
# PREQIN SPECIAL REPORT: FOUR EMERGING LESSONS FROM COVID-19 FOR NORTH AMERICAN PRIVATE DEBT

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# Contents



## About This Preqin Special Report

This report forms part of our coverage on how the alternatives industry is managing the impact of COVID-19.

The report combines data-driven analysis highlighting key lessons from history with thought leadership from three industry experts:

- Jess Larsen, Partner and Head of Americas, FIRSTAvenue
- Rich McKinney, Managing Director and Head of the Asset-Backed Strategies investment unit, D.E. Shaw Group
- Randy Schwimmer, Senior Managing Director, Head of Origination and Capital Markets, Churchill Asset Management, an investment-specialist affiliate of Nuveen

For more analysis and insights on the impact of the pandemic on alternative assets, please visit our COVID-19 Knowledge Hub.

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# Four Emerging Lessons from COVID-19 for North American Private Debt

**Firms most likely to thrive post-crisis will be those able to respond to investor demand for innovative, uncorrelated products**

*By Kainoa Blaisdell and Nicole Lee*
*With data support from Justin Bartzsch and Thomas Mulready*

The global economic shutdown triggered by COVID-19 has put the North American private debt industry to its first major test. Private debt has ballooned in size in the decade since the 2008-2009 Global Financial Crisis (GFC), when regulatory changes forced banks to deleverage their balance sheets, and private debt funds emerged as alternative loan providers to fill the void. And fill it they have. North America-focused private debt funds have amassed a record $500bn in assets under management (AUM) as of September 2019, an increase of 11.7% since December 2018, according to **Preqin Pro**. That is $332bn in unrealized value, and $169bn in dry powder that will need to be put to work – at a time when the International Monetary Fund expects the US economy to contract by 5.9% and the global economy by 3%, an outcome far worse than the GFC, the IMF said.

Top of mind for industry professionals right now is how the US private debt market is likely to fare. Looking back, what lessons can be learned from the GFC that are relevant today? What lessons are emerging as a result of COVID-19? And looking forward, how might the industry evolve? To help answer these questions, we compared GFC-era data and Q1 2020 data across key metrics such as fundraising, deals, and performance. We also spoke with industry experts who were active during the GFC and could offer valuable insight into how the market has changed – and what that might mean for the future.

## 1. What Lessons Can Be Learned from the GFC that Are Relevant Today?

It is important to note a few caveats before identifying GFC-era lessons that apply today. First, we are in the early stages of the current crisis. It has only been a little over a month since the World Health Organization (WHO) declared COVID-19 a pandemic, and warned that its epicenter could shift to the US.

Second, while the GFC's origins are financial, COVID-19's origins are biological. This distinction matters because the policy measures needed to tackle the latter are likely to be more complex, requiring support beyond the fiscal and the monetary. The GFC started out as a severe liquidity squeeze back in August 2007, when investment bank BNP Paribas froze three funds that were exposed to the US subprime mortgage market, sending shockwaves through financial markets. Investors were spooked even more when the subprime crisis brought down two storied Wall Street names: Bear Stearns in March 2008 and Lehman Brothers in September 2008. But coordinated central bank and government support helped to restore investor confidence, and by April 2009, markets began to recover.

By contrast, COVID-19 started out as a public health problem in the city of Wuhan, China and quickly spread across the globe. A novel coronavirus for which a vaccine has yet to be developed, COVID-19 has resulted in more than 2.4 million confirmed cases and over 163,000 deaths, according to the WHO. About a third of the world's population remains in lockdown. In the US, 22 million people are out of work, and according to the National Association for Business Economics, the unemployment rate is forecast to remain at around 10% in 2020, up from 3.6% in January.

All that said, there are similarities between the GFC and COVID-19 worth noting – starting with the basic fact that both crises occurred in a late-cycle environment characterized by significant leverage.

"Broadly speaking, we've been reminded once again that highly leveraged financial systems are vulnerable to unexpected shocks, and that liquidity events can quickly turn to solvency events," said Rich McKinney, Managing Director and Head of the Asset-Backed Strategies investment unit at New York-based investment management firm D.E. Shaw Group.

"We are again observing that the areas most impacted by the initial liquidations appear to be those that may have benefited the most from easy financial conditions and a 'risk-on' sentiment. For example, mutual funds' reach for yield – and their out-of-benchmark migration into less liquid and riskier instruments – has been remarkable."

