Private Debt Investor

Future of Private Debt

October 2023 • privatedebtinvestor.com

Fast forward

The innovations that are framing the future

PEI

PEMBERTON

Leading Private Credit Strategies

Unlocking Value Creation with **NAV FINANCING**

London | Luxembourg | Frankfurt | Paris | Milan | Amsterdam | Copenhagen | Madrid | Dubai

How to contact us

Senior Editor
Andy Thomson
andy.t@pei.group, +44 20 7566 5435

Head of Special Projects
Graeme Kerr
graeme.k@pei.group,
+44 20 3862 7491

Americas Editor
Robin Blumenthal
robin.b@pei.group, +1 646 970 3804

News Editor
John Bakie
john.b@pei.group, +44 20 7566 5442

Reporter
Christopher Faille
christopher.f@pei.group

Contributors
Claire Coe Smith, Hannah Roberts, Ben Payton

Managing Editor, Production: **Mike Simlett**

Production Manager: **David Sharman**

Senior Production Editors: **Tim Kimber, Adam Koppeser**

Production Editors: **Helen Burch, Nicholas Manderson, Jeff Perlah**

Copy Editor: **Khai Ojehomon**

Art Director: **Mike Scorer**

Head of Design: **Miriam Vysna**

Art Director – Americas: **Allison Brown**

Senior Designers: **Denise Berjak, Lee Southey**

Designers: **Shanzeh Adnan, Ellie Dowsett**

Global Business Development Director – Private Debt: **Beth Piercy**
beth.p@pei.group, +44 20 7566 5464

Subscriptions and Reprints
subscriptions@pei.group

Customer Services
customerservices@pei.group

Editorial Director, US: **Rich Melville**

Editorial Director: **Philip Borel**

Director, Product Management: **Amanda Janis**

Director, Research and Analytics: **Dan Gunner**

Operations Director: **Colm Gilmore**

Managing Director, US: **Bill O'Conor**

Managing Director, Asia: **Chris Petersen**

Chief Commercial Officer: **Paul McLean**

Chief Executive Officer: **Tim McLoughlin**

For subscription information visit
privatedebtinvestor.com

PEI

Private Debt Investor

Future of Private Debt

ISSN 2051-8439 • OCTOBER 2023

Insight

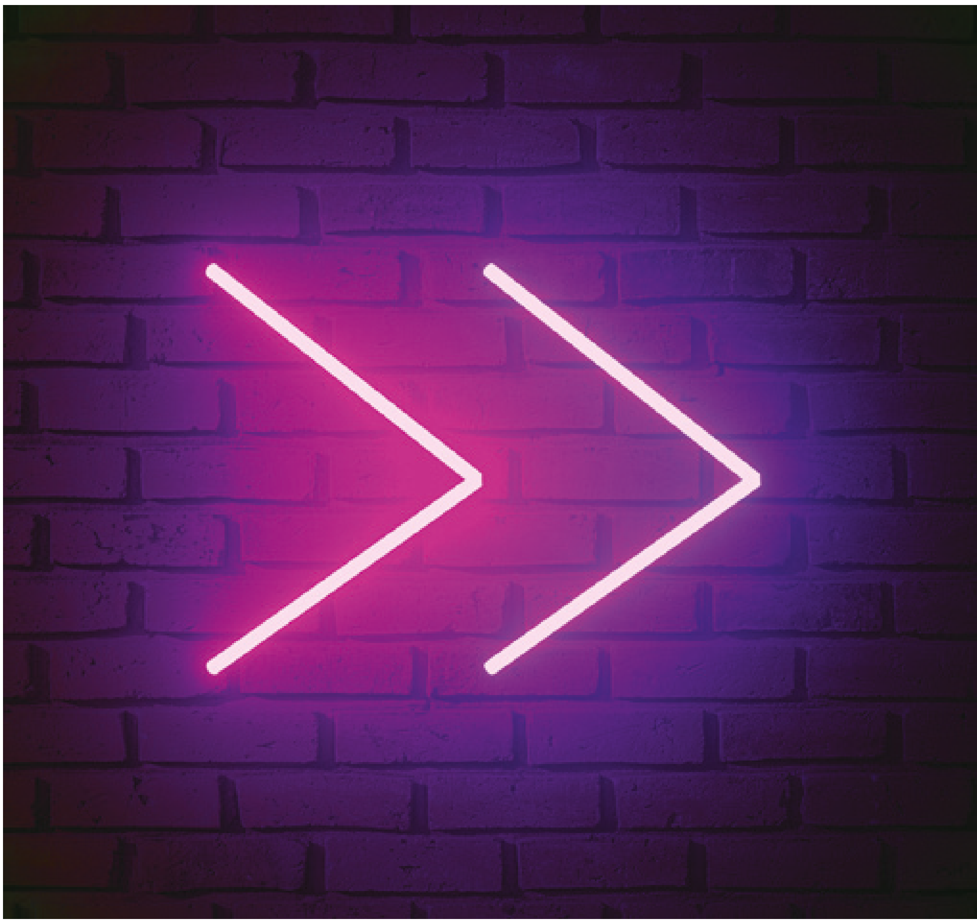
Key takeaways **Returns may be strong but we need to be careful to guard against complacency**

As we take our annual look at the key trends shaping the future of private debt, it seems apt to begin with some cautionary words from our senior editor Andy Thomson, who noted the references made to the 'golden age of private debt' at our PDI Forum in New York in September.

So what, he wonders, could possibly go wrong? Surely fundraising capital will flow freely again before much longer? Investors are much more cautious, he says, and have highlighted a number of concerns that they feel should mitigate against complacency.

While it may indeed be a 'golden age' for current vintages, there was, as he notes, a view that recent past vintages may struggle unless considerable underwriting discipline has been applied. "What happens when the music stops?" is the rhetorical question he poses.

Graeme Kerr outlines five key takeaways from our *Future of Private Debt* report, heavily underscored with a note of caution that we really shouldn't get too carried away with bullish predictions amid unprecedented uncertainty for the asset class.



Private debt is better placed than other asset classes

Three years ago, *Private Debt Investor* launched a cross-asset class *Fund Leaders Survey* comprising more than 100 senior buyout, growth, private debt, venture capital, real estate and infrastructure executives.

The difficult fundraising climate took its toll on this year's poll, which found that a smaller proportion – only 56 percent – say their current fund is larger than the predecessor, down from 75 percent in 2022 and 74 percent in 2021. Instead, 30 percent say they are targeting the same amount for their next fund as their last, which was the case for just 1 percent of fundraises last year.

But market participants say the landscape may be more positive for private debt than other asset classes. "Unlike in private equity where there has definitely been a pronounced slowdown in the need to raise capital and the size of funds, in credit the fundraising numbers are a bit higher," says Jeffrey Griffiths, co-head of global private credit at placement agent Campbell Lutyens.

"We see more like two-thirds of managers fundraising right now and most groups are looking for larger fund sizes."

And returns are strong: "This is the best environment we have seen since 2009-10," say Gregory Racz, president and co-founder, and Daniel Leger, managing director of MGG Investment Group.

"With interest rates much higher and capital scarce because of the pressure on banks, we can get paid more, and it is easier to negotiate the tight covenants and other investor protections that are standard in our loan agreements. We are finding we can get better origination fees and higher floors, so the packaging overall is more favourable to the lenders."

That point is backed up by Mark Posniak, European lending development director at Arrow Global Group.

"Specialist lenders have historically done well in recessionary periods, filling the gap left by the banks as they get to grips with their legacy positions," he says. "The non-bank lenders can really come into their own if they have efficient capital to deploy, as they can create products to deliver solutions without having to push the boundaries in terms of leverage, borrower solvency and asset quality."

> "NAV financing is poised to become an integral part of the private equity financing ecosystem"
>
> Thomas Doyle
> Pemberton Asset Management

All eyes are on AI

The same survey also suggested a growing role for AI in shaping business and investment processes over the next decade: 63 percent of fund leaders agreed or strongly agreed with the statement that artificial intelligence will be the most significant technology to shape business and industries over the next decade, with due diligence and data analysis seen as the areas of greatest impact.

Keith Miller, global head of private debt at Apex, says this is reflected in a growing number of conversations about opportunities for AI around the review of underlying assets. "That credit review process has always been incredibly manual but the big win for the asset class is the ability to review the underlying assets from a portfolio and risk monitoring perspective and conduct predictive modelling across assets to deliver scenario analysis."

Retail is making inroads

Tokenisation, which can convert private debt assets into tradeable instruments, is opening the door for fund managers to reach out to retail investors. Trailblazers including Hamilton Lane and KKR are already embracing tokenisation as a means to broaden their investor bases and lower minimum subscriptions.

Robin Doumar, founder and managing partner at Park Square Capital, believes retail channels are an "interesting opportunity".

"We want to be thoughtful and to make sure, from a distribution standpoint, that we're tapping into that channel in the appropriate way. But while I do agree that it's important, I think the emphasis might be a little overstated," he says. "Personally, I think private credit investing is a more natural fit at the most sophisticated end of the individual investor market."

63%
Agree or strongly agree that AI will be the most significant technology to shape business over the next decade

$100bn
Current size of NAV financing market

30%
Of fund leaders are targeting unchanged amounts for their current fund

4

Bigger is better

One notable trend over the past few years has been the increasing deal size – something fund managers fully expect to continue to grow.

Blackstone started its private credit business in 2005 when the deals to mainly small businesses were done privately for more complicated credits. Blackstone's Brad Marshall says that by 2024, multi-billion-dollar private financing will have multiplied to the point that the firm could lead a $12 billion private financing if an issuer was looking for it.

"We increasingly see that investing in larger companies has a lot of intuitive advantages," says Marshall, global head of private credit strategies and chairman and co-CEO of both Blackstone Private Credit Fund and Blackstone Secured Lending Fund. "Bigger companies tend to grow because their products or services are high quality, they may attract a strong management team, a compelling PE sponsor, and they are likely a bit more diverse in terms of their business mix, which de-risks the investment."

Craig Packer, co-president of Blue Owl Capital, also notes demand for bigger deal sizes. "We recently surveyed 100 private equity firms asking what they would like to see from direct lenders, and it was interesting but not surprising to hear back that they like direct lending, they are happy with the product and they want to use it more," he says.

"It was very clear that they embrace private credit and want to use it for more solutions, so they would like to see direct lenders broaden out the kind of solutions we offer, particularly in terms of size, where they want to work with larger players that can write and hold bigger cheques."

> "Specialist lenders have historically done well in recessionary periods"
>
> Mark Posniak
> Arrow Global Group

5

NAV lending is set to grow

A decade ago, the sub lines market was in its early stages and there was much hesitancy about its adoption as a fund management tool. Now it is used by more than 90 percent of private equity funds, and many predict that NAV financing will go the same way.

In an environment of longer hold periods, NAV facilities offer both a route to liquidity to effectively provide a bridge to LPs waiting for assets to sell and a source of capital to keep driving value creation at the tail end of a fund's life.

"NAV financing is currently estimated to be around $100 billion in volume. We certainly see this as becoming larger than the sub line business, which is now worth over $500 billion globally – and that is just for buyouts," says Thomas Doyle, partner and head of NAV financing at Pemberton Asset Management.

NAV financing is "an all-weather solution". Pemberton expects adoption to keep accelerating as it becomes clearly designated as a private debt product with private debt structures, covenants and instruments. "NAV financing is relevant across market conditions in both up- and down-market cycles. We therefore believe that NAV financing is poised to become an integral part of the private equity financing ecosystem."

Matthew Taylor, head of alternative debt at LGIM RA, agrees that the NAV financing space, although relatively small compared with subscription lending, has growth potential. "There are a small number of institutional investors today alongside banks, and activity levels for both can be expected to mushroom in the coming years. That is a market we are watching closely," he says. ■

Editor's letter

The road to somewhere

Graeme Kerr
graeme.k@pei.group

Are we nearly there yet? Well, yes, actually – we're a whole lot closer than you may have thought. Whether it's evergreen structures, the use of AI or the inroads being made in attracting retail clients via tokenisation, this year's *Future of Private Debt* report reveals significant progress on some age-old themes.

The advent of ChatGPT has been accompanied by an avalanche of coverage about the AI revolution, so it's heartening to report that artificial intelligence is becoming a must-have rather than a nice-to-have in an increasingly competitive private funds market. For private debt firms that want to differentiate and obtain a due diligence edge, implementing AI solutions at the fund level has become a key strategic priority.

The same is true of tokenisation, the umbrella term given to a suite of blockchain technologies that allows private debt to reach out to retail investors and become a tradeable asset. This year, Hamilton Lane tokenised a portion of its $2.1 billion Equity Opportunities Fund V, allowing US qualified purchasers with at least $5 million in invested assets to access a tokenised feeder fund for $20,000 at a time, down from a traditional minimum ticket size of $5 million. KKR also tokenised a portion of its $4 billion Health Care Strategic Growth Fund II.

“Just make sure you're wearing a seat belt”

And the move from traditional closed-end funds in favour of more flexible, open-end solutions is well and truly underway as more and more managers respond with bespoke vehicles that allow investors to either withdraw money after shorter investment periods or make their investments in perpetuity.

Our cover story (p. 22) charts the progress on these initiatives as we consider five innovations set to revolutionise the asset class. The good news for those in the back seat is that while we're not there yet, we are getting close to a destination that could transform the private debt industry. Just make sure you're wearing a seat belt, as this could be quite a ride.

Graeme Kerr

PEI

New York
130 West 42nd Street
Suite 450
New York
NY 10036
T: +1 212 633 1919

London
100 Wood Street
London
EC2V 7AN
T: +44 20 7566 5444

Hong Kong
Room 1501-2, Level 15,
Nexxus Building,
No. 41 Connaught Road, Central,
Hong Kong
T: +852 2153 3240

Private Debt Investor
Published 10 times a year by PEI Group. To find out more about PEI Group visit **pei.group**

Printed by Pureprint Group
pureprint.com

FSC
www.fsc.org
MIX
Paper from responsible sources
FSC® C022913

E X P E R T Q & A

Direct lending has grown sharply and looks set to account for a far greater share of the leveraged finance market in coming years, says Craig Packer, co-president of Blue Owl Capital

Private credit proves its flexibility across the cycle

SPONSOR

BLUE OWL CAPITAL

Q Direct lending as an asset class has seen strong growth in the past 10 years. What has been driving that, and how do you see it going from here?

It has certainly been an exciting time for the industry. Five or six years ago, direct lending represented only about 10 percent of the total leveraged finance market and that sits at about 20 percent today. While this equates to astounding growth, it's worth noting that this was off a small base, and we believe there is still ample room to grow. We have seen some indications that the asset class could grow upwards of 20 percent per annum for the next few years and still only represent less than half of the total leveraged finance market.

There are a couple of key drivers of this growth. First, there is robust demand from investors. Clients increasingly view direct lending – and private credit more broadly – as an important strategic allocation in a well balanced portfolio. Several years ago, it may have been a more tactical or opportunistic allocation. Direct lending can deliver consistent yield that is not correlated to public markets. As a result, investors have become increasingly comfortable sacrificing immediate liquidity for stability and a yield premium.

