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Insight

Analysis

Insight

US private debt **With sustained interest in US private credit opportunities, we identify five trends of which investors should be mindful**

When it comes to responding to investors' wishes, fund managers rarely miss a trick. The insatiable appetite of pensions, foundations, endowments and insurance companies for North American private debt strategies has driven a flurry of fund launches over the past three years, ***writes Joe McGrath***. According to *PDI* data, 146 North America-focused private debt funds closed in 2018 – the third-highest number in any year since the global financial crisis, though slightly below the 158 closes recorded in 2016.

There has been a similar trend in terms of the total amounts of capital raised. Last year's aggregate total of $59.5 billion was the second highest since the crisis – an increase on the $46.5 billion reported in 2016, but below the 2017 record of $80.6 billion.

1 Concerns about loan covenant standards are growing

Competition in the market has forced private lenders to make concessions to secure higher yields for their investors. However, with lots of capital chasing every opportunity, pricing has started to tighten and leverage levels are creeping up. "The US market has become massively aggressive," says Patrick Marshall, head of private debt and CLOs at Hermes Investment Management. He argues that if institutional investors are chasing a higher level of yield than the market is prepared to offer, private debt funds have to find another way to compete if they are to secure those higher yields from the businesses they lend to. "That tends to be by competing on the loan terms."

Marshall adds that fierce levels of competition have allowed chief financial officers to demand less restrictive loan terms in return for paying higher levels of interest. Supporters of more relaxed underwriting point to the fact that the number of loan defaults remains low, despite the ongoing concerns about lending standards. However, he believes this does not tell the full story. "My argument is defaults are at an all-time low because there are no covenants upon which to default," he says. "What you will see, in time, is that recoveries are going to be far lower."

> "Defaults are at an all-time low because there are no covenants upon which to default. What you will see, in time, is that recoveries are going to be far lower"
>
> Patrick Marshall
> Hermes Investment Management

2 Loan leverage is rising

According to figures from Schroders, the US leveraged loan market had ballooned to $1.1 trillion by the end of 2018, nearly twice what it had been just seven years previously. This could greatly inflate the losses investors will

be expected to shoulder if market conditions deteriorate significantly. "The debt cushion beneath the average loan has gotten smaller throughout this cycle," says Michelle Russell-Dowe, head of securitised debt in Schroders' US fixed-income team. "This means loan losses, in the event of default, are likely to be higher – especially given the increasing prevalence of loan-only deals – relative to past experience."

Marshall of Hermes Investment Management agrees: "Where there are defaults, performance will go down quicker for investors."

3 Nervousness about the economy is building

Monetary policy has been a key focus for private debt because of the inverted yield curve: the yield on 10-year Treasury bonds has dipped below that of shorter-term bills. Until late July, the Federal Reserve maintained it would not respond to "short-term" swings in the markets. It eventually cut the rate by 0.25 percent on 31 July. This, coupled with ongoing uncertainty about the trade war with China, has caused some investors to review their allocation to US private debt.

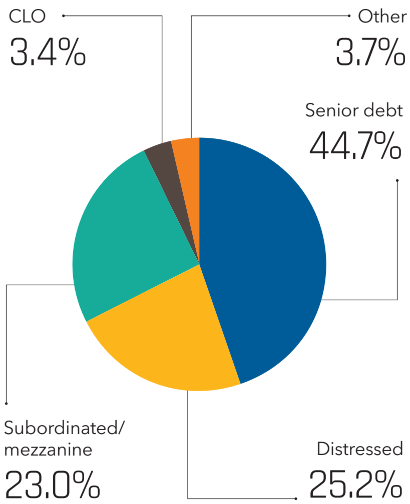
"Yield spreads have tightened substantially," says Schroders' Russell-Dowe. "Uncertainty exists around global growth, geopolitical issues, tariffs and trade, just to name a few. It feels again that 'priced to perfection' is a theme that demands review.

"Whilst we are no strangers to a confluence of global risks, we should expect to be compensated for this additional uncertainty."

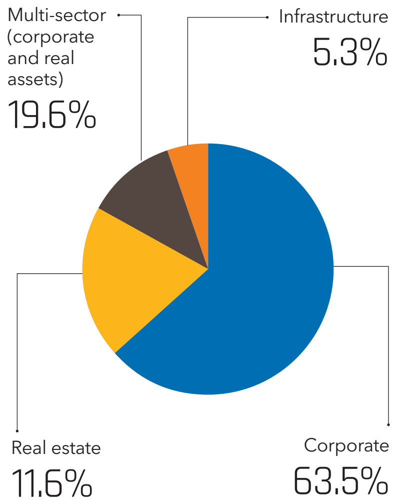
4 ESG investing is creeping in

Investors are beginning to expect that asset managers factor environmental, social and governance-

Around 45% of capital raised between 1 January 2018 and 31 March 2019 was for senior debt



Vehicles with a real assets strategy accounted for more than a third of the capital raised over the past 12 months



Source: PDI

based criteria into the terms of any loans they make.

Once the preserve of the global equity markets, the arrival of ESG metrics into US private credit can partly be explained by UN-backed organisation the Principles for Responsible Investing introducing new guidance on sustainable investing for private debt funds.

"Responsibility for responsible investing extends beyond the equity stack and captures lenders too," says Matthew Craig-Greene, managing director of data and analytics at investment consultancy MJ Hudson.

"In response, the UN PRI launched a tailored ESG due diligence questionnaire for private debt funds in February, covering policy and governance; evaluation, pre-investment; and monitoring, after a deal is done."

> "Responsibility for responsible investing extends beyond the equity stack and captures lenders too"
>
> Matthew Craig-Greene, MJ Hudson

5 US strategies deploy capital quicker than European ones

Market conditions in the US have stimulated a greater number of opportunities for direct lending than in Europe.

As a result, funds focused on US private debt are deploying their capital far more quickly than their Europe-focused counterparts.

This trend is, in part, the result of structural differences between the US and European markets.

"The markets in the US and in Europe are very different in size," says Ken Kencel, chief executive officer of Churchill Asset Management. He explains that over the past 15 years the volume of institutional leveraged loans in the US has, on average, been more than six times greater than that in Europe.

"The pool of direct lending opportunities is substantially smaller in Europe, particularly as managers focus on the deals the banks are not doing. As a result, given the amount of capital raised, the pace of deployment is much slower compared to that of US funds." ■

The big quotes

Wit and wisdom from industry insiders

> "Standards for credit issuance have been very loose. The defaults will come later than they otherwise would've, but they'll probably be worse"

Howard Marks, co-chairman, Oaktree Capital Management (February 2019)

> "The Fed has kept interest rates low in a way that's been designed to push investors away from cash, from treasuries and toward riskier asset classes"

David Golub, chief executive of Golub Capital BDC, on the volatility in late 2018 (March 2019)

> "Low interest rates, reductions in quantitative easing – it's creating a very bad environment for bonds"

Tod Trabocco, Cambridge Associates' managing director, on why private credit returned 10.3 percent for the year to 30 September 2018 and bonds posted a 1.37 percent loss (April 2019)

Year in review **The biggest US private debt stories reported by PDI over the past 12 months**

HPS agrees distressed debt acquisition

HPS Investment Partners agreed to buy Dallas-based distressed debt specialist Talamod Asset Management. The New York-based firm, which has more than $46 billion in assets under management, said it would absorb several key Talamod employees, including founder and managing member Andersen Fisher as a managing director. Kyle Mapes and Jay Steen, both of whom joined Talamod shortly after it was founded in 2008, joined HPS as executive directors.

Goldman Sachs reaches final close on senior debt fund

Goldman Sachs held a $4.4 billion final close on its latest senior debt fund, putting it among the largest 2019 closes so far. The New York-based investment bank closed Broad Street Senior Credit Partners II at $4.4 billion. The total comprises $1.75 billion in limited partner commitments and $2.65 billion of committed long-term leverage, according to Tom Connolly, global head of the private credit group. Goldman is the largest single investor in the fund, comprising 24.9 percent of LP commitments.

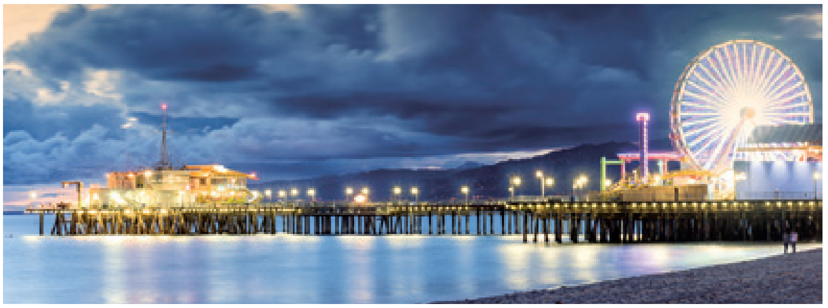
SEP 18 · OCT · NOV · DEC · JAN 19 · FEB · MAR

Kennedy Lewis hits $500m target on initial fund

Kennedy Lewis Investment Management closed its debut vehicle only a year after opening shop. The oversubscribed fund hit its $500 million capital raising target in November. It will invest in bespoke financing arrangements and special situations. KLIM said it was aiming for a 1.5x multiple on invested capital on each investment, and that it was agnostic across industry, geography and security type. The firm charges a management fee of up to 1.5 percent and 20 percent carried interest.

Brookfield agrees to buy Oaktree

Toronto-headquartered Brookfield Asset Management acquired a majority stake in fellow alternatives manager Oaktree Capital Management. An agreement between the two sees Brookfield, which closed its inaugural infrastructure debt fund early in 2018, take a 62 percent stake in Oaktree, which closed its own real estate debt vehicle on $2.1 billion last October. The deal creates one of the largest alternative asset managers in the world. Between them the two companies have assets under management of $475 billion and fee-related revenues of $2.5 billion.



Twin Brook pulls in record $2.75bn for latest direct lending fund

Twin Brook Capital Partners closed on $2.75 billion of equity commitments for its AG Direct Lending Fund III, exceeding its original target of $2 billion. The vehicle will focus on US lower mid-market companies with less than $25 million in EBITDA. Fund III is sector agnostic, though Twin Brook has expertise in healthcare, financial services, insurance and technology.

Clearlake rakes in $1.4bn for latest special situations fund

Santa Monica-based Clearlake Capital Group held a $1.4 billion final close of its latest distressed product, Clearlake Opportunities Partners II, surpassing its $1 billion target. The fund will lend to mid-market companies with an enterprise value between $200 million and $2 billion and is targeting a net IRR of 15 percent. The firm's core industries include technology-enabled services.

APR MAY JUN JUL

Ares closes on more than $1bn for latest distressed fund

Ares Management held an interim $1 billion close for its latest distressed product: Ares Special Opportunities Fund. The LA-based credit manager is targeting $2 billion for the fund, which seeks to invest in companies that are stressed or going through transitional change and need additional capital. The vehicle received a $70 million commitment from the Pennsylvania State Employees' Retirement System. This is the first distressed-focused fund launched since Ares hired Scott Graves from Oaktree Capital Management as head of distressed debt.

Owl Rock's direct lending fund shoots past $1bn target

New York-based Owl Rock Capital Partners beat its original $1 billion target to hold an interim close of more than $1.11 billion for its Owl Rock First Lien Fund. The fund is looking to lend to upper mid-market businesses with at least $75 million in EBITDA and plans to take an average position size of 1-2 percent of the fund in each company.

$46bn

Total AUM of HPS Investment Partners, which bought Talamod Asset Management

12

Number of months it took for Kennedy Lewis to reach a final close on its debut fund

62%

Stake Brookfield acquired in Oaktree

$4.4bn

Total raised by Broad Street Senior Credit Partners II

$2bn

Total target for Ares Special Opportunities Fund

$1bn

The now surpassed target of Owl Rock First Lien Fund

Editor's letter

What's the name of the credit cycle game?

Graeme Kerr
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A question for sport lovers: are we watching a cricket or baseball match? This slightly unlikely *PDI* poser cropped up at our latest US Roundtable when participants considered the age-old question of where exactly we are in the credit cycle. "We've been saying we're in the seventh inning for a while," said Randy Schwimmer, senior managing director at Churchill Asset Management, preferring the baseball scenario.

For Bill Brady of Paul Hastings, the action was slower-paced and prone to repeating itself: "For me this conversation is *Groundhog Day* over the past four or five years. I actually think we have to move from baseball now to cricket, which can go on for five days and end in a tie."

Laughter aside – and there were chuckles all round – both participants had a serious point. Whichever sporting metaphor you choose, the action has stalled somewhat. Yes, we are clearly close to the top of the credit cycle. Heightened competition, compressed terms and worryingly loose covenants all hint at a possible turn. But we've been here for a pretty long time, and the single biggest catalyst – a rise in interest rates – is no longer a threat. If anything, rates are likely to fall further.

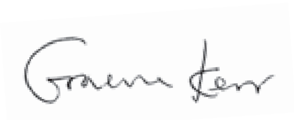
> **"We've been saying we're in the seventh inning for a while"**

And this game clearly has life left in it. As this supplement makes clear, for all the negative talk, opportunities abound, especially in the mid-market where there are anywhere between 200,000 and 300,000 companies in the US alone. Direct lending is attractive and there are appealing sectors – notably tech, with software-as-a-service one of the most promising industry verticals, according to Brent Humphries, president of AB Private Credit Investors.

The other heartening trend is new investors coming into the asset class across all regions, including Asia-Pacific. These newcomers are seeking yield and, according to Eric Lloyd of Barings, another Roundtable participant, private debt is a logical place for them to look for it.

So it's game on in what promises to be another pulsating year for US private debt.

Enjoy the supplement



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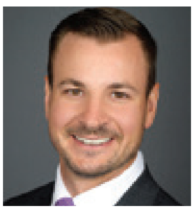

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KEYNOTE INTERVIEW

The middle market: past and present

Direct lending in the mid-market has changed over the past five years. As Twin Brook Capital Partners approaches a milestone anniversary, founder and managing partner Trevor Clark discusses the state of the industry and how it has evolved since 2014

Q Wasn't the middle market already very crowded in 2014? What inspired you to start Twin Brook?

Although Twin Brook was only founded five years ago, many members of our team have been in the industry for well over a decade. Prior to starting Twin Brook, I had been in the business for over 20 years and helped found Madison Capital, so I was able to bring that industry expertise and experience to Twin Brook.

We brought together a highly motivated, thoughtful group of leaders – all of whom were excited by and committed to executing on the opportunity we saw: to establish a reliable, consistent industry leader dedicated to serving the lower middle market. This was an opportunity specific to the part of the market that we target, and where many of us had operated for years.

SPONSOR

TWIN BROOK CAPITAL PARTNERS

While there were a number of established direct lenders in 2014, there were very few – particularly with our breadth of experience – that were exclusively focusing on the part of the middle market that we were. Many of these lenders, while in existence for a long time, had shifted their strategies to follow where the money was at a given time, floating from the lower middle market to the upper middle market, and sometimes even to the broadly syndicated loan market.

