Private Debt Investor

US Report

September 2024 • privatedebtinvestor.com

Five key themes for US investors

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US Report

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Insight

Fundraising trends **A difficult environment for fundraising skews the odds in favour of the largest managers**

North American fundraising during the first half of 2024 ran far behind the results of the first half of 2023, according to the latest *Private Debt Investor* data.

Roughly $46.2 billion was raised in North America through the first half of the year, less than 70 percent of the $66.7 billion raised during the first half of 2023. That means that North America accounted for slightly less than half of all global fundraising, but still the highest percentage share, ***writes Sergio Padilla.***

So far, 87 funds have been raised successfully, and while enthusiasm still abounds for dealmaking, it may look different than in years past. "A lot of the large [credit managers] went out and raised very large funds last year and therefore they don't need to come back and fundraise more, especially with the serious decline in M&A activity," says Ben Clarke, founder and CEO at Spartan Advisors.

He adds that the decline in leveraged buyouts this year also weighs heavily on fundraising. The relationship between leveraged buyouts and private debt is obvious, given that the latter provides the leverage. Fewer deals means less capital required, which in turn slows down deployments.

> "We're in an election year – which historically creates volatility"
>
> Ben Clarke, Spartan Advisors

The difficult environment for fundraising also skews the odds in favour of the largest managers that have pre-established relationships with limited partners.

Wider economic trends

Broader economic trends related to inflation, interest rates and even the US presidential election have influenced decisions to deploy and raise capital.

Adam Weiss, managing director of credit for Petra Funds Group, sees those as the driving forces behind fundraising numbers this year.

But he believes interest looks to be solid for the fundraising environment for the remainder of 2024. "There's an assumption that there's still capital that's going to be deployed, and there's still a massive fundraising interest in this sector," Weiss says.

Meanwhile, the average size of a North American private credit fund is growing. During the first half of 2024, the average size of a North American-focused private debt fund was $864.6 million, the largest ever – much higher than the 2023 average of $761.9 billion.

Record target-hitting

Funds are also reaching their target size at the highest rate on record. During the first half of 2024, 78 percent of debt funds met or exceeded their target.

One of the more dramatic examples is the $10.4 billion HPS Specialty Loan Fund VI. The fund, a North American senior debt direct lending strategy, held a final close in June far ahead of its $7.5

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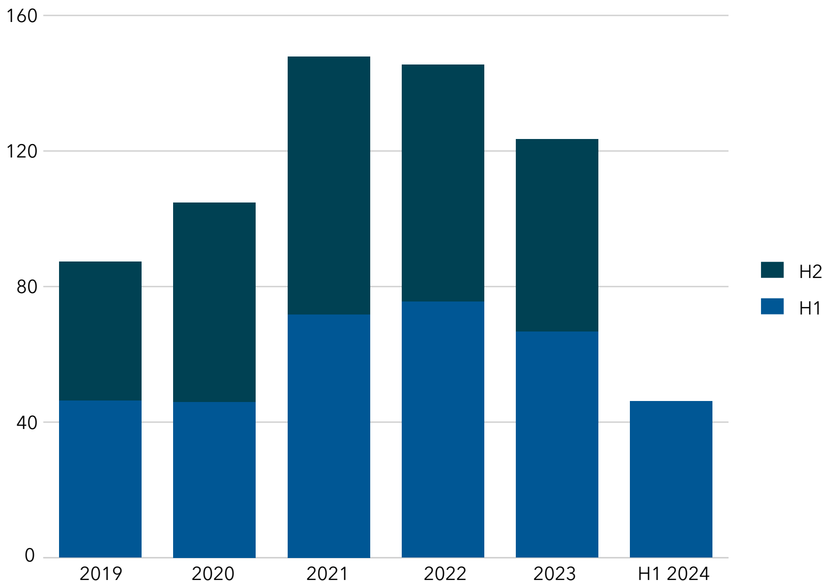
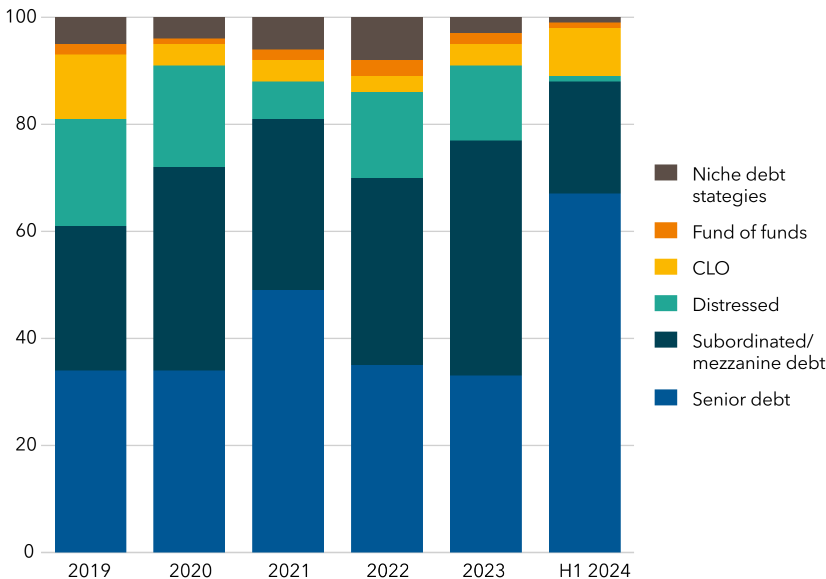
North America-focused private debt fundraising ($bn)



Proportion of North America-focused debt funds by strategy (%)



Source for all data: Private Debt Investor

billion target. "For the established managers who've been in this space for a long time, and continue to have good results, they have their base LPs, and now there's new appetite coming in," says Weiss.

He adds that investor interest has been piqued by senior secured direct lending, which tends to be attractive to insurance companies, high-net-worth individuals and registered investment advisers. That dynamic directly disadvantages smaller managers, who cannot build on the same sort of existing relationships the larger managers already have.

The interest in senior direct lending is apparent, however, as a whopping 67 percent of fundraising during the first half of the year went to senior direct lending funds.

"It's symptomatic of market sentiment towards risk," says Clarke. "For starters, we're in an election year – which historically creates volatility. And if you're going to go and deploy capital for your underlying investors, you probably want to be more senior in the capital stack than junior."

Evergreen fund structures

That same cautiousness has also renewed an interest in evergreen fund structures. Going forward, these structures have the potential to grab a greater portion of allocations, and are currently in high demand by LPs.

"Historically, drawdown structures have presented investors with challenges in hitting and maintaining their targeted allocations," says Dan Pietrzak, global head of private credit at KKR. "Full deployment can take several years, defined by a more traditional investment period, after which distributions are kicked back."

He adds that this dynamic forces investors to manage uncalled commitments during draw-in periods and makes them more likely to park cash elsewhere in their portfolios while remaining underexposed to private credit.

"We have observed a steady increase in LP demand for open-end structures," he says. "These provide a number of benefits including faster deployment and capital compounding, ability to stay invested for longer without having to re-underwrite new funds or subsequent vintages of the same strategy.

"They also provide more efficient liquidity management, since LPs have the option to receive quarterly interest income or reinvest all proceeds to compound and grow their exposures over time." ■

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Editor's letter

Investors look to the future despite fundraising slump

Graeme Kerr
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Just what should we read into the H1 North American fundraising figures showing a sharp fall compared with a year earlier? On the face of it, another reminder that the grim economic mood is reverberating for far longer than many of us thought. Just $46.2 billion was raised for North America-focused private credit funds in the first half of 2024, the lowest figure since pre-covid, according to *Private Debt Investor* data. Just 87 funds closed, well below half of the 218 that successfully completed capital raises in the whole of 2023.

And yet, beneath the fall in fundraising lie solid signs of a rebound. Market participants interviewed for this report say LPs are continuing to favour private debt over other asset classes and, liquidity constraints not withstanding, are keen to invest more.

“Beneath the fall in fundraising lie solid signs of a rebound”

That sentiment comes over loud and clear in our cover story for this report (p. 26) where we pick out five key themes for US investors. There has been something of a sea change among LPs over the past few years as allocations mature and familiarity with the asset class increases.

From an initial focus on direct lending to the mid-market, differentiation has become the order of the day, with many LPs looking to diversify. It's always difficult to pick out just five investment themes in a market expanding as fast as private credit, but the topics we have chosen – tech and healthcare, speciality finance, open-end funds, real assets and ESG (more in Europe than the US) – are a reminder that while the first half may have disappointed in terms of capital committed, the future looks bright for private debt in an array of different sectors.

Graeme Kerr

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KEYNOTE INTERVIEW

We believe lending to smaller business has some distinct advantages for investors, says Trevor Clark, founder of TPG Twin Brook

The lower mid-market offers LPs an attractive diversification play

Q How do you define the lower mid-market and how does it differ from the core mid-market and upper mid-market?

We define the lower mid-market as companies with EBITDA of $25 million or below. The core and upper mid-market are a bit more difficult to define, given that direct lenders playing in those markets are increasingly competing with the broadly syndicated loan market. We are now routinely seeing direct lenders supporting companies with EBITDAs of $200 million or more. As a result, in the upper mid-market we are finding that the borrower-lender relationship is becoming more commoditised. Ultimately, for a lender that means the interest and the fees you get paid go down as the size of your borrower increases.

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There is also a structural risk component that differentiates the core and upper mid-markets from the lower mid-market. In upper mid-market companies, you typically see more debt as a multiple of cashflow, which increases financial risk. You also typically have more covenant-lite packages with unrestricted subsidiaries and the ability to add debt at the same level as other lenders in the syndicate, creating less lender protection. So, in our view, you're ultimately getting paid less for effectively taking on more risk.

On the flip side, in the lower mid-market there is typically a strong borrower-lender relationship and lender protections are standard practice, so we believe you ultimately get paid more for effectively taking on less risk.

Q What is the appetite among institutional investors for lower mid-market lending?

We have been lower middle market lenders for over 20 years and raising capital from a broad institutional base for the last decade. In the last three years, we have seen clear recognition that the lower mid-market is offering a very different opportunity compared with that which many of the large

> *"We continue to see a lot of white space for lenders to successfully transact in the lower mid-market, and we expect those opportunities to multiply in the remainder of this year and into the next"*

global asset managers active in the upper mid-market are offering.

Whether that recognition is due to the portfolio overlap analysis, which shows many of those managers present in the same transactions, or whether it is due to lenders moving down the balance sheet, adjustments to cashflow or the volatility of returns, the upper mid-market is getting called into question. We believe the differentiation that a scaled lower mid-market lender can bring is now really clear to institutional investors.

Many large global institutional investors entered the private credit market via an allocation to upper mid-market direct lenders, but those investors are now looking to lower mid-market lenders for a compelling diversification play. We are seeing allocation sizes to the lower mid-market increase, with some of the largest global investors allocating larger amounts of capital to this market segment.

Q Some lenders have moved upmarket in pursuit of larger transactions. Is that impacting lower mid-market participants?

Over the past few years, the so-called forcing of certain lenders upmarket is related to two factors: the first being the large amount of capital raised in such a short period of time, which meant a number of managers had to speed up their pace of deployment; and the second being the fact that these managers didn't need large teams to be successful at transacting. With the broadly syndicated market dislocated, many upper mid-market lenders were able to quickly move in and fill that void.

We see less of that today. With the broadly syndicated market now open, many large direct lending credit facilities have been refinanced out, and the shift upmarket has reversed, with upper mid-market lenders moving downmarket to fill their deployment needs.

While that downmarket movement has impacted the core mid-market, it has had less of an impact on the lower mid-market, where the strength of the borrower-lender relationship is highly valued. What I mean by this is that at the top end of the market the amount of debt and the cost of debt is baked into decision-making processes. In the lower mid-market, however, the borrower relies much more on its lender for support alongside the private equity sponsor executing the borrower's growth strategy.

Lower mid-market borrowers need to know their direct lender is going to support them over a growth horizon, including with potential add-on acquisitions, team expansion, and diversification of product lines. These borrowers require a lender with experience to support that exercise, and few lenders have that capacity. That is why the competition is a bit less severe in the lower mid-market, even as the upper mid-market has started competing with core mid-market players.

Q Do you expect the opportunity set in the lower mid-market will continue to evolve?

For the aforementioned reasons, we continue to see a lot of white space for lenders to successfully transact in the lower mid-market, and we expect those opportunities to multiply in the remainder of this year and into the next.

While we know that longer hold periods, the impact of higher interest rates for longer, and the misalignment of buyer and seller expectations are still an issue, especially in private equity, our expectation is that these trends cannot continue. There are only so many continuation vehicles to be executed and private equity can only sit on assets for so long.

We believe that we are going to see a change in the interest rate policies in the US, and as interest rates come down, it will generate more M&A activity, which will allow the lower mid-market leaders to deploy capital in their traditional target markets.

While deployment opportunities will likely expand, both deployment opportunities and fundraising dollars are increasingly accumulating in the hands of fewer market leaders. Given the sheer number of managers that have been created in recent years and the advantages veteran market leaders offer, we foresee a much clearer delineation of the winners in the lower middle market and elsewhere.

Q How do deal structures in the lower mid-market compare with those upmarket?

Part of the potential benefit of investing in the lower mid-market versus the upper mid-market is better economics, lower leverage and stronger lender protections. As market factors ebb and flow, so too can differences in leverage and pricing.

Over time, those differences are driven by the sheer flow of capital, so when large volumes of capital are flowing into the upper mid-market, pricing comes down very quickly and leverage starts to go up. You have less of those swings in the lower mid-market.

For a period of time, there was around a 30-basis point difference between loans getting closed in the upper mid-market versus those in the lower mid-market, which felt very tight. For loans printed over the last quarter that premium was small, but you still had meaningfully more leverage on upper mid-market companies than on lower mid-market companies. All this is to say that it's important not to look at one factor in isolation but to examine risk as a whole.

Q Are you finding dispersion of performance between market segments?

There are many ways a lender can structurally address a potential weakness in a portfolio. While there has been some dispersion of performance among different market segments, in our experience in the lower mid-market, we have seen stable, experienced managers able to deal with portfolio pressures and navigate the macro shifts effectively.

Moving upmarket, we are seeing investors really digging into amendment activity in portfolios, what proportion of portfolios have PIK interest components, what the non-accrual percentages look like, and the overall leverage levels. There is also a greater focus on valuation methodology, what is happening to marks, and whether a third party is involved. There are plenty of early warning signs now for investors assessing their credit portfolios.

The lower mid-market, on an apples-to-apples basis, has smaller degrees of PIK and smaller amounts of non-accruals because there is less debt in companies and more covenants and triggers that allow lenders to quickly engage with borrowers.

This harkens back to my earlier point: we believe the lower mid-market can offer an attractive diversification play for investors, particularly given that we believe you take on less risk for higher reward. ■

"We believe the differentiation that a scaled lower mid-market lender can bring is now really clear to institutional investors"

Q Are certain sectors offering more opportunity to lower mid-market lending today?