At the same time, 'supply' has also increased as capital has flowed into the asset class and private equity firms have become increasingly comfortable choosing private financing over public markets execution. Not only can direct lenders speak for large size on deals, but they can also offer a full range of solutions across the capital stack to meet different risk/return profiles. In fact, we are increasingly hearing from our sponsor partners that they prefer to work with us over the syndicated market.

They appreciate that we hold our loans to maturity, move quickly, have the sector-specific expertise to be thoughtful and efficient in diligence, and can customise structures to meet borrower needs. These bespoke solutions run the gamut from multi-currency tranches to delayed-draws that allow borrowers to seamlessly pursue growth plans. Over the next few years, we anticipate direct lenders will continue to push the boundaries and deliver innovative solutions.

Q How has the direct lending opportunity set evolved this year as banks retrench from new capital commitments?

It has been a great environment for private credit since we started Blue Owl Credit back in 2016. However, from our vantage point, the last 12 months have been the most attractive since our inception. Banks pulled back from underwriting new capital commitments as they dealt with the aftermath of 'hung' syndicated deals last autumn, as well as a rapidly evolving economic backdrop and the regional banking turmoil this spring. Direct lenders stepped in to provide certainty of capital and finance the vast majority of transactions in recent months.

Importantly, deal quality has been extremely attractive. Amid an uncertain market backdrop, only high-quality borrowers have been able to transact, while underperforming companies have struggled to get deals done. In addition to strong credit quality, we are also securing attractive economics, lower leverage and tight lender protections such as enhanced call protections and covenant packages.

While we do not think you can ever perfectly 'time the market', we think the last year will likely prove to be one of the strongest vintages for private credit on both an absolute and risk-adjusted return basis.

"We have seen some indications that the asset class could grow upwards of 20 percent per annum for the next few years"

Q When markets normalise, what role do you think banks will play versus direct lenders in financing the market?

As I mentioned, amid this ongoing share shift away from the investment banks, we have certainly benefited from some shorter-term temporal factors in a volatile market backdrop. We don't expect this to last forever and indeed have begun to see public credit markets reopen modestly this year.

Fortunately, the vast majority of our history at Blue Owl has been in a period in which the banks have been very active in the leveraged finance markets. We have coexisted with the banks for quite some time and believe direct lending is positioned to succeed regardless of the banks' posture toward their leveraged lending businesses.

So, it is not a question of whether the banks will have a role when markets normalise. After all, they still hold

Q What themes or types of deals are you seeing in the market today and where do you see the biggest areas of opportunity?

Deal activity was slow to start this year but picked up in the second quarter. Generally, activity has been well-diversified across a range of transaction types. Sponsor-to-sponsor LBOs, which were latent over the last couple of quarters, began to come back. We also continue to finance tack-on acquisitions to existing borrowers, as well as corporate carve-outs and take-private transactions. We have been able to find alpha-generating opportunities by virtue of our scale, flexibility and specialised underwriting capabilities. While we continue to finance large, high-quality companies, deal sizes this year are smaller on average than the mega-deals of 2022. In addition to our core diversified direct lending strategy, we continue to see attractive opportunities across true first-lien lending, software and opportunistic capital solutions.

Looking ahead, we believe there is meaningful pent-up demand for M&A. This should yield an increase in deal activity as economic conditions improve and the rate outlook stabilises. Indeed, global private equity firms are sitting on more than $1 trillion of dry powder and will be focused on returning capital to LPs after a period of light distributions.

approximately 70 percent share of the leveraged finance business. The real question is, who can provide better financing solutions for private equity? Direct lending will not be the solution for every financing need, but it is certainly becoming a bigger piece of the pie.

Q What might the next round of innovation look like for private credit? What areas are sponsors looking to see the market grow into?

We have always prided ourselves on being innovative and responsive to the needs of our borrowers and limited partners. One benefit of having more than 600 sponsor relationships across the Blue Owl platform is that we are always speaking with private equity firms. This has informed the areas we have identified as growth vectors for our business to better serve our borrowers.

Indeed, our software, first lien and opportunistic strategies all spawned from reverse enquiry from sponsors and pre-existing deal pipelines before we even raised dedicated funds. When we launched our technology strategy in 2018, some people thought we would be hamstrung by a lack of demand. Fast forward to today and we now manage more than $17 billion across our software-focused funds.

We still strive to stay ahead of the curve. Recently, we surveyed 100 PE firms about what they would like to see from direct lenders. Not surprisingly, they want to expand their use of private solutions so that they have an attractive alternative to the investment banks in a broader range of scenarios. They want direct lenders to finance companies of all sizes ranging from core mid-market to large-cap.

They also want flexibility in terms of instruments, collateral packages, PIK components, bespoke covenant packages and unfunded commitments to support M&A strategies. They seek a variety of price points for different risk profiles, ranging from low-levered 'vanilla' transactions to higher-octane opportunistic situations.

Finally, sponsors appreciate working with partners that have dedicated industry expertise. Our underwriting team is organised by sector. This allows us to deliver quick and accurate feedback to sponsors, to be efficient in diligence, and thoughtful in deal structuring. When we speak the same language as our partners, we can deliver better outcomes both for our borrowers and our stakeholders.

Q How is Blue Owl positioning itself as a solutions provider for borrowers and sponsors moving forward?

Lenders that can credibly position themselves as true solutions providers to private equity firms will continue to be successful. First and foremost is scale and breadth of capabilities. Sponsors want to work with partners that can be a one-stop shop for all their financing needs. This includes not just credit, but also our GP strategic capital and other strategies. Within direct lending, we will continue to launch new products to provide holistic solutions to the alternative assets industry.

Another key differentiator is partnership. We focus on building strong relationships with private equity firms by employing a collaborative approach. While our primary goal is always to protect our investors' capital, we try to find solutions that present a 'win-win' for both our sponsor partners and our stakeholders. We do not take an adversarial approach with our borrowers and believe that our success is intertwined. Our sponsor relationships span from our founders down to the individual deal teams, which also provides multiple touch points across the organisation. Finally, it sounds trite, but culture is really important. If our partners like working with us, they will continue to grow with us over time. We think we have built a great team, and we could not have achieved the growth that we have without them. We think we are still in the early innings of our growth trajectory and are excited about what lies ahead. ■

Private debt looks to the future

*From secondaries to ESG and NAV lending,
private credit has pushed new boundaries over the last 12 months*

Capza receives €120m mandate for ESG credit fund
France-based alternatives manager Capza received a €120 million mandate from insurer MAIF to invest in environmental impact opportunities in line with MAIF's "société à mission" status, and to support companies that are reducing their carbon footprint and developing their social commitments.

Ares formalises credit secondaries business via $1bn JV with Mubadala
Ares Management officially launched its debt secondaries business via a joint venture with Gulf giant Mubadala Investment Company. The Los Angeles-headquartered firm will initially deploy roughly $1 billion of capital to buy LP stakes in credit funds and invest in credit-focused GP-led processes.

NOV 2022 DEC JAN 2023 FEB MAR APR

Fasanara and Tifosy team up for $250m sports receivable fund
UK-based firms Fasanara Capital and Tifosy Capital & Advisory partnered to launch a credit fund focused on sport receivables in February. The Sports Lending Fund was set to provide football clubs with access to working capital financing. The firms claimed it was the first such fund in the world, and was targeting a soft close on $250 million with a hard-cap of $500 million.

Polestar adds four new investors to impact fund
Dutch impact investor Polestar Capital secured four new investors for its impact debt fund, which brought total capital committed to the fund to €187 million. The Polestar Capital Circular Debt Fund received new backing worth €85 million from Dutch state impact investor Invest-NL, insurers Onderlinge's-Gravenhage and De Hoop, and the Province of Limburg.

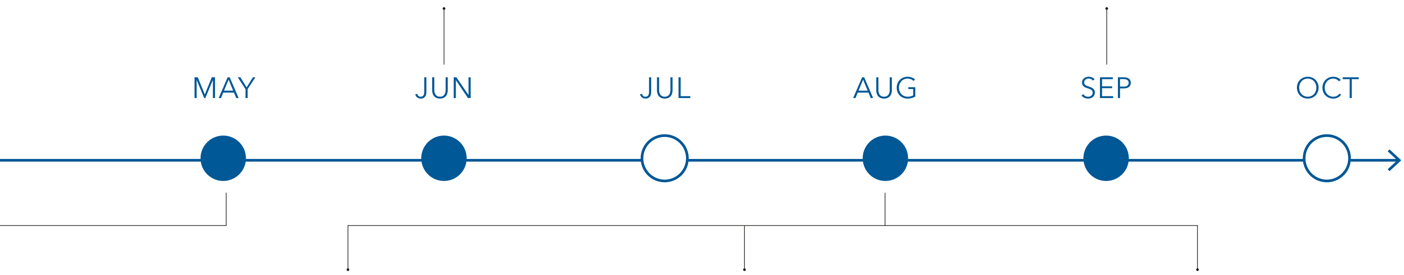
KKR: Asset-based lending to be worth $7.7trn by 2027
According to a KKR white paper, the private asset-based finance asset class grew 15 percent from 2020-22 and was expected to increase from $5.2 trillion to $7.7 trillion by 2027, with the US responsible for the majority of the transactions. The drivers of this growth were presumed to be inflation, the retreat of traditional lenders in the face of high interest rates, and volatility in the banking system.

Carlyle secures NAV loan worth more than €1bn on fifth Europe fund

The Carlyle Group, the world's fifth-largest private equity firm according to the PEI 300, took out a large NAV financing loan against assets held in one of its flagship Europe buyout funds, in a sign that such facilities are being increasingly used by alternative asset managers. The Washington DC-headquartered firm secured the €1.25 billion loan against some portfolio assets of its 2018-vintage Carlyle Europe Partners V fund, according to three sources familiar with the matter.

Initiative Climat publishes credit firms emissions guide

A private-markets-focused initiative to improve the industry's approach to climate change launched a guide to help private credit firms to better measure greenhouse gas emissions. The Initiative Climat International said it hoped the guide would promote greater measurement of emissions in the industry and improve transparency and disclosure to assist decision-making.



Blackstone closes energy transition fund on $7.1bn

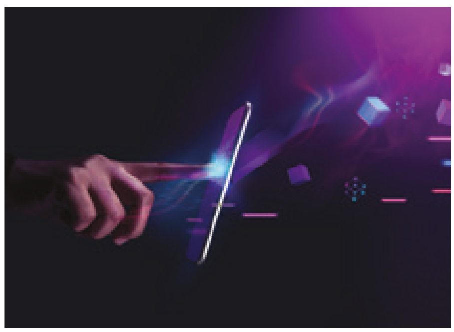
Blackstone Credit announced the final close of its energy transition credit fund on its $7.1 billion hard-cap, making it the largest energy transition private credit fund ever. Blackstone Green Private Credit Fund III was launched in July 2022 and surpassed its initial target of $6 billion.

Apollo lays $4bn pipeline for NAV loans

Apollo Global Management is eyeing the burgeoning strategy of loans tied to the net asset value in private equity portfolios, with around $4 billion of potential opportunities in the near-term, a source told affiliate title *Private Funds CFO*. The originations are planned for the coming months and are primarily for buyout funds, although the source cautioned those details were not set in stone.

Firms invest in platform to democratise private credit deals

Tradable, a California-based tech concern founded in 2022 to bring fintech to private credit, partnered with Victory Park Capital and Spring Labs to develop and launch a platform to democratise institution-quality private credit deals. The platform was an expansion of its Tradable Live Data Room.



EXPERT Q&A

Private credit is well positioned to capture allocations from private equity, says Park Square's Robin Doumar

Disciplined managers set to enjoy spell in the sun

Rising default rates, falling M&A activity and renewed competition from the syndicated loan market could be interpreted as bad omens for the private credit industry. But that's not the whole picture, says Robin Doumar, founder and managing partner at Park Square Capital.

Doumar agrees that there will be more discrepancies in how managers perform, yet he believes private credit continues to benefit from powerful tailwinds – higher yielding strategies, he points out, can almost match private equity returns, with considerably lower risk.

The key to success, Doumar tells *Private Debt Investor*, is to remain disciplined in lending only to high-quality businesses.

SPONSOR
PARK SQUARE CAPITAL

Q With the syndicated loan market showing signs of life, how will private credit perform over the next year?
For high-quality transactions, the market has reopened on both sides of the Atlantic after a year-and-a-half hiatus. To some degree, business will return to the syndicated loan market, especially for larger tranche loans.

Having said that, I do think that many of the inroads that private lenders have made into the syndicated loan market are likely to be sustained. Private debt firms will emerge with a significantly larger share of the lending business than they have historically held.

While we certainly like being in a lenders' market where we've had improvements in term structure and pricing, we don't want financing to be so expensive that it restricts transaction activity – that's been the world we've been living in for the past 18 months.

We were at a 10-year-low in terms of M&A transaction activity in the first quarter of 2023. The big benefit of the syndicated loan market's reopening is that we'll see more deal activity, and that's also fantastic news for firms providing solutions in junior debt.

I don't think it's bad for the existing mid-market direct lending business either. Mid-market companies will continue to use mid-market direct loans, and in the large-cap space, private debt firms have made gains relative to the CLO market.

Q Are you as optimistic about the outlook for the industry as you were a year ago?

Yes, I think it's a terrific market. A year ago, we were facing a substantial dislocation in the debt and equity markets, and so we deployed significant capital into the secondaries market, acquiring loans at a discount. And that has been great, but at some point, we needed to see new deal activity resume, because that's the bigger component of our business.

It's encouraging for me to see the syndicated loan market reopening for high-quality borrowers and it's a very promising time for the industry; base rates are up, leverage levels are lower than they were 18 months ago, and it's clear that the trend is pointing towards a substantial increase in transaction activity.

As buyers of loans have started to ramp up investment activity, the inventory that was for sale in the secondary loan market has now been cleaned out. Demand for loans has caught up, and the greater transaction volumes will likely soak up some of that demand.

Q Which key factors will determine how managers perform?

We're going to go through a period where highly leveraged companies will be tested by higher rates – there's going to be some pain out there for firms that have lent to the wrong companies.

"Base rates are up, leverage levels are lower than they were 18 months ago, and it's clear that the trend is pointing towards a substantial increase in transaction activity"

I do think there's going to be more differentiation in how managers perform, something we haven't seen for quite some time because it's been a one-way market. A number of managers that came into being over the last 10 years have focused on building market share, so they can get to the next fund and grow AUM rapidly.

As an investor, market share isn't the right thing to focus on. The key elements are to maintain discipline in terms of new transaction activity, monitor portfolios aggressively, and to be very, very selective in lending. Avoiding losses and zeros is the fundamental thing we focus on.

Avoiding catastrophic losses tends to be all about business quality. I hear a lot of lenders talk about the leverage multiples that they're lending at, or their return per unit of leverage – but I tend to think of that as misguided. Lots of businesses should have no leverage; for example, zero is a good amount of leverage for a retailer or for the hospitality sector.

But the private credit industry is generally well positioned to weather a rise in defaults as the hike in base rates provides a lot of protection against losses at the portfolio level. Firms that have stuck to stable and predictable businesses with high-quality management teams – and maintained solid capital structures – are going to be just fine.

Q Are larger firms better suited to this environment?

You need to be large enough to be able to solve your client's needs; otherwise, you can't be in a position to provide solutions.