Unlike others, our strategy from the start – and one that we remain committed to today – was focused on sponsor-backed transactions in the middle market, which we define as companies with $3 million to $50 million in EBITDA, with an emphasis on those in the lower middle market – meaning with $25 million of EBITDA and below. Furthermore, in Angelo Gordon, we had the support of a parent company that understood this approach and shared our focus on building a long-term business.

Q Why was – and is – having a lender with experience, specifically in the lower middle market, so important?

There are a large number of companies in the lower middle market, and private equity firms that focus on this sector typically have a very active ownership style.

These sponsors are focused on ways to meaningfully transform these companies – whether that be through add-on acquisitions or projects to improve operations, professionalise management and staff, or enhance infrastructure – which often requires additional financing and ongoing lender interaction.

Because of this, they are looking for a lending partner with a long-term view – one that has a demonstrated ability to work alongside sponsors to grow portfolio companies, and who will be in the trenches with them handling any issues that may arise during this transformation process. Sponsors are also looking to partner with lenders who have a proven ability to manage through multiple credit cycles, particularly in their part of the market. When we started, and still today, there are few lenders that focus on this sector, have been through a full cycle in the space, and can provide the consistency, reliability and expertise we bring to bear.

Q Does that mean you consider experience one of your key differentiators and something you compete on?

Certainly. If you look at the landscape of direct lenders, it's difficult to find firms with leadership teams that have over 20 years of experience executing on the same strategy or focused on the same sector of the market – and this is especially true when it comes to the lower middle market. As a result, our breadth of experience and the length of time that many of our team members have worked in this segment differentiate us from many peers or managers in the broader space.

Q Some might say that deals across the middle market are all alike, regardless of whether they're in the upper or lower middle market. Do you dispute this idea?

Absolutely. The middle market is distinctly bifurcated, and there are clear differences between the upper segment – defined as companies with over $25 million of EBITDA – versus the lower segment – defined as companies with $25 million of EBITDA and below. The upper middle market tends to be more transactional and commoditised when it comes to lending. Sponsors in this market often seek the highest leverage, loosest terms and the lowest interest rate, regardless of a lender's experience. In the lower middle market, we see less of that. Many lower middle market sponsors place greater priority on the quality of their relationship with the lender, whom they've often worked with for many years, across multiple transactions with a variety of portfolio companies. These sponsors are not worried if a lender has a financial covenant because they have worked with them through both good times and bad, and both parties understand – based on previous experiences – how to resolve various credit issues.

> *"Lower middle market sponsors place greater priority on the quality of their relationship with the lender"*

> *"We may be seeing slightly fewer financial covenants – one or two instead of three or four – but we are avoiding transactions that are covenant-lite and covenant-wide"*

Q Although deals across the market aren't all the same, are there any types of companies or industries that are popular among lenders in a variety of segments?

Many direct lenders are generalists, so few firms focus on just one or a select handful of industries. With that said, healthcare and financial services are two spaces where we have closed a number of deals, and where we have seen significant interest across the broader industry.

Companies in these fields are particularly appealing to us because they are operating in highly regulated industries that require a level of expertise that resonates with the sponsor community. These borrowers provide a good example of characteristics we target in all of our borrowers, including business models with recurring revenue, as well as solid margins and limited needs when it comes to capex or working capital, allowing for high free cashflow.

Q Has the lower middle market experienced the same trends as the upper middle market, including a reduction in covenants and loosening documentation?

It would be a fallacy to say our documents look exactly the same as they did in 2014, but that's not to say all parts of the market behave the same way when it comes to lender protections. In the lower middle market, there are still the traditional lender protections that we believe are key to managing credit risk. We may be seeing slightly fewer financial covenants – one or two instead of three or four – but we are avoiding transactions that are covenant-lite and covenant-wide. Other sectors – including the upper middle market – have seen more significant shifts. In these sectors, pricing is more dynamic, lender protections have eroded dramatically, EBITDA definitions are highly problematic and covenants are far less frequent – all of which can affect the risk profile of assets.

Q Do you think there will be more covenant reductions and loosening of documentation among direct lenders as a whole? In the industry at large, are there any other trends or behaviours you have concerns about?

As mentioned before, we have definitely seen a shift away from covenants in other parts of the middle market, and I would not be surprised if the trend towards looser documentation continues in those segments. However, many of the managers abandoning covenants or not using lender protections have not lent in an environment where they needed them. These lenders typically were not in the market in the early to mid-2000s, as we navigated the global financial crisis, and may have never worked through a downturn. This is the crux of the issue, as you cannot truly understand the importance of something you've given up until you are put in a situation where you need it.

In particular, the number and size of EBITDA add-backs that market participants are being asked to accept – from both an acquisition and leverage perspective – has significantly evolved and certainly been a topic of much discussion in the upper middle market. For those lending based on enterprise value, this raises questions and concerns about how sustainable those values are in the long term. Again, in the lower middle market you are shielded from most of those issues, but we always thoroughly analyse the quality of a company's earnings and make sure we clearly understand how EBITDA is being defined, as it can impact the borrower's debt service coverage covenants.

Q Looking at other changes in the market, do you find that sponsors emphasise speed more than before?

Increasingly, sponsors want a lender that has the ability to compress the timeframe between first receiving a term sheet and closing a deal. We typically process a deal – start to finish – in approximately 60 to 90 days, but we have recently shown that we can compress that timeline down to as little as three weeks. Our team in Chicago currently includes over 60 people and we have access to Angelo Gordon's outstanding infrastructure, so we can bring forth the resources needed to get through due diligence both quickly and thoroughly.

Additionally, sponsors are getting better at knowing what information lenders need and getting it to them quickly. However, not every sponsor runs the same process, so having long-standing relationships with many private equity firms helps us come to understand how each individual sponsor's process works.

Q Beyond building sponsor relationships, what do you consider to be key growth drivers of Twin Brook? What are you doing to keep the firm healthy through the ups and downs of the coming years?

Since 2014, we've closed over 370 transactions, issued total commitments of approximately $10.4 billion, and built a stable platform with the wherewithal to survive economic cycles. There are a number of actions that have enabled this progress, though I believe two of the most important ones are the assembling of our world-class team and our commitment to the lower middle market.

From a risk management perspective, our team's extensive experience is critical when it comes to managing a downturn. By attracting, retaining, developing, and motivating a highly skilled team, we limit the impact of market cycles.

It is key to ensure that for each borrower in a lender's portfolio, there is a committed team with deep knowledge of the company, and that your people have the bandwidth to manage those credits.

At Twin Brook, the lead originator and underwriter on each deal stay with that borrower post-close, and individual underwriters are responsible for overseeing no more than five to seven borrowers. We believe that this underwriter-to-borrower ratio is one of the most compelling aspects of our ability to manage through a downturn. If distress or another issue presents itself during the life of a loan, additional resources and people are at the ready to be brought in. As a result, we believe that we have built a scalable, proven model that is well-positioned for the future. ■

"Sponsors want a lender that has the ability to compress the timeframe between first receiving a term sheet and closing a deal"

Founder and managing partner Trevor Clark is a member of Twin Brook's Investment and Executive Committees and has been responsible for overall operations of the firm since its inception in 2014. Previously, he was a co-founder and CEO of Madison Capital Funding, overseeing operational and strategic activities of the middle market lending operation, and held positions in loan underwriting and origination at Antares Capital, GE Capital and Bank of America

Beyond a downturn

Competition, compressed yields and loose terms all hint at a turn in the cycle, but there is opportunity amid the risk. Joe McGrath reports

Whether it's direct lending, mezzanine financing, M&A funding or non-sponsored loans, private debt has increasingly appealed to investors seeking more favourable returns than the record low yields on offer in their traditional hunting grounds. This demand has driven a surge of interest in the asset class in recent years and North America has been one of the largest regions to benefit. Private Debt Investor data show that around 36 percent of all private debt capital raised in 2018 was focused solely on the region.

Darius Mozaffarian, co-president at US investment manager White Oak, explains that interest in the asset class is not unique to any one investor type, and that his clients range from small pension funds to major insurance companies. "It's a very diverse mix," he says. "There continues to be a lot of demand for traditional direct lending, mainly to sponsored companies. This type of private credit has been around the longest and is what most investors are familiar with.

"Since the financial crisis, a majority of capital raised has been to support leveraged buyouts, which are largely private equity-sponsored transactions. After the crisis, more private credit firms focused on sponsored lending."

However, as more investors seek the same opportunities, many have widened their search for yield. This insatiable appetite for US private debt has led them to seek more direct lending opportunities. "We spend a lot of time educating investors on non-sponsored lending too," says Mozaffarian.

The broad range of interest in US private debt opportunities is perfectly illustrated by the size and range of fund closures throughout 2018, which spanned direct lending, mezzanine financing, distressed debt and special situations. Goldman Sachs closed the largest private debt fund last year with $9.9 billion raised for GS Mezzanine Partners VII in June, while GSO Capital Partners closed a $7.12 billion distressed debt fund in March. Both focus on the US as part of a multiregional strategy. Meanwhile, Kayne Senior Credit Fund III and Ares Senior Direct Lending Fund raised the largest North America-only funds, with each attracting $3 billion in commitments.

Despite the widespread enthusiasm for private debt, economists have recently questioned the health of the US economy, after the yield on 10-year treasuries dipped below that of shorter-term bills in May. Historically, economists have seen this inverting of the yield curve as an indicator of a potential recession, but this time is different, say fund managers.

"While we have seen the yield curve invert a couple of times, we have not yet begun to see any related cracks in our portfolio," says Ken Kencel, chief executive of Churchill Asset Management. "The question on everyone's mind continues to be: what innings are we in? How long will this stage of the US economic cycle last?"

Inflation concerns

Growing concerns about the threat of inflation have led to some investors urging the US Federal Reserve to slash interest rates.

"With the Fed's decision to hold rates steady against market expectations for one to two rate cuts this year, inflation is one of the biggest risks to markets," explains White Oak's Mozaffarian. "Should higher inflation come to bear, markets will be caught off guard and the Fed will have to be reactive and increase rates. A disruptive rate raising process will be negative for market sentiment and can introduce more volatility."

Mozaffarian warns that higher rates – whether from a Fed reaction to inflation or not – could also be problematic for companies with significant borrowing, especially to companies with highly levered balance sheets. Despite this, the Fed intends to maintain its course. In a speech to the Council on Foreign Relations in New York at the end of June, Federal Reserve chairman Jerome Powell defended the decision to hold rates steady. "Monetary policy should not over-react to any individual data point or short-term swing in sentiment," he said. "Doing so would risk adding even more uncertainty to the outlook."

Investors in US private debt are not just dealing with headwinds from domestic monetary policy, though. They must also contend with ever-growing levels of competition for good investments and the impact this is having on pricing – factors that are making the investments far less rewarding in relation to the associated risks.

"As dry powder has increased substantially, with fundraising continuing to trend upwards, competition for deals is high," explains Joanne Job, managing director and head of research at investment consultancy MJ Hudson Allenbridge. "Therefore, pricing has become tighter across the board. Yields are compressing, and leverage levels are increasing."

Job explains that the increased competition in the market has also led to an increase in the number of loan agreements with lower levels of lender protection.

"Covenants have become looser, with the level of 'cov-lite' debt in the US dramatically increasing," she says. "As such, credit quality is a risk, particularly as we near the end of the cycle."

Despite having to contend with these pressures, investors have continued to flock to private debt funds. *PDI* data show that the aggregate capital raised by North American-focused vehicles over the past three years totalled $81.6 billion. Although 2017 was the most active year, with $42.3 billion raised, 2018 was also strong, with funds raising $39.1 billion.

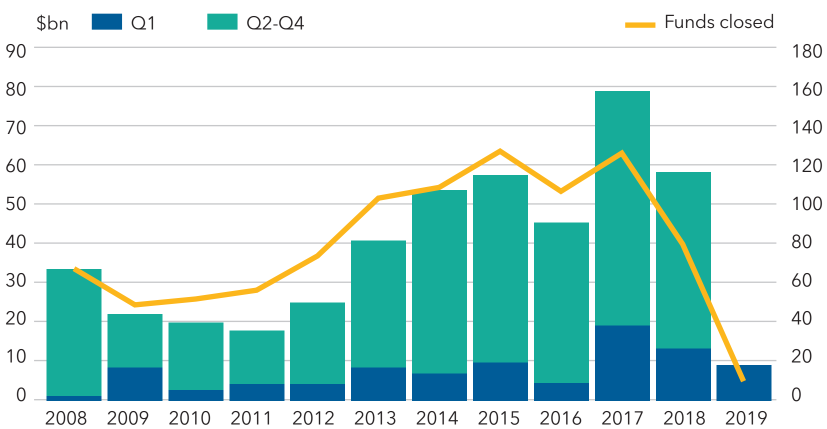
To put these figures in context, this compares with $22.7 billion raised over 2009, a total that has nearly been matched by the $20 billion raised in the first five months of 2019 alone.

Kencel is not surprised by the sustained interest in direct lending. "We believe investing in directly originated senior secured loans to private equity-backed traditional middle market companies – between $10 million to $50 million of EBITDA – provides an attractive risk/return opportunity for investors," he says.

"With our portfolio as a proxy, these as-

> *"These 185,000 middle market companies have interests and ambitions to grow their business. As a result, we said we need to expand our product base to include equipment financing and asset-based lending"*
>
> **DARIUS MOZAFFARIAN**
> **White Oak**

Two record-breaking fundraising years have left North America-focused funds with a lot of dry powder to deploy



Source: PDI

sets can offer yields in the 8 percent range, along with floating interest rates, reasonable leverage, solid loan-to-value and financial covenants."

Kencel's view of the asset class is echoed by others who have noticed the continued support for mid-market opportunities.

"A lot of investor capital has flown into the traditional middle market and is a large part of the market," explains MJ Hudson's Job. "Direct lending remains the largest sub-strategy by capital raised, but mezzanine funds have also increased in popularity."

Competition impact

Kencel, meanwhile, is expecting opportunities for directly originated mid-market senior secured loans to remain attractive in the coming months and years, notwithstanding the macroeconomic, fiscal and competition-related pressures.

"Everyone knows there will be an economic downturn at some point, and we believe senior middle market loans provide investors access to attractive yields from relatively conservative assets with inherent downside protection," he says.

"With record private equity capital fundraising and nearly $600 billion in expected refinancing activity over the next several years, the opportunities for directly originated middle market senior secured loans are expected to remain attractive for larger investment platforms that can access the highest quality investment opportunities.

"We also believe private equity is increasingly reliant on direct lending, as direct lending dry powder in North America is currently $70 billion – just 16 percent of buyout dry powder."

There is a logic to Kencel's assessment. After all, the majority of US-based mid-market businesses have revenue streams that are predominantly domestic-focused. S&P 500 companies, on the other hand, often have revenues split evenly between US and international sources.

Investment group White Oak agrees that the mid-market is where opportunities are likely to appear in the medium term, though its preferred approach differs slightly.

"What is the real need of middle market companies?" asks co-president Darius Mozaffarian. "Companies often need capital to acquire a competitor or to buy out a minority shareholder. These, we thought, are good candidates for term loans. Then, there are those looking to purchase new plant or machinery, and these are good candidates for equipment financing.

