



FINANCING THE ECONOMY

The future of private credit

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FOREWORD

Welcome to the latest edition of the Alternative Credit Council's (ACC) *Financing the Economy* research series, produced in partnership with Dechert LLP. To mark the fifth anniversary of this research series, this year's edition is focussed on the growth and success challenges that will define private credit over the next five years. In addition to surveying more than 60 management firms, we have enlisted the thoughts and insights of 30 leading industry individuals to support this endeavour. The survey includes managers from all corners of the world, with aggregate AuM of close to \$400bn in private credit strategies. The narrative of the paper is then complemented by a synthesis of structured conversations with leading individuals whose insights you will find throughout the paper. We would like to convey our thanks to each of the firms and our interviewees for being so generous and forthright in their contributions to this research. We would also like to thank Nicholas Smith and Anton Balint, the authors of this paper, for pulling all of the pieces together in a truly remarkable manner.

At its core, private credit is about providing borrowers with growth finance, and investors with access to assets within the lending markets in the most direct manner. Substantial progress has been made by private credit managers on this front over the past ten years. Their success is evident in the way capital allocated to private credit has continued to surpass expectations.

While such progress should rightly be celebrated, private credit managers have only begun to scratch the surface of what is possible for the asset class. The expansion of the private credit universe will continue to be a key feature of the market, both from a geographic and strategic perspective. This will see managers

build on their existing presence in core markets while also breaking newer ground in less developed markets. At the same time, we expect newer strategies that provide investors with access to borrowers in markets that are currently out of reach to become more prominent.

This expansion takes place at a time when questions about the sustainability of private credit become more prominent in the thinking of investors and policymakers. Are responsible lending practices being adhered to? Does private credit exacerbate pro-cyclicality in the markets or act as a useful buffer? How will the industry perform during an economic downturn? Private credit managers recognise that long-term perceptions of investors and policymakers towards the asset class are extremely important. Rather than shying away from such challenges, many managers have put them at the forefront of their thinking when building their businesses and investing in their operating infrastructure.

Inevitable challenges lie ahead for private credit. Risks continue to build up in many credit markets, and the resilience of business models will be tested over the next five years in different ways. The success of the asset class during this period will come from private credit managers continuing to be a valuable and trusted partner to their borrowers and investors in good and bad times. This research showcases how private credit managers are preparing to meet this challenge and ensure their stakeholders continue to prosper, whatever the economic weather.



Jiří Król

Global Head
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Chris Gardner

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EXECUTIVE SUMMARY

Drivers of long-term structural growth are intact

The factors supporting the growth of private credit – increasing attraction of private markets to investors, retrenchment of the banking sector and the appeal of direct lender relationships to borrowers – will fuel further expansion of the asset class over the next decade. Capital allocations to the asset class will be driven by private credit managers' ability to offer differentiated growth and income opportunities, especially in a low-yield environment, as well as the potential downside protection in times of market turbulence. This will see a greater diversity of markets and strategies evolve within the broader private credit label. The market is likely to increasingly differentiate between private credit managers focussed on niche markets and those who can provide investors with access to multiple private credit strategies.

Cyclical concerns are top of the agenda

The credit and economic cycle is a primary consideration for nearly all private credit managers, influencing their approach to underwriting practices, and the way they price risk and structure deals. Capacity to deal with stressed loans is now a key point of differentiation for investors when assessing private credit managers, as they look to identify managers with resilient business models. When it comes to human capital, the industry is experiencing a growing demand for skilled individuals and continues to compete with the private equity world for skilled labour.

Harvesting the complexity premium is key

Flexibility towards their client's needs remains a recognised strength of private credit, but one which comes at a price in the form of ever-increasing demands on operational infrastructure. The unique regulatory barriers faced by private credit managers in some markets continues to be the single biggest determinant of growth for private credit in those jurisdictions. Private credit managers are addressing this by investing heavily in staff with the necessary skills and experience, introducing greater efficiencies into the lending process with the help of new technology and engaging with policymakers to reduce regulatory barriers.

Institutional capital pulls parts of the market towards homogenisation

Private credit has always been an institutional asset class and the influence of institutional investors will continue to have a significant bearing on its development. Their expectations around risk management, portfolio monitoring and reporting are already driving investment by private credit managers in their operating infrastructure, and we expect this trend to continue. The acceptance of private credit by institutional investors who have not yet allocated capital to private credit is likely to be accelerated by the development of more sophisticated data sources and recognised performance benchmarks. Prudentially regulated investors continue to push for harmonised risk metrics and ratings, which can sometimes conflict with the bespoke and idiosyncratic nature of private credit assets.

ESG considerations shaping the market

A structural shift in the attitudes of investors towards ESG considerations in private credit has taken place. Inconsistency in how ESG elements are reflected in investment choices and the absence of standardised data formats is hindering the incorporation of ESG into broad market practices. However, the industry continues in its effort to establish a consensus on what constitutes relevant ESG metrics or approaches and support investors' understanding and demands. Private credit managers are also making a corresponding investment in their own systems to capture, monitor and report relevant data. Meanwhile, diversity is increasingly recognised as a business development (attraction of talent) and competency issue, including as a safeguard against the risk of groupthink.

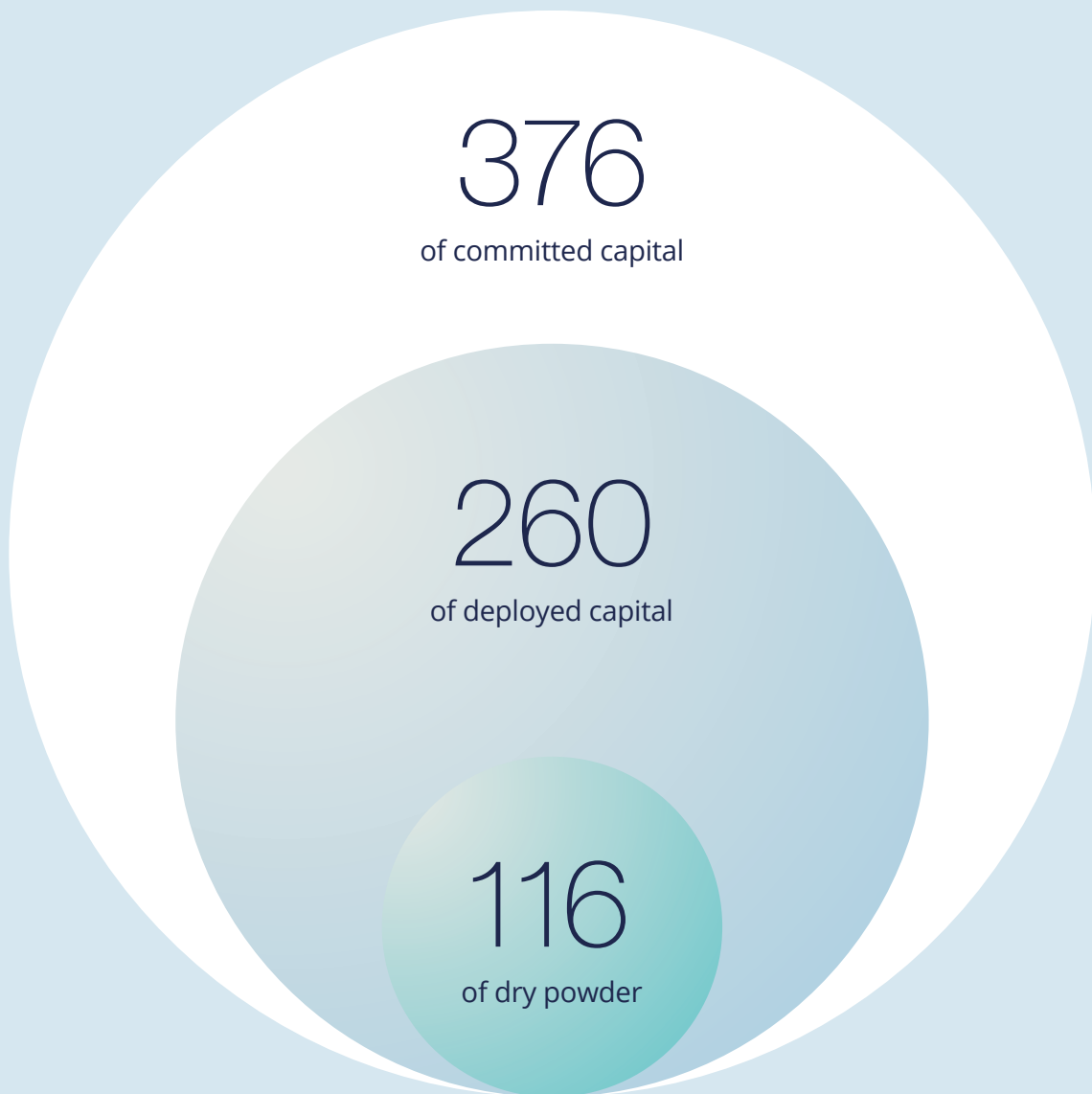
Transparency is key to sustainability

The need for the industry to support investor and policymaker understanding of private credit remains paramount. Establishing better sources of market data and appropriate performance and risk metrics is just one way the market will demonstrate the value of private credit to these stakeholders. It will be essential for private credit managers to support an evidence-led policy approach to the sector at a time when concerns around late cycle dynamics increasingly colour perceptions of the market. The challenge for private credit will be to reframe this conversation to one about private credit stimulating economic expansion and delivering value to its investors.

Research methodology

Financing the Economy draws its content from several different sources. It is primarily informed by a series of structured interviews with leading figures within the private credit industry. The paper also incorporates data obtained by a survey of private credit managers conducted by the Alternative Credit Council (ACC) and Dechert LLP (Dechert). 60 private credit managers responded to the survey; collectively they manage almost \$400 billion in private credit investments, across a broad cross-section of jurisdictions and strategies.

Figure 01:
Respondent demographics by private credit AUM (\$bn)





LEADING GLOBAL OPINIONS

We are grateful for the contributions
of the participants in this research.

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WHAT IS PRIVATE CREDIT?

//
...privately negotiated [credit] transactions...

//
...it is just lending...

//
...anything that is directly negotiated with the borrower and is probably unrated...

//
...the notion of private credit will itself go away over time and more niche asset classes will emerge...

//
...non-traditional sources of lending or less regulated or non-regulated sources of lending...

//
...is no different to creating vehicles that provide loans to primarily sub-investment businesses in situations where historically the banks were lending...

//
...it is becoming an asset class with its specific allocation 'titles' in investors' portfolios...

//
...private credit is actually something where at any point in time there are fewer buyers and sellers and there are fewer people around the table...

//
...any loan of private placement, bond origination that is not the product of a syndicated process...

//
...is really lending with some degree of control...it includes an element on the origination side rather than participating in a widely distributed transaction...

//
...a lot of what defines private credit is simply terminology...for us private credit is...not liquid, not traded, not quoted, not rated...

//
...private credit means a lot of different things to different people...it's held by locked up vehicles. It's not liquid. You can't trade it. You buy it, you own it...

//
...when we mean private credit we typically mean closed-end funds, highly originated-type transactions in situations where you have capital that is locked in for a very long period of time...



...typically debt investments that are not provided by banks...and are not issued or traded on an open market...



...privately originated, privately negotiated and with a view that we are going to own these assets or own the loans until maturity...



...for us, private credit consists of privately originated and privately negotiated transactions...



...everything that is a non-public security in a provision of a loan...



...loan transactions that are directly negotiated or transactions directly negotiated with a counterparty that are bespoke, the terms and conditions remain private and confidential between the lender and the borrower, and they are not tradeable public securities...



...a financing solution that is not publicly traded in which lenders facilitate the capital needs of promising companies...



...it is definitely seen as an asset class and really the truth of it is whether the general market perceives it as an asset class. Once it does, then it is an asset class...



...the asset class is very wide... ranges from primary lending to more alternative strategies like the more junior or mezzanine-type of products...



...the definition of private credit I think is probably anything that is non-bank lending (in the widest form)...



...they are transactions which aren't traded on listed markets and which enable you to have far more control over structuring and over terms...



...private credit is anything that is a fixed income instrument that's not liquid, that's not traded on an exchange...



...an investment strategy that is not homogenous and which consists of making privately negotiated loans to companies...



...it is dedicated to privately held assets...but most importantly it is a non-banking way of lending provided by closed-ended structures (usually)...



...there are various definitions of what people mean by private credit...the more liquid strategies wouldn't be defined as private credit as much as things like specialty finance, mortgages, real estate and so on...



...privately negotiated, lightly syndicated and bilateral [credit] financing ...private credit is a very important mechanism to foster global growth and economic development...

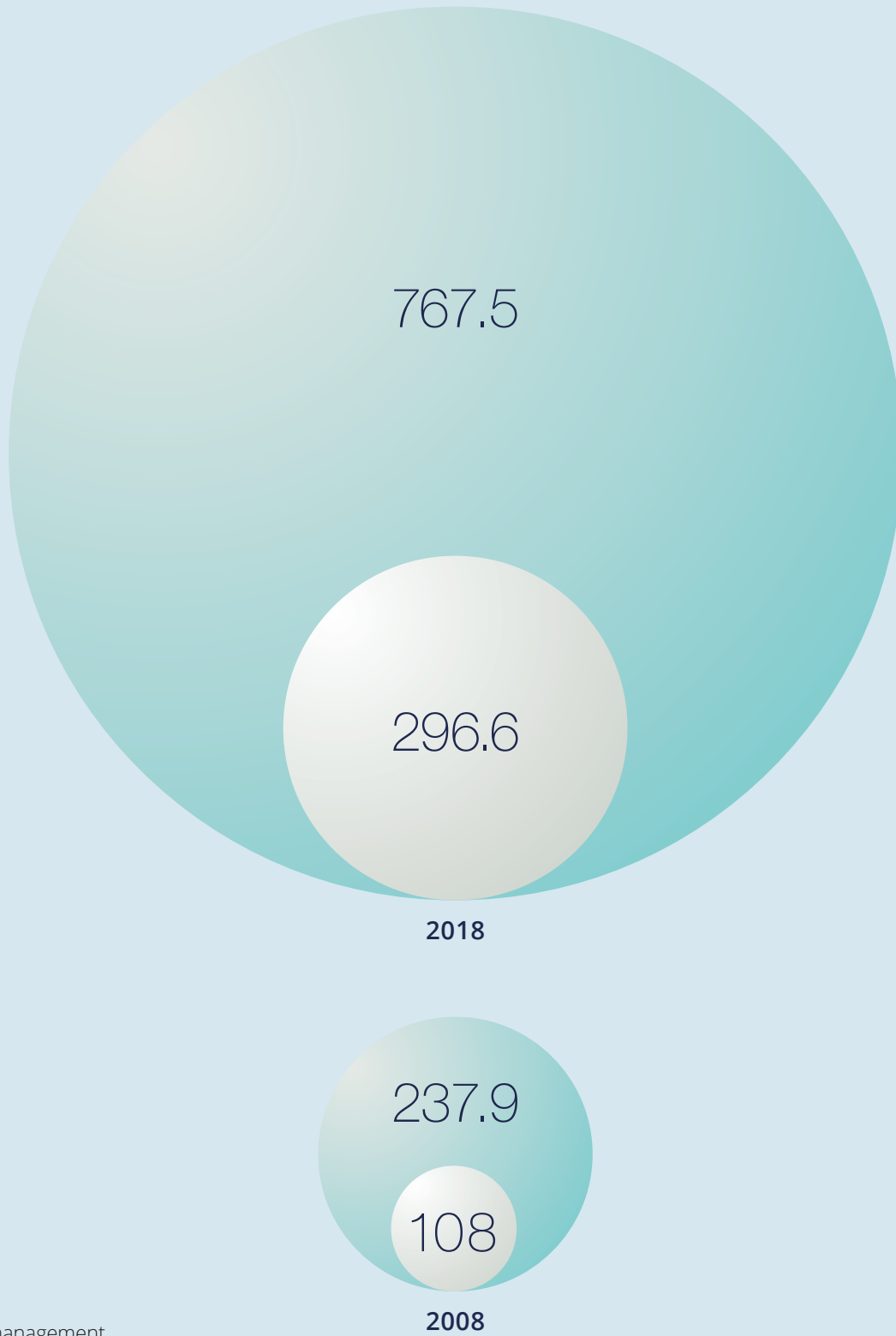
01

AN INDUSTRY FAR FROM ITS POTENTIAL

The ACC's *Financing the Economy* research series has charted the development of the private credit market for the past five years. During this time, the sector has grown from a relatively niche part of the alternatives market into a permanent fixture of the capital allocation models employed by some of the largest and most sophisticated investors in the world. At the same time, private credit has established itself as an essential source of finance for the real economy – financing that enables companies to grow their businesses which, in turn, supports job creation and innovation. Private credit's appeal to both investors and borrowers has led to a substantial growth in the volumes of capital allocated to and deployed in private credit strategies as shown in Figure 02.

The increasing amount of capital invested in private credit strategies has naturally given rise to questions regarding the sustainability of this growth and whether it is possible for such large capital inflows to be put to work efficiently and effectively. In this section we seek to address these questions by highlighting the key trends that will support the continued sectoral expansion of the private credit industry.

Figure 02:
A decade of global private credit AUM growth (\$bn)



● Assets under management
● Dry powder

Source: Preqin



Mark Jenkins

Managing Director & Head of Global Credit
The Carlyle Group

The expansion of private credit

Globally, private capital (both credit and equity) is an increasingly important market component for both investors and businesses in the real economy. This growth has often come at the expense of investments through the public markets¹. From the investor perspective, there are several key drivers behind this fundamental shift – these include the benefits of illiquidity and other investment premia, portfolio diversification, and access to a greater range of assets that offer a mixture of income and growth. There is also a 'control' premium whereby private market investors reap the benefits of reduced principal agent problems.

The trend towards private markets is currently most pronounced in the private equity space, with the sector deploying ever larger volumes of capital into the economy over recent years. This has created a significant opportunity for private credit managers who are able to offer financing for the pool of transactions such as M&A, LBOs, recapitalisations and corporate restructurings that underpin many private equity strategies. In these types of deals, the ability of a lender to manage complex credit structures, while also providing flexible solutions and acting with speed is highly valued by private equity firms (a.k.a. the sponsor). Given these factors, private credit managers are well placed to be the lenders of choice to the private equity industry as they continue to deploy the substantial capital that has been raised in recent years – with private equity firms now having access to \$2.44trn of dry powder².

Sponsored lending currently represents a significant proportion of the private credit market, but the number of corporate borrowers (companies seeking credit finance) backed by private equity represents only a small fraction of all businesses. The finance needs of this broader population of borrowers are currently served by either public markets (via bond issuances) or the banking sector (via commoditised loans or syndicated credits). However, there is compelling evidence that this is changing rapidly as managers have now started serving the larger corporates and non-sponsored firms.

There are about half as many public companies as there were 20 years ago, and that trend does not seem to be changing. Those private companies need both equity and credit financing markets. On the credit side, while banks have historically provided capital, they are no longer liquidity providers and as such, they have been disintermediated by alternative credit managers such as ourselves. We are observing a trend that we have already seen play out in private equity, and are hearing from more investors who are looking to increase their allocations to private credit as they continue to search for yield in a low-rate environment.

¹ <https://business.cornell.edu/hub/2019/02/28/mas-are-up-ipos-are-down-whats-the-story/>

² <https://www.ft.com/content/2f777656-9854-11e9-9573-ee5cbb98ed36>

Kipp deVeer

Director & Chief Executive Officer, Ares Capital Corporation;
Partner & Head, Ares Management Credit Group



The term “private credit” tends to refer to anything that is directly negotiated with the borrower and is probably unrated. The reason the industry has grown is that banks have de-banked or retrenched from financing many segments of the economy over the last several decades.

Banks are likely not as interested in private credit since it doesn't work well with rating requirements and most of the deals are getting originated and invested on the behalf of institutions that don't care as much about ratings. People tend to believe that it is bank credit departments that are saying “well, my limit is really here”. In fact, the banks' limits are where the rating agencies' limits are set.

Obviously, as it relates to the borrowers, we see a lot of growth in this market because private capital markets are actually supporting businesses that were underserved in the past. Therefore, there are solutions available for companies today, whether it is Uber being a north of \$50 billion private company without having to go public for a long time, or a simple LBO that gets done with privately placed junior capital that might have been issued in the high yield market years ago. I believe the private markets have grown a little bit at the expense of banks. As the banks have increased in size, there is a portion of the mid-market, probably \$500 hundred million leveraged finance transactions and below, that is just not of interest to them. The reality is that with the growth of private capital providers like Ares, there are better solutions for those companies today and they get better attention when they get more customised solutions from folks like us.



Benoît Durteste

Chief Executive Officer & Chief Investment Officer
Intermediate Capital Group plc

There are two reasons why I don't think we've hit a high watermark. Firstly, there is still a structural shift away from the banks to direct lending. Private lenders are long term take-and-hold investors with long term funds and thus no asset/liability mismatch.

A bank is much more suited to be an intermediary and to provide the ancillary business, provision of working capital line, interest hedging and the foreign exchange for example. These functions have generally been more profitable for them in any case.

As a result, banks and private lenders are not so much competing as they are splitting which part of the risk they take in those transactions based on what they are inherently better suited for. It is a natural evolution and the US, as is often the case in our industry, is ahead of Europe in this regard.

Secondly, private debt is very much linked to what's happening in private equity. There are non-sponsored transactions of course, but the vast majority of transactions, certainly in senior debt - the bulk of it in volume - is linked to what's happening in the private equity space.

Private equity is becoming increasingly prominent while public markets are dwindling. As private equity capacity increases, more deals and larger deals are being done in the private space. This is why we are seeing larger and larger deals in private debt and the limits keep on being pushed.

Ten years ago, this market barely existed in Europe. Even five years ago one would have said that deals worth several hundred million dollars would be out of reach for direct lenders. Today, private equity sponsors are investing in ever larger transactions and turning to private debt as they have in the past for the flexibility and the speed of execution which can be critical when pre-empting a process. Direct lenders are growing and will continue to grow in size essentially to match their PE peers and the market growth.



Arif N. Bhalwani

CEO
Third Eye Capital

The retrenchment of banks from some markets is a well-known consequence of the micro- and macro-prudential regulation introduced by policymakers to de-risk the sector's balance sheets. While the effect of these policy decisions is commonly described as reducing a bank's ability to lend, it is more accurate to describe it as aligning banks' business models with the risk bearing capacity they have as highly levered institutions with significant liquidity and maturity mismatches.

Additionally, and for reasons not necessarily associated with regulation but the simplification of their business models, banks have also narrowed their product range. The consequence of this has been a commoditisation of the lending that they are willing to continue to provide. This trend supports the further expansion of private credit solutions in markets such as SME lending, speciality finance, real estate and infrastructure debt where private credit also provides a genuine alternative finance model for borrowers.

A bilateral relationship with its lender gives a borrower significant advantages over both syndicated credit and more commoditised debt solutions (such as traditional bank lending and public bond markets). This supports the development of tailored finance solutions that more readily match the needs of the borrower and the interests of the lender. The latter point is regularly cited as a significant attraction for borrowers who prefer a collaborative relationship with their lender, and who also retain a strong preference for debt over equity financing and the dilution the latter entails. Private credit has a similar appeal to borrowers in jurisdictions with less developed banking systems that are unable to support the full growth potential of the economy.

These trends offer robust evidence that the growth potential for private credit remains strong.

Our approach is lending directly to non-sponsored companies. Generally these are companies that are perceived to be too risky by traditional lenders which can be for a variety of factors. It could be timing, there could be some complexities associated with the business and, of course, a theme that's permeated the markets for a long time, is regulatory restrictions. When we think about our USP, our competitive advantage, we have to talk about it in the context of who our clients are.

In our business we have two distinct clients. We have our investors and we have our borrowers. To our borrowers, we position ourselves to be not just merely a capital provider but also a business accelerator, we help our companies set out structural, strategic and operational changes all with a goal of maximising profits. We want to set out building strong, trusting partnerships with management teams and that means you need a lot of significant time and upfront investment to do that, so we're very much relationship focused – building those relationships is very important. It gives us a competitive advantage but also the reputation that we are able to help our companies through a combination of financing and deep business expertise. Which would mean that we could bring to them our networks and relationships – the strategic advice and operational guidance to help them prosper is key. We are demonstrably helping our borrowers create value and in the course of doing that we will benefit our investors.



