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The Race for Assets

Private Debt:
The Rise of an Asset Class

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"We have increased our overall allocation towards private debt because the number of companies seeking capital is very high. This creates a strong market that we, as investors, are keen to capitalize on."

Director of Finance, Sovereign Wealth Fund, EMEA

PRIVATE DEBT FUNDRAISING reached new record-breaking levels

The post-crisis era has seen private debt become an established asset class in its own right, matching the needs of yield-seeking institutional investors and companies looking for capital to grow. We look at some of the drivers for this growth and assess how firms can build on further opportunities in the market.

The growth of the private debt market has been nothing short of phenomenal over the last decade. With traditional lenders cutting back their financing following the financial crisis, funds have filled the vacuum to provide crucial financing to the real economy and to meet this very real demand. This, combined with institutional investors' quest for yield, has provided the right conditions for private debt funds to flourish.

Even after several years of growth, private debt fundraising reached new record-breaking levels in 2017, with the total raised globally surpassing US$100bn for the first time, according to Preqin figures.[1] The market shows little sign of abating. With private debt funds currently managing around US$600bn in assets worldwide, this figure is set to increase to US$1trn by 2020, the Alternative Credit Council predicts.[2]

A drive for direct lending

Direct lending funds have been among the biggest beneficiaries of investor appetite for private debt and demand among corporate borrowers, with these funds accounting for nearly half (more than US$50bn) of the total raised in 2017, up from just US$24bn in 2016. The signs are that this growth is likely to continue. In our *Race for Assets* survey of institutional investors, 49% said they planned to increase their exposure to this section of the market.[3]

The biggest growth has been in Europe where, pre-crisis, traditional lenders dominated. While the proportion of bank lending across Europe remains high (over 70%), the number of private debt firms has increased markedly, with the amount of dry powder they hold rising five-fold over the last 10 years, according to Preqin figures.[1] Post crisis, with traditional lenders' cautious stance on providing credit, the European Central Bank has encouraged local regulators to support loan origination funds. The shift from loan participation to loan origination is not only aiding the recovery through the provision of alternative financing channels for borrowers, but also providing investors with attractive return opportunities.

The U.S. has also seen considerable growth, albeit from a more mature starting point: dry powder has doubled among U.S. private debt funds in the last decade. In Europe, the type of strategies offered by private debt funds has proliferated. In the U.S., the growth has come from firms raising increasingly larger funds, an expanding universe of funds providing debt to middle-market companies and more capital being allocated to areas such as infrastructure debt and commercial real estate debt funds.

Diversification brings benefits

For investors, part of the attraction of the private debt market is the breadth of options now available to them. While direct lending funds have captured a large share of institutional capital, the variety of different private debt strategies, such as funds targeting real estate, infrastructure, collateralized loan obligations (CLOs,) mortgages, or other more specialist areas, such as energy or asset-based loans (ABL), provides investors with a wealth of choice and a variety of risk and return profiles.

Institutions, initially attracted by the opportunity for higher yield than traditional fixed income strategies could offer, now find that private debt can provide significant diversification benefits.

Private debt strategies offer investors a different way of accessing other alternative assets. They provide exposure to areas such as real estate, infrastructure, or corporate financing at a point in the cycle where returns on equity strategies in these asset classes are challenged by high valuations.

The different durations and characteristics of the various credit strategies can bring diversification of income to investor portfolios. Direct lending, for example, can have relatively short investment horizons, while at the other end of the spectrum, infrastructure debt is a much longer-term strategy.

> **"Size can be a key factor for success in private debt. If you are big and consistent in this market, you are usually able to source opportunities ahead of others and get better allocation – these are important for deployment of capital."**
>
> Deborah Shire, Head of Structured Finance, AXA

Why size matters

So far, the asset class appears to have performed well for investors, with 96% of respondents in the *Race for Assets* survey saying that private debt had performed at or better than their expectations—higher than for any other type of alternative investment.[3]

Yet with little sign of investor appetite for private credit waning any time soon, the challenge for funds will be to ensure they can continue to deploy capital in a disciplined manner. Liquidity and competition in the market has led to lower pricing and some loosening of terms in the U.S. and Europe. The continued emergence of new entrants to the market and the expansion of existing players into new strategies is only adding further pressure.

Nevertheless, the trend toward increased fund sizes is likely to mitigate the number of new entrants somewhat. The average size of direct lending funds raised in 2017 more than doubled to US$1bn from US$478m in 2016, according to Preqin data.[1] In many other areas of the market, managers are looking to scale up, too. Larger fund sizes offer managers a greater choice of deal flow, provide them with stronger negotiating leverage with borrowers, given they can often now lend across different parts of the capital structure, and give them a more powerful role in situations that are not performing to plan.

In the interest of investors

The growth in popularity of the asset class has resulted in greater demands from investors, and managers are increasingly making moves to meet these requirements.

