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Preqin Special Report: Private Debt: The New Alternative?

June 2014

Institutional Investor Appetite for Private Debt

We examine investor appetite for private debt based on Preqin's recent survey of over 240 institutional investors.

Private Debt Investor Preferences

We take a look at which private debt fund strategies are drawing the most interest from institutional investors, as well as their appetite for different geographies.

Institutional Investors' Target Returns for Private Debt

What do investors' target returns tell us about risk appetite and performance expectations? We explore the answer to this key question and more.





Foreword

The private debt market has grown in recognition as an alternative source of value for investors globally in recent years. The continued regulatory development has affected traditional bank lending practices in the aftermath of global crisis, building opportunities for non-bank lenders, such as debt fund managers, to step into a larger role across the industry.

As such, an expanding group of investors with varying risk appetites are approaching private debt fund investments with several different goals in mind. We set out to investigate these investors' perspectives, risk appetites, preferences, and plans.

This research report examines the following:

- How do institutional investors view the private debt market?
- Do they consider the segment as private equity, fixed income, or a hybrid of structures?
- Which fund strategies are most sought after?
- What do target returns tell us about risk appetite and performance expectations?

In this report, we evaluate the latest investor sentiment toward closed-end private debt vehicles and strategies in order to assist fund managers in targeting institutional capital. The main component of this investigation is based on direct communication with 240+ institutional investors globally to assess their interest in the private debt market. Preqin research is developed in-house and executed by dedicated research teams globally.

We hope you find this report useful, and welcome any feedback you may have. For more information, please visit www.preqin.com or contact info@preqin.com.

In Numbers: Private Debt



Two out of every three institutional investors surveyed are considering or are investing in private debt funds.



16% of investors have set aside an exclusive debt allocation.



27% of respondents have a fixed target allocation to private debt.



5.6% is the mean current allocation for investors in private debt funds, with a median of 2.1%.



24% of private debt fund investors allocate from fixed income pools.



78% of investors prefer direct lending funds when investing in private debt



20% of investors contribute to private debt from their private equity allocation, with another 19% coming from a general alternatives allocation.



69% of investors have a preference for senior debt as a fund structure.



North American investors in private debt report an aggressive range of target returns from 9% to 15%.



European investors in private debt target slightly more conservative target returns of between 7% and 13%.

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Institutional Investor Appetite for Private Debt

On the Hunt for Yield

Private debt as a standalone asset class has welcomed sustained growth amid an alternatives landscape marked by consolidation and increased fundraising competition. The post-crisis appetite of investors for private debt exposure has developed aggressively as traditional fixed interest vehicles struggle to offer the attractive yield or risk profiles as before the credit crisis of 2008. This report investigates investor sentiment toward closed-end private debt funds in 2014 and beyond, when, unsurprisingly, fundraising success appears to be driven by significant market opportunity on the horizon. Preqin recently surveyed over 240 institutional investors to shed some light on where private debt fund commitments could be coming from in 2014.

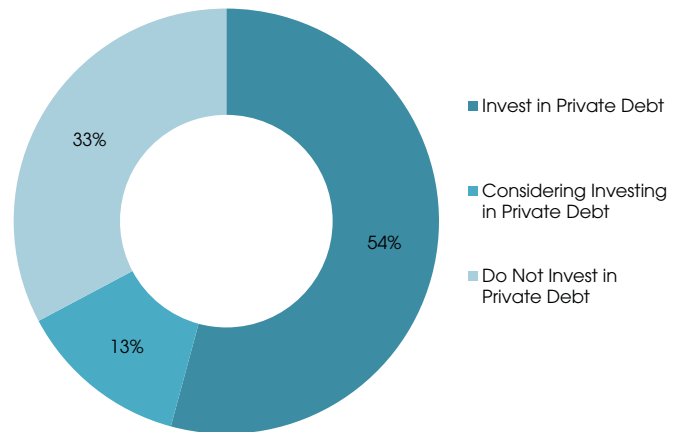
The results of Preqin's survey show that the outlook for fund managers coming to market remains positive as capital flows out from corporate and sovereign debt towards the private sector in search of strong risk-adjusted returns. Increased regulatory pressure on banks has already boosted private lending activity in the US and will continue to fuel progress in Europe for the foreseeable future as alternative financing structures take hold. As a result of a heightened regulatory framework, banks continue to re-work traditional lending practices and maintain higher capital reserves. Direct lending, mezzanine and distressed debt strategies will continue to be a focus of investment firms as considerable opportunities arise. From here, a wide range of managers will compete to fill a lending vacuum in the global post-regulatory climate; Preqin set out to find where their investor support is coming from.

Investor Review – Allocations on the Rise?