But you don't want to be so big that you just become a beta manager, and you have to do every deal that people put in front of you. I do think some managers in direct lending have got too big for the market. They're under pressure to deploy capital, which they prioritise over performance, and the sheer quantity of funds they need to raise just to stay constant is enormous; I don't think that's received the scrutiny it deserves.

Q There's a lot of excitement about the retail channel. What is the future of retail investment in private credit going to look like?

It's certainly an interesting opportunity. We want to be thoughtful and to make sure, from a distribution standpoint, that we're tapping into that channel in the appropriate way. But while I do agree that it's important, I think the emphasis might be a little overstated. Institutional investors have the level of sophistication that's required to invest in private credit – and most retail investors don't have that. There's a risk that they're misdirected towards a very high fee product that isn't right for them and doesn't generate the returns that it should.

Another challenge is that private credit tends to be tax-inefficient for most retail investors – it's a fabulous product for institutions, but returns for individuals are usually treated as ordinary income.

We ought to be open-minded, but a healthy dose of scepticism is warranted. Personally, I think private credit investing is a more natural fit at the most sophisticated end of the individual investor market.

"We're going to go through a period where highly leveraged companies will be tested by higher rates – there's going to be some pain out there"

I left a big, well-regarded investment bank and formed Park Square because I felt that a business that solely focused on credit, had no conflicts, and was not competing with its customers, would have a superior business model. We could focus on being investors and delivering great performance for our LPs.

I see a number of these alternative investment firms have grown so big that they've effectively become banks; they're doing exactly what I left a big firm to avoid doing.

Q What do you expect to happen with interest rates in the long term, and how will this affect the private credit market going forward?

Higher interest rates are clearly going to create challenges for private equity and opportunities for private credit.

For private equity, higher rates generate a substantial headwind, as higher interest burdens come directly from the pocket of PE firms in terms of their returns. In addition to the rising costs of leveraged capital structures, we're also seeing multiple contraction and resulting longer holding periods, particularly in tech.

Whilst private equity remains a very attractive asset class, it seems evident that returns are likely to be lower in this new environment.

In contrast, I think private credit returns are going to be much larger. Yes, defaults might increase, but base rates are consistently higher. In our junior debt business, we generate between 13-15 percent net returns, very close to private equity levels – and we sit ahead of 60 percent invested equity in our deals.

I think you're going to see increasingly sophisticated institutional investors move away from private equity and allocate more capital to private credit, particularly into higher returning strategies. Of course, private equity remains an attractive asset class, but on a relative basis and in this environment, it makes sense for investors to put more of their eggs into the private credit basket. ■

Managers rein in fundraising ambitions

Fund sizes in private markets look set to stagnate over the next 12 months, but investors are more optimistic about debt, writes Claire Coe Smith

A more challenging fundraising environment for private markets may mean fund sizes stagnate over the next 12 months, suggests our 2023 survey of fund leaders in the private market industry. But private debt may defy the trend, as it draws allocations from other asset classes, industry observers say.

The *PDI Fund Leaders Survey 2023*, which compiled responses from 101 senior buyout, growth, private debt, venture capital, real estate and infrastructure executives globally over the summer, found only 56 percent said their current fund is larger than the predecessor, down from 75 percent in 2022 and 74 percent in 2021. Instead, 30 percent said they are targeting the same amount for their next fund as their last, which was the case for just 1 percent of fundraises last year.

The figures show 60 percent of managers are currently fundraising, with a further 20 percent planning to start raising later this year.

Robert Molina, managing director and head of origination at Briarcliffe Credit Partners, says: "We are seeing a very similar sentiment in that GPs are targeting less ambitious fund sizes. That is because LPs, while they might be pleased with their relationships and the way returns are performing, just don't have enough capital available to re-up at the same size or greater than previously. Often they haven't had the distributions coming through from private equity and the competition for LP capital remains even more fierce than in the past."

Jeffrey Griffiths, co-head of global

56%

Are targeting a larger size for their current or next planned fund

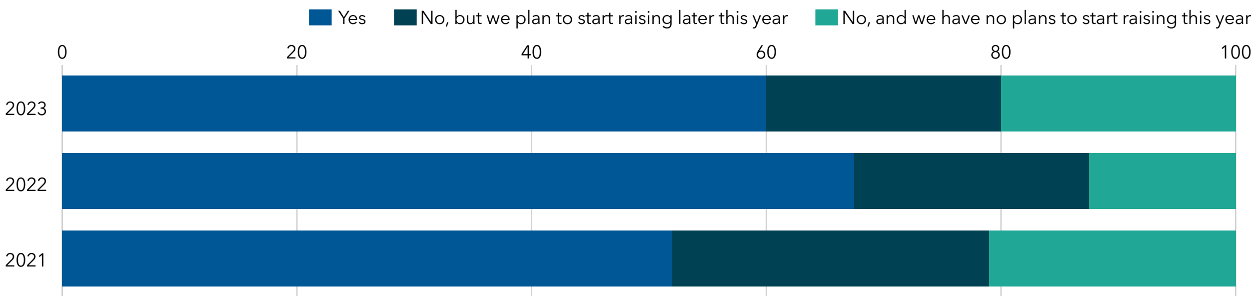
30%

Expect the size of their next fund to be unchanged

$18bn

Oaktree's record-breaking target for Opportunistic Fund XII

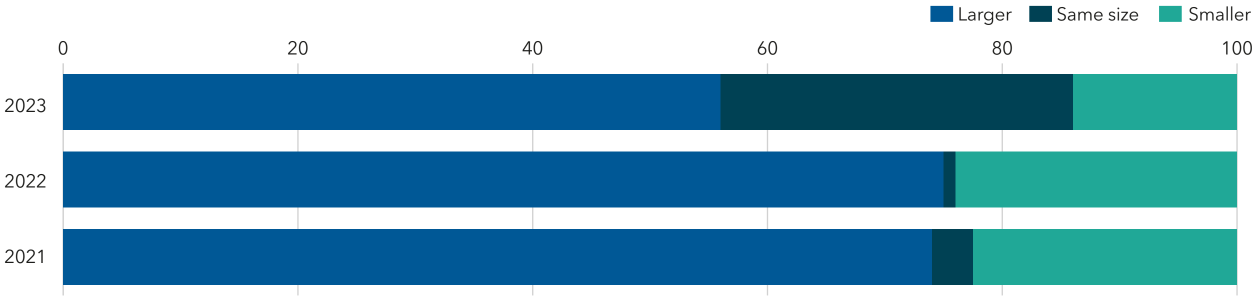
Are you raising a fund now? (%)



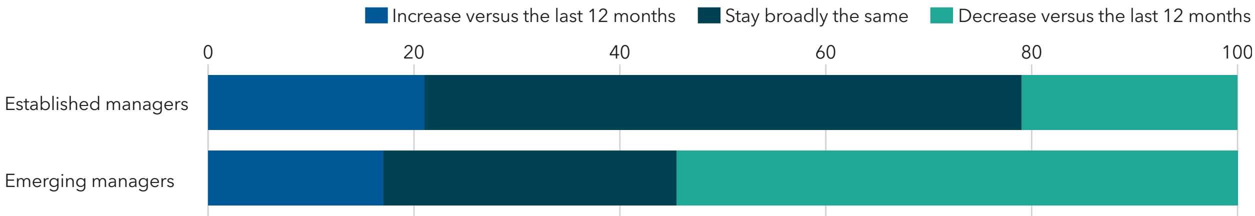
Source: PDI Private Fund Leaders Survey 2023

Analysis

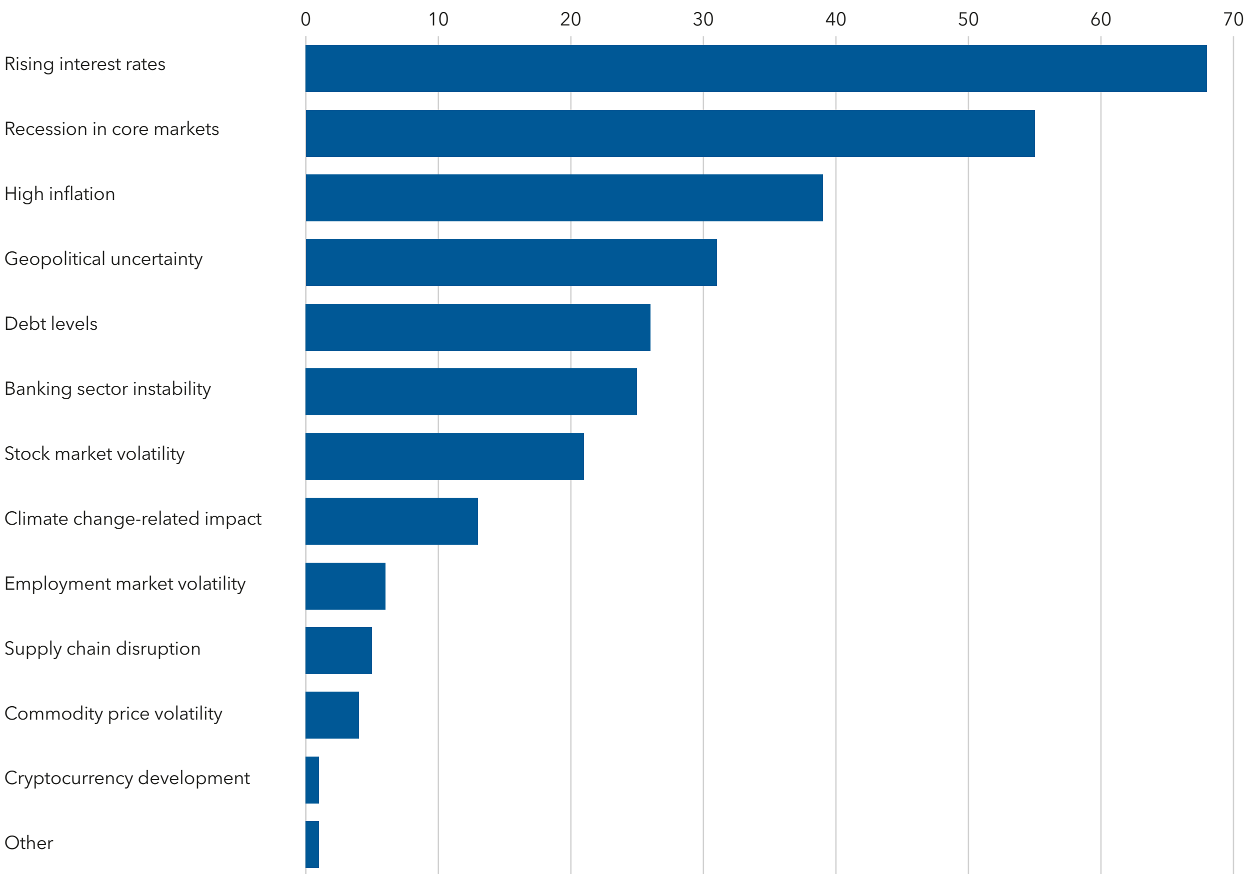
How does your current or planned fund compare with previous iterations? (%)



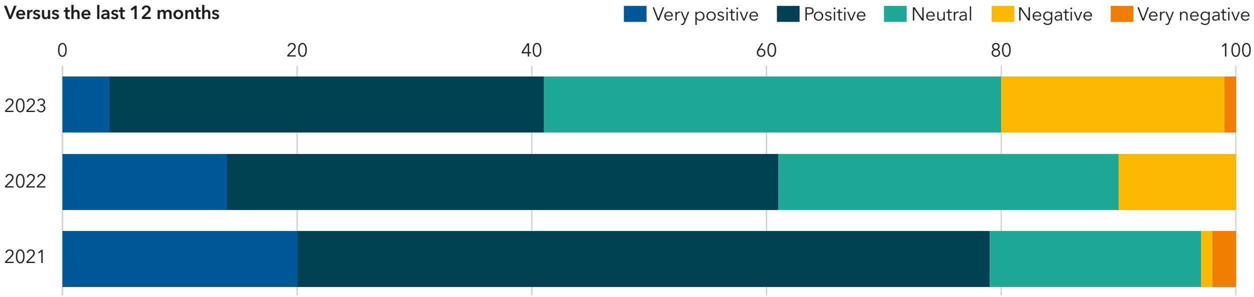
In the next 12 months, how do you expect private markets fundraising will fare for the following types of manager? (%)

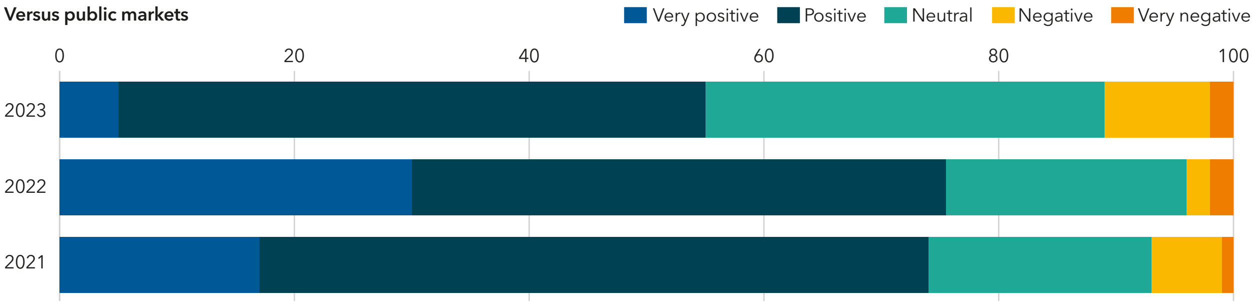


Which three economic and political factors will have the greatest impact on private markets over the next 12 months? (Up to three options selected; %)



How positive do you feel about the operating environment for private markets in your region in the next 12 months: (%)





Source for all data: PDI Private Fund Leaders Survey 2023

private credit at placement agent Campbell Lutyens, says the landscape may be more positive for private debt than other asset classes. "Unlike in private equity, where there has definitely been a pronounced slowdown in the need to raise capital and the size of funds, in credit, the fundraising numbers are a bit higher," he says. "We see more like two-thirds of managers fundraising right now and most groups are looking for larger fund sizes."

Largest fund ever

One of the biggest fundraisings currently in the market is Ares Management Corp's new European direct lending fund, which is looking to surpass the €11 billion raised for its previous fund in 2021. Elsewhere, Oaktree Capital Management has set an ambitious target for its Oaktree Opportunistic Fund XII, seeking $18 billion to create what would be the largest private debt fund ever.

Griffiths says: "It is difficult to fundraise and there is less ability to invest in most alternatives given the constraints on private market allocations. But the return opportunity in private credit is so attractive it is drawing larger allocations and new allocations, at the expense of private equity and publicly traded fixed income."

Nevertheless, fundraising is taking longer and is more arduous, with processes typically taking 18 to 24 months to complete.