In addition, in a globalized world, financial contagion is a factor, McKinney said. "As in 2008, I believe we run the risk of potentially meaningful spillover and knock-on effects due to the high level of interconnectedness of our market-based economies in the US and EU," he said. "For example, I believe that both the types of risks and the potential financial impacts of discrete risks to banks, which generally entered this crisis in good health, increase the longer the pandemic and economic uncertainty lasts; this could result in instability not only in assets typically originated or held by banks, but also in banks' capital instruments themselves."

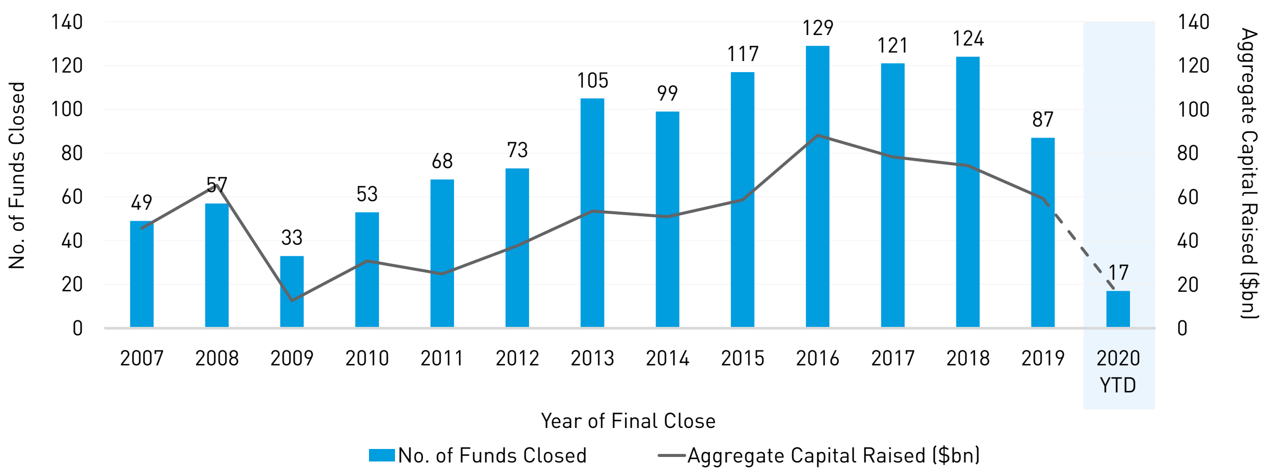
### 1a. How the GFC affected fundraising

The GFC affected both the number of funds closed and the aggregate capital raised. But as Fig. 1 shows, there was a lag. As the crisis was ramping up in 2008, the number of funds closed jumped from 49 to 57, while the amount of capital secured rose by 43% to $65bn. It was not until 2009 that the number of funds closed sank from 57 to 33, while aggregate capital raised cratered by more than 80% to $13bn.

Quarterly fundraising data reveals peaks and troughs throughout 2008 as investors had to digest the news that both Bear Stearns and Lehman Brothers had collapsed, the former in March and the latter in September. Fundraising took a nosedive in Q3 2008, falling by 96% from the previous quarter – and 91% vs. Q3 2007 – to stand at $1.1bn (Fig. 2). But the market bounced back by Q4 2008 with 24 funds closed and a total of $15bn collected. At the time, the US Government was implementing a $700bn bailout of the banks. As the crisis continued to play out, mezzanine and distressed debt fund managers emerged as the clear winners in the 2008 fundraising market, securing $24bn and $34bn respectively.

In the first quarter of 2009 the fundraising market plunged again. The amount of capital raised slid to $1.9bn with just seven funds closed as the US economy contracted by more than 4%, reigniting investor fears over the stability of the banking system. By April 2009 central banks and governments, including the US, were taking action to support the global economy. The recovery was gradual, and fundraising remained sluggish throughout most of 2009. While most private debt strategies faced a tough fundraising environment,

**Fig. 1: North America-Focused Private Debt Fundraising, 2007 - 2020 YTD**




*Source: Preqin Pro. Data as of April 2020* special situations fund managers bucked the trend. Total capital raised in this strategy soared by more than 660% to $4.6bn as GPs eyed opportunities in turnaround and complex situations.