"The middle market in the US alone is anywhere between 200,000 to 300,000 companies. That is an enterprise value of between $50 million and $1.5 billion. That portion of the market in the US is the bread and butter of our GDP."

Mozaffarian says that of those 200,000-300,000 companies, only around 15,000 will have a private equity sponsor, and that this presents a different opportunity to investors: "These 185,000 middle market companies have interests and ambitions to grow their business. As a result, we said we need to expand our product base to include equipment financing and asset-based lending."

"While we have seen the yield curve invert a couple of times, we have not yet begun to see any related cracks in our portfolio"

KEN KENCEL
Churchill Asset Management

Hunting resilience

As investors become more focused on their preferred type of private debt exposure, they are also becoming more discerning in their choice of asset manager. Fund groups say they are being quizzed more often on the skills and capabilities of their staff, prior to being awarded mandates.

"Selecting the right manager is imperative," says Kencel. "Scaled direct origination platforms with strong relationships built over time have the best access to high quality dealflow and the ability to be the most selective."

He adds: "An experienced team with a strong track record of disciplined credit underwriting is of the utmost importance. To gauge this, look to managers that have already been through past economic cycles and performed well."

Mozaffarian agrees, saying that it is important for investors to understand the approach that a firm takes to underwriting and to ask the right questions in order to understand the experience within the core investment team. "A lot of us have sellside experience here and most of us come from more of a bank lending or a principal investing background," he says.

These skills may prove useful should economic conditions become more choppy in the months ahead. Experience from the sellside during the global financial crisis may certainly be useful should fund managers need to deal with defaults more frequently.

However, identifying the correct combination of skills within a company is tricky and investors will never truly be able to assess the relevance of a fund group's skills until those skills have been called upon. ■

EXPERT Q&A

Software and technology is one of the most promising growth sectors in the US direct lending market, with a shift to cloud computing helping support an attractive opportunity set, says Brent Humphries, president of AB Private Credit Investors

The risks and rewards of targeting tech

AB Private Credit Investors is the mid-market direct lending platform of AllianceBernstein, managing approximately $8.7 billion in investable capital and lending across first lien, unitranche, second lien, mezzanine debt, structured preferred stock and minority equity co-investments. With a focus on mid-size companies with an EBITDA of $5 million to $50 million and enterprise values of $75 million to $500 million or more, it recently launched a growth stage capital initiative to capitalise on opportunities outside of traditional sponsored direct lending.

Q How do you see the overall dynamics in US direct lending today?

The cycle has clearly extended longer than people expected, with the consensus now that growth is slowing in the US, although it remains in a strong position relative to most other developed economies. We have seen a significant inflow of capital into direct lending, leading to deterioration of underlying documentation terms and spreads.

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That said, while it is easy to quantify the supply of new capital coming into the market, it is harder to measure the supply that has left the market, particularly from banks de-emphasising mid-market lending. One factor that is often overlooked is the significant scale and fragmentation within the US middle market. Estimates peg the US middle market at $6 trillion in revenues, which would be the third largest global economy on a standalone basis, and upwards of 200,000 companies. While there are certainly a large number of lenders in the space, many focus on different channels such as sponsor versus non-sponsor, industry verticals and deal sizes. This has enabled platforms such as AB-PCI to still deploy capital prudently.

From a relative value perspective, I believe this remains one of the best places for investors to deploy capital. The private debt industry still generally targets net returns of 8-12 percent, which compares favourably to the public debt and equity markets on an absolute basis and is even more attractive on a risk-adjusted basis.

Q Where do you see opportunities outside the traditional sponsored direct lending space?

The market is more competitive and you need to be cautious and selective, but there are still areas to expand the opportunity set. One competitive edge we have observed is within our industry sector expertise, where we see software and technology as one of the most promising industry verticals. The software sector, including Software-as-a-Service (SaaS), stands out given both the significant amount of growth being witnessed in that sector and the demand for private capital.

There are a number of factors driving this, including the fact that technology is prevalent in all aspects of our daily lives. Venture-backed companies are also remaining private for much longer periods of time and regularly reach the size and scale to attract the interest of core PE buyout funds and direct lenders.

The shift to cloud computing is driving significant sector growth, and the SaaS business model is conducive to private debt because it can support meaningful levels of leverage given its predictable, recurring subscription-based revenue streams. This is an area where we are going to continue to see growth, both in core private equity-backed direct lending but also increasingly by expanding into the growth stage segment of the market by partnering with VC firms.

Q What is it about the growth stage segment that is particularly attractive at this point for private debt?

Growth stage for us typically means companies with annual recurring revenues in excess of $20 million and up to $100 million-plus, and enterprise values ranging from $100 million to $1 billion or more. So, growth stage does not mean early stage – these are not small companies. When we invest in growth stage companies, we look for companies with well-established products and strong competitive positioning. We are comfortable underwriting execution risk in the growth stage segment, but we do not take on significant technology risk.

From an underwriting perspective, this is a natural progression of what we do today in our core software private equity lending practice, where we have strong expertise evaluating SaaS business models.

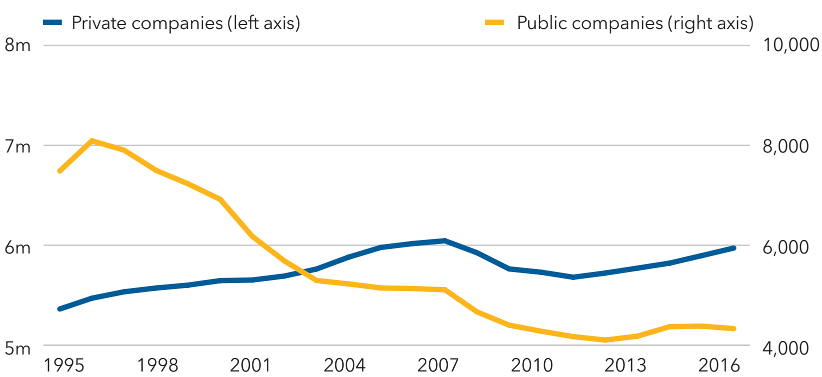
Away from debt capital, we also see a significant opportunity to co-invest alongside venture capital firms as they often need additional sources of later stage, pre-IPO equity for larger companies. Many times the VC firms want to broaden their investor base to support future capital raising rounds. Our ability to provide flexible growth capital across debt, hybrids and equity, as well as our scale, are viewed as value-added in this context. In addition, AllianceBernstein carries a strong reputation as a public investor in the technology sector at the IPO stage and beyond.

Q How do you mitigate risk in the high-growth segment of the technology sector?

We have been investing in software for a long time and believe we have significant expertise in the sector. Our focus is to drive attractive risk-adjusted returns for our investors by being selective on the opportunities we pursue. We can take a discerning approach to asset selection as we intend to deploy capital within the growth stage segment methodically, rather than simply trying to grow market share. Our focus on scaled businesses with established products and solutions, along with enterprise values typically of $100 million to $1 billion or more is another way that we mitigate risk. We view our approach in the growth stage segment as less risky compared to venture lending, for example.

We also focus on businesses with strong IP and differentiated technology, and we look at the lifetime value of a contract and a customer relative to the customer acquisition cost. We avoid businesses that are not generating good returns on investment from their sales and marketing spend. We also avoid businesses that exhibit concentration within their customer base or value chains.

The number of US private companies is growing as the number of public companies shrinks



Source: US Census Bureau, World Federation of Exchanges, Bank of America Merrill Lynch

Q A rush of capital is moving into this space. What mistakes are new entrants making and how can platforms differentiate themselves?

We are seeing increased interest in the sector, including from new entrants. Many of the newer competitors are deploying aggressive tactics to gain market share that may ultimately backfire. One major area of concern is lenders that do not place enough emphasis on ensuring a secured interest in IP. We believe that IP is very important, particularly when lending to software companies, but also in other markets. For example, we often see weak terms and structural protections that enable material IP to be held or transferred outside of the guarantor group, including instances where IP is located outside the US.

Another concern is around firms adopting a one-size-fits-all mentality when making recurring revenue loans. There is a need to size the debt quantum for SaaS businesses using multiple factors, including capital efficiency, the growth rate, profitability and stickiness of recurring revenue streams, in addition to loan-to-value and debt-to-recurring revenue multiples. Some new entrants consider all recurring revenue to be created equal, which it is not. Simply placing a multiple on recurring revenue without considering these other factors is not sound underwriting in our opinion.

Q Companies are staying private for longer. How do you see this impacting the future of capital markets and the evolution of LPs' overall investment behaviours?

It is true that venture-backed companies are staying private for longer periods and becoming larger in size. These companies are also motivated to raise additional cash on the balance sheet to fund growth initiatives or simply to provide a liquidity cushion. This creates additional demand from growth stage businesses for private capital, including private credit. Investor behaviour is also shifting as direct lending has become an established alternative investment segment and investors have become more comfortable with the tech sector in general. With the number of US public companies nearly cut in half over the last 25 years, it has become essential for investors to allocate an increasing amount to the private markets to gain exposure to the largest and fastest growing segments of the corporate economy. ■

The all-weather technology strategy

Lending into the IT and software space could generate robust returns, even in a downturn – provided you pick the right spots. David Turner reports

Zia Uddin, managing director and portfolio manager for private credit at Monroe Capital in Chicago, is enthusiastic about lending to the tech sector – but he backs this zeal up with hard data.

Monroe has financed more than 70 technology businesses in the US and Canada over its 15-year history. Uddin says that, along with healthcare, technology is the largest sector on its loan book. He particularly likes lending to software companies that serve businesses, a category known as enterprise software.

Advisory firm Gartner estimates that global IT spending will rise to $3.79 trillion in 2019, an increase of 1.1 percent on last year. Much of this growth will come from enterprise software, a market set to reach $427 billion this year, up 7.1 percent from $399 billion in 2018. Loan default rates among tech firms have historically been low: 2.2 percent since 1995, and under 0.5 percent for software, according to S&P LCD. "The default rate for enterprise software is low if you understand the space and the products," adds Uddin.

If anything, software's attractiveness to lenders has strengthened in recent years. This is partly because of the huge amount of private equity software deals, which present a wide range of direct lending opportunities.

Observers detect a useful shift from around 2010, when paying for software started to morph from the on-premise licence system of large upfront payments and lower maintenance payments, to the software-as-a-service model of regular payments every month, quarter or year, with software upgrades included. Finding good credits is not easy. One consideration is that the health of software companies depends, at least in part, on the health of the sectors they serve.

Buyer beware

Suhail Shaikh, head of US direct lending at Alcentra in New York, illustrates the point with a real-life example. In December 2018, Alcentra lent to a business that had created an online wedding services platform. "Weddings are generally recession-proof," he says. "Regardless of whether the economy is good or bad, people are going to spend money on them" – though some economists have attributed a decline in marriage among America's white working-class to a long-term dwindling of economic opportunities.

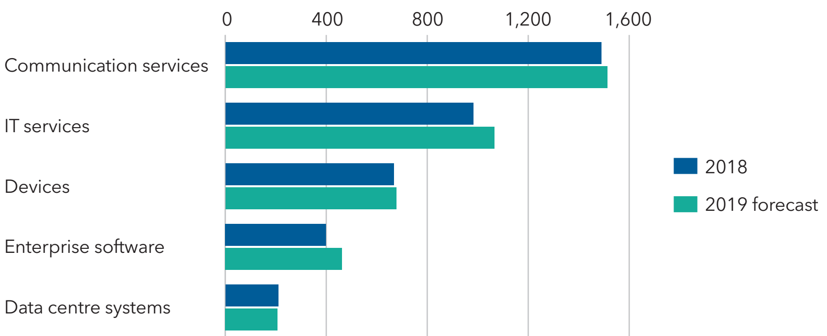
Shaikh adds that if Alcentra were asked to lend to a similar type of company that served real estate investors, "we would take a harder look at that, because the underlying market would be a lot more volatile".

On the other hand, lenders say technology companies are better protected and more attractive, even if they are serving cyclical industries or if their product is – as Monroe's Uddin puts it – "mission-critical". "You and I use Word, Excel and Outlook every day," says Uddin. "If our business dropped 50, 60 or 70 percent, we would still need that online storage software offering."

There is also a danger in being too positive about lending to technology companies. Matthew Linett, managing director and head of underwriting at Churchill Asset Management in New York, says a good software business could support leverage as high as 7x EBITDA, but it would have to be a "significant company" with the highest market share in its niche. For smaller software businesses "with otherwise attractive attributes", he suggests leverage of 5x or 6x.

Jeff Davis, co-head of private credit at Eaton Partners, a placement agent and advisory firm based in Rowayton, Connecticut, thinks the many funds dedicated to technology lending are not being sufficiently cautious: "These types of dedicated lender need to be careful to avoid becoming too comfortable with 'owning' their space, to the point where they issue too many covenant-lite leveraged loans, with too much flexibility in call protection, restricted payments and the definition of EBITDA."

Worldwide IT spending is predicted to grow 1.1% this year ($bn)



Source: Gartner

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EXPERT Q&A

As private credit continues to see substantial growth in AUM, as more products are launched to increase competition and as capital continues to concentrate around the largest GPs, Jess Larsen, partner and head of Americas at FIRSTavenue, says others must adjust for a tougher environment

Preparing for fundraising challenges

Q How do you see the current fundraising environment for private credit in the US?

Private credit continues to witness significant growth as an asset class, growing from $300 billion in assets under management a decade ago to $800 billion today, and it is expected to hit $1.4 trillion by 2023. As banks have retreated from the asset class, we have seen quality GPs coming into the space and raising new funds and products with new strategies, including many of the credit hedge funds and private equity firms pivoting into private debt.

There are currently about 400 private credit funds in the market fundraising, not counting pre-marketing, which is at a record high and is still projected to increase.

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Hence, the competition for LP capital is growing rapidly. At the same time, the LPs are favouring the larger GPs as LPs' private credit programmes are maturing and focusing on re-ups with the incumbent relationships.

In 2010, only a quarter of capital was going to the larger funds, whereas today more than half of the capital in the space is sitting with the 20 largest GPs. This means it is becoming progressively more challenging to start up new funds unless you already have a loyal LP backing that can anchor your new fund.

Q What challenges do GPs typically face when fundraising?

LPs have spent the last five or six years selecting which direct lending GPs they like to partner with, and therefore only a few new relationships are being added. These LPs have circa 400 GPs approaching them, yet there are only so many the LPs can conduct deep-dive due diligence on. In the end, they are likely to only invest with up to four GPs, of which two are most likely re-ups. This means it is highly unlikely they will enter into any more than two new relationships a year.

To further challenge the GP fundraising, the various high-profile pay-to-play scandals over the past decade have materially changed the way in which LPs and GPs interact. Old-school dinners, lunches and sporting events are no longer acceptable means of relationship-building and LP engagement.

Q How can GPs adapt their offering to the current fundraising environment?

There is a clear trend of GPs coming back to the market much sooner than they have historically done, which serves to increase the number of GP managers in the market and consequently adds to the competition. Furthermore, the GPs are finding that the standard practice of limited LP interactions between funds is no longer viable.