We are cashflow lenders to any industry, subject to certain industries that typically violate our strict underwriting standards, and we find the largest lenders globally have tended to do the same, whether that's focusing on healthcare, technology, or business services. Of course, industries with a large market presence, many companies, and long histories of performance, are typically the ones generating the most activity for lender participation.

At the same time, there are other industries that are growing – such as sports, insurance, and financial services – but we are yet to see a new sector emerge that fundamentally shifts where the most active lenders are transacting. We believe that the greatest opportunities for a lender come from a lender's ability to originate dealflow, and that origination comes from scale, experience and track record.

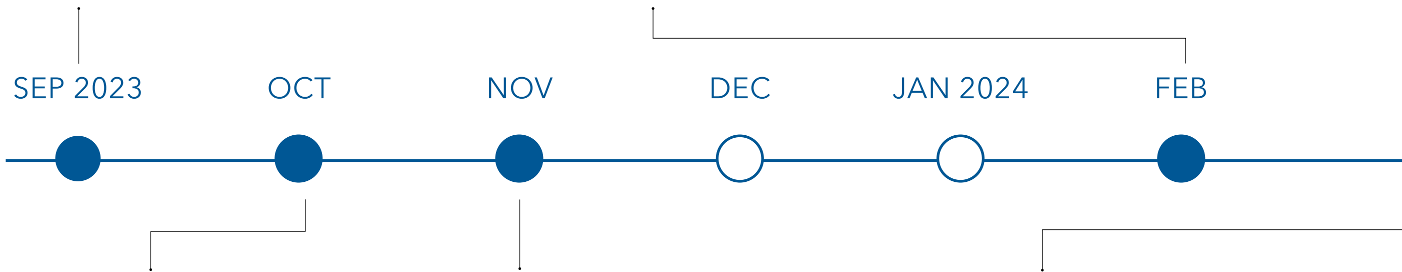
Trevor Clark is founder and managing partner of TPG Twin Brook, TPG's middle market direct lending business.

A year in review

The past 12 months have seen notable hires at major investment firms, fund closures, strategic partnerships and capital fundraising

Monomoy Capital closes second credit opportunities fund
Monomoy Capital Partners closed its second credit opportunities fund on its $300 million target. The Greenwich, Connecticut-headquartered firm had total AUM of $2.7 billion. Through the fund, the firm was set to invest in mid-market loans and senior secured notes, mainly in the US.

Charlesbank closes opportunities fund on $1.5bn
Charlesbank Capital Partners closed the third vintage of its opportunities fund on $1.5 billion, beating its target of $1.25 billion. The fund was formed to invest in high-quality mid-market companies, mainly in North America, with enterprise values of $150 million to $3 billion.



PIMCO closes CREDF II amid sustained appetite for US debt
Asset management giant PIMCO held a final close for its second US commercial real estate debt fund, demonstrating the demand from institutional capital to be part of a wave of alternative lenders in the sector. The Newport Beach-based manager closed PIMCO Commercial Real Estate Debt II on $3 billion.

KORE Wireless deal sees big cut in first lien leverage
Atlanta-based KORE Wireless refinanced its outstanding broadly syndicated debt of $300 million. The deal reflected a broad trend of refinancings in US mid-market businesses – the company wanted to refinance debt it acquired via broadly syndicated loans but rather than turn back to the BSL market or regulated banks to do so, it went to private credit.

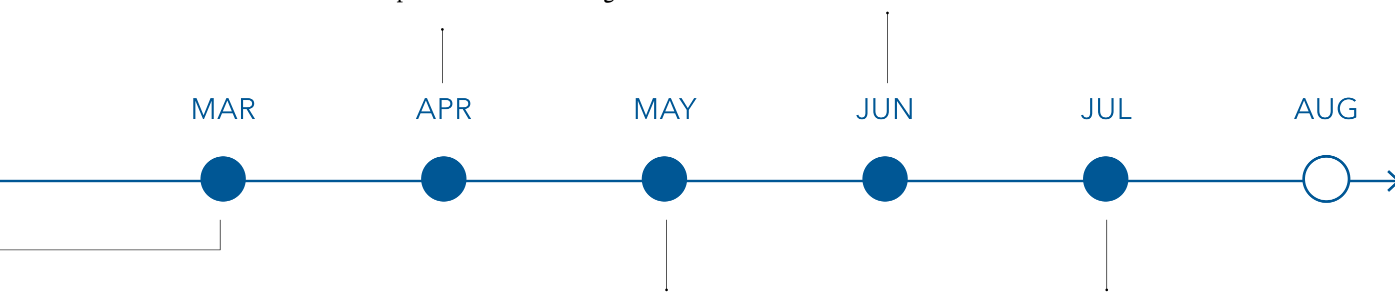
US state pension allocations to private debt grow further
US state pension allocations to private debt grew by 1.56 percent over a five-year period, from 2.13 percent in June 2018 to 3.69 percent in June 2023, according to research from investment and advisory firm Cliffwater. This was relatively modest compared with the 5.42 percent growth in private equity allocations over the same period.

Nassau and Golub form new strategic alliance

Golub Capital and Nassau Financial Group became strategic partners, with Golub becoming the largest minority equity holder in Nassau. The parties also entered into an investment management agreement which provided that Nassau's insurance subsidiaries would benefit from Golub Capital's mid-market direct lending strategies.

GP stakes firm concludes $3.3bn fundraising

Hunter Point Capital, a US-based investment firm providing capital solutions and strategic support to alternative asset managers, closed its inaugural GP stakes fund, HPC Fund I, with $3.3 billion in capital commitments, exceeding its initial target. The firm said HPC Fund I was the largest-ever debut GP stakes fund dedicated to private market strategies.



Hayfin agrees management buyout deal with Arctos

London-headquartered private debt manager Hayfin Capital Management agreed to a management buyout supported by Texas-based private investor Arctos Partners. The deal will see a partnership between Hayfin's management team and Arctos Partners acquire the majority stake currently held by British Columbia Investment Management Corporation.

Capital Group and KKR seal new partnership focused on public-private market investment solutions

Capital Group and KKR formed a partnership to create hybrid public-private market investment solutions to investors. The strategies are designed for financial professionals and their clients. They are expected to launch in the US in 2025.

Ares closes US direct lending fund with a record $34bn capital base

Ares Management held a final close of its Senior Direct Lending Fund III with $15.3 billion of equity commitments, and a total expected capital base of $33.6 billion, a record for a private credit fund. The fund, launched a little more than a year ago, exceeded its $10 billion target by more than 50 percent.

EXPERT Q&A

Whether you opt to outsource or run your own team, experience is key, says Greg Myers, global sector head, debt capital markets at Alter Domus

Honing operating models to capture growth opportunities

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Q Given the rapid growth of private credit, what do managers need to consider when shaping their operating models to take advantage of new opportunities?

There are a number of considerations – not only the outsource versus insource question, and which systems and technologies to engage, but also the allocation of costs. Typically, overheads and internal staff are paid for by the management team whereas fund expenses or middle office administrative costs are borne by the funds themselves. Attempting to reach that balance with the right oversight and the correct cost allocations is a challenge, as is how much control you want over the entire system.

Oversight and control can take many forms, managers need to ask themselves whether it is enough to have a small staff overseeing a provider, or whether building an entire oversight operation that oversees everything done by a provider would serve their interests better.

Similarly, private credit has far more moving parts than exists in bonds or equities. Obviously, the oversight and investment management is similar, but loans are more complex with multiple tranches, different rates and payments of principal and various sources of income that need to be tracked. Added to that, the information ecosystem that exists for broadly syndicated loans isn't there for private credit, so you may be in a small group of lenders where the data is not easily recovered, creating its own problems.

The choice of operating model also depends on the size of the manager and their level of experience. The infrastructure required for private credit operations and accounting is very different to private equity. In credit, you need the ability to track portfolios that are very dynamic – an entirely different skillset for accounting and operations staff.

Investors now typically require a fund administrator, so the question really is what level of infrastructure is needed to engage and oversee your chosen administrator. At Alter Domus, we use a number of systems. We own

> *"Understandably, LPs want more and more"*

innovative technology such as Solvas, which offers integrated accounting, modelling and credit risk solutions, alongside a licensed loan administration platform called Sentry. This means we can support from inside a client's own portfolio management system – integrating data and sometimes even operating from within the client's systems.

All these options feed into our fund accounting systems, which provide managers and investors with regular reports – either on a monthly or quarterly basis. Clients receive data feeds so they can update their own internal accounting systems. Some clients are very light touch and comfortable with an outsourcing model; others run a full internal operations team that tracks what we are doing daily. There is a cost implication to the latter, but we work to what our clients need.

Q What should managers look at when considering outsourcing versus insourcing options?

Not all fund administrators offer portfolio accounting in their loan administration system, but at Alter Domus, we find that it is key to the core team having enough understanding to be able to check daily. Whether you opt to outsource or run your own team, experience is key, something which we have found is getting harder to find amid the talent squeeze that exists within running private credit operations.

Finally, I'd highlight the value in an organisation's ability to manage and track data internally and whether they have the requisite software and IT systems that can support substantial data.

Q How can managers maximise opportunities around technology to support their operations?

We have found that a lot more managers opt for co-sourcing arrangements today, meaning we do the work on their systems. They can trust that they have full transparency and access to everything we do, as well as the ability to seamlessly access the underlying data that we work with. This is becoming the preferred model and more commonplace, as managers can achieve greater efficiencies when they don't have to manage or hire staff – they are making the investment in the technology but not the headcount.

We have completed several successful lift-outs over the past few years when we took on the staff and cost from a client and updated their systems. In doing this, we construct a revenue model that makes sense for the manager, while giving their people a career path that they might not have access to if they stayed at the fund manager.

It is much more important to investors today that they have access, through their manager, to all their underlying portfolio data, so it often makes sense for managers to own that IT infrastructure.

Q What should GPs prioritise for data integration?

Within each GP, there is often a struggle between constituencies. Investor relations teams want a whole set of data around performance and what they can put together for investors; operations teams need enough access and availability to analyse data and satisfy investment professionals; the front office wants feedback on performance of the portfolio assets, and the accounting team need to make sure the fund books and internal books of the manager are up to date.

There is no single system that does all those things and satisfying all of those constituencies is huge task. Many of our clients will focus on one aspect first before moving forward with others, depending on their own priorities.

Q How are both LP and regulatory demands likely to evolve going forward, and what can managers do to future-proof their approaches?

It is always risky to speculate on this, particularly in the US, given the political backdrop of a presidential election year. What is clear is that there will be an even greater increase in regulation and oversight down the line, as legacy private credit was historically handled by regulated banks and institutions.

Despite the overruling of the SEC regulations, we expect an increase in adoption of the practices and disclosures recommended in them, as well as a heightened focus on how private credit operates with investor money being lent to private companies.

Understandably, LPs want more and more. The operational data that we help clients prepare for the more sophisticated LPs is increasingly time-consuming, with requirements for everything from information safeguards through to physical office security. The detail required in these requests is also getting more and more granular.

Managers need to have a highly robust framework in place to ensure their internal infrastructure can meet those demands. That means thorough change management investment underwriting and oversight processes, and partnering with service providers that have corresponding policies and procedures. Even more investment is going to be needed into compliance infrastructure, or in partnering with others that have made that investment in a way that can be relied upon. ■

US private credit on the brink of a rebound

All the signs show that the tide is beginning to turn, writes ***Claire Coe Smith***

While deal activity and fundraising remain subdued for US private debt funds, all indications are that the tide is turning as managers prepare for a busy end to 2024. Hopes of interest rate cuts that would fuel M&A activity mean many big credit funds expect to do far more mid-market direct lending over the next 12 months, despite a choppy start to this year.

When it comes to deployment, the recovery in US public debt markets has made it challenging for private credit to compete for large deals. An excess of capital chasing opportunities in the upper mid-market has led to spread compression and even more competition for dealflow in the core mid-market.

Kevin Lawi, managing director in the credit investments group at UBS Asset Management, says: "There is a pendulum that swings between borrower-friendly markets and lender-friendly markets, and we are currently in a market that favours borrowers. The years 2022 and much of 2023 were very lender-friendly environments but back in 2021, after covid, spreads were tight, banks were underwriting risk, the syndicated markets were robust and private credit had to compete for deals. That is very similar to where we are today – terms are competitive but there are still good transactions to do."

Randy Schwimmer, vice-chairman for investor solutions at Churchill Asset Management, argues the core mid-market is the best place to be right now, given the heat around the bigger deals. "In 2022 and 2023, broadly syndicated loan activity was muted and borrowers had to come to us," he says.

"Today, if you are a credit manager in the large-cap space, you are competing with the banks. We don't do that; the private equity clients we are partnering with are looking for structures for growth and flexibility, and for lenders that can speak for whole deals rather than syndicating to 50 different lenders they don't know.

"Investing within the traditional middle market allows for much more consistency in the way we source deals because whether there is a broadly syndicated loan market or not doesn't affect our strategy. Our dealflow has actually increased with more liquid credit available, because our market segment isn't going for that liquid credit."

Spread compression

Putri Pascualy, senior managing director and client portfolio manager for private credit at Man Group, says investors increasingly see the appeal of lending to smaller companies. "In the upper mid-market we are seeing a bit of spread compression, so at the moment the spread differential between the upper mid-market and the core and lower mid-market is pretty meaningful, between about 175 and 200 basis points. The lower mid-market also continues

to offer better lender protections and lower leverage, making the risk-adjusted returns even more attractive."

Emma Bewley, partner and head of credit at outsourced investment office Partners Capital, says: "We have seen material spread compression in well-understood parts of the senior direct lending market due to capital inflows and dealflow being significantly less than anticipated. That has made that part of the market less attractive on a relative basis and if we don't see an improvement in deal volumes, there is a risk that becomes a race to the bottom. But we are not there yet."

Instead, the hope is that interest rate cuts will unlock dealflow and more sponsor-driven M&A will fuel lending opportunities going forward.

Increased competition

Still, we may not see a significant movement away from the borrower-friendly terms now evident in the US market. Jason Ewart, a partner at law firm Clifford Chance, says: "The new normal is increasing competition amongst lenders, as evidenced by the flexibility of debt documents. Even during the competitive lending markets of the past couple of years, when we would expect tightening of covenants and improvements in lender protections, we noticed only a small movement away from borrower-favourable terms. To retain market share, I think we can expect providers of private credit to maintain those terms and agree to items that can often be flexed out in the BSL market."

On the fundraising side, just $46.2 billion was raised for North America-focused private credit funds in the first half of 2024, the lowest figure since before covid, according to *Private Debt Investor* data. Just 87 funds closed, about two-fifths of the 218 total that successfully completed capital raises in the whole of 2023.

But the fundraising market is coming back to life, according to those close to it. Jess Larsen, founder and chief executive of Briarcliffe Credit Partners, says: "The private credit fundraising market is really active – it is night and day compared to last year. Briarcliffe is probably raising three or four times as much as we were 12 months ago and year-to-date we are already well ahead of the total raised in 2023.

"LPs are starting to get some modest distributions from private equity, which is driving allocation from private equity to private credit. Additionally, more allocation is occurring as a result of credit hedge funds folding into private credit, and fixed income replacement strategies with private credit."