2010 provided light at the end of the tunnel for private debt fund managers looking to raise funds: aggregate capital raised doubled from 2009 to $31bn. At the time, confidence was starting to return to financial markets as asset prices began to recover and central banks kept supportive policies in force. In 2011, a year which saw US sovereign debt downgraded, fundraising activity dipped briefly. It has trended upward since, although the amount of capital raised in 2019 fell by more than 20% to $59bn as competition intensified and valuations continued to rise. The drop in private debt fundraising has been even more pronounced in Q1 2020 in light of COVID-19.

How does GFC-era fundraising compare with the first quarter of 2020? Rather than lagging the crisis, the impact of COVID-19 on fundraising seems to have been more immediate. That is understandable, given that travel has been suspended and roadshows are on hold amid the COVID-19 lockdown. Globally, across six alternative asset classes – not just private debt but private equity, venture capital, real estate, infrastructure, and natural resources – the number of funds closed in Q1 2020 was lower when compared with the same period a year ago, Preqin data shows. The number of North America-focused private debt funds reaching final close fell to 15 vs. 23 funds in Q1 2019. Meanwhile, aggregate capital raised dropped by 17% to $8.4bn. North America was not the only region to struggle – globally, total capital raised by private debt funds was 41% lower when compared with Q1 2019. That makes the start of this year the worst fundraising quarter for the asset class since Q3 2016.

What GFC-era data suggests is that fundraising is indeed affected by financial crises. And as the peaks and troughs of 2008 indicate, the impact can be significant.

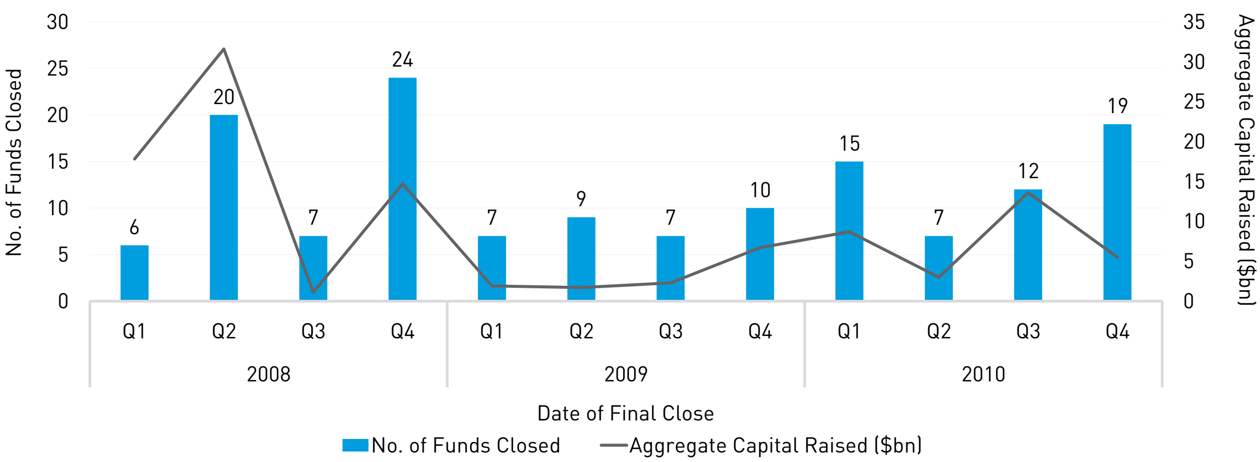
**1b. The outlook for deals during the GFC**

Between 2007 and 2008, as the US sub-prime mortgage market unraveled, the value and volume of North American private debt-backed deals tumbled. The number of deals fell from 323 in 2007 to 246 in 2008, while total deal value slid by 62% to a low of $4.1bn (Fig. 3).

On a quarterly basis the steepest drop in deal volume occurred in the earlier stages of the credit crunch, between Q4 2007 and Q1 2008. The number of deals fell from 90 to 63, while deal value dropped by about 74% to just $1.0bn (Fig. 4). Deal value subsequently plateaued in the next two quarters of 2008 before rising slightly to $1.2bn in Q4 2008. Meanwhile, the number of deals tumbled from 70 in Q3 2008 to 45 in Q4 2008. This reflects a slowdown in buyouts at the time – buyout activity fell by 81% compared with the previous quarter to $2.7bn in Q4 2008.

