



LOOK Before You LEAP

Key Considerations for
Asset Managers Launching
Private Debt Funds



Demand for private debt is strong and managers are responding with new fund launches and product strategies.”



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Stemming from the contraction in bank lending since the 2008 global financial crisis, there was a shift from traditional lending models to alternative lenders looking to provide capital to mid-market borrowers. Stimulated further by an ongoing low-interest rate environment and the search for yield, institutional investors such as pensions and endowments are now more willing to invest in long term credit assets. Private debt funds managed approximately \$640 billion¹ in direct lending in June 2017 and this trend is likely to continue as many corporate CFO's now view private debt lending as an increasingly important tool in their tool kit.

For asset managers looking to set up a private debt fund, the domicile of the fund, operational complexities of originating loans, and data reporting and transparency procedures should all be evaluated as part of their entry strategy into the market.

Choosing the Domicile

The fast-growing private debt industry is expected to hit €1 trillion by 2020.² The US is the largest private debt market, accounting for more than 60 percent of the new money raised globally in 2017.³ The European market accounts for the remainder, while Asia is largely undeveloped and even restricted in certain jurisdictions.

While the US is the largest market, the direct lending opportunity in Europe is significant. It's a local, fragmented market with thousands of investable companies, most of which are serviced by long-standing banking relationships. However, accessing the European market presents its own challenges including significant language barriers and bankruptcy and security enforcement laws that are unique to each country.

¹ 2018 Preqin Global Private Debt Report

² Alternative Credit Council

³ 2018 Preqin Global Private Debt Report

If managers decide to enter the private debt market in Europe, they can choose various structuring options as both Ireland and Luxembourg offer credible product solutions. Luxembourg has a robust and well established closed-ended fund regime allowing for flexible asset mixing and concentration limits, which meets the needs of a private loan strategy. Ireland has recently enhanced its direct lending code, revising and relaxing direct lending criteria, making it easier for managers to mix asset types and borrowers. Ireland is also in the process of upgrading its partnership legislation to compete more directly with that of Luxembourg.

Navigating Operational Complexities

First, it is important to understand the role of the key players in the market. Long term investors such as insurance companies, pension funds, sovereign wealth funds and high net worth investors provide the investable capital, the investment manager is responsible for day to day fund operations and portfolio management, while the custodian and fund accountant provide the framework for asset supervision and investor servicing.


Understanding the asset is key to the success of both the manager and its providers. Private debt is more than broad, syndicated loans for mature companies; growing companies that require complex financing solutions will also be part of the universe of potential borrowers.

Asset Types

Managers need to recognize the nuances between asset types and leverage their existing operations where possible, however, they must be prepared to adjust and modify their back office as needed to accommodate the new product type. The manager should gain a thorough understanding of the typical behavior or process flows of the asset and ensure they have internal systems and controls to support the loan type. For example, the move from syndicated loans into private loans will reveal many differences in the lifecycle of a transaction between the two loan types and managers need to have addressed any operational gaps prior to trade initiation.

Technology Strategy

Managers should assess their technology strategy and whether they have the infrastructure to support a new asset class. Often managers face loan administration challenges because they do



not have appropriate loan tracking and reporting systems. Loans are complex instruments with myriad technical elements and it may be more efficient to outsource some of these tasks to a third-party who can provide specialist expertise as well as the technology infrastructure.

Advances in the use of technology over the next three to five years will radically transform the loan market. We expect to see increased straight-through-processing (STP) from new technologies such as financial products markup language (FpML) and distributed ledger technology (DLT). Leading technology platforms will drive the standard in advancing repetitive operational processes and investment managers will need to embrace these new technology developments. However, some may face significant challenges as they assess the best way to integrate with their existing systems.

Closely linked to technology, data presents another operational complexity. Accurate data drives all processes, and can cause confusion or error if not properly gathered, stored, secured, delivered, and reported.