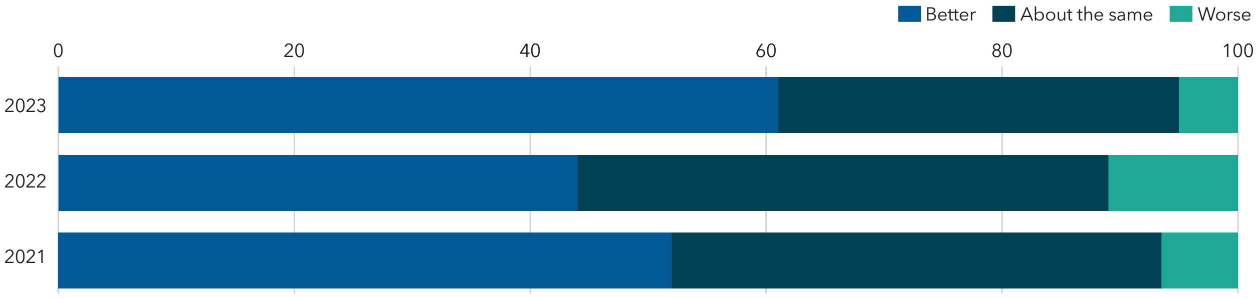
"We are seeing new investors add allocations to private debt, but it takes time. They have to get approvals for that, which often means moving allocation away from something else, and then they have to go out and start meeting managers," says Griffiths. "That can take a year or two from start to finish, but we have now been in this higher rate environment for 12 months so that is starting to flow through,"

Senior appeal

Molina says three areas in particular are attracting interest from LPs during credit fundraisings. "The three areas of interest right now are firstly senior lending strategies, because people want

> *"The return opportunity in private credit is so attractive it is drawing larger allocations"*
>
> **JEFFREY GRIFFITHS**
> **Campbell Lutyens**

How do you expect your funds to perform over the next 12 months compared with the last year? (%)



Source: PDI Private Fund Leaders Survey 2023

to be at the top of the capital structure as a conservative stance, and secondly, asset-based lending strategies, because investors want to be close to the asset in case things do go wrong.

"Lastly, we see a lot of interest in opportunistic credit or so-called all-weather strategies that seek the most attractive relative value across multiple credit types, whether that is primary or secondary, public or private debt, senior or junior, structured or non-structured."

Emerging managers

Looking forward, most fund leaders expect fundraising to be particularly challenging for emerging managers – 55 percent expect fundraising to decrease for that segment in the coming year. Only 21 percent expect established managers to increase their fundraising in the year ahead.

Griffiths says credit is an especially challenging sector for emerging managers: "The concept of the emerging manager is quite different in private credit versus private equity.

"In PE there is more of a risk-seeking opportunity, so investors are more willing to take a risk on the strategy side or on a new team or a new manager. Private credit investors are more risk averse, so it is much harder for new managers to break in."

He says this has always been the case and it is now even more difficult as allocations are more constrained.

New managers that achieve successful fundraises typically have a cornerstone investor for support. Meanwhile, Molina says GPs are having most success in winning over new LP relationships when they are offering a diversification opportunity beyond direct lending.

"Where we see new relationships between LPs and GPs it tends not to be on direct lending right now," he says. "That is because direct lending is a victim of its own success; returns have been consistent and continue to rise as interest rates rise, so LPs are typically happy with those relationships. Where they are looking for those new relationships is in areas like asset-based finance or opportunistic credit."

Rising returns

Managers say the three factors that will have the greatest impact on private markets in the next 12 months are rising interest rates, recession in core markets and high inflation.

In all, 41 percent feel positive about the operating environment for private funds in the next year compared with last year, whereas 61 percent felt positive when asked the same question a year ago and that figure was 79 percent back in 2021.

Fifty-two percent of those who completed the survey expect their funds to do better in the next 12 months than they did last year, while 7 percent think their funds will do worse.

The outlook may be more bullish for private credit managers than their peers in other asset classes. Molina says: "For private credit, this is an encouraging environment right now. As interest rates are higher and most of those strategies are floating rate, return expectations are rising.

"At the same time, the competitive environment for public credit has decreased, allowing private credit to be more competitive. Then of course, inflation risk is addressed because as inflation rises, so do interest rates. So I would think sentiment on the equity side is probably worse than on the credit side."

As funds shape up to diversify their investor bases and tap into new sources of capital, 21 percent of fund leaders say they now have a team dedicated to private wealth clients, while one in four have a defined strategy to attract a larger proportion of private wealth investors.

On innovation, more than six in 10 respondents feel artificial intelligence will be the most significant technology shaping businesses and industries over the next decade.

Still, just 14 percent have implemented AI solutions in their portfolio companies already, and fewer than 10 percent have introduced AI at fund level. The biggest area of focus today is on portfolio management and performance tracking, where four in 10 plan to start employing AI over the next year. ■

E X P E R T   Q & A

Private debt has a key role to play in alleviating property shortfalls in Europe, say Arrow Global's Mark Posniak and Maslow Capital's Ellis Sher

Direct lenders stand ready to address housing issues

While deal activity may seem muted, there are good reasons to believe that demand for private debt across Europe remains resilient, especially in the real estate sector, say Mark Posniak, European lending development director at Arrow Global Group, and Ellis Sher, CEO and co-founder of Maslow Capital. Arrow Global announced the full acquisition of Maslow Capital in August after buying a minority stake in the real estate lender in December 2021, forming part of Arrow Lending Opportunities (ALO) investment strategy.

SPONSOR
ARROW GLOBAL

Q How has the direct lending market evolved in the past 24 months, and what does the European lending landscape look like today?

Mark Posniak: Over the last 24 months, the direct lending market across Europe has experienced something of a transformation. The non-bank lenders are growing in prominence due to their agility and ability to offer far more flexible funding solutions than the banks. The increased regulatory and solvency pressures on the banks mean they are retreating from certain areas of the credit market and leaving substantial gaps for private debt funds to fill.

Ellis Sher: Since we came into this space in 2009, specialist non-bank lenders have been taking market share from the banks. Banks have been far more disciplined and focused on their core banking capabilities, allowing space for the non-banking sector to expand. European regulators have focused on weeding out poorly run or undercapitalised banks, resulting in a 35 percent reduction in banks between 2008 and 2021.

Q Why are investors excited about the future of the

direct lending private debt strategy?

ES: Since the GFC, allocations to private debt have been steadily increasing. That is because in many cases the loans are asset-backed, yield-certain and non-correlated compared with some of the more liquid fixed-income alternatives.

More recently, that interest has really accelerated due to the numerous rates rises, pushing rates to pre-GFC levels. Most non-bank lenders provide floating rate loans, which has significantly increased both IRRs and money multiples. In absolute terms, these instruments have become more numerically interesting.

A number of investors have also started to see this type of private debt as an all-weather asset class, so while the underlying property sector is cyclical, done correctly there should not be as much volatility on the secured debt side as there might be with equity.

Q How will lending change as we head into a recessionary period and what sort of opportunities will be created?

MP: Specialist lenders have historically done well in recessionary periods, filling the gap left by the banks as they get to grips with their legacy positions. The non-bank lenders can really come into their own if they have efficient capital to deploy, as they can create products to deliver solutions without having to push the boundaries in terms of leverage, borrower solvency and asset quality.

We do anticipate non-bank lenders getting slightly more selective, but they will still be able to create high-quality loan books via their flexibility and accessibility during these uncertain times.

ES: Everyone speaks about the refinancing gap that this higher interest environment will bring. That gap is estimated at about $93 billion, but we are yet to see it coming through in refinancing requests, nor have we been presented secondary books to acquire. I do wonder whether the opportunities that everyone anticipates will materialise. I am beginning to think that with sufficient pragmatism, flexibility, patience and liquidity in the system, the refinancing cliff may not materialise to the extent anticipated.

Q How have broader macroeconomic factors influenced the role of private debt in the housing sector?

ES: We continue to play our role in the provision of debt for new-build housing developments. A lot of private debt is focusing on the living sector – it seems that multifamily residential is the new industrial. There is unfortunately only so much the lending market can deliver because the planning systems are inefficient.

Despite best intentions, we are seeing a continuous slowdown in the time it takes to achieve planning along with heightened costs of doing so. Governments across Europe are missing their new homes targets, while need is heightened by an ageing population, longer life expectancy and smaller households.

Private debt is available, as is equity, but the issue is that supply is systematically curtailed by planning systems that are deeply flawed and in need of modernisation, across many parts of Europe.

MP: Housing supply is not keeping pace with demographic changes, creating a substantial opportunity for developers and non-bankers alike. Much

Q How can ESG play a role in direct lending?

MP: ESG is built into the framework for our product design and lending programmes, with a core focus on energy efficiency, financial contributions to the local council, end-unit price points, affordability and developer procurement, reputation and governance of the business.

ES: We have seen the market attempt green-linked loans where the cost of credit is attached to the development's green credentials. That is yet to have a significant impact but is certainly the direction of travel. There is no question that in Europe, failure to have a positive and measurable ESG policy that delivers in the real world will make institutional fundraising particularly challenging.

of the European housing stock is deficient in quality and volume – major refurbishment and energy efficiency enhancements are required for more than 50 percent of housing stock across the UK, Ireland, Germany, Spain, Italy, Holland, etc.

In fact, looking at the UK, most of the properties were built in or before the 1980s and are going to struggle to meet the government-imposed new energy efficiency standards, so there is a huge opportunity to help buy-to-let landlords to upgrade their properties to achieve the required Energy Performance Certificate ratings.

Across the rest of Europe, there are going to be improvements required to rental properties to make them energy compliant and better places to live. So, while non-bank lenders can fill the funding gap left by the banks, we need governments to facilitate that by increasing the number of homes and the energy efficiency of existing properties to meet legislative changes being proposed.

Q What are the supply and demand dynamics in the direct lending space? How are loans being structured to get deals done?

MP: Borrowers need quick and certain decisions, with funding packages that provide them with the flexibility required to meet their business plans, rather than trying to fit a banks' credit mandate. Non-bank lenders can be flexible around how they structure a facility across duration, leverage, serviceability and composition of pricing, making capital much easier to access.

ES: While deal activity is currently muted, there is an oversupply of debt capital versus demand; however, that ebbs and flows. We are starting to see a rebalancing as some liquidity withdrawals from the market and the rate at which central banks have been increasing rates begins to moderate.

"Specialist lenders have historically done well in recessionary periods"

MARK POSNIAK

"Multifamily residential is the new industrial"

ELLIS SHER

The fundamentals of the sector have not changed: populations are growing; existing housing stocks require extensive improvements; and planning laws remain complex, hindering new supply. Despite the challenges we have witnessed, we are seeing a notable pick-up in new-build enquiries.

There is a way to go but that pick-up is an indication of two things. First, the market believes we are through the worst of interest rate rises and sponsors are slowly becoming more comfortable that they can transact with more certainty. Secondly, there is no question that inflation across construction is moderating, albeit more so across Europe than in the UK.

Q What can we expect to see when it comes to performance, risk-adjusted returns and value creation?

MP: Non-bank lenders will continue to focus on delivering competitive risk-adjusted returns relative to traditional fixed-income assets. Value creation will come from expertise in credit selection, proactive risk management and seizing opportunities that emerge during market dislocation.

ES: On value creation, nothing has changed. It is best to have a large origination funnel, allowing one to understand which deals offer the most favourable risk-adjusted returns. Deal selection is key, along with diligent underwriting and ongoing management of the loan, all performed by highly competent people supported by intelligent systems. Those are the fundamentals.

Q From a borrower's perspective, what are the advantages of private credit vs the syndicated market?

MP: Direct lending is quickly becoming the norm across Europe because it is quicker, easier and much more flexible. Furthermore, a lot of the specialist lenders take that old-school lending approach, where it is not a tick-box exercise.

ES: The syndicated market is much less flexible, and everyone will tell you that the cost of putting a syndicated deal together is considerable. The truth is the syndication market only works for large deals, and if you are looking for anything less than €150 million then it is not a cost-efficient funding source. Maslow Capital, part of Arrow Lending Opportunities (ALO), has funded €5.9 billion of developments across 257 loans. Only one of those was syndicated, and I promised I would never go through that pain again! ■

Fast forward
Five innovations set to revolutionise the asset class

Whether it's the remarkable rise of artificial intelligence or new evergreen structures that are prolonging investments, private debt is embracing innovation in myriad ways.
By Claire Coe Smith

AI's grip on the future

The credit review process is a prime candidate for early adoption of artificial intelligence

With the adoption of artificial intelligence and machine learning tools skyrocketing in the wake of ChatGPT's launch late last year, its potential to revolutionise private credit has been thrust into the spotlight. Right across the asset class, from deal origination and due diligence through to investor reporting, accounting and risk management, the scope for managers to leverage the efficiencies of AI to work smarter could fundamentally change the status quo.

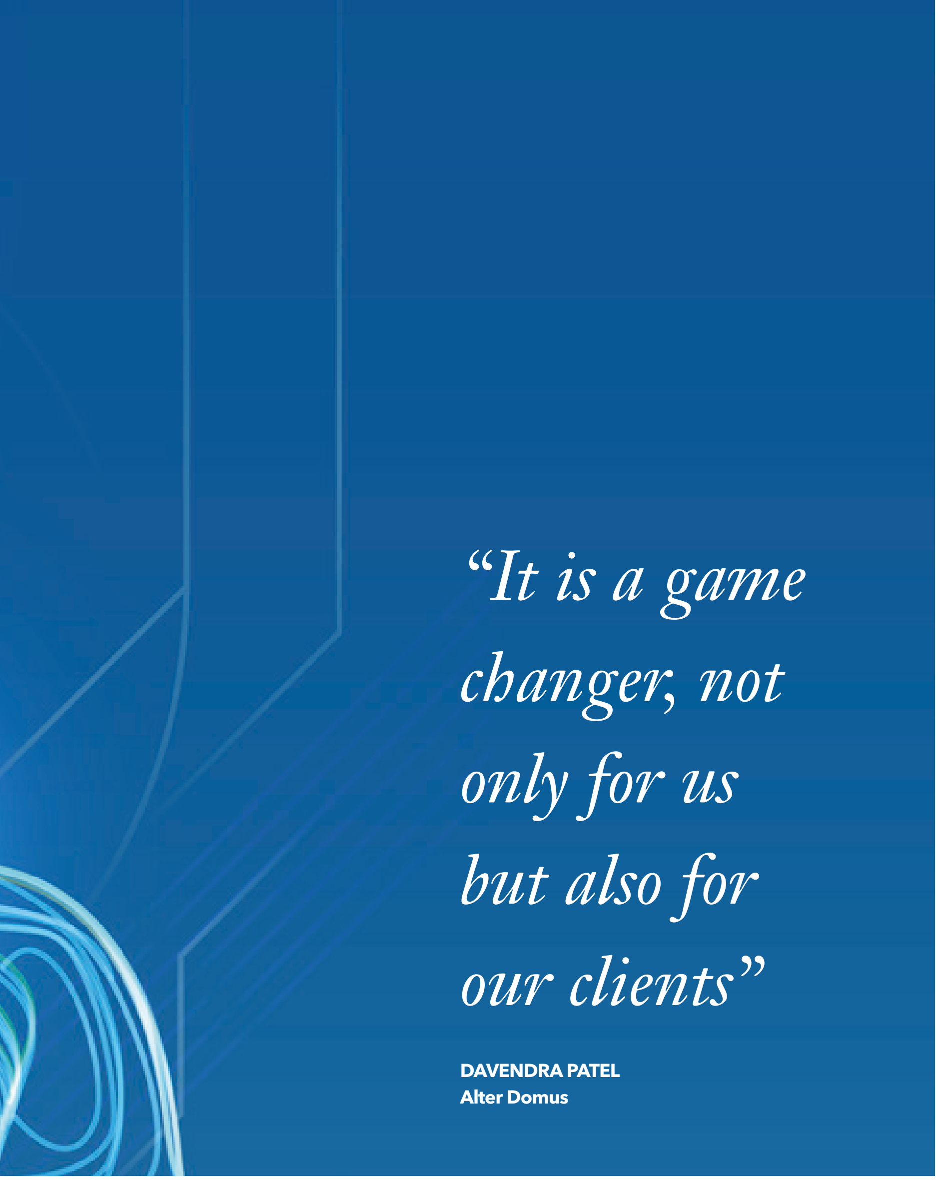
In California, the TerraCotta Group has long been at the forefront of applying data analytics and quantitative techniques to commercial real estate lending. Founder Tingting Zhang says narrow AI is already proving a powerful addition to real estate credit investment processes by using robots to think like humans.