In Q1 2009 deal value plunged to $0.4bn, but eventually rebounded in Q4 2009, matching the highs of Q4 2007 at $3.8bn and creating what looks roughly like a W-shaped recovery. The number of mezzanine deals remained relatively robust throughout 2008 (Fig. 5).

**Fig. 2: Quarterly North America-Focused Private Debt Fundraising, Q1 2008 - Q4 2010**




*Source: Preqin Pro*

As the data shows, the GFC had a marked impact on both deal volume and value. Deal value in particular fell sharply in the initial stages of the liquidity crunch and remained low for most of 2008-2009.

The good news is that the market regained lost ground fairly rapidly. Since 2010 the number and aggregate value of deals have grown steadily. Deal value reached a peak of $61bn across 980 deals in 2018 before falling to $50bn across 637 deals in 2019, highlighting tougher market conditions as asset prices rose and competition for deals increased.

By triggering a recession in the US and across the globe, COVID-19 has put the brakes on rising asset prices. If the market does follow a similar trend to that seen during the GFC, the hope is that it will rebound sharply, just as it did by Q4 2009.

#### 1c. Outperformance of crisis-vintage funds

Preqin data shows that North American private debt funds with vintages coinciding with crisis periods tend to outperform funds of other vintages on a median net IRR basis.

Fig. 6 highlights two periods of outperformance: the GFC and the dotcom bubble of the late 90s and early 2000s. The bursting of the dotcom bubble saw the precipitous 77.42% peak-to-trough decline of the NASDAQ from 5,048.62 on 10 March 2000 to 1,139.90 on 4 October 2002. Isolating North America-focused private debt funds with vintages in this three-year time period reveals a median net IRR of around 13.5%, with funds in the 2000s category clocking a median return of 14.7%.

Similarly, GFC-era funds with vintages between 2008 and 2010 recorded a median net IRR of between 10.3% and 13.5%. Funds that began investing at the height of the crisis in 2009 offered up the highest returns of 13.5%. Median net IRRs continued to slide for funds of later vintages – 9.4% for vintage 2011 funds and 8.8% for vintage 2014 funds, for instance.

What the performance data suggests is that funds that begin investing in crisis periods – when asset prices are expected to fall – do indeed tend to outperform. And that outperformance can be significant.

### 2. What Lessons Are Emerging as a Result of COVID-19?

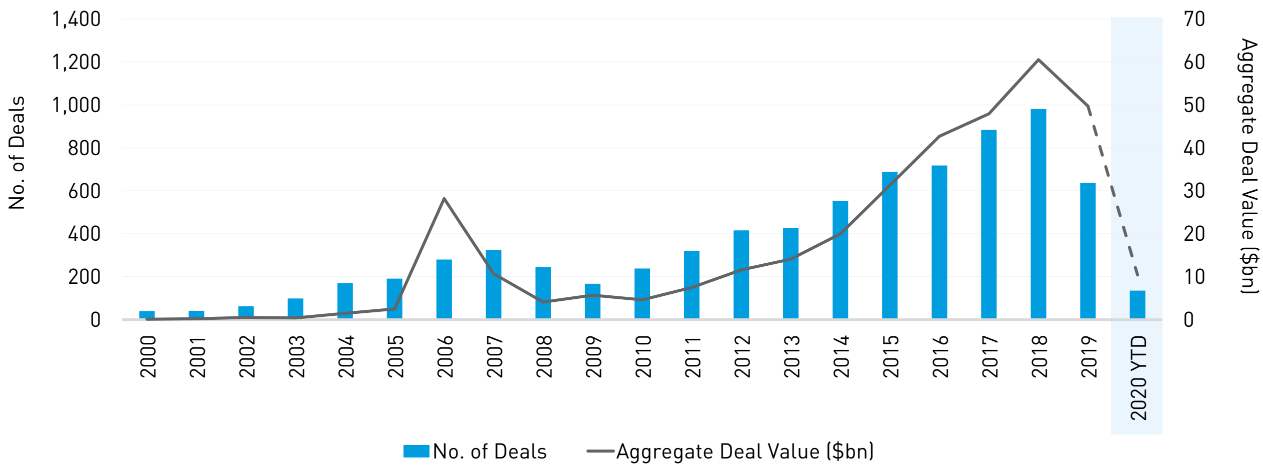
It is early days in the current crisis, but at least four lessons are becoming clear, industry experts say.

