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PRIVATE DEBT: PREPARING FOR THE UNKNOWN

2018 SEI Preqin Survey of Private Debt
Managers and Investors





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EXPLORING THE PRIVATE DEBT FRONTIER

The prodigious growth of private debt in recent years has been extensively documented. Growing competitive pressures and macro-economic changes are starting to affect the private debt ecosystem, leading to increased discussions of the risks that may accompany this growth. As concerns mount, SEI collaborated with Preqin to survey and interview more than 200 private debt managers and investors in order to discern how GPs might best weather an impending slowdown.

Our research revealed myriad opportunities available to fund managers and investors alike. It also became abundantly clear that these opportunities are accompanied by risks, and the private debt market must be navigated with care. A variety of factors make the business more vulnerable than it was a few short years ago. The scale and competitiveness of the private debt business mean risk has largely been transferred away from banks, but the bountiful supply of credit means fund managers and their investors have been ceding power to borrowers. Covenant-lite loans account for a growing slice of the overall market. While it's not obvious where the risks ultimately lay, it's clear that investors and their fund managers may not be protected.

Governments assumed much of the risk in the depths of the last downturn after it proved to be too much for banks and their depositors. With market risk now theoretically borne by a much more global and diverse set of investors, including pension plans, insurance companies, wealth managers, and family offices, it's difficult to say what will happen when the market is seriously tested again.

In a market full of promise yet fraught with risk, what is the best way forward? Our findings suggest a number of important considerations for managers wishing to take advantage of the opportunities in private debt. These range from niche lending strategies and customized portfolios to the use of advanced data analytics and a greater emphasis on operational efficiency and resilience.

In addition to illuminating some future opportunities, our survey revealed another familiar dynamic: fund managers are considerably more comfortable than investors with the current state of the market and their place in it. This is notable because we observed a similar disconnect between hedge fund managers and investors when we began surveying them a decade ago. Like private debt managers now, hedge fund managers then were largely unconcerned with growing competition, restive investors and looming regulation. That nonchalance gave way in the intervening years to grudging acceptance of the real costs involved. The hedge fund business subsequently evolved and participants became more sophisticated as a result.

Will the evolution of the private debt market mirror these developments? As astute as managers are, it seems fair to point out that it can be difficult to fully grasp the broader market from inside the silos in which many of them operate. This produces a more myopic perspective than the one enjoyed by investors whose exposure to multiple asset classes and strategies allows them to step back and take in the big picture.

Any ambivalence is understandable. Despite slowing growth, the private debt market continues to flourish and is expected to top \$1.4 trillion within the next five years.¹ Nobody knows when the next restructuring will happen, and we're not trying to imply or answer the question of whether or not the boom in private debt may pose systemic risk. Individual managers, however, should be asking themselves what they can do—strategically, operationally or technologically—to hedge some of this risk, enhance their competitive positioning, and prepare for the inevitable slowdown or downturn.

PRIVATE DEBT GOES FROM PERIPHERY TO PROMINENCE

The phenomenal growth of private debt over the past decade can be traced back to the global financial crisis. Financial institutions needed to offload debt and the regulatory response included sharp increases to capital requirements. Both factors caused banks to curtail corporate lending and adopt a much more conservative approach to origination. Fund managers stepped into the breach, effectively replacing banks in the corporate lending landscape. Private equity sponsored deals have driven much of the growth, but nonsponsored loans are a growing part of the picture. In Europe, for example, nonsponsored loans accounted for over a third of overall loan volume in 2017, compared to less than 20% in 2007.²