Angela Samfilippo Gorder

Managing Partner, Argentem Creek Partners LP

Private credit continues to expand into newer markets

Until recently, the term private credit was used interchangeably with mid-market corporate direct lending. This is no longer the case – there is now a more nuanced understanding of the different strategies that sit under the private credit label.

As private credit strategies expand beyond the traditional mid-market lending space, an increasing number of investors are showing a greater appreciation for the breadth of opportunities within the asset class. This expansion is taking place in three key areas.

Several private credit managers are actively developing lending products targeted at much larger borrowers. The most striking example of this is the emergence of private credit managers able to finance large corporates at deal sizes in excess of \$1bn.

A few years ago, deal sizes in the hundreds of millions were seen as the upper limit for even the largest private credit managers. Managers have gained investors' confidence to lend larger sums of capital by demonstrating an ability to maintain discipline in their due diligence and underwriting processes, irrespective of the loan size, while at the same time retaining the qualities that distinguish them from other financing sources and smaller deal sizes. From a borrower's perspective, the combined benefits of dealing with one lender and obtaining bespoke, flexible terms, that are non-public make this a compelling proposition.

While billion dollar deals naturally remain the preserve of managers with the available capital to make loans of this size, the change in perception this has engendered will influence the outlook for the entire asset class. These deals demonstrate to investors that the population of potential borrowers is broadening, creating new opportunities for managers to efficiently deploy their capital. Loans of this size also offer further validation to borrowers of the benefits of private credit, and that it represents a genuine alternative to more traditional sources of finance becoming a new vertical in the product mix.

With over a decade of low interest rates, investors' desire for yield has reached new levels in recent years and credit managers have met this demand with ever creative lending solutions. As such, what was known as private credit has expanded into a spectrum of potential investment opportunities that range from traditional, such as US-based middle-market lending, to niche strategies, such as bespoke lending to smaller companies.



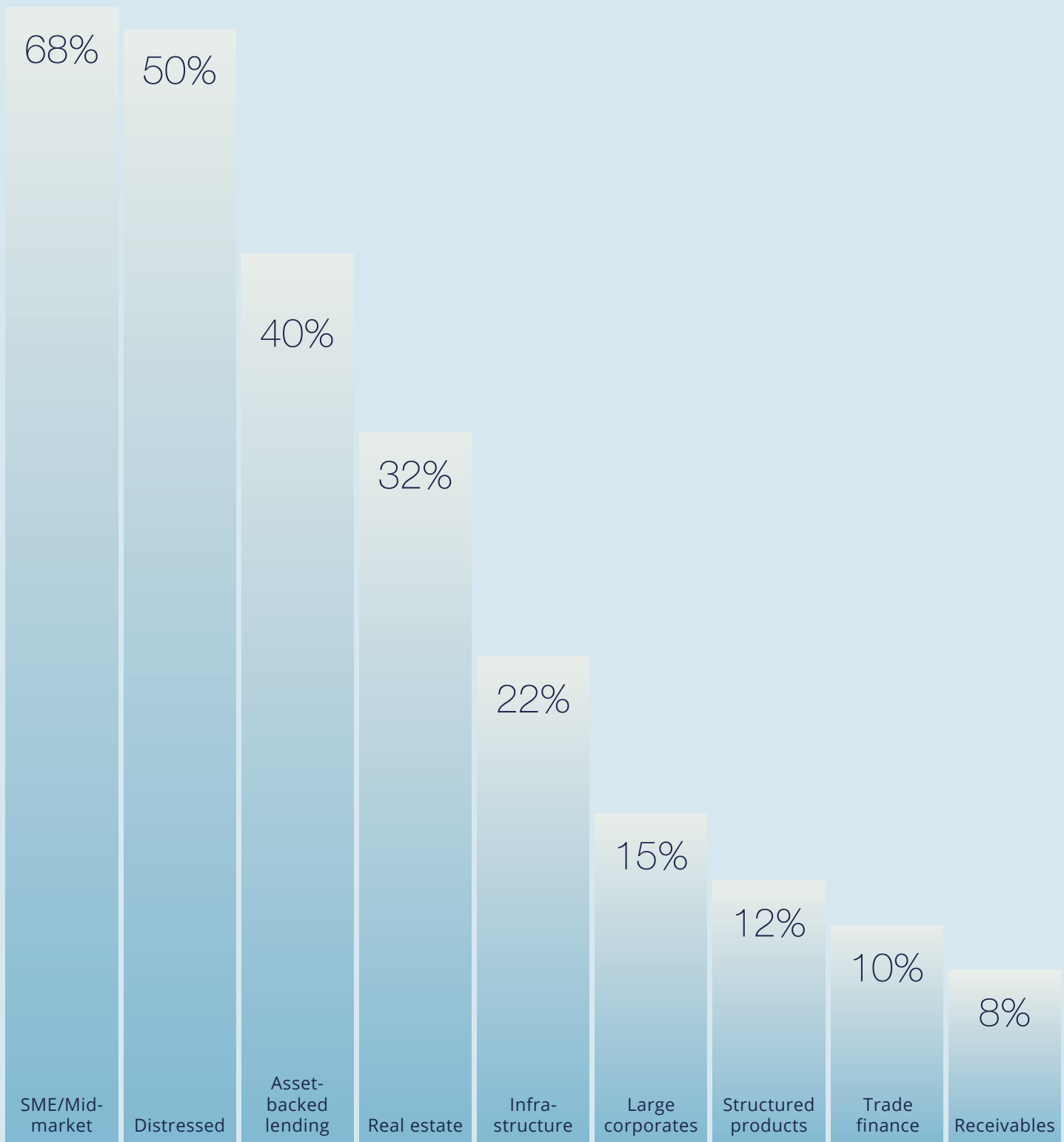
Kipp deVeer

Director & Chief Executive Officer, Ares Capital Corporation;
Partner & Head, Ares Management Credit Group

We believe that we have a nice seat in that market, but again it is back to the point of selectivity and whether you can generate strong risk adjusted returns. The question is if we took our originations to \$25 to \$30 billion annually instead of \$10 to \$15 billion annually, would we have the same track record that we have today and would that be compelling for investors? Ten years ago, we probably did \$2 billion a year of originations, and we thought it would be really difficult to go to \$5 billion per year. The growth dynamic has helped our ability to move up market and to offer a real value proposition to borrowers in that \$500 million transaction level, where our borrowers look at us as being the more valuable partner and they view the bank as trying to get the smaller deal for them on a rated syndicated transaction. So, the market has grown and our approach has allowed us to benefit from this trend.

Figure 03:
How do private credit managers see their investment in private credit markets changing over the next three years?

Percentage of respondents who expect to invest more in these markets



Market sentiment strongly suggests further expansion of private credit across all strategies (see Fig 03). This is most pronounced in the core SME and mid-market lending space where two thirds of the market expect to grow their business. We also detect greater appetite and capacity amongst managers to develop new lending strategies as an alternative or a complement to their mid-market lending strategies. There are an increasing number of ways to lend to borrowers outside of traditional sponsored lending channels, such as 'specialist' credit strategies which require a unique approach or target a defined subset of borrowers.

While these alternative opportunities are, at least in the short term, unlikely to immediately provide the same volume of deals or scale that already exists in mid-market lending, they are attractive to many due in part to the lower levels of competition. This translates into less downward pressures on loan terms or pricing, which enables lenders to be more selective in relation to borrowers or loan transactions. Further, private credit managers with specialised skill sets or with knowledge of markets with higher barriers to entry can maximise their competitive advantage. For investors, these newer lending strategies provide them with efficient means to diversify their exposure to private credit, as well as their portfolio more generally.

Our research also shows that private credit managers are expanding into less familiar geographies. Most jurisdictions rely on their domestic banking systems to finance economic growth. A combination of policymaker-led initiatives to diversify sources of finance within their jurisdiction and borrower demand for capital is creating fertile ground for private credit to take on a greater role than it has done historically. Our data indicates that private credit managers expect to increase their investment in almost every region over the next three years (see Fig 04).



Mark Jenkins

Managing Director & Head of Global Credit
The Carlyle Group

Our borrower clients often seek bespoke private capital solutions from one lender rather than having to coordinate with a number of lenders focused on specific parts of the capital structure. We often see this with entrepreneurial-owned or family-owned companies. As one of the largest private equity firms, we have experience partnering with private companies, and with developing creative capital solutions that evolve with a client. As such, we continue to find more and more opportunities to customise credit solutions for our borrowers.



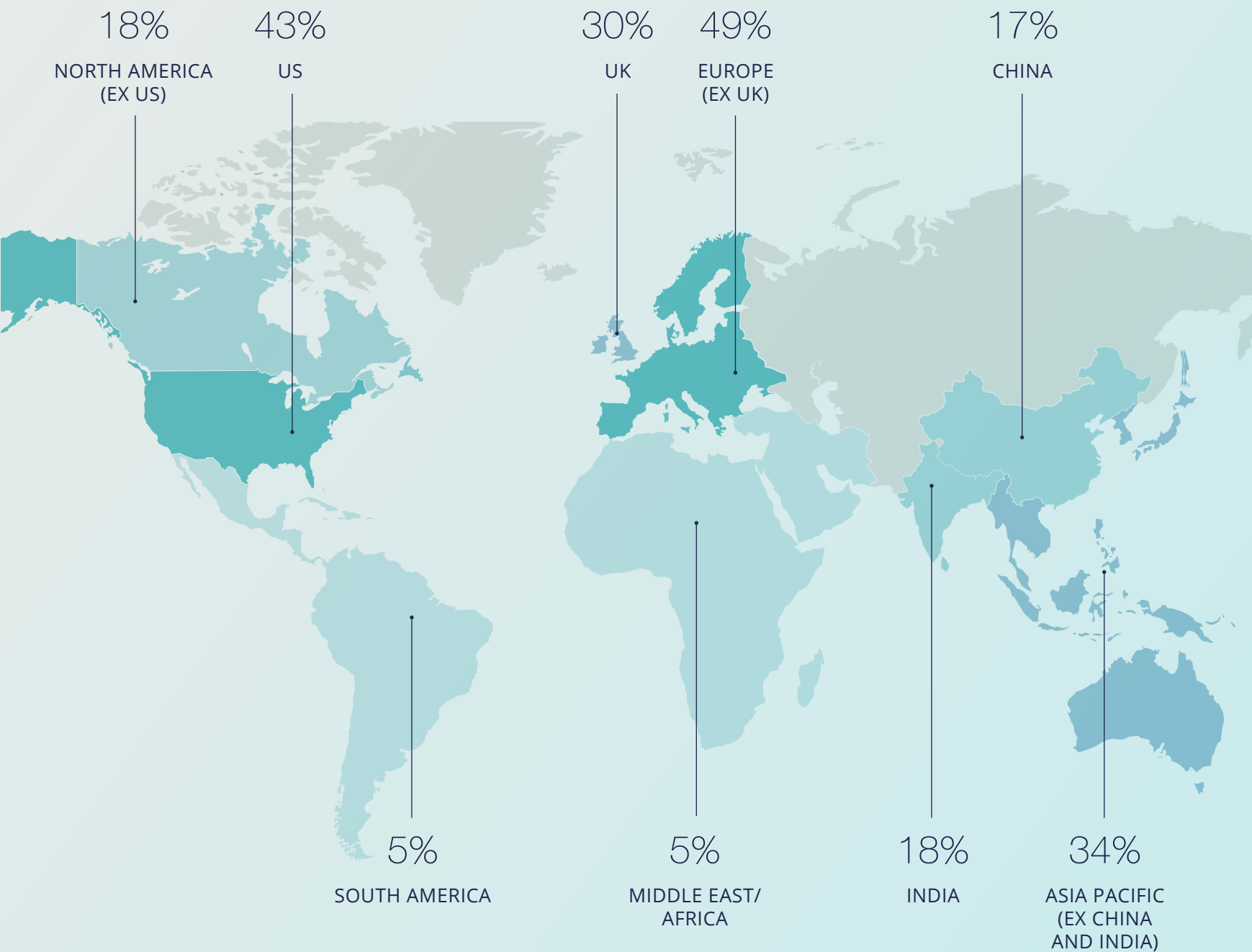
Jon Fox

Partner
Vårde Partners

We do a lot of specialty finance investing, either by providing finance to specialty lenders or owning and operating non-bank finance companies. We've been one of the larger players in the market adopting a private equity approach, where we buy a credit card, consumer finance or commercial finance business through our funds.

Figure 04:
How do private credit managers see their investment in private credit markets changing over the next three years?

Percentage of respondents who expect to invest more in these markets





Tim Flynn

Chief Executive Officer
Hayfin Capital Management LLP

In Europe for example, private credit continues to build on the footholds it has established, with countries such as France and Germany now seen as tested propositions in a similar manner to the UK. There is also evidence that capital is being allocated to borrowers in less-developed European markets as private credit managers continue to expand their businesses throughout the wider region. Although substantially reduced, the volume of non-performing loans (NPLs) remains extremely high in Europe relative to other developed markets. This provides opportunities for private credit managers who are willing to carefully analyse these loan portfolios and spot potential risk mis-pricings. While the differing barriers to lending in Europe continue to create additional complexity for non-bank lenders³, this becomes a diminishing concern once firms obtain the knowledge and expertise to navigate these challenges, and reforms enacted by policymakers enable private credit managers to lend in their markets.

Similar characteristics are also evident in jurisdictions outside the US and Europe where investors are becoming more comfortable with private credit strategies in these markets. The process of familiarisation can take some time, especially where markets are less efficient than those in the US or Europe, or are seen to lack the infrastructure needed to service large, institutional investors. As one of our interviewees explained, it is a challenge to find talent that is versed in the cultural nuances of those markets (language, legal practices and so on) and are also of 'institutional quality'. However, once this barrier is overcome and investors see their capital deployed effectively, this often acts as a path for others to follow.

Certain parts of the middle market buyout financing market have become expensive. What I mean by expensive is the risk return has gone from being in favour of the lender to being in favour of the borrower. We like to finance buyouts, but we also finance all manner of other assets and companies that are non-sponsored deals. For example, we want to finance cash flows, ships and other transportation assets, healthcare IP, real estate, widget makers, oil and gas assets, inventory, credit card pools, receivables, etc. What the best strategies tend to do in a shallow market like Europe is to try to cover as much territory as they can [...]. To have a balanced book, you have to focus on particular sectors in that month or that year which appear to be in the lender's favour and be cautious in the sectors that are more in the borrower's favour. That's the way I think the market works.

³ See the ACC's white paper – Non bank lending in the European Union
<https://www.aima.org/asset/2FF3699E-6354-4816-8BBFF179BE79693C/>



Dan Pietrzak

Member
KKR Credit New York & London

I learned the very hard way out of the gate in Europe, you need the local knowledge.

We are trying to find assets or asset classes that we think are probably underserved and very interesting from a relative value perspective and then I think we've set the business up well because we can lend to people who are doing that, we buy the loans or we can actually start a platform ourselves. An example of something in the UK we really liked was the UK auto lending space, because we thought the assets there were very mispriced for what you could get for similar risk in the US.



Benjamin Fanger

Managing Partner
ShoreVest Partners

The ability to scale in our space is limited by the primary bottlenecks, which are reliable institutional human capital and experience. I don't mean just experience in sourcing and underwriting, but also in navigating the process to exit, which can be very difficult for newcomers. Making an investment in Chinese direct lending or non-performing loans also demands a platform with institutional quality. Today in China, there are local groups who buy non-performing loans or do direct lending transactions; you can also find other groups of institutional quality but with little experience. But when you put those two criteria together, it is extremely hard to find good people or teams. And so that is the gating factor.



Jon Fox

Partner
Värde Partners

You have to be prepared to take on complexity, beyond simply pricing in risk. Any investor is capable of entering a market like India or Italy and saying “I’m just going to price that in”. However, there will typically be a small number of players, with a presence on the ground, who are prepared to do the hard work. These managers are capable of accessing deeper and more sustainable versions of the opportunity, while those coming from afar are less able to compete. Our business model is predicated on embracing complexity, employing local experts with the requisite language skills and domestic market experience to understand the opportunity.



Katherine Abrat

Chief Operating Officer
Arkkan Capital Management Limited

Our experience is that Asian credit strategies are increasingly appealing to investors. They view the region's credit markets as inefficient, recognise that banks have scaled back their participation and that opportunities exist for new providers of capital. Alongside this they can see that lending decisions made during the rapid growth of the region's credit markets are spurring credit events in current market conditions. Investors agree that skilled and experienced managers can source attractively priced opportunities, manage complexity and deliver returns with a low correlation to traditional asset classes and investors' broader portfolios.

While we have seen steady growth in investor appetite for Asian private credit, we recognise that the attendant Asian jurisdictional, legal and structural complexity is unfamiliar to some investors and requires effort and time to understand. However, we see that this complexity provides natural barriers to managers seeking to navigate the market and a corresponding opportunity set for investors willing to consider the asset class. We work alongside experienced consultants to ensure potential investors appropriately understand the strategy and opportunity this inefficiency and complexity presents.



François Lacoste

Managing Partner in Charge of Private Debt
Idinvest

We have been active in Germany for over ten years – initially, it was very difficult to position ourselves compared to bank financing but management and private equity funds finally realised the importance in having a solid and reactive financing partner and flexible financing to support the development of their companies. However, it takes time to change investors' views of private credit. The UK and France are by far the most mature and important markets for direct lending in Europe, other countries are less developed, even if Germany has experienced strong growth over the past years and is representing an important market.

One important part of our strategy is to avoid raising larger funds and becoming completely lost in a different market. We prefer to stick to the market we know and to adopt a cautious approach, instead of shifting to the highly competitive and aggressive middle market. We are simply looking for new strategies across Europe. What has proven difficult is finding the right strategy that fits our DNA – we need the right team (a key element) and we need to be able to deliver good returns to investors given the risk.

It is important to understand how each country operates because when you look at the transactions, they are all different – you cannot do transactions in the same way as with people living in London or in Paris because things are done differently in Germany, in Spain, in Benelux and so on. Therefore, you need to be experienced in each region that you target and understand the culture and traditions of each country. This means having people based locally.



Loïc Fery

CEO & Co-CIO
Chenavari Investment Managers

The outlook for private credit

The sentiments of our interviewees and the data collected for this research supports the view that the outlook for private credit remains healthy. Both indicators suggest there is greater capacity for expansion of private credit across almost all markets. Even SME lending, commonly assumed to be the most competitive part of the market, is expected to expand in coming years and in fact shows the highest likelihood of growth in the near term. Growth in the core US market will also be accompanied by expansion in Europe and emerging private credit markets such as China, India and the wider Asia-Pacific region.

The expansion of private credit is occurring at a time when the outlook for the global economy is becoming less certain. This and other risk indicators suggest that the economy at large and lenders in particular may face challenging circumstances in the near to medium term.

When this view was put to our interviewees, they suggested that while this may be a fair characterisation of the market in the broadest sense, it ignores the differences that exist among lenders, strategies and geographies, and the steps that lenders have taken and are taking in preparation for a more challenging market.

For example, the growth in capital allocated to private credit is undoubtedly contributing towards pricing competition, which can create unhelpful incentives in some parts of the market. Most managers are exercising caution in light of these incentives and adapting their businesses by augmenting their workout capabilities, developing new products and focussing on markets that offer more favourable returns for lenders. The next chapter of this paper is devoted to the questions that private credit managers are asking themselves in anticipation of the market testing them in new ways.

Our DNA is to seek alpha in less crowded segments of the European credit market, where we have strong expertise and access. Our focus will evolve depending on where we are in the credit cycle.

In the private credit market, Chenavari can be categorised more as a specialty finance player as opposed to a mid-market direct lender. We are probably one of the main investors in Europe in origination of consumer loans, mortgage loans and real asset-backed loans. Initially, back in the early years of direct lending, we participated in direct lending from unitranche to PE sponsored mid-market borrowers, but then the evolution of that market led us to concentrate more on the areas of the market where we see more value. The incredible growth of supply in mid-market lending is no longer offering value: weakening credit fundamentals, increasing leverage metrics, weaker covenants as well as tighter spreads on these loans.

At the current stage of the credit cycle, we are very happy to be in European specialty finance segments which have higher barriers to entry since they require the ability to rely on a strong servicing and origination set-up: specialty finance is operationally more intensive. We also tend to benefit from strong downside protection, as most loans are highly collateralised.



Benjamin Fanger

Managing Partner
ShoreVest Partners

Private credit in China is something that's extremely unique right now, in the sense that it is probably, by various measures, the second largest private credit market in the world. On the non-performing loan side, the government is really welcoming of foreign capital to come help clean up the banks. A couple years ago I asked a director of the China Banking Regulatory Commission, "What are you going to do to dissolve your trillions of dollars of NPLs?" And he replied, "We don't want to extend and pretend because we don't want to become like Japan. We don't want to do a government bailout." In Chinese he said "the government won't pay for lunch". He said "Instead, we want to let the market digest it." I pointed out that the problem China will face is that there really aren't any massive global credit funds who have the capability to just back a truck up and fill it with Chinese NPLs. Even if they did, they wouldn't have the experience with how to exit them. And he said, "That's why we are going to do everything we can to encourage the market to exist by making it easier to transact, and by making the legal system more predictable." So the government itself is trying to reduce the barriers to entry.



Deborah Zurkow

Global Head of Alternatives
Allianz Global Investors

Our USP is the ability to develop new markets, often in partnership with a large anchor investor who's willing to seed us so that we can build a track record and bring innovative strategies to market. We did it first with infrastructure debt, and we've repeated it with a number of strategies since. We are in the unique position of being a very large organisation but still having the ability to be entrepreneurial at the same time. So, a combination of the stability of Allianz Global Investors and our core investors' appetite for innovation is driving our expansion into new markets. I think what we have done to date is look for ways that can help us develop a broad platform that unlocks new cash flows for our investors. We just launched a trade receivables business which is a market that is still in an early phase of participation by asset managers, but one that we think will grow very quickly. Impact funds are also developing rapidly, but we're very clear with our offering that the impact needs to be measurable. So our USP is this willingness to try to help create new asset classes to differentiate ourselves and bring new cash flows to our investors.

02

THE CYCLE LIVES ON

Private credit, like many other asset classes, is cyclical in nature. Our data confirms that the impact of the economic and credit cycles on its future growth prospects is at the forefront of private credit managers' minds.

Throughout our interviews, optimistic statements about the future of the asset class were tempered with caution that we have yet to see private credit tested through 'the cycle'. With managers increasingly deploying capital on a global basis, it is not necessarily useful to talk about 'the cycle' without specifying the jurisdiction or relevant region or, indeed, the strategy or market in which capital is deployed. However, the longer-term nature of private credit investments requires managers to factor in cyclical downturns across all their forward-looking risk assessments.

While some aspects of the current macroenvironment are adding greater complexity to this planning process, the basic challenge for lenders remains the same – maintaining discipline in underwriting practices alongside successfully monitoring and managing portfolio risk.



Loïc Fery

CEO & Co-CIO
Chenavari Investment Managers

I think that the differentiating factors are going to be structure, pricing and origination.



Tim Flynn

Chief Executive Officer
Hayfin Capital Management LLP

After ten years of artificial rates and quantitative easing there are bound to be excesses in the market.



Benoît Durteste

Chief Executive Officer & Chief Investment Officer
Intermediate Capital Group plc

We are not seeing a slowdown in commitments or investments from LPs. They are, however, becoming more selective which benefits established players. There is still a lot of money being invested and increasing amounts being deployed in alternatives generally, not just in private debt.

There will be a slow down at some point when the next economic or financial crisis takes place, as investors tend to hold back and take stock at times like these. But, if you take a long-term view, the trend will resume because structurally most investors are increasingly shifting towards alternatives with quite some way to go.