"If we were to make an investment in a shopping centre, for example, as a human expert we would be very interested in the location of a property," says Zhang. "The human expert would go for a look around, see how many people were in the shops, how affluent the area looks and how busy the car park is.

"Now, using various machine learning algorithms, we can get that data instantly from government sources, cell phone information, public sources and our own proprietary platform."

Speed is the big advantage, she says: "The 'robots' are very quick to compute. For a human to look at 60 data points would take days, but the machine can do it instantly, it can detect patterns, and it doesn't make mistakes or take a more optimistic or pessimistic outlook depending on its mood."

Once the AI has identified an investment as being in a good location, human judgment takes over to move forward in how TerraCotta thinks about the credit.



Outside investment processes, many private funds are looking to integrate AI into their back-office and middle-office processes to speed things up, deliver enhanced insights and save on resources.

"When we talk about AI in fund servicing, we are not yet at the stage of using a friendly robot that produces your NAV while drafting the minutes of your next board meeting and advising on your ESG strategy," says Agnes Mazurek, senior consultant for private credit at Apex Group.

"It is unlikely we will be there for many years because adoption of AI tools is very gradual. What we have now is a lot of tools that digitise information and we are seeing a lot of initiatives across private credit to create the building blocks to get there."

Keith Miller, global head of private debt at Apex, says this is reflected in the growing number of conversations about opportunities for AI around the review of underlying assets. "That credit review process has always been incredibly manual but the big win for the asset class is the ability to review the underlying assets from a portfolio and risk monitoring perspective and conduct predictive modelling across assets to deliver scenario analysis."

Accelex is one company harnessing AI to bring more transparency to the asset class, with technology that gives firms timely access to performance and transaction data from funds in a clean and easy-to-analyse format. Their tool automates the extraction and preparation of data, giving managers quick access to thousands of data points that would previously have taken huge effort to obtain, and allowing them to significantly enhance the accuracy of their reports.

Nicole Weder, co-founder and chief product officer at Accelex, says: "The additional complexity of private debt investments means reporting requires more granular data for investment monitoring and decisions. Debt teams need access to instruments rather than just asset-level information. In response, we have upgraded our data science capabilities to capture that detail.

"Investors want easier access to this data. They want to know what securities we are invested in, where we are in the capital structure, what the risk is, what kind of cashflows will be happening in the future. We also have an analytics suite, because if an investor is able to extract that data in real time, we can tell them what is happening in their portfolio, what the return drivers are, and then they can decide whether they want to make a commitment to the next vintage or the next fund from a particular GP."

Right tool for the job

Other service providers and technology companies are developing their own tools to automate everything from the calculation of carried interest allocations to deal sourcing and ESG reporting.

Alter Domus has created its own version of ChatGPT and is already using bots across its business to help clients automate complex processes.

Davendra Patel, head of AI and automation at Alter Domus, says: "We have automation that can read emails, take out the attachments, automatically classify them, extract information and then summarise that in a report. We have been working hard on building this for the last four years and we are starting to see the fruits of that. It is a game changer, not only for us but also for our clients." ■

E X P E R T Q & A

These are the best lending conditions for years, say Gregory Racz, president and co-founder, and Daniel Leger, managing director of MGG Investment Group


Why higher rates lead to more non-sponsored opportunities

Q Is what is happening to US regional banks good or bad for private credit? And for non-sponsor lenders in particular?

What happened this spring is a continuation of a 40-year consolidation cycle driven by bank failures and regulation. The recent failures just exacerbate the absence of bank lending for mid-market businesses, and most expect small and mid-sized banks in the US to get further regulated.

In the US, we have gone from more than 14,000 banks in the late 1980s to around 4,000 today, and those banks don't really lend money to businesses in the way that we expect. They own a lot of commercial real estate loans, but they don't serve middle market business loans the way they used to.

SPONSOR

MGG INVESTMENT GROUP

All of this is good for private credit because it continues to create an opportunity for us to step in and take what was once the natural role of banks. For non-sponsor lenders, it is particularly powerful because we already operate in a less competitive space. Most of the capital raised for private credit is going to large, sponsor-backed lenders and largely bypasses the non-sponsored space. While more challenging to source the opportunities, the US mid-market is estimated to be worth about $10 trillion, making it an economy larger than that of Japan. There are more than 200,000 businesses, and only 5 percent of these are owned by private equity, so there is a huge opportunity.

Q Overall, how does this environment compare with others for private credit?

This is the best environment for what we do since 2009-10. With interest rates having risen and capital scarce because of the pressure on banks, we can get paid more, and it is easier to negotiate the tight covenants and other investor protections that are standard in our loan agreements. We are finding we can get better origination fees and higher floors, so the packaging overall is more favourable to the lenders.

Q If base rates stay elevated, what does this mean for US lower mid-market borrowers?

In our current loans, we find the interest rate to be sustainable because the growth rates of these businesses are substantially above the cost of capital, with very healthy mid-20s EBITDA margins. With the amount of debt we provide, which is typically about only four turns, this can be supported by the cashflows of the business.

For borrowers, it obviously means the cost of capital is going to remain high and we may reach a point at which companies choose to issue equity or not borrow. We don't believe we have reached that point yet, but we are getting closer to it. But over time, borrowers are going to be more cautious about how much debt they take on.

Q What do elevated base rates mean for the majority of lenders? Will defaults increase substantially?

Many often sponsor-backed businesses took on as much as seven turns of debt before interest rates went up and at that level you are going to have a lot of workouts. Given how few covenants those sponsor-backed lenders have, by the time they take possession of assets, the recovery rates are likely we believe going to be substantially below historic levels. Recovery rates used to be around 70 percent and we are now looking at potentially between 20-40 percent.

There have not been many bankruptcies yet but when they occur, the lenders are recovering a lot less. When you add to the mix the threat of creditor-on-creditor violence in the sponsor-backed world – given the lack of covenants and protections that went into those deals – by the time private equity owners hand over the keys there may not be much value remaining.

We think the low default rates are thus far providing false comfort. They will go up, though perhaps not as much or as fast as people think because private equity sponsors have so many rights in existing structures. This may deliver better outcomes for private equity but not necessarily for their lenders.

"This is the best environment for what we do since 2009-10"

Q What does this environment mean for mid-market businesses that need both debt and equity financing?

There are a number of issues driving demand. Obviously, the cost of borrowing has gone up and there are fewer sources of capital. The increasing number of issues in lenders' portfolios also means they have less capital to lend because they have things to address. Equity financing in the public markets has also been difficult, with the IPO market all but closed, and selling to strategics is less attractive to businesses still looking to grow not sell. So, if you are a business looking for debt and equity capital, you will have trouble finding equity at an acceptable price.

This means it is a really good moment to be a lender that provides both debt and equity financing to growing mid-market businesses. We call these types of investments structured solutions. It allows us to support growing mid-market businesses and become a one-stop shop for them, where we can get paid well on the debt (with all the lender protections) while also purchasing equity at very attractive mid-single-digit multiples. We find that is a powerful offering right now, with a lot of demand with few other options for the business owner (and much less dilutive for the owner versus pure equity financing).

Q There have been reports about sponsor-backed lenders looking to do more non-sponsor deals. Are you seeing that? And what about the reverse? Are there more sponsor-backed opportunities for MGG in this market?

We are not seeing evidence of that yet. There are two important reasons to be cautious about moving into non-sponsored lending. One is sourcing because it is hard to find businesses in the numbers you need – we saw 1,400 deals last year and ended up funding 18. There is little room for tourists.

Two, you need to do all your own due diligence because you can't rely on a private equity firm's due diligence package. That is resource-intensive and challenging for typical sponsor-backed lenders.

On the other hand, we are seeing more sponsors willing to accept our terms, in part because we have the capital and, in part, because other folks are nursing portfolios that need a lot more attention. So, we have looked at more sponsor-backed deals in the last year than we have previously.

Q How will a higher-rate environment impact the private credit market longer term?

If rates stay higher for longer, this is going to be a really great asset class to invest in. Even rates a couple of hundred basis points below where they are now means a cash pay in low double-digits, which is very attractive in almost any environment.

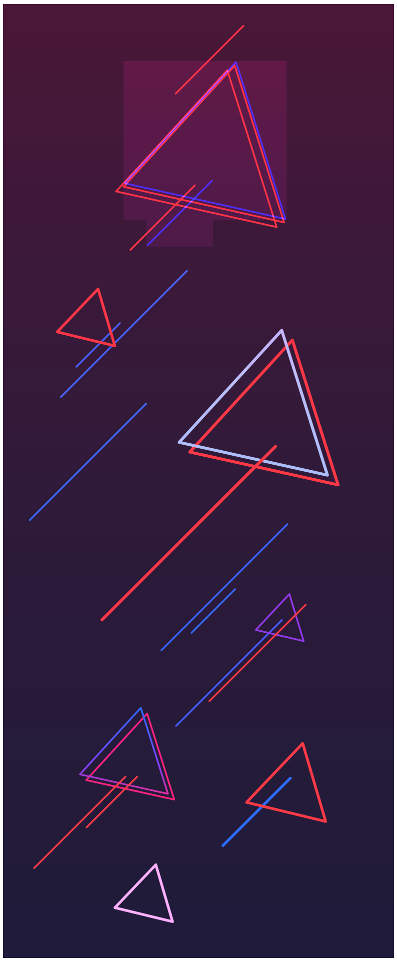
From a regulatory standpoint, the government is going to continue to want private credit to support businesses more than banks, so we see a huge opportunity for many years to come, particularly in non-sponsored lending. ■

Evergreen structure favoured for its flexibility

More managers are moving away from traditional closed-end funds in favour of more open-end solutions

With liquidity front of mind for both established institutional investors, and newer investor bases coming into the asset class, private debt funds are seeing fast-growing demand for evergreen structures. Moving away from traditional closed-end funds in favour of more flexible, open-end solutions, more and more managers are responding with bespoke vehicles that allow investors to either withdraw money after shorter investment periods or make their investments in perpetuity.

The Carlyle Group and Blue Owl Capital's direct lending arm, Owl Rock, are among the prominent names moving into the evergreen space, while Partners Group was also an early promoter of the approach with its €1.4 billion Private Loans Sicav Fund, launched in 2016.



Dispiriting drawdown delays

Andrew Bellis, head of private debt at Partners Group, says: "Closed-end funds are certainly not going to disappear and are always going to remain relevant, but we see evergreens becoming an increasingly large part of our assets under management. In private debt, there is a bit of LP frustration around closed-end funds as a result of unpredictable drawdown schedules that make it difficult to manage overall NAV exposure. Open-end solutions give them more flexibility to increase or reduce allocations over time.

"Then on the other hand you have a whole growing wealth channel where evergreen vehicles are more palatable too, so those two client-side drivers are really pushing demand forward."

Diala Minott, co-chair of the investment funds and private capital practice at Paul Hastings, says: "There is certainly more and more interest from LPs in bringing more liquid frameworks into private debt. People want to be able to continue to reinvest interest and principal in a fund with a longer term, or even no term, and be able to redeem in and out – so they are really looking for more open-end features."

For general partners, running evergreen vehicles is much more burdensome and is not to be underestimated, with the requirement for far greater transparency around valuations to allow investors to come in and out and hold things at book value. But with demand for these products outpacing expectations, the potential for a widespread reshaping of the asset class over the mid-term is considerable.

The specifics of how these funds work varies, with innovation ongoing around how structures offer liquidity to investors. Bellis says: "Private credit evergreen funds sound great in concept, but how do you generate liquidity? You either have to sell assets, which means you need to hold some assets that are a bit more liquid, or you need tight gates on the fund.

"The alternative is that if someone wants to come out and you can't offset that with someone else coming in, you need to run off assets and get liquidity over time. We have used run-off strategies in the US, but those are probably easier for institutions to understand than private wealth."

Bellis believes the direction of travel is certainly towards more evergreen funds, "but how standardised they are and what mechanisms they use remains to be seen. There is a lot of work going on right now." ■

Sports lending: In a league of its own

Ares is among fund managers targeting this booming area

One area of alternative lending attracting growing investor interest is the opportunity presented by professional sports. Ares Management last year raised $3.7 billion of dedicated capital to invest across the capital structure in sports leagues, sports teams and sports-related franchises, as well as media and entertainment companies. It has already lent to teams including Atlético de Madrid, the San Diego Padres, McLaren Racing and Inter Miami CF.

Mark Affolter, partner and co-head of Ares' US direct lending and sports, media and entertainment strategies, says: "We very much believe that the demand for content, and the uniqueness of some of the content in sports, is sustainable and set to drive valuations in the sector. We have already seen sports franchises grow their valuations, especially in European football, and those growth dynamics have been uncorrelated to the broader economy and haven't experienced the level of volatility seen elsewhere."

There are also substantial sums involved. In March, the NFL issued $1.27 billion of 2023 term notes under a league-wide credit facility, and the NBA sold $271 million of new debt in June.

George Pyne, founder and chief executive officer of Bruin Capital, pointed out the attractiveness of sports lending in a recent article: "For lenders, the stability of recurring revenue flows, multi-generational fanatical loyalty among consumers, and the upside of thriving adjacent markets like sports betting, are an enticing mix that insulates professional sports from many of the macroeconomic stressors that impact other areas of the economy."

$1.27bn

Size of the 2023 term notes issued by the NFL in March

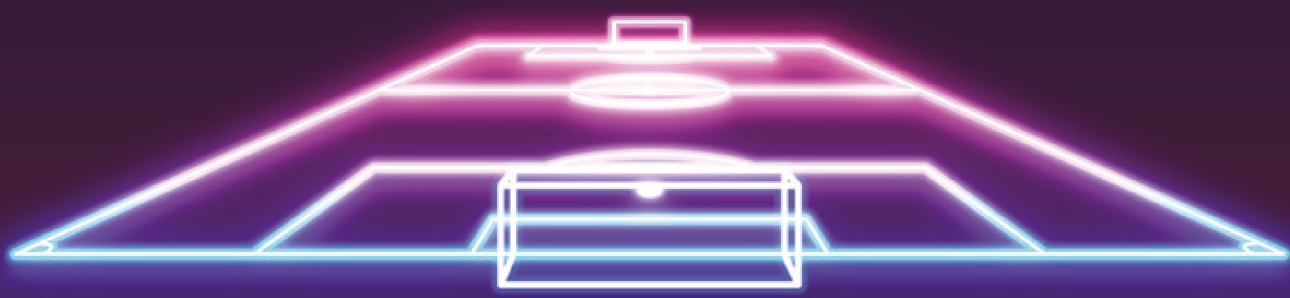
In March, UK-based firms Fasanara Capital and Tifosy Capital & Advisory teamed up to launch a credit fund focused on sports receivables, targeting professional football teams in Europe. Francesco Filia, founder and CEO of Fasanara, says: "We have helped more than 10 teams across Europe and there is huge demand for our services because we live in credit-starved times and clubs are in need of finance. The double-digit yields available are appealing to investors and the probability of defaults is quite low. Plus, there is an emotional element that LPs enjoy feeling close to the teams."