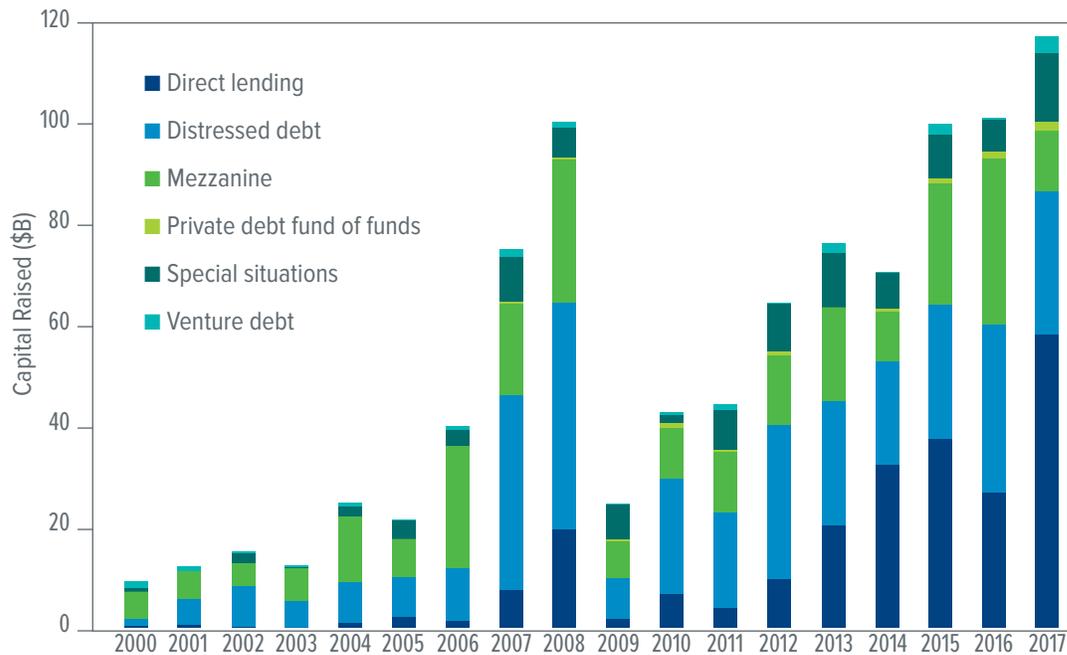
Meanwhile, investors suffered in the prolonged yield drought driven by easy money policies enacted by central banks to stimulate economic activity. Unable to meet their cash flow requirements with investments in most traditional forms of fixed income, they were increasingly drawn to private credit. Increasingly viewed as a stand-alone asset class, private debt was seen as attractive in part because it was largely protected from interest rate hikes by the use of floating rates. Correlations with other assets were also thought to be relatively low, making private debt an excellent source of risk diversification. Furthermore, risk-reward characteristics looked attractive. Recent research has borne this out, showing that the pooled internal rate of return (IRR) for all vintages from 2004 to 2016 was 8.1%, despite including the negative effect of the financial crisis. Direct lending funds were particularly successful, with a pooled IRR of 11.8%.³ The same study reinforces the fact that “direct lending funds’ low correlation with all benchmark indices indicate they could provide diversification benefits for investor portfolios.”⁴

A less-discussed factor is growing investor interest in private debt relative to other asset classes. Passive investments and private debt have been notable beneficiaries of growing discontent with actively managed long-only strategies using publicly traded securities. Private equity and its yield-producing cousin—private infrastructure funds—have also benefited.

The net result has been a series of banner years for private debt funds. Approximately \$100 billion was raised by private debt funds in 2015 and again in 2016, matching the high watermark previously seen in 2008 (Exhibit 1). Interest continued apace in 2017, as investors put almost \$120 billion into private debt funds. Assets under management skyrocketed from \$245 billion in 2008 to almost \$667 billion a decade later. They are projected to double again by 2023.⁵

How long will this continue? Fundraising has slowed down through the first three quarters of 2018, but has not dropped precipitously. More interesting than the magnitude of current growth, however, is its composition. Investors are seeking the safety of established managers with demonstrable track records with whom they may already have relationships and in some cases seeking to amplify these relationships by establishing “strategic relationships” or SMAs. This trend means assets are increasingly concentrated in fewer hands. In Q2 2018, the five largest private debt funds raised \$28 billion—or 66% of total assets raised.⁶ Investor attention is also being redirected among subcategories. Interest in direct lending and mezzanine credit all but evaporated in Q2 2018 as investors turned instead to special situations.⁷ These developments suggest that we may not necessarily see more deal volume, but bigger transactions are almost guaranteed.

EXHIBIT 1 Annual aggregate private capital raised by asset class



Source: Preqin.