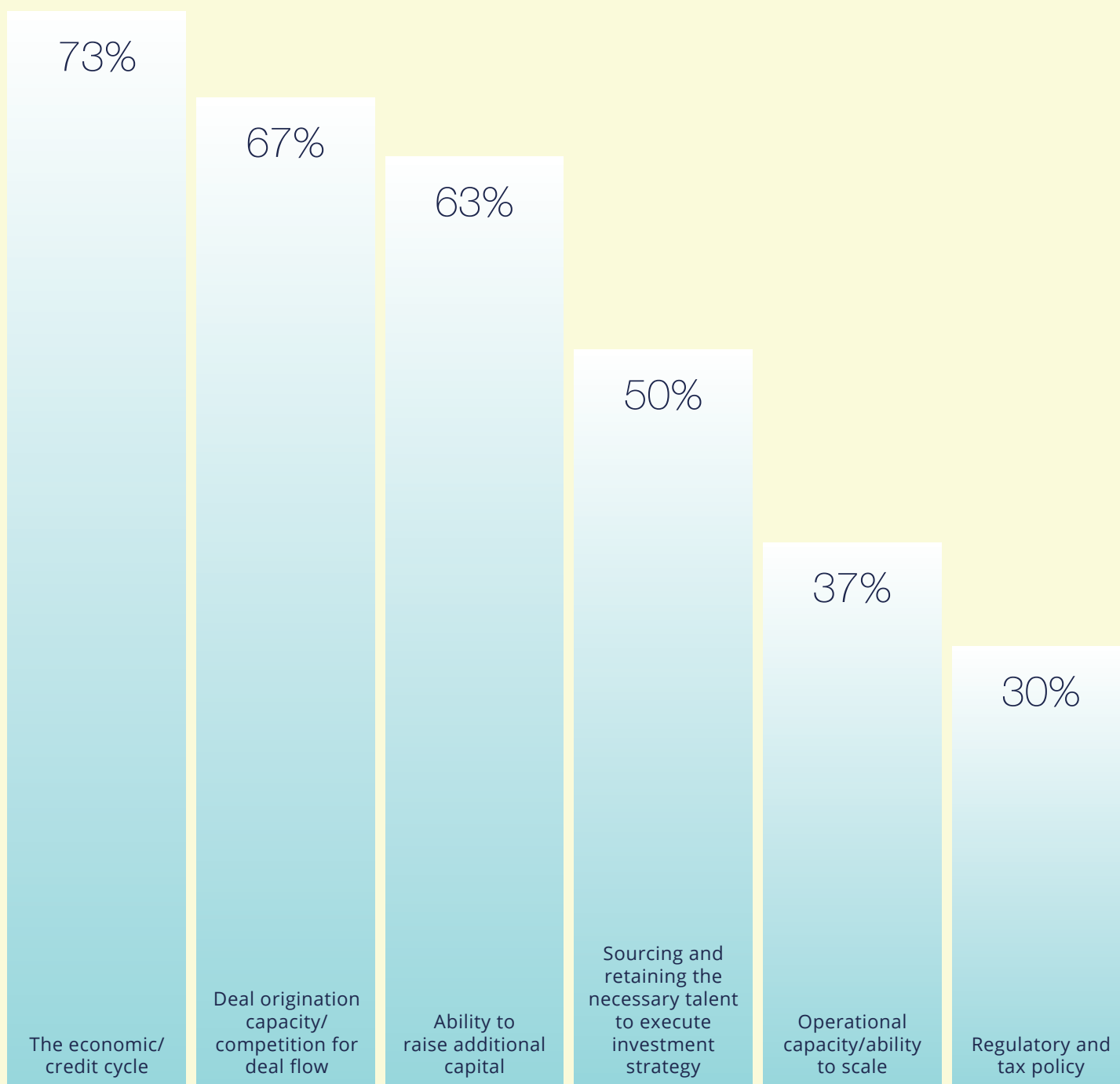
Anthony Fobel

CEO
Arcmont Asset Management

The real test for us and other managers will be when we go through a cyclical downturn. That's when we'll really see whether we did indeed lend to high quality businesses, and whether the structures we put in place were robust enough to withstand a market downturn. At the moment, everyone's numbers look good.

Figure 05:
Which factors will have a significant impact on the future growth of private credit firms?

Percentage of respondents who cited these factors





Steven Clark

Founder
Omni Partners LLP

Lots of projections have been made by managers and asset allocators about the strength of their chosen credit and how it will perform in a downturn, but none of these have been tested yet.

You're going to find some horror stories when it is. Plenty of money has come into the private credit space on the basis that it works a bit like listed bonds – it'll always kind of be fine and there will be ample liquidity to refinance at maturity. But I don't think that's always going to be the case. It's going to be very interesting to see that hypothesis get tested in a downturn. We've had lots of managers raise an awful lot of capital. The sheer volume of cash being deployed is driving yields down and driving covenants out. The incentive for managers is to get the capital out the door because they only really get paid when they've deployed it. The problem arises when it comes time to get it back in. If the market is soft and a manager doesn't have the next fund to roll the assets into, what does the manager do?



Mark Jenkins

Managing Director & Head of Global Credit
The Carlyle Group

We are clearly late cycle and need to be conscious of that in every investment. In this environment, there are generally two camps of investors. One group looks back at the global financial crisis and waits for the opportunity to buy performing credits at discounted prices. A second group looks back and worries that such an economic crisis could happen again. Both groups tend to be risk adverse and reluctant to deploy capital. We believe today's macroenvironment is different, largely because there isn't as much leverage in the system today. Companies have much healthier balance sheets because we have had 11 years of virtually uninterrupted earnings growth. So we see opportunities to deploy capital every day, but we clearly avoid certain highly cyclical companies and industries in secular decline.



Ramesh Kashyap

Managing Director & Group Head Alternative Income Group
Ninepoint Partners

Maintaining discipline

Globally, credit markets are showing signs of later cycle behaviour. Interviewees cited the impact of the broader macroeconomic environment as a concern, with private credit unlikely to be immune to the impacts of liquidity shocks, a slowdown in economic activity and rising geopolitical risks.

As well as making it harder for managers to identify potential risks, these factors also make it difficult for investors to differentiate the relative performance of private credit managers. Taken together, it is hard to come across any conversation within private credit that doesn't address the impact of the cycle on market discipline. Interviewees highlighted three areas which typically underpin this discussion.

The first of these is the way in which private credit managers are originating deals. Most managers intend to develop their direct relationships with borrowers [see Figure 06] – unsurprising as it gives private credit managers unique investment opportunities. This channel also reflects the prevailing sentiment that once borrowers have had a positive experience with a private credit manager, they will return to them for future financing rounds – often referred to as 're-ups'. In many cases, private credit managers will make a commitment to provide further rounds of financing, subject to certain conditions being met. This gives the borrower greater certainty around future financing.

In preparation for an economic downturn and following credit contraction managers must focus on strong underwriting and collateral coverage. The influence of a mismatch between the supply and demand of capital could result in some private credit providers drifting from their mandated style. It is easy to take unlimited capital and manufacture yield, but when the market softens the impact of loose underwriting and myopic oversight becomes apparent. The reputational risk to the industry will be the lazy underwriting of some of the participants right now.



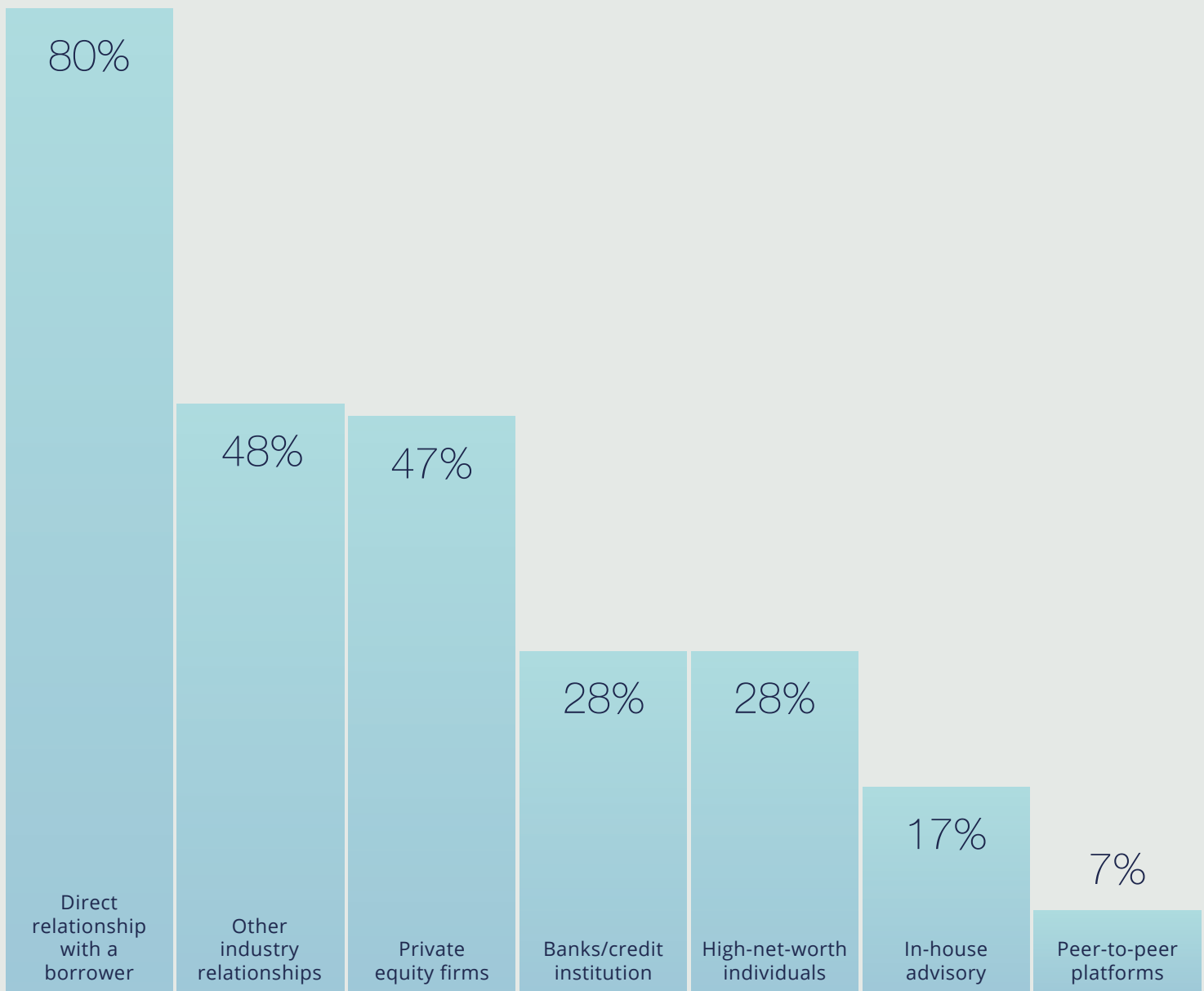
Stuart Fiertz

Chair, Alternative Credit Council, Co-Founder
President & Director of Research, Cheyne Capital

We have seen deals (that we have either passed on or have known the terms of) where we have been very surprised to see the transactions get done. Those terms and the poorer set of covenants will ultimately cost investors. I don't think that private debt's loss of discipline exhibits unique characteristics from any other cycle in credit underwriting and credit appetite, but the work-out of these deals will be much faster than has been the case historically with bank loans because we don't have the same ability to "extend and pretend" or keep loans marked at par. They'll be marked down to a sensible level whereby a solution can be found much more quickly and the approach and attitude on the fund manager side will be much more dynamic. As an industry, we need to keep emphasising the point that, as lenders, we understand that a company is worth more as an operating business than in liquidation, and that's going to be true in almost every case. Therefore, we have every incentive to find a solution that keeps a company operating. What you would typically find in a well-structured deal is that the lender would have the power to restructure the business before it gets so dire that you're close to a liquidation-type scenario. That's one of the reasons why it's important to have strong covenants so that, by the time you're sitting down with the borrower, there are still assets in there and there's still a viable business to be saved.

Figure 06:
How do private credit managers plan to develop their origination channels for potential credit opportunities over the next three years?

Percentage of respondents who expect to source more credit opportunities through these origination channels

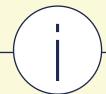


The bilateral relationship between private credit managers and borrowers can also support the efficient resolution of issues, should a borrower face more challenging circumstances. The more direct alignment of interest between both parties incentivises early remedial action. As noted above, the more direct relationship also eliminates the need for lenders to co-ordinate (or compete) with other creditors, an important factor given that time is critical in any restructuring or recovery process. Indeed, the lower frequency of hard defaults in the private credit space is testament to the effectiveness of the private credit model.

Our data indicates that private credit managers are also seeking to expand their deal origination networks more broadly. This supports the sentiments expressed by our interviewees on how deal origination quality will increasingly be a differentiating factor for investors. Some private credit managers are (rightly or wrongly) seen as having a dependency on a narrower range of origination channels. Many of the interviewees regard this as a potential weakness in some business models. On the other hand, having a singular focus on specific industries or geographies can also be a source of competitive advantage.

When questioned about the expansion of their own origination processes (whether gaining footholds in new markets or developing existing relationships), interviewees noted that their own efforts to expand often faced greater challenges than they initially expected. This suggests that the expansion of origination channels may prove more difficult despite the optimism evident in our data.

The second differentiating factor highlighted by our interviewees was the flexibility around underwriting and loan structuring. In practice, most private credit managers see more investment opportunities than they have capacity for and employ a filtering process to evaluate these efficiently. Although this process naturally differs between firms, it will typically involve an initial review of credit fundamentals, loan or deal structures, likelihood of completion and an initial assessment of the risk/return profile of the lending opportunity. Most deals will not make it through this initial review. Those that do, however, are then subject to additional due diligence that incorporates the institutional expertise of the manager concerned.



Typical credit and market risk management policies and procedures

Credit risk is the risk of loss from the failure of a borrower to meet its obligation of settling outstanding amounts in full and on time. Credit risk can arise from factors related to the borrower's business activities - for example, failure to meet production or sales targets leading to decreased revenues, or external factors, such as market conditions within a particular jurisdiction or industry sector. Market risk is the risk of loss due to factors that affect the overall performance of the financial markets, including developments affecting the liquidity of investments or collateral, the cost of funding and so on.

Private credit managers will typically identify and measure potential credit risks arising from their investments that may impact a given fund's performance. At a minimum, the process will include:

- a thorough review of the risks which could impact the fund, with consideration given to balance sheet developments, profit and loss considerations, reputation-related matters and ESG, borrowers' financial health, investors' demands, regulators' perspectives;
- using various tools and processes to identify risks. Data should be gathered from internal and external sources to support the identification of risk;
- an organisation-wide key risk register, categorised by the main risks faced by the fund and reviewed regularly by the risk committee;
- regular reviews integrated into business planning, project management and new product development processes (including future due diligence processes); and
- regular reviews of market considerations, such as interest rates and liquidity conditions.

When defining and measuring these risks, private credit managers will employ methodologies and models to produce what they believe to be the most accurate measures of risk in different market conditions. This data then informs their decisions when assessing risk appetite, allocating capital and establishing reporting requirements throughout the period of investment. This process also takes into account the limitations of any chosen models using additional data sources, which produce results reviewed by skilled and experienced professionals. Private credit managers will also have in place procedures to ensure that overall limits are set in relation to credit origination to a single obligor or group of obligors. Where necessary, they will also apply a sectoral or country risk limit depending on the nature of the portfolio. These exposures will be monitored on a regular basis, both gross and net of offsetting collateral and any other relevant security.

At the same time, there is an awareness throughout the market that the prevailing macro-economic environment, as well as the increased competition within private credit, is making it harder to evaluate and appropriately price risk. This is a critical challenge for investors as they consider whether to make, maintain or increase a capital allocation to different private credit strategies. In this respect investors are adopting a relatively cautious approach, with many showing a preference for higher profile names or managers who have a demonstrable track record of good performance through previous cycles – with a particular focus on capital preservation. A further layer of due diligence being employed by investors relates to the blend of skills and experience within individual private credit managers or deal teams. Investors' confidence in the ability of private credit managers to identify and manage risk is informed by healthy scepticism and practical assessment.

Documentation is seen as the third leg supporting a disciplined investment process and an area that will differentiate performance between managers. Ensuring that the loan documentation appropriately reflects the risks identified in the underwriting and due diligence process is critical. However, the creeping trend of greater borrower/sponsor power (add-backs in EBITDA calculations, the removal or weakening of loan covenants, the way security is pledged and mechanisms by which a lender can enforce a claim on assets have all become more nuanced) is making it increasingly hard for all parties to do so in a clear manner.



Dan Zwirn

Chief Executive Officer & Chief Investment Officer
Arena Investors LP

A big secular change is the massive volume of dollars that need to find a home and make a yield, based on post-crisis monetary policy and the fact that the central banks have effectively printed a lot more dollars that need to find a home to make a yield. There is only so much return to be had, and so how do you deal with that? And that leads to these horrible distortions that ultimately will show themselves when risk is appropriately repriced.



Tom Newberry

Partner, Global Head of Private Debt & Senior Portfolio Manager
CVC Credit Partners

One thing that concerns me is documentation terms that were born in the large cap loan market creeping down to the mid-market. We are very focused on ensuring stronger protections in the documents we sign. Frankly, there is a whole industry of lawyers and professionals that are paid simply to build trap doors in documents, and they have raised it to an art that is fairly extraordinary at this point. Given this shift in lender protections, I tend to agree with some of the agencies that the recoveries on these loans, particularly in the large cap market, are probably going to be lower than what we've seen in past default cycles.

Some complexity in documentation is a natural consequence of the non-standard loans that are a hallmark of the sector. Nevertheless, this did not stop some interviewees expressing concern that the trend of ever-increasing complexity may create unexpected friction in a restructuring scenario or unwittingly facilitate style drift or shifts within the capital structure. The question asked by many in the industry is whether this complexity has now reached the point where it is hindering the ability of lenders to accurately assess and price risk. It also restricts an investor's ability to make a reasoned assessment of the relative performance of private credit managers.

One manifestation of this trend can be seen in relation to loan covenants which, in times of market stress or poor performance, are an important tool in managing risk and minimising potential losses. Naturally, covenants are heavily negotiated by both borrowers and lenders with each party drawing on in-house and external legal resources. Ideally, the terms of the loan are sufficiently flexible to meet borrowers' objectives, while retaining protection for the lenders' interests. Flexibility, however, does have limits and the extent to which covenants are being weakened within loan documentation or removed entirely is a source of concern across the market.

The current decline in covenant protection within the broadly syndicated market is well documented. This trend is also shaping perceptions of private credit, despite covenant protection across the sector generally holding up much better than in the broadly syndicated markets. Although less stringent loan covenants are not a direct proxy for less robust lending practices, this development is dampening expectations of how private credit may perform in a downturn.



Dan Pietrzak

Member
KKR Credit New York and London

Our base case models have a recession in there. We are late cycle credit and the market is pretty hot and frothy, so you need to make sure you are doing your work and deploying money on things that you have high conviction in. We spent a lot of time in the past two years institutionalising our business. What I mean by that is building out the team – we have enhanced our origination footprint meaningfully, we have enhanced our skill set in structuring and execution and we have brought on someone recently with almost 40 years in the leverage finance market to help with underwriting and execution of deals. We hired desk lawyers in both the US and Europe, so someone who is sitting with the investment teams, not in our general counsel's office – directly involved in negotiating documents. I really want consistency in our business.



Mark Jenkins

Managing Director & Head of Global Credit
The Carlyle Group

The rise of covenant-lite loans will certainly decrease the probability of default over the cycle. The only way you are going to default is if you have a payment default. The severity of those defaults, of the actual recoveries, however, could be much worse.



Lindsey McMurray

Managing Partner
Pollen Street Capital

While many would subscribe to the view that it's better to lend to a good borrower on poor terms, than a poor borrower on good terms, this may be too simplistic a calculation during times when even good borrowers may face a challenging outlook. The assumption that lenders' interests are not as well protected as believed was challenged by some of our interviewees. For many, a lender's appetite and capacity to step in and work with a borrower, whether it be restructuring the loan or business model, is a more important factor (and one which highlights the very real differences between private credit and traditional lenders) than the mechanics of how they can do so under the documentation.

Faith in workout capabilities

If you are in the lending business, you are also in the restructuring business. While the best outcome for any lender is for the borrower to repay the loan on time and in full, it also needs to prepare for scenarios where this may not be possible. Single or multiple borrower defaults within a loan portfolio will place pressure on the ability of a private credit manager to deliver the expected level of returns to investors. Operationally, dealing with a borrower in default requires the commitment of more internal resources than monitoring a performing loan. Capacity to deal with stressed loans is now a central topic of discussion between managers and investors.

Most private credit managers differ from traditional lenders in their approach to workout capabilities. Private credit managers typically combine workout capacity within the loan origination team. This ensures that there is an appreciation of potential downside scenarios as much as upside scenarios when considering whether to lend.

One of the reasons LPs tell us they are investing in areas outside of corporate lending in private credit is the increase in 'cov-lite' deals that has resulted from the weight of capital in that space. By contrast in asset secured lending there remains a very significant supply/demand imbalance, so both the pricing and structuring dynamics have remained strong. We structure our investments to take security over an asset pool and then establish full covenant suites which are tightly set against the performance of both the assets and the corporate. In addition, we're typically taking a senior position with the originating partner providing the first loss so there is significant alignment of interest in the structure as well.

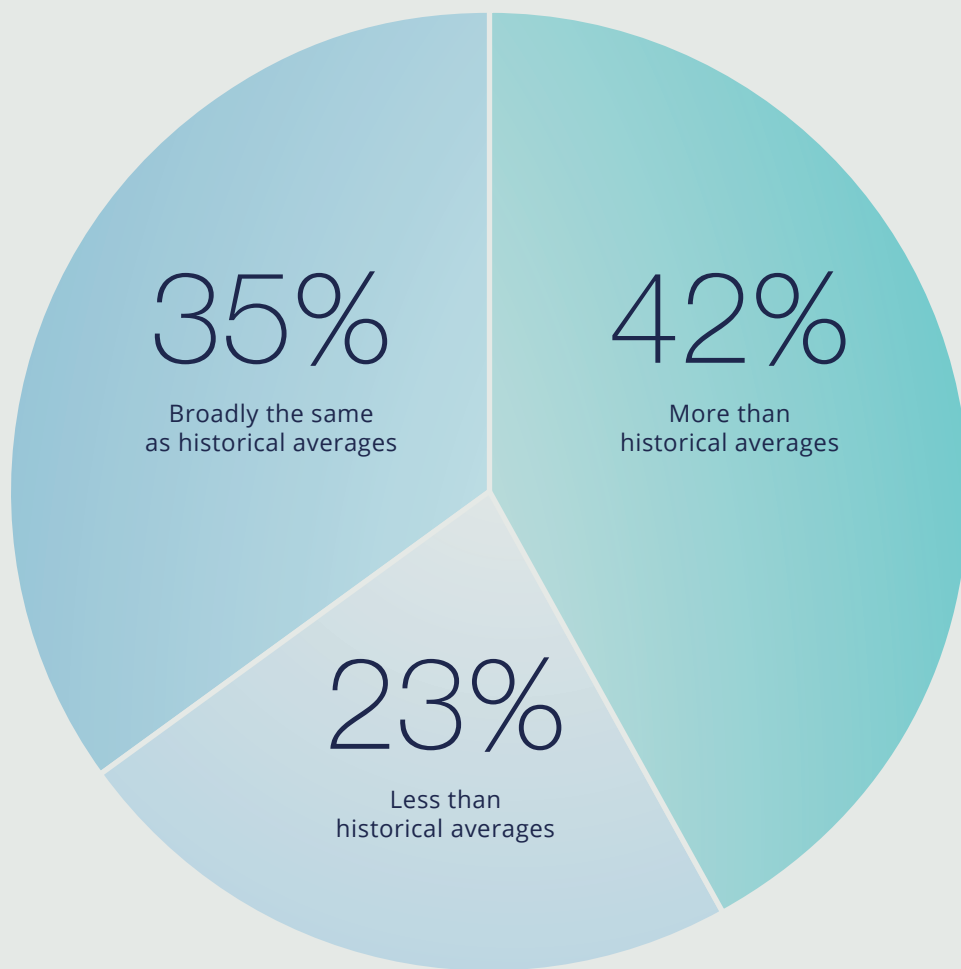
Tim Flynn

Chief Executive Officer
Hayfin Capital Management LLP



One of the challenges for a vanilla direct lender is around the scale of your team. In the good times you might have the odd road bump or the odd default, but you don't need much of a workout team to manage that. Therefore, direct lenders don't tend to have that capability because workout specialists are usually very expensive people. However, in Europe certainly, direct lending funds are yet to really experience a downturn. When the downturn comes, clearly the demand for workout capability will grow. Right from the beginning, how we manage workout has always been front of mind. When we started ten years ago, we decided to create a different private credit team by combining our direct lending and special situations expertise. We don't hire people here who can only do one. You might have more experience on one side or the other, but to work at Hayfin, you have to be conversant in both financing performing assets and restructurings.