All signs are that investors increasingly favour the asset class over other alternatives. Bewley says: "We have seen considerable interest in private debt over the last year. Given what we see in terms of absolute yields, and the long-term return profile and resilience of the asset class, that has proven really attractive and has been competing with equity allocations for some allocators."

Jeffrey Griffiths, global head of private credit at Campbell Lutyens, says constraints on limited partners continue to hold back fundraising. "Most US alternatives allocators have not had enough liquidity over the past few years, with not enough cash coming back from private equity and venture for them to reallocate," he says.

"Private credit is seen as attractive, with strong relative value right now, but a lot of investors have found it challenging to put in place a rotation into private credit out of private equity because of that lack of liquidity.

"When investors do have mature portfolios and capital to allocate to private credit, the first thing they tend to do is re-up with existing managers, and those re-up requests are quite significant. Then they move on to considering what they want to do across their portfolios that is different to what they currently have, where the big theme is diversification away from traditional direct lending in favour of asset-backed and asset-based lending strategies."

Despite current headwinds, the expectation is of a busy 2025 for the US private debt markets, as investors increase allocations and sponsors become more active. ■

'A powerhouse market'

The US stands to benefit in particular as LPs have more capital available to pile into private debt

"Almost the number one topic when groups of LPs get together today is some of the geopolitical risks arising around the world," says Alicia Gregory, managing director at Blue Owl Capital. "Investors can move capital pretty quickly and the US is attractive in a more divided political world. The US has always been seen as a safe haven. Where other markets like Europe and Asia are more export-dependent and rely on a more interconnected world for their economic growth, the US is more of a powerhouse market."

> *"Terms are competitive but there are still good transactions to do"*
>
> **KEVIN LAWI**
> **UBS Asset Management**

E X P E R T Q & A

The cost of US healthcare is going up but outcomes are getting worse – the venture community is at the heart of the search for innovative solutions, says Luke Düster, chief investment officer at CRG

Lending to the healthcare disruptors

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Q How would you describe the market opportunity for private debt in the healthcare sector?

Our focus is on the hyper growth segment of healthcare private credit, working with the innovators and the disruptors, which represents only 1 percent or less of the total healthcare market.

If you are growing slowly, you can predict a lot, you have control over your expenses and you can manage your payors, so you are generally easy to lend to. If you're growing fast, though, you are consuming cash and it is difficult to predict your account receivables – you might have positive EBITDA but your cashflow may be negative. Our focus is on the latter, but we don't underwrite binary risk. We don't invest in companies unless they have FDA approval, and they are in the market, delivering revenue and growing.

Traditional private credit tends to lend based on a spreadsheet – we like to get into the company, analyse the industry, the management team, the supply chain and so on. We do the same due diligence as private equity, because the cashflows we are looking at are so volatile. We want to lend to the companies that are going to make the system better, improve outcomes, reduce costs and increase access for patients.

In terms of the current market opportunity, in the US, healthcare accounts for around 17 percent of GDP, so it is a huge market and one of the largest industry sectors. About $4.5 trillion is spent each year, with half of that paid by the US government. There are public and private payors in healthcare and both are complicated to understand because they have different incentives.

It would be hard to find a large private credit manager without exposure to healthcare, as it accounts for a sizeable component of most private credit allocations. Still, 99 percent of that capital currently goes to what I would

Q What does the future look like for private credit in healthcare?

In our segment, the future looks really good because we have all those tailwinds driving change. There has to be a shift in the cost structure, and that is forcing people to adopt new technologies and try out new business models.

It is less clear what will happen for the behemoths of private credit looking to lend to more mature companies. Generally, private credit is having its moment in the sun, and those moments come and go. Allocators come in and out of asset classes but private credit is here to stay unless there is some massive deregulation in the banking sector, which seems highly unlikely in my lifetime. The issue, though, is that the asset class gets top-heavy, which could lead to fee compression and downward pressure on returns in traditional direct lending.

What we do is exciting, and the market can sustain itself because it is a less competitive space with higher barriers to entry. We feed off venture debt and the truth is that if companies have loans that they cannot repay, that creates a refinancing opportunity. So, the more loans that are made, the more private credit opportunities there are down the line.

Private credit is now institutionalised and well embedded in the healthcare space, and that is not going to change. Our niche can generate higher returns in a differentiated way, and that will continue to be appealing to investors moving forward as the healthcare industry undergoes a period of significant transformation.

term the dinosaurs – inefficient larger companies that do not evolve quickly.

In pharma, for example, R&D budgets have gradually become smaller over the last 30 to 40 years and those big companies now outsource innovation to the venture community. The same is true in medical devices and healthcare services, creating an opportunity for growth equity and venture to invest in innovation. This market was booming until 2022.

With the collapse of the venture debt market in 2023, M&A down, IPOs down and SPACs off, all the things we were competing against in 2021 are gone, so the market opportunity for lenders has never been so good. We are seeing an amazing opportunity in the 1 percent of the market we are targeting, and there is materially less competition.

Q What are the attractions of the asset class for LPs?

LPs like this strategy because the spreads are high. We are in a returns business, and returns are higher here than in traditional private credit. You can get similar returns in traditional private credit by using a lot of leverage, but here we can achieve those returns without that. So, for LPs, this is a different way of achieving an attractive return profile. In addition, there are all the usual things that make traditional private credit attractive: great downside protection, good recurring cashflows, low volatility and always the first money out.

If you compare private credit with the equity in some of the companies we are lending to, equity is going to be a bit more volatile, with winners and losers. We mitigate that volatility by being senior secured and we are indifferent to the size of the ultimate exit, unlike the equity.

For a lot of LPs looking for healthcare-specific investments that make a positive impact on society, with good returns and low volatility, this is very compelling.

Q What benefits are there for lenders in being a sector specialist?

In order to do what we do, you cannot be a tourist. You have to be absolutely here, living in the world of healthcare, so that you understand the reimbursement environment, the regulatory landscape and the competitive environment.

A sector specialist is never going to have a trillion-dollar fund but they will be able to find bespoke deals. If you have been in the industry a long time, you have a different sourcing mechanism. We have never done a syndicated loan, for example – almost everything we do is proprietary, and we are always the sole lender.

We are typically investing in companies that we have been tracking for at least three years, so it is about developing relationships from an early stage. We might get to know a management team before a product gets approved, then monitor whether they secure approval, evaluate if they can effectively manage their supply chain, execute on their sales force buildout and so on. We look at their key performance indicators for success and that gives us a critical advantage when it comes to making the right decisions on what goes into our portfolio.

An example is Oura Health, which is a Finnish health technology company founded in 2013 that created the world's first wellness ring that links to an app. We identified that opportunity early, evaluated the product, saw they were doing the right thing and reached out to them, so that when they were looking for a lender, they came to us. We will likely be taken out of that investment by a traditional lender at some point, but it takes a non-traditional sector specialist to identify that initial opportunity.

Q What are the current trends driving the growth of the opportunity set?

The trends are primarily about trying to fix what is broken. In Western healthcare, that is spending enormous sums of money, but not getting great outcomes. In the US, the cost of healthcare is going up but outcomes are actually getting worse, not better, creating an incentive for governments and private insurance companies to do better for patients and reduce costs.

The other challenge is increasing access, because one of the things that leads to higher costs is you may have a patient at home who catches a cold, is 85 years old, has diabetes, and that cold leads to pneumonia, which then triggers a heart attack. That patient ends up in an intensive care unit, costing the system thousands of dollars a day, when it would have been so much better to reach them early and get them antibiotics before they became critically ill.

Furthermore, there is also a huge trend towards value-based care. Right now, we have a fee-for-service model where doctors get paid based on how many surgeries they do rather than whether or not those surgeries are the best thing for the patient. What we need is all parties to collaborate and determine what is best for the patient in terms of outcomes instead of procedures.

That is going to be the long-term macro trend but it will not be easy. It is going to require new business models, new technologies, advancement in care and huge data analytics to measure outcomes across patient populations. Right now, the system is focused on treating symptoms and we need to move upstream to help people avoid becoming symptomatic. That will need innovation and a lot of work, but it is absolutely necessary.

"LPs like this strategy because the spreads are high"

"The trends are primarily about trying to fix what is broken"

"We need to move upstream to help people avoid becoming symptomatic"

Q Are there any headwinds facing lenders to the healthcare space?

The real challenge is talent. On the credit side, we are competing with private equity for talented healthcare specialists because it is not people with traditional credit backgrounds that we need. We need people with a deep understanding of the sector, able to analyse the companies from a standpoint of what they are worth, and that is a different skillset.

Additionally, we are a small fund with limited resources, competing with big groups for fundraising, so that can be challenging. And then, of course, the biggest challenge for lenders is to be patient and remain disciplined in the face of numerous deployment opportunities. ■

The looming maturity wall

With trillions of bonds due to reach maturity over the coming years, what opportunities could this present investors? By Jon Yarker

In the coming months and years, a significant amount of debt of different colours is expected to reach maturity. Often called the 'maturity wall', this phenomenon is usually accompanied by eye-watering figures, which speaks to the extent to which debt has been issued in recent years.

Jonathan Barzideh, partner at Canyon Partners, points to a "confluence of four over-levered balance sheets" as cause of this. This, he explains, includes the US federal government, corporate balance sheets, commercial real estate and banks. In particular, the US government is $35 trillion in debt and CRE markets are facing a record wave of maturities, with roughly $2 trillion expected between 2024 and 2026, according to research by advisory Newmark.

"So many [corporate] balance sheets were designed for a zero-rate environment, which helped these companies get financed at very high going-in leverage metrics that are now an impediment to a refinancing exercise," adds Barzideh. "The cashflow metrics at higher rates, exacerbated by generally lower valuations, are making it difficult for leveraged issuers to access capital markets."

"One thing that has been very helpful is the market has seen a lot of refinancings this year"

VIVEK MATHEW
Antares Capital Advisers

Trillions are yet to mature but many in the industry are remaining optimistic about when – or if – this wave of maturities will hit. For Vivek Mathew, president of Antares Capital Advisers, the situation is "manageable", which he ascribes to the return of bank lending, which has boosted refinancing supply. This abundance of refinancing has helped borrowers with debt nearing maturity to reset their situations and buy more time.

"One thing that has been very helpful is the market has seen a lot of refinancings this year," says Mathew. "Part of the reason for that is the banks have been slow in terms of activity from

mid-2022 through to 2023. They had to work through the risks they had on their books. Today there is an appetite on behalf of banks to refinance transactions and spreads have been tightening."

Looking at the data, Kelli Marti, head of CLO management at Churchill Asset Management, says the scale of refinancing activity that has taken place in 2024 is "robust". Pointing to recent PitchBook/LCD data, Marti explains how out of the $700 billion of leveraged loan activity year-to-date, 80 percent of this volume is due to refinancings and repricings.

"Given the very muted supply of new loans coming to market, loan investors have been willing to agree to repricing activity, which can also include maturity extensions," says Marti. "This heavy investor appetite for loans, even with amended terms, has addressed most of the upcoming maturities for 2024 and 2025."

The impact on pricing

Looming maturities are bringing more debtors to the market in need of refinancing, which raises questions about the impact on pricing of these opportunities. Fortunately for borrowers, there has been an even greater appetite to lend according to Michelle Russell-Dowe, co-head of private debt and credit alternatives at Schroders Capital, who has seen credit spreads tighten as a result.

However, she warns: "In the current environment, we believe it is extremely important for credit investors to remain disciplined and highly selective. Investors should also consider diversifying their credit exposure by investing in securitised assets such as CLOs, which have experienced historical default rates well below comparably rated corporate debt."

Also promoting a cautious approach is Krishna Thiyagarajan, partner, head of portfolio management and co-chief risk officer of sponsor finance at SLR Capital Partners. He is also seeing spreads tighten but warns that a rush to refinance ahead of maturity should not lead to a compromise of standards.

"A more cautionary trend is emerging as the opportunities for refinancing healthy borrowers dwindle. Some lenders who feel compelled to deploy at a rapid pace may lower their underwriting standards to maintain origination targets, creating the potential for increased defaults down the road," he says.

Spreads may be tightening as demand grows, with more lenders keen to refinance debt that is nearing maturity, but the current supply/demand

More PIK opportunities

With rates higher, the cost of this debt has also ratcheted up and has put some borrowers under greater pressure. This has led to an increase in payment-in-kind (PIK) arrangements

According to Fitch, they are likely to provide more income in 2024, especially in business development companies. These instruments, paying a higher rate of interest while supporting beleaguered borrowers, have also proven popular with private credit lenders. Antares' Mathew says the firm has selectively accessed PIK investments as a result.

"We see a decent opportunity to provide junior capital in the form of PIK or preferred," says Mathew, reflecting on the trend towards these instruments. "If purchase price multiples don't really change that much, you have to finance the company somehow. Direct lenders will only go so far down the capital structure – there will be a gap there."

Thiyagarajan has also been watching this trend, noting more borrowers have defaulted or been forced into PIK arrangements, but is more interested in the role of asset-backed debt.

"The advancement of asset-based finance has created alternative sources of debt capital for those companies that are cashflow constrained yet have significant assets that can serve as collateral," he says. "With the increased demand for asset-based working capital solutions from issuers unable to refinance in the cashflow loan market, coupled with the pullback by traditional banks from the space, we're seeing significant opportunity in our asset-based, speciality finance businesses."

relationship could still be upset. Adopting an objective view, Antares' Mathew believes the tightening currently being seen is more a reflection of natural market cycle conditions.

"Despite pent up demand to refinance, we think spreads could widen overall when we get the full impact of all the private equity capital that has been raised," says Mathew. Here, he points to the return of M&A, which he expects could place even higher demands upon markets.

"When that happens, there could be a real deluge of M&A over the next few years given how much capital has been raised. It's interesting there's more demand than supply today; that could reverse after 2024."

Tomorrow's opportunities

This activity, with so much debt to be refinanced, is creating opportunities for private credit investors. Canyon's Barzideh points to firms specialising in distressed debt investment as having the capacity to take on these refinancings, which he says would be a true test for the sector. Born out of 2008, many of these funds were braced for distressed situations that failed to materialise during the pandemic when state support held up beleaguered corporates.

"In this environment, the pendulum can swing back towards lenders in terms of covenants and a focus on pro forma deleveraging of these balance sheets," explains Barzideh. "In a target-rich environment where distressed lenders can choose to be even more selective, experienced practitioners are well placed to cherry-pick those opportunities that present particularly compelling risk/rewards."

Refinancing opportunities may be plentiful for lenders with capital but Guido Musitelli, head of research at Pictet Alternative Advisors, warns about potential risks lurking in the market. Pointing out the impact of higher base rates and an uncertain economic outlook, Musitelli also questions why LPs have not been as vocal around transparency of this debt. From his perspective, the head of research thinks LPs should be stronger when challenging how GPs mark the value of their bonds when the issuer is potentially in trouble.

> *"Heavy investor appetite for loans, even with amended terms, has addressed most of the upcoming maturities for 2024 and 2025"*
>
> **KELLI MARTI**
> **Churchill Asset Management**

"We therefore expect investors to question track records more deeply, especially around 'amend and extend' practices, to understand how close loans came to real impairment before getting help from a more benign market environment," adds Musitelli. "As always, due diligence will be key."

