalisation are also reconfiguring the whole financial ecosystem. "Origination used to be a client-facing function through branches of banks. Now it needs to be digital; banks no longer have any unbeatable edge in origination. As they also have less capacity to hold risk, banks are increasingly becoming customer relationship managers (CRMs) that need to partner with providers of capital like Chenavari. We have the speed and agility to smartly fill funding gaps present in both mature, core European markets such as Germany and the Netherlands, and in countries such as Ireland, Portugal and Greece, where demand for credit largely exceeds available supply," says Fery.

Chenavari in key numbers

10
Years – firm history

100
People – firm professionals

800
Staff working in affiliated speciality finance companies in Europe

11
Number of affiliated speciality finance originators in Europe

270
Companies financed in Europe

2 million
Consumer clients in Europe

€3 billion
Origination each year

No. 2
Ranking amongst CLO Risk Retention providers in Europe

€5.3bn
Assets under management

Over 90%
Percentage of assets from institutional investors

European recovery

When he set up Chenavari ten years ago, Fery's vision was to create a dedicated European player spanning the liquid, tradable credit market in addition to the full capital structure of banks, including their equity, which is starting to attract more attention from Chenavari as Europe's economic recovery takes hold and raises the prospect of rate rises. Private credit, private equity in financial institutions and structured finance are also important parts of Chenavari's repertoire. "In Europe, we have much more reach than most US credit managers: our teams and track-record give us a lot of credibility in Europe, with more people on the ground," Fery argues.

This gravitas is being rewarded as Chenavari has sight of a rich pipeline of potential deal-flow. Most recently, it was selected in a competitive process to acquire Creditis, the consumer finance portfolio of Italy's Banca Carige, the largest bank in Liguria (northern Italy). "We were considered as a strategic and long-term industrial partner. We have an 80% interest in the now independent consumer finance unit and the bank has 20%. We acquired the portfolio and the servicing capabilities. We also have agreed a 10-year distribution agreement with the bank and its 550 retail branches. The bank is re-inventing itself due to legacy pressures, regulatory pressure and new technology. It is moving to a new business model of European banking, with a strong institutional investor as a partner," says Fery.

Like many other Italian banks, Banca Carige was disposing of Non-Performing Loans (NPLs), however Chenavari currently favours performing loans over Italian NPLs. "A process of price discovery is taking place in Italian NPL, similar to what we saw in Spain from 2010-2011. People are assuming recoveries higher than actual levels, so we feel that there is a bit too much hype on the NPL side," observes Fery. On the other hand, performing loans can potentially generate high double digit returns, once Chenavari has securitised them and refinanced senior paper at lower rates. "There is a lot of alpha in the transformation of performing private credit portfolio into public ABS," Fery says. Fery's trading and structuring experience has proved a strong asset: after the stint in Asia, he managed the global credit markets team on the sell side of investment banking at Calyon, including over 100 proprietary traders, market makers and credit structurers.

While many credit or distressed debt hedge funds invest predominantly or even exclusively on core Northern Europe, Chenavari casts its net over the entire European Union. It has been active in Southern Europe for at least seven years: in Italy, in Greece and in Portugal. Bank origination remains scarce in some markets. "Ireland has a huge scarcity of mortgage supply. We have initiated a EUR 200 million origination program focused on buy to let mortgages there." Chenavari has explored opportunities in Eastern Europe, specifically Slovakia, although currently finds the pricing is very competitive in these regions.

Fery is very excited about the European economic recovery and has been familiar with French President Macron's agenda since at least 2010. "A stronger Europe is a game changer. We see this in business confidence surveys, such as PMI readings not only in France but also in Europe. Brexit naturally strengthens the stronger countries in Europe," he says.

ABS & CLOs

Chenavari thinks that reflation in Europe – and potential for associated interest rate rises – could be transformational for banks' net interest margins, and for the excess cash flows from the asset/liability spreads on ABS and CLOs. "When rates are rising and you expect fundamentals to remain strong, you may want to be at the bottom of the capital structure of a credit origination vehicle," says Fery. Chenavari is confident that the CLO arbitrage will prevail, as senior spreads should stay tight. "There are significant technicals that guarantee there will be buyers of senior tranches. Solvency II means it is not capital efficient for insurance companies to buy BB- or B-rated paper. If senior spreads stay tight, the IRR could even increase when rates rise. This is IRR accretive for ABS/CLOs and in general for transforming private credit pools into public ABS pools."

Pictured Loïc Fery, Chief Executive Officer and Co-Chief Investment Officer, Chenavari Investment Managers

Chenavari closed three CLOs in 2017 and is readying another two for this year. "On a relative value basis, Chenavari continue to find European CLOs are preferable to the US CLO market and is seeing strong inflows from US investors. In a listed vehicle it managers, Chenavari Toro Income Limited, Chenavari's retrocession of a large part of CLO management fees contributes to increase forecast target IRR from 12% to 22% on CLO retention strategies.

Chenavari does not envisage a rapid normalisation of monetary policy: they are closely monitoring ECB tapering and do not expect any sharp impact on the spread and rate environment in the short-term. "As we saw with the US, tapering is a very complex and long process. The ECB has reaffirmed the continuation of net asset purchases at a slower rate. We believe they may reach status quo by late 2018 or early 2019," says Fery.

Complexity premia and distressed debt

Chenavari currently dislikes SME risk secured on corporate EBITDA and prefers to focus on niches with higher barriers to entry, such as trade finance. At this point in the cycle, Chenavari is more interested in complexity premia than competing with tons of capital providers on very basic direct lending strategies, where Fery believes "you are not paid for the illiquidity premium and the weakening credit metrics, higher leverage for lower spread."