Figure 07:
What are private credit managers' expectations around recovery rates on defaulted loans during the next three years?





Tom Newberry

Partner, Global Head of Private Debt & Senior Portfolio Manager
CVC Credit Partners

It also means there is a strong corporate memory within the lender in relation to the loan and the borrower, making it more likely that early signs of stress or increased risk will be picked up sooner, and any necessary remedial action is taken promptly and proactively. This 'cradle to grave' model is further augmented with independent oversight of front office and investment activities – particularly in relation to risk management and valuation – and is reinforced through remuneration structures that align the interests of the deal team with the success of the loan. While it is impossible to protect lenders in all circumstances, this approach is generally believed to encourage greater resilience in times of stress and defaults.

The approach taken by private credit managers to stressed and distressed borrowers is typically more dynamic than traditional lenders. There are generally fewer instances of hard defaults (i.e. where a borrower ceases to pay or be a going concern in any form) within private credit and our data suggests that recovery rates are expected to be either the same or higher than historical averages.

The way in which private credit managers raise and invest capital provides them with significant flexibility to adapt to a change in circumstances, e.g. moving loans from one fund vehicle to another, working with a borrower on an alternative business model, restructuring the repayment profile of the loan or refinancing the loan or portfolio entirely. Private credit managers also face fewer incentives than other lenders to continue marking stressed or defaulted loans at par. Restructuring the loan so that it more accurately reflects the borrower's circumstances or risks involved is often necessary to support the transformation of that borrower's business model and ensure it remains a going concern.

Our practice is that we don't have a workout department like a bank might have; we ask the people who originate the deal to manage the deal from cradle to grave. We find that if something does happen to go wrong, that team is in the best position to lead the process of dealing with it. We are a big platform, with significant resources for our private debt people to draw on, including our Special Situations team and a large CVC Group network of investment professionals and operating partners. We continue to like the model that we've developed – you buy it, you own it. Based on this philosophy, and a relatively low level of stress in our portfolios, we are not setting up a workout group.

Although private credit managers are expected to perform well through any downturn, they will face several challenges. Any stressed, default, restructuring or turnaround situation is inherently resource intensive. Even a single non-performing loan within a portfolio will take a disproportionate amount of time to resolve. In some instances, it may also require private credit managers to take on a role closer to an equity position, entailing a more direct involvement in the running of the business. This is a fundamentally different proposition from being a lender and it may lead to situations where private credit managers need to re-assess whether they have sufficient capacity to manage this workload. For some investors, moving from a debt to an equity position may also present difficulties in terms of their portfolio composition.

Cyclical issues are also affecting perceptions towards other asset classes, and private credit is not a unique case. Many in the industry would argue that an investment in private credit ultimately provides more protection due to its seniority in the capital structure and will therefore prove more resilient than other asset classes. There is also a sense that a downturn is a necessary rite of passage for private credit if it is to overcome the reticence that exists amongst some who remain unconvinced by its merits or its status as an asset class.



Gaudenzio Bonaldo Gregori

Managing Partner
Pillarstone Italy SpA

So what you need to do in most cases is to have a very hands-on approach in terms of investment strategy and management approach. In most cases we have invested in, this is required. Our team support and integrate management teams when/if required, we challenge and review the business strategy, and this translates into the definition of the turnaround plan and goes back to the question I asked you at the very beginning which is “can we believe there is a turnaround plan?” But also can we understand everything in regard to who has control and responsibility to deliver that plan? I do believe that our long-term partnership model can be more effective when investing in distress versus a more opportunistic short-term approach. We can enhance value for the company we invest in and also for the underlying economy where we invest.

If we buy a distressed asset or get involved in a distressed situation in a company, what is fundamentally important for us is to understand the underlying business from both an industrial and market point of view – there are two basic questions we ask ourselves before proceeding. Question number one should be is there a viable turnaround plan that we believe can succeed? The second question is do we think we can help and support all stakeholders to actually deliver that turnaround plan, and support the company throughout the restructuring first and development of the business thereafter. We are focussed on investing in the business, creating value in the business and the turnaround plan is based on the value that we can create throughout our investment period. We aren't an opportunistic short-term financial investor, we are a long-term partner.

03

ACCESSING COMPLEXITY PREMIA

Private credit is often associated with justifying an illiquidity premium but, for many, the value of private credit managers comes from their ability to deal with complexity in a manner that is also scalable. Loans and credit assets are often harder for investors to reach than other assets such as bonds or equities. A greater value can therefore be attributed to the ability of private credit managers to help investors access these assets efficiently. They typically do this by augmenting market knowledge and technical expertise with substantial investment in technology.



Tim Flynn

Chief Executive Officer
Hayfin Capital Management LLP

I think the single biggest operational challenge we face today is around complexity. Underlying products – in terms of illiquid loans, the way they trade, the way they settle and the way that we need to book and hold them – are intrinsically complex and on top of that, fund structures are becoming more bespoke. We have an increasing amount of separately managed accounts that we manage on behalf of our clients and each present their own challenges, such as providing sufficient transparency to investors so they can satisfy their own reporting requirements. One example is Solvency II; another is profile reporting for American investors. These challenges are more significant today than they were 10 years ago.

Managing complexity

The management of capital on behalf of investors requires private credit managers to simultaneously manage business, legal, tax and regulatory requirements. Balancing these considerations, while developing products that support the alignment of interests between private credit managers and their investors, is a core competency for private credit managers. The variety of strategies that currently sit within private credit means there are few areas within a typical fund checklist that can be addressed in a systematic way. Flexibility to clients' needs is a recognised strength, but one which comes at a price in the form of ever-increasing demands on operational infrastructure to deliver.

Private credit also faces unique regulatory barriers when seeking to lend in markets that place restrictions on the granting of credit by non-banks⁴. This requires private credit managers to have a thorough understanding of the precise legal and regulatory requirements in each country of operation. This significantly affects any structuring that may be required underneath a credit fund, as well as the choice of lending instrument. Emerging or less developed markets outside the US and Europe can also be described as presenting similar challenges from a regulatory or tax perspective.

The combined impact of these considerations places a premium on the ability of a private credit manager to navigate these requirements efficiently, concurrently and successfully. Addressing multiple complications in a holistic manner was cited by our interviewees as one of the most valuable things private credit managers do for investors when enabling them to gain exposure to assets that were previously inaccessible.

⁴ The ACC's paper Non-bank lending in the European Union gives an overview of the various approaches that are required, and barriers to lending that exist, in some of the key European markets <https://www.aima.org/asset/2FF3699E-6354-4816-8BBFF179BE79693C/>



Angela Samfilippo Gorder

Managing Partner
Argentem Creek Partners LP

For the most part, fund manager firms are small businesses with small business risk. In this asset class, settlements and valuation are complex, portfolio and risk management systems need a high level of customisation, and investor relations requires reporting and senior-level infrastructure to explain the complexity. Appropriately trained staff with low turnover is important. The business side must run properly in order for the investment side to function. We spend a lot of time thinking and talking about business risk at the management committee level.

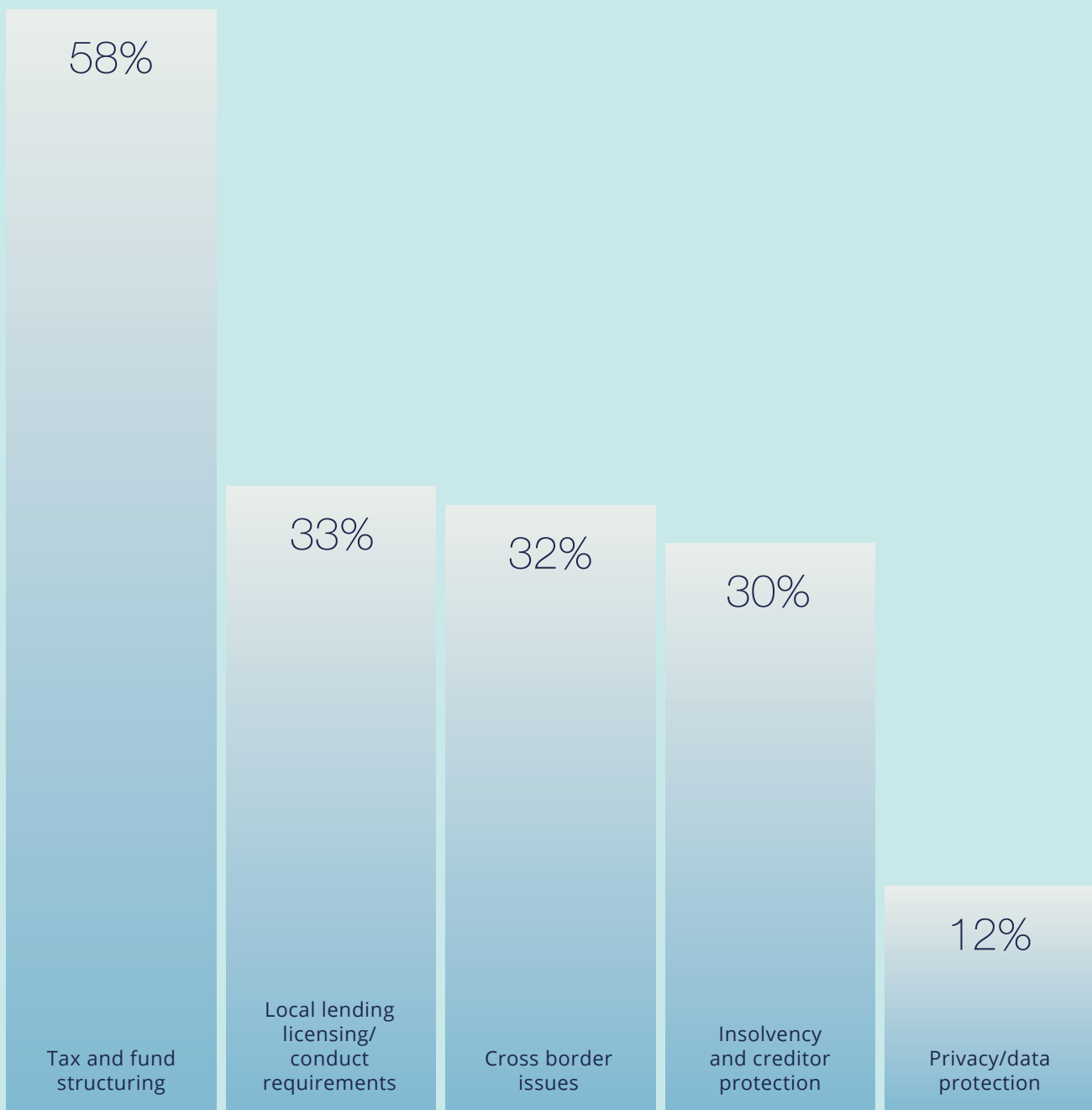


Katherine Abrat

Chief Operating Officer
Arkkan Capital Management Limited

The complex and idiosyncratic features of each Asian high yield credit investment, overlaid with jurisdictional nuances, do not lend the strategy to the easy adoption of off-the-shelf technology and operational systems. Instead, we have focused on investing in an experienced non-investment team and developed bespoke in-house tools and processes to cater to the strategy's needs and drive efficiency in our business.

Figure 08:
What are the biggest regulatory challenges facing private credit managers?
Percentage of respondents who cited these challenges





Drew Schardt

Managing Director, Head of Private Credit
Hamilton Lane

Technology as a means, not an end

The operational infrastructure for private credit, and the capacity of service providers to support private credit managers, is still evolving⁵. While having the necessary technology to manage risk and investment decisions remains key, many interviewees still see scope for technology to introduce even greater efficiencies into the lending process.

This is partly a consequence of the flexible (and typically bespoke) approach to lending by private credit managers which can preclude the adoption of standardised processes in some areas. Our research suggests this is becoming less of a concern among private credit managers who have consistently invested in technology to support areas such as credit underwriting, risk management, loan servicing and investor reporting.

Increasing investor expectations in relation to operating infrastructures demand that private credit managers adopt a more structured approach in relation to data gathering, portfolio monitoring and reporting. Much of this involves the incorporation of existing technology, which is then customised to meet the specific strategies being pursued by lenders and the needs of their investors.

Managers who tend to struggle are those who are slow to utilise technology platforms and related infrastructure. These are often complex investments that require efficient, timely sharing of information, not just from the borrowers themselves, but also with underlying investors and LPs. Our observation, based on our position in the industry, is that the level of customisation required, the demands and requests that investors – rightfully – put on managers, have grown exponentially. The biggest area of differentiation we've seen today is between managers who have chosen to embrace technology and create or invest in tech solutions and thus move away from Excel-based templates – and those who have not. We're living in a world where people want more information, more quickly and cut in 50 different ways. Ultimately, I think those who embrace that trend are likely to fare better than those who do not.

⁵ See Enhancing the loan administration function - <https://www.aima.org/asset/5897B478-C455-4BE1-958B7CB456DECB4C.1636BF7D-0F58-46ED-B6B08CBB675B0BF8/>



Cécile Mayer-Lévi

Head of Private Debt
Tikehau Investment Management

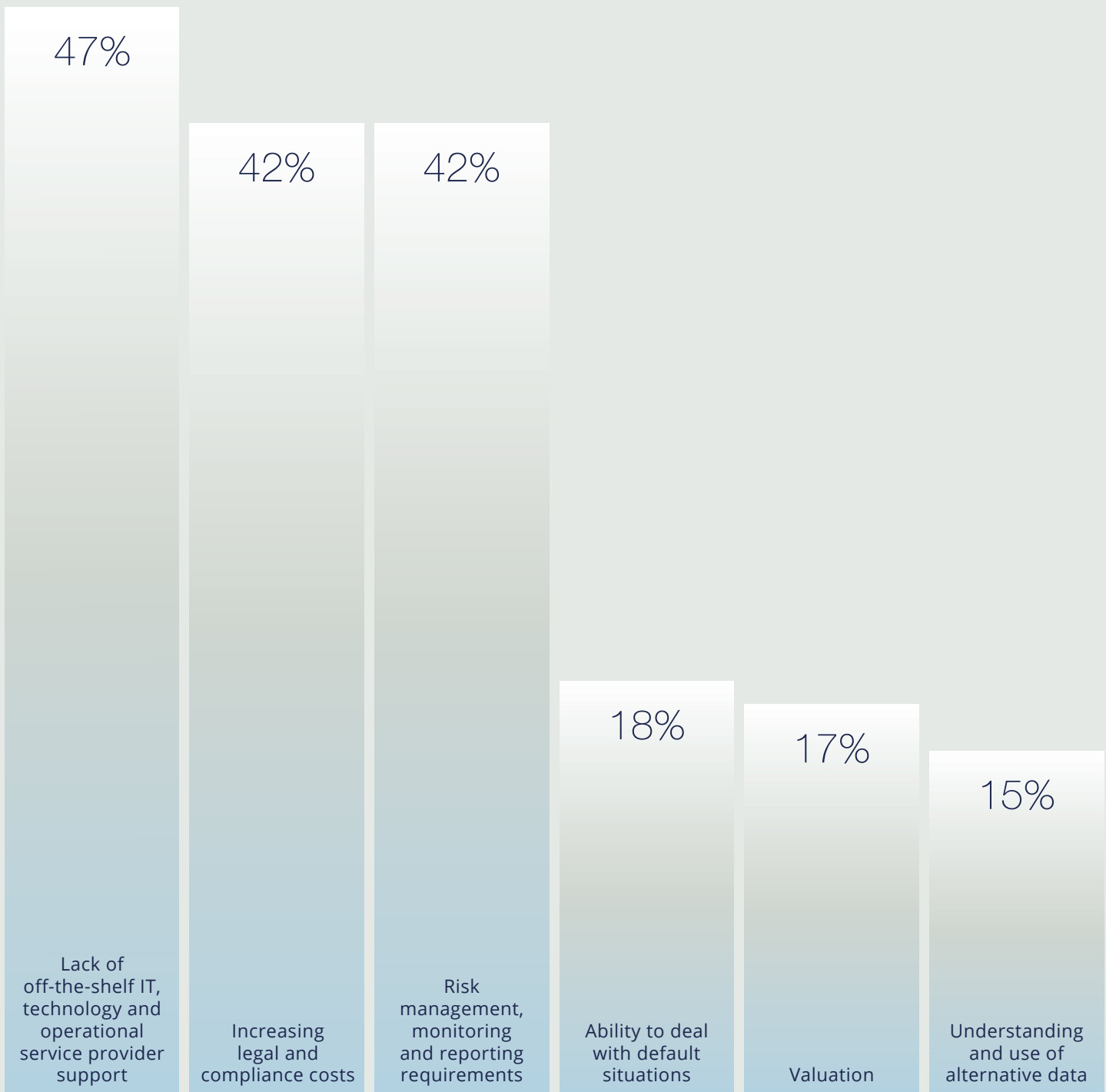
The areas identified by interviewees as most prone to innovation included: record keeping using distributed ledger technology (DLT); borrower due diligence via AI data analytics; text recognition to support document review and the use of cloud-based software to support the provision of information to investors. Several private credit managers also see this as an attractive alternative to increased headcount as they grow their businesses. These trends will continue to drive significant investment in technology across the private credit sector.

The adoption of newer technology is also viewed with a degree of healthy scepticism. While using DLT to establish 'golden copies' of documentation that would function as a single authoritative source of information is viewed as a potentially positive development from a KYC/AML perspective, there is also some caution about using this same technology to tokenise loans. While the former would greatly simplify a complex and time-consuming area, the latter has the potential to disconnect creditors from borrowers. This would undermine the bilateral relationship at the heart of private credit, with tokenisation becoming another method of syndication. It would also limit the ability of the lender to manage the loan over its lifetime.

One of the next revolutions in the private asset industry could be related to the role of custodians. The current fund structures used out of Luxembourg often require the involvement of a custodian for regulatory and legal reasons.

The tasks they need to perform have remained highly manual, which can be a source of mistakes, distraction and problems. The closing part is very often a nightmare and full of last-minute surprises, errors and need for reconciliation. It is striking how this role has not been more disrupted by fintech style workflow or platform as in other parts of the financial services industry.

Figure 09:
What are the biggest operational challenges facing private credit managers?
Percentage of respondents who cited these challenges





Lindsey McMurray

Managing Partner
Pollen Street Capital

One of the benefits of asset secured lending is the granularity and diversity of the underlying assets which form the security for our lending, particularly when it comes to monitoring the performance. We are big believers in the use of data and technology. While there is a lot of jargon around the use of AI, the value of it is real. We have a huge amount of data that we collect from our borrowers and partners that details the performance of their assets. We have a separate team of four people that focus on how to collect the data. We then have an analytics team that looks across the data to identify learnings and patterns across the data sets and where we are starting to see changes in performance – can you see degradation in performance, can you see patterns across the different borrowers so that we can then go to our partners with insight and hence be a value added partner. So there is definitely value in data today and, frankly, we have been implementing AI for decades. AI is learning from what you did yesterday and asking if you can learn do it better. So where something happens in the dataset, you will then go and re-program and learn from it. Over time, you can automate more of the learning but the concept of learning from what you find in the data and then improving what you do at the front end of underwriting, is a concept that has existed forever. We now have a more automated way of implementing the learning.

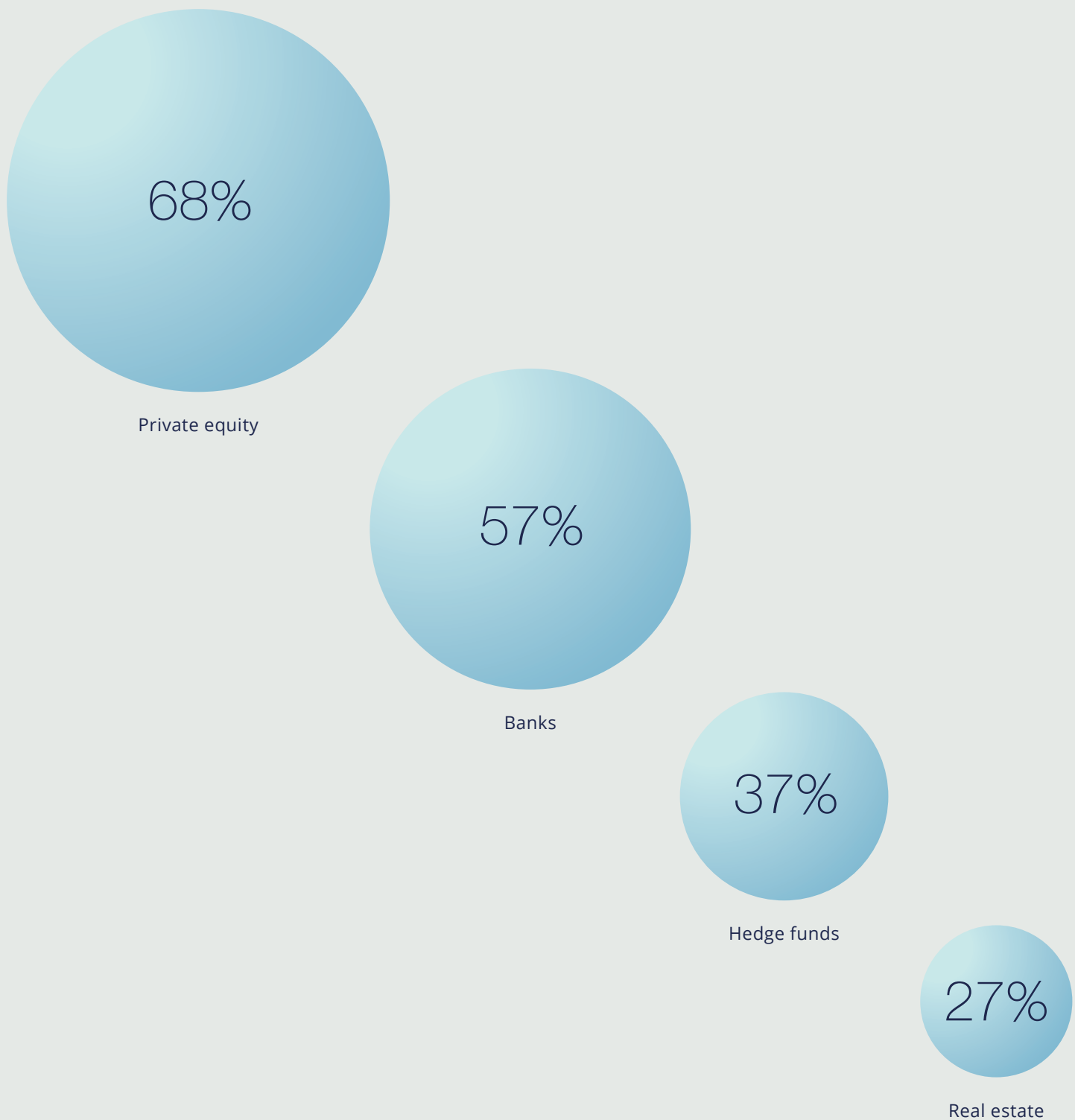


Stuart Fiertz

Chair, Alternative Credit Council Co-Founder
President & Director of Research, Cheyne Capital

We've investigated the potential to use blockchain technology to reduce the life cycle costs of direct lending, and it's still on our radar. We do think, ultimately, that some form of keeping a golden copy of all the documentation, of the cash flows, of the evaluation reports, and the AML pieces that have to be done on an annual basis will generate cost savings. The danger is that too many participants in blockchain immediately make the leap to unitising the loans which is something that is likely to be catastrophic. A unitised loan will have no single sponsor who would be in a position to manage the full life cycle of each loan. While every loan is made with the expectation that it will be repaid on time, and that there will be no issues or adjustments that need to be made, the reality is that the world is dynamic and issues and opportunities arise, and you need to have somebody who can manage that asset.