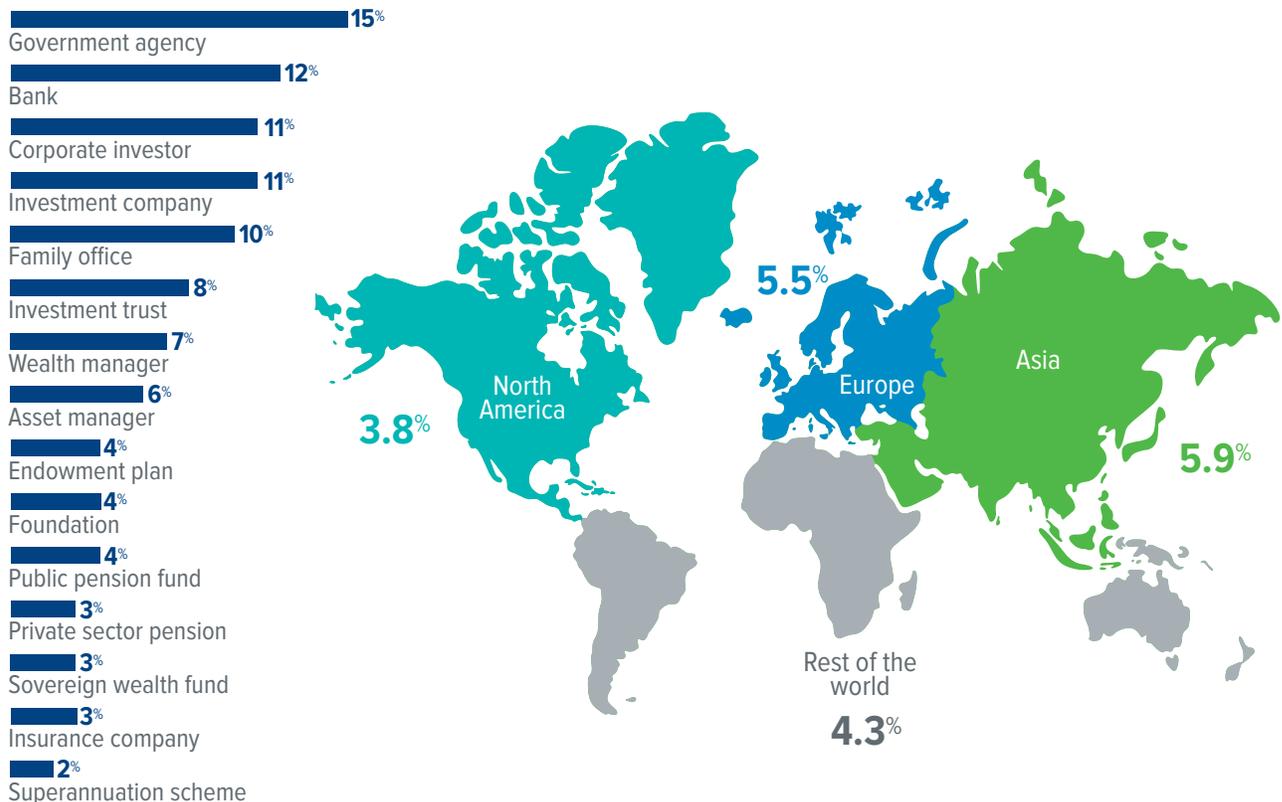
Approximately **\$100 billion** was raised by private debt funds in 2015 and again in 2016, matching the high watermark previously seen in 2008. Interest continued apace in 2017, as investors put almost **\$120 billion** into private debt funds. Assets under management skyrocketed from **\$245 billion** in 2008 to almost **\$667 billion** a decade later.

WHO'S INVESTING AND WHY?

How this plays out over the coming years has a lot to do with who is investing. Private debt is a global phenomenon. As the popularity of private debt exploded, so did the diversity of its investors. Regardless of location, institutional investors need to match long-term liabilities with long-term investments. Companies everywhere need access to credit, especially when banks stop lending. That being said, all investors have their own objectives and risk parameters. Some of these are idiosyncratic, while others may typify the characteristics of a particular region or investor type. A public-sector pension fund in South Korea, for example, is likely to have different needs and concerns than that of a German wealth manager.

While North American investors comprise 57% of the estimated 3,100 institutions in the asset class globally, they are not the biggest allocators to private debt products as a percentage of their overall portfolios.⁸ That distinction belongs to institutional investors in Asia, who currently allocate an average of 5.9% of their portfolios to private debt funds (Exhibit 2).

EXHIBIT 2 Average of current allocation to private debt (%)



Source: Preqin.

European investors account for a sizeable share of the global total, and their enthusiasm is also reflected in their relatively high allocations to private debt (5.5%). Given their particularly heavy reliance on bank credit, European borrowers raced to embrace private debt in the wake of the financial crisis. Investors obliged, and the boom was further spurred on by the sovereign debt crisis, solidifying the role of private debt in the portfolios of European investors. The increasingly vibrant market for private loans now means there is an abundance of local product to satisfy institutions looking to invest in locally sourced assets.