Elite game

There are few lenders active in the space thanks to high barriers to entry that require investors to be plugged into the space. Ares has established an advisory board that includes high-profile former players, athletes and executives.

Affolter says: "We think the addressable market opportunity – including for media and entertainment – is quite significant. There are great underlying fundamentals, but it is a more specialist industry vertical when it comes to capital provision."

Ares can offer flexible capital across senior debt, junior debt, preferred equity and minority equity. "This requires a differentiated insight from the LP base to provide more patient capital and more flexibility," says Affolter. "The primary areas of focus for us continue to be the US sports leagues, while we expect to see more opportunities within global women's sports, across European football and in other sports like cricket and rugby." ■



EXPERT Q&A

Lending against net asset values, or NAV, is proving a valuable source of liquidity and capital to private equity funds as they near the end of their investment period and move into the harvest period, says Pemberton's Thomas Doyle

Why LPs are warming to NAV financing

Q What are the current use cases for NAV financing at fund level?

NAV financing is not new and has been applied to many asset classes. However, the focus has now turned to NAV financing for private equity buyouts, always secured on a diversified portfolio of performing companies. NAV financing is an incredibly flexible financing tool and can be applied to solve a myriad of liquidity and capital needs at the fund or management company level.

Examples of growth-orientated applications include the provision of financing in support of portfolio company bolt-on acquisitions at the fund level or at the management company level, financing to support a new strategic initiative or supporting GPs to increase their commitments in future fundraises.

Defensive applications may include the proactive optimisation of portfolio company debt, which is particularly pertinent today, given the recent rise in interest rates, to ensure a fund's portfolio companies have sustainable debt obligations and, as such, are able to operate effectively, with management teams left to focus on driving growth rather than diverting cash to service debt.

SPONSOR

PEMBERTON ASSET MANAGEMENT

$100bn

Estimated size of current NAV financing market

Q What is the outlook for NAV financing and what are the key growth drivers?

We believe the outlook is incredibly exciting, not least as growth is underpinned by robust drivers, which can be grouped into four broad buckets: firstly, growth in underlying collateral pools is driven by the well-documented growth in the private equity buyout market – increased fundraising both in its velocity and in the size of funds – this capital has now been deployed or is being deployed and post seasoning, will yield significant financing opportunities; secondly, as the NAV financing market matures, a broadening array of NAV financing applications are being applied; thirdly, we see increased adoption by funds and GPs, as the asset class becomes increasingly mainstream; and finally, and by no means least, the growth in demand is being serviced by the growth in supply of capital as dedicated providers like Pemberton enter the market to service the pent-up demand.

NAV financing is currently estimated to be around \$100 billion in volume. We certainly see this as becoming larger than the sub-line business, which is now worth over \$500 billion globally – and that is just for buyouts. NAV financing is an all-weather solution, and we expect adoption to keep accelerating as it becomes clearly designated as a private debt product with private debt structures, covenants, and instruments. NAV financing is relevant across market conditions in both up- and down-market cycles. We therefore believe that NAV financing is poised to become an integral part of the private equity financing ecosystem.

Q How does NAV financing compare to other asset classes for institutional investors?

Structured appropriately, NAV financing solutions provide institutional investors with access to a new, large, fixed income, investment grade asset pool, that benefits from reduced volatility, and meaningful premia relative to public market equivalents.

The asset class compares favourably and represents a valuable addition to investors' alternative credit portfolio. NAV financing can operate across the risk paradigm, from the comparable single B-rated risk found across direct lending portfolios through to investment grade financing solutions. In each case it provides attractive relative risk-adjusted returns.

> *"NAV financing is poised to become an integral part of the private equity financing ecosystem"*

Compared to secondaries, that market is currently 85 or 90 cents on the dollar, so NAV financing offers good relative value, with a better risk-adjusted exposure to the similar underlying portfolio risk at 30-40 percent loan-to-value. There is a real relative value opportunity in the space because of the significant equity cushion on seasoned assets, the relatively more structured

Q What is the case for NAV financing in the current economic climate, from an investor perspective?

There are numerous factors that substantiate the growing popularity of NAV financing with investors. The fact that all these transactions are secured against a portfolio of assets means there are multiple sources of repayment, which in itself is very attractive. This is further reinforced by ensuring these portfolios are diversified by end sector and geography, providing additional resilience to the asset class.

The increasing adoption of these transactions by successful sponsors, where the underlying companies have been operated and owned by the existing sponsor for several years, provides asset seasoning, a further risk mitigant and makes the NAV/valuations inherently more stable.

Finally, the low, absolute, LTV attachment points, together with more robust underwriting of valuations by experienced credit organisations, make this a very attractive alternative asset class and complements existing allocations.

and covenanted nature of transactions, and the greater alignment with the borrower, who remains the owner of the assets.

Q What do LPs think of these financing structures?

LP acceptance of NAV financing is critical to the growth and longevity of the asset class. We have always championed strong engagement to ensure structures align the interests of LPs with those of GPs. In recent transactions we have seen managers benefiting alongside LPs who have seen upside in liquidity.

It is important for GPs to explain the purpose and benefits of the transaction. This enables a win-win when applied to the right situations.

These win-win situations are becoming increasingly prevalent, as NAV facilities are being adopted by proactive, successful GPs who are not looking to utilise facilities to artificially enhance returns, but rather drive accretive growth for their seasoned portfolio assets or conversely preserve the value they have created to date. This is particularly pertinent given the uncertain economic climate, which is yielding unforeseen extended hold periods, where capital and liquidity reserves may not be available to the fund without access to NAV facilities.

Q Is NAV financing leverage on leverage? Why should an investor be comfortable with NAV from a risk perspective?

NAV financing is not about creating unsustainable levels of leverage. In many situations these transactions are leverage neutral or may ultimately help reduce leverage as they facilitate growth. For instance, the proceeds of a NAV financing transaction can be used to refinance existing debt or finance transformational bolt-on acquisitions. Equally, as discussed, a NAV solution remains an efficient tool for optimising leverage across a fund. That said, ensuring that look-through leverage remains appropriate is a key credit consideration for both the lender and borrower and should remain an important data point reported to investors.

> *"We believe the outlook is incredibly exciting, not least as growth is underpinned by robust drivers"*

> *"NAV financing is an incredibly flexible financing tool and can be applied to solve a myriad of liquidity and capital needs"*

Q What is the competitive landscape like for NAV financing providers?

We think there is huge growth potential here and so inevitably there will be more competitors coming into the market. Right now, there are very few dedicated players, although a number of firms are doing this using side pockets or commingled funds.

We welcome new entrants to this asset class as it supports the growth of the market, which holds extensive opportunities for innovation as supply and demand increase.

Q What are Pemberton's USPs in this space?

Pemberton, with our extensive direct lending business developed over the past 10-plus years, has created an extremely strong origination platform. Our large office network across key European economies enables a continuous dialogue with sponsors and gives us first-hand insight and knowledge of local markets. NAV financing as an additional product is incredibly relevant to these sponsors.

There are very few firms with a dedicated NAV financing product that have invested in a large credit team. With 18 credit analysts, who have assessed close to 3,000 private equity-owned companies in recent years, we feel we are uniquely placed to make informed investment decisions – which is the DNA of Pemberton.

Finally, core to our strategy is our independence. We are a dedicated lender to the European middle market and do not have a competing private equity, loan-to-own, or distressed lending offering on a direct or indirect basis. That makes us an ideal partner for the sponsor community. ■

Thomas Doyle is partner and head of NAV financing at Pemberton Asset Management

Using NAV to monetise portfolios

Financing based on net asset value is increasingly seen as a source of both capital and liquidity

A decade ago, the sub-lines market was in its early stages and there was much hesitancy about its adoption as a fund management tool. Now it is used by more than 90 percent of private equity funds, and many predict that NAV financing will go the same way.

In an environment of longer hold periods, NAV facilities offer both a route to liquidity to effectively provide a bridge to LPs waiting for assets to sell and a source of capital to keep driving value creation at the tail end of a fund's life.

Kevin Alexander, partner in Ares' alternative credit strategy, says: "With the cost of capital so much higher, it is challenging for GPs to effectively achieve desired returns. NAV lending solutions have the ability to provide GPs with a lot of flexibility in terms of the time to monetise their portfolios.

"In today's market, PE managers are looking for us to provide lending solutions against the assets they hold. NAV solutions can be an accretive and cheaper form of capital versus pure equity capital because of the shorter duration."

With NAV adoption gaining pace and LP acceptance increasing, lenders are innovating to provide bespoke solutions, including hybrid loan facilities that are underwritten on the basis of both a fund's investor capital commitments and its investment portfolio.

Richard Sehayek, a managing director in Ares' alternative credit strategy, says: "I don't believe we've yet scratched the surface of NAV financing. Right now, most of the activity we see is from 2016- and 2017-vintage funds, and as time goes on, we expect to see more and more. We believe the facilities being done today represent a small percentage of the potential in this space."

Thomas Doyle, partner and head of the NAV financing business at Pemberton Asset Management, points out that the sub-line business already stands at more than $500 billion globally, with NAV financing currently estimated at $100 billion but set to overtake.

"In five years' time," Doyle says, "this will be very much established as an asset class in its own right, with allocations from LPs coming either as part of private credit strategies or from standalone buckets. It will be much larger than it is now, and it will be clearly designated as a private debt product with private debt structures, covenants and instruments. We will also see much more adoption… and a much broader appreciation by LPs of the win-win nature of these financings."

'Here to stay'

Andrew Bellis, head of private debt at Partners Group, adds: "Our view is that NAV financing is here to stay and grow as a tool for GPs to manage liquidity. We are in a very different place today in terms of financing, fundraising and exits, which is challenging for sponsors, and you also have a dynamic where banks are still active in this area but only in a certain part of the market.

"There is a big opportunity for private debt providers here, and we think about this not just as a GP tool but also as an LP tool. Instead of doing a secondaries sale, LPs could access liquidity through the use of finance. Given how heavily allocated people are to private markets, tools like this are going to be increasingly useful." ■

Turning tokenisation into a trillion-dollar business

Hamilton Lane and KKR are among those using tokenisation to convert private debt assets into tradable instruments

> *"I am 100 percent convinced that we will ultimately tokenise everything"*
>
> **CHRISTOPH GUGELMANN**
> **Tradeteq**

A recent report by Jersey Finance highlighted the potential for the tokenisation of real assets to turn the global fund industry upside down, with forecasts that asset tokenisation will grow into a $16.1 trillion business by 2030.

Trailblazers including Hamilton Lane and KKR are already embracing tokenisation as a means to broaden their investor bases and lower minimum subscriptions. This year, Hamilton Lane tokenised a portion of its $2.1 billion Equity Opportunities Fund V, allowing US qualified purchasers with at least $5 million in invested assets to access a tokenised feeder fund for $20,000 at a time, down from a traditional minimum ticket size of $5 million.

Elsewhere, KKR tokenised a portion of its $4 billion Health Care Strategic Growth Fund II, while Singaporean digital assets platform ADDX secured an allocation in 2021 to Partners Group's €5.5 billion Global Value SICAV Fund, giving non-US investors access with a minimum ticket size of $10,000.

Now, platforms are springing up as part of efforts to democratise private credit beyond institutional investors. Tradeteq founder Christoph Gugelmann says there is an estimated $3.5 trillion of private debt and real assets under management globally, and traditional asset managers securitise those assets into funds but then charge high management fees and interest for manual workflows that deter investors. Sellers also face capital restrictions that hinder their efforts to free up their balance sheets.

Tokenisation can convert private debt assets into tradable instruments with real-time processing, more advanced reporting and reduced friction costs. Assets are securitised into regulated security tokens using blockchain technology, opening them up to a wider pool of investors.

Gugelmann says: "We are focused on repackaging private credit to make it more accessible, and I am 100 percent convinced that we will ultimately tokenise everything because it takes a lot of intermediaries out of the process." He predicts tokenisation will take off when the first large government launches a central bank digital currency.

In August, Tradable, a California-based tech start-up, announced a partnership with Victory Park Capital and Spring Labs to develop and launch its platform. Johnny Reinsch, Tradable's founder and chief executive, told *Private Debt Investor*: "During [the] zero percent interest rate environment, a lot of great technology platforms were built for private equity or fundraising, but there wasn't a lot of focus on private credit because yields weren't as interesting. Now, the risk-free rates have climbed, yield is great and private credit is interesting to everybody. My goal is to help provide the picks and shovels that allow the opportunity to invest in these assets to be felt by more and more people."

Origin story

So far, the focus of Tradable has been on digitising credit agreements so it is clear who owns what. "By establishing the provenance of the asset, which is the base line unit, we can next move onto secondary trading, settlement and potentially leverage," says Reinsch. "Those are readily achievable. If you add up the entirety of the value that has been tokenised in some shape or form so far, it is a relative drop in the bucket of the assets that could be tokenised. We are very much at the first innings.

"The interesting thing driving adoption now is that private credit is pretty cool and lots of people want to take advantage of what is an otherwise illiquid asset class. New entrants will come in and that will create a virtuous circle." ■

EXPERT Q&A

Investing in larger companies has many advantages, especially in these more challenging times, say Blackstone's Brad Marshall and Jonathan Bock

Why bigger deals can drive better returns

SPONSOR
BLACKSTONE

Q Let's start by discussing how this asset class has grown into what it is today. How would you describe the growth of private credit?

Brad Marshall: We started our private credit business back in 2005 when the deals that were done privately were for companies that couldn't get financed publicly. They were smaller businesses and more complicated credits. There were only a few private capital providers, representing about 5 percent of US leveraged finance.

Since then, we have seen a secular shift from public to private markets. In 2021, there was an acceleration of multi-billion-dollar private financings and companies now routinely choose to go with a private solution. Going into 2024, we now believe we could be the largest and lead lender in a $12 billion private financing if an issuer was looking for that.

Jonathan Bock: One of the largest private credit managers in 2005 was a company that sold refrigerators, GE. The institutionalisation and quality of managers has evolved materially, with most major alternative asset managers having large private credit arms today.

The deals have changed too. In the early days, it was very much a junior debt market because managers believed they had to find double-digit returns to compensate investors for taking that risk. Then there was a recognition that you could do a senior loan with lower risk; those opportunities were plentiful and popular with insurers, pension funds and now individual investors.

Q What is driving the evolution of the opportunity set in private credit?