Figure 10:
Which sectors do private credit managers primarily compete with for talent?
Percentage of respondents who cited these sectors



Talent management

Private credit managers typically recruit from the banking sector, other asset management firms or tap into the legal and advisory sector. There is an increasing demand for skilled individuals within the private credit industry, and a growing awareness that it may not be possible for the sector to rely on other industries to develop staff in perpetuity. The pipeline of people with credit experience has shrunk in correlation with the reduction of the banking sector in some jurisdictions.

In less developed markets, the need to source people who combine a knowledge of local markets with the ability to meet the needs of institutional investors is a more pressing challenge. In response, many firms are adopting a policy of 'green horns and grey beards' whereby newer staff work alongside those with greater experience. Such processes can be relatively unstructured but tend to help develop a sense of loyalty and collaboration that supports a positive culture within a firm.

The other main topic of discussion relating to human capital is the impact of diversity and inclusion. For many, this is primarily seen as a business competency issue and one which helps firms guard against the risks of groupthink. Creating a culture of internal challenge and being able to draw on different skill sets when making lending decisions means that diversity, in all its aspects, contributes to the success of the business. This is already changing how managers approach recruitment and internal talent management with many broadening their recruitment pools, establishing stronger links with affinity groups and taking steps to limit bias in their hiring processes.



Steven Clark

Founder
Omni Partners LLP

I've run this business now for more than 15 years and the biggest successes we've had, by far, are with home-grown talent.



Deborah Zurkow

Global Head of Alternatives
Allianz Global Investors

I think that diversity is now integrated into the thinking of investors and asset managers as a critical component to avoiding groupthink. In my opinion the worst decisions in history and in credit have been the result of group think. A lot of people get together, they think the same, they act the same, they do the same things and they actually just don't think to question.



Tom Newberry

Partner, Global Head of Private Debt & Senior Portfolio Manager
CVC Credit Partners

The available talent pool in Europe has shrunk, as a lot of bankers have moved to direct lending funds. Often these people move earlier in their careers and, as time goes by, they begin to accumulate accrued performance fee awards, which can sometimes be quite significant – at least hypothetically. Once that has happened, it can be quite expensive to hire them away. This makes our own position more defensible, but likewise it's more difficult to extract people. We have found that hiring people in Europe has become a little bit more challenging as the market has matured.



Lindsey McMurray

Managing Partner
Pollen Street Capital

Diversity – it's not just a numbers issue, it is a decision-making, organisational improvement – you become better thinkers with different approaches, and you make better decisions.

Yes, you manage numbers because it's a good way to just test ourselves industry wide, and I've gone from frankly not being that supportive of quotas to being supportive of them because it forces you to bring in the change in the first place. But once you get there, actually there's a real sense that you get better diversity of decisions and better decision making and I think we're going through that. It takes a while to get to that – and I think we're there.

04

MEETING INVESTOR PREFERENCES

The range of lending strategies contained within the private credit asset class allows investors to build balanced portfolios that deliver returns through different stages of the economic cycle. They can provide investors with (i) differentiated growth and income opportunities, (ii) downside protection and (iii) a boost to returns in times of market turbulence.

Few private credit strategies can provide all these things simultaneously and the challenge for investors mainly lies in identifying which strategies and managers are best suited to their needs. Most investors' initial experience with private credit is often through an allocation to corporate direct lending. Investors are, however, increasingly familiar with the broader opportunity set that exists beyond direct lending. Education is paramount in this respect, particularly in relation to improving investors' understanding of the asset class and the range of risks and opportunities that accompany different investment strategies.



Andrea Ash

Investment Director
RPMI Railpen

As a pension fund we are long-term investors. We want to build a balanced portfolio that can perform across a cycle by pulling on different return levers; having a clear idea over strategy is key. We also want to be able to take advantage of dislocations or disruption as they arise in the interim however; a more fluid approach lets us do this. Flexibility comes from a number of areas. It's in the way we construct our private markets portfolio – we don't want to be constrained by 'filling buckets' and we work closely as a team to balance the dynamics between equity and credit risk. It also comes from running mandates with managers that are willing to flex for us; credit offers a host of strategies with different risk return asymmetries that can work well together across a cycle.

This doesn't work in all strategies, or even across the full "private credit" spectrum, however certain sub-sectors in credit can really lend themselves to a more holistic approach. Here we can cut across collateral types and even across liquidity profiles. Other more niche strategies that serve a specific purpose can equally be better accessed on a standalone basis. We also look to access investments in the most appropriate way; that means being open to different formats – funds, co-investments and direct positions.

In order to do all of this we look for strong relationships with our managers; we believe in an open and honest dialogue about what that opportunity set is and want to back managers when they arise. We are looking for partnerships. People often use that word, 'partnerships', but I've never seen it targeted in the same way Railpen does. It's one of the main reasons I joined the team. Working closer with GPs allows us to get closer to the underlying investments, understand what the risk is and ultimately why we want that risk in our portfolio. We are no longer prepared to simply be LP number 99 with a quarterly investment letter.



Tod Trabocco

Managing Director
Cambridge Associates

When I say maturing, I'm referring to LP acceptance. And while it appears that LPs are accepting of applied credit strategies, I still sense a broad and deep undercurrent of reluctance and disbelief in certain asset classes and I believe that a measure of the acceptance to date has been driven by desperation or desperate yield seeking. So what I mean by that is if I were to look into the brains of a lot of LPs I think they're saying to themselves 'I don't know if these guys know how to lend'. I don't know what my recoveries are going to be, but I need yield and high yields aren't giving it here. So I think there's that element of not fully embracing it yet. I think what will happen is all these private credit strategies, not managers, but strategies will make it through the next downturn. Once LPs have a tested result of the resilience of private credit, I think the reluctance that haunts them today will fall away. I think that they'll increase their allocations. The challenge that private credits faces is the challenge that all asset purchasers today face, which is making good decisions that will result in what you promised in a world of asset inflation.



Anthony Fobel

CEO
Arcmont Asset Management

Private credit as an asset class

While the compelling investment case for private credit has been accepted by many investors, its inclusion across all investor portfolios is not happening in a uniform manner.

For many investors, private credit is primarily an alternative to investing in fixed income, particularly at a time when a substantial amount of fixed income products are returning extremely low-to-negative yields⁶. The potential returns from investing in private credit investments of similar maturity are therefore very attractive. Other investors come to the asset class with expectations of different return profiles that are more typically associated with private equity, real estate or other alternative investment strategies.

This range of approaches means that while some investors are establishing dedicated private credit allocations, others are more comfortable creating space for private credit within their existing private equity, fixed income, real estate or alternatives allocations.

One potential downside of investors having pre-determined allocation categories (whether to private credit or other asset classes) is that they reduce the flexibility available to investors to react to opportunities as they arise. Where investors seek to increase their allocations to private credit, they often do so within less rigid mandates to ensure they do not curtail their ability to react to investment opportunities as the market evolves. Many investors see this as the most effective means of increasing their exposure to the asset class, with the caveat that the success of this approach depends on their relationship with their private credit manager.

This acceptance of private credit by investors is, however, not yet wholehearted⁷, despite the broadly positive performance of private credit in recent years. As such, prospects for a further expansion to the industry should be tempered with a degree of caution.

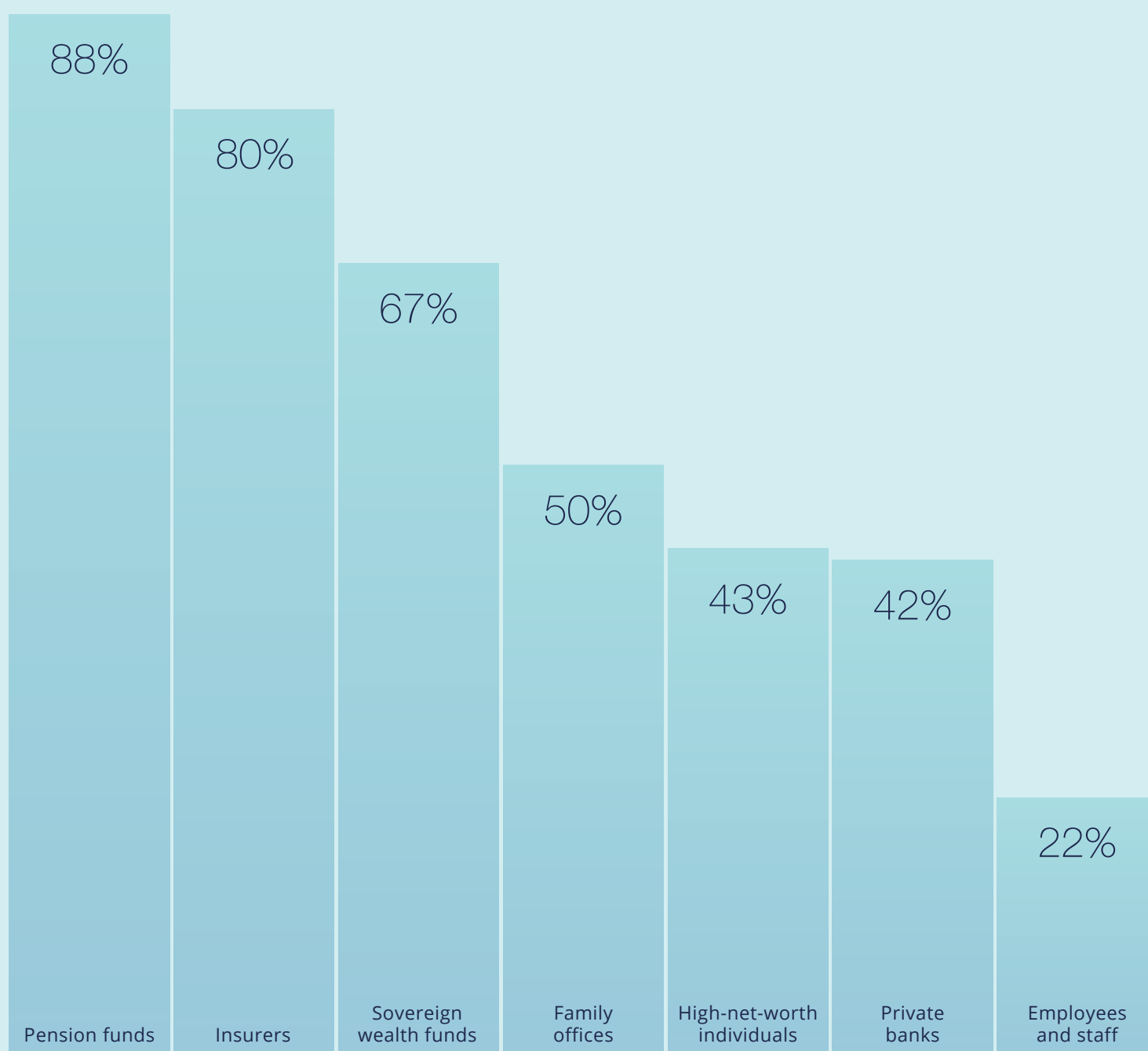
In the early days before private debt established itself, you had a number of quite opportunistic investors, family offices, and so on that really saw private debt as a product of the financial crisis. But they didn't necessarily feel that it was an asset class that was here to stay. At that same time, you had the big institutional investors who didn't really have a bucket for private debt. It wasn't liquid credit and it wasn't liquid private equity. What's happened over time is that some of those opportunistic investors have gone on to other opportunistic things. But you've seen a much more institutional client base come into the private debt asset class, including the leading pension funds, insurance companies and sovereign wealth funds globally. As the private asset class has become much more accepted, it has become much more professionalised and institutionalised and the level of due diligence that investors do is extremely rigorous.

⁶"Germany prepares to sell 30-year bond with no coupon", Financial Times 20 August 2019
<https://www.ft.com/content/d9c789c0-c329-11e9-a8e9-296ca66511c9>

⁷ACC analysis on Preqin data suggests that as of September 2019 almost half of all institutional investors have no allocation to private credit

Figure 11:
How do you expect allocations to private credit from different types of investors to change over the next three years?

Percentage of respondents who expect more investment into private credit strategies from these investors





Dan Zwirn

Chief Executive Officer & Chief Investment Officer
Arena Investors LP

The notion of categorising exposures by asset classes and benchmarks has been taken too far. Private credit is simply lending. Just because it is not syndicated or there is no CUSIP doesn't change the underlying nature of the exposure. I would urge investors to look at diversification based on the actual state of the asset – the underlying risks, underlying collateral – and define asset classes based on their having risks that are differentiated from other asset classes. But to call something private credit as distinct from other forms of credit will not in and of itself protect investors in the next downturn.



Thierry Adant

Head of Illiquid Credit
Willis Towers Watson

We definitely need a mind shift from investors to look at credit as a long-term hold, and to give them the ability to invest over the long term by providing suitable opportunities. If I look at a typical US defined contribution plan, they might have one percent to lightly syndicated or private deals and that would be because one of their managers has a very small proportion in their fund. They're forced to own it, as public rates are not yielding enough and they're providing the returns they need, not because it's part of their core mandate, so that tells you a lot. Long-term investors and savers should be owning a lot more of these but they're typically constrained by liquidity and governance.



Mark Jenkins

Managing Director & Head of Global Credit
The Carlyle Group

The sector's growth rate and current market conditions make it harder for investors to differentiate between private credit managers and the credibility of the value proposition they offer. Loan origination, for example, is commonly cited as a capacity constraint for private credit, with the supply of deals not keeping pace with capital allocations. A more accurate description from an investor perspective would be that there is a capacity constraint for deals at an appropriate rate of return for the risks involved. In response, the due diligence undertaken by investors on private credit managers in areas such as origination, workout capacity and operating infrastructure has become more intensive. This trend is driving private credit managers to continue investing in their business infrastructure, as already noted above.

A conservative approach is also informing investor sentiment towards the distressed credit space. Timing market entry points to maximise returns is notoriously challenging. Instead investors are using more traditional fund and deal structuring, e.g. using drawdown vehicles, as instruments from which they can gain exposure to distressed credit. This approach offers investors greater flexibility to scale up as and when opportunities arise without the need to be fully invested.

The investor base for private credit remains predominantly institutional. Private credit has an obvious appeal to investors with longer-term horizons and greater capacity to assess the risks and returns available. Retail investor participation is relatively limited outside the US, where Business Development Companies (BDCs) are a prominent part of the private credit universe. BDCs enable retail investors to access illiquid strategies, such as alternative credit but this concept is solely confined to the US markets (see text box P76).

Credit, like most asset classes, should not be bucketed simply by liquidity profile. Liquidity is just one of many risks, and we tend to focus on seniority and structural protections to mitigate risk. There is a continuum across the credit spectrum and you need insights into all asset classes to make the best investment decisions. For example, many people would limit the credit continuum to illiquid credit through real assets because they don't consider liquid credit to be private. Once you make that separation, however, you have lost a whole host of opportunities. Some of those liquid credits become special, distressed or opportunistic situations.



Angela Samfilippo Gorder

Managing Partner
Argentem Creek Partners LP

Investors in this asset class must choose between their comfort with larger managers who risk sacrificing returns due to desired deal size, and smaller managers who may have more perceived (or even real) business risk, but are able to achieve consistent outperformance. Some investors are simply not able to reach the required comfort level to invest with smaller managers. Further, this is a human and infrastructure intensive strategy and smaller managers lack scale to provide it as efficiently as some of their larger peers, who have more flexibility to compete for business by offering lower fees.



Andrea Ash

Investment Director
RPMI Railpen

Outside the BDC world, retail investors in private credit tend to gravitate towards investment strategies with shorter maturity profiles – for example, receivables, invoice discounting or trade finance – than longer-dated strategies. In these instances, private credit managers may also work through an intermediary such as a private bank instead of having a direct relationship with the end clients. This is often preferable from a risk and operational perspective, as many private credit firms are simply not set up to deal with retail investors directly.

The role of retail capital within private credit is likely to depend on two things. First, any deterioration in the willingness of institutional investors to allocate capital will undoubtedly require private credit managers to reassess their approach to retail investors. Second, if jurisdictions outside the US introduce similar vehicles to BDCs that better cater to the needs of retail investors, this will support greater retail participation in the asset class. The debate currently taking place within the EU regarding a review of the ELTIF framework in order to render it more attractive to private credit managers suggests that there is a recognition that more can be done in this area.

There is a lot of talk around allocating to distressed strategies; this is nothing new at the end of a cycle however it's a hard one for investors to balance. Structuring is key here and we believe it's about investing in the most appropriate way; in my opinion drawdown vehicles in both public and private markets are the best option here as we need to be committed before the cycle turns so we are ready, but we don't necessarily want to be fully invested because it can be painful on the way down. This will be hard for more traditional liquid managers to adopt as it involves a change in mindset; rather than being fully invested across a cycle, you invest when the right opportunities occur, and charge fees when that money is invested.

This means as an investor I might have less money with you when trades are scarce, but it means I am willing to scale up, and pay for it, when they are abundant; in theory we are both aligned here. Again, partnerships are key for us and we want managers that we can have open and honest conversations with about the opportunity set.



Benoît Durteste

Chief Executive Officer and Chief Investment Officer
Intermediate Capital Group plc

There is very little direct investment from retail investors because of the regulatory constraints, as well as the administrative burden this would entail. The way retail investors get access to private equity or private debt is from listed vehicles like investment trusts or via wealth management where a third party institution, such as a global bank, acts as the intermediary and sets up a feeder fund through which retail investors can get exposure to private funds.



Ramesh Kashyap

Managing Director & Group Head, Alternative Income Group
Ninepoint Partners

Much of our business growth comes from the retail market, where alternatives are significantly under-represented. The biggest challenge is a lack of education on the merits of allocating to alternatives and how liquidity risk affects a portfolio. Private credit strategies are often deemed riskier due to the illiquid nature of the loans, and this misconception is something that we are working hard to change. While the large institutions have been convinced for years on the benefits of portfolio diversification, many retail investors have their assets stuck in an outdated allocation approach. Our goal is to act as a thought leader and educator on the space, to allow more informed decision making across the retail advisory channels.

The most compelling term we see quite often relating to investors in the retail space is the need for liquidity. However, we believe concerns over liquidity are overblown. Investors receive a premium for investing in assets that are less liquid and are compensated for it. Investors should view this asset class as a yield enhancer and diversifier for its fixed income portfolio. This should be a long-term investment and they should consult a licensed investment advisor on their allocation strategy.



Joseph Glatt

General Counsel
Apollo Capital Management, LP



Josh Bloomstein

Partner, General Counsel, Ares Management Credit Group
& Deputy General Counsel, Ares Management Corporation

BDCs: what are they and what do they do?

BDCs are a long-standing and vital source of finance for small businesses in the United States. The challenges affecting the US economy in the late 1970s and early 1980s created a drought of funding for small and medium-sized businesses, not dissimilar to that witnessed globally in the past decade. In order to revitalise economic growth, the US Congress modified the Investment Company Act of 1940, creating something that didn't exist before – a closed-ended fund whose sole purpose was to facilitate lending to small and medium sized businesses. Thus, the BDC was born.

BDCs have some unique features which make them an excellent source of finance for small and medium-sized businesses. The capital they lend is raised from retail investors who, in return, receive income in the form of dividends. This means that Main Street is financing Main Street. BDCs can incorporate some leverage to augment the capital they have raised from investors. Where leverage is used, it is done so within prescribed and very clear limits established in legislation. Most of the capital invested by BDCs goes directly into the real economy – a typical BDC lends a minimum of 70% of its financial firepower to non-listed, small to medium-sized businesses across the United States. The remaining capital can be allocated to other opportunities, such as financial firms, foreign companies and various types of credit products. This approach provides retail savers with access to private assets and investment returns that are harder to find in the public markets. BDC managers file quarterly reports like any other operating business and disclose the valuation of securities held in the BDC portfolio. Therefore, any shareholder can look at the balance sheet and income statement on a quarterly basis and see exactly what they own, and the value of those assets. It is also a requirement under the Investment Company Act of 1940 that an independent third party determines the fair value of these holdings. Although some valuation differences can occur, these are usually small, and the process overall is very robust, transparent and consistent.



BDCs can be internally or externally managed. This means that the affairs of the BDC can either be managed inhouse or outsourced to an asset manager. The way they are managed affects, *inter alia*, the way compensation works – if it is internally managed, then all the compensation is paid through the BDC to its employees. However, if the BDC is managed externally, then the compensation structure becomes a management fee plus a performance fee (also known as carry). This fee structure ranges between 1% – 1.75% for the management fee and between 17% – 20% for the carry element. Performance fees are measured on returns and there is typically a hurdle rate of 6% – 8%, depending on the strategy pursued. This aligns the interests of the BDC manager with those of its investors.

When it comes to the liquidity profile, there are three types of BDCs. First, you have a public BDC which is listed on a public exchange and registered under the Securities Act of 1933, and therefore, benefits from substantial liquidity. Another model is the non-listed BDC. As the name suggests, these are not listed on securities exchanges, but are also registered under the 1933 Act and are less liquid by nature. Finally, there are private BDCs which have become more popular in recent years. These are not listed on any securities exchange and are not required to be registered under the 1933 Act as they fall within the Act's private placement exemption. Private BDCs are therefore less liquid than listed BDCs. The different liquidity profiles of these BDCs means that investors have greater choice in matching their desire to invest in BDCs with their specific liquidity needs.

Although most BDCs are backed by retail money, some of the larger ones also receive capital from alternative asset managers. These larger vehicles tend to have more capital from institutional investors, who are attracted by the yield that BDCs offer in a challenging market and the supportive tailwinds (such as continued borrower demand) that underpin the market. BDCs, like many other non-traditional lenders, have witnessed a period of substantial growth for the best part of the last 10 years. It is estimated that BDC assets

under management increased from about \$19 billion in the final quarter of 2009 to roughly \$105 billion at the end of the first quarter of 2019 (an increase of 452%)⁸. The number of investments made by these vehicles grew from about 2,500 to almost 12,500 in the same period⁹. This growth underlines the huge demand for alternative credit within the real economy and investor appetite to provide capital to this business.

The BDC remains a unique way for retail investors to benefit from investment strategies that may be hard to access, such as alternative credit strategies, while funding the real economy. European managers are increasingly looking to emulate this model, but the biggest challenge they face is the lack of regulatory harmonisation across the region. If some of the more antiquated provisions of the BDC could be tailored for the European market, this could be an extremely attractive and much needed product. Establishing a European version of the BDC could also act as proof to other jurisdictions.

⁸ Source: Houlihan Lokey, Direct Lending Update, Summer 2019 – <https://hl.com/about-us/insights/insights-article/?id=17179871313>

⁹ Houlihan Lokey, Direct Lending Update, Summer 2019, supra note 8



Angela Samfilippo Gorder

Managing Partner
Argentem Creek Partners LP

Alignment of interests

The relationship between investors and private credit managers is framed by the three Cs – customisation, collaboration and communication. While these factors are not unique to private credit¹⁰, the lower levels of familiarity amongst some investors with the asset class does mean that there can be a greater need to ensure potential investors understand the investment strategy and underlying assets.

While closed-end drawdown private equity style structures remains the most popular vehicle for direct lenders, this may not be suitable in all instances depending on the profile of the borrowers or the lending instrument. Some investors looking for semi-permanent allocations or more customised products are also seeking to adopt evergreen fund structures or SMAs, or to increase the efficiency of their capital allocation models. It is expected that investor demand for these arrangements will become more prevalent in the market.

Investors' demands for a collaborative relationship is having an impact on the information they expect to receive from private credit managers. The private nature of the market means that investors have less readily available comparable data for both individual investments and at an aggregate level. This has fostered a strong culture of openness and transparency across private credit, with private credit managers providing granular information on their performance and risk management practices to investors. This culture is also reflected in the willingness of private credit managers to continue investing in their reporting infrastructure to meet the needs of their investor base.

Increased investor demands for transparency and communication have been experienced by managers across asset classes for years now; this is not new. However, pressure to achieve returns coupled with explosive asset growth in private credit has forced some investors to get up the learning curve quickly, requiring additional time and attention from managers. Patience and openness during investment due diligence and through the investment relationship can lead to long-term LP relationships based on trust and understanding – and those are the best LP relationships to have.