Three of the 10 largest private debt funds in the world are from Europe, and strong demand is causing even more capital to rush in: Euro-focused direct-lending funds regularly accounted for more than 40% or even 50% of the global annual total over the past decade.^{9,10} Growth has slowed in recent years, but investor interest in Euro-focused funds is undeniable: Dry powder in European private debt grew by 4.5x over the 10 years through 2017.^{11,12}

In contrast, dry powder in North America only doubled in the decade following the financial crisis. Average allocations among investors are lower, but the number in the market and the total amount invested still dwarfs other markets. Funds focused on North America still comprise 53% of those raised globally, as well as a notable 59% of the aggregate total raised.¹³

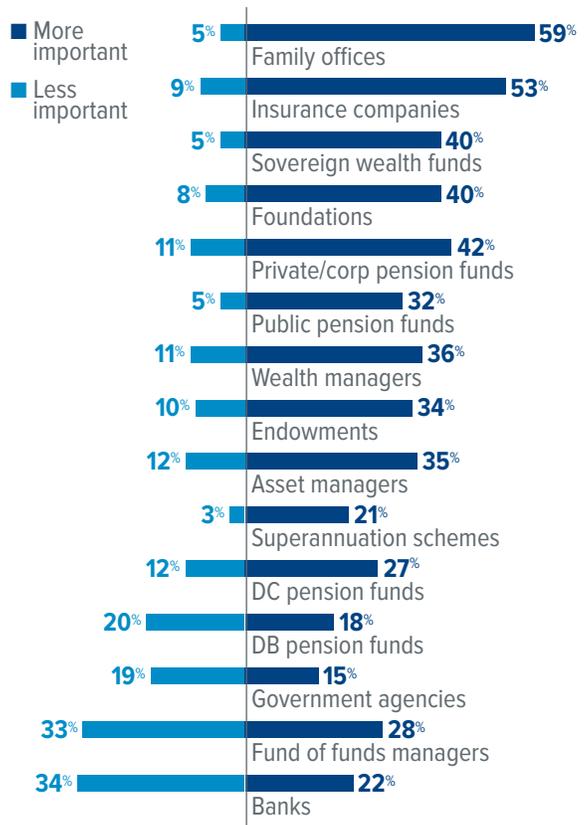
Asia is a growth market for private debt despite ongoing concerns about governance, creditors' rights and geopolitics in the region. There are vast pools of capital that have yet to be tapped alongside a plentiful supply of credit opportunities. As the founding partner of a fund manager which has raised over \$500 million in direct lending funds focused on sector-specific sponsored transactions in North America pointed out, "Asia, especially Korea, is now a regular stop [on fundraising trips]. The Koreans we have spoken to are in the process of learning about the space. They are where the U.S. institutional market was 3 or 4 years ago."

Recent take-up has been rapid. By the start of 2018, Asian investors accounted for 11% of the global total, up from just 6% two years earlier.¹⁴ Direct lending is not as popular among Asian investors, who are more likely to choose mezzanine or special situations debt.¹⁵ Although their total footprint remains diminutive, investors from countries like China, South Korea and India are increasingly drawn to the unique characteristics of private debt. The number of investors allocating to private debt in these countries rose by 52%, 36%, and 110% respectively during 2017.¹⁶ The pivot toward Asia is not limited to investors. Faced with increasingly mature markets at home, fund managers also see the region as a fertile source of investment opportunities.

Geography aside, private debt appeals to a wide variety of investors. Public- and private-sector pension funds account for 29% of all investors, followed by foundations and endowments comprising another 22%.¹⁷ Government agencies and banks have the largest average allocations, followed by corporate investors and investment companies. Pension plans, foundations and endowments have relatively low allocations in the 3% to 4% range. It's no surprise then, that they should be viewed by many managers as being particularly ripe targets for fundraising over the next few years (Exhibit 3). Signaling a shift toward the individual investor segment, however, is the role of family offices. Already major investors in private debt with 10% average allocations, they are also seen by 59% of managers as becoming an even more important source of capital going forward.

EXHIBIT 3

Q (Asked of GPs) How important do you think the following investors will be as a source of capital in 2023?

