Private Debt in 2015: Thinking Outside the Bank

The confluence of bank regulation, low yields on traditional fixed income, and a strong supply of potential US and European borrowers has convinced more fund managers to enter the private debt space than ever before. The conditions that brought opportunity and growth to private debt remain in place, and continued expansion, driven by aggressive fundraising, can be expected in 2015 and beyond.

In this paper, Brown Brothers Harriman and Prequin explore the systematic and secular shift to private debt investing and examine what types of asset managers are likely to succeed.

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THE ERA OF BANK DISINTERMEDIATION
In the wake of the financial crisis the global economic landscape continues to reshape itself. One driver has been the measures taken to prevent bank insolvency from striking markets again. Macroeconomic factors and liquidity concerns have influenced the development of large scale regulatory directives such as Dodd-Frank, Alternative Investment Fund Managers Directive (AIFMD), and Basel III. These regulatory requirements have forced banks to off-load inventories of corporate and mid-market debt assets, and to scale back traditional lending for the foreseeable future. Banks are mandated to simplify their businesses and shrink balance sheets. In 2012, the International Monetary Fund estimated that European banks needed to reduce their asset base by $2.6 trillion. While in the US, banks have reduced leverage to nearly single digit levels, resulting in a decline in loan originations.

Although banks are paring back lending, the demand for capital remains. The liquidity to fuel American and European businesses is now coming from alternative investments and fixed income managers who have entered the private debt market to fill the incremental lending vacuum left by bank disintermediation.

THE RISE OF ALTERNATIVE LENDING
Fund manager and specialty finance participation in primary lending activity is hardly a new phenomenon, but in light of the low yield environment, the private debt segment is enjoying a healthy growth scenario. Since 2006, the private debt industry has nearly tripled in size, with AUM increasing from $152 billion to $441 billion as of September 2014. This model has taken firm hold in the US and is on the rise in Europe.

Global Private Debt Fund Market Triples in Size

Note: By the end of 2014 the decrease in dry powder indicates a greater level of deal activity.
Non-bank Lenders Surpass Banks in the US

In the US, non-bank lenders accounted for over 85% of leveraged loan activity in 2013, a figure that has increased from nearly 37% in 1998. It is estimated that there are nearly 37,000 American businesses that fall into the category of credit-worthy mid-market borrowers, classified loosely as companies with $5-$75 million in EBITDA. Borrowers in this range fall below the threshold that attracts traditional Wall Street investment capital, but present a sizeable opportunity for non-bank lenders even in the developed US funding sector.

Shift in Leveraged Loan Investors Since 1998

Demand Outpaces Supply in Europe

Historically, European debt markets had a strictly national focus. That, however, has been changing with the markets becoming integrated and serving the full European Union. Alternative lending in Europe currently represents around 20% of the market, according to Preqin estimates. However, demand for direct financing in Europe is outpacing supply, as demonstrated by an 88% increase in the number of European direct lending managers in two years (from 2012-2015 the number of managers jumped from 45 to 85).

In the US, a similar trend has been in place for over a decade and has provided the fuel needed for growth. Such fuel will be needed for European growth and it is, therefore, logical to assume that the EU model is likely to follow the American banking system toward smaller, more sustainable balance sheets, thus opening a mid-market lending opportunity for alternative players.

Growth Driven by Supply and Demand Factors

In addition to bank disintermediation, continued economic recovery, and a low interest rate environment, the following factors are likely to reinforce the growth in private lending.

- **Flexible Loan Terms**
  Non-banks are able to offer more attractive loan terms to borrowers including less restrictive loan covenants and creative payment structures.

- **Regulatory Validation**
  AIFMD and Dodd-Frank have increased investor confidence in the alternative funds market and private debt.

- **Rising Allocations from Institutional Investors**
  65% of institutional investors intend to increase their allocations to private debt over the long term.


Did You Know?

Our research shows that 59% of global asset managers surveyed view the movement to alternative lending as a fundamental shift and not a short-term yield strategy.

Over 50% of survey respondents have increased their private debt holdings in response to their clients’ growing appetite for private debt funds.

Preqin and Brown Brothers Harriman partnered to survey over 150 global asset managers to identify how trends in private debt have impacted their operations and reporting functions. To learn more visit www.bbh.com.
• **Increased Familiarity with Private Debt**
  Corporates are becoming more comfortable with this new funding channel.

**AN OPPORTUNITY FOR ASSET MANAGERS**
For borrowers, asset managers and institutional investors, private debt (specifically direct lending strategies) is becoming a more prevalent source of financing for EU businesses with 75% of target returns on investor profiles falling between 8-14%. According to Preqin research, 90% of investors feel that the returns from their private debt portfolios in 2014 met or exceeded expectations. This fact is evidenced by a number of premier private equity managers who now have the majority of their capital deployed as debt rather than equity (Ares 80%, Apollo 73%, and Blackstone 50%).