BM: At a high level, we continue to see growth driven by the shift towards private credit, away from the public markets, driven by investor demand and companies that are seeking more flexible capital solutions. We are also seeing the size of the deals and types of solutions grow.

When the market thinks about private credit, they often think about corporate finance for sponsor-backed transactions, which has been the bulk of the industry's growth.

What is driving the evolution today is not only the size of deals, but also the range of private credit products that managers like ourselves can offer.

Banks have historically been in the "package and distribute", or syndication business. Today, issuers are seeing the benefits of working directly with private lenders who have long-term capital from their investors and are able to hold the loans. And then the private managers partner with the banks in a variety of different ways. So, you are seeing this evolution around a more efficient way to own and distribute risk. Private solutions have moved past just corporate loans to royalties, asset-based financings, private investment grade, structured credit in more complicated sectors like technology, life science and energy transition. And then from a geographic standpoint, you are seeing the same maturation globally, in Europe and Asia.

Similarly, there is the evolution of the investor base, with more individuals looking for longer duration and yield premium in private structures. That evolution on both the product and the investor side is creating an interesting intersection of opportunities for managers like us.

"Investing in larger companies has a lot of intuitive advantages"

BRAD MARSHALL

JB: As managers like Blackstone expand, our ability to offer loans now touches audiences that have never had the option before, so we continue to evolve our offerings and capabilities in the market.

Q The growth of private credit also has its sceptics, often when it comes to large deals – why would an investor want exposure to larger transactions?

BM: We work with companies of all sizes. No matter the size, you need to be investing in the right sectors, in the right capital structure and on the right terms. But in addition, we increasingly see that investing in larger companies has a lot of intuitive advantages. Bigger companies tend to grow because their products or services are high quality, they may attract a strong management team, a compelling PE sponsor and they are likely a bit more diverse in terms of their business mix, which de-risks the investment.

All those elements are supportive to a credit manager, especially in a period that is a little bit more complicated. You want the depth of capital of a big private equity sponsor and managers that can be supportive, plus you want a well-managed company that can navigate headwinds if necessary. We have been doing this for 18-plus years and in US direct lending, and we have not experienced a default on a large company with EBITDA of $100 million-plus. For context, the average EBITDA of companies we lend to is $200 million-plus. Our data shows that bigger deals have tended to drive better risk-adjusted returns.

Q A big driver of growth in the private credit industry, and specifically at Blackstone, has been the BDC structure.

"I expect AI and data science to transform not just private equity but private credit as well"

JONATHAN BOCK

How are BDCs positioned in this environment?

JB: When the BDC structure is operated with the right alignment and a sophisticated investment manager, great things can happen. For too long, the space had too high an underlying fee structure, which resulted sometimes in riskier, bad deals or poor returns.

Blackstone began to offer institutional-calibre funds to individual investors, allowing the space and the structure to evolve. Others followed suit and that has been a positive for the structure and for its investors.

We have started to see BDCs emerge as a way for individuals to access private credit, so the structure continues to grow – this is a great thing. It will be a big focus for both individuals and institutions because it allows investors to put capital to work immediately without navigating the traditional fund drawdown process and offers low leverage as well as a level of liquidity in an otherwise illiquid asset class.

Q Everyone mentions they have favourite sectors they like to lend to. What are yours? Why?

BM: Unsurprisingly, we take a fairly diversified position given the amount of capital we oversee. We do have some sectors we like more than others, which fall into three categories: technology and software; healthcare and life

Q What's the next shoe to drop? And how does Blackstone prepare for it?

BM: As credit investors, that is all we think about – we aim to deliver for our clients. The market has shifted so much in the last 18 months because of interest rates, which have effectively doubled the interest burden of companies. So, there is some concern around companies' ability to service that debt and, therefore, rising default rates.

This is where the 'three S' come into play. Sector selection, scale of company, seniority of capital. All three elements are defensive, and a manager's weightings in these areas will drive fund performance. We have been talking to our investors about this for quite some time as we saw the inflationary data flowing through our private equity portfolio years ago, which prompted our move to be defensive.

sciences; and renewable energy and energy transition. All three are large, have good growth outlooks, historically lower defaults and generally much better cashflow characteristics. Each of these is highly specialised, so you need an additional layer of resources to source, structure and underwrite those deals.

Q Many managers speak to their size, experience and diligence as points of differentiation. What would you say are the greatest points of differentiation for a partner working with Blackstone?

JB: There are plenty of people with the intellectual capital and the financial capital to make a loan, but I believe we are one of the only firms that can offer supplemental support to a company after a loan is made. Our Value Creation programme provides both operational support and resources for portfolio companies. Blackstone's proposition of taking its scale across businesses to drive revenue and cost advantages for borrowers is what differentiates us. Being a value-add partner is a rarity on the lending side.

BM: We think of ourselves as a capital partner, not just a capital provider. Ninety percent of the credit companies that our Value Creation team is introduced to use this post-investment offering that Jon mentioned. What also makes our platform exceptional is that we can go and create solutions, not just react to a company or sponsor calling us. We can provide those solutions globally and we can do so with scale. Committing to $4 billion in a single deal is within our capabilities and that opens up more opportunities for our investors. We aim to win by being creative and flexible, with deep pools of capital and by adding value where we can – that's what being a good partner is all about. If we create value for our equity partners, we can create wealth for our investors.

Q Finally, what's next? Any future innovations we can expect?

BM: There is product innovation, where we will continue to see more ways to bring various private assets to different types of investors, just like the innovation we have already seen in the BDC space. You are also going to see innovation in other markets, with more evolution in Europe to open up the asset class to different classes of investors – like individuals and insurers – and a shift in the Asian markets away from a historical reliance on banks for financing. Away from investors and product structures, you'll see the evolution of more specialised lending over time to serve a broader need across the corporate and asset-based market.

Furthermore, data is going to drive the market in a lot of different ways. Blackstone, like others, sits on a treasure trove of data from our companies and the buildings we own or to whom we lend. Artificial intelligence is something we have been working on for a while – as leveraging our proprietary data can help drive better decision-making, whether at the macro level or in specific deal analyses. We think AI is also going to be disruptive in certain sectors, so understanding that, especially from a credit standpoint, is important.

JB: I agree. I expect AI and data science to transform not just private equity but private credit as well. If the investment industry is all about connecting dots better than your competitors, Blackstone's scale and expertise gives us more dots than anyone else, with $1 trillion AUM across all our major markets. ■

Brad Marshall, global head of private credit strategies, and Jonathan Bock, senior managing director, are co-CEOs of Blackstone Private Credit Fund and Blackstone Secured Lending Fund

How to future-proof private debt

Forward-thinking managers are able to safeguard their investments by taking a flexible approach to emerging risks, writes Claire Coe Smith

Whether it is economic uncertainty, regulatory upheavals or global geopolitical challenges, the ability to get ahead of emerging risks is more important than ever for private debt funds. By thinking ahead, GPs and LPs can take steps to mitigate stumbling blocks that might emerge down the line, building flexible provisions into their documents that allow them to pivot and react as needed.

When setting up a credit fund with a seven- to 10-year time horizon, Peter Olds, a partner in the private funds group at law firm Proskauer, says the two big things that managers need to think about are: what is going to happen to regulation over the next decade, particularly as that relates to expenses, and what is going to happen to investment allocations.

"There has been a long-term trend in private credit for managers to come out with multiple product lines," says Olds, "whether that is direct lending versus mezzanine versus distressed, or whether that is different funds for different geographies. They have a bigger issue to contend with than private equity, for example, when it comes to choosing which of those buckets to allocate a deal to."

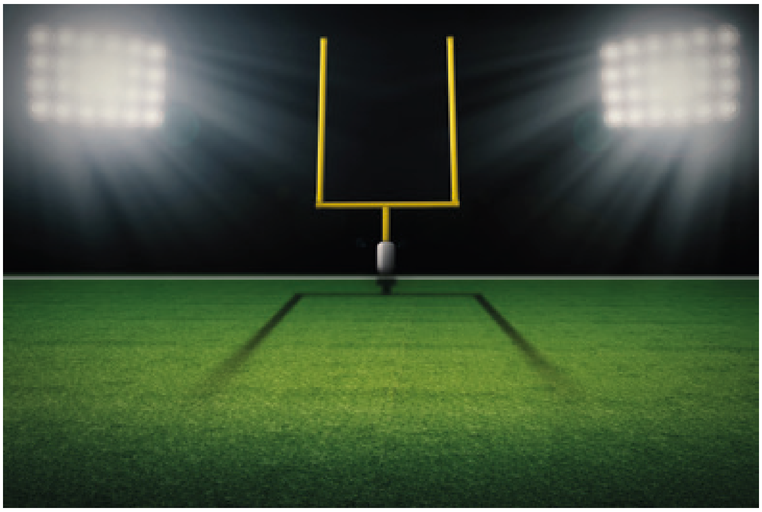
Investment allocations

Forward-thinking debt managers are therefore future-proofing their funds by addressing that challenge up front. "One thing to focus on is tying your hands as little as possible in the way you have to allocate a deal. Most managers are trying to do that by taking investment allocation out of the limited partnership agreement, instead having a policy with a lot of flexibility and an LPA that says investments will be allocated in accordance with that policy."

Given such arrangements leave a lot of discretion to managers, there is pushback from LPs who would rather know the fund they are invested in will get a first look at a deal, and that the best team will be focused on their fund. "On the whole, GPs are winning the argument," says Olds. "Partly, that is down to supply and demand on the popular funds – a lot of managers are in a position to say 'take it or leave it'."

A key element of future-proofing always comes down to embedding flexibility for managers, advisers say. John Anderson, international counsel and a member of the investment funds practice at Debevoise & Plimpton, says: "Credit fund managers are increasingly looking to embed more flexibility in investment mandates into their documents, so that they are not being locked into just doing mezzanine, for example, which we have seen morph into different things over time and evolve differently in the UK and the US. We also saw many funds wanting to take advantage of dislocation during the pandemic.

"More and more, investment managers are saying they will aim for a certain risk-adjusted return but will get there through a variety of routes. So the theme is to build in more flexibility, and the challenge is navigating the ability to do that with LPs who are maybe a little resistant to change. Most are now getting comfortable with that need for managers to be nimble, though."



The SEC shifts the goalposts

Perhaps the biggest sweep of new regulation currently focusing the minds of private credit funds is the SEC's new rules aimed at enhancing the regulation of private funds.

Adopted in August 2023, the reforms include several quarterly reporting requirements around performance, fees and expenses, plus increased transparency regarding side letters and other preferential treatment for investors and prohibition of certain liquidity rights.

Pointing to changes like the need for fairness opinions on continuation funds, additional constraints around co-investment and tightening of the rules around fees and expenses, Debevoise & Plimpton's John Anderson says: "This is watershed stuff from the SEC, which is going to require a lot of examination of documents by managers. There will need to be upgrades to bring terms and processes into compliance where necessary, while leaving flexibility where possible."

New requirements

The changing economic backdrop is also creating new requirements for managers to address.

Diala Minott, co-chair of the investment funds and private capital practice at Paul Hastings, says: "We are anticipating a lot of restructurings and debt-for-equity swaps coming through, and funds need to be sure they can hold the line there.

"A lot of debt funds aren't allowed to hold equity, but you could now have scenarios where debt funds are mostly equity, depending how loans perform. Investors are keeping a close eye on that because they don't want these funds turning into distressed funds. Documentation at the fund level is being drafted or amended with this in mind."

Another issue that can create challenges is bankruptcy situations, Minott says: "If a debt fund ends up holding part of a bankrupt group, working through that requires a different set of skills and expertise to working on a senior loan. Managers need to make sure their loan agreements allow for them to vote if they are part of a creditor committee, for example, because many of these funds haven't thought about those things because you don't typically vote on a loan."

Again, future-proofing a manager's ability to react to new situations in the portfolio requires building in more flexibility than might have otherwise been envisaged at the outset of a fund's life.

Anderson says the impact of the rise in interest rates may yet have a more fundamental impact on credit fund agreements if higher rates look set to last.

"We have seen the first fundamental interest rate movements for a decade," he says, "so we should at least be prepared for more fluctuation of both interest rates and other metrics for credit assets. Credit funds need to start building that into documents, with one example being the possibility of floating rate preferred return.

"When you have the possibility of moving rates, the old-school construct of a fixed-rate preferred return in a closed-end fund doesn't necessarily make a lot of sense if you hold predominantly floating rate assets. This might be the time to address a more aligning metric with LPs, to deal with the market as it is moving over the lifetime of the fund."

Broadly, a few big themes need to be on the radar of forward-looking fund managers, including everything from their approach to technology adoption to their strategy for addressing ESG and climate risks and the way in which they will respond to the growing demand from limited partners and new investor bases for evergreen or semi-evergreen fund structures.

"We are seeing investors asking more and more about ESG topics," says Tina De Baere, head of ESG at Polus Capital Management and co-chair of the ESG committee at the European Leveraged Finance Association. "The two topics that really come to mind are climate change and diversity, equity and inclusion. While two years ago, managers were being asked what they were doing about ESG and what their ESG policy was, now the focus is on reporting and keeping investors up to date with respect to ESG scores and climate emissions across the portfolio.

"Many end-investors are considering going net zero themselves and are increasingly facing complex regulatory disclosure obligations. They come to us as asset managers for the data and climate change risk assessments that detail the transition risk and physical risk that their portfolios are potentially facing. For most managers that is still quite a challenge, but this is going to be a more common ask going forward."

> *"One thing to focus on is tying your hands as little as possible in the way you have to allocate a deal"*
>
> **PETER OLDS**
> **Proskauer**

> *"This is watershed stuff from the SEC, which is going to require a lot of examination of documents by managers"*
>
> **JOHN ANDERSON**
> **Debevoise & Plimpton**

The evolution of ESG

Regulatory change is likely to drive further rapid evolution of ESG policies in coming years, while an ongoing regulatory focus on fees and expenses should also be front of mind when looking forward.

"A big focus of expenses provisions is going to be regulatory expenses," says Olds, "because compliance costs are getting to be very big and they are typically shared across a number of funds. The same goes for things like technology because as managers are becoming more and more reliant on technology to do research or using AI in their investment processes, the question is do the documents say those costs can be charged back to the fund and, if so, how is that cost split up between multiple funds.

"In terms of future-proofing, it is about getting enough detail into your documents in terms of what you expect the fund to pay for in regards to compliance and who you expect to pay for things like the use of AI. Related to all this is of course cybersecurity, where again you have to be very explicit in the documents about who is going to pay."

Given the longevity of fund lifetimes, the ability to horizon scan and anticipate how activities will evolve is critical to future-proofing both fund documentation and investment theses. ■

EXPERT Q&A

Whether it is shorter loan durations or more esoteric products, we believe private debt is proving that it can innovate to attract investors, say Lushan Sun and Matthew Taylor of LGIM Real Assets

'Borrowers are looking for flexibility'

Q How would you describe the evolution of the private debt asset class in recent years?

Matthew Taylor: While private debt is a long-standing asset class, it has grown to compete with the public markets at the higher end of the credit spectrum. It is now viewed by such issuers as a credible alternative to the public markets, not least because it tends to remain open when the public markets may close during periods of volatility. That has been welcomed by issuers and their reliance on private debt has increased.