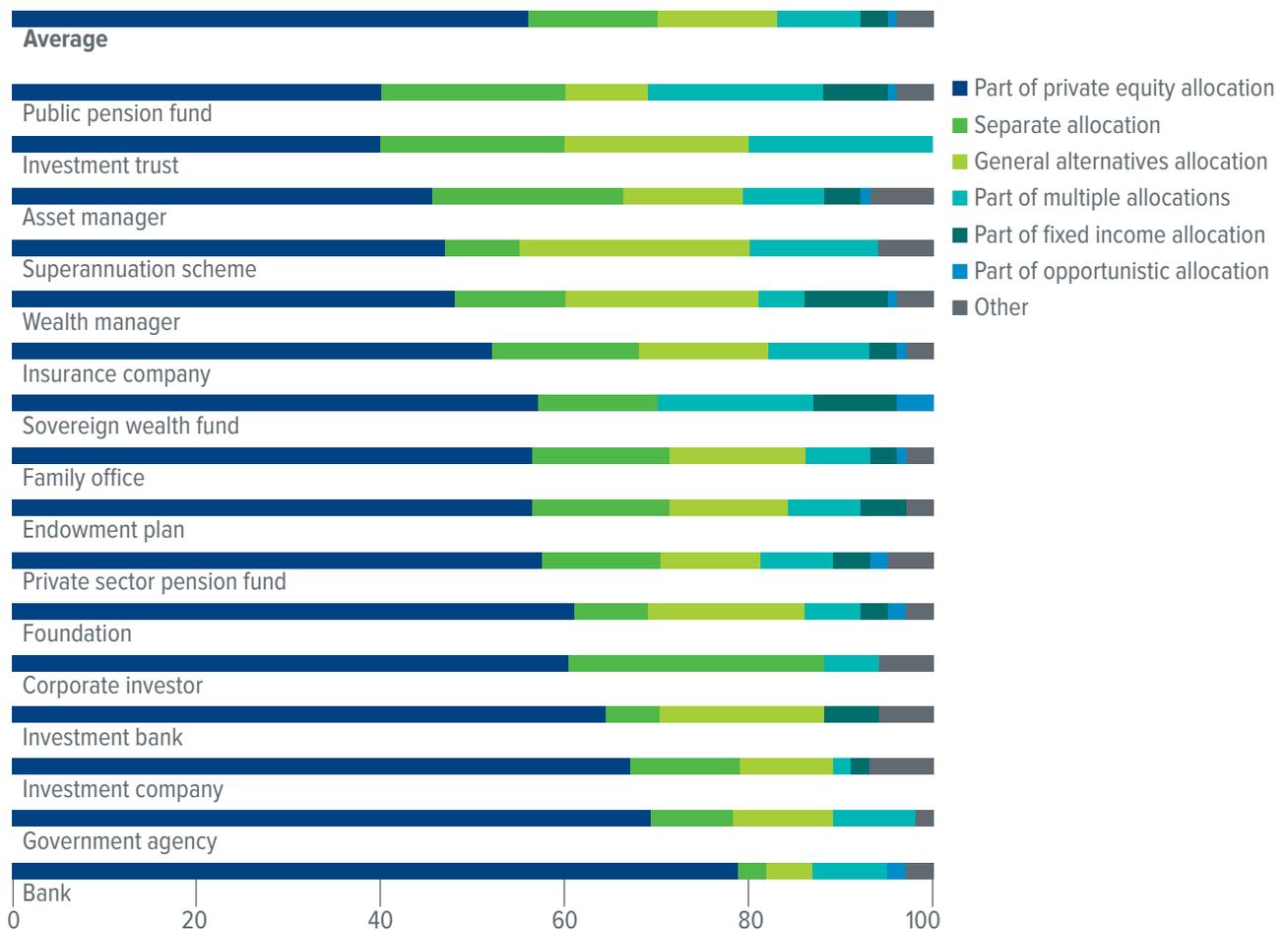


Source: SEI Preqin Private Debt Survey.

By and large, investors in private debt are content. According to Preqin, two out of three say their private debt investments met expectations over the past 12 months.¹⁸ One out of four stated that their expectations were exceeded. Only 10% said their private debt investments fell short of expectations, compared to 29% of hedge fund investors.

How this plays out in coming years depends in part on how portfolios are constructed and performance is measured. Only 14% of investors now have a separate and distinct allocation to private debt, while the majority continues to lump it in with private equity investments (Exhibit 4). As it continues to grow in size and prominence, private debt will inevitably be categorized and scrutinized as a discrete asset class. Performance benchmarks and other metrics are still relatively underdeveloped in comparison to more mature asset classes. As this situation changes, it will invite more robust comparisons to other types of assets alongside deeper dives into risk profiles, diversification benefits and contributions to overall portfolio performance.

EXHIBIT 4 Source of private debt allocation by investor type



Source: Preqin.

This evolution of the asset class is important to understand, because it goes hand in hand with the expectations of investors and the responsibilities of managers. Long-only managers and hedge funds have already been subjected to periods of reconciliation, which private equity and debt managers may not have yet had reason to go through. Education plays a key role in fundraising and investor relations, but it also increases awareness and sophistication. The net result will be investors who are more likely to be vocal and articulate in communicating their needs to managers.