One area of distressed where Chenavari has recently been active is shipping. "We were one of the early investors at the end of the shipping distressed cycle. We have rolled several investment strategies, from acquiring ships with seasoned operators to financing the scrapping trade cycle. We have financed over 50 acquisitions of second-hand boats in the past 18 months," says Fery.

Tradable hedge funds and UCITS

Hedge fund managers live or die by their long-term performance. "We are defined by the long-term performance delivered to investors. It is not just about last month's number. It is about money multiples and IRRs over many years. We have been working with institutional investors for over a decade and have good long-term relationships with our limited partners. We are looking forward to the next 10 or 20 years with humility, confidence and ambition and are convinced that Chenavari is rightly positioned in a market that is profoundly transforming due to European banking's evolving business model that opens up significant investment opportunities," says Fery.

In most years, Chenavari's illiquid credit strategies have, unsurprisingly, generated the highest absolute returns, partly as their income yields are higher. Yet in 2017, Chenavari's MS2 multi-strategy hedge fund and its UCITS fund (which has reached assets of USD 150 million on the Lyxor platform) were also top performing strategies on the liquid side.

Chenavari also sees opportunities in the liquid space, which are managed by Fery's main partner and co-CIO Fred Couderc. In general, Chenavari forecasts wider dispersion and decompression of credit spreads. Therefore, in liquid strategies, it finds it essential to have convexity and the flexibility to go short. In some areas of the corporate credit market, the firm is happy to buy cheap volatility that might profit from a blowout in spreads.

"Fundamentals are strong, but valuations are excessive in many areas, especially equities. Technicals are also weak, especially liquidity, which has been reducing across the board. Markets could be up to a significant correction at some point" Fery says.

Hedges and shorts

2018 does not look like 2008. In early 2018, Chenavari's base case outlook is sanguine, given a unique combination of robust economies, good fundamentals, and persistently accommodative monetary policy. Yet Chenavari is always alert to risks including geopolitics, terrorist events, wars, and a China slowdown – as well as liquidity risk in credit markets. "ETFs can create very large imbalances that may burst at some points," says Fery. "Valuations are also a worry both in credit, where very levered companies can borrow at very tight levels, and on the equity side," he told us, before the equity market correction occurred in early February.

Chenavari's liquid funds employ a wide gamut of liquid hedges, including futures, shorts, bond shorts, CDS and options. The illiquid funds have also been able to profit from adroit and opportunistic trading during routs. "Our ABS fund Toro Capital 1A made c.25% net to its investors in 2011, a year when the asset backed securities market lost 25%," recalls Fery. "When the next crisis comes, we will be able to extract value," he expects. Chenavari also has a dedicated short strategy, which is attracting more interest from investors who are drip-feeding assets into the strategy, which offers "highly levered returns on short positions, efficiently constructed."

The opportunity set for short and relative value trades has improved, because most spreads are so compressed. Chenavari implies that the basis between cash and derivative instruments could blow out as the ECB tapers, leading the liquid derivatives to outperform (this happened spectacularly in 2008). Chenavari finds CDS an attractive instrument, as it allows the expression of a pure view on credit spreads without the need to hedge interest rate risk.

LSE-listed vehicles

Chenavari's portfolio manages two LSE-listed closed-ended fund vehicles, which offer access to illiquid credit strategies within a structure that can be traded daily (to the extent that market liquidity permits) on the Specialist Fund Segment of the London Stock Exchange. Toro Limited, recently rebranded as Chenavari Toro Income Fund Limited, was ranked in 2017 as the best performing credit fund above $500 million. Toro pays out a dividend yield of 8% based on its NAV, but trades at a 15% discount to NAV, so the effective yield on the share price is close to 10%. Chenavari owns a significant and growing share of the vehicle as its performance fees are paid partly in shares and is very much committed to the listed space, with a dedicated in-house sales representative responsible for the marketing effort. While Toro is an evergreen structure, Chenavari's other listed vehicle, Chenavari Capital Solutions Limited, has an amortisation feature that will automatically return capital to investors in a self-liquidating fashion.

Asset growth, staffing and scalability

Chenavari's assets are a function of the opportunity set. "We have hard closed funds, and also returned capital to investors when the opportunity set no longer allows us to meet our performance aims," points out Fery.

"Today, funds are fully invested, we have no trouble in deploying capital in attractive transactions and have a very visible pipeline across geographies and asset classes. We don't have an AUM ambition. Only a performance ambition. We raise capital as and when needed: the assets we manage could be $5 billion or $20 billion depending on the opportunities," he says.

For example, "we have made large investments in Greece in the past 2 years and we are getting larger there. There are structural changes in private origination of specialty finance. We have exclusive interaction for credit transactions with a 4-people strong origination team based in Athens and feel our reading of timing is better than others."

Human capital resources have significantly evolved as the firm's financial capital has grown.

When recruiting, niche expertise in credit markets and track-record are obviously key attributes the firm is looking for. But one thing that Chenavari leaves no latitude for is compromises on its ethics. "There should not be the slightest doubt about compliance and integrity at the firm and for every individual," Fery states.

Chenavari seem determined to keep on assembling the top talents of the market. BNP Paribas' global head of credit markets Benjamin Jacquard, a seasoned and highly respected credit market professional, is set to join Chenavari in a senior role later this year. "We are a people business: our team combined with the strength of our institutional infrastructure is our alpha," says Fery. **THFJ**