Instead, a successful GP needs to be in constant dialogue with its LPs and needs to track the success of the dialogue in between fundraises to ensure a strong re-up rate on the next fundraise. All of which forces a re-think and restructure of sales teams as a result of the drop-off in some of those relationship-building options.

It has long been typical to structure your sales teams according to personal LP relationships, an unscalable and inefficient structure for the new paradigm they are facing. The more sophisticated GPs implement structures according to either asset classes, LP types, geography, outsourcing or a combination of the above, to match the complexity of their products and the rapidly changing fundraising environment.

GPs are also finding themselves required to pay much closer attention to the terms and fees they are charging versus the competition. As an example, the difference between charging on committed as well as invested capital versus invested only, which the market is moving towards, can be immensely hampering in attracting capital from both existing and new LPs. The same applies to American versus European waterfall and fee skimming.

To avoid being met with "you are the 140th direct lender to call me this year and I am not sure how you are all different", GPs must spend significant time before launching fundraises to precisely and concisely articulate the differentiating factors of their strategy versus the competition. Fund positioning work can make or break a fundraise.

Q What are LPs focused on when it comes to US private debt investing right now? What does LP demand look like?

"The timeframe for acting on private credit co-investment opportunities is a real challenge for some LPs"

If you go back six or seven years, mezzanine was the dominant strategy in private credit, and that continued up to 2017, where mezzanine and other subordinated strategies like unitranche were very much in demand. In 2017, LPs became much more concerned about where we were in the credit cycle and they were looking to reduce risk, hence they pivoted more into senior secured strategies higher up the capital structure.

Now, in 2019, the concern about the credit cycle is only increasing and there is even more tension out there in the system. That is leading LPs towards increasing their exposure to strategies such as asset-backed lending, whether that is in real estate or infrastructure, and we are witnessing a real uptick in special situations and opportunistic credit.

We are also seeing sophisticated LPs looking very much at the less crowded space of mid-market strategies, with the large GPs operating in the large cap market.

We have been positively surprised about the North American LPs' appetite for non-US strategies, in particular European strategies. Though it is difficult to call how Brexit is going to play out, it is certain it will create volatility and opportunities. For that reason, we are seeing an uptick in demand for European special situations. We are also seeing more LPs looking towards Asia, albeit to a lesser extent.

Q With so much competition, how can GPs clearly position their funds?

With so many GPs fighting for the LPs' attention, the old 'spray and pray' model is no longer viable as a means of achieving the best LP hit rate. Instead, managers are building a better understanding and analysis of which are the most relevant LPs to approach. GPs need to do careful research and then differentiate their strategy so that the pre-qualified LPs can quickly and clearly understand their strengths.

Co-investment is a dominant dialogue for LPs at the moment, but in the credit space – even more so than private equity – the timeframe for acting on co-investment opportunities is a real challenge for some LPs. Private credit does not offer the same length of decision-making as private equity and this substantially shorter timeframe can pose real challenges for LPs that like to participate in co-investments.

A lot of GPs are therefore beginning to think about having the right LPs on board if they are going to offer co-investment, and more generally looking to build a mix of LPs by type, size, geography and so on. Not all LP dollars are necessarily created equal, and GPs need to consider the appropriate mix for their strategies and growth plans.

Going forward, the fundraising process needs to be as process-driven as the GP's investment process. At every stage, the fundraising process needs to be continuously analysed to secure a clear understanding of success drivers and momentum levers to drive the fundraise to a successful close. An institutionalisation of private credit GPs' fundraising efforts is now inevitable. ■

ROUNDTABLE

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The GFC: 10 years on

The mid-market continues to attract private debt investors as the Federal Reserve cuts interest rates. Could this provide more juice to the economy and fuel a red-hot deal market, or are we nearing the end of the credit cycle, Andrew Hedlund asks a panel of experts

Private credit is in a precarious position, as it has been for several years. No one is quite sure where the economy sits within the now decade-old economic expansion, and lenders do not know if, or when, permissive EBITDA definitions and loose covenants will come back to haunt them. The appetite for private debt among limited partners, many of which have jumped into the asset class, shows no sign of abating. So, where does that leave us? Six industry participants offered their views.

Q Let's start with the age-old question: where do you think we are in the credit cycle, and what could be the catalyst for a downturn?

Randy Schwimmer: We've been saying we're in the seventh inning for a while. Now with the Federal Reserve rate cut it appears we're in a rain delay, so this cycle could go on for a while. That eliminates higher rates as a catalyst for a downturn – at least for now – which leaves trade issues as the most visible market worry.

Scott Essex: We are very late in the cycle. This is the longest-running recovery in economic history in this country. I think the question is what will tip this cycle, which is really unknown. International tariffs and the exchange rate environment – those are external [global factors]. An internal [factor] is a growing dynamic between the politicisation of the Federal Reserve [by] the executive branch. That's concerning.

Bill Brady: For me this conversation is *Groundhog Day* over the past four or five years. I actually think we have to move from baseball now to cricket, which can go on for five days and end in a tie and which is a whole other conversation.

Q What are conditions like in the deal market?

Eric Lloyd: The competition is fierce. And it's not just leverage and pricing, but documentation terms and other things. In market conditions like the ones we're seeing now, the scale of a manager's platform really matters.

We think it's critical to have large, well-resourced teams in place to underwrite transactions, work through challenging situations and prudently manage portfolios. It's

PHOTOGRAPHY: **SALEM KRIEGER**

Randy Schwimmer
Senior managing director,
Churchill Asset Management

Schwimmer supervises origination and capital markets. His firm finances senior debt and unitranche facilities for private equity-backed companies. He is also the founder and publisher of private debt industry newsletter *The Lead Left*, which has 50,000 subscribers and to which *Private Debt Investor* is a contributor.

Eric Lloyd
Deputy head of global markets and head of global private fixed income, Barings; chief executive, Barings BDC

Lloyd is responsible for managing all private fixed-income strategies, including mid-market lending, infrastructure debt and asset-backed securities. His firm pursues various investment strategies, from senior debt through to equity co-investments, in companies that generally have between $5 million and $75 million of EBITDA.

Ira Kustin
Partner in the investment management practice, Paul Hastings

Kustin advises fund managers on a wide range of regulatory compliance matters and on secondary transactions. He works on all aspects of structuring, formation and closing of hedge funds, private equity funds and separately managed accounts. Kustin also negotiates platform agreements between private fund managers and placement agents or other similar institutions.

Andre Hakkak
Co-founder and chief executive,
White Oak Global Advisors

Hakkak's firm offers multiple credit strategies, including term loans, asset-based lending and factoring, and equipment lending. White Oak's senior secured debt investments range from $10 million-$500 million with hold sizes of $10 million-$150 million in mainly non-sponsored companies. His firm operates multiple industry verticals, including healthcare, transportation, materials and government.

Bill Brady
Partner and head of the alternative lender and private credit group, Paul Hastings

Brady provides counsel on closing initial transactions as well as restructurings. He advises private lenders on an array of healthy and distressed debt structures in multiple forms: unitranche, first lien, recapitalisations and refinancings, among other transactions. His practice spans the US, Europe, Asia and Latin America.

Scott Essex
Partner and head of private debt Americas, Partners Group

Essex sits on multiple investment committees and chairs the global direct debt investment committee. His firm lends across the capital structure from senior debt to mezzanine loans globally in an array of industries including information technology, healthcare, and business and financial services.

> *"There are a lot of 'smaller' changes to the terms in transaction documents that are happening. In isolation, these can all be rationalised, but in the aggregate, they become more concerning"*
>
> **ERIC LLOYD**
> **Barings**

also important to be able to provide capital solutions that are flexible and that meet the needs of sponsors and borrowers as market conditions evolve.

Andre Hakkak: We see some examples of loosening provisions in loan documentation. For example, the definition of EBITDA used to be very clear. Now, when you search for the legal definition of EBITDA within a loan and security agreement, the definition could be five paragraphs, maybe a whole page. Similarly, many companies today can add leverage on property, plant and equipment that's separate from just your cashflows.

BB: The key in approaching deals in a market like this is to be commercial and competitive, but with a laser focus on what will matter most in a workout or restructuring. It's important to focus on conditions [relating] to any leakage, by way of restricted payments or investments, on the borrower's ability to incur additional debt, whether it is junior debt or pari.

RS: Conditions remain very constructive. Yes, there are fundamental credit concerns, like higher leverage. Those are medium- or longer-term issues. They'll become real when the economy hits a bump or anything that creates hurdles for issuers trying to make pro forma adjustments work. Otherwise you're looking at a very different credit than what you signed up for.

AH: The other thing that one has to be thoughtful about is the cure period [on any defaults]. Assuming there are any sort of financial covenants and assuming that they can even be breached, the cure period has extended. There is so much money on the sideline, there's a lot of opportunity to provide protective advances to cure what seems like a one year-plus cure period for credits that may deteriorate over time.

SE: Despite the covenant-lite deal terms, there's something to be said for having a little bit of cushion allowing the sponsor, in our view, to work through their challenges without having to come to the table. However, when there's a payment default, it's a bigger problem.

Q What are the less-explored areas of concern in the deal market?

RS: Leakage, particularly with the debt incurrence baskets that allow the borrower to raise additional debt outside of the facility that you're focused on – that's a cause for concern. Leverage is debt over EBITDA.

> *"We believe that a lot of investors are leaning toward a non-sponsor approach because the reputation is that you're going to get more favourable terms"*
>
> **ANDRE HAKKAK**
> **White Oak Global Advisors**

"I think it's still pretty rare to guarantee co-investment opportunities to LPs outright"

IRA KUSTIN
Paul Hastings

If the EBITDA is squishy, thanks to adjustments, and you've got squishy debt, thanks to debt-incurrence, then leverage is squishy. It becomes a challenge to make a solid underwriting decision.

EL: There are a lot of 'smaller' changes to the terms in transaction documents that are happening. In isolation, these can all be rationalised, but in the aggregate, they become more concerning. When you start layering looser terms on top of looser terms, the risk can grow exponentially. For us, this means redoubling our efforts when it comes to credit underwriting and risk management.

BB: A hole that exists in a large part of the market is who can provide the new debt. A most-favoured nation clause keeps [an outside lender] from ratcheting up the rate, but often the MFN only applies to the incremental debt. A worst-case scenario, regardless of an MFN, is a situation where the company needs additional liquidity, which the sponsor provides in an incremental equivalent. The sponsor ratchets up the rate on their loan and they're getting cash-pay interest, which is like a recurring dividend over time but with pari treatment in an insolvency – while you are potentially watching the ice cube melt.

Q A lot of investors have got more familiar with private debt post-2008. Given that, what are the most common questions LPs are asking about the asset class?

Ira Kustin: One development I think is relatively new – and we'll see where it goes – is some high-net-worth 'platforms', sponsored by brand-name banks or brokers, starting to put together arrangements with private managers in the credit space to get access to sophisticated, high-net-worth individuals who qualify to invest in the funds.

AH: One thing that we've been known for in the marketplace is being more of a traditional lender [to non-private equity-backed companies] and less focused on the sponsored marketplace.

Given some of the topical headline points that were made earlier, we believe that a lot of investors are leaning toward a non-sponsor approach because the reputation is that you're going to get more favourable terms.

SE: I would add that what we hear – it's consistent with the diversity already mentioned – is that differentiation and lack of correlation to other traditional lending strategies. Sourcing of transactions certainly brings that differentiation – the ability to bring unique content – as well as relative value within the capital structure, [which] has always been an important element to selecting the right strategy within the private debt community.

RS: Unique or differentiated origination is critical, based on investors we speak with. Our scale and LP-GP relationships are extremely helpful to address that question. Also, being late in the cycle, it's common to hear the question, "What's your workout experience?" Fortunately, our team has worked through a cycle or two. And after that, the most common question investors ask is, "How quickly can you put money to work?"

IK: One other trend I'm seeing develop is investors coming to a manager and saying, "I know this product is intended to focus on X, Y and Z market segments. I'd like to commit solely to a subset that will focus just on X. Or I'll participate in the overall vehicle's full strategy up to some percentage of my capital commitment, with the remaining percentage allocated solely to the narrower strategy."

"The key in approaching deals in a market like this is to be commercial and competitive, but with a laser focus on what will matter most in a workout or restructuring"

BILL BRADY
Paul Hastings

Q How often has co-investing been coming up with LPs? It's growing pretty quickly in the private equity asset class, but have you guys noticed any significant growth in private debt?

SE: It's been a conversation for many years. There's a desire to do co-investments, and it often is determined by the size of the team that has the willingness to do a co-investment and the size of their capital pool. Probably the most important element is meeting transaction timelines. Often, deals have fairly quick timetables for underwriting [and] completing diligence, and the ability to transact can be a hurdle at times.

IK: I would say managers often are willing to give significant investors not a promise of co-investment opportunities, but at least a willingness to offer them up if the terms, timing and certain other factors are appropriate. But I think it's still pretty rare to guarantee co-investment opportunities to LPs outright.

Q What are some of the issues that are unique to private debt in terms of fund fees and expenses?

IK: Expense reimbursement is an area where this investment strategy is treated slightly differently than others. For example, this might include an affiliate that specialises in workouts or restructurings and can provide these services to an affiliated fund or account more efficiently than an unrelated third party.

It may make sense for the credit manager to charge those expenses to the fund, whereas in a private equity fund that would be subject to a management fee offset. Those are things that just have to be disclosed clearly.

Q Has LP demand for the asset class been softening, or has it remained relatively robust?

EL: At Barings, we've been fortunate to see continued support from our existing investor base. We've also seen new investors coming into the asset class across all regions, including the US, Europe and Asia-Pacific. And while I think there's some merit to the argument that most of the investors who are going to invest in private debt are already there, I'd also keep in mind that the longer this low-yield, low-rate environment persists, the more investors ultimately need to find some form of yield.

And, we believe private debt is a logical place to look for that.

RS: Our investors show no signs of slowing in terms of continued interest in investing in the asset class. There remains, though, a continued need to educate them on the nuances of private credit.

The term encompasses a variety of strategies with different risk-return parameters. It's like a big circus tent. There are a lot of acts going on under that tent. You have to understand whether you're with the lion tamers, the clowns or the jugglers.

SE: We've seen increased appetite for programmes that bring not only diversity from a capital structure risk perspective and geography, but also the types of content. That would include real asset-based [debt], and therefore infrastructure and real estate [credit] coming into the same pool as corporate loans. That has been something that we've been able to raise capital for across the world.

AH: Overall, the demand for private debt globally remains robust, especially for managers who can offer differentiated strategies. However, each conversation can be more nuanced. For example, a recent LP told us, "[We're at the] top of the cycle, I'm going to slow down private debt [allocations]."

"Our investors show no signs of slowing in terms of continued interest in investing in the asset class"

RANDY SCHWIMMER
Churchill Asset Management

"The most important element is meeting transaction timelines"

SCOTT ESSEX
Partners Group

But in the same conversation, we hear they are adding to private equity. Why is that? If investors are worried that we are at the top of the cycle, we wonder why they would want to go lower in the capital structure by investing in equity.

Q What's the best way to tackle a restructuring scenario?