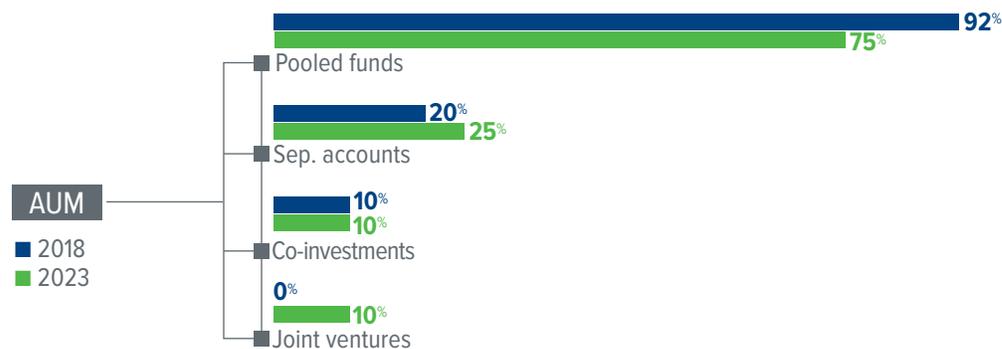
Some investors are choosing to partner with consultants or OCIOs, amplifying their voice. As Candace Shaw, senior managing director and portfolio manager, Private Fixed Income at Sun Life Institutional Investments (Canada) Inc. explained, “The OCIO model (is) all about keeping costs as low as possible. Where is the line in terms of how much fees can be compressed before fund managers become unwilling to operate their businesses? I don’t think the really big funds or big institutions will ever completely outsource, but the smaller and midsize ones are starting to do so already.” Ultimately fee sensitivity will almost certainly increase, even as the demand for customization grows.

Valuations already top the list of concerns investors have about private debt, according to Preqin’s Investor Outlook.¹⁹ Almost half of all investors think assets are currently overvalued, and 60% of these think a correction is due within the coming 12 months, if not earlier.²⁰ Meanwhile, performance concerns are fading, but deal flow is increasingly a worry.

There is likely to be growing interest in club deals and other approaches that optimize exposure, liquidity and cost-effectiveness. Traditional pooled vehicles will continue to feature prominently, but are expected to lose market share to other types of investments over the coming years (Exhibit 5). Investors should bear in mind that cost control can itself come with additional costs. Ed Robertiello, managing principal at Blueprint Capital Advisors, a niche specialty lending manager, was careful to point out that “... investors should look at co-investments as more than just a simple way of reducing fees and understand the additional risks associated with allocating to the co-invest. It’s important to recognize that they’re a single allocation without any diversification; they’re relying heavily on the managers while underwriting.”

EXHIBIT 5

Q How are your assets under management split by structures? And how do you expect that to change by 2023?



Source: SEI Preqin Private Debt Survey.

“The OCIO model is all about keeping costs as low as possible.”

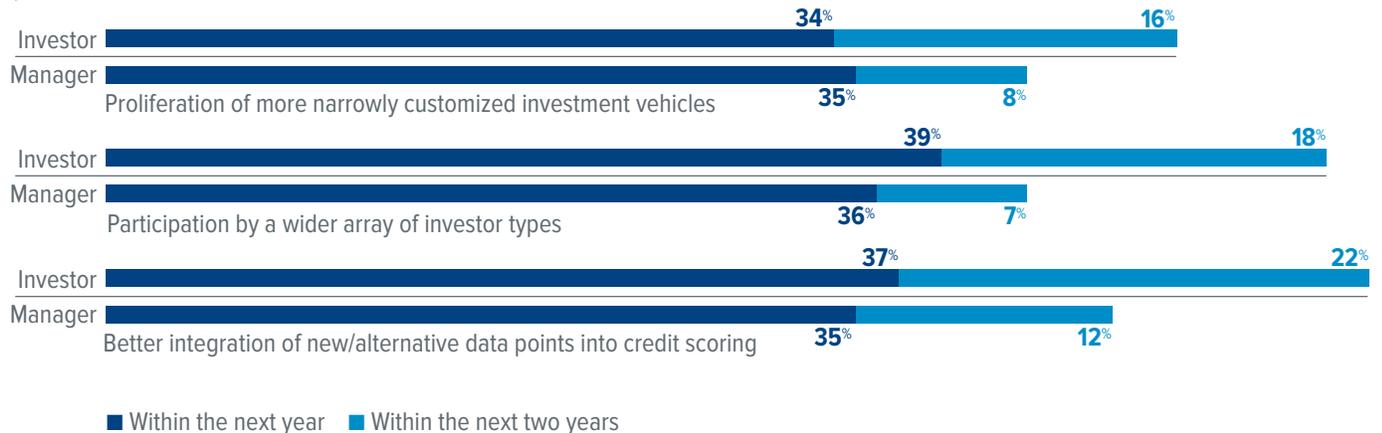
- Candace Shaw
Sun Life Institutional Investments (Canada) Inc.