Fee levels reduced from 2013 to 2017, with private debt funds charging, on average, management fees of 1.52% in 2017, down from 1.76% in 2016, Preqin data shows.[1]

And they are also finding ways to help investors meet the desire to keep their capital invested while offering a greater degree of liquidity than is available in traditional closed-ended, fixed-life funds. Open-ended credit funds are now a feature of the market, offering investors the opportunity to keep their cash at work while also relieving managers of the need to divert resources to fundraising every two to three years. On the more traditional closed-end type funds, investors are increasingly accepting broader investment guidelines that permit initial investment to more liquid credit, followed by divestment to the funds' core strategy or to a broader multi-strategy type investment allocation.

Transparency, technology and transformation

Transparency is a fundamental issue across alternative asset classes. And although private debt fared better in our *Race for Assets* survey than most of its peers (only private equity was seen as more transparent asset class), investors are still looking for more.

Providing detailed reports to investors in a timely manner, and in a format they can use, is becoming increasingly challenging for those still running on legacy IT systems and processes. This is particularly the case where firms have multiple funds to manage and where they are now running a variety of strategies and/or offering separate and managed accounts.

Investors now expect more frequent and more granular reporting. For high yield bonds and syndicated loans, investors now require more frequent dealing and reporting with a move to daily or weekly valuation common along with additional transparency for risk and regulatory purposes to the underlying holdings and drivers of performance. In less liquid strategies, such as mid-market loans, infrastructure and high yield bonds, investor requirements are for a timely valuation at quarter end and enhanced reporting of performance and attribution.

Managers increasingly need access to state-of-the-art systems that enable them to automate processes, analyze large amounts of data at the touch of a button, and provide real-time information on exposures and positions. As a result of this need and investor expectations that managers work with administrators who understand the nuances of the asset class, funds are now turning to outsourcing their back and middle offices to expert third parties. With more efficient systems and processes at their disposal, these managers also find that they are able to grow and scale more quickly than they could with legacy systems.

In some areas, technology is also playing an important role in transforming front office operations. While many parts of the asset class still rely on human interactions and judgment for finely tuned credit decisions, CLOs are one segment of the asset class where the development of new tools is making the investment decision and process increasingly efficient, as large quantities of data can be analyzed quickly and presented in user-friendly formats.

Scope to Grow

The private debt market still has plenty of scope to grow. Preqin, for example, forecasts that this part of the alternatives universe could reach US$2.5trn in assets under management in the next 10 years.[1]

For their part, investors are likely to continue to allocate to private debt strategies, given their unique benefits of higher returns than traditional fixed income with floating rate structures that protect against interest rate risk. This is a key consideration, given the shift in monetary policy seen in the U.S. already and the predictions of tightening in Europe over the medium term.

It's also highly likely that we'll continue to see innovations and new strategies emerge among fund managers as they seek to meet investor needs and requirements.

A Note on Regulation

As with other types of alternative investments, the regulatory framework for private debt funds differs between the U.S. and Europe. In Europe, many funds are subject to the Alternative Investment Fund Managers Directive (AIFMD), which has been in place since 2014. The AIFMD mandates compliance around transparency of fees, marketing rules to EU investors and investment strategy, among other issues, and requires the appointment of a depository. Its requirements have led to many funds domiciling in Europe, with Luxembourg and Ireland, in particular, witnessing significant growth as a jurisdiction. Recent proposals to change the regime for loan originating funds in Ireland, however, has generated increased interest and both should benefit from this move to European structuring.

In the U.S., the regulatory regime has stabilized since the Dodd-Frank Act was passed post-financial crisis. And while a bill was passed by Congress in May loosening restrictions on banks with less than US$250bn in assets, whether this leads to a greater appetite for lending among banks remains uncertain at the present time. Nevertheless, the recent rescinding of a requirement for CLO managers to retain 5% interest in the funds issued has provided a boost to the market.

Words of wisdom

Three steps to success for fund managers

1 **Demonstrate clearly the ability to deploy capital.** Increasing competition in parts of the private debt space has the potential to compress yields. This means investors will allocate only to managers with a clear ability to deploy capital either through strong origination capability or who have the scale to offer loans across different parts of the capital structure and have greater bargaining power with borrowers and other lenders.

2 **Be open-minded about vehicle structures.** The private equity closed-ended fund structure remains the most common type of vehicle employed by private debt funds, but open-ended structures are becoming an increasingly popular alternative, and segregated mandates continue to use other frameworks. It is important to offer investors the right level of flexibility and consider how investors may want to keep their capital deployed. At the same time, the evergreen nature of open-ended platforms gives managers the ability to recycle capital and offers greater investment scope.

3 **Let your technology do the heavy lifting.** This can assist in scaling up—there is less need to invest heavily in back and middle office staff, for example—while also enabling managers to provide the kind of complex, granular information on a timely basis that investors have now come to expect.

[1] http://docs.preqin.com/reports/2018-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf

[2] https://www.aima.org/article/acc-sees-private-credit-market-reaching-1-trillion-by-2020.html

[3] https://www.bnymellon.com/_global-assets/pdf/our-thinking/the-race-for-assets-alternative-investments-surge-ahead.pdf

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