These situations may not always be as distressed as they first seem. Adopting a different view, Churchill's Marti argues this is instead a reflection of muted levels of sponsor-to-sponsor asset trades over the past few years. This has forced some businesses to be held for longer.

"Asset managers have the ability to extend maturities for solid performers, which is helpful with regard to portfolio management, as funds have less repayment dollars to redeploy," says Marti, reasoning that investors are better off aligning with asset managers with track records tested over several cycles.

"Further, selecting asset managers with a competitive advantage in deal sourcing is imperative, as those managers have the ability to remain highly selective in periods of dislocation rather than being forced to 'buy the market'," she adds.

Making refinancings work

This theme of being highly selective resonates with many investors. Lenders may be spoilt for choice with so many borrowers needing refinance solutions, but they will nonetheless face stiff competition for the best opportunities. Musitelli argues the lenders that have expanded their sourcing options in anticipation will be the successful parties.

"Managers need to have more tools to be successful in the current credit cycle, where there is visible competition by private credit and where recovery rates may be far from previous ones even for first-lien senior secured lenders," he explains.

Faced with looming maturities, industry experts agree the market has sufficient capacity to withstand this. Opportunities will emerge, with some investors feeling confident given the rate of refinancing already recorded in 2024. Despite this, Pictet's Musitelli warns against investors trying to be "too cute" in predicting the cycle when trying to time market strategies. Instead, he advocates following certain principles such as diversifying capital deployment across both public and private markets and considering multiple geographies.

"We should re-think duration in this market," adds Musitelli. "Funds used to plan on a five/six-year lifespan, which worked in the global financial crisis. But today's environment needs a longer timeframe to deploy appropriately and harvest the returns in full, especially considering the importance of portfolio construction – with net TVPIs benefiting from heavy recycling within funds' investment periods – to deliver solid risk-adjusted returns." ■

EXPERT Q&A

The US private credit market remains ripe with opportunities, with software-as-a-service a particular standout, says David Flannery, president of Vista Credit Partners

Why the golden era of private credit is not over yet

As an asset class, private credit has enjoyed strong fortunes in recent years with many declaring this period as a 'golden era'. As with any period of prolonged growth, some have raised concerns that this may be ending, but many in the sector still see numerous opportunities to continue building their loan portfolios. *Private Debt Investor* sat down with David Flannery, president of Vista Credit Partners, the credit investing strategy of Vista Equity Partners, to find out where the private credit market might go next.

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Q The last few years have been named the 'golden era' of private credit – however, recent sentiment has indicated this may be changing. What factors are influencing market dynamics?

Over the last several years, the private credit market in the US has experienced one of the most attractive environments, generating higher risk-adjusted returns. Private credit has become such an important part of finance, providing a much-needed source of growth capital to companies – at a time when the banking system continues to tighten its lending standards in response to regulation.

Additionally, more and more companies don't want to deal with the volatility of the public markets and are staying private for longer – further driving the need for scaled financing solutions. Given these factors, I believe that with continued structure and underwriting discipline, the private credit market will continue to perform well for investors.

Q Most opportunities for private credit have been in the sponsor market. However, Vista has been able to pursue opportunities with non-sponsor, founder-led software

"We see opportunities to generate unique risk-adjusted returns by providing financing solutions directly to the founders of software companies"

"More and more companies don't want to deal with the volatility of the public markets and are staying private for longer – further driving the need for scaled financing solutions"

companies. What opportunities do you see in this area?

The sponsor side of direct lending has certainly been more of the historical focus for the private credit market. However, we see opportunities to generate unique risk-adjusted returns by providing financing solutions directly to the founders of software companies. Our ability to capitalise on this opportunity is driven by our position within the broader Vista platform, which has nearly 25 years of experience investing in the enterprise software ecosystem.

Our credit solutions provide highly developed software companies with less dilutive capital than historical alternatives – prior funding for these businesses was largely sourced from the growth equity and IPO markets. Given current volatility in both these segments of global capital markets, we have seen significant increases in our dealflow. With the right underwriting discipline, unique sourcing capabilities and established brand, we believe these dynamics will drive more compelling opportunities in the road ahead.

Q How are the founders of these businesses leveraging the private credit channel to grow their businesses?

We often remind founders and management teams that when we make a loan to a company, the cash stays on the balance sheet for the company to invest. Most of the time, this capital is used in the go-to-market function of the business – sales, marketing and customer success. This investment is predicated upon high ROI generation that can be replicated over time.

We've also seen a trend emerge with more companies looking for loans to help them finance M&A. In these situations, we are lending money to software companies who are looking to consolidate market share.

Here again, Vista has a wealth of experience. Our credit strategy has executed on more than 620 transactions since inception and we have numerous experts throughout our firm who can help us evaluate the risk.

Q How can private credit investors mitigate risks when investing in non-sponsor companies?

A core part of how we mitigate risk is the due diligence before we underwrite a loan. We deploy Vista's operational expertise alongside our core credit underwriting to assess the breadth of potential risks that could lie in any given transaction. For example, our technology diligence process is conducted by Vista's Value Creation Team, which often identifies underlying issues with a company's product architecture – some are small and easily fixable, and others are serious enough that we pass on the investment entirely.

This is where the benefit of a $100-billion-plus platform focused on software comes to bear. Generalists and lenders with fewer available resources typically don't have that level of visibility and aren't able to move away from problematic opportunities in the way that we can.

We often hear private credit firms talk about better structures and stronger covenants, which I'd argue rings even more true in the context of non-sponsored lending where the financings are bilateral in nature. This results in some of the tightest maintenance covenants in the market, including a covenant that often requires considerable revenue growth.

At times, we are also active investors through board seats or board observer rights. This can give us real-time information about what is happening at a company, and we have the opportunity to influence outcomes at a management level. That is uncommon in private credit. Due to the experience we bring to the table as software specialists, our viewpoints are often welcomed by CEOs. They want to hear what we have to say and how we can

Q What is your outlook for the credit market? Is the team generally bullish, bearish or somewhere in between?

It's a great environment right now for what we do in software. Companies are growing, margins are expanding and yet the public equity markets are not reflecting that optimism. This presents opportunities for lenders like us – for context, our credit portfolio is growing well above most generalist direct lending books. We're excited about this growth and the continued opportunity for our credit portfolio.

help them grow, given our experience in the market.

Q How are new structures such as business development companies, or BDCs, changing private credit?

The arrival of new structures is good for private credit overall, providing a broader base of investors, including the private wealth channel, with more liquid options and a different way to invest in the growing credit opportunity.

Accessibility is a positive, but it has made the generalist sponsor lending financing market very competitive. We believe that many BDC portfolios today are burdened with legacy positions in over-levered companies as well as a limited ability to go on the offense and capitalise on attractive investment opportunities.

Additionally, there is significant overlap among the largest private credit investors and their BDCs – we estimate more than 50 percent at the borrower level for the larger vehicles – which means a potential issue in one portfolio can have an outsized impact.

"AI will help private credit investors develop tools that will allow them to access data extremely quickly and gain better insights"

Vista Credit Partners raised its inaugural BDC last year, and because we began deploying capital in late 2023 – after the market high – we believe we are less constrained by these factors. We believe our BDC is well positioned to deploy fresh capital into companies that have withstood the rate hike at better pricing, tighter documents and lower LTVs.

Q How has the arrival of generative AI impacted the private credit market? What opportunities are you seeing as a result of this trend?

There has been a huge amount written and spoken about AI, but in our view, there are three key opportunities.

First, AI will help private credit investors to develop tools that will allow them to access data extremely quickly and gain better insights. If we can apply generative AI to our own data and extract interesting trends and learnings we can act on, there are exciting opportunities to be had. This will also give us more time to do what we do best – invest in software businesses.

Second, we have seen a pullback from late-stage growth equity providers that have funded software businesses in the past because they are very focused on the opportunity in generative AI. There is a real gap in the market for late-stage software companies – our target market, in other words – that still presents real value. We'll continue to focus on enterprise-grade software, which we feel is a more predictable investment than consumer-focused software.

And third, data is going to uniquely drive value in AI. Software companies control the data sets for their businesses and have the domain expertise to leverage this data at scale, which is going to be very important on a go-forward basis. We believe our software companies across private equity and private credit are at the cutting edge of implementing new generative AI tools to drive new revenue opportunities. ■

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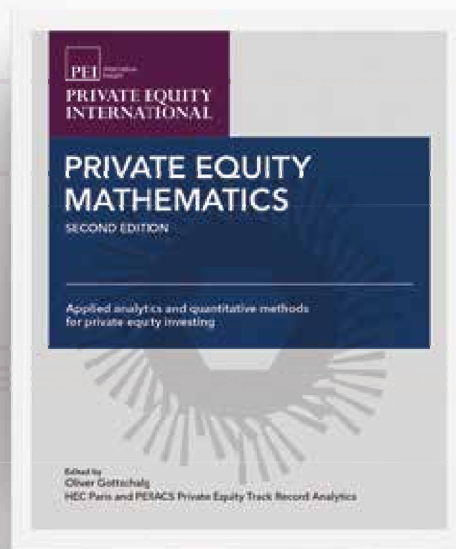

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Five key themes for US investors

Differentiation has become the buzzword as institutional LPs look to build out their private credit strategies. By Claire Coe Smith

US investors are changing how they approach private credit, as allocations mature and familiarity with the asset class increases. Having begun with a focus on mid-market direct lending, many are committing more capital and looking to diversify.

James Clarke, global head of Blue Owl Capital's institutional business, says LP attitudes to private debt have shifted over the past decade. "The biggest sea change we have seen in the last five to 10 years is that our clients have gone from viewing direct lending or private credit as a trade to seeing it as a permanent investment," he says.

"They are no longer episodically looking to take advantage of dislocation and then pause and then come back. Now, private credit assets have moved to be more a traditional exposure. More often than not, we now find ourselves in the fixed income portfolio, which was mostly public market fixed income."

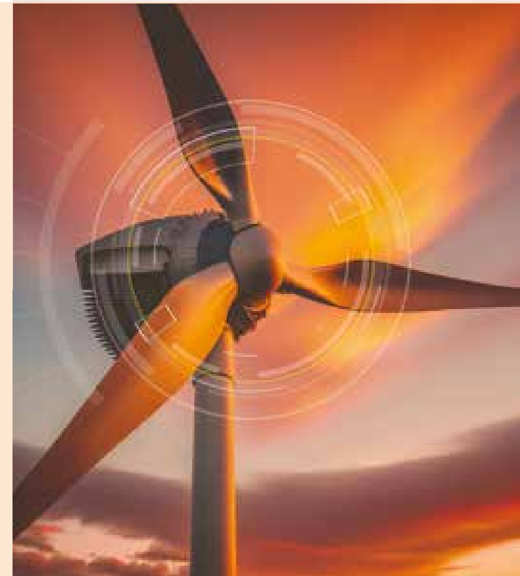
A lot of clients have now established a core allocation and are building out exposure to some less trafficked parts of private credit, Clarke says. "That leads them to gravitate to the larger managers, so that they don't need to deal with multiple managers to get there."

Andrew Bellis, head of private debt at Partners Group, agrees. "Institutional LPs, particularly in the US, continue to like private credit, and there is probably a bit of a build-out in private credit strategies that US LPs are ahead of," he says. "They have allocated to US private credit and we now see a good amount of appetite for European private credit, but also further interest in other private credit strategies such as asset-based financing, NAV lending and secondaries.

"The first place that investors look has typically been corporate direct lending, but as allocations increase, there is only so much corporate direct lending they want to do."

New investors

The shift away from direct lending is further fuelled by new investors. Jess Larsen, founder and CEO of Briarcliffe Credit Partners, says endowments and foundations are getting much more active in private credit. "With higher returns in private credit, they can get 8-10 percent interest paid out quarterly, which means they can meet their liabilities just with interest paid, plus an element of capital appreciation. Because those investors are looking for higher returns, they are often going outside traditional mid-market direct lending



"Clients have gone from viewing direct lending or private credit as a trade to seeing it as a permanent investment"

JAMES CLARKE
Blue Owl Capital

and focusing on speciality finance."

Likewise, Jeffrey Griffiths, global head of private credit at Campbell Lutyens, notes: "There is a strong appetite for shorter duration, higher returning private credit, particularly from the high-net-worth and family office pools of capital, and that tends to lead them to asset-based lending strategies."

Even within direct lending, allocations by US LPs are becoming far more nuanced. Putri Pascualy, senior managing director and client portfolio manager for private credit at Man Group, says: "A decade ago, no one made a distinction between the upper mid-market, the core mid-market and the lower mid-market, but now that comes up within the first 10 minutes of any LP conversation. That shows how the market has grown, and also the sophistication of investors."

Trevor Clark, founder and managing partner of TPG Angelo Gordon's mid-market direct lending business, Twin Brook Capital Partners, says LPs are diversifying into the lower mid-market. "We have been lower middle market lenders for over 20 years and raising capital from a broad institutional base for the last decade," he says. "In the last three years, we have seen clear recognition that the lower mid-market is offering a very different opportunity compared with that which many of the large global asset managers active in the upper mid-market are offering.

"Whether that recognition is due to the portfolio overlap analysis, which shows many of those managers present in the same transactions, or whether it is because of the moving down the balance sheet, adjustments to cashflow or the volatility of returns, the upper mid-market is getting called into question. We believe the differentiation a scaled lower mid-market investor can bring is now really clear to institutional investors."

With differentiation the buzzword for private credit allocators in the US market, we outline five themes that underpin the current investor landscape.

Tech and healthcare are back

Sector specialism is in vogue, especially in areas where valuations have come down

As competition hots up in the US direct lending space and LPs seek out differentiated returns, the appeal of sector specialists is once again in the spotlight. Given the fairly significant correction that has taken place in healthcare and technology valuations over the past few years, investors are eyeing a refreshed opportunity.

Emma Bewley, partner and head of credit at Partners Capital, says: "Sector specialists are now seeing a bit of interest because of the opportunity set being created to provide non-dilutive financing into areas like technology and healthcare, where valuations have come down."

She says the firm is starting to see more interest in software lending, life sciences and healthcare lending, where the story is probably more straightforward now there has been that value correction. She adds that some borrowers do not really want to raise equity because of the risk of dilution, but need to raise capital for growth and are happy to take on relatively expensive debt finance for a limited period and retain that equity value for themselves as valuations improve.

Jess Larsen, founder and CEO at Briarcliffe Credit Partners, argues that it is harder today for sector specialists to stand out in a crowded market. "When a GP can provide additional value to the LP by having a particular sector focus, you see them being more competitive than the generalists. LPs don't necessarily want to have more line items in their portfolios, so they have to really get something they can't get elsewhere."

Flexible capital

At Vista Credit Partners, a specialist software lender, president David Flannery says there is growing appetite among LPs. "There is a real interest from LPs in specialisation and in the technology space," he says.