CHANGE HAS MANY FORCES

Investors and fund managers don't always share the same perspective. This dissonance drives change in the industry, although not always in predictable ways. The role and potential of technology, for example, is perceived differently. There is little doubt that the rapid pace of change will change the industry in many different ways, but when asked specifically about data analytics, LPs were invariably more likely than GPs to say that there would be a noticeable impact more quickly. What sort of impact might we expect? Half of all investors think advancements in analytics will spur the development of more customized investment vehicles. Even more think data analytics will soon permit more types of investors to participate in the private debt market. The most likely impact, though, is better integration of alternative data into credit scoring decisions (Exhibit 6).

EXHIBIT 6

Q In which of the following ways do you see data analytics having an impact on private debt?



Source: SEI Preqin Private Debt Survey.

Conversations with managers echoed their skepticism that advanced analytics would play much of a role in shaping the industry. Hank D'Alessandro, head and chief investment officer of Morgan Stanley Credit Partners said, "... for each company there are different returns on invested capital, different needs for capital expenditure, seasonality, cyclicity, margin structure, and industry framework. Maybe if you're making microloans, data analytics will make a difference; but in private credit's 'sweet spot,' companies with \$10 million to \$50 million of EBITDA, I just don't see much impact." Ken Aseme, director of accounting and fund controller at Indigo Global Advisors pointed out that, "We take an old-school approach to what we do. What's important to me is to understand the collateral, and understand the borrower as opposed to relying on things like credit scores."

Sam Chawla, portfolio manager at the \$3 billion Perceptive Advisors pointed out, “Issuing private credit and direct loans to companies is still a very personal business that is extraordinarily challenging to package in an algorithm. Every company has nuances as does every specific situation ... a more commoditized area of the private debt market—and admittedly, I don’t know where that is—that would be the first area that could potentially get disrupted with advancements in technology.” The founding partner of a \$500 million direct lending fund manager went on to hypothesize, “Banks are where data analytics may ultimately have the most transformative impact. Deregulation will cause banks to poke around in markets which are now dominated by private lenders. The change will be sparked by deregulation but sustained by data.”

Although there is widespread agreement among managers that direct lending will remain relatively unaffected by new analytical tools due to the sheer variety and contexts of loans, some remain more open to the notion that information may be processed differently. The vice president of Alternative Investment Strategy at a top 25 U.S. institutional tax-exempt manager stated, “As tools that allow for additional data analysis and manipulation become available, it will [become] easier to develop insights that might not have been available before. I certainly think it will have an influence and an impact. The fundamentals are the same, but it just becomes easier over time to take advantage of the data that’s available and get the most information out of it.”

Of course the data must be available in the first place to be analyzed at all. Sun Life’s Candace Shaw pointed out that “by design most data is kept private within a very small circle of fund managers and investors. It’s very hard to accumulate large amounts of data which you could analyze or try to use in some sort of quantitative investing strategy.” This sequestering of data may slow the introduction of advanced analytics, but it’s unlikely to stop it altogether. New sources of structured and unstructured data crop up with some regularity, and combined with machine-learning technology, offer the promise of insights that were unimaginable only a few years ago.

“Banks are where data analytics may ultimately have the most transformative impact. Deregulation will cause banks to poke around in markets which are now dominated by private lenders. The change will be sparked by deregulation but sustained by data.”

- Sam Chawla
Perceptive Advisors

EXHIBIT 7

Q GPs, over the next five years, where do you think the growth of demand for private debt borrowing will be greatest?



Source: SEI Preqin Private Debt Survey.

Technology, of course, encompasses far more than just data analytics. Its ability to upend long-standing norms and processes is legendary. Its effect is so profound up and down the financial services value chain that it has coined its own term and spawned its own industry: fintech. Almost one out of three investors we surveyed said one notable feature of the fintech landscape—peer-to-peer lending platforms—is a disruptive phenomenon that could displace traditional funds in the private debt market. Some pointed out the ease with which such platforms had disrupted personal lending, suggesting it had the potential to do the same on an institutional scale. According to TransUnion, 36% of personal loans in 2017 were originated by fintech companies, up from less than 1% in 2010.²¹ Ken Aseme at Indigo Global Advisors pointed out that, “Technology lowers the barriers to entry. LendingClub and those sorts of things give access to borrowers and lenders in a way that doesn’t require pounding pavement. As consumers find it difficult to get loans from banks, they do look at alternative situations for some of those small denomination loans. Especially the younger generation—they are used to online everything, so that opens up a lot of opportunities for technology to play into.” Most managers we spoke with, however, dismissed such a scenario outright. Only time will tell which perspective is correct.