#### 2a. 'Liquidity' is the watchword

"First, it's all about liquidity," said Randy Schwimmer, Senior Managing Director, Head of Origination and Capital Markets at New York-based Churchill Asset Management, an investment-specialist affiliate of Nuveen. "Having available cash in times of stress has always been and continues to be a prime tenet of prudent financial management. That goes for borrowers and lenders."

Financial sponsors typically keep up to 20% of each fund in reserve for M&A and incremental liquidity needs, to avoid having to go back to investors for further commitments. But at a time when multiple portfolio companies may be generating little to no revenue as a result of the global economic hiatus,

**Fig. 3: North American Private Debt-Backed Deals, 2000 - 2020 YTD**




*Source: Preqin Pro. Data as of April 2020* access to liquidity is vital – and lenders must be prepared for that, Schwimmer said.

"Financing requires significant capital during times of growth, but also in times of contraction. During steep contraction, lenders need extra reserves in case their clients require additional support," Schwimmer said.

For GPs, managing their liquidity profiles need not be purely defensive, said McKinney. "Opportunity sets can migrate, sometimes rapidly, between liquid and less liquid credit markets. In our view, private or hybrid capital pools can complement hedge fund capital pools and give managers the flexibility to capitalize on both types of market opportunity sets," he said.

"We also believe that managers with access to both liquid and illiquid capital pools have a comparative advantage over market participants focused on one or the other, and thus develop better sourcing networks. Intuitively, GPs and LPs should be aligned in wanting managers to take maximum advantage of their capabilities and sourcing networks."

Jess Larsen, Partner and Head of Americas at global placement agent and advisory firm FIRSTAvenue, highlighted what he calls "the two Ds" – distributions and the denominator effect – as investors look to manage their liquidity.

"For the last three years, capital calls have been higher than distributions; we can probably expect distributions will be further reduced over the next 6-12 months" as valuations fall and the number of exits diminish, Larsen said.

The other issue is the denominator effect. This occurs when there is a sharp fall in the value of equities, which results in the investor's private fund holdings exceeding their asset allocation target.

"Because of the denominator effect, LPs have to consider rebalancing their portfolios. This could mean reducing their private fund investments to match their overall asset allocation policy and crystalizing losses.

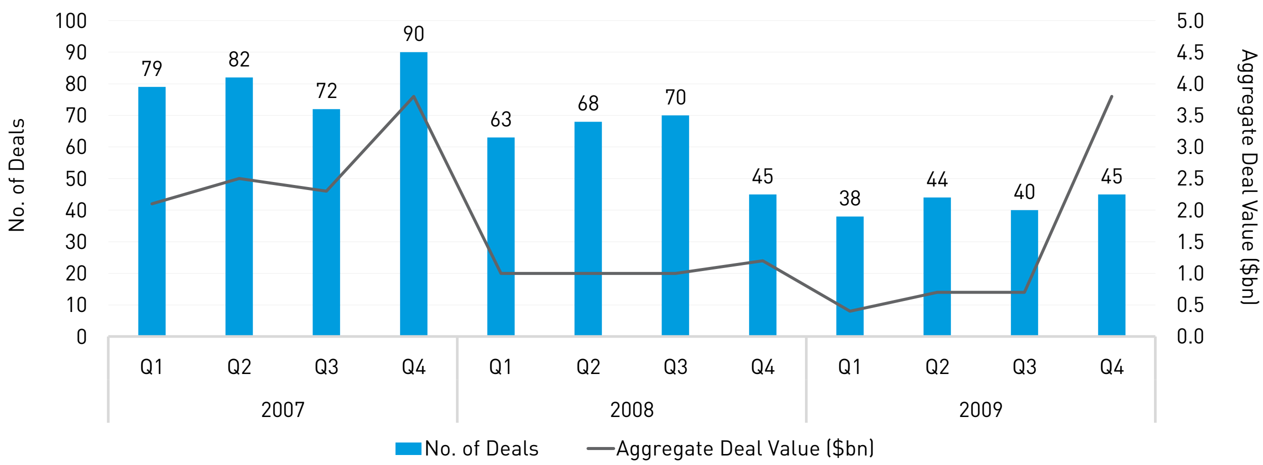
Or they could decide to be overweight to private funds. It's pleasing to see that a number of influential investment consultants are advocating this – in some circumstances, recommending that LPs raise capital from their bonds or treasury holdings to capitalize on opportunities in the private market. Given the actuarial interest rate of close to 7%, many US pensions will need private fund performance now more than ever."