Tod Trabocco

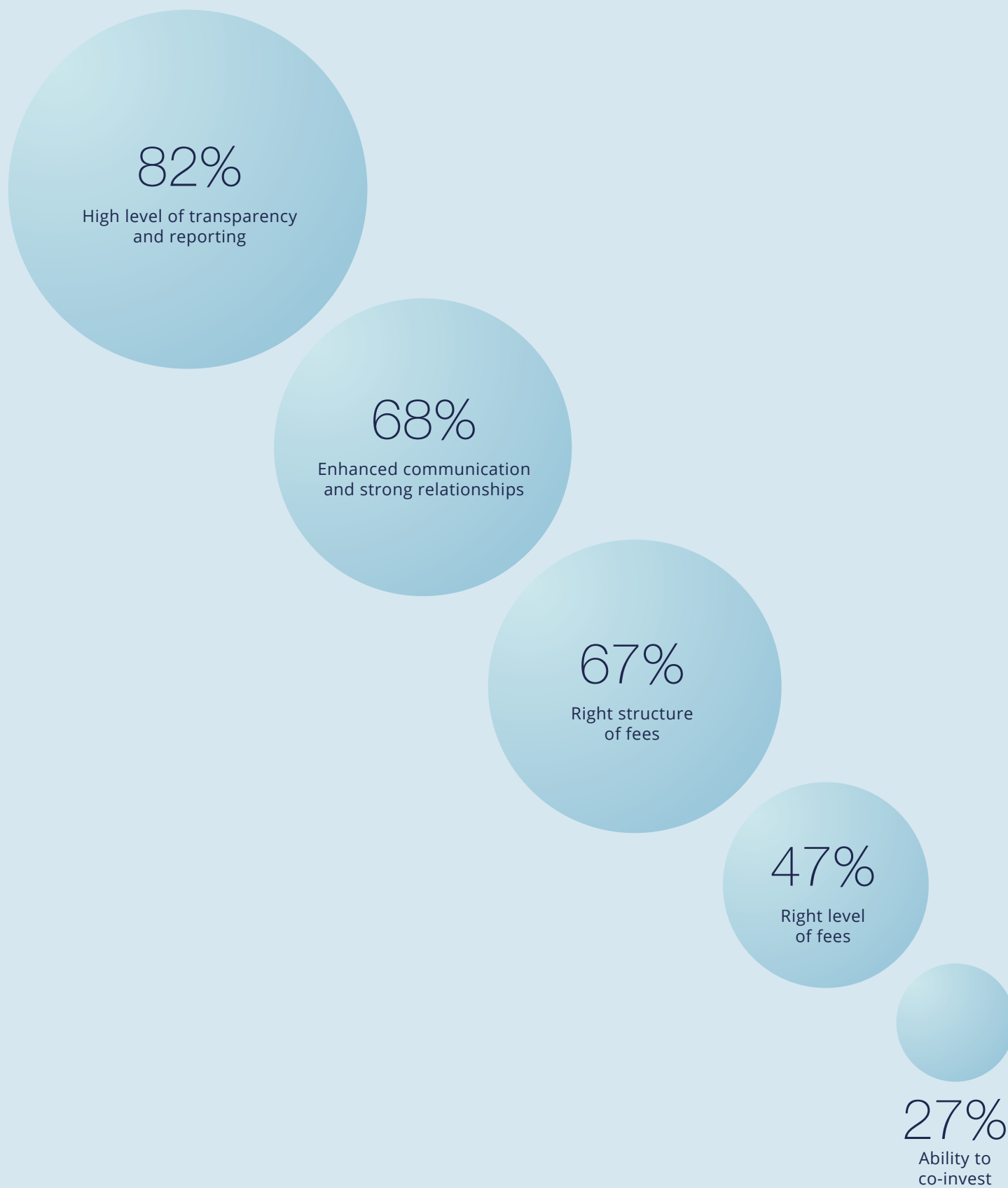
Managing Director
Cambridge Associates

There's definitely a desire to institutionalise because the enterprise risk is real. If you have millions of dollars of cashflow coming through to your business, from different sources every month, and you've got to distribute that to five different funds and a couple of SMAs, you can't afford to screw it up.

¹⁰ See AIMA publication In Harmony <https://www.aima.org/educate/aima-research/in-harmony.html>

Figure 12:
What are the most important factors in achieving alignment of interest between private credit managers and investors?

Percentage of respondents who cited these factors



Relevant loan performance metrics, portfolio data and financial information vary across different private credit strategies – making like-for-like comparisons either very difficult or immaterial. To meet this challenge, there must be an understanding between investors and private credit managers about the relevant and material data points. Several of our interviewees highlighted how they had worked very hard with their investors on this topic and emphasised the value of ongoing dialogue around this point.

Taking this debate one stage further also brings us to the question of what constitutes the right benchmark for private credit, which is made more complex by the relative newness of the asset class, and one with such a diverse subset of strategies. The absence of an established benchmark means that investors do not have an appropriate lode star to guide their approach to different strategies and managers. Such a hurdle is likely to have also slowed down the adoption of private credit by some allocators. We expect this to change substantially in coming years as individual investors and investment consultants use their own data sets to establish benchmarks. While private credit managers were sceptical and cautious about the appropriateness of such benchmarks, there is an acknowledgement that this is part of the natural evolution of the asset class.



Tim Flynn

Chief Executive Officer
Hayfin Capital Management LLP

Something that has changed significantly is reporting requirements, which have become more thoughtful and more comprehensive. We embrace that because we think you've got to be transparent, especially in our business, where we invest in an illiquid, opaque asset class.

What has shifted is that most of our clients today have private credit benchmarks and groups and, most, I would say, are now specialists.



François Lacoste

Managing Partner in Charge of Private Debt
Idinvest

We see more and more demand regarding risk management and transparency. Our twelve years of experience in our market segment in direct lending combined with our senior team with more than twenty years of experience is a key element to manage the risk. There are very few lenders that are focusing on the lower end of the middle market for this many years and have a proven ability to manage through multiple credit cycles. We have invested a lot in IT and in people in order to maintain a good level of risk in our portfolio.



Andrea Ash

Investment Director
RPMI Railpen

It's not about asking for blanket transparency across strategies, it's about trying to identify where the key risks are in that strategy and getting transparency around that. So for example, I could go to a direct lending manager and say I'd like full look-through on all your loan exposures, and I'd like to understand the metrics behind all of them. If I went to someone doing credit risk transfer there might be 100,000 loans in one deal, so I'm not going to be asking for the same information. And even if they could give it to me, I probably wouldn't know what to do with it. So, it's about really understanding the investment and understanding the risk of it. I want to know what within this strategy is going to lose me money, what the real downside case is and how can I get comfortable with it. The riskier the investment, the more important transparency is and really understanding where we're exposed. Once again relationships are key here.



Benoît Durteste

Chief Executive Officer & Chief Investment Officer
Intermediate Capital Group plc.

Fee structures

Any consideration of the alignment of interest between investors and private credit managers requires some discussion of fees. While both parties bargain hard, fee levels are not seen as a particularly fierce battleground at present, with fee rates generally described as competitive relative to the returns being delivered¹¹. There are, however, some signs that greater attention is being paid to fee structures and the range of fees that managers may receive beyond a management and performance fee at fund level to ensure they remain suitable as the market develops.

Private credit managers and investors are largely agreed on a management fee model that is based on drawn capital both during the investment/commitment period and during the holding and realisation period. The alternative to calculating management fees on a drawn capital basis is to calculate them based on committed capital (which includes both drawn and undrawn amounts). This metric can incentivise excessive asset raising to try and maximise the committed capital without necessarily having deal flow to support the AUM raise. Therefore the first alternative is generally recognised by investors and private credit managers as more appropriate for credit strategies.

While each approach involves trade-offs, there is some concern that the payment of fees on drawn capital may undermine lending discipline if managers try to deploy capital more quickly than is prudent to increase the proportion of drawn capital. However, overall sentiment suggests that this concern should not be overstated. The continued investment in robust origination, underwriting processes, insistence on adequate fund terms and continued dialogue with borrowers suggests that managers continue to place a greater emphasis on prudent asset allocation over a short-term incentive to deploy assets quickly.

Every investor has their own type of reporting requirements, so I don't see any standardisation of reporting. It would certainly make life easier for managers, but one has to recognise that the reporting constraints and requirements from sovereign wealth funds, insurance companies, pension funds or family offices are bound to be different. The growth of segregated mandates is also pushing for bespoke reporting rather than standardisation.

Quality of information is improving however. The entire industry is becoming generally more sophisticated. LPs are more demanding and managers realise that there is a merit providing quality information to your clients.

¹¹ See page 30 *Financing the Economy* 2018 <https://www.aima.org/educate/aima-research/fe-2018.html>

Incorporating ESG factors into private credit strategies

There have been many precursors to ESG in the investment world, such as exclusionary policies or specific investment mandates on non-financial priorities and frequently cited avoidance of headline or reputational risk. In recent years, interest in this topic has deepened and asset owners are now commonly applying an ESG lens to almost all their investments.

ESG factors are now an essential risk management indicator for end investors, particularly in relation to the impact of environmental considerations on different economic sectors. There is a realisation across the market that previous assessments of these risks were inadequate and that a repricing of these risks is necessary. This is taking place alongside an accompanying wave of regulatory attention that encompasses financial services legislation, risk management processes, corporate governance, investor disclosure and consumer behaviour¹².

There is almost universal agreement amongst managers that a structural shift in the attitudes of investors towards ESG considerations has taken place. As highlighted by our data, the absence of standardised data and reporting against ESG factors is a key challenge for private credit managers when meeting investors' demands. A huge effort is being undertaken within the financial services sector in order to share knowledge and support investors' understanding of this topic.

In response to these challenges most private credit managers have adopted ESG policies at firm level. These usually include parameters whereby investment opportunities which sit outside



Stuart Fiertz

Chair, Alternative Credit Council Co-Founder
President & Director of Research, Cheyne Capital

As the risk and cost of externalities become ever more explicit, ESG considerations have already become a critical part of the effective underwriting of any investment. Remaining ignorant of the risks of stranded assets, of consumer boycotts, of labour unrest, of poor governance and the like is simply no longer an option.



Tod Trabocco

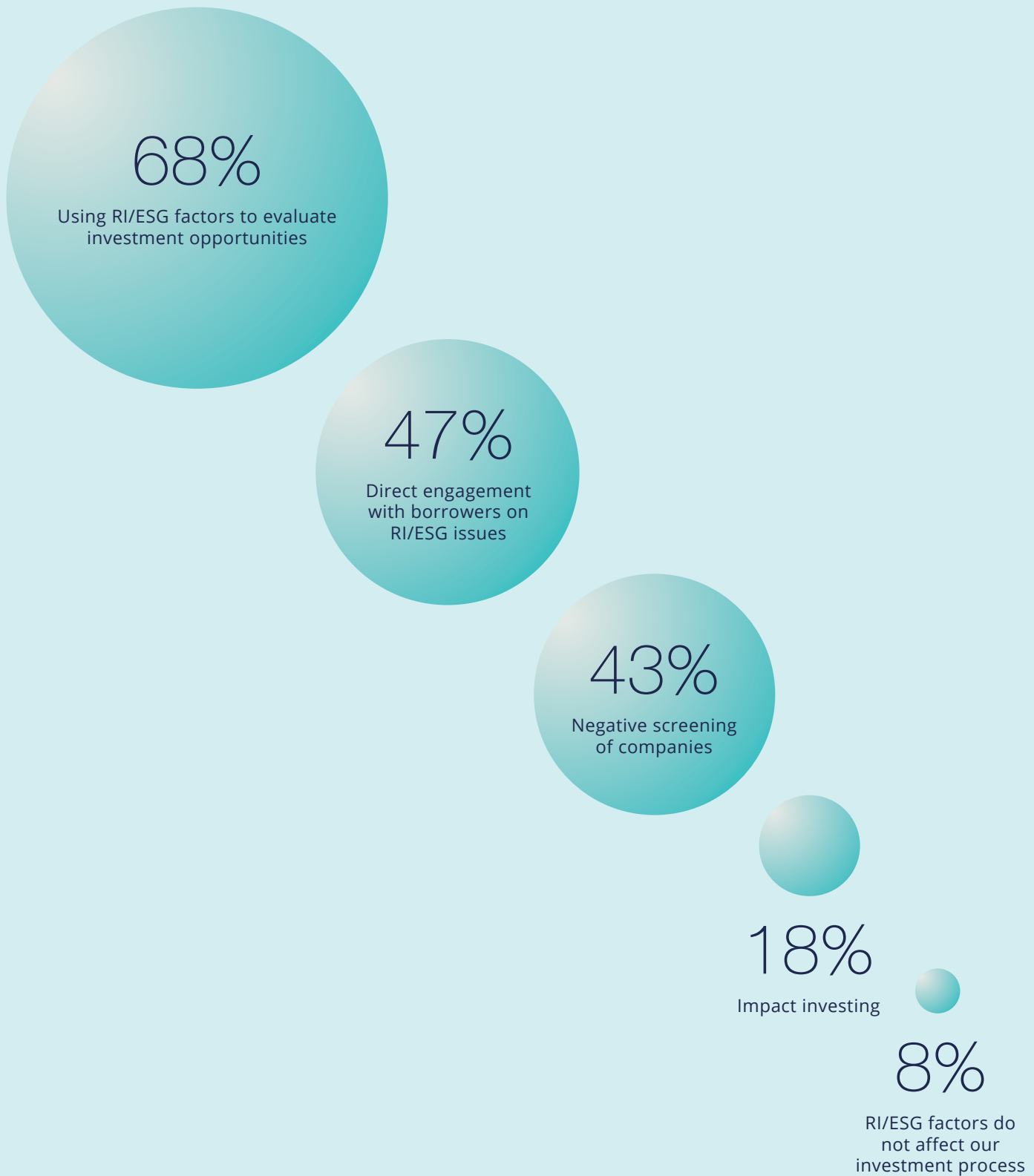
Managing Director
Cambridge Associates

I think LPs understand the difficulties of trying to actually originate ESG-oriented assets. For that, they can go to some of the speciality managers out there like urban renewal. There actually are managers on the credit side that do only this. So, if you can, scratch that itch through them. But LPs get it – they recognise that you do the best you can in ESG, but you're never going to be a source of ESG as a credit manager.

¹² For example, the European Commission Action Plan on Sustainable Finance - https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

Figure 13:
How do private credit managers incorporate Responsible Investment (RI)/ESG into their investments?

Percentage of respondents who cited these approaches





Deborah Zurkow

Global Head of Alternatives
Allianz Global Investors

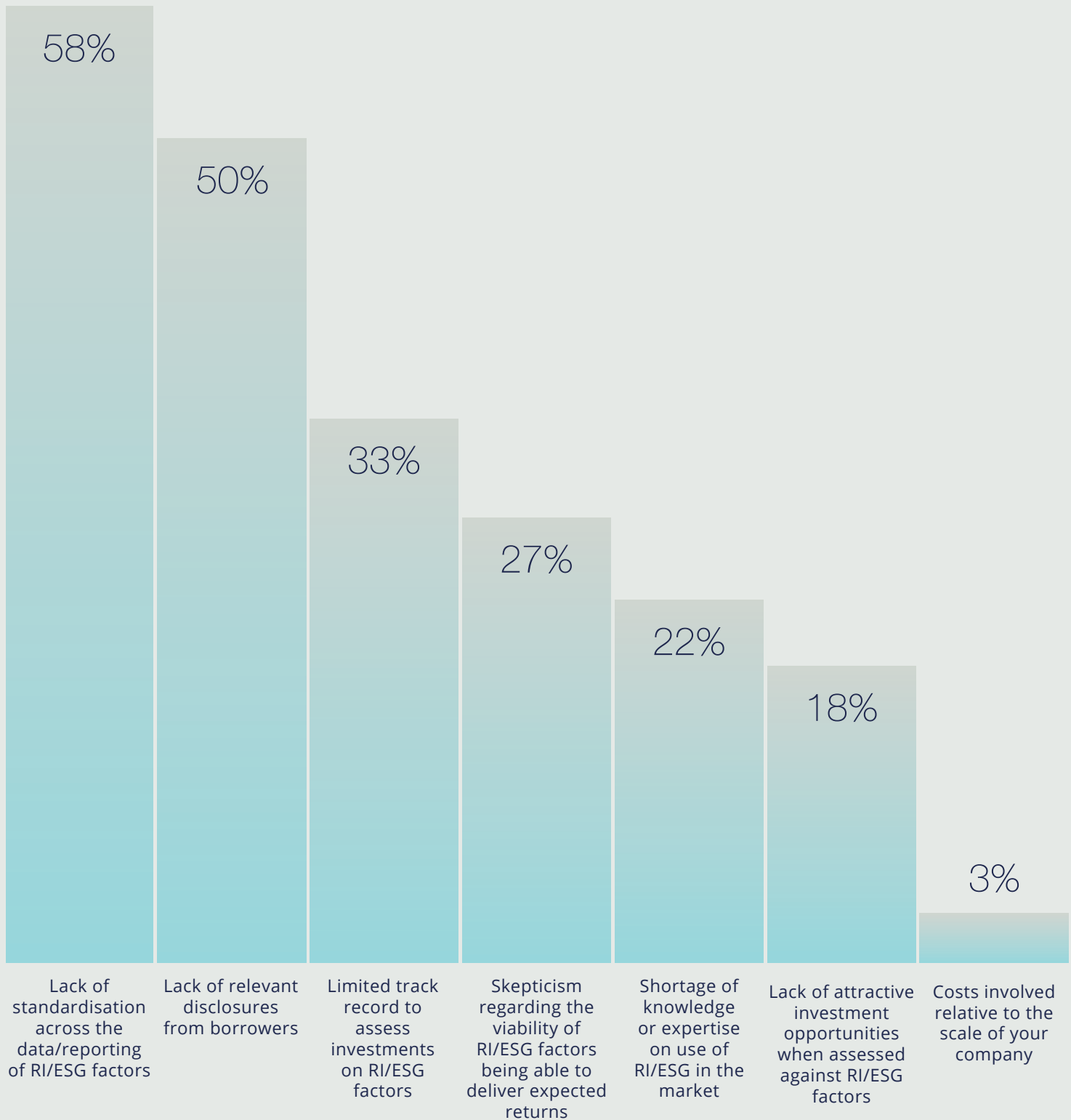
these boundaries do not proceed. Such criteria are often designed in conjunction with investors to ensure any ESG mandate or overlay is appropriate; ESG is now an increasing driver of product design. This incorporates both structuring and investment strategies with the former used to ensure no overlaps with conflicting investments, whereas the latter might mandate a focus on businesses owned by women or ethnic minorities, or with a beneficial impact on the environment. A corresponding investment has been made by private credit managers in processes and systems to manage and monitor adherence to these policies.

There is some scepticism regarding the validity of certain ESG strategies. For example, environmental metrics can be used in an inappropriate manner (greenwashing) or without consideration of other more material factors. There is also a more fundamental question as to whether investors will ultimately prioritise non-financial returns. This scepticism is evident in our data which shows that a sizable population of respondents do not use ESG in their investment process.

Impact investing is really interesting and there is a lot of debate around the taxonomies and the definitions which is really important. In keeping with who we are we are being quite purist about it. Our private credit impact funds have quite sophisticated metrics that they plan to achieve. There will be auditors involved and checking to ensure that it really is delivering a notable quantifiable impact. It may be environmental alpha, it may be social alpha, but I think it's understood that you don't necessarily have to give up financial alpha to get environmental and social alpha. We think it is critical to investors today - as the mother of two millennials I can say that the new generation of savers/ investors care about investing with positive impact. They want to know that what they are doing passes not just an ESG test but actively contributes to environmental and social wellbeing.

Figure 14:
What are the biggest challenges to the adoption of RI/ESG factors into a private credit strategy?

Percentage of respondents who cited these challenges





Andrew Lockhart

Managing Partner
Metrics Credit Partners

We think that investment processes that incorporate an assessment of ESG factors delivers good investment outcomes for our investors. We adhere to ESG policies designed to limit risk to our investors and we are big advocates of the importance of assessing and monitoring ESG risks. We don't think there are too many lenders that would sit there and say, ESG is a bit of an odd concept. Because for us it is just very good practice in terms of lending money. That is because poor ESG practices in the companies you lend money to results in greater risk and greater risk of loss. As a lender it is in your DNA to minimise loss, so ESG assessment and monitoring as part of your credit risk management processes is fundamentally a sound lending practice and is incorporated in all of our activities.

Steven Clark

Founder
Omni Partners LLP



ESG has moved beyond the early tick-box days of the simple use of exclusionary lists and the like. There's a greater emphasis and more thoughtfulness placed on what ESG means now. Generally private credit managers face some challenges as it relates to ESG. Certain strategies, such as infrastructure debt, lend themselves to natural incorporation of ESG into the investment process. But others, like most direct lenders in the broad SME market, struggle to meet the requirements of investors who are very committed to ESG. It stands to reason that it'll be difficult for the industry to come to grips with a consistent ESG ranking system focused solely on investment process.

Other relevant and meaningful ways exist for managers to address ESG, but they're usually outside of the investment process. It's important for allocators to be open-minded about how managers incorporate ESG, but at the same time managers need to genuinely understand why ESG matters to investors. Our strategy provides a lot of finance that facilitates increased levels and quality of housing stock that regular people can afford. There's obvious value to this in an expensive real estate market like the UK. This angle isn't immediately obvious, so we need to be better at articulating it. In terms of direction of travel, the allocator base will be split by ESG. There'll be the big dedicated ESG folks who may struggle to get away from using black and white, tick box style metrics simply because they need to be able to easily and consistently evidence their commitment to the space. This is likely to be the biggest pool of capital. Then a middle bucket of allocators will weigh both returns and ESG in the allocation process but will have the flexibility to be more pragmatic about how ESG is measured. Ultimately the smallest bucket will be the investors who decide they don't want to incorporate ESG at all.

05

DELIVERING TAILORED TRANSPARENCY

The ACC was established to demonstrate the value of private credit to borrowers, investors and policymakers. The perceptions of these stakeholders towards private credit, whether welcoming or cautious, will have a significant impact on whether the expected expansion of private credit over coming years will be achieved in practice. Our research suggests that there are three areas that will have the biggest influence on private credit's reputation across these stakeholder groups. All of them have to do with delivering the right kind of transparency:

- better overall market data
- better risk reporting to investors
- better engagement with regulators and policymakers

Need for better industry data

There is growing appreciation of the differences between the opportunities that exist within private credit and the different risk-return profiles these investments offer investors. Supporting investor education around these differences is a crucial part of a manager's business development activity.

The most stark example of this relates to the increasingly prevalent view that, today, any investment in 'credit' automatically represents a higher risk profile than other investments. While such a view is understandable given the length of the current credit cycle, there is a growing awareness that the credit cycle does not have a uniform effect on all private credit strategies, and that actions taken by private credit managers play a significant role in managing the potential risks presented by the cycle.

By identifying the appropriate position within the capital structure, using the right type of lending instruments or investment structure, security and collateral commitments taken or by targeting different industrial sectors or geographies, the private credit manager can offer investors a wide range of investment opportunities tailored to their own risk-reward appetite.

It is therefore crucial for investors and policymakers to have a greater appreciation of what constitutes 'good' and 'bad' lending practice across different markets and strategies. The most prominent example of this relates to the ongoing debate on trends in the syndicated leveraged loan and CLO markets and how this is affecting perceptions of the loan markets more generally.



Steven Clark

Founder
Omni Partners LLP

We're in a world now where there's a lot of money chasing returns, and there's pressure to deploy capital. That creates a competitive marketplace. Managers are willing to accept weaker covenants and to push the levels they'll lend at. This is a natural part of the cycle, so investors have to ask the question: am I prepared to be committed but not fully deployed when I believe that the risk taken is not appropriate given the return available?



Kipp deVeer

Director & Chief Executive Officer, Ares Capital Corporation;
Partner & Head, Ares Management Credit Group

Investors aren't going to want to be in the private markets for ten percent returns if they can be in the public markets and get ten percent returns with daily liquidity. So the limitation on growth in available capital really is how institutionalised do things get? How comfortable are investors with illiquidity and how compressed do returns get?