Preqin researchers recently surveyed over 240 institutional investors in an effort to investigate their plans in the near future. Two-thirds of investors surveyed are active in or are considering investing in private debt (Fig. 1). This strong proportion of investors is poised to maintain and expand, with continued warming toward the wide array of private debt fund structures. Among these investors, the mean current allocation to private debt instruments is 5.6%, with a median allocation of 2.1% (Fig. 2). Furthermore, 73% reported no target allocation, suggesting there may be opportunistic investing in the space, or the allocation is coming from broadly defined pools (Fig. 3).

While an increasing number of large public firms continue to organize and establish exclusively debt-focused units, a substantial share of investors plan to allocate to private debt from fixed income (24%), private equity (20%), and general alternatives buckets (19%) (Fig. 5). One large US-based pension fund told Preqin that they currently have a private debt allocation of 1.8% of total assets, pulled from a private equity bucket. These results show a clear fragmentation of the market, with some investors considering the vehicles as fixed income instruments and others classifying private debt funds under alternatives.

Fig. 1: Proportion of Institutional Investors Investing in Private Debt



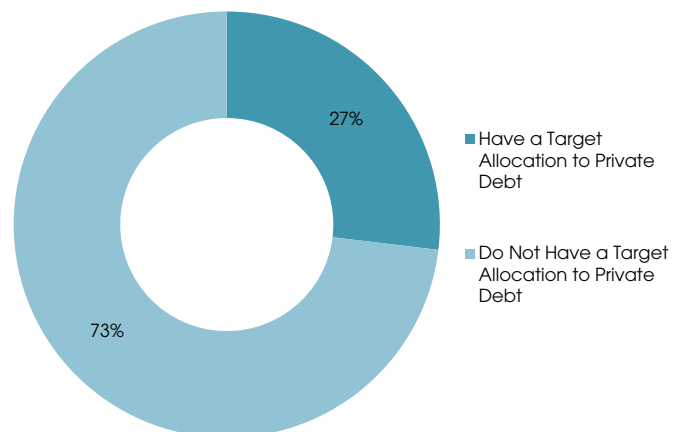
Source: Preqin Investor Survey, March 2014

Fig. 2: Institutional Investors' Average Current Allocation to Private Debt (As a Proportion of AUM)

| | |
|---|------|
| Mean Current Allocation to Private Debt | 5.6% |
| Median Current Allocation to Private Debt | 2.1% |

Source: Preqin Investor Survey, March 2014

Fig. 3: Proportion of Institutional Investors with a Target Allocation to Private Debt (Only Includes Firms that Invest in Private Debt)



Source: Preqin Investor Survey, March 2014

Fig. 4: Institutional Investors' Average Target Allocation to Private Debt (As a Proportion of AUM)*

| | |
|--|------|
| Mean Target Allocation to Private Debt | 6.8% |
| Median Target Allocation to Private Debt | 5.0% |

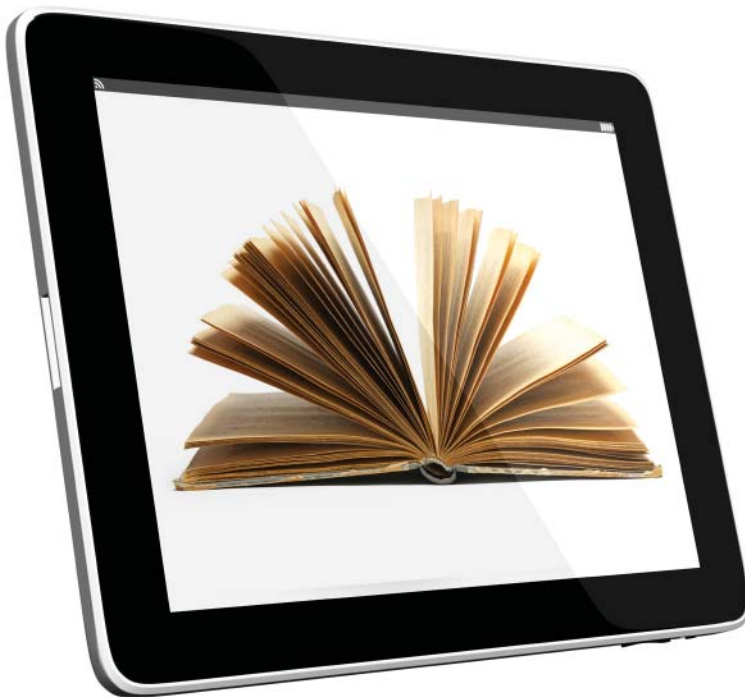
Source: Preqin Investor Survey, March 2014

*Please note: as shown in Fig. 3, many investors may not have a specific target allocation to private debt.