BB: I think the number one mistake that I see made in some of these workouts is lenders being reactive instead of proactive and failing to get out in front of things. You can be proactive without being necessarily aggressive. You can be proactive externally if the relationship calls for it. You can be proactive internally [also] so you're ready if things take a turn for the worst.

AH: It's a delicate balance when a sponsor is involved. In the non-sponsored space, timing is everything – the earlier a team comes in to evaluate the business and come up with a plan of action, the better.

EL: Each one is so unique. You may have one interaction with a sponsor on a deal where you're the sole lender. They may say, "OK, now you're the agent on the next deal, we know how you're going to interact." And you may respond, "Well, not really." Because there might be four or five other firms involved in those deals. ■

EXPERT Q&A

Whether it is high leverage levels or covenant-lite loans, there are plenty of issues weighing on fund managers' minds, say Kevin Griffin, CEO and CIO, and Greg Racz, president, of MGG Investment Group

What should keep credit investors up at night?

Q What's up with the corporate leveraged loan market?

The two headline points are that covenant-lite loans are eating the world (in Europe, 95 percent of levered loans are cov-lite, according to JPMorgan Asset Management, and 80 percent in the US) and the leverage in those loans is very high. Indeed, real leverage based off a borrower's actual EBITDA is even higher. This is due in part to the massive EBITDA addbacks that are now common in the private equity sponsor and broadly syndicated market. Such addbacks boost EBITDA as borrowers and lenders agree to give credit to future proposed cost savings that may, or may not, ever happen.

One example recently sported 5.2x debt/EBITDA with addbacks, but more than seven times without. That kind of nose-bleed leverage typically is a non-starter for us.

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Such high leverage is also one reason PE borrowers have a 50 percent higher default rate. There is a saying: little kids, little problems; big kids, bigger problems – it's the same with leverage.

Q Anything even crazier happening?

Yes, sometimes it feels like *The Twilight Zone*. The crazier things get, the more you think they can't get any crazier. Then something even more bizarre occurs.

First, rather than giving lenders thin reports quarterly, some PE and BSL borrowers now try to provide reports only every 120 days. We call this 'info-lite'. In contrast, in the non-sponsor market, we generally receive much more detailed reports monthly.

Second, PE sponsors are often able to move assets into unrestricted subsidiaries away from lenders. This is so-called 'collateral-lite'. Third, PE sponsors are sometimes now able to eliminate the right of lenders to speak with borrower management. This we call 'access-lite'. For borrowers, this is great. For lenders, not so much.

Q When is the downturn coming?

As baseball legend and coach Yogi Berra once said: "It's tough to make predictions, especially about the future." Rather than try to time the downturn, instead we try to put ourselves in a good place to excel and take advantage of a downturn by having a portfolio of defensive businesses and assets with low leverage, senior secured first lien with a lot of covenants. Plus, you need real workout expertise, through prior cycles, with proven success minimising losses.

Q What should investors worry about in this environment?

Credit investors are paid to worry about the downside. So, in addition to the longest US expansion on record, we worry about lots of things: from how resilient is the borrower's business in a downturn, to leverage levels (nearing record highs in market deals, which we seek to avoid) to covenants (largely absent in PE sponsor and broadly syndicated loans) as just mentioned. Another risk, albeit rare and hopefully never an issue, is fraud, which luckily we have not had.

Q How can an investor mitigate the risk of fraud?

It is not easy, of course. Those who commit fraud are often skilled at hiding it. But experience teaches the keys are 'don't trust' and 'independently verify'. We try to do a few things to mitigate the risk: first, we typically hire our own independent forensic accountants to conduct an independent audit and quality of earnings review; second, we run detailed background and reference checks; and third, we do our own in-depth research and diligence.

One reason we prefer non-sponsored lending is we can do all of the above. In contrast, when dealing with PE sponsors and/or bank-led broadly syndicated loans, the PE firm and syndicating bank don't want the lender doing independent diligence or having a direct open and ongoing dialogue with management either before or after the loan closes.

Q Have you ever spotted fraud?

Yes. During diligence in one deal a couple of years ago we identified varied orange to red (to blazing red) flags: signatures on documents that did not look real; alleged currency hedging that both made no sense and was allegedly being done for the company by a PE firm; people whose identities we could not confirm either in person or online; information that was unavailable because of "secret military national security" concerns. Both we – and our long-time seasoned outside counsel – sensed something was not right. We told the potential borrower we were pencils down until he resolved our concerns. We never heard from him again. Then months later the FBI called saying they had arrested him for fraud against a Texas bank.

"PE sponsors are sometimes now able to eliminate the right of lenders to speak with borrower management. This we call 'access-lite'. For borrowers this is great. For lenders, not so much"

"The crazier things get, the more you think they can't get any crazier. Then something even more bizarre occurs"

Q Do you worry about changes in regulation?

Changes in regulation in specific industries tend to create more opportunities than not. As to the banking regulatory landscape: the 35-year massive consolidation in the US banking system (during which roughly 10,000 of the 11,000 small banks in the US have disappeared) has resulted in a structural opportunity unlikely to change for a material amount of time, if ever. New bank starts have plunged post-crisis and are all but non-existent. Online lending has increased, but our size borrowers can't typically find our size loans online and, more importantly, would not want to borrow online. This is because in the event of a covenant breach or default, it is much easier to negotiate with a lender like us who is a seasoned lender and can work things out with the borrower based on decades of workout experience.

Q How do you think about changes in interest rates?

Our loans typically have floating interest rates with LIBOR floors. If interest rates go down, we are protected by the floor. If rates rise, our businesses, which are on average only 3x or so levered, should be able to pay the added interest without much hardship. In contrast, the much more highly levered loans common with PE borrowers or the broadly syndicated levered loan market could eventually feel real pain in the event that interest rates go up materially.

Q Anything else you worry about?

One thing we think a lot about is technology and disruption risk. We try to avoid sectors that are ripe for disruption. We actually like businesses that are benefiting from favourable technology trends such as our NHL team borrower (live sport is one of the few things people will watch and sit through commercials for, and is one reason sports teams have seen significantly rising valuations) or our airport concessions loan (longer security times force travellers to spend more time, and therefore more money, in airports). Then to turn things on their head we also like things that are in areas being disrupted or are out of favour but where we feel the leverage is low enough and/or the risk is materially mispriced, so the safety is a lot higher than others realise. ■

Cross-border financing enters uncharted territory

European borrowers wanting generous underwriting terms used to venture across the Atlantic. But after almost a decade, they're looking much closer to home, writes Joe McGrath

In the immediate aftermath of the Global Financial Crisis, Europe-based firms looking to make acquisitions found their financing options heavily restricted as banks retreated from multiple areas of lending. With limited liquidity in their home markets, borrowers started looking across the Atlantic for alternatives. Their curiosity was rewarded.

Borrowers discovered the US Term Loan B market was a suitable alternative to their sadly lacking European funding sources, with cross-border syndicated loans available on favourable terms from a deep pool of institutional investors. From modest beginnings, US cross-border issuances flourished and by 2017, cross-border loans issued from the US Term Loan B market totalled $68 billion, according to data from S&P Global's *LCD Global Review*.

"Whether you are playing in the largest EBITDA space, the higher middle market, or the lower mid-market, there are very efficient alternatives for financing," Ted Koenig president and chief executive at Monroe Capital, tells *Private Debt Investor*. "Historically, there were limited efficient financing options in Europe or elsewhere, so transactions had tended to be financed out of the US."

European challenge

In Europe, the market had been traditionally dominated by major banking institutions, but with an absence of funding sources in the aftermath of the financial crisis, specialist asset management groups and institutional investors recognised an opportunity. Very quickly, a market there developed too.

Figures from S&P Global show European cross-border issuance totalled $22 billion in 2016, climbing to $42 billion by 2017 and nudging up slightly more in 2018 to $43 billion.

The trajectory for US issuers, however, has not mirrored this trend. In 2018, US issuers saw cross-border loan issuances fall to $61 billion, $7 billion down on the previous year.

"The market has gotten so efficient," says Koenig. "Whether in the Netherlands, the UK, or Italy, there are greater numbers of financing sources in local jurisdictions.

"Today, there are probably two dozen financing sources, asset management firms or financial institutions that could easily do a financing transaction in Europe of up to €350 million."

> *"Historically, there were limited efficient financing options in Europe or elsewhere, so transactions had tended to be financed out of the US"*
>
> **TED KOENIG**
> **Monroe Capital**

Another of the attractive qualities of the US-issued market was that borrowers were traditionally able to secure loans with more relaxed underwriting terms than they would have been able to in Europe. However, since 2017, the prevalence of covenant-lite deals in the US market has been widely reflected by European issuers.

A November 2018 report by Dechert, *Financing the Economy*, looked at all types of private credit issuances over the previous 12 months. It concluded 32 percent of capital committed had been from North American investors, with 31 percent coming from European issuers.

Unnecessary effort

Many US managers, however, have been content to focus on their domestic market, which has been very strong. As a result, most have been unfazed by the growing queue of challengers in Europe from lenders such as BlueBay Asset Management, Intermediate Capital Group or Pemberton Capital.

"If the market wasn't as strong here in the US, you would see more asset management firms looking at other places," Koenig explains. "The US has been very active over the past five years in terms of transaction volumes. There has been enough for the asset managers to stay focused at home."

Other industry experts offer a different explanation for US managers' reluctance to be more active in Europe. The UK's decision to leave the EU may have led some US managers to pause plans for new outposts in Europe until the political climate has calmed, according to Matthew Poxon, a partner at law firm Paul Hastings.

"There has been a pause in establishing any new legal entities or corporate structures while the European political turmoil plays out," he says. "Those with existing legal entities and corporate structures have been actively exploring whether or not they need to reorganise and or relocate them, and some have implemented such reorganisations already."

But for those US managers already established in Europe, there is still a healthy appetite to finance European deals, according to Poxon.

"We are seeing the highest amount of interest directed towards businesses that are less exposed to the risks of local market volatility," he says.

The road ahead

Regulation, the global macroeconomic picture and the availability of accommodating underwriting terms will all play a part in whether European investors continue to embrace their domestic market rather than venture across the Atlantic.

For European non-bank lenders, however, the signs are good. Basel III is likely to dampen the appetites of banks for any significant expansion into this market, given that the regulation means it is more expensive for them to hold these loans on their balance sheets. For European insurers and investment managers looking for alternative sources of returns in the now clichéd 'low-yield environment', private debt is a no-brainer.

In the US, managers have been enjoying the benefits of artificial stimulation from the Federal Reserve and just before publication, another rate cut was implemented. Any future withdrawal of this stimulation could trigger a negative reaction.

At the same time, the US is about to enter an election year, which could see US managers' home market become more volatile.

"In the latter part of the year I think there could be a tremendous amount of volatility surrounding the elections," says Koenig.

"It is possible that the pace of transactions and the amount of activity could slow. You could have performance issues or tax changes. There have been a number of transaction-friendly regulations introduced over the past two years. If the market changes, some of those provisions put in place could evaporate and that could lead to a substantial slowdown."

Should any of these scenarios play out, it is entirely possible that lending strategies may change and cross-border activity may be deemed to be more attractive to US managers again.

"To date, there has been enough activity so much of the US based managers haven't had to reach very far," adds Koenig. "[But] we are about to go through a challenging period, we are going to have some currency skirmishes and we are going to be in uncharted territory." ■

EXPERT COMMENTARY

Asking a few simple questions can reveal the essentials of a manager's leverage strategy and its ability to protect investors' interests, writes NXT Capital's Neil Rudd

Looking under the hood of fund-level leverage

Investors considering a new fund always investigate its risk and return characteristics, the manager's track record, deal sourcing and underwriting processes, and reporting and controls.

For levered funds, investors also evaluate the nature, use and terms of the fund-level financing.

Or do they? When it comes to levered funds, these factors tend to take a back seat to the maximum leverage outlined in the placement memo. Considering this 'sticker', leverage is certainly one important measure of risk, but it doesn't tell the whole story. Fund leverage deserves a closer look under the hood.

There are various forms of fund-level leverage and no single right way to use them. Each approach offers benefits, but also has inherent potential risks that investors should understand.

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Starting with the basics

There are two primary forms of fund-level leverage: asset-backed credit facilities and subscription facilities. Each is secured by different collateral and is often used for different purposes. Today, a levered fund is likely to include both long-term subscription and asset-backed facilities.

Asset-backed credit facilities These are secured by a fund's loans. Borrowing availability increases over time, generally in lockstep with the size of the investment portfolio.

There are two common types of asset-backed credit facilities that have some important differences:

Approval rights The credit facility agent reviews and approves each loan's eligibility as collateral. Once eligibility has been determined, the agent assigns it an advance rate based on the underlying risk, which is typically measured by leverage and debt service coverage. The agent retains the right to alter the advance rate as these metrics change over time.

Approval rights facilities have fewer and more generous portfolio-level tests – for example, high concentration limits – which can give managers added flexibility in constructing a portfolio. The ability to work with the agent can also be beneficial if loan-level performance declines, allowing the agent to consider all relevant facts and adjust advance rates as the loan is rehabilitated.

As added protection, the facilities typically have loan-level performance measures that must be triggered before the advance rate can be reduced, rather than changes in the broader credit markets.

When considering a fund that uses approval rights leverage, it's a good idea to investigate the length and nature of the manager's relationship with the agent, and request details on historical approval rates and the nature of advance rate reductions.

Non-approval rights These facilities operate similarly to a CLO. A manager can contribute a loan to the pool at a defined advance rate if the loan meets specific characteristics. The pool of loans must also satisfy certain additional concentration tests and other collateral quality tests to obtain a full advance. These facilities can offer greater certainty, but they may also present obstacles to making investments or optimising leverage if they don't 'fit the box'. Similarly, if a loan runs into difficulty, reductions in advance rates or eligibility tend to be hard-baked and may not allow for consideration of additional facts.

Subscription facilities Subscription facilities are secured by the fund's equity capital commitments and are generally less expensive than asset-backed credit facilities. They are most helpful early in a fund's life when uncalled commitments are substantial, because the size of a subscription facility decreases as capital is called.

Today, many managers maintain a subscription facility to finance the portfolio's initial ramp, as it provides a lower borrowing cost and more immediate access to debt than an asset-backed facility. Once a larger diversified portfolio has been built and the amount of uncalled capital has declined, these loans are then rolled into an asset-backed facility.

As long as there is uncalled capital, managers often retain a subscription facility to avoid the time-consuming process of calling capital for short-term expenses or funding loans. Having a subscription facility available also reduces the need to maintain a large liquidity cushion, which could otherwise depress fund returns.

Recent press has put subscription facilities under the spotlight due to occasional abuses. Investors should definitely talk to a prospective manager about a fund's fee structure and the impact of the planned use of a subscription facility on manager fees or carried interest.

> *"There are various forms of fund-level leverage, and no single right way to use them"*

Understanding a fund's leverage strategy

Fund-level leverage facilities can seem complex, but by asking a few of the right questions, investors can quickly come to grips with the most important elements.

What fund-level leverage are you planning to use? Why is that facility best suited to the fund? What is your experience managing this type of facility? These questions may seem obvious, but in our experience, investors do not always ask them. Without this information, it's challenging to establish a full picture of a fund's potential risks and a manager's ability to mitigate those risks.