"What we are hearing from the large allocators is that many have been investing in direct lending for a decade now, and they have their generalist sponsor-backed direct lending portfolios pretty well built out. They generally like those GPs they have been with for a while, but they are increasing allocations to credit and like things that are a

"There is a real interest from LPs in specialisation and in the technology space"

DAVID FLANNERY
Vista Credit Partners

bit different, maybe a little less correlated, which sector funds can fit into."

Through its FounderDirect channel, Vista offers flexible capital solutions direct to founders seeking less dilutive terms, bypassing the sponsor market. "At Vista, being specialist is what gives us the ability to do what we do in the non-sponsored market," says Flannery.

"Because we are heavily specialist and heavily focused, in our sourcing, our underwriting and our due diligence, that allows us to do a lot of non-sponsored lending. That is something LPs particularly like because it feeds this theme of something that is different to what they already own.

"We hear a lot of people saying, often in large family offices, that over the past few years they have shied away from private credit because they felt like there was a lot of capital there. But with our specialisation, our technology focus, and our non-sponsored lending, we are different enough that they find us interesting."

In healthcare, valuations have similarly taken a tumble as inflation exposed vulnerabilities to wage rises. CRG is a specialist lender targeting high-growth innovators and disruptors in the healthcare ecosystem. Chief investment officer Luke Düster says: "A sector specialist is never going to have a trillion-dollar fund but they are going to be able to find the bespoke deals.

"If you have been in the industry a long time, you have a different sourcing mechanism. We have never done a syndicated loan, for example – everything we do is proprietary, and we are always the sole lender."

He says the firm typically invests in companies it has tracked for at least three years, so it is about developing relationships from an early stage. He says his team might get to know a management team before a product gets approved, then see if they get approval, see if they can manage their supply chain, execute on the sales force and so on.

He says: "We look at their KPIs for success, and that gives us a critical advantage when it comes to making the right decisions on what goes into our portfolio."

Differentiated sourcing

It is that differentiated sourcing and underwriting that continues to enable sector specialist lenders to attract new LPs. The underlying growth dynamics of technology and healthcare, driven by significant megatrend tailwinds, are also boosting investor sentiment.

Flannery says: "We are in a period in the economy where, if you pick the right software businesses that deliver high returns on investment to their customers, there is a lot of organic growth available that is really good in a credit portfolio. As a credit group, we have done well in explaining to investors that, when you look at tech multiples over the last few years, the highs were too high and the lows were too low.

"Being in a credit product with really good downside protection is a good way to stay invested in the digital economy without having to worry about where multiples are at any given point in time."

The sponsorless lending space is especially appealing at a time when private equity deal volumes are depressed. Flannery adds that volumes in the sponsor market are still a bit muted and most direct lenders are waiting for that to pick up.

"We are almost countercyclical in the sense that we are not impacted by the busyness of private equity. The IPO market is far from going strong, the late-stage growth equity market in Silicon Valley is a bit distracted by its own portfolios, and that leaves a funding gap for late-stage, well-developed software businesses.

"That is where we focus, so we see a compelling deployment opportunity at a time when the rest of the private credit market is waiting for sponsor activity to pick up." ■

EXPERT Q&A

The rapid growth of private debt is testing the mettle of loan administration teams, say Michael Von Bevern and Harvey Tian of Suntera Fund Services

Keeping up with private credit's evolution

As the private credit space has grown, so has the complexity of these structures as firms continually innovate to corner the market and secure business. This complexity creates new administration challenges requiring novel and bespoke solutions from service providers. To find out more, we sat down with Michael Von Bevern, managing director for the Americas for Suntera Fund Services (formerly Socium Fund Services), and its head of loan administration and agency services, Harvey Tian.

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Q How have private debt funds become increasingly complex?

Michael Von Bevern: All funds are becoming more complex, not less. Fund structures require specialisation. For instance, facilitating distributions in a closed-end private credit fund before the fund is closed to new investors is tricky.

Facilitating nuances, such as distribution classes or other features to enhance attractiveness to other investors, can be challenged in a closed-end vehicle. Funds are not as straightforward as they were a few years ago. LPs require more customisation.

Harvey Tian: Recently, we have also seen a significant increase in PIK deals. Traditionally, with a PIK, if the borrower doesn't want to pay cash, they capitalise the PIK interest on their loan balance. We have found that a lot of lenders are doing synthetic PIK deals. Instead of paying cash for this interest, they are using additional loans to make these payments.

Operationally, if a deal pays an interest payment regularly, we collect payment from a borrower and send it to a lender. For synthetic PIK deals, we have to process borrowing activity at the same time. Operationally, this can create multiple loan transactions just to shift funds from one place to another.

Q To what extent could rate cuts in the second half of 2024 be a consideration for the administration and operation of these private debt funds?

HT: Following the recent non-farm payroll numbers, a rate cut is nearly guaranteed this year, which could create a wave of refinancing in the market. Borrowers will try to access new deals when they can. When there is a rate cut, the margin and the spread tend to go up. Any floating-rate loans that closed after covid or around that time will probably have a low margin. However, fixed-rate loans will probably try to refinance at a lower rate.

Q What challenges is greater complexity creating for loan administration?

HT: We are seeing a greater volume of loan transactions. Historically, loan agency and fund administration teams have not communicated well with one another. This lack of synergy can lead to miscommunication, which in turn can create costly delays and potentially affect the overall efficiency and effectiveness of the fund administration process.

MVB: Our loan administration service offering primarily focuses on private bilateral senior secured debt between a fund – or multiple funds – and the portfolio company. From our standpoint, administering that means complexities such as the need for the data from these GPs.

Harvey and his team become the clients' middle office team. The loan administration and fund administration are one team. Suppose you think about everything that can make it complex, such as multiple systems or lack of systems, data management, and an ability to read and understand loan documents. In that case, we have worked hard to minimise that. Our clients operate in the mid-market; they don't have the resources that the biggest firms have. They rely heavily on what we do. We're trying to give them a minimalist degree of separation when it comes to us and them.

> *"Funds are not as straightforward as they were a few years ago. LPs require more customisation"*
>
> **MICHAEL VON BEVERN**

Q To what extent are bespoke fund service solutions preferable when it comes to increasingly complex private debt funds?

MVB: Whenever we have a prospect, I go in from the accounting and reporting perspective and look at the structure to make sure we can do it. Harvey will look at this from the loan side – can we handle the loans, the timelines, the reporting, etc? We then come together and assess if we can create a tailored solution that meets the unique needs and requirements of that client.

Fortunately, we have much influence with our software provider. Most of the customisation our software provider has created has been based on Harvey's recommendations, and he has an uncanny knack for knowing what things should look like for the borrower.

Having that seamless integration with the fund accounting team helps. Remember, with the size of our clients, our fund accounting team and the loan team could be talking to the same person. We want to make sure everything is preserved in translation.

Both our systems are very customisable. We have yet to see a fund we cannot do in our nine years. We are unique – I don't think anyone who does mid-market fund administration, loan administration and loan agency is really out there.

There are big guys, but very few focus on the under $3 billion in assets under management space.

Q In terms of private debt fund administration, what is your outlook over the next 12-18 months?

MVB: Private credit has the potential to be a massive industry shortly, and there will always be a place for credit solutions. The asset class makes a lot of sense to portfolio companies that want to expand their capital base without diluting control. Putting in senior secured, or even mezzanine, loans will remain viable.

HT: It helps that the market has become much more structured. The Loan Syndications and Trading Association (LSTA) is operationally trying to normalise this space. The more standardised it becomes, the easier it will be for investment teams to choose between debt versus equity.

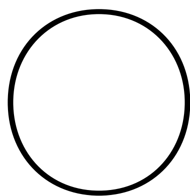
We're working with the LSTA on their efforts to standardise how a loan operates in the operational sense. This means all teams will be able to co-ordinate better and more efficiently for the loans they operate.

MVB: The reality is that very few people are focused on private credit. One of the complexities as the industry evolves is being able to find people like us who are willing to keep up with change. As Harvey mentioned, we are working with the LSTA to create standard practices and procedures. Creating things like a standard subscription document, for example, is essential.

Standardisation will come, but firms will need people who can accommodate bespoke things until that time. ■

Open-end funds appeal in hunt for liquidity

The range of alternative structures on offer continues to grow



Over the past few years, the number of open-end, evergreen options available to US private credit investors has ballooned as demand for more liquidity in an illiquid asset class drives innovation. As the range of alternative structures on offer continues to grow in the US, GPs say there is no let-up in demand, particularly as the range of investors in private debt keeps diversifying.

Andrew Bellis, head of private debt at Partners Group, says open-end funds continue to be seen as a more efficient way to allocate capital to private credit, particularly for the smaller or mid-sized institutional LPs. "We have seen the evergreen vehicles becoming popular, and we continue to see growth. If you're a large LP and you are going to allocate significant capital, you can do that by a mandate that you can make evergreen yourself, but that is much more difficult for a smaller institution.

"Those smaller institutions are much more interested in an evergreen solution whereby they get invested, stay invested, their NAV grows steadily and they don't have to deal with capital calls and recommitments. For them it is an increasingly relevant choice versus more traditional closed-end funds, and this year we have seen continuous growth in demand for our evergreen options."

Enhanced liquidity

David Ross, head of private credit at Northleaf Capital Partners, says evergreen vehicles have an important role to play in attracting new classes of investors.

"The enhanced liquidity provisions of open-end structures have, in part, helped to broaden the investor base for private markets," says Ross. "These structures have attracted more demand from different pockets of LP capital, for example family offices, endowments and high-net-worth individuals. It has also been particularly attractive to smaller institutional investors making their first allocation to the asset class. Managers continue to innovate and develop flexible structures to meet the needs of different LPs."

He says there are several drivers of demand. An open-end, evergreen vehicle, for instance, can offer immediate exposure to a diversified portfolio of private credit investments. He adds

"This year we have seen continuous growth in demand for our evergreen options"

Andrew Bellis
Partners Group

that investors can benefit from consistent quarterly cash yield, shorter drawdown periods and the ability to more efficiently maintain or rebalance exposure to the strategy over time. However, he says larger allocators with advanced operational platforms have long been familiar with managing their investments through closed-end structures, which are still most common across private markets.

Jeffrey Griffiths, global head of private credit at Campbell Lutyens, says larger managers now routinely offer their investors an evergreen option alongside a traditional closed-end fund. But he agrees that traditional closed-end structures will continue to dominate: "We do now see that most direct lending firms of size and scale will have open-end structures available for investors to access.

"That is an important part of the market that is becoming more prevalent and will continue to grow but will not replace traditional drawdown structures. Traditional drawdown funds allow investors to express a vintage view, investing in new deals, rather than having to buy into an exposure to older deals."

He adds that the open-end structures he sees do not typically offer a lot of liquidity, with maybe an option to get out at certain times. But in times of market stress that ability to take money back is unlikely to be there given the restrictions set out in liquidity provisions, so he thinks that is something to look out for in the future. He expects to see some disappointment with some of the structures when they are tested.

Emma Bewley, partner and head of credit at Partners Capital, is similarly cautious about the degree of liquidity on offer: "We describe these open-end funds as offering qualified liquidity because there may be liquidity available, but it should not be relied upon, and the underlying remains an illiquid asset class.

"The ability to maintain a consistent NAV profile without having to manage capital calls and distributions while trying to maintain exposure, is attractive to a lot of investors. However, we caution that they should still re-underwrite a manager on a regular basis and these should not be seen as a means of cutting the diligence burden."

Growing demand

Putri Pascualy, senior managing director and client portfolio manager for private credit at Man Group, is also witnessing a growing demand from LPs. "The open-end structure is seeing more popularity with institutional investors, where there is a growing realisation that, particularly in private assets, timing the market is less important than time in the market," she says.

"Historically, with the traditional drawdown structure, LPs were not consistently invested, so many that are now more familiar with direct lending like the ability to stay more invested and have access to that exit ramp if they need it."

It remains to be seen how that investor appetite will continue to develop as the asset class further expands its constituency. Ross says that open-end structures have, in part, helped to broaden the investor base and that he expects this to continue.

"These structures have attracted more demand from different pockets of LP capital, for example family offices, endowments and high net worth individuals," he adds. "They have also been particularly attractive to smaller institutional investors that are making their first allocation to the asset class. Managers will continue to innovate and develop flexible structures to meet the needs of different LPs."

It seems managers are going to have to diversify their offerings to stay abreast of varying demands. Bellis says: "There are always going to be those LPs that like closed-end funds and want to be able to manage their commitments and adjust allocations that way. There will also always be a group that prefers evergreen solutions." ■

EXPERT Q&A

Bryan High, head of Barings' Global Private Finance Group, reveals where he sees direct lending heading in the rest of 2024

All to play for in 2024

Direct lending has continued to grow in prominence as an asset class. Attractive returns and durability have helped it gain allocations over other alternatives, but what does the rest of 2024 hold? We spoke with Bryan High, head of global private finance at Barings, which has been investing in the direct lending market for over 30 years and supports more than $300 billion of credit investments globally.

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Q How is the direct lending asset class positioned headed into the second half of the year?

Direct lending continues to offer the potential for compelling risk-adjusted returns versus other asset classes. Deconstructing the basic return components, base rates have remained elevated longer than many were anticipating, and even as central bankers look to begin easing cycles in developed markets, we expect the higher-for-longer rate environment to persist through 2024 and into 2025. When combined with consistent underwriting spreads that seasoned platforms can achieve for senior secured debt, we believe the all-in-yield profile for direct lending remains attractive. More generally, we expect this year's strong performance to continue and note that direct lending returns have proven durable historically, exhibiting consistency and low volatility over long periods of time.

Continuing the trends we've seen in recent years, direct lending has taken share from the public markets in a number of ways. From an investor standpoint, we attribute the movement into private markets to the yield premium on offer, largely a result of the illiquidity of the asset class. Historically, private mid-market loans have offered a premium of roughly 200-400 basis points over broadly syndicated loans – and importantly, lower default rates and higher recoveries.

And from a sponsor perspective, while the broadly syndicated market has reopened this year for some companies and certain transactions, we see direct lending continuing to provide value as a tailored financing solution insulated from the potential noise and volatility in public markets.

Today, direct lending has become somewhat mainstream within private credit, representing roughly half of the $1.7 trillion market. But while the stable, income-producing nature of the asset class has led to increased adoption across a well-diversified global investor base, our observations suggest there is opportunity to grow allocations further.

For example, a majority of investors still report being underallocated to the asset class, especially relative to the largest allocators. Overall, we believe there is more capital that will move into the space – and while there's been a lot of focus on the growth in the market over the last few years, it's important to point out that aggregate direct lending dry powder today is a fraction of the anticipated financing needs for private equity activity in the years to come.

Q What are some of the dynamics shaping the direct lending market today?

Sponsor-financed M&A activity has traditionally been a significant driver of dealflow in the direct lending market. However, over the last 18-24 months – coinciding with some of the most aggressive global central bank policy tightening in decades – leveraged buyout (LBO) activity has slowed substantially.

What this means is that at the same time we've seen a proliferation of allocations to the asset class, there has been a slowdown in terms of dealflow for new platforms – and this supply/demand imbalance has created an interesting dynamic in the marketplace. Specifically, as dealflow and M&A activity have slowed, certain market participants have had to re-think their approach to deploying capital.