### 2b. GPs with funds in market should focus on current LPs

"This is not going to be a strong fundraising year for private credit in general, so expectations need to be adjusted," said Larsen. "GPs will need to predominantly build their asset-raising plans around their existing relationships."

In a world where all meetings have to be virtual, LPs are not in a position to do the same level of due diligence on a new GP relationship – and that is unlikely to change in the foreseeable future, Larsen said, adding, "trying to win trust and raise capital from a brand new relationship in this environment is exceptionally challenging."

**Fig. 4: Quarterly North American Private Debt-Backed Deals, Q1 2007 - Q4 2009**




*Source: Preqin Pro*

"I'd argue that the asset-raising winners over the 12 months will be the GPs who have three qualities. First, they already have a strong relationship with their LPs – their LPs trust them. Second, they demonstrate flexibility in coming up with solutions. They can offer structures such as SMAs [separately managed accounts], a fund of one, and so on. Third, they have capabilities in the areas likely to benefit from market dislocation. GPs that are willing to show flexibility to solve their LP's problems will come out stronger and will be able to raise more capital, relatively speaking."

### 2c. Distressed debt, special situations, and mezzanine strategies likely to benefit

Direct lending has long been the focus of private debt investors. Indeed, "for many market participants and observers, 'private debt' became code for 'direct lending,'" said McKinney, citing Preqin data showing the rapid growth in direct lending AUM, which rose from $85bn as of the end of 2007 to $222bn as of June 2019.

But in today's crisis environment, small and medium-sized enterprises that are highly leveraged are vulnerable, McKinney said. "We believe the distressed debt, special situations, and mezzanine components of private debt could emerge as the main near-term beneficiaries." He highlighted a November 2019 report from UBS, which estimated that a total of $2.3tn was outstanding in US leveraged loans, high-yield bonds, and middle-market loans rated B+ or below, with 84% or $1.9tn of that debt issued by private (i.e., non-public) firms.

"To us, this suggests that there now could be an attractive opportunity set for the non-direct lending cohort of the private debt universe, especially those distressed debt and special situations players that possess a combination of the necessary skillset and the right type of capital (i.e., committed, longer-duration capital) to benefit from pricing inefficiencies that may emerge," McKinney said.

"This is not to suggest that direct lenders don't have an important role to play during and after the crisis. Stronger, more resilient lenders, and especially those with ample dry powder, could be well placed to grow market share and position themselves for post-crisis growth. Some may even push into the distressed and special situations arenas."

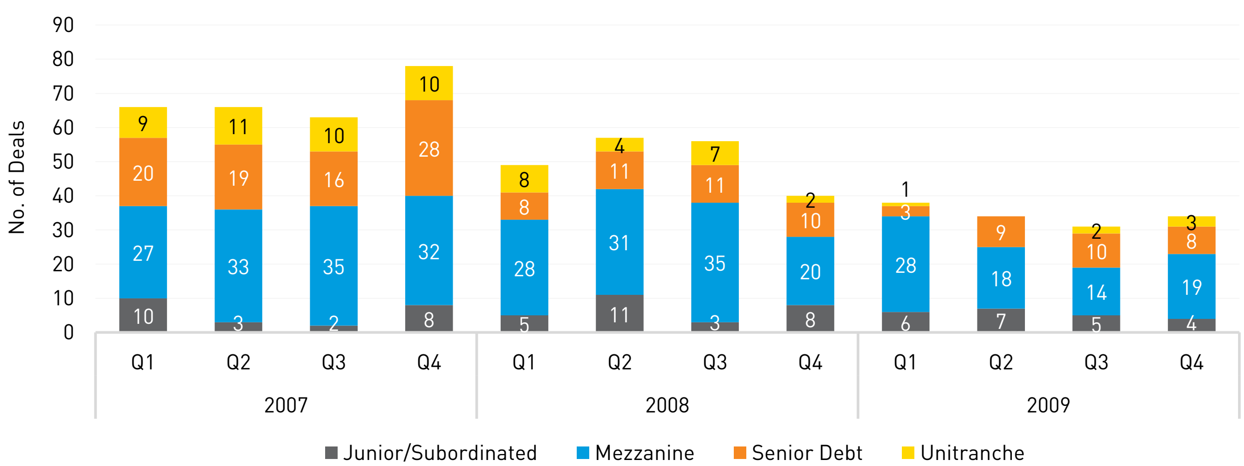
Distressed and special situations are not the only strategies likely to offer promising opportunities, however. "The relative importance of mezzanine debt, and thus mezzanine-focused funds, may increase as senior players could push for thicker subordinate tranches in capital structures," McKinney said. "We could see this theme develop in both public and private credit markets."