If more than one lender is required to round out the facility, what is your syndication strategy? Fund managers need to balance the certainty of having credit available with the costs of assuming debt before it is needed.

Taking down debt on a real-time basis reduces costs and optimises returns, yet also creates the risk that lenders may be reluctant to provide expanded capacity when needed due to a shift in the cycle or other institutional reasons. Credit terms may also be less favourable than those available today. This can constrain a fund's capacity and leverage, and thus, its returns.

It's helpful to ask a manager about the size of its bank group, the quality of relationships with these lenders and whether they have established exposure limits for the manager that may come into play.

How will you avoid hitting a 'maturity wall'? A fund life of six years or longer is not uncommon, but most banks will not provide a credit facility for more than five years. In addition, managers may choose less expensive short-term financing with the intention of extending it throughout the fund life.

If the market changes materially, a lender may be unwilling to extend the financing and require the manager to accelerate amortisation or pay off the credit facility. This may reduce or even shut off cash flow to investors, force asset sales or require additional capital calls to avoid a payment default. A discussion with the manager can help investors understand how it intends to mitigate the risk of a maturity wall and balance the fund life with the financing time horizon.

What systems and controls do you use to track and fulfil the facility's requirements? These facilities are complicated instruments with substantial compliance and reporting provisions. Many credit facilities require notification every time loans trigger certain credit thresholds (specified increases in leverage, for instance).

Financial reports and portfolio models are usually submitted every quarter. The facility may also require financial covenant certifications, all of which must be tracked and delivered in a timely manner.

Inadvertently failing to meet these requirements can trigger liability or even escalate to default. The risk may be higher for managers that have not operated levered funds in the past and have not built the infrastructure to manage the requirements, or for a manager that is working with a new lender that may have different processes.

Look under the hood

Each form of fund-level leverage offers benefits and risks. Asking questions about a manager's leverage strategy and ability to execute it effectively should become a standard part of investor due diligence. Looking under the hood to understand fund-level leverage is a prudent step in making fully informed decisions about levered funds and their potential returns. ■

Neil Rudd is chief operating officer at NXT Capital. He oversees NXT Capital's asset management platform and leads the company's strategy and corporate development effort, focusing on accelerating product development initiatives, M&A, strategic planning and expanding connectivity with other ORIX businesses

The best bet in your backyard

Relatively insulated from global trade volatility, the US business services sector is attractive to domestic lenders, finds David Turner

Direct lenders express enthusiasm about lending to business services companies at any point in the cycle.

"In the US market, business services is certainly in the top tier of those sectors offering the most attractive opportunities," says Suhail Shaikh, head of US direct lending at Alcentra in New York. "Businesses often have high cashflow, and revenues that are contractual and sticky – this creates a lot more visibility than for a discretionary consumer or industrial company, where revenue must be earned from scratch every day."

This high "visibility" means higher leverage. "In business services we see lenders extending leverage well above 6x, because of the visibility of cashflow and the stickiness of revenue," says Shaikh. By contrast, "for manufacturing and more cyclical businesses, we generally see lenders accepting one or two turns less of leverage". He says this rule of thumb is Alcentra's general practice too.

But business services companies also look particularly good in 2019, relative to other potential borrowers. Lenders note that the sector is less exposed to the vagaries of global trade, which tends to rise and fall faster than GDP in the US. This consideration is particularly important in the context of the trade wars Washington has been fighting on several fronts.

"Business services tend to be more domestically focused and a little more insulated, so you see a little less volatility," says Shaikh. Lenders also see many US-based business services companies as less sensitive to the domestic economic cycle – an important consideration when observers are wondering how much longer the country's record bout of uninterrupted growth can last.

Service risk

Timothy Conway, head of private credit at First Eagle Investment Management in New York, is not a doom-monger. He agrees that business services looks less risky than other sectors, such as manufacturing, and he expects it to remain his own firm's largest focus for direct lending this year. However, he sounds a note of caution. "If you have less business risk, in an efficient market you have higher financial risk," he says. "I see pretty aggressive leverage for some deals in business services." First Eagle is a conservative financier, lending on average at about 4.5x EBITDA for business services – a metric Conway says is "a little higher than for some other sectors".

"If you have less business risk, in an efficient market you have higher financial risk. I see pretty aggressive leverage for some deals in business services"

TIMOTHY CONWAY
First Eagle Investment Management

Within business services, Matthew Linett, managing director and head of underwriting at Churchill Asset Management in New York, likes distribution companies that provide products, such as parts to factories. "These companies are very attractive to us because they generally don't require a lot of capex or heavy working capital, so they present good free cashflow profiles," he says.

Agricultural services is also favoured by many lenders and has even spawned its own specialist funds. Jeff Davis, co-head of private credit at Eaton Partners, a placement agent and advisory firm based in Rowayton, Connecticut, says: "As with other business services, the presence of tangible collateral is attractive to an agriculture lender: land, industrial plants and equipment, receivables, and the commodity itself."

Zia Uddin, partner in private credit at Monroe Capital in Chicago, says his firm likes tech-enabled business services. He argues that because of their role in making companies more productive and efficient, they are resistant to the economic cycle.

He adds that these services are often also less commoditised, and that the companies that provide them are therefore in a stronger competitive position than business services firms that rely more on unskilled labour. He notes that the growing cybersecurity sector is attractive, while physical security – based largely on security guards – is less so. ■

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EXPERT Q&A

The growing size and complexity of the private debt market requires ever more responsive administrative systems to meet investors' and regulators' demands, say Maximilien Dambax and Tom Gandolfo of Alter Domus

Servicing a growing market through technology

With the acquisition of Cortland Capital Markets Services in 2018, Luxembourg-based fund and corporate services firm Alter Domus cemented its global capability to provide administration and compliance for private debt managers. In this increasingly complex space, characterised by global and regional investment structures, there is a need for greater transparency with regard to investors and regulators. Maximilien Dambax, Alter Domus's head of fund services, North America, and Tom Gandolfo, the firm's head of sales, North America, explain how outsourcing to a partner with scale, expertise and cutting-edge technology can help fund and investment managers meet the challenges.

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Q How has the acquisition of Cortland Capital Market Services transformed Alter Domus's debt fund administration business in the US?

Maximilien Dambax: It has been a real game changer. From a successful but concentrated geographic reach in Europe, we expanded our footprint in North America, the deepest and most mature market with half of all private debt activity globally. More important is the service, people, expertise and technology we now have. We can provide a fully integrated suite of services from middle office through to back office. We do this not only at the portfolio level, but across multiple investment vehicles covering commingled funds, joint ventures and separately managed accounts, including business development companies and collateralised loan obligations.

Tom Gandolfo: Alter Domus gained a tremendous franchise dedicated to alternative investments. Cortland is one of the few fund administrators that really has an end-to-end solution which can support the private debt community through services like administrative agency, trade settlement, CLO services and fund accounting. When you combine that with the capability to service each level of the structure – at the holding company, special-purpose vehicle, fund and asset levels – we think that's a unique offering in the market today.

Q What other benefits does it bring?

TG: We have 40 locations worldwide, so that ability to provide a global one-stop shop is a big value-add for our existing clients in the US, especially as Luxembourg is such an attractive jurisdiction for fund formations. About half of Alter Domus's client base was headquartered in the US pre-acquisition, and we can now support them at the local level as well.

MD: It's a two-way street. For example, US-based managers can tap into our Alternative Investment Fund Managers Directive solution in Europe – either by working with us on the full set-up of their own AIFM or through an outsourcing arrangement with different hybrid solutions. On the other hand, our European clients now have access to a very strong and experienced team of credit and capital markets practitioners in the US, many of whom have been through multiple credit cycles.

Q How is the increasing scale of US private debt markets changing the playing field for managers and investors?

TG: The private credit market is expected to top $1 trillion of assets. With increasing investor appetite, a lot of managers are moving into credit from other asset classes, notably private equity and real estate. These managers realise that their infrastructure is going to have to adapt, which has led more of them to consider outsourcing solutions for reporting and administrative functions. This allows them to focus on the business of capital raising and investment management.

MD: In addition to the infrastructure requirements, there is the catalyst of the credit cycle on special events like workouts or restructurings. These scenarios require a proper technology platform to capture data and process it, as well as dedicated and specialised turnaround and restructuring teams. The US has a little way to go to catch up with Europe on the outsourcing trend, but it is accelerating.

Q What demands are investors placing on fund managers, and how are those managers reacting?

MD: At the macro level, as private debt markets become more developed, some managers are moving beyond the blind-pool fund model to offer alternatives, such as co-investments, JVs or separate accounts. Such structures offer exposure to certain assets and give investors more control over their portfolios – and potentially lower fees – while tapping into the managers' skills and deal pipelines. And, on the asset manager side, those vehicles are fostering stronger investor relationships and providing an additional source of funding to execute deals. The result is that managers' platforms need to be able to sustain that diversity, while communicating effectively with different stakeholders, including investors and regulators.

Q How is transparency evolving and what are the key topics?

MD: Transparency requirements have dramatically increased in recent years. The Institutional Limited Partners Association's Principles 3.0 are a good illustration of the trend towards best practice, and how it directly impacts the middle and back office. For instance, in addition to standardised disclosures on fees and expenses, managers have to provide data on capital calls and distributions with carry calculations, or fund performance, with or without the use of subscription lines. The challenge is not only to capture and disclose the data, but also to have the right level of automation to cope with the volume and data aggregation in a cost-effective way.

We have seen an important emphasis on environmental, sustainability and governance procedures and protocols, going beyond a commitment to behaviour and into documentation and verification. Frameworks need to be put in place to measure and report the true impact of ESG. It's also impacting us as an organisation, as we have a new generation that is spending more time investigating and understanding ESG matters.

Q What are the regulatory issues the US private debt industry needs to consider, and how should it prepare?

TG: There are a number of things happening on the regulatory front that managers need to consider as they continue to raise new funds. LIBOR is expected to end as early as 2021 and it's important to be prepared for a new benchmark rate. From an industry perspective, understanding the documentation and deals today, and having the ability to adjust existing systems and data feeds to link to a new rate, is going to be crucial for a seamless transition.

There is the possibility of more stringent privacy laws in the US, similar to the General Data Protection Regulation in Europe. Counterparties need to be able to identify, track and capture personally identifiable information quickly. Flexibility of systems and investment in compliance procedures will be increasingly important to comply with those requirements.

Alter Domus also supports a number of BDCs operationally, and the enactment of the Small Business Credit Availability Act in March allowed them to increase their leverage profile to a 2:1 debt-to-equity ratio, up from 1:1. This has resulted in more activity in the BDC space and we think that will continue.

Q How can technology and data management tools help managers meet the rising demands of investors and regulators?

TG: Investors, regulators and other third parties are increasingly data-driven. There is an expectation to have self-service access to information like portfolio and asset performance, or trading history and trend analysis, which is best achieved through a web-based platform. Data is not the only driver as managers use portal access to provide content to market their funds, articulate investment strategies and push regular communications. Providing digital content in the right way really strengthens the relationship between a manager and investors.

MD: Technology is definitely a critical enabler in transparency. Today the same core information needs to be sliced and diced and disclosed differently for managers, regulators and investors. It's definitely a balancing act between industry and regulatory standards, with a certain level of flexibility needed to accommodate specific LP requests. But as the asset class matures, we see customisation as another way for managers to stand out from the crowd. The investor experience is also being reshaped through digitisation, with data access through web portals providing huge benefits in terms of accessibility, security and transparency. ■

Digital lenders find a home on Main Street

Online platforms have become part and parcel of the US small business lending space, offering capital within days, if not hours. Vicky Meek looks at what's next for these digitally enabled credit providers

Small business is big business in the US. There are nearly 30 million such companies employing close to 50 percent of the nation's workforce, according to the US Small Business Administration. And, with banks stepping back from lending to smaller businesses in the wake of the global financial crisis, a gap opened up that has been at least partially filled by technology-enabled platform lenders, such as Kabbage and OnDeck. Indeed, in late 2017, S&P Global estimated that digital lenders in the small- and medium-sized enterprise space would see a compound annual growth rate of over 20 percent in the five years to the end of 2021.

For some, the arrival of internet-based lending represents a democratisation of the credit market for smaller businesses, which may struggle to access debt capital elsewhere, while offering an efficient distribution model to those that are lending.

"Platform lenders fill quite a large niche," says Lawrence Kaplan, chairman of bank regulatory in the global banking and payments systems practice at Paul Hastings. "They are disrupting the space and have turned everything upside down by offering loans based on monthly repayment affordability or repayments based on a percentage of profits, and providing debt quickly – often within 24 hours. It's highly efficient because lenders can reach these borrowers very easily."

Models differ. Square and PayPal, for example, lend largely to existing users of their payment systems so they can make underwriting decisions based on, among other things, sales data and deduct repayment directly. OnDeck, meanwhile, is publicly listed, lends from its balance sheet, has a partnership with JPMorgan Chase and has created a scoring system based on a combination of data sources, including transactions, accounts, public records and proprietary information. But between them, the platform lenders have advanced significant funds to small businesses over the past decade: OnDeck says it has lent $10 billion and Kabbage $7 billion.

Big bucks

Many also claim to be able to advance fairly significant amounts – in the case of Kabbage, up to $250,000; for OnDeck, up to $500,000. Invoice-factoring clients at BlueVine can get credit lines of up to $5 million, according to their websites. And more specialist online lenders are starting to emerge – 6th Avenue Capital, for example, can provide bridge loans.

> *"Platform lenders fill quite a large niche. They are disrupting the space and have turned everything upside down"*
>
> **LAWRENCE KAPLAN**
> **Paul Hastings**

So are these tech-enabled lenders muscling in on business development company territory? The past few years have seen many private debt and equity firms establishing BDCs to access the small business financing market. According to Deloitte, there were 95 of these vehicles at the end of 2018 with a shade over $100 billion of assets, up from just 37 and $23 billion in 2009.

The answer to the question is: not exactly. Many online lending platforms have partnered with banks, thereby attracting revolving credit facilities from traditional lenders, for example. However, their reach is also proving attractive to a number of BDCs. In 2016, New York's Prospect Capital was linked to the online lending space, having acquired loans from OnDeck and, later on, a securitised consumer portfolio from Lending Club. More recently, securitised portfolios have increasingly become a means for BDCs to gain exposure to a variety of small and medium-sized company loans without a lot of origination legwork.

"We haven't yet seen a convergence between direct lending vehicles such as BDCs and online lenders," says Ted Koenig, president and chief executive of Monroe Capital. "That may come, but we are seeing direct lenders provide capital to online lenders, and some invest in platform lenders' securitisation offerings." Securitisations are also increasing in size – Kabbage recently claimed it had completed the largest

asset-based securitisation to date by a small business online platform, at $700 million.

"BDCs are actually benefiting from the growth of online small business lenders," adds Sandeep Gupta, partner and co-leader of Deloitte's fintech practice. "The creation of securitised products is giving BDCs exposure to a large number of small company loans – it's helping the growth of BDCs. In any case, the market is so vast and, as the banks have moved away from small business lending, there's plenty of room."