Credit Agreements

Credit agreements are not standardized – certain provisions can be interpretive, and often documents are more than one hundred pages long. Managers are instrumental in establishing bespoke loan documentation recording processes which would provide the administrator and agent with the information necessary to process, record, and control the cashflows and economic value of private loan. Inaccurate loan set-up by the manager could result in errors and omissions across the trading and reporting cycle.

Managers should ask themselves whether they need a loan agent. For deals with some form of syndication, it could be money well spent. Ongoing asset servicing is a key challenge and the largest operational strain for most managers. Many providers offer turn-key solutions that they can white label as needed.

Reconciliation

With so many touch points between asset managers, fund administrators, and agents, it is essential to establish a strong reconciliation process. Irish and Luxembourg domiciled funds are required to have documented reconciliation processes, but it is valuable to have a similar process no matter where the fund is domiciled.

Fund Administration

The final functional consideration is whether a fund administrator has the global footprint to support a manager's activities. In some markets, immediate funding may be required at the time a deal closes and so an administrator and custodian with appropriate market coverage is required to enable the manager's investment activities. Adding market specific counterparties will add complexity to the operating model.

Whether due to regulation or pressure from boards and stakeholders, the push for transparency is growing. Managers should evaluate which data they are required to report and how they plan to do so before setting up a private debt fund. For example, deal specific data such as loan ratings may be hard to obtain due to confidentiality provisions in the structuring of the facility, and there is now greater emphasis on ESG reporting. Managers need to consider all current reporting requirements for regulators and investors, and also prepare for enhanced disclosure requirements in the future.

Exploring Entry Strategy

Many managers entering the private debt market come from a position of deep experience in a different sector, such as corporate bonds. This means they are already skilled in credit analysis and now wish to expand their business model to the private debt strategy. When creating this new product, managers typically approach execution in one of three ways: build, buy, or borrow.

Some managers build teams in-house, expanding their core skill to incorporate a direct lending product. For example, a fixed income manager already understands credit risk, and will understand balance sheets, cash flows, and other considerations in private debt lending. Private equity managers often choose this strategy as the lending activity complements their deep analytical expertise and long-term investment goals.

Other managers choose to buy the capability – buying the skills and experience required by acquiring another manager or team and folding them into their own outfit to run the new product. Finally, some managers borrow the expertise by outsourcing the investment management process to a firm that already has experience with the strategy.

All three strategies have their own merits and challenges and we have seen managers develop new lending products via all of these routes.

On the Horizon

As with any maturing market, the global direct lending sector is constantly changing and presents both opportunities and challenges. One side-effect of the popularity of the sector is that demand is currently outpacing supply leading to growing pools of uninvested capital, otherwise known as dry powder. In an attempt to put money to work, managers have changed fund and loan terms and net returns have fallen but there are still areas of opportunity.

In Europe, infrastructure debt is attracting much attention – the world needs it, and private investors are willing to provide the finance thanks to the long term returns from the asset. Cashflows from the underlying asset produce an income stream and the long-term nature of the loan aligns with the long-term requirements of the pension fund and insurance company investors.

Another area of growing demand is distressed investing. European banks are still deleveraging and large, sophisticated private equity managers are buying these assets. Banks are also selling performing loans if they are no longer considered core to the bank as part of their deleveraging activity.

Demand for private debt is strong and managers are responding with new fund launches and product strategies. Given the inherent illiquidity of the loans, investors need to understand the long-term commitments they are making when choosing the asset class and managers need to demonstrate robust risk management expertise. The asset servicer is the synapse that connects the investor and the manager and brings together accounting, valuation, safekeeping and oversight. As asset complexity increases, the role of the administrator and custodian with deep understanding of the asset class as well as strong risk mitigation protocols is essential to the successful operation of a private debt fund.

Brown Brothers Harriman Private Debt Servicing

Servicing over \$100 billion in private debt assets,* BBH has worked with many of the leading global asset managers on private debt fund launches and ongoing servicing needs. Ensuring the right decisions are made during the set-up process is critical to the fund's success going forward. For further information please contact:

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