Andrew Lockhart

Managing Partner
Metrics Credit Partners

The dynamics at play in the syndicated leveraged loan space are often used as shorthand to describe the bilaterally negotiated private credit market at large. Focussing on leveraged loans also downplays the different approaches to risk management that are both necessary and desirable across different underlying strategies and geographies. Similarly, the trends around covenants and loan pricing are framing perceptions of a market pregnant with a lot of unique risks, but this is not necessarily the case. Pricing pressure, increased indebtedness of corporates, declining credit terms and higher asset valuations remain present across a much broader range of markets and asset classes.

The absence of an established source of data on the private credit market in aggregate exacerbates these challenges. The perceived opaqueness of the market was frequently cited by our interviewees as the primary reason why some investors and policymakers retain a diffident attitude towards private credit. While private credit managers are open and transparent in the data provided to their own investors, there are few reliable sources of aggregate data in the manner that already exists in other lending markets, or for other asset classes. This also creates a challenge for policymakers who are unable to find data that will support an evidence-based policy approach to the sector.

Investors and investment consultants are already using their own data to develop appropriate benchmarks to support their allocation decisions and measure performance. The quality and quantity of data which underpins their efforts will be crucial to the success of these endeavours. Until adequate data exists for these purposes, there will be a strong need for private credit managers to continue to support the investor community's understanding of the asset class.

Private credit is not an homogenous asset class. You can take on more risk or you can lower risk, depending on your risk and return objectives. For instance, if you want to lend to a company you can lend senior secured on one hand, but if you are going to take on more risk then you may do a unitranche or a mezzanine structure, or seek to participate in equity-like performance of the company. These investments have a different risk-return profile. What I find difficult to understand is this thinking that this asset class of private credit is all the same and that we're only lending to higher yield financial sponsor-backed transactions. What investors needs to consider is that it is not the full extent of the opportunity.

Loïc Fery

CEO & Co-CIO
Chenavari Investment Managers



The greater involvement of non-bank lenders in private credit tends to contribute to greater financial stability, as funds are replacing banks as providers of capital. A bank is 8 to 10 times levered (it used to be even 12 times) in the sense that a bank's balance sheet will have 10 to 12% of equity.

A private credit fund is rarely lending more than its own equity in loans. Leverage can be minimal in the sense that a fund is rarely committed to more than 1.5 times its equity (0.33 times levered). However, what needs to be watched carefully is the increasing usage of leverage in private credit funds, especially in the direct lending space. Those funds are increasingly running three times leverage or more and that is where closer monitoring is important to avoid any potential weakness in this market.



Thierry Adant

Head of Illiquid Credit
Willis Towers Watson

We need more education and disclosure in order for the market to assess risks across the asset class. Private debt is typically not transparent, it's not frequently reported, and some of these asset classes or investors haven't had enough experience to judge and make the critical assessment. For example, having a measuring stick for people to be able to compare investments would be extremely useful. As an industry, we could benefit from more transparency from investment managers and from all the different people on the value chain.

One potential enabler of this is technology. Generally there is an under-adoption of technology in many of these markets by both investment managers and limited partners. For example we've seen a lot of disruptors having a better client acquisition system to source new business to better credit models.



Jon Fox

Partner
Värde Partners

The level of investor sophistication has grown immeasurably over the last two decades. Today, investors have a detailed knowledge and understanding across alternatives and credit, and the level of expertise only continues to grow. I compare it to science, where we make incremental progress as each generation builds on the knowledge and discoveries of the last.



Tom Newberry

Partner, Global Head of Private Debt & Senior Portfolio Manager
CVC Credit Partners

Risk reporting

Several of our interviewees used the term ‘maturing asset class’ when describing the challenges that lie ahead for private credit.

Private credit managers acknowledge that meeting the growth expectations for the asset class will require greater efficiencies to be introduced into the market. For example, reporting information about borrowers, loans and portfolio management is often reliant on data and processes that are harder to automate or digitalise. There is also little harmonisation of investor reporting templates or data points. We expect to see greater focus amongst both private credit managers and their investors in this area over the coming years, particularly in relation to the speed, format and delivery method of investor reporting.

Having the capacity to service increased business volumes and a more diverse investor base will require managers to address the inherent complexity that this brings. These challenges are compounded by the different expectations investors have about the necessity and desirability of managers sourcing their support infrastructure from best in class third parties or developing this infrastructure in house.

Most managers invest heavily in their own bespoke operating systems, which provides them with greater control and the ability to customise solutions that work for them and their investors. At the industry level, this approach leads to some fragmentation. The alternative, whereby greater numbers of private credit managers harness external expertise, is limited at the current time because

Managers often think that technology solutions should be the same, whether you are investing in directly originated loans or broadly syndicated loans. We have found that that is not necessarily true given the differing requirements of managing these assets. There is a learning curve that comes with scaling your business that exposes these issues, so you need to be able to react and implement the best solution, flexibly. We found that, for instance, the administrators that we used on some of the other credit funds on our platform weren't really set up to manage private debt funds, and so we moved that business to a new service provider who has dedicated themselves to building infrastructure for private debt funds.



Stuart Fiertz

Chair, Alternative Credit Council Co-Founder
President & Director of Research, Cheyne Capital

current market solutions remain sub-optimal for private credit businesses. This is primarily an issue of scale for external providers as private credit markets aren't often large enough to offer a compelling enough commercial opportunity. We expect these dynamics to change as the market grows with the key driver being the increasing volumes of institutional capital allocated to private credit.

The profile of the firms that make up the private credit market is also subject to strong currents of change. Size continues to beget size within private credit, with much of the growth in the asset class over recent years concentrated within the larger private credit managers. Investments already made by these firms in their operating infrastructure are likely to make them more attractive to investors, and to the human capital that plays such a significant role in the industry.

Not all subscribe to this view, with some sceptical whether the establishment of more structured operating infrastructures is compatible with the bespoke approach that is the hallmark of private credit. There will always be room for more nimble managers to offer something unique to both investors and borrowers that larger firms will find harder to replicate.

The appropriate role of credit ratings agencies within private credit is another topic which is being debated as part of the broader conversation about maturity. From an investor's perspective the potential role for ratings in a private credit setting is two-fold. First, there may be a regulatory need for ratings if they are to invest. This currently creates a limitation on an investor's ability to access some private credit markets. Second, there is the question of how ratings might augment an investor's existing risk management processes and its ability to compare private credit strategies. Managers are

One of the biggest challenges here in the UK is that almost every DC platform has been set up to require daily liquidity on the underlying funds. And whilst the specific set up depends on the individual saver, in many cases DC programmes are set up for twenty to forty years out so it would be appropriate for the savers to invest in less liquid assets. That roadblock needs to be addressed and the platforms redesigned in a way that will allow DC investors to capture some of the illiquidity and complexity premia that you see in private debt.



Cécile Mayer-Lévi

Head of Private Debt
Tikehau Investment Management

I don't know to what extent private credit managers will be able to continue, as an industry, to accommodate highly flexible and very demanding requests from investors, given the ongoing pressure on management fees. This will require enhanced IT systems and data collection mindsets, with more data scientist type analysts becoming part of the teams.

Some insurance groups are very keen to replicate some methodologies used for fixed income and rated bonds for private credit allocations. They like to rely on ratings but, so far, this seems more as a box-checking exercise. Indeed, investment teams and portfolio managers do not rely on or consider these third-party ratings as a sound measure of risk, and are keen to keep their independence and skillsets which have shaped the tailor-made aspects of private credit.

Year after year, the large rating agencies have tried to address the private credit market, but never really managed to enter it because it is too expensive in absolute terms for a marginal use. There is also a resistance from companies' CFOs to deal with these agencies – why would they? The very reason they are pleased to work with private credit fund managers is precisely because they have direct and privileged access to their lenders for bespoke solutions.

We have seen more and more smaller or independent rating agencies emerging for the purpose of some insurance groups. I don't know how far this "new" category of rating businesses will go and if it will be a success – maybe some form of automated platform at some stage would replace these agencies. For now, working with most rating agencies on private credit deals just doesn't work.

Tod Trabocco

Managing Director
Cambridge Associates



A lot of desire for ratings is driven by insurance companies. But the rating agencies out there are assigning ratings to very small companies that astute investors don't believe. However, enough of the insurance companies accept those ratings because these ratings agencies are qualified as NRSROs, Nationally Recognized Statistical Rating Organizations, so that works for insurers – they can check that box.

I don't know how insane investment grade ratings are for a \$15,000,000 EBITDA company. I imagine that the probability of default is going to be higher but, in the right hands, it could be a lot lower. This is something that needs to get unpacked, because the default statistics that are historically robust are from S&P, Moody's and Fitch, all dealing with a highly disaggregated and uncontrolled lender and bondholder base. The ability to control and drive the outcome is critical to mitigating losses in private credit.



Thierry Adant

Head of Illiquid Credit
Willis Towers Watson

cautious on this point, arguing that ratings add costs which many do not see as value-adding to either their own or their investors' risk management and underwriting processes.

Finally, regulators are also inconsistent in their approach towards the appropriate use of ratings. In some areas they are discouraging reliance on them, while at the same time making them central for the purposes of capital requirement calculations for many type of institutions.

Even if one takes the view that these considerations are not insurmountable, there is also a more fundamental unease about whether the greater application of ratings within private credit would represent a step forward. Many private credit managers believe this would create an agency problem for asset owners and reduce the healthy pressure on their own due diligence processes. Expert advice and external validation are important for all types of investors, but there is a fine line between this and outright reliance on third parties who ultimately do not bear the investment risk.

Greater use of a rating-based approach could also encourage private credit managers to commoditise their offerings to meet standardised criteria. This would detract from private credit's ability to offer tailored finance to borrowers. The creation of artificial categories may also lead to different types of assets being captured under the same label, making it harder for investors to understand the risks they are taking on. Encouraging private credit managers down the same road as the banking sector and public markets is also likely to reduce the diversity of views in the market on how to measure credit risk. These factors have hindered the adoption of ratings within private credit to date. The issue of risk compatibility is unlikely to become less relevant for investors and therefore it may be time for private credit to give deeper consideration to this issue.

We believe private credit is a very important mechanism to foster global growth and economic development. It's needed and it's not a negative term.



Stuart Fiertz

Chair, Alternative Credit Council Co-Founder
President & Director of Research, Cheyne Capital

Policy framework for private credit

Discussions around the right policy framework for private credit are generally framed in terms of its role protecting financial stability, investors and borrowers. The strong view of many private credit managers is that the conversation should instead focus on how it can support sustainable economic expansion.

In several jurisdictions the appropriateness of the policy framework for private credit remains the single biggest determinant of growth for private credit. This can take the form of restrictions on the ability of private credit managers to carry out lending, or ill-fitting regulatory and supervisory regimes which place a ceiling on the growth of private credit managers. In this respect, it will be necessary for private credit managers to shift the debate amongst policymakers from limiting harm to supporting the sustainable growth of private credit.

Policymaking requires balancing different objectives and enacting rules which deliver these objectives in an efficient manner. With respect to private credit these can broadly be categorised as (i) whether the existing financial system is able to provide the finance needed to support borrowers and economic growth, (ii) whether those providing finance are subject to appropriate oversight and supervision, and (iii) what impact their lending activity may have on the stability of the financial system or the economy.

Many jurisdictions have an identifiable need for additional capital to support the growth of their economies. It is also desirable for that capital to be provided from a more diverse range of sources in order to reduce that jurisdiction's dependency on traditional lenders. The ability of private credit managers to provide finance tailored to a borrower's needs and circumstances is also likely to be more supportive of innovative products and business models

With the work that we've been doing at the ACC we have achieved access to most markets in Europe now so that the regulatory constraints of accessing each market are much less. The legal framework under which a lender can effect a recovery, if necessary, or encourage good behaviour from borrowers is still evolving and it's better in some European jurisdictions than others.



Steven Clark

Founder
Omni Partners LLP

than traditional lending solutions. The experience of private credit managers is that this holds true across markets with both more developed and less developed financial systems. This suggests that policymakers should focus their attention on how to address our second and third considerations. Namely, how lending activity is overseen and supervised to ensure that these rules are supportive for private credit managers, without creating incentives that have a negative impact on the stability of the financial system.

This often means allowing the existing asset management framework to operate without imposing bank regulatory models onto the sector.

There are also market practices in place to support responsible lending and reduce pro-cyclical behaviour. For example, private credit managers employ robust liquidity risk management structures that mitigate against maturity mismatches. As we have observed in earlier chapters of this paper, private credit firms also undertake rigorous credit underwriting to ensure they are prepared for loans to be paid in full or enact recoveries in stressed situations. Even allowing for some of the more recent developments in the market, leverage is still extremely low, particularly when compared to other alternative asset classes or traditional lenders. Most importantly, it is investors in the funds, rather than depositors or taxpayers, who bear the risks of their decisions, succeeding or failing without requiring government support or endangering the economy.

You can end up with lending freezing up for a period of time, which is generally what happens in credit markets through crises. Governments inevitably react by turning the taps on. They don't want markets to freeze so they flood the place with cash. But it's less direct now. Before the banks were in control of the market, so there was a direct route into the economy through the banks. But it's increasingly indirect now, because so much financing is being done outside the banks. So in thinking about how that mechanism responds and the speed of response, one would naturally assume that it's going to be less efficient and slower.



Deborah Zurkow

Global Head of Alternatives
Allianz Global Investors

Private credit is unlikely to be immune from the consequences of government-driven excess liquidity and leverage in the financial system. Any period of economic stress will also require private credit managers to deal with a higher volume of stressed and distressed borrowers.

The way in which private credit managers deliver value for their investors during this period will have a profound impact on policymaker attitudes towards private credit. The experience of private credit in Europe has shown that engagement with policymakers is critical to the expansion of private credit into newer markets. A crucial challenge for the sector will be to maintain this engagement via the transparent communication that has characterised private credit's relationship with policymakers to date.

Regulators are starting to realise that this market is burgeoning and they want to understand it. There can be a tendency to look to regulate when you're not sure where a market's going. Sometimes it requires a watch-and-see approach, because if you regulate too soon you create hurdles to a burgeoning market which, in this case, can make real contributions to the real economy. It is more appropriate to take a step back and think about what private credit managers are trying to do – that is to put pools of capital at work in the real economy.

Drew Schardt

Managing Director, Head of Private Credit
Hamilton Lane



I admittedly am a proponent of the asset class, and I think it's because there's a real reason this market exists. Not just in terms of the underlying supply and demand dynamics with borrowers and lenders, but for the differentiated opportunity for LPs and investors in private credit. The asset class has and continues to evolve. In other words, the strategies available today were not necessarily there 10+ years ago. There has been a proliferation of strategies, managers and geographies in recent years, which I believe is ultimately a good thing, because it means more choice for investors. That's not to say that it won't be complex to navigate that landscape; or that it's bulletproof.

There will be winners and losers, both on underlying investment strategies as well as managers. But the private credit market today, in many ways, is akin to the private equity market in the early 2000s – PE allocations have continued to grow. And they haven't grown just versus other allocations. Historically, the outperformance has been there; the value proposition has been there; the differentiations of returns and strategies have been there, and so I think it's an exciting time for credit. It's not going away. I think it's here to stay.

CONCLUSION

The retrenchment of the banking sector, the increasing importance of private markets for investors, and the enduring appeal of a direct lender relationship for borrowers are among the key structural factors underpinning the continued expansion of private credit. These tailwinds are here to stay, allowing private credit managers to develop new products, strategies and markets for their investors.

These structural factors are likely to be tempered by what one of our interviewees called the “the most talked-about and anticipated turn of the credit cycle in history”. How the industry navigates this challenge in some of its most mature markets will be important for the future of the asset class.

While some think we will experience a ‘make or break’ moment in the next few years, most feel that the model is sound enough and well established to weather any storm. The latter view doesn’t translate to a naive optimism, but a recognition that private credit has an important role in the financing mix of the economy in any future state of the world.

The ACC’s *Financing the Economy* research series has been central to the dialogue and collaboration between managers and their key stakeholders – borrowers, investors and policymakers. It highlights the need for a continued improvement in disseminating data and educational materials to improve the understanding of our rapidly developing market. The continued support of this collective effort will ensure the sector’s sustainable future.

FINANCING THE ECONOMY SURVEY DATA

Figure 15: What is the estimated deployed capital allocated to private credit?

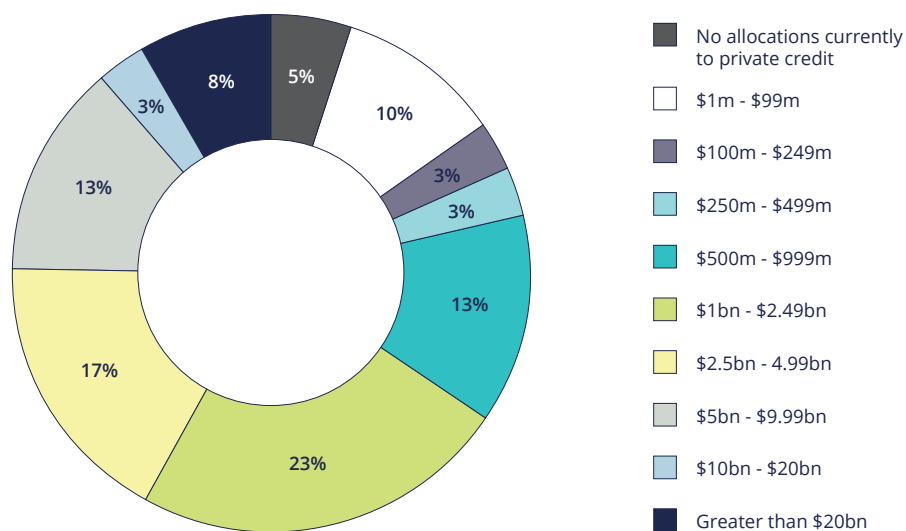


Figure 16: How much undrawn capital do you have to allocate to private credit investments?

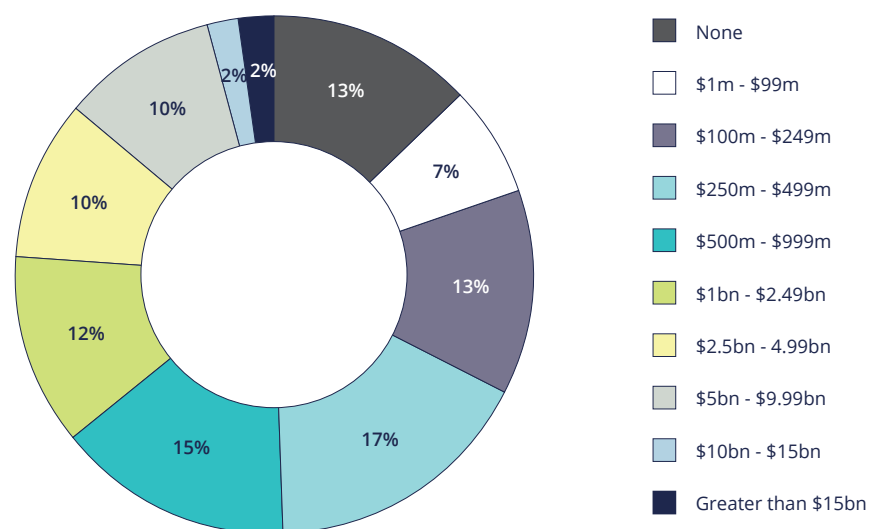


Figure 17: How do you see your investment in these private credit markets changing over the next three years?

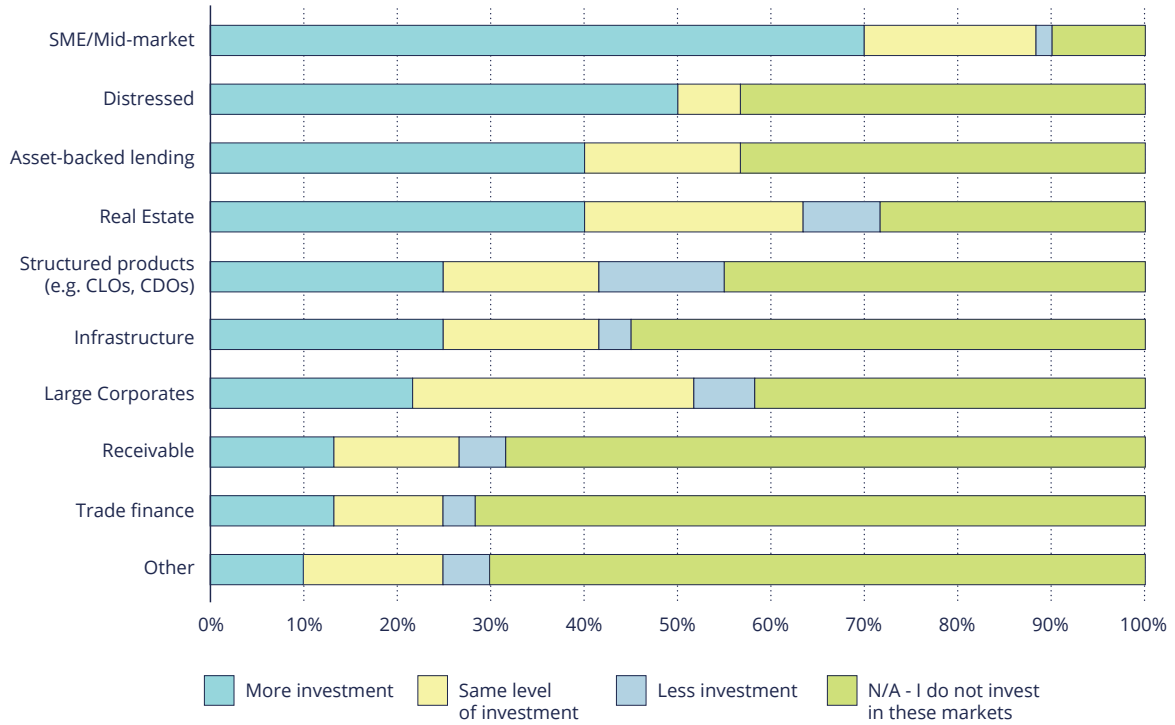


Figure 18: How do you see your investment in these markets changing over the next three years?

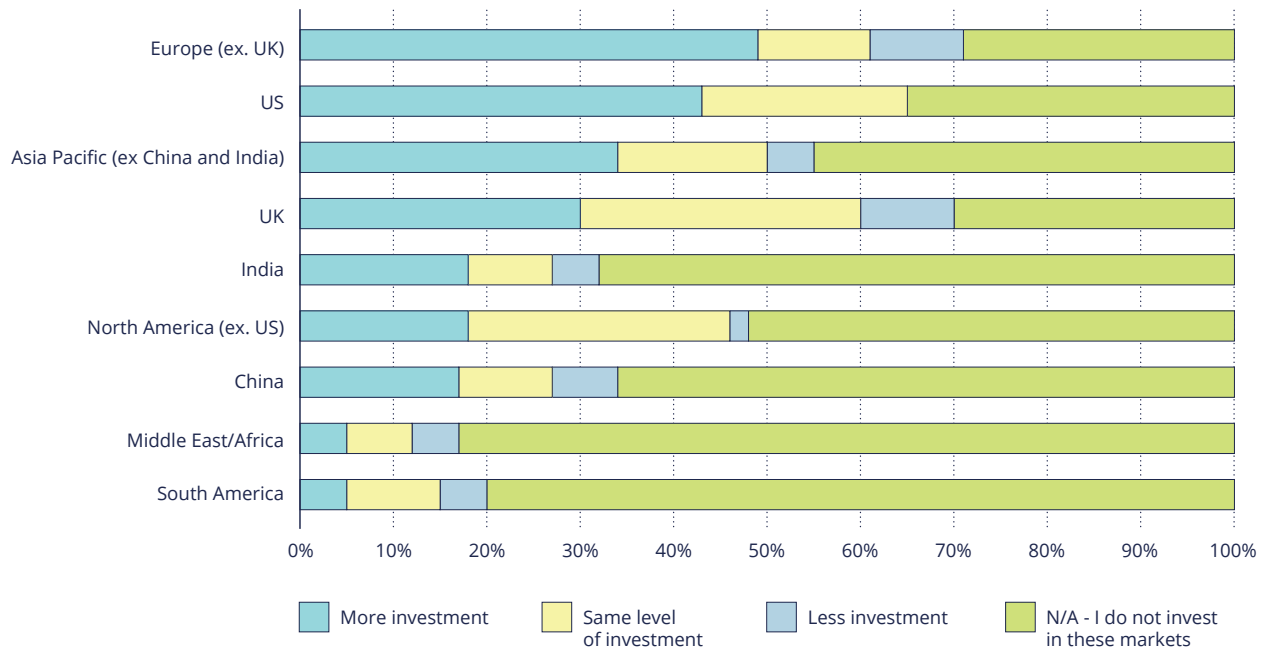


Figure 19: Which of these factors will have a significant impact on the future growth of your business?