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Interestingly, Preqin’s survey revealed aggregated target returns for private debt investors globally to be within a range of 8%-14%, reflecting the variety of investment goals and expectations among LPs. Signalling a divergence in risk appetite, target returns for investors vary across regions, with North America-based investors typically targeting higher returns from their private debt portfolio (9%-15%) compared to their European counterparts (7%-13%).

Sixteen percent of investors surveyed have set aside a fixed allocation specifically for debt strategies. For example, San Antonio Fire and Police Pension Fund created a 6% target allocation to private debt in September 2012, and in H1 2014 approved a motion to search for an additional private debt fund manager to partner with. The observed proportion of private debt investors with a specified private debt allocation is likely to grow as presumably more institutions install personnel to oversee debt portfolios. Another sizable example is Stanislaus County Employees’ Retirement Association, which made its initial foray into the private debt asset class in 2013, creating a long-term 7.5% target allocation to the asset class, with an allowable range of 2%-9% of total assets.

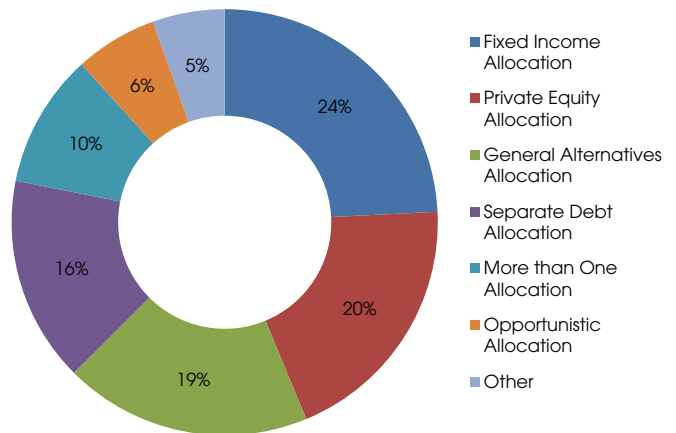
Aligning fund strategies and LP partiality remains a key issue for fundraisers in a complex private debt environment. As shown in Fig. 6, direct lending funds (78%) are currently the most attractive to investors, followed by distressed debt (59%) and mezzanine (61%) structures. The wide variety of fund structures available in the space can offer diversified exposure to investors, but Preqin’s survey shows that investors have a strong preference for direct lending vehicles.

The majority of investors surveyed demonstrated an interest in senior debt structures, with 69% of respondents expressing a preference for the relatively protected arrangement (Fig. 7). The secured income offered by senior debt is often supported by real assets or revenue producing agreements. The aspect of collateral or contractual obligation is vital protection for risk-averse institutions.

Vehicles that include subordinated debt, such as mezzanine and blended structures fall further down with 50% and 43% of investors preferring these vehicles respectively (Fig. 7). The relative safety of senior debt vehicles appears to outweigh the more risky upside of uncollateralized components in mezzanine or other subsidiary debt classes. However, with the lowest proportion of respondents expressing interest in exposure to junior debt at 38%, there is clearly relative parity among the main sub-senior structures, as they are often packaged together in a varied fund scheme.

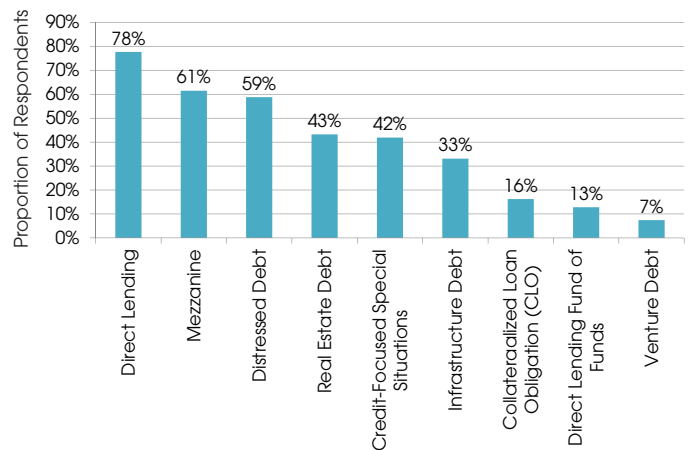
As might be expected, geographic investment preference skews strongly toward the west, with North America (74%), and Europe

Fig. 5: Breakdown of Investor Allocations Used for Private Debt Funds



Source: Preqin Investor Survey, March 2014

Fig. 6: Institutional Investors’ Private Debt Fund Type Preferences



Source: Preqin Investor Survey, March 2014

(59%) receiving strong preference for private debt investment exposure (Fig. 8). Respondents were able to express several areas of interest, with most firms reporting from the top regions represented.