We have also seen an expansion of what is being offered in private credit, with mid-size issuers increasingly seeking to avoid relying solely on banks in order to obtain longer dated finance and diversify funding sources. Beyond the classic US private placement or loans across corporate, infrastructure or real estate debt, we are seeing more potential opportunities in areas that have traditionally been only bank financed.

SPONSOR
LGIM REAL ASSETS

Banks have evolved from a take and hold to an originate to distribute strategy for many, promoting the recycling of capital to institutional investors. That can now include anything from short-dated trade finance to long-dated derivatives alongside the more typical loan offerings.

When I joined five years ago, such discussions with banks were limited to their retrenchment from long dated assets, typically 20 years plus, that didn't sit comfortably on their balance sheets and better matched the long-dated liabilities of insurance or pension fund capital. Over the last three or four years, these conversations now cover the full spectrum of maturities, down to even a month or two, as banks look to meet growing borrower needs and optimise their balance sheets.

This forms a part of a gradual shift in Europe for capital markets, both public and private, to play a larger role in financing corporates and other sectors, a feature that has long been the case in the US.

Lushan Sun: At the same time, investor requirements have changed. If we look at the UK, defined benefit pension schemes are much closer to end game today, so they are thinking about getting their assets buyout ready. In our view that drives demand for shorter duration assets or assets that are aligned to an insurer's requirement.

On the flip side, we are seeing increasing demand from defined contribution pension schemes that want to tap into the potential higher yield available in private credit.

Q How do you expect the market to evolve from here? What will be the key growth drivers going into 2024?

MT: Against an unclear macroeconomic backdrop, we are seeing slightly shorter debt issuance, partly because there are mixed views as to whether we are in a higher-for-longer rate environment or if rates may come down. Those that believe the latter are avoiding locking in rates for long tenors where they have this optionality.

We are also seeing an increasing demand in the private credit world. Those that were relying on banks or the public markets now very much see private credit as part of the toolkit in a way that they may not have done in the past.

When competing the various markets against each other, borrowers are looking for simplicity, flexibility and best value. In private credit, issuers don't need to offer a benchmark size, enabling issuance of a range of maturities that better manages a corporate's refinancing risk in a manner that is only possible for the larger credits in the public markets.

LS: From a sector perspective, in Europe we have seen a wider mix as borrowers turn to private debt amid bank retrenchment and public market volatility. The issuance this year in the US has very much been dominated by sectors such as energy, utilities and industrials, those with regulated cashflows that are able to pass through the rising costs of debt.

Some of the popular sectors in the UK such as universities, housing associations and REITs in the US have been very quiet, put off by that higher cost of capital. If rates are going to be higher for longer, we could see some of those sectors forced back into the market.

Q The fund finance market is another area of growth. What are your predictions for that space?

MT: There are two large parts to that market: subscription line finance and NAV lending. The subscription line business has been around for more than 25 years, with around $1 trillion of outstanding capital, according to NLC Fund Finance in 2023. It has a phenomenal track record with barely any credit concerns and outstanding growth, though we expect to see this slowing given the drop-off in M&A activity.

> *"We think the net-zero transition represents a huge opportunity for private credit"*
>
> **LUSHAN SUN**

We also see supply side changes in that space, with banks such as some of the US regional banks, which were historically large players, reducing their exposures, leaving a supply-demand imbalance that has yet to be absorbed by the increasing presence of institutional lenders.

Banks often use subscription lines financing as part of a broader ancillary product offering to funds, which is not threatened by distribution to institutional investors like LGIM.

LGIM launched its Short Term Alternative Finance Fund in 2021, with a follow on fund set to launch later this year, to open this investment strategy to the full range of our clients that may be seeking enhanced returns for sub-one year capital, park capital prior to making longer dated investments, or to diversify their investment portfolios.

LS: For our investors, we believe it could represent a resilient asset class, strong investment grade ratings, with stable returns offering yields over the longer term, at levels that are in our view attractive. We are seeing a lot of pension funds, endowments and charities who sit on a cash reserve interested in its potential to deliver a pick-up to money market funds or gilts. It is also a fairly liquid asset class because the assets are short dated (typically three to 12 months), while seeking to benefit from an illiquidity premium.

MT: The other side of the fund finance market is the NAV financing space, which is still in its growth phase and is relatively small compared with subscription lending. There are a small number of institutional investors today alongside banks, and activity levels for both can be expected to mushroom in the coming years. We are watching this market closely.

Q How different do you think the asset class might look in five years' time?

MT: My expectation is that it will

> *"The private credit markets can now deliver scale in a way they couldn't previously"*
>
> **MATTHEW TAYLOR**

be much larger on both the supply and demand sides. The supply of capital will come with more and more players moving in as people look for enhanced returns and recognise the drivers of growing markets like private credit.

The private credit markets can now deliver scale in a way they couldn't previously. We have invested in single transactions of £300 million ($372 million; €348 million) or more, and we are not alone.

There will be increased demand from issuers as we see them recognising they can do slightly more bespoke transactions, including CPI-linked for example, outside public markets.

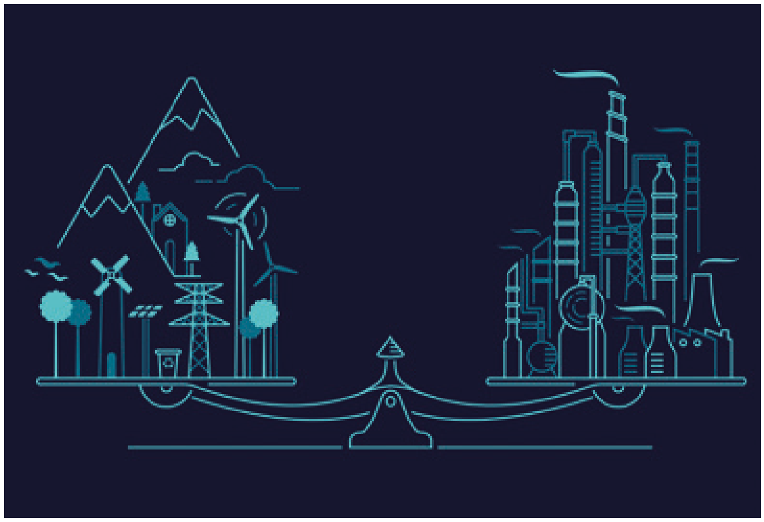
We also predict an expansion of the institutional market into new areas previously thought too esoteric for much of the private debt market. Institutions are increasingly comfortable with new asset classes, so asset-backed securities (ABS) will become more widespread, for instance.

We are also likely to see regulatory change in the UK through the upcoming Solvency II reforms that could allow insurance capital to become more active in areas that didn't previously work.

LS: We have seen massive growth in private credit since the GFC but that has been in benign credit conditions. Now it will be interesting to see how the market performs during a downturn. We are likely to see pockets of stress – we are already seeing rising defaults in high yield private credit. The ability to navigate stress will become critical.

Finally, we expect to see more products with better liquidity provisions so that, especially in the UK, the defined contribution market can become a bigger source of capital. We are already seeing a shift to more evergreen or open-end structures to meet demands for liquidity. We are in a place with real momentum as asset managers like ourselves get our heads together on how to give DC investors access to private credit. ■

Matthew Taylor is head of alternative debt and Lushan Sun is private credit research manager at LGIM RA



Q What kind of opportunity does the net-zero transition create for private credit managers?

LS: We believe the net-zero transition could represent a huge opportunity for private credit. The amount of capital required to meet net-zero goals by 2050 is enormous: we are deploying about $1.5 trillion into this per annum, and by 2030 that needs to reach $5 trillion, accoring to Bloomberg in 2023. A significant part of that funding gap is going to need to be filled by private capital because governments cannot afford to.

A lot of renewables, wind farms, solar farms and transport electrification projects are already funded by private credit, and we expect more potential opportunities to come through, especially in new and emerging technologies like hydrogen, battery storage and carbon capture.

MT: There is also a real push from investors to help finance that transition and these assets often provide a strong, longer dated debt profile that could potentially be attractive to investors in our view.

Whilst universally supported for renewables, and other seasoned green technologies, however, this becomes more nuanced in support for interim transition financing. For instance, the shift from coal to gas is viewed in much more favourable terms in the US than it is in Europe, in part driven by where the energy mix sits for each.

Charting the

Managers have mixed opinions on which areas of private funds management will most benefit from artificial intelligence technology, according to Private Debt Investor's latest Private Fund Leaders Survey. Hannah Roberts reports

Nearly one-third of GPs identify due diligence and data analysis as the business area in which artificial intelligence will have the greatest impact over the next five years, according to *PDI*'s *Private Fund Leaders Survey 2023*.

The survey, which compiled responses from 101 senior buyout, growth, private debt, venture capital, real estate and infrastructure executives globally, found that 32 percent of GPs believe AI will have the biggest impact on processes in

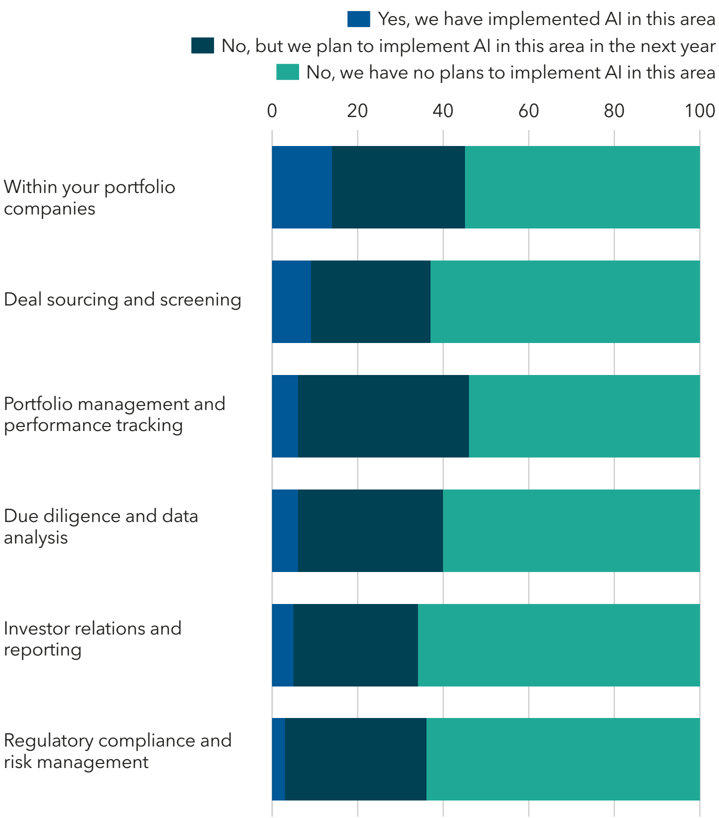
Which of the following do you expect AI to have the greatest impact on over the next five years? (%)

Source for all data: PDI's Private Fund Leaders Survey 2023

To what extent do you agree with the following statement? 'Artificial intelligence will be the most significant technology shaping businesses and industries over the next decade' (Figures have been rounded)

future of AI

Are you investing in and implementing AI solutions in the following areas? (%)



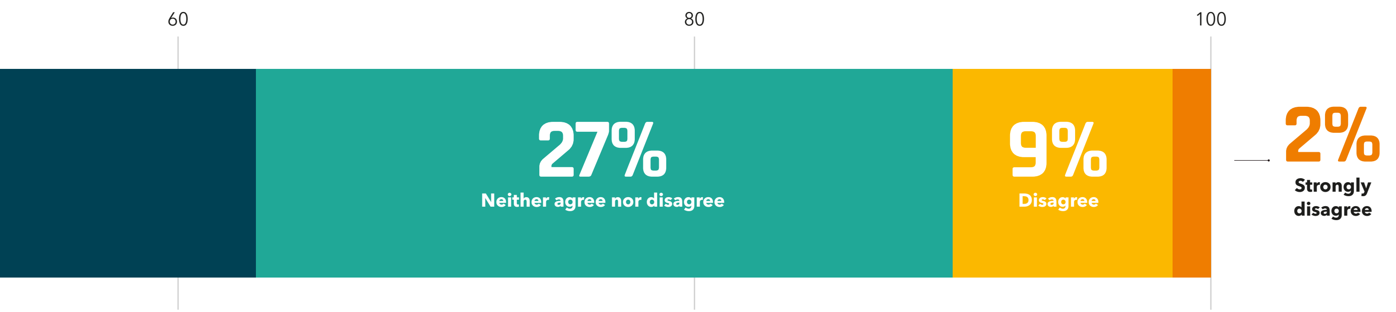
this area, followed by portfolio management and performance tracking (20 percent) and investor relations and reporting (18 percent).

The area in which AI adoption has been more popular to date is within portfolio companies, with 14 percent of respondents saying they have implemented AI solutions in their portfolios and a further 31 percent having plans to do so in the next year.

Meanwhile, the area set to receive the highest proportion of AI integration in the near-term is portfolio management and performance tracking, into which 40 percent of GPs say they will look to integrate AI in the next 12 months, in addition to the 6 percent of managers that have already implemented the technology.

Just 6 percent of GPs have already implemented AI into their due diligence and data analysis processes, though this is an area where a further 34 percent of managers say they will be focusing investments over the year.

The survey also suggests that the private funds industry's interest in AI is unlikely to disappear any time soon, with nearly two-thirds of GPs reporting that they believe AI will be the most significant technology to shape businesses and industries over the next decade. ■



Is this really a 'golden age'?

Private credit receives acclaim as a well-positioned asset class for the times, but investors are not entirely void of concerns, writes Andy Thomson

Private debt GPs, in common with GPs across all private markets, found fundraising to be a challenging task in the first half of 2023. Our data shows that just $84 billion was raised for private debt globally in H1 this year – the lowest total for the equivalent period since 2016.

The major reason typically cited for this was the trauma experienced by public markets, which has led to a denominator effect and tied investors' hands when it came to new allocations of any type – including private markets.

This was a practical issue that did not indicate investors had lost faith in private debt. To the contrary, surveys – our own and others – have consistently suggested that sentiment towards the asset class is more positive than ever. Moreover, LPs are generally under-allocated to private debt and keen to commit more capital to address this.

At our New York Forum in September, reference was made to a "golden age of private credit". So what, we ask, could possibly go wrong? Surely fundraising capital will flow freely again before much longer? While that may indeed be the case, investors at the event urged caution and highlighted a number of concerns that they feel should mitigate against complacency.

It was pointed out that while those lending on a floating-rate basis stand to benefit, rising rates would nonetheless pressurise borrowers and likely force up the default rate. At least one investor at the event feared a rise to as much as 9 or 10 percent, though estimates of this vary greatly.

"What happens when the music stops?"

While it may indeed be a "golden age" for current vintages, there was a view that recent past vintages may struggle unless considerable underwriting discipline has been applied. "What happens when the music stops?" was the rhetorical question posed.

It was also said that a "higher for longer" rate environment would not sit well with the increased leverage that was liberally used when rates were at or near zero.

Concerns were further expressed around the more stringent recent demands from the US Securities and Exchange Commission (currently being challenged in the courts), private debt's reputation as a laggard on the ESG front and the appropriate level of fee charging in a more sober environment – should hurdle rates stay the same, for example? None of these worries are likely to derail the private debt train – but they should perhaps give pause for thought. ■