For some managers, this has meant style drift – moving up-market from the traditional or "true" mid-market lending strategy, opting to ramp larger portfolios quickly by making bigger investments in larger companies with $100-plus million of EBITDA. As a result, we've seen several multi-billion dollar transactions in the direct lending space, a rare occurrence just a few years ago. But bigger isn't always better, and transacting in the upper end of the mid-market has implications, particularly from a return and protection standpoint.

For example, spreads on some of these larger transactions have narrowed more materially than has been the case in the traditional mid-market. In some cases, they have come closer to those in the liquid broadly syndicated markets – suggesting an erosion of the premium that has historically stemmed from the illiquid nature of direct lending. Likewise, it should be noted that underwriting standards can differ at the upper end of the market, with fewer covenants, potentially weaker documentation and higher leverage, all of which can have negative return implications for investors in the event of a default.

Going forward, a slight tightening of spreads could catalyse some activity by private equity firms as their cost of debt financing comes down. Anecdotally, we've seen more platform opportunities arise in our pipeline – whether they come to fruition remains to be seen – but we're encouraged by increasing activity levels. To some extent, this is also a function of the fact that distributions from private equity portfolios are at their lowest level in roughly 15 years, and managers are increasingly facing pressure from their LPs to realise assets and return capital.

Another contributing factor is the upcoming US presidential election. Election cycles often lead to uncertainty, driving market participants to transact ahead of any policy changes and seek to avoid execution risk and potential volatility that can exist in public markets.

Q What are the benefits of the mid-market?

As previously mentioned, there are a number of benefits to remaining disciplined and focusing on executing deals in the traditional mid-market, where company EBITDA tends to range from $15 million-$75 million. The more conservative parts of the capital structure, namely first-lien senior debt, continue to offer the potential for strong risk-adjusted returns. These deals tend to have lower leverage profiles, better documentation and more stringent financial covenants relative to the larger end of the market. For us, these are critical components of the direct lending market and key tenets of our investment philosophy – we've applied disciplined underwriting and portfolio construction to build diverse portfolios of mid-market companies designed to weather different environments.

Q How do direct lending managers differentiate themselves?

In direct lending, capital preservation and seeking to avoid losses are critical. If you think about the nature of a loan, you have a contractual rate of return and a bit of appreciation from a discount or fee on the front end. And that's it – there's not a lot of upside to that. It's really about protecting yourself from the downside and making sure you limit losses to the best of your ability. This comes down to a few key areas: credit selection, experience, scale and a long-standing presence are key differentiators. A deeply resourced team is also critical.

Importantly, these characteristics can allow managers to stay active and continue deploying capital to attractively priced opportunities, even as deal volume fluctuates. In environments like we're in today, where dealflow is somewhat muted relative to recent years, the most attractive opportunities from a risk/return perspective often are add-on transactions with existing portfolio companies.

Lenders like Barings, with a large book of portfolio companies, are particularly well-positioned in this respect. We've continued investing in new originations through portfolio M&A activity, as evidenced by a significant portion of our activity over the last 18 months coming from existing issuers. Ultimately, we believe it is critical to retain mid-market terms in businesses with longevity and established track records to build consistency of return for our investors. ■

Investors remain split on ESG

There is a growing divide between US and European LPs on responsible investing

If there is one area where many US LPs diverge quite notably from those in Europe, it is on the issue of environmental, social and governance (ESG) standards. Republican politicians in America have attacked ESG as the corporate world's adoption of a liberal agenda, attacking a number of responsible business agendas from cutting carbon emissions to advocating for more diversity, equity and inclusion (DE&I) in teams.

BlackRock, the world's largest asset manager, faced a boycott in Texas and came under investigation in some Republican-controlled states over ESG, leading boss Larry Fink to say he was going to stop using the term and claim it had been "entirely weaponised". As a result of this trend, the scrutiny of GPs on these topics is nothing like that seen in Europe.

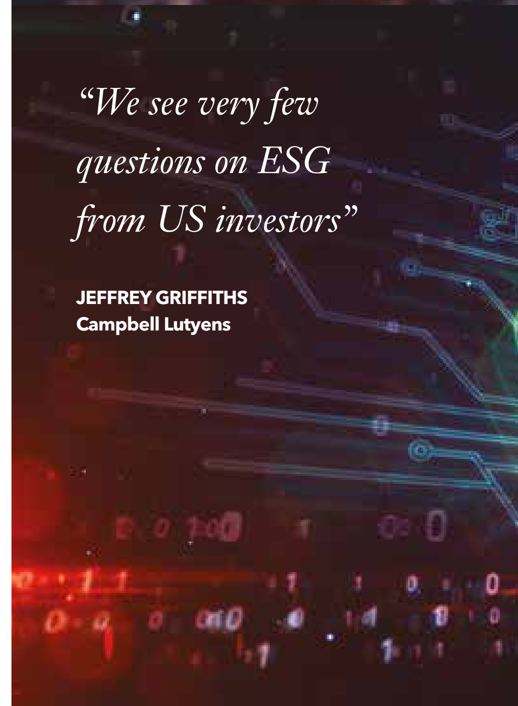
DE&I challenges

One head of private credit at a large asset manager, who did not want to talk about ESG on the record, says: "We have seen a bit of a de-emphasis globally on the ESG label. There are definitely US LPs focusing on ESG and DE&I from a GP perspective, but we see more people choosing to tackle that through an allocation to an impact or an energy transition strategy, rather than trying to make everything fit into an ESG bucket."

Jeffrey Griffiths, global head of private credit at Campbell Lutyens, says: "We see very few questions on ESG from US investors. If an investor has a particular environmental focus or wants to express a view on sustainability, there are plenty of options for them to invest in funds that are supporting energy transition or renewables. The US market offers plenty of strategy options for investors seeking to have that impact, but there is little interest as part of investment due diligence in how GPs are approaching these issues more broadly."

He says there are also growing challenges around DE&I for US investors who want to encourage diversity. "On the DE&I side, we have seen some investors explicitly using that as a screening tool when looking at managers.

"But there is an increasingly tricky legal environment in the US, with lawsuits flying about and people claiming the application of DE&I screening potentially breaches fairness and



"We see very few questions on ESG from US investors"

JEFFREY GRIFFITHS
Campbell Lutyens

anti-discrimination laws. While we know some investors think about it, they are no longer asking for managers to fill out DE&I questionnaires, but are instead approaching it less explicitly."

US divide

Jess Larsen, founder and CEO of Briarcliffe Credit Partners, says: "In Europe, ESG can be a driver for investment decisions, though we don't see that as widely in the US. Similarly with impact funds, if they can still produce great returns while generating a positive impact, that is a differentiator that will allow a GP to stand out in a crowded market, but the high returns are essential."

He adds that there are split opinions in the US on fossil fuels, meaning investors may take different views on how to weight ESG considerations. Though there is increasing activity around, and attention paid to, DE&I, those criteria still only represent a small minority of due diligence questionnaires the firm sees.

Despite the complex backdrop, managers have generally done nothing to scale back their ESG efforts, albeit giving them a lower profile.

David Ross, head of private credit at Northleaf Capital Partners, says: "Generally, LPs understand that, as credit investors, we do not have ownership or exert operational control. However, they are looking to understand how we assess and integrate ESG risks in our investment processes, what the material ESG risks of our strategy are, if we are providing transparent disclosure to investors on ESG matters, and how we are engaging with borrowers on their ESG journey.

"ESG continues to be important for LPs and we are seeing an increased level of sophistication and more questions from LPs on the topic."

Data collection

Brittany Agostino, principal in Ares' environmental, social and governance group, says: "It's an exciting time for the responsible investment agenda in private credit. While private equity has a longer history and better ability to influence ESG integration practices, the current moment and relatively earlier stage of ESG in private credit translates into an opportunity to define and disseminate practices.

"We've been focused on helping to discuss practices and highlighting different approaches as the current chair of the UNPRI's Private Debt Advisory Committee, with particular emphasis on ESG data collection from portfolio companies, potential engagement with portfolio companies or their sponsors, and climate, with approaches to carbon footprints and climate initiatives."

Alicia Gregory, managing director at Blue Owl Capital, adds: "Some LPs care more about ESG than others. But there is a common thread, which is that, as a long term investor in illiquid asset classes, there are components of ESG sustainability that will impact the value of investments. That unites investors around elements of these conversations and allows for progress." ■

EXPERT Q&A

Global trends are less of an issue in the traditional mid-market, say Churchill Asset Management's Randy Schwimmer and Derek Fricke

Direct lending: Where LPs should be focused

Q As interest rate expectations shift and the broadly syndicated loan market has reopened, how can investors evaluate the private debt opportunity today between the lower, traditional and upper-mid market?

Randy Schwimmer: As market observers look at what is going on in public and private credit, what often gets overlooked is the traditional mid-market. Headlines tend to focus on large sponsors and the global M&A dynamics, losing sight of many great companies that are not traded and may fly under the radar.

People may not know the names of the companies in our portfolio as well, but over time, traditional mid-market private equity has been able to build value in these small and mid-sized businesses. They have grown these companies organically with sophisticated management tools, capital and resources to help take them to the next level. Traditional mid-market companies, with EBITDAs between $15 million and $75 million, generally tend to be more growth-orientated, less cyclical and more service-focused, so with sponsor support, there are natural tailwinds that allow them to generate good value for LPs.

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We believe financing these companies is attractive because they typically come with covenants, more conservative lending structures and slightly better pricing than the liquid markets.

Derek Fricke: In our private equity and junior capital business, we have focused on the traditional mid-market because of the embedded growth opportunity that sponsors with a demonstrated track record can bring to the table.

Additionally, as an LP in more than 300 private equity funds, we can actually access that track record data and use it to our advantage. The fundamental question is always "why should this sponsor own this platform, and why are they the right buyer to execute the value creation strategy?" We look at prior outcomes to truly understand if they are the right buyer and the ability to

> *"It's important to hone in on how a manager thinks about selectivity and diversification"*
>
> **RANDY SCHWIMMER**

> *"Traditional mid-market companies offer multiple ways to win"*
>
> **DEREK FRICKE**

underwrite both the company and the sponsor really differentiates our investment approach.

In larger upper mid-market transactions, however, you often get limited access to information and have limited time to complete your underwriting, which is why our model works best in the traditional mid-market, where deals are often directly negotiated.

We also believe traditional mid-market companies offer multiple ways to win. They don't have to maximise leverage to hit the base case, and can carry a more conservative capital structure that aligns to their growth initiatives with a built-in cushion so they can service their debt even while re-investing in the platform.

Q How do deal sourcing strategies differ and, in a more competitive market, which managers are accessing the top deals?

DF: Scale matters, as does having a true partnership approach. Can the lender construct a comprehensive and creative capital solution that aligns with the sponsor's goals? Having a strong balance sheet and capabilities spanning senior and junior debt to equity co-investments and secondaries helps.

We have hundreds of long-standing private equity relationships, many of whom we are an LP in, and importantly, we have proven to be a good partner over time – in the good times and the bad. That differentiates us from competitors that just want to compete on price and allows us to consistently

Q When looking under the hood of a manager's track record, which key metrics are really most important?

DF: It is all about providing investors an in-depth understanding of where they sit on the balance sheet and how you are delivering an appropriate risk-return profile. Some of the key metrics that investors hone in on are absolute leverage, LTV, fixed vs floating and all-in coupons, total returns, and what your historical loss ratios are.

Collectively, these metrics give an investor a picture of the risk-return they can likely expect through an investment. Over the last 12 years, our junior capital detachment point has been approximately 5.5x, our LTV is roughly 50 percent, and our all-in total yield is in the double digits. Over the same period, our loss ratio is less than 2.5 percent across $7.5 billion of invested capital.

RS: Track record is a bit like sourcing: the reality is that having low losses in a benign environment is wholly different to having low losses in a high interest rate environment and being able to continue to grow the portfolio when global M&A is down.

Being able to work with private equity clients to continue to source quality transactions, and knowing they will be there to support the businesses through difficult times, is just as important as track record.

source attractive dealflow through market cycles from top firms.

RS: As companies get to a scale that qualifies for high yield bonds or broadly syndicated loans, the nuances of structuring tend to fall away. The discussion is more about higher leverage, lower pricing and weaker structures. In direct lending, there is more focus on flexibility and having a quicker and more efficient financing process with a lender that can be trusted.

In 2022 and 2023, broadly syndicated loan activity was muted and borrowers had to come to us. Today, if you are a credit manager in the large cap space, you are competing with the banks. We don't do that: the private equity clients we are partnering with are looking for structures for growth and flexibility, and for lenders that can speak for entire deals rather than syndicating to 50 different lenders they don't know.

Investing within the traditional mid-market allows for much more consistency in the way we source deals ,because whether there is a broadly syndicated loan market or not doesn't affect our strategy. Our dealflow has actually increased with more liquid credit available because our market segment isn't going for that liquid credit.

DF: Our dealflow quarter-over-quarter has remained strong over the last 18 months relative to the overall market backdrop being down 20-30 percent. We think that is because sponsors are calling a smaller group of core lenders that they know have the capital and creativity to construct capital structures that will work in a higher rate environment.

Q In light of today's lower new deal environment, which managers are best positioned to consistently put investor capital to work in attractive opportunities?

RS: The sponsors we target have been working with mid-market companies and industries for decades, with operating partners and senior leaders that can identify attractive opportunities for growth. They seemingly know all the competitors and vendors in their respective sectors, and develop M&A strategies that don't necessarily depend on what buyers and sellers are willing to pay in auctions. As a result, even in today's slower LBO environment, add-on acquisitions and refinancings from our existing portfolio of more than 450 companies has kept us quite busy.

DF: Being the incumbent lender to hundreds of portfolio companies is an enormous advantage when it comes to sourcing deals. Sellers, management teams and founders want to work with a sponsor that is already educated on their space, just as sponsors want to work with lenders that are educated in their space. They don't want to be bringing lenders up to speed on business models and industry verticals.

A sponsor that we know well is buying a food business right now and we have lent to two of their prior food companies in a junior capital position. They have put the same senior lender group together as they had on the previous deals, and came to us as sole junior capital provider. They know we know how to construct an attractive junior capital facility to fit the business model and complement their thesis.

Q Randy, you serve on Churchill's senior lending investment committee, and Derek, you on junior capital. What are some key questions LPs should ask during due diligence when evaluating a manager's underwriting approach and risk management?

RS: It's important to hone in on how a manager thinks about selectivity and diversification, which we believe are cornerstones to building a solid private debt portfolio.

We bring in about 1,000 deals a year and only close on 6 percent, so we have a long list of requirements that companies need to fulfil. We draw on our 18-year track record of seeing which businesses do well despite economic slowdowns. And that selectivity continues into how we construct our portfolio, because we might really like a business but still look at the overall portfolio construction and conclude we don't need another healthcare company, for example.

LPs are laser focused on how we select deals, how we monitor them once they are in the portfolio, and importantly, what we do if there is a problem. Historical data, numerous case studies and detailed examples of outcomes are paramount here. It is all about protecting the downside.