Presumably even more risk tolerant investors will prefer to remain within the confines of the countries with the most transparent legal systems, highest investment activity, and available market intelligence. These facilities are necessary to establish stable interest terms, uphold deal framework, and see through complex compliance mandates between lenders and borrowers.

Are You Active in Private Debt?

If you are actively working in the private debt space and would like to learn more about Preqin or add details on your firm, please get in touch with us:

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Fundraising Challenge – Positioned to Succeed

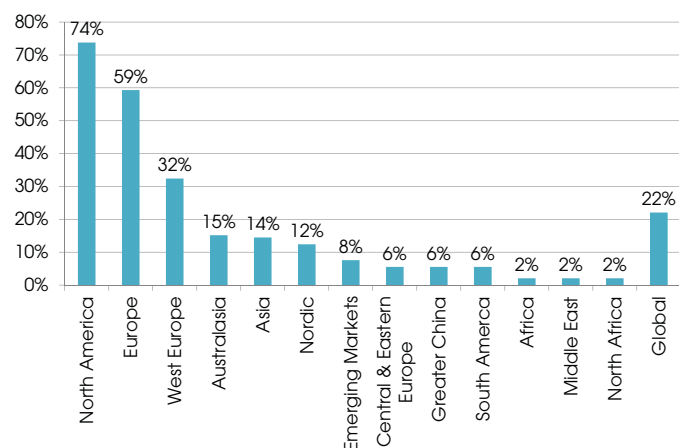
Large public investors led the way in 2013 with sizable commitments to private debt funds. Given the changed lending environment, private debt as an asset class is continuing to solidify itself in institutional portfolios. The trend of rising target allocations for fund investors continues to progress as favorable cash flow and capital structures are put into play.

Challenges remain, however, for private debt managers in search of commitments. The structure and positioning of funds is vital to fundraising success, especially for emerging managers, as the sources of institutional capital vary widely among investor portfolios. Identifying targets could be made easier by a shift in fixed allocations in relevant alternatives and fixed income buckets. As more eyes open globally to the establishment of private debt investing led by diversified North American institutions, the asset class has developed an identity separated from private equity and hedge fund classifications, which will aid would-be fundraisers in the future.

Market Opportunity – Defining a Strategy

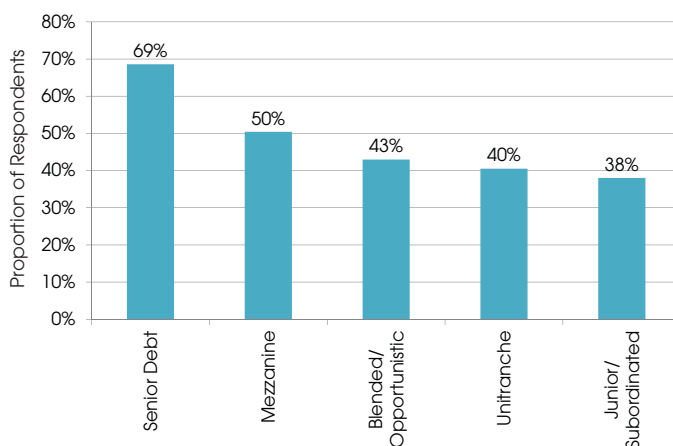
With spread forecasts remaining tight and continuously low interest rates, investors are seeking specialty managers with a pedigree for performance while managing downside risk in the hunt for yield. The ability to identify opportunities, build partnerships, construct agreements, and raise capital moving forward will dictate the winners over the next few years of what could be a favorable time in opportunistic financing activity. In Europe alone, the need for new commercial debt will likely be quite high in the near term, particularly driven by the mandates of new regulations and a sustained economic recovery. Banks continue to become less important in the practice of traditional lending while still playing a large part by offering industry insight, administrative services through partnerships, and facilitating relationships.

Fig. 8: Institutional Investors’ Geographic Preferences When Investing in Private Debt



Source: Preqin Investor Survey, March 2014

Fig. 7: Institutional Investors’ Direct Lending Capital Structure Preferences



Source: Preqin Investor Survey, March 2014

Private debt managers coming to market will be well served understanding the investor’s perspective toward the asset class as a whole. Most importantly, the ability to position a fund strategy to match LP risk tolerance and allocation preferences will likely be key for managers targeting fund commitments in 2014. The potential for immediate returns and low correlations offer coveted diversification for investors willing to take on relative illiquidity. A well defined and properly positioned debt fund will have the opportunity to target increasing pockets of capital as the story of private debt continues to develop.

Fig. 9: Institutional Investors’ Target Returns for Private Debt (Against Absolute Return)

| | Min | Max |
|--------|-------|--------|
| Mean | 8.56% | 13.95% |
| Median | 8.00% | 14.00% |

Source: Preqin Investor Survey, March 2014

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