In addition to demand from private equity managers, demand for private debt is increasing among pensions, insurance companies, and endowments who value high yielding assets in which they can invest for the medium to long term. Interest in private debt from asset managers and institutional investors is likely to continue. When asked to speak to the growth of private debt and bank loan type strategies, an executive at a US headquartered fixed income manager with nearly $30 billion AUM commented: “Our clients have become familiar with the [private debt] space, and it’s an opportunity that we’ve been transitioning resources toward…”

As of May 2015, Preqin tracked over 1,500 institutional investors with interest or investment in private debt funds. This represents an increase from 990 in July 2014.

**WHICH ASSET MANAGERS WILL SUCCEED?**
A highly diverse group of managers are focusing on this asset class. Global asset managers are gaining traction in a market once dominated exclusively by mega private equity firms. While credit focused managers are moving down the liquidity scale into the distressed bank loan space, private equity managers are shifting focus from equity participations to debt participations, and infrastructure managers have broadened from directly owning infrastructure assets to financing projects. Despite the new entrants, the premier private equity managers responsible for the market expansion of the past 15 years are expected to enjoy continued success.

The hallmark of successful asset managers will be unchanged. That is, they will continue to rely on their core skill set. For example, if an experienced infrastructure investor wishes to raise an infrastructure debt fund it is conceivable they will be successful. Not only will success come from expertise in the sector, existing brand and distribution capabilities will also play large roles. Select fixed income managers with relevant investment skills, loyal investor bases, and strong brands are having successful fund raisings.

All managers moving into this space will need the sophistication and scale to overcome the operational, compliance, regulatory, and reporting costs of managing a relatively bespoke asset. This will require back and middle office support with the expertise, systems, and processes required. Our survey results indicate that 60% of respondents have outsourced or are planning to export functions, with administration and valuation amassing the largest proportions.

In addition, over 70% of survey respondents view offering a high level of reporting and transparency as a competitive advantage when it comes to client acquisition. According to one respondent, “Transparency and reliability of reporting builds confidence with our investors”. This sentiment was echoed by another respondent who said, “You just have to do it.”

**FUTURE OUTLOOK FOR PRIVATE DEBT**
The confluence of bank regulation, low yields on traditional fixed income, and a strong supply of potential US and European borrowers has convinced more fund managers to enter the private debt space than ever before. Direct lending funds closed on $30 billion in institutional capital across 50 vehicles in 2014. Of this $30 billion, 94% is identified for investment in the US and Europe. This segment continues to lead fundraising momentum for alternative credit in 2015. As a whole, private debt shows no sign of slowing down.
Even the most durable banks will continue to be capital-constrained moving forward, particularly regarding the risks associated with middle market corporate lending. Their step back from the market will create opportunities for debt managers to identify opportunities, organize units, and raise and deploy capital.

As the European middle-market private lending model continues to gain footing, it is important to note that banks are not simply exiting the space. They are transitioning into new roles that more closely suit the new mandates, such as custodial services, administrative support, and participation in loan syndication for CLOs and other vehicles. The symbiotic relationship between banks and private lenders is likely to be expanded as banks establish pipelines for passing on loan proposals to alternative parties.

For non-bank lenders, brand presence and perception will be vital, as borrowers accustomed to traditional banking institutions may be weary of entering into relationships with alternative debt-specialized lenders. Further potential lies in the American corporate credit market, where non-bank lenders have taken on the majority of leveraged loan activity in the last decade. The increasing levels of competition will make it supremely important for managers to place a premium on core investment activity and profitability.

Regarding interest rate movement and the future of private debt, it is essential to note that the large majority of deals incorporate floating interest rates as protection from medium term interest rate risk. Therefore, the effects of an increase or decrease will only be minimally felt among fund managers and investors as part of a wider fixed income adjustment. The conditions that have brought opportunity and growth to private debt remain in place and continued expansion driven by aggressive fundraising can be expected in 2015 and beyond.

Why Private Debt?

**Relatively Predictable Yields**
Yields are known up front and unlikely to vary significantly over the life of the loan. Given the current low rate environment, any variation in yields is likely to be on the upside.

**Low Correlation to Market Trends**
Given the nature of senior lending and debt activity, private debt generally has a lower correlation to equities than traditional fixed income.

**Downside Protection**
Private debt offers downside protection when collateralized by real assets.

**Leverage Existing Manager Expertise**
Direct real estate specialists, have the pipeline, connections, and expertise to find the right debt opportunities. The same is true for managers who have teams focused on infrastructure, mid-market corporates, emerging markets, etc.

**Favorable Supply and Demand Dynamics**
Taking into account the demand from investors and the existing expertise of managers, this asset class offers opportunities to raise funds.
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