Tests to come

Yet despite the promise of relatively easy access to traditionally hard-to-originate small business loans, these developments are starting to raise eyebrows. "Other groups involved in this area have a history through the cycles," says Koenig. "Online lenders have not yet lived through that. As long as there are tailwinds in the economy, they will continue to grow, but when conditions change – and they will at some point – the model will be tested. They're largely assuming a 6 percent to 8 percent default rate, yet it could be as high as 20 percent."

The trend for securitisations is of particular concern. "Some are lending from the balance sheet," adds Koenig. "Others are parcelling off loan portfolios and selling them to investors that are not sophisticated in this area. There is the potential for a repeat of what we saw in the mortgage securitisation crisis if these loans default at higher-than-anticipated levels. While these loans are not being held in the financial system and so don't pose a systemic risk, some people could lose an awful lot of money."

"These lenders have not been tested in a downturn," says Gupta. "It will be interesting to see what happens when more challenging conditions come into play. People need to be mindful of what we saw with CLOs in the last crisis and stay one step ahead of a change in the cycle."

It has already been far from plain sailing for a number of platform lenders. Lending Club, for example, got into hot water in 2016 when an internal review found irregularities relating to $22 million of loans, which led to founder and CEO Renaud Laplanche standing down (he's since set up a rival consumer lending platform, Upgrade). Funding Circle, too, has had its share of woes. Listed in October 2018, its shares fell after it announced that it was winding up its SME Income Fund, which made loans to US and European small businesses. Reports suggested that rising default rates and the cost of hedging currency exposures were eating into returns. The online lender has since launched private debt-style closed-ended funds targeting the UK and, separately, Germany and the Netherlands.

It's an interesting move, although not one we were able to explore in any great depth with Funding Circle as it, in common with the five other online lending platforms we approached, declined interviews on the growth of the market in the US.

It is believed to be the first online lender to raise closed-ended funds, but there's not much to stop others from following in its footsteps. With an average loan size of around €60,000 for the Germany and Netherlands-focused fund, Funding Circle won't be competing with the more traditional private debt funds. But could this happen with others? It depends on who you ask.

"These lenders are advancing relatively small sums and, in many cases, rely on algorithms to generate credit scores," says Koenig. "That's very different from the funds' traditional business of financing larger, sponsor-backed transactions, where a high degree of human involvement and company underwriting is necessary because each deal is bespoke."

Data-driven

The technology used by online lenders currently only offers advantages in highly repeatable situations. However, at least some of the human element will inevitably be taken out of the private equity-backed deal underwriting world over time, too, as machine learning and data analytics become more widely adopted and sophisticated. And that leads some to believe that private debt funds may well need to shift their models in the not-too-distant future. "Will private equity funds team up with online lenders?" asks Kaplan. "In 10 years' time that could happen. Once people become more comfortable with platform lending and see that it can deliver loans more efficiently, faster and more cheaply, sponsors will absolutely want to work with the online players."

We will have to wait and see whether this vision of the future pans out. It's quite likely the economic cycle will turn within that period, and only then we will really know how robust the model is. ■

EXPERT COMMENTARY

Can the statistical model that revolutionised a great American sport be applied to private debt? Tom Quimby, managing partner with Tree Line Capital Partners, thinks it can

Moneyball for portfolio managers seeking yield

In 2003, the author Michael Lewis published *Moneyball*, a book about the Oakland Athletics' general manager Billy Beane, who pioneered an analytical, evidence-based, 'sabermetric' approach to assembling a competitive baseball team. *Moneyball*'s central thesis was that the collected wisdom of baseball insiders is subjective and flawed, and that a paradigm shift was occurring in how to construct a team and value talent. Beane realised he could spend a fraction of the top payrolls and win by identifying overlooked and undervalued players.

Beane shifted the mindset of his organisation to buying wins versus buying players; and to buy wins, it was necessary to buy runs. As he assembled a small group of undervalued players, many of whom had been rejected as unfit for the big leagues, he proved the strategy worked. The A's created one of the most profitable and successful franchises in Major League Baseball, and in 2004 the Boston Red Sox used the same system to win the World Series.

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As we sit in the 10th year of an economic recovery following the global financial crisis, the private credit markets are anything but certain. Looking closely across the asset class, with a focus on the compelling opportunities that exist in the lower middle market, there are lessons that can be learned from *Moneyball*. When applying the philosophy to credit, the shift in mindset is to be guided by data and invest in risk-adjusted returns (ie, wins) rather than simply investing in debt held by large companies regardless of the trends or metrics (ie, players).

It is important to understand how the private credit markets have shifted and matured during this 10-year run. The asset class, which has added $500 billion in capital since 2009, can be split into three categories: the leveraged-loan market (companies with typically $75 million in EBITDA); the mid-market (companies with $25 million to $75 million in EBITDA); and the lower middle market (companies with less than $25 million of EBITDA).

The leveraged-loan market is following pre-crisis trends. In 2018, 73 percent of loans issued were greater than 6x leverage and 41 percent were greater than 7x. The only other time in the last 20 years when this has been the case was in 2007. Moreover, 79 percent of all loans outstanding are cov-lite and on the road to no-document underwriting.

Mid-market direct lenders, which were once said to be filling the void left by bank consolidation following the crisis, are now victims of their own success. This category has attracted investors searching for yield in their droves, but the result has been commoditisation. In a crowded market it doesn't take our friends in private equity long to chip away at terms and effectively gut a lender's rights and the remedies available to it.

When lending becomes competitive, two things are sacrificed: price and structure. Spreads decline first as leverage creeps up and discipline takes a back seat to deployment. Market terms shift, and the rights that are critical during a downturn to equip lenders to act in advance of defaults are watered down, or even eliminated.

Moneyball and the lower middle

The lower middle market is where the moneyball strategy can be put to work. Tree Line Capital Partners is a direct lender and focuses on making senior secured loans to borrowers with between $3 million and $25 million in EBITDA. However, we also find significant advantages in companies with EBITDA of less than $10 million as these companies are predominantly overlooked and undervalued. For those willing to evaluate the data, the lower middle-market delivers a niche opportunity.

In baseball, general managers using a moneyball strategy will seek players who consistently deliver a specific result necessary to produce a run or a win. By focusing on statistics and metrics, general managers can set aside criteria such as size, height or weight, which might play into their preconceived notions of a player's suitability. The objective is to identify overlooked talent at a discount price. For example, a player who walks to reach first base is of equal value to a player who hits a single to reach first base. Beane discovered that on-base percentage was an undervalued asset, and that power hitters were overvalued assets as baseball insiders valued hitting a single over a walk.

In the credit world, a perception can exist that a portfolio carries more risk or volatility if it is comprised of loans to smaller companies. Investors will often take comfort in a belief that larger companies will mitigate risk in a distressed environment. The idea that risk is simply a function of a company's size of revenue and EBITDA is misguided. This ignores critically important credit fundamentals, such as security type, structure, yield, leverage, debt service coverage and covenants. At Tree Line, we apply a data-driven approach to our senior secured lending strategy with a heavy emphasis on leverage, margin, coverage, stability and growth. We measure these factors through a screening algorithm and it delivers a far more comprehensive assessment of a company's health and risk than simply size of EBITDA.

Beane found value in overlooked players and acquired them at a discount. Similarly, lower middle market lenders can invest in underserved companies and earn a premium through favourable credit structures. A willingness to look beyond the size of a company's revenue and EBITDA will provide a more accurate understanding of the risk-adjusted return associated with the lower middle market. This market has provided Tree Line with an opportunity to consistently deploy our investors' capital in senior secured loans with outsized returns and favourable structures. The sheer size of the lower middle market, with approximately 175,000 companies, creates an immediate advantage as it enables disciplined direct lenders to construct a highly selective portfolio.

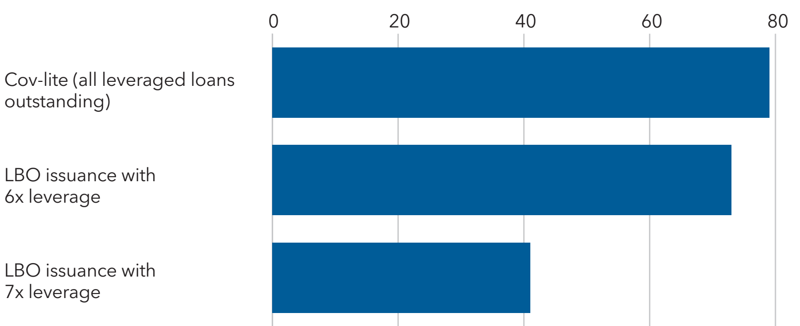
We have observed significant growth in private equity activity in the lower middle market. New entrants are forming and spinning out of blue-chip middle market private equity firms to chase the large opportunity set, avoid auction-led processes and obtain attractive valuations with the prospect of buy-and-build strategies. The lower middle market private equity community has never been more sophisticated or capable.

Lower middle market lenders are working with companies that are typically smaller but which have established track records and a demonstrated ability to generate consistent cashflow.

In this case, smaller is not synonymous with venture or unproven. Lower middle market companies will typically have revenues of between $10 million and $100 million and are meaningful participants in all sectors of the US economy.

We take comfort in our current weighted average leverage of 3.8x, our weighted average fixed-charge coverage of 2x, our weighted average loan-to-value of 41 percent and the significant cash equity from reputable financial sponsors. These metrics are a result of an intensive, direct underwriting process that has been developed over the course of our careers and is designed to perform in all phases of a cycle.

The leveraged-loan market reflects pre-crisis trends (%)



Source: Tree Line Capital Partners

Putting the philosophy to work

Moneyball has taught us to set aside subjective thinking and look more closely at the ingredients of what it takes to win. In the current environment, we believe niche and specialised strategies will outperform over the long term.

Simply flocking to platforms and companies with size will not get it done in the face of 7x leverage, cov-lite loans. As the prevailing conversation is focused on the frothy conditions of the leveraged-loan market and the mid-market, the lower middle market presents an opportunity to capture alpha in disciplined structures for those willing to take a moneyball approach. ■

Sizing up the opportunity

Indicators from the National Center for the Middle Market show growth remains strong among US mid-market businesses, but there's growing uncertainty

Performance indicators from US mid-market firms were somewhat mixed in Q1 2019, according to the National Center for the Middle Market. The 8.7 percent average year-on-year revenue growth was the second highest recorded, but the number of firms reporting overall improvement in company performance fell to 67 percent for the first three months of the year from 73 percent a quarter earlier.

Despite these challenges, most mid-market businesses enjoy strong growth. Compared with the same period last year, a similar proportion of firms – 44 percent – say they have plans to expand into new domestic markets over the next 12 months. Meanwhile, 48 percent say they will be introducing a new product or service. ■

8.7%

Year-on-year revenue growth in Q1

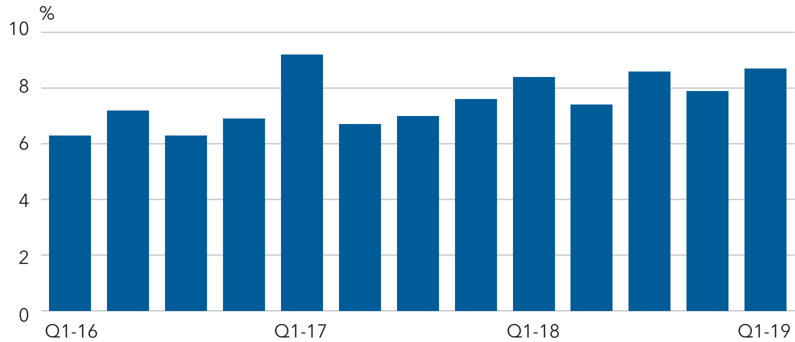
1/3

Mid-market share of US private sector GDP and employment

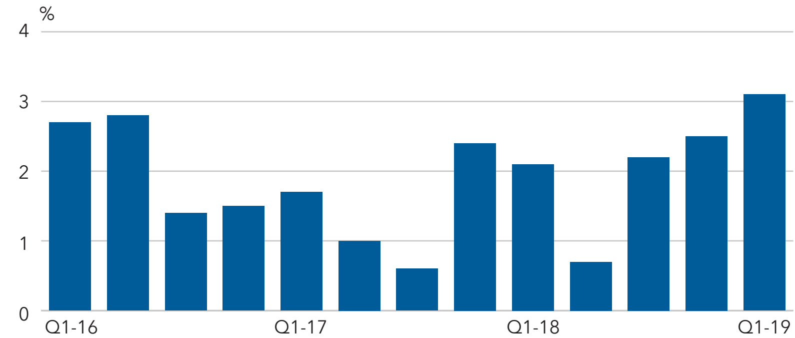
5.4%

Projected revenue growth for next 12 months

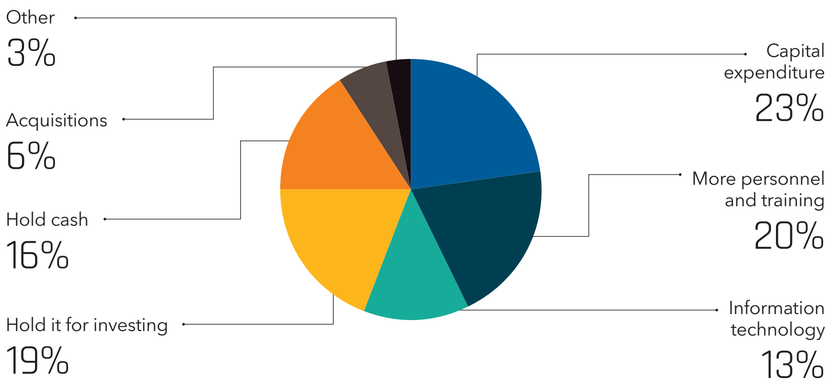
Year-on-year revenue growth rates among US mid-market companies improved in the first quarter of 2019



Mid-market companies have reported a year-on-year productivity increase for the past three quarters



Capital investment: 35% of mid-market companies are putting money aside rather than spend



Source: National Center for the Middle Market 4Q Middle Market Indicator

E X P E R T Q & A

Lending to non-sponsored businesses or underbanked industries requires greater resources but can generate higher returns, say Robert O'Sullivan, Greg Reynolds and Jason Gelberd of Comvest Partners

Why complexity pays in the middle market

Comvest Partners is a US middle market private equity and credit firm with $3.3 billion in assets under management. Robert O'Sullivan, managing partner, and Greg Reynolds and Jason Gelberd, partners and co-heads of direct lending, talk about the complexity premium that can be found in less competitive lending sectors such as non-sponsored borrowers or underbanked industries, including specialty finance (eg, leasing companies). They also discuss their approach to lending to non-sponsored and non-traditionally sponsored (eg, family office-owned) businesses. Other topics include the importance of having access to industry operating expertise, the resource-intensive nature of non-sponsored lending, and the need for disciplined loan structures – including maintaining comprehensive and stringent covenant protections.

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Q Has the middle market become very competitive?

Robert O'Sullivan: Sponsored lending has grown significantly, with more competition in the market – and particularly, the larger part of the middle market. Lending has become somewhat commoditised, resulting in pressure on pricing and structure.

Q How can lenders respond to this increased competition?