Percentage of respondents who cited these factors

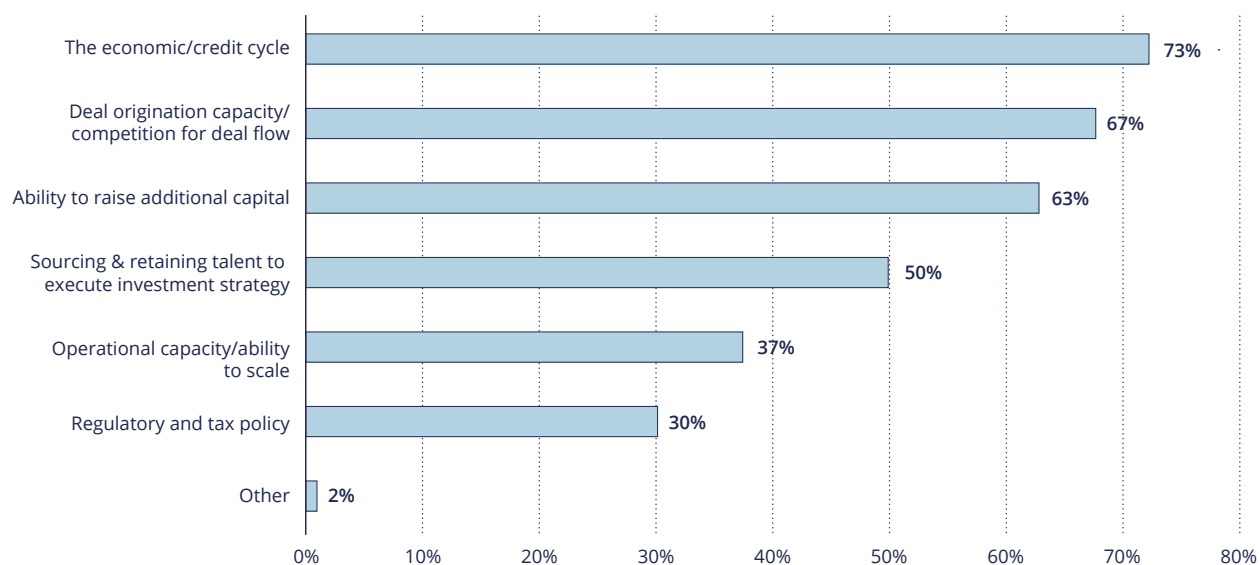


Figure 20: What are the biggest challenges in the operational side of your business?

Percentage of respondents who cited these challenges

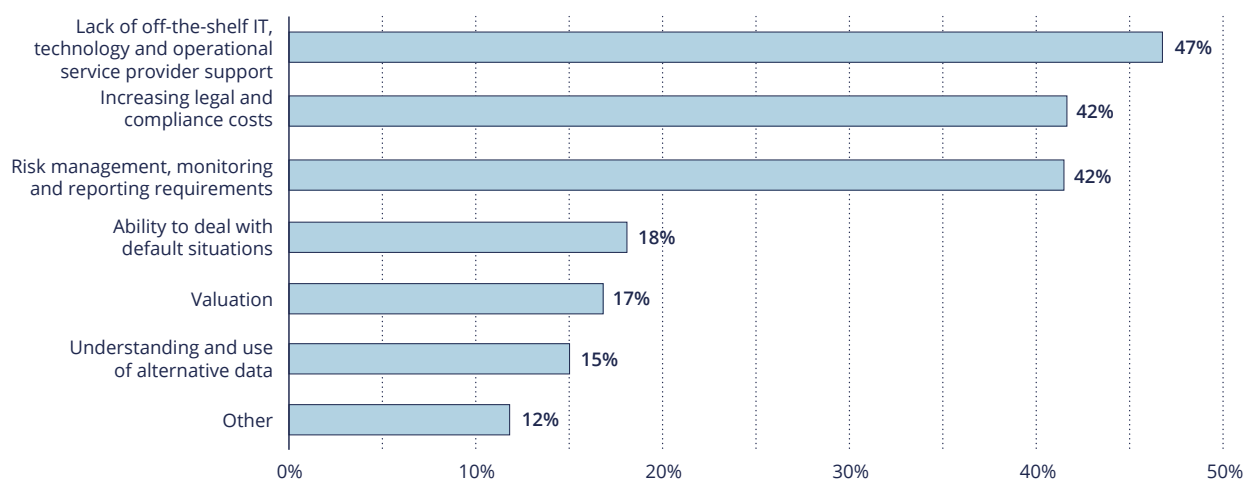


Figure 21: What are the biggest regulatory challenges facing your business?

Percentage of respondents who cited these challenges

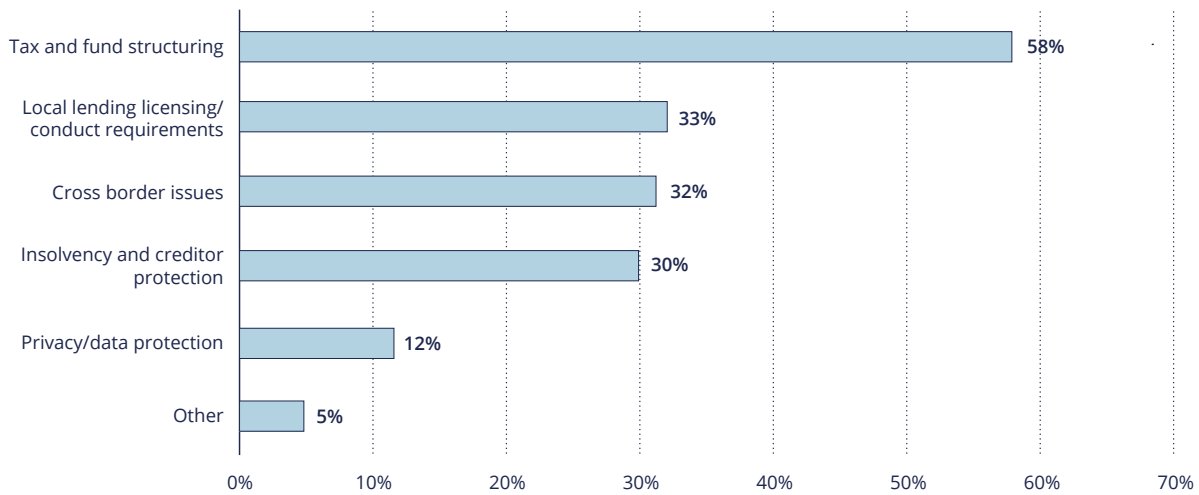


Figure 22: How do you plan to develop your origination channels for potential credit opportunities over the next three years?

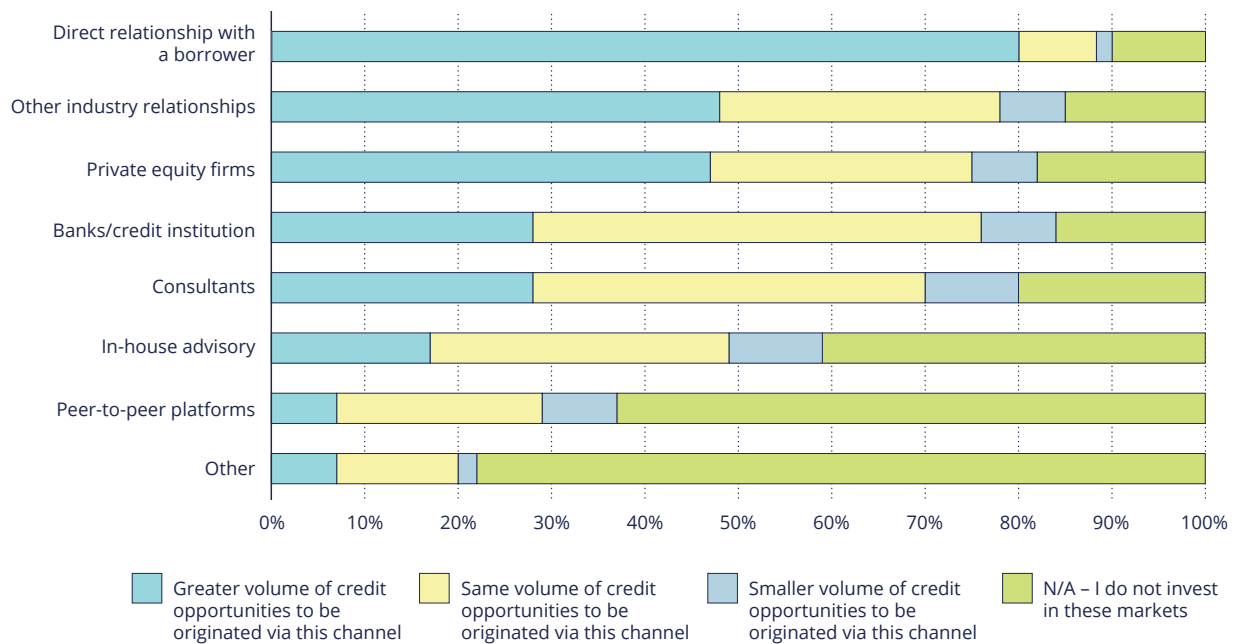


Figure 23: What are your expectations around recovery rates on defaulted loans during the next three years?

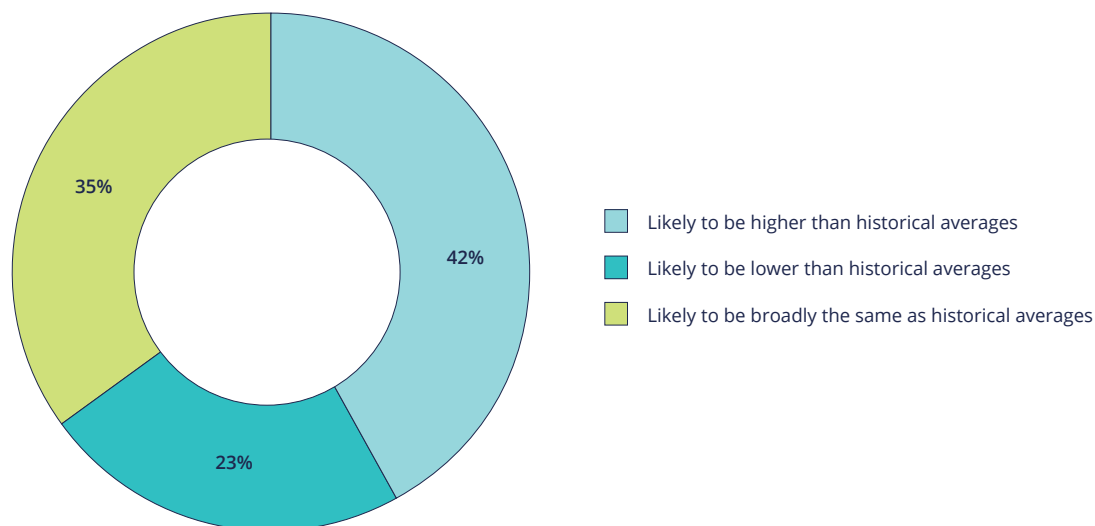


Figure 24: Which sectors are you primarily competing with for talent?

Percentage of respondents who cited these sectors

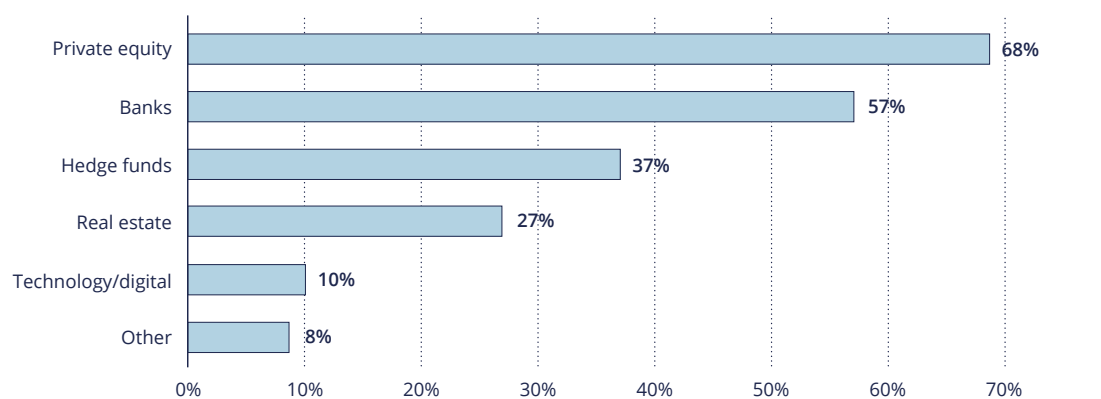


Figure 25: How do you expect allocations from these types of investors to change over the next three years?

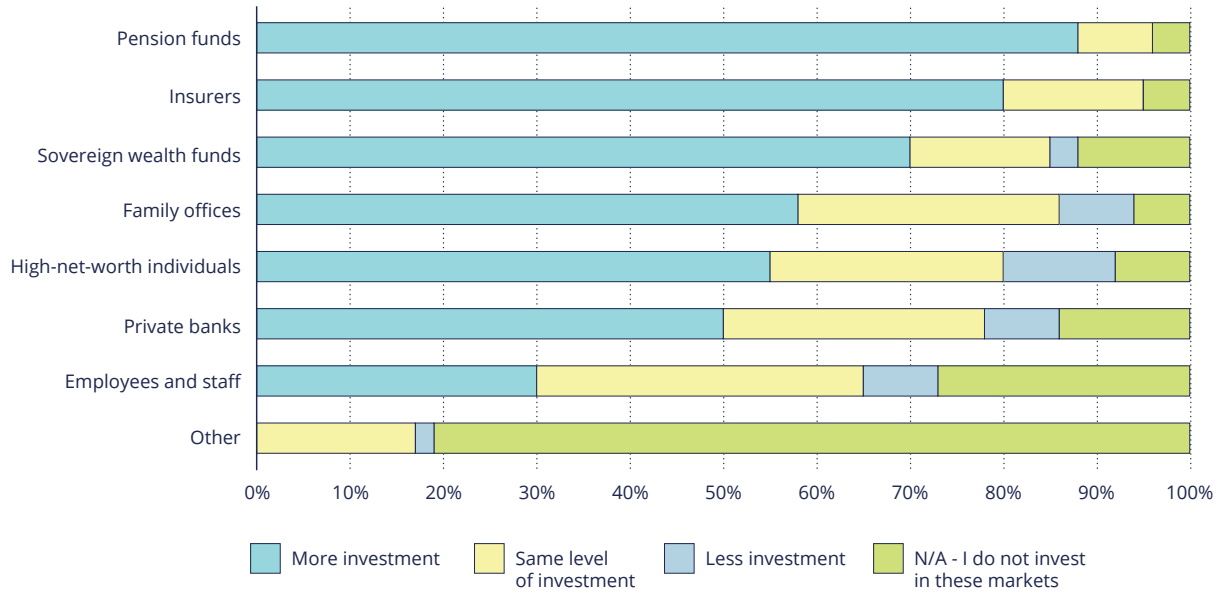


Figure 26: What are the most important factors in achieving alignment of interest between you and your investors?

Percentage of respondents who cited these factors

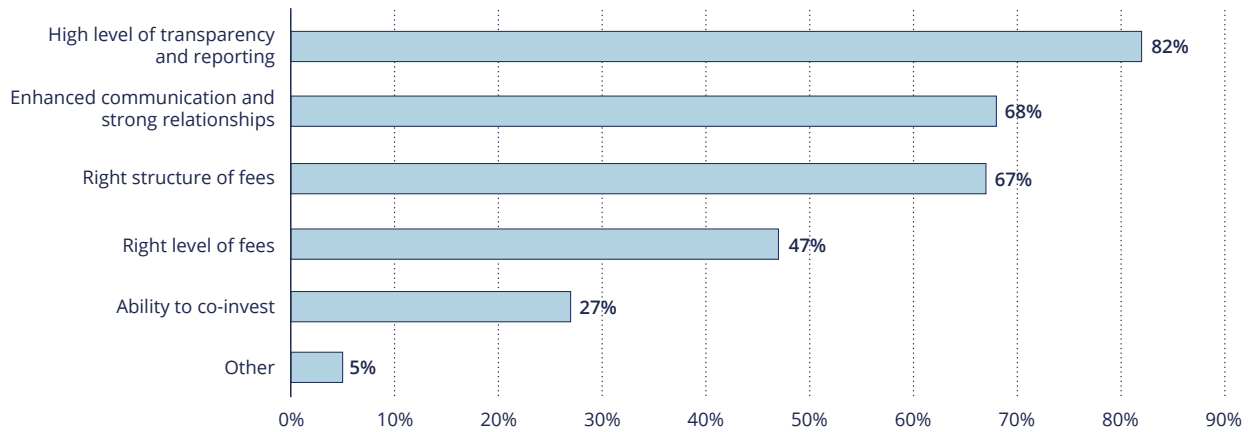


Figure 27: Which of the following best describes your firm's approach to Responsible Investment (RI)/ESG?

Percentage of respondents who cited these approaches

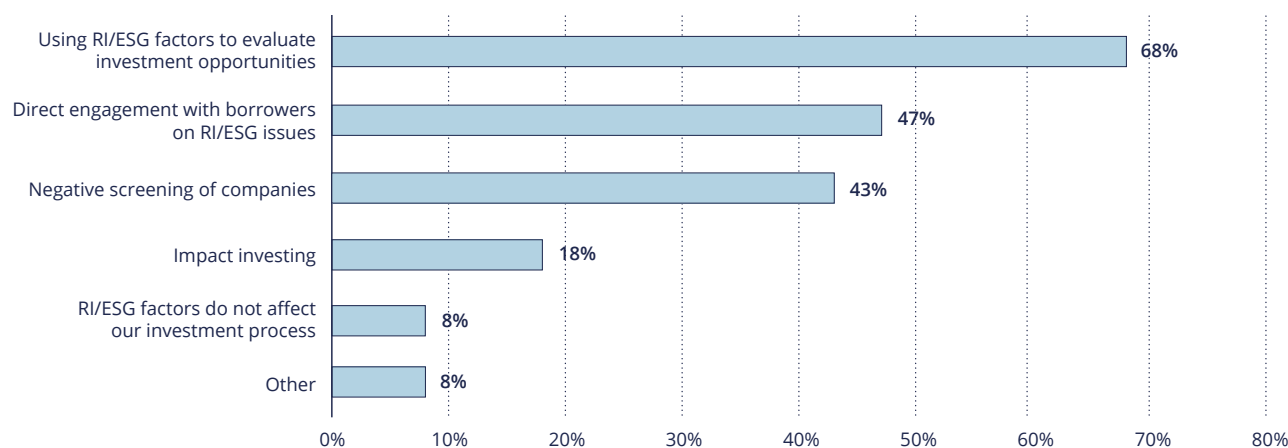
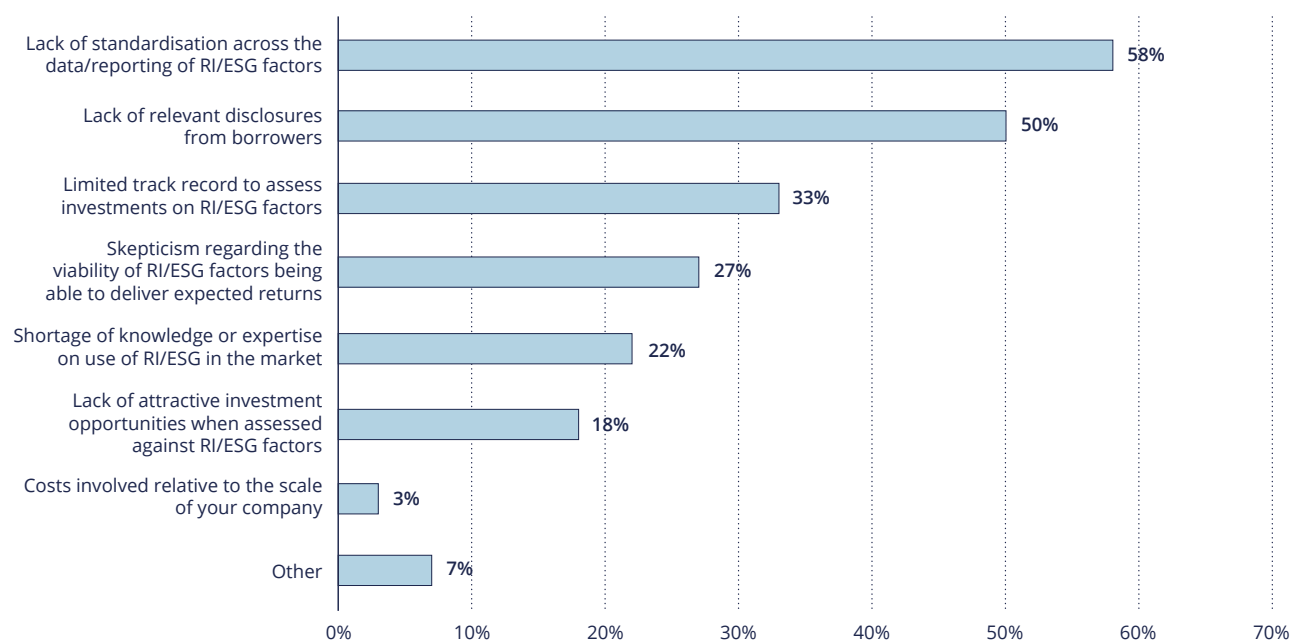


Figure 28: What are the biggest challenges to the adoption of RI/ESG factors into a private credit strategy?

Percentage of respondents who cited these challenges





About ACC

The Alternative Credit Council (ACC) is the global body representing asset management firms in the private credit and direct lending space. It currently represents over 170 members that manage \$400bn of private credit assets.

The ACC is an affiliate of AIMA (the Alternative Investment Management Association). It is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They finance mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure and the trade and receivables business.

The ACC provides guidance on policy and regulatory matters, supports wider advocacy and educational efforts and produces industry research to strengthen the sector's sustainability and economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.



About AIMA

The Alternative Investment Management Association (AIMA) works to grow the alternative investment industry to benefit the world's economy, savers and investors.

To achieve this, we strengthen the links between fund managers, investors, regulators and industry service providers.

Our thirty-year heritage means AIMA understands its members' priorities, who access our resources to grow their businesses, create lasting connections using our events and benefit from the effect our advocacy work has on the environment in which they must operate.

Since our formation, the industry has grown by 60 times. AIMA's capacity to deliver local support across the globe has made us connected, knowledgeable and influential, and means our 2,000 members are now based in over 60 countries. For further information, please visit AIMA's website, www.aima.org



About Dechert

Dechert is a global law firm with approximately 1000 lawyers in 26 locations worldwide. Over 200 lawyers are dedicated to funds and financial services and 250 lawyers focus on finance matters. The firm has expertise across all major asset classes, fund domiciles and structures and provides expertise at every stage of the investment lifecycle.

We were the first and are the leading major international law firm with a funds practice that spans the key European investment fund centres – Dublin, Frankfurt, London, Luxembourg, Munich and Paris – as well as throughout the U.S., Middle East and Asia. As a result, our lawyers are in a unique position to give jurisdictional-neutral and unbiased advice about the right structures for raising and deploying capital both in Europe and beyond, with strong attention to tax efficiency and market terms.

Dechert is one of the most active law firms in the sphere of debt fund formation, representing a range of debt fund sponsors from large platforms to boutique and emerging managers. The firm's internationally recognised finance practice provides complex financings and deal structuring. www.dechert.com

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