### 2d. Cooperation between borrowers and lenders is especially vital

In a crisis like COVID-19, where all industries across the economy are affected in some way, it is even more critical that borrowers and lenders work together.

"While sticking with non-cyclical or counter-cyclical sectors is a key part of a conservative investment strategy, COVID-19 has affected every company in

**Fig. 5: Quarterly North American Private Debt-Backed Deals by Debt Type, Q1 2007 - Q4 2009**




*Source: Preqin Pro*

the US one way or the other. Even if a business is advantaged during this crisis, you still need healthy employees to produce goods and services. Outside your home, there's no place to hide from this virus," said Schwimmer.

"When companies go through this epic level of disruption, the notion of a 'default' is almost quaint. For issuers suddenly hitting the wall of this global event, it isn't just a question of 'Can I make my interest payment?' It's 'Do I have enough cash for rent and payroll?' In that environment, owners and credit providers need to come together in a very different, more creative fashion. The mutual goal is to get as quickly and safely as possible through this interim period to the other side of the crisis."

Larsen said that a key difference he's noticed when comparing the impact of the GFC and COVID-19 is that GPs and LPs are being more cooperative. "When we talk to the market, people are cognizant that they have severe issues that they need to work through, but they're calm about it." Given how high the stakes are, "GPs and LPs are trying to work together rather than fight," he said.

### 3. How the Private Debt Industry Might Evolve in Future

The GFC gave rise to the private debt industry as we know it today. And now, as a result of COVID-19, the market is evolving. Direct lending is likely to continue to serve a core purpose in private credit portfolios, industry experts say. But they expect investor demand for creative, uncorrelated solutions to grow.

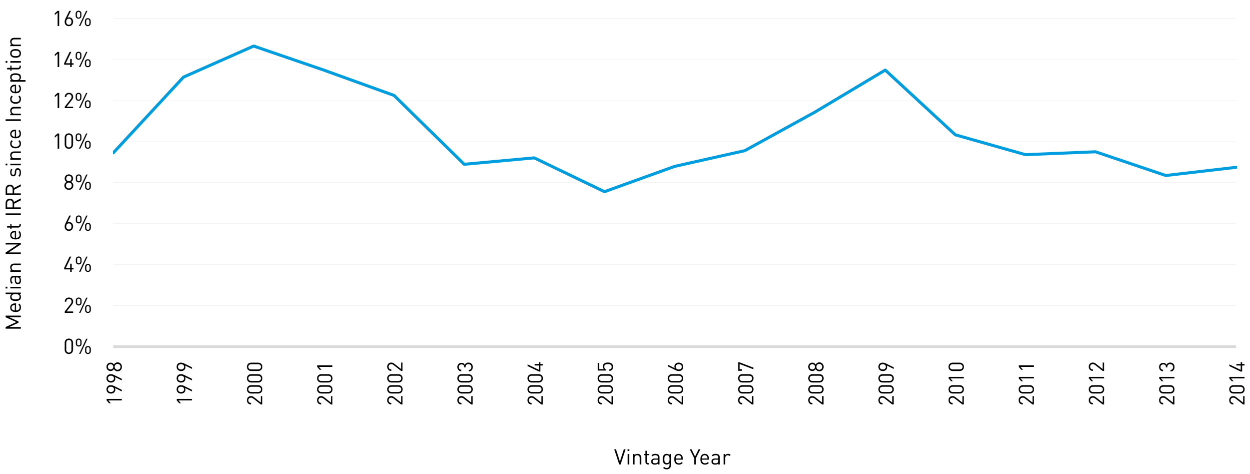
"Currently, the private credit industry is dominated by direct lending, mezzanine, and distressed/special situations strategies," said Larsen. "As we come to the other side of this pandemic-driven crisis, LPs will increasingly look to diversify their private credit portfolios with a broader subset of strategies. Innovation and thinking out of the box will be necessary. Strategies such as ABL [asset-based lending], specialty finance, royalties, leasing, and secondary private credit will, among others, see a surge in demand.