DF: We have a similar investment philosophy across senior debt and junior capital. We get a lot of the same questions about why sponsors ultimately choose us as a partner and what's different about our sourcing model.

They want to know what types of assets we are targeting, and whether they are in defensive growth industries or with service-orientated business models that create recurring revenues, with high free cashflows. They ask if we are conservative with our capital structures, how we think about leverage and how we align a sponsors' interests with our own.

It's a trust but verify model. We benefit from the fact that if you look back over the 12 years since we began our junior capital programme, the annual metrics are consistent, the leverage profile is consistent, the loan-to-value ratios are consistent and the EBITDA profile, size and margins are all consistent. That gives investors comfort that we execute on the strategy that we say we do, and it's proven successful. ■

Randy Schwimmer is vice-chairman for investor solutions and Derek Fricke is senior managing director in the junior capital and private equity solutions team at Churchill Asset Management

The speciality finance opportunity is opening up

Asset-backed lending taps underlying loans that were previously the domain of banks

Asset-backed lending is another diversification strategy gathering interest from US LPs seeking to move beyond corporate credit. Covering everything from consumer lending and litigation finance to NAV lending, royalties and trade finance, these investments allow institutional investors to tap vast platforms of underlying loans that were previously the domain of the banking system.

Emma Bewley, partner and head of credit at outsourced investment office Partners Capital, says: "For the groups that have committed to private credit as a long-term portion of their portfolio, asset-backed credit now seems to be the next step. There is a clear opportunity set there driven by the withdrawal of the banks from certain areas of the market, and we have seen a number of new funds launched in that space with a reasonable amount of scale."

She adds that speciality finance is viewed as a natural next step, but that it is harder for investors to get their hands around and understand the nature of the platforms they are financing within these structures.

She says it is really important for LPs to understand the interaction of the fund with the underlying platforms and the various cashflows, as well as costs associated with these platforms.

Banks step back

Felix Zhang, partner in the alternative credit strategy at Ares, says the way banks think about investing in consumer assets and holding them on balance sheets is changing. This will lead to them being less active in the lending market, less active in buying loans from originators, and to changing how they treat these assets on balance sheets.

He says: "We see a big opportunity to partner with banks and help them fund these assets. There are a lot of reasons why banks should remain in the consumer lending space but the risk part of those assets can be transferred in one form or another, and that is what we are working on. Having flexible capital in scale is the entry price to those discussions."

Chris Edson, partner and co-head of global FIG at Apollo, says: "Asset-backed finance allows LPs to supplement their corporate credit exposure and access an asset class with less concentration risk and a strong track record of performance."

He adds: "There have been very few ways for investors to access investment grade private credit historically, and we are seeing a significant level of interest from our LP base in that offering."

Both see an emerging opportunity set around the US consumer. "Our approach to consumer lending is focused on the more insulated parts of the market," says Edson. "For example, one of the biggest differences compared to 15 years ago is the amount of equity US consumers now hold in their homes, where the average LTV has come down significantly.

"We have a consumer finance business that provides home improvement loans. These are primarily loans to higher income homeowners that have excess equity in their houses, and we can see from our track record that these borrowers typically outperform from a consumer credit perspective."

Vincent Salerno, a partner in alternative credit strategy at Ares, adds: "There are lots of places for managers to invest in the consumer space, given it is such a large part of the market. LPs should select managers that have a demonstrated ability to get really granular in their assumptions to underwrite these assets, and ensure managers have the requisite infrastructure in place to properly monitor and track performance." ■

Real assets offer stability

Infrastructure as an asset class has benefited from a flight to quality

Credit secured against real assets is popular with US investors right now, as infrastructure, real estate, energy, transportation and even agriculture assets are shown to offer a defensive source of income and diversification.

Several tailwinds are driving a move towards infrastructure debt. Spencer Ivey, head of infrastructure debt for the Americas at Ares, says: "Investors value infrastructure debt as a way to diversify their portfolios, as it has low correlation against corporate credit and serves as a good hedge against inflation and interest rate increases.

"In addition, Infrastructure as an asset class has benefited from a big flight to quality: these are strong assets that offer mission critical services to society, and have experienced inelastic demand through market cycles."

He adds that on the infrastructure credit side, investors are benefiting from the higher interest rate environment through higher returns, while the cash yield component continues to be attractive.

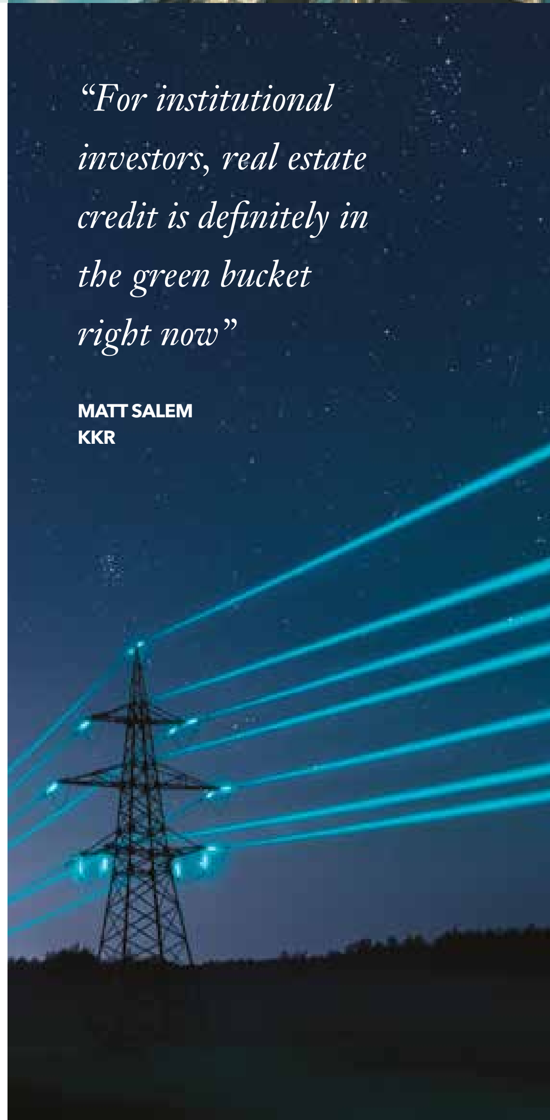
Three mega-trends make infra particularly appealing: digitalisation, decarbonisation and increased mobility. Ivey says: "On the latter, there is a huge fleet of ageing transportation infrastructure across the US, with airports and roads primarily requiring huge capital needs for upgrades, as an example. Given the increased mobility of both people and goods, there is a growing demand for connectivity. Across those three themes, the demand for capital far outstrips the supply available.

"Private markets continue to have a critical role to play as the asset class has expanded to include other asset types such as data centres."

Real estate lure

While dynamics in real estate are somewhat different, LPs are also finding that market attractive. Matt Salem, partner and head of real estate credit at KKR, says: "For institutional investors, real estate credit is definitely in the green bucket right now; they are attracted to the high yield environment for credit generally, and the recent reset in valuations.

"When you drill down a level beyond that, people start thinking about relative value across the credit complex, and there is appetite for asset-based lending and particularly for the slightly different competitive dynamic that



"For institutional investors, real estate credit is definitely in the green bucket right now"

MATT SALEM
KKR

comes with real estate." He points out that the US banking system is the single largest lender to commercial real estate, representing about 40 percent of the market.

But that is changing and a lot of investors are currently trying to fill the void where the banks have historically participated. The institutional investors recognise that gap in the market and are very much trying to capture that, he says.

There are significant variations within the real estate credit universe, and it is not a big syndicated market. Lenders such as KKR are doing a lot of directly originated loans, working with individual sponsors on granular underwriting so that each property has its own capital structure.

Real assets have been particularly attractive in a higher interest rate environment, but Salem sees no reason to think investors will retreat.

"I personally think that interest rates coming down will have a pretty small impact on returns, because we are a floating rate lender," he says.

"The biggest benefit, which will far outweigh that, is that commercial real estate has seen a really dramatic decline in deal volumes over the past 18 to 24 months, and that is starting to come back now.

"A cut in rates will really fuel the opportunity set and fuel transaction volumes, giving us a lot more to look at that will offset some of the base rate decrease to create outsized returns." ■

EXPERT Q&A

Convergence in the upper mid-market is creating opportunities, say Kevin Lawi and Christopher Kempton of the Credit Investments Group, UBS Asset Management (formerly Credit Suisse Asset Management)

'Terms are competitive, but there are still great transactions'

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Q How would you describe the state of the private credit market? Has too much money been allocated to the asset class?

Kevin Lawi: There is a pendulum that swings between borrower-friendly markets and lender-friendly markets, and right now we are in a market that favours borrowers. 2022 and much of 2023 were lender-friendly environments but in 2021, after covid, spreads were tight, banks were underwriting risk, the syndicated markets were robust and private credit had to compete for deals. That is very similar to where we are today – terms are competitive but there are still good transactions to do.

We get asked a lot by LPs whether the market is too hot, and can we compete with the syndicated markets. The answer is that those dynamics are not new. Of course, we prefer markets like 2022 when we can set our price and terms more, but sometimes the environment is more competitive.

A great virtue of private credit is that it can generate really nice returns in a variety of different market environments, so today we can shift to do a little more junior capital or find smaller unitranche transactions for higher quality assets. There remain lots of good reasons for borrowers to pick private credit.

I don't think we're at the point where too much money has been allocated to the asset class. You have to remember that private credit is a derivative of private equity, so if private equity is doing deals, we are doing deals. Right now, the M&A market is quiet and private equity is not transacting so much, causing a supply-demand imbalance leading to tighter spreads.

However, with interest rates where they are, we are getting double-digit returns for first lien senior secured risk. Those are very attractive compared with historic returns.

Christopher Kempton: When I get this question from LPs, I think it's important to define what we're talking about. The headline figure for private credit may be $1.5 trillion but that includes all private credit assets under management, including committed capital.

We are exclusively focused on lending to the upper mid-market, so when you take out things like mezzanine and special situations, the proportion of that capital that competes with the loan and bond markets is maybe $200 billion to $300 billion. That's a big number and there has been growth there, but it is maybe not as dramatic as the headlines suggest. So, the yields we are getting are still very good.

If you zoom out and look at credit generally, across direct lending, loans and high yield, spreads in the bond market have come in about 20-25 percent since last fall. If you take the loan market as a proxy for direct lending, those spreads have come in about half of that. So, the question is what premium you are getting for the credit risk you are taking, which remains attractive in the loan market and in direct lending.

Q What are investors looking for from private credit managers today?

CK: We talk a lot about convergence between these markets. Our team is focused on upper mid-market direct lending, to companies with EBITDA of $50 million or more – we have built our platform in anticipation of convergence.

The direct lending market has evolved and that interplay between the two markets is creating compelling opportunities for those able to navigate between the two. We have built our platform to be a lender to the upper mid-market regardless of form, whether it is a syndicated loan, a high yield bond or a direct lending deal.

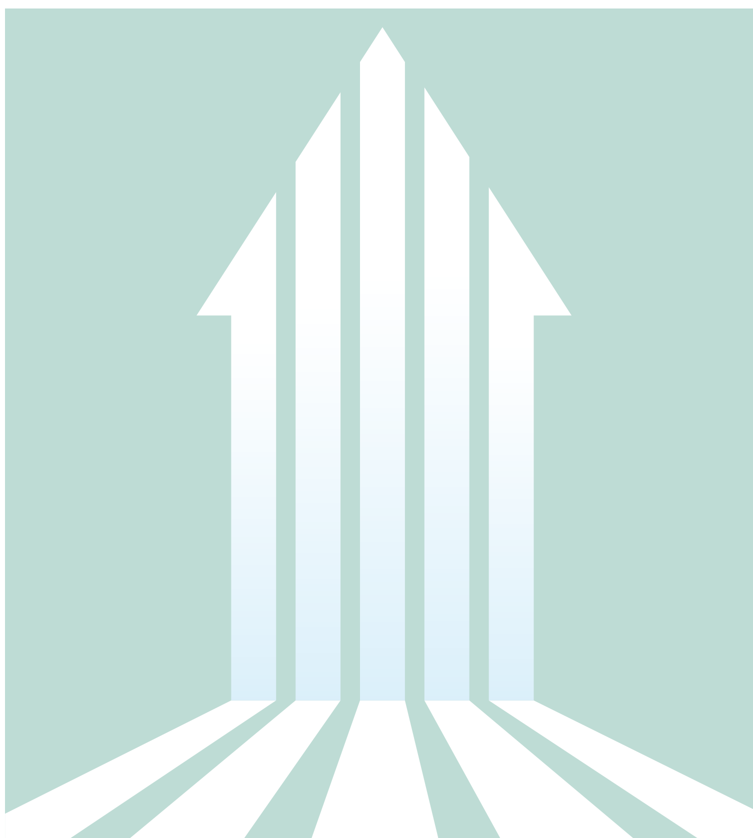
As markets converge, we see more value there and increasing demand

Q Can you give some examples of the current convergence between private credit markets and liquid markets?

KL: Sponsors are sophisticated and they are always looking at where they can optimise their financing structures. For example, we were the lender to a business that we first got to know in the private credit market because we were a lender to one of its competitors. The sponsor came to us because they knew we were up to speed on the industry, and we then started lending to them in the private credit market with some junior capital back in 2021.

As the business grew from $60 million EBITDA to around $150 million, the sponsor opted to refinance the capital structure and went to the high yield bond market. So that was an interesting example of a deal that was in private credit and moved to high yield, which we were able to help anchor. Our ability and flexibility to do high yield bonds, private credit and syndicated loans is really attractive to a sponsor. We can pivot and we are pretty agnostic to the market, allowing us to provide solutions in all environments.

There is also a phenomenon where there are deals in the broadly syndicated market that were underwritten in a zero interest rate environment and are now borderline triple-C rated. As those issuers face upcoming maturities, we are in a position to advocate for some additional equity coming in and a refinancing, and typically that borrower goes from a syndicated transaction to a private deal. This convergence is a secular shift enabled by the growth of the asset class.



from investors. The underlying drivers of performance in an upper mid-market portfolio are based on lending to the same types of companies, whether you are packaging that as a syndicated loan or a direct lending transaction.

KL: Private credit is getting a lot of attention because of the volume of growth, which can make investors nervous about the asset class. We are getting a lot more questions from LPs about interest rate coverage, over-leverage and terms.

The point we try to make is that, at its core, private credit is no different to public credit because your fundamental underwriting and credit analysis is the same. There is risk in lending to sponsor-backed companies at full leverage, so investors have to pick managers that can assess those risks and have long-standing track records.

Q How is the private credit market reacting to compression in spreads in the broadly syndicated market in the past year?

KL: All markets are interrelated and so when the investment grade market tightens that spills over into the high yield market, and double-Bs tighten too. When investors can't find risk or returns in one market, they switch. The spread tightening we have seen in the broadly syndicated markets has led to tightening in the private credit market because borrowers do have options to pick and choose.