RO: We focus on segments of the mid-market that are generally less trafficked by other lenders. Consequently we think we can get a good risk-adjusted return, with premium yields and better structures. These less competitive areas include non-sponsored and non-traditionally sponsored borrowers. We also finance sponsor-owned businesses in situations that are typically more complex or where we think we have an information edge through Comvest's private equity industry operating resources available to us. We focus on sectors where we have significant investing experience and access to operating expertise, such as healthcare, and industries we consider to be underbanked, such as financial services companies.

Greg Reynolds: The common characteristic of our deals is complexity because it reduces competition. This is sometimes referred to as the 'complexity premium'. If you are willing to take on the complexity and have the necessary resources, you achieve negotiating leverage to position yourself to be able to achieve conservative loan structures – lower leverage, lower loan-to-value ratios – with comprehensive controls, while receiving a material pricing premium.

Q How would you characterise a non-traditional sponsor?

RO: A non-traditional sponsor is either a small or first-time sponsor, or a manager without third-party capital.

For example, a family office or fundless sponsor seeking to buy a business with a combination of debt and equity that is not a regular borrower like a seasoned PE firm.

Q Is it hard to find non-sponsored firms?

Jason Gelberd: Yes, and this is precisely what makes it less competitive. Non-sponsored lending requires more work and resources than sponsored lending, starting with a more elaborate origination infrastructure.

RO: While everyone at Comvest has some origination responsibilities, 11 people out of about 100 work full-time on private debt and private equity origination at our New York, Los Angeles, Chicago and West Palm Beach offices. As originators, we target about 2,000 intermediaries ranging from one-person boutiques to middle market investment banks that we have established relationships with over the past 20 years.

Q But once you have a potentially suitable non-sponsored company, it can still be hard work?

GR: Yes, origination is just one component. We feel proper non-sponsored company diligence requires private equity-type due diligence. An important factor is being part of a broader platform with a long history of private equity investing. We can utilise the firm's industry operating resources to help us make well-informed decisions. In general, the underwriting process is lengthy and labour-intensive, which usually reduces competition from more volume-oriented lenders.

RO: I absolutely think completing non-sponsored deals would be harder without our private equity division's experience, knowledge and capabilities.

Q Which lending metrics make the most sense?

JG: For cashflow-based loans, many lenders focus on leverage, and our average leverage historically has been about 3.8x. However, we focus most on the loan-to-value ratio, which averages slightly under 50 percent in our cashflow-based loans.

Q What about specialty finance structures?

JG: Historically, about one-third of our portfolio has been borrowing base-governed, asset-based transactions, which are typically loans to financial services businesses. Within this focus, we lend to finance companies, including various consumer and commercial specialists. This is a market I've been active in for more than 10 years, beginning with overseeing the development of Goldman Sachs' lender finance group. While there, I saw how loans performed in different economic cycles, learned a lot about structuring and risk mitigation, and saw how predictive models informing our lending held up during a recession.

This sector is attractive to Comvest because we believe it is a proven strategy that requires expertise, thus reducing competition. You need deep knowledge of differentiated sector sub-segments, and generally companies are non-sponsored, which we like. Some of the key origination focus areas are companies doing small business finance, consumer point-of-sale transactions, healthcare, and auto and motorcycle finance. Conversely, we avoid some sectors, including real estate finance, because of performance during the last cycle.

Q What sectors are interesting right now?

JG: Comvest has significant healthcare investing experience and access to sub-sector industry expertise through our operating partner network. We recently lent to a chain of paediatric urgent care clinics where we had experience and knowledge of consumer habits and spending due to a prior private equity urgent care investment in Fastmed. Accessing our existing relationships enabled us to have a greater understanding of the industry drivers and the competitive environment, which gave us the confidence to underwrite a growing niche player in the healthcare sector.

Similarly, in financial services, we take advantage of our expertise and acquire significant data by completing multiple transactions in the same sub-segment. We've completed numerous transactions with companies that lease used motorcycles, primarily Harley-Davidsons, to consumers. Used motorcycles generally have a very predictable and flat depreciation curve after a few years, which makes them attractive assets to lease.

Q What is the best way of approaching covenants?

GR: We have on average four financial performance covenants per transaction. While this metric is important, we find it more important to understand the type of covenants, how tightly the covenants are set, and whether borrowers have the flexibility to make significant adjustments to measurements such as pro-forma EBITDA. Because we compete in niche middle-market segments, we normally have negotiating leverage with covenant protections. We focus covenants on key performance indicators, such as recurring revenue when lending to a software company.

Additionally, we target relatively tight covenant tolerances compared with the borrower's projections – typically around a 20 percent cushion. Finally, we strive to maintain simple and well-defined definitions within our credit facilities on all terms, including those that are fundamental to covenant calculations.

Q Is there more competition than there was a few years ago?

RO: Compared with two or three years ago there is more competition broadly in middle market direct lending, but we've seen significantly less in the complex pockets of the middle market where we operate.

Although there are always new middle-market lenders, many existing firms have left due to poor performance or have been acquired by larger platforms. Other former competitors for loans of between $50 million and $100 million – our sweet spot – are concentrating on larger deals because they have grown their assets significantly or returned to traditional sponsor lending.

Q Where are we in the cycle, and how does that affect your attitude to lending?

GR: We assume that we are at the peak of the economic and credit cycles, which strongly influences our market participation and loan structuring.

We are cautious about heavily cyclical industries, such as consumer durables, and we concentrate on less cyclical industries like healthcare. Having said that, we track and analyse our existing portfolio closely, and do not see signs within these companies that a slowdown has begun.

JG: We also focus on senior-secured debt these days. Having to trade some return for maintaining disciplined structure has always been our mantra. The team has worked together through multiple cycles and has deep experience to respond to whatever dislocation may be awaiting us. ■

Distressed debt's appeal surges amid market uncertainty

Bain Capital is the latest manager to target non-performing real estate loans, a strategy that has been attractive to institutional investors, writes Kyle Campbell

Fresh from raising its first real estate fund, Bain Capital formed a half-billion-dollar venture in July to acquire distressed real estate debt. Joining forces with a New York lender, the Boston-based private equity firm sees opportunity in the loan-to-own space.

The group is allocating capital to the partnership from its credit platform's distressed and special situations strategy. But Bain is far from the only firm interested in non-performing loans.

Through the first two quarters of 2019, real estate funds that include distressed debt as part of their mandate closed on $18.75 billion, according to data from P*rivate Debt Investor*'s sister title *PERE*, making it the most popular debt strategy this year. Funds focused on senior loans have closed on $4.6 billion while subordinate or mezzanine debt gathered less than $1.1 billion.

For distressed debt, the H1 equity haul was the largest half-year volume for such vehicles over the past five years. Since the start of 2016, an aggregate of just $23.65 billion has been closed on by similar funds.

Much of the capital entering this space has gone into diversified real estate funds targeting equity and debt strategies. Lone Star raised the largest amounts, raking in $8.2 billion for Lone Star Fund XI and $4.7 billion for its Real Estate Fund VI. The next three-largest closings, however, involved debt or credit-specific funds. Cerberus Global NPL and Cheyne European Strategic Value Credit attracted $4.1 billion and $1 billion respectively, while Lone Star's $750 million second North America-focused residential mortgage fund rounded out the top five biggest funds targeting distressed debt.

> *"By almost every key metric the New York City market peaked in the 2015-16 timeframe and we're seeing it come down, albeit slowly, from that peak"*
>
> **DAVID DESPREZ**
> **Bain Capital**

A common thesis is that mature pricing has driven cap rates down, and that this has made some equity acquisitions less appealing. Taken in tandem with other market trends, some managers see this pricing environment leading to a rising demand for refinancing and, ultimately, to more defaults.

David DesPrez, Bain Capital Credit's vice-president of distressed and special situations, sees opportunities arising in three areas in particular: luxury condominiums, subsidised multifamily properties and retail.

Underwriting is an issue in all three property types, he tells *PERE*, with developers and landlords assuming certain prices that now seem unattainable because of changing market dynamics or new regulations. He says Bain Capital Credit saw these trends playing out on a large scale in New York, where it has made SKW Funding, a private lender and distressed debt platform based in the city, its local partner.

"By almost every key metric – transaction volumes, average condo price, land prices – the New York City market peaked in the 2015-16 timeframe and we're seeing it come down, albeit slowly, from that peak," he says. "We are also seeing pullback from lenders, so it's become incrementally more difficult for borrowers to refinance or to get any outside-the-box debt."

Carol Faber, co-chair of the distressed property practice at Akerman, a Miami-based law firm, credits the uptick in interest to widespread uncertainty in the real estate market. Although there are few signs of distress in the market at present, she says many investors were wary of the long-running growth cycle. "People are starting to think a downturn is coming sooner than later," she says. "They want to be well positioned to take advantage, so they're talking about it and trying to raise money for it, but they aren't necessarily deploying it just yet."

Faber says although fund managers have been more disciplined with their use of leverage following the global financial crisis, the real estate debt space has also become more complex since then. "They sliced and diced the capital stack in a number of different ways, so to the extent that there is distress, the workouts will be a lot more complicated than they were last time," she adds. "But where there are challenges, there are also opportunities." ■

3G sets sights high **The firm's $10bn target capital raise puts its vehicle at the top of the US funds in market leader board, while distressed proves a popular strategy**

Fund	Manager	Target size ($bn)	Strategy	Sector
3G Special Situations Fund V	3G Capital	10.00	Subordinated/mezzanine debt (origination)	Corporate
Apollo Hybrid Value Fund	Apollo Global Management	3.00	Distressed debt (acquisition)	Corporate
Bain Capital Distressed & Special Situations 2019	Bain Capital	3.00	Distressed debt (acquisition)	Corporate
Energy Investment Opportunities Fund	Goldman Sachs Asset Management	3.00	Distressed debt (acquisition)	Corporate
Apollo Structured Credit Recovery Fund IV	Apollo Global Management	2.50	Distressed debt (acquisition)	Corporate
TCW Direct Lending Fund VII	TCW Group	2.50	Senior debt (origination)	Corporate
Carlyle Credit Opportunities Fund	The Carlyle Group	2.00	Subordinated/mezzanine debt (origination)	Corporate
Related CRE Debt Fund	Related Companies	2.00	Subordinated/mezzanine debt (origination)	Real estate
TSSP Capital Solutions	TPG Sixth Street Partners	2.00	Distressed debt (acquisition)	Corporate
York Structured Credit Opportunities Fund	York Capital Management	2.00	CLO	Corporate
Oaktree Special Situations Fund II	Oaktree Capital Management	1.75	Distressed debt (acquisition)	Corporate
ABRY Advanced Securities Fund IV	ABRY Partners	1.50	Senior debt (origination)	Corporate
BlackRock Middle Market Senior Fund	BlackRock	1.50	Senior debt (origination)	Corporate
Bridge Debt Strategies Fund III	Bridge Investment Group	1.50	Subordinated/mezzanine debt (origination)	Real estate
Carlyle Middle Market Fund	The Carlyle Group	1.50	Senior debt (origination)	Corporate
Churchill Middle Market Senior Loan Fund II	Churchill Asset Management	1.50	Senior debt (origination)	Corporate
CRG Partners IV	CRG	1.50	Distressed debt (acquisition)	Corporate
Evolution Credit Partners I	Evolution Credit Partners	1.50	Subordinated/mezzanine debt (origination)	Corporate
Kayne Real estate Debt Fund III	Kayne Anderson Capital Advisors	1.50	Subordinated/mezzanine debt (origination)	Real estate
MTP Energy Opportunities Fund II	Magnetar Capital	1.50	Venture debt (origination)	Corporate
Torchlight Debt Opportunity Fund VI	Torchlight Investors	1.50	Senior debt (origination)	Real estate
Dune Real estate Fund IV	Dune Real estate Partners	1.25	Distressed debt (acquisition)	Real estate
Falcon Private Credit Opportunities VI	Falcon Investment Advisors	1.25	Subordinated/mezzanine debt (origination)	Corporate
Avenue Energy Opportunities Fund II	Avenue Capital Group	1.00	Distressed debt (acquisition)	Corporate infrastructure
Guggenheim Distressed Debt Fund	Guggenheim Investments	1.00	Distressed debt (acquisition)	Corporate
LBC Credit Partners V	LBC Credit Partners	1.00	Senior debt (origination)	Corporate
Ninepoint Monroe US Private Debt Fund	Ninepoint Partners	1.00	Senior debt (origination)	Corporate
OHA Credit Solutions Fund	Oak Hill Advisors	1.00	Subordinated/mezzanine debt (origination)	Corporate
Owl Rock First Lien Fund	Owl Rock Capital Partners	1.00	Distressed debt (acquisition)	Corporate
PIMCO Private Income Fund	Pacific Investment Management Co (PIMCO)	1.00	Subordinated/mezzanine debt (origination)	Real estate

Source: PDI

2018 USA Lender of the Year[1]

Churchill Asset Management

We have been providing middle market companies with consistent and flexible financing solutions for over a decade and have invested across market cycles. We access the market through long-established private equity sponsor relationships and employ a highly selective, disciplined investment process.

With the scale and resources of our parent company, Nuveen, a $1 trillion asset manager[2], our platform offers more solutions for institutional investors than ever before.

$6.5bn	$11bn	13yr
of committed capital	of senior loans invested	track record

Recent Transactions

Company	Role	Facility	Sponsor	Date
Boulder Scientific Company™ Innovative Specialty Chemical Solutions	Co-Lead Arranger	Senior Secured Credit Facility	QUAD-C	Jun 2019
BROWN & JOSEPH	Agent Tier	Senior Secured Credit Facility	INCLINE Equity Partners	Jun 2019
IMPACT FITNESS	Sole Lead Arranger	Senior Secured Credit Facility	Morgan Stanley Investment Management	Jun 2019
RANDYS	Co-Lead Arranger	Unitranche Credit Facility	TAILWIND CAPITAL	May 2019
natura)(yslim	Sole Lead Arranger	First Lien Credit Facility	Riverside	May 2019
AHEAD	Co-Lead Arranger	Senior Secured Credit Facility	Court Square	May 2019
datablue	Co-Lead Arranger	Senior Secured Credit Facility	Court Square	Apr 2019
OTC Ohio Transmission Corporation	Co-Lead Arranger	First Lien Credit Facility	GENSTAR CAPITAL	Apr 2019
planet fitness	Sole Lead Arranger	Senior Secured Credit Facility	Centre Partners	Mar 2019
brillio	Agent Tier	Senior Secured Credit Facility	BainCapital	Mar 2019
Payment Alliance International	Sole Lead Arranger	Senior Secured Credit Facility	Further Global	Jan 2019
clarity	Sole Lead Arranger	Senior Secured Credit Facility	Morgan Stanley Investment Management	Jan 2019

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All information as of July 31, 2019, unless otherwise noted. [1]By the Global M&A Network at the USA M&A Atlas Awards. [2]As of 6/30/2019.

The specific investments listed above do not represent all of the securities Churchill has purchased, sold, or recommended for clients over the past year. The reader should not assume that the investments listed above were or will be profitable. This presentation contains no recommendations to buy or sell any specific investments and should not be considered investment advice of any kind.

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