It is these developments in strategies that will help private credit grow to an industry far above the trillion-dollar mark. Private credit 2.0 will be even more diversified and sophisticated."

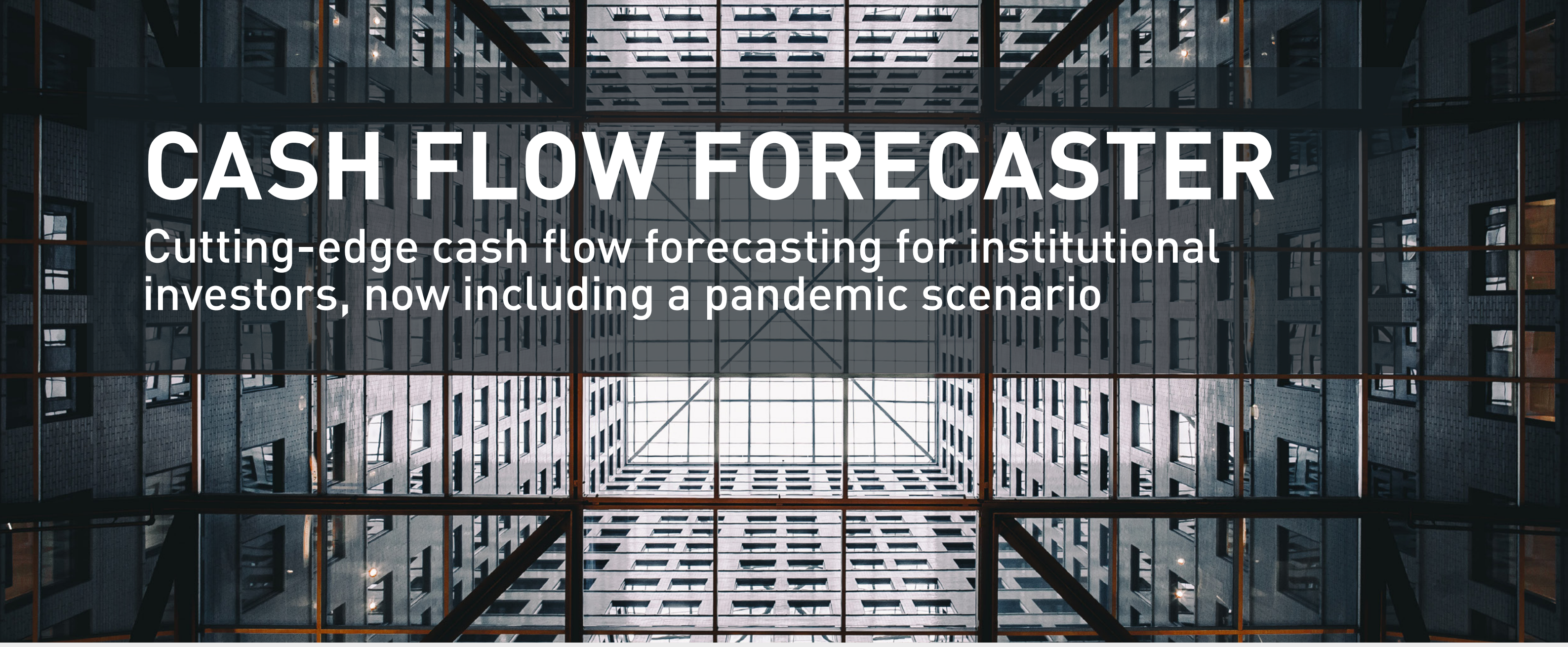
A more diversified asset class is a stronger asset class, industry experts note. In the meantime, they see GPs and LPs looking to build closer relationships.

"We are all going to go through this downturn together, and we will hopefully come out of this like we did in '08 and '09," said Schwimmer. "I think it's not only a possibility, but it's inevitable for the industry to come out of this crisis stronger."

**Fig. 6: North America-Focused Private Debt: Median Net IRRs by Vintage Year**




*Source: Preqin Pro. Data as of June 2019*



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