There are certainly pros and cons for both markets but at the end of the day pricing is important and the broadly syndicated market is typically cheaper. That means the private credit market has to respond. From 2022 to today, we have seen maybe 150 basis points of spread tightening in direct lending and there has probably been a similar amount of tightening in the broadly syndicated space. However, the risk premium of the private credit market over the broadly syndicated market has remained intact.

"One of the advantages of direct lending right now is we know where the problems are"

CHRISTOPHER KEMPTON

Q What does the outlook look like for upper mid-market private credit markets?

CK: The yield opportunity right now is really attractive compared with historically, with the flipside being the risk. There is no free lunch and we have seen default rates come up a little bit across the board, in high yield, loans and direct lending.

When we think about upper mid-market direct lending default rates, we see a direction of travel similar to the loan and bond markets. One of the advantages of direct lending right now is we know where the problems are. We are in a higher for longer rate environment and we have been dealing with these problems for a year-and-a-half now. The expectation is that we end up with a long term average default rate around 3-4 percent. So, we have a really attractive yield and return opportunity alongside average risk.

The key thing is to manage that with credit selection, but an advantage of the upper mid-market is that borrowers have access to different forms of public and private capital so they have more of an ability to find solutions.

"We are getting a lot more questions from LPs about interest rate coverage, over-leverage and terms"

KEVIN LAWI

KL: We anticipate some bifurcation in the market, with really good businesses able to continue servicing their debt as top-tier credits and a steady tail of refinancings and restructurings occurring with more challenged companies.

We don't see a recession on the horizon in the near term but if that were to happen, that would amplify the bifurcation. Those refinancings and restructurings present opportunities because there is a lot of common and preferred equity on the sidelines in the form of opportunistic capital ready to come in and de-lever those balance sheets.

We anticipate something of a soft landing as interest rates come down and the M&A machine starts moving again. That will drive more deal activity and private credit activity, which will put a floor on spreads tightening. Spread tightening has been enabled by high base rates because lenders could still get good returns. Once the market prices in rates coming down, we could even see spreads widening to compensate.

In short, that rebound in deal activity will rebalance supply and demand to help stop the compression in terms of pricing, so we are optimistic about 2024 and 2025. ■

Kevin Lawi is managing director and head of private credit and Christopher Kempton is managing director and global head of client portfolio management at the Credit Investments Group in UBS Asset Management (formerly Credit Suisse Asset Management)

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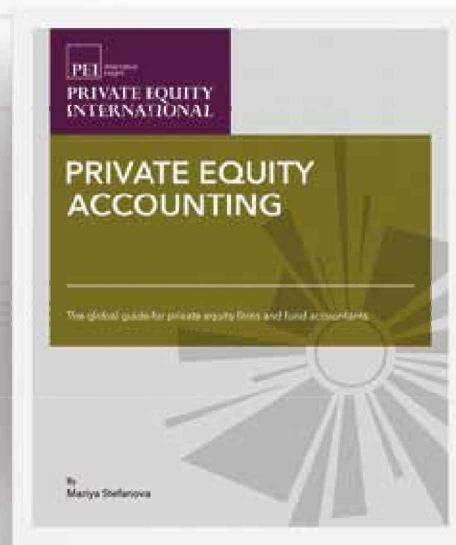

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What next for the regulation of private funds?

The SEC's proposed private fund adviser rules may be dead in the water. But that doesn't mean GPs can rest easy, says Claire Coe Smith

Private funds regulation in the US was thrown into disarray in June when a Federal Appeals Court threw out the Securities and Exchange Commission's proposed private fund adviser rules and left the regulator with little room to revisit them.

While we are yet to see what action the commission might take to try to revive its proposals, it did not appeal the court's decision by a late July deadline and so the rules as they had been envisaged are now officially dead.

Still, while the Fifth Circuit decision may have succeeded in killing the regulations, it is unlikely that GPs can step back from adhering to what the regulator was trying to achieve.

Robert Sutton, partner in law firm Proskauer's private funds group, says: "Although those rules were vacated, it is important to remember that they were aimed at practices that the SEC has long felt were problematic, and that have received critical focus in SEC exams and enforcement for many years."

By way of example, he points to GPs granting certain investors preferential redemption or portfolio information rights in ways that could have been harmful to other investors, or instances in which the adviser borrowed from the fund without prior authorisation.

Other things in the spotlight with the new rules were a lack of transparency on fees and expenses, or the non-pro rata allocation of investment-related expenses, or the processes behind GP-led secondary transactions.

"The Fifth Circuit decision removes the rules' additional bright-line requirements and prohibitions that the SEC could have wielded in its examination and enforcement efforts," says Sutton, "but the SEC's focus on this conduct is likely to continue under existing fiduciary and disclosure concepts."

In other words, fund managers should remain prepared for ongoing SEC examination and enforcement work focusing on the practices that the commission sought to crack down on in the rules. In essence, market practice may shift even if the rules are gone.

The investor community has a key role to play in shifting how GPs behave, too, and the Institutional Limited Partners Association had been instrumental in shaping the SEC's plans at the outset. When the Fifth Circuit announced its decision, ILPA issued a statement criticising the decision as failing to "acknowledge the SEC's long-standing authority to protect private market investors" and uphold mandated standards on information related to performance and fees and expenses charged to investors.

ILPA chief executive Jennifer Choi said: "ILPA has viewed the private fund advisers rules as effectively addressing three primary factors that pose actual and meaningful risks to private equity investors: lack of transparency, conflicts of interest and the lack of effective internal governance mechanisms to protect the capital managed by private funds." As such, it is likely institutional investors will continue to push GPs to agree to many of the practices that the SEC sought to mandate.

Unintended consequences

The decision from the Fifth Circuit may put other SEC proposals in doubt, too. Jefferey LeMaster, partner in the investment management practice at

law firm Clifford Chance, says: "What's interesting about the business trade associations successfully bringing suit over the private fund rules is the unintended consequences where they are also challenging two other rules – this in relation to the expanded definition of dealer and on short position reporting."

He adds: "There are some fund managers now looking at the success that happened with the private fund rules, and these current challenges, and they are choosing to kick the can down the road with a view to expecting the same. It has maybe become a bit more difficult for us to help our clients focus on these regulations coming down the line as a result of this success."

Looking forward, the demise of these rules now raises the prospect of other planned new regulations going the same way. The SEC's proposed safeguarding rules, outsourcing rules and predictive data analytics rules all rely on either the section of the Dodd-Frank Act that the court ruled applies only to retail customers, or the anti-fraud provisions of the Advisers Act under which the panel said the SEC failed to articulate any rational connection between fraud and the rule.

Kevin Bettsteller, partner in the investment funds group at law firm Gibson, Dunn & Crutcher, says: "Those are proposals that have been out there for a while, would affect private funds advisers and could now be re-proposed. The safeguarding rules in particular would represent another sea change and the industry is very concerned that they are difficult to comply with. There is a lot going on and so we are all waiting to see what happens next."

"There is a lot going on and so we are all waiting to see what happens next"

KEVIN BETTSTELLER
Gibson, Dunn & Crutcher

New headaches

Sutton says there are plenty of additional compliance headaches coming down the pipe for GPs, so there is no time for taking the foot off the pedal. "Beyond simply trying to stay on top of all of the new rules and ongoing day-to-day compliance with existing rules, which is admittedly quite a burden on its own, private fund advisers should also be mindful of ongoing SEC enforcement priorities that are independent of recent SEC rulemaking," he says.

In particular, Sutton points to the SEC's current enforcement sweep regarding off-channel, non-archived electronic communications by SEC-registered investment advisers. "That is likely to result in more enforcement settlements in the near term, driving advisers to change their communication and archiving practices and technologies – we're already seeing this start to happen, but the pace of change will likely accelerate as the year progresses."

And then there is the prospect of further upheaval as the presidential election looms. "As we move deeper into the election season in the US," says Sutton, "both registered investment advisers and exempt reporting advisers will need to increase their compliance efforts relating to US political contributions under the political contributions rule, which is a perennial SEC enforcement focus."

LeMaster says: "The election adds an extra layer of complexity, as it is possible we are looking at a different commission following that. If it is a Democratic win, then the commission may stay very similar to what we are looking at currently.

"If it's a Republican win, the commission will change and could look very different. Generally, the SEC during Republican administrations has not been quite as heavy-handed when it comes to rule-making and enforcement, so we may see the focus swing back towards the capital formation portion of the SEC's mandate."

The Fifth Circuit decision only really goes to demonstrate the critical importance of staying close to regulatory opinion and being alive to the SEC's priorities, regardless of the shape of proposed new laws. ■

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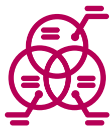

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Self-regulation under the microscope

Private debt is continuing to attract scrutiny from a wide range of organisations – including LPs, writes Andy Thomson

In a recent edition of our online *Friday Letter*, we drew attention to the ongoing debate around whether private debt managers have sufficient skin in the game to be truly aligned with their investors – and included a rebuttal of the claim from industry body, the Alternative Credit Council.

The ACC, whose global head Jiří Król pens a monthly column for *Private Debt Investor*, does a sterling job of defending the asset class against some of the wilder and more misinformed accusations. But some would say there's no smoke without fire and, at the very least, it seems safe to say private debt is now under more regulatory scrutiny than ever before.

Implied nervousness

We reported the latest in a string of relevant developments in *Loan Note* in July, when rating agency Moody's raised concerns over the continuing self-regulation of private debt in light of the court decision in the US to vacate the SEC's Private Fund Advisers Rule. "Private credit participants will continue to self-monitor risks at a time when the market is rapidly expanding in new directions," noted Christina Padgett, an associate managing director in Moody's Ratings' private credit team, in a statement where the nervousness can be read between the lines.

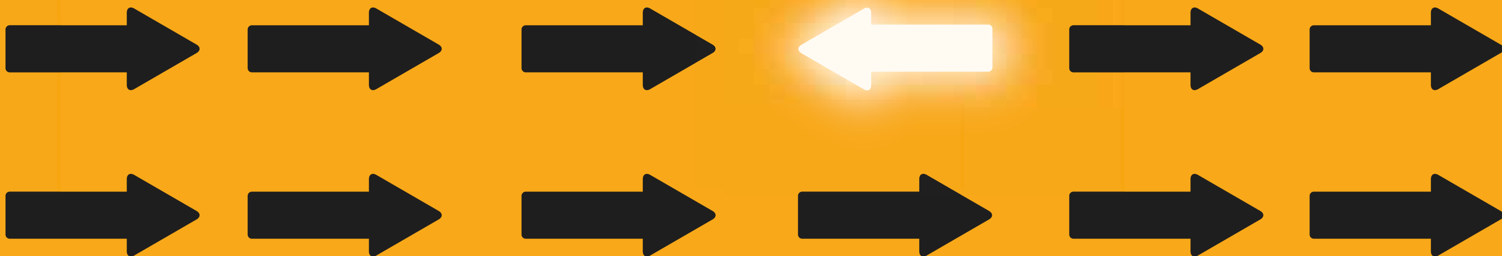
It could be said that the concerns of ratings agencies, central banks,

politicians and other contributors to the debate don't count for much compared with the views of the investors who oil the wheels of the industry. If they remain happy that appropriate regulatory guardrails are in place, then there's arguably not too much to worry about.

The problem is, we do hear some unease in our conversations with LPs as well. This is what one had to tell us: "My concern in private debt is… does it pose a systematic risk to the overall economy? I've seen 60-plus private debt managers in the last year, and the majority of them will say that they only do 5 percent of the deals that come across their table, all their deals are covenant-heavy and they've got great restructuring expertise."

Now, my only concern is there's a lot of debt managers out there. Somebody's doing the other 95 percent of those deals. A lot of those deals came from highly regulated bank balance sheets into an unregulated private debt market, which isn't as transparent as the public markets."

Due partly to the bounce-back in the syndicated market (as well as a slowly changing rate environment), the 'golden era' of 2023 has arguably given way to a more sober assessment in 2024: private debt remains a favoured asset class but has moved down a little from its peak. What remains at a peak level, it seems, is regulatory scrutiny. ■



Struggling and high-quality are not contradictions

There can be a lot of value in helping debt-ridden US mid-market borrowers through their problems, writes Andy Thomson

'Within the special situations and distressed categories in the US mid-market, there are lots of loans trading in the secondary market at significant discounts to par," says Sandor Hau, managing director at fund manager Charlesbank, which has offices in Boston and New York.

These loans are often trading at around 70-90 cents on the dollar. But is there a good reason why? Not necessarily. In the view of Hau – who joined Charlesbank in 2016 as head of opportunistic credit investing, having previously been a managing director at Goldman Sachs – many of the borrowers are of the highest quality, but suffering from issues that may be temporary and resolvable with operational help.

He gives examples of how loans to good firms end up being sold at discounts: "Maybe it's a misunderstood company, maybe it's a company with challenged numbers because margins were a little bit lower, maybe there's a ratings downgrade which forces CLOs to sell."

'Surprising degree of safety'

But whether it's a technical sale or one that hints at more fundamental issues, Hau points out there can be a surprising degree of safety built in: characteristic of these loans is a high debt coverage ratio (two times coverage is common) and a loan-to-value of 50 percent. Investing in these secured loans at between 70-90 cents enables Charlesbank to target returns of between 15 and 25 percent, Hau says.

He makes the point that this is a "highly inefficient" market and contrasts it with the increasingly popular but "highly efficient" market for large unitranches. "All the larger managers have been successful at raising capital and want to do big investments", so have decided to try to grab market share from the high-yield bond market for deals typically ranging in size between $2 billion and $6 billion, he maintains.

Charlesbank's credit investing activity has three strands: performing, special situations and distressed. In the latter, target businesses are typically in default or about to go through a bankruptcy or out-of-court restructuring. "There are lots of high-quality companies that may just have too much debt or the margins have gone down and they have short-dated maturities," says Hau.

Unsurprisingly, a lot of these firms were caught out by inflationary pressure. Leverage has in many cases gone up in tandem with depressed earnings, with inevitable results.

Charlesbank's focus on leading restructuring originates from even before the firm's founding in 1998, with roots in the founders' prior role running an investment portfolio for the Harvard University endowment.

Sunny outcomes arise surprisingly often. Hau neatly summarises why: "A company may have too much debt, but just because it has too much debt, it doesn't mean it's a bad business." ■

Private Debt Investor

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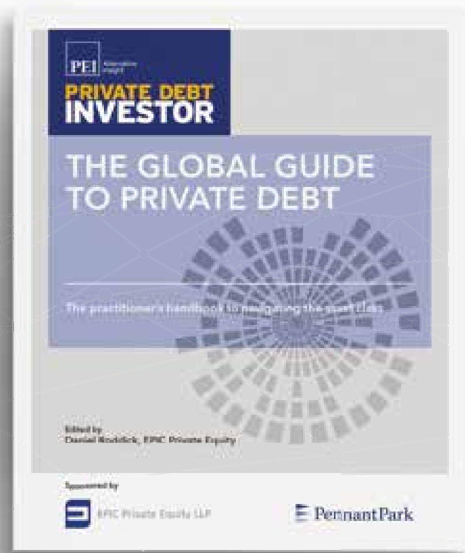

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