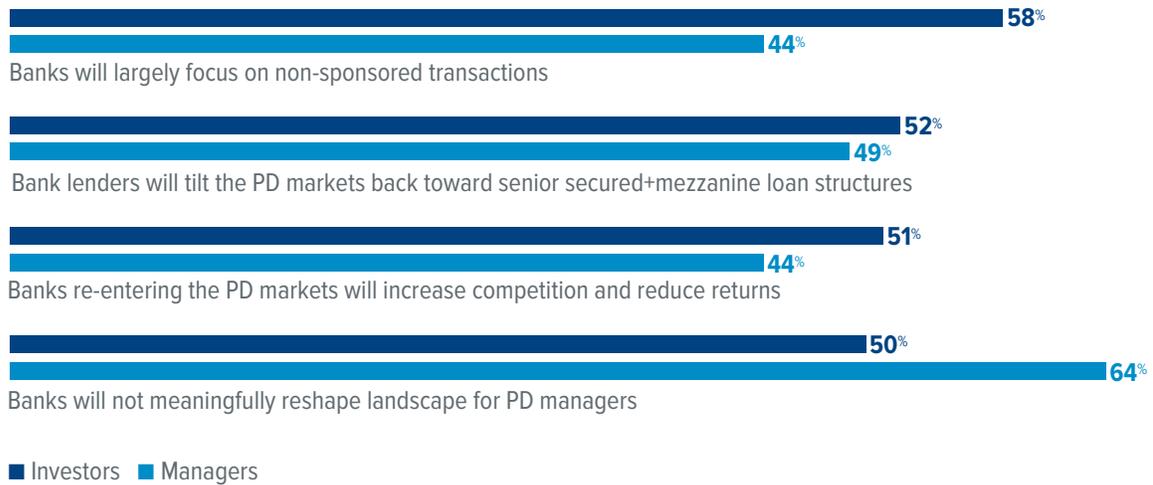
Technology aside, we can expect the private debt market to change in other ways. Deal flow, for example, is expected to shift away from PE-driven M&A activity toward middle-market borrowers who are not backed by sponsors (Exhibit 7). There are pros and cons to each, but ignoring either is to ignore a significant part of the addressable market. Investing in both is an effective way to diversify portfolios. Morgan Stanley Credit Partners’ Hank D’Alessandro contrasted these two types of deals thusly, highlighting the pros and cons of both: “There’s merit in each, but there are also trade-offs. Sponsored deals are the least expensive to originate and you can certainly deploy money readily with financial sponsored transactions. At the same time, sponsored deals tend to have higher leverage, lower pricing and less attractive covenants. Non-sponsored deals are extremely time intensive and therefore more expensive to originate, but non-sponsored deals generally have lower leverage, higher pricing and better covenants.”

Some of this demand may be met by banks as they re-enter the market, invigorated by deregulation and rising rates. Investors think so, but managers seem less certain (Exhibit 8). Investors are, in fact, more convinced that banks are likely to increase overall competition in the private debt market, driving down returns in the process. Managers are more optimistic, with two out of three opining that banks are unlikely to re-enter the market at a scale sufficient to meaningfully reshape the landscape.

This confidence is understandable. With a growing percentage of assets locked up by a small group of mega-lenders, today’s private debt market gives every indication of being a stable, orderly, secure corner of the asset management world. But potentially disruptive technology is knocking at the door. Traditional lenders in the form of banks remain on the side lines. Meanwhile, thousands of hedge funds are launching lending products. Will all of these parties be able to coexist? Will innovation flip the script? Where are the opportunities for managers in a market that is becoming undeniably more competitive?

EXHIBIT 8

Q Do you think the combined influences of banking deregulation and interest rate increases will affect the deal flow of private debt funds? (% agreeing with statements)



Source: SEI Preqin Private Debt Survey.

NEW MANAGER NICHES AND OPPORTUNITIES AVAIL

Asset managers in the current climate are forced to tackle what might be called “the specialization paradox.” On the one hand, many would rather not be narrowly labelled. Rather than being saddled with the name of a structure of asset class or investment vehicle, these firms would rather be seen as vehicle-agnostic asset managers that offer their expertise packaged in a variety of products. The allure of this approach is enhanced by the fact that it provides some degree of protection against the risk of a downturn in a particular industry. On the other hand, investors and intermediaries need to categorize managers, who are also faced with growing competitive pressure to stake their claim in a particular area of expertise. According to the founding partner of a \$500 million direct lending fund manager, “People are more willing to look at sector-specific funds now, and there’s a lot more interest there. This is the natural evolution of the industry.”

This message came through loud and clear from firms in our survey, with 71% of managers stating that they anticipate growing interest in those who can demonstrate specific-sector expertise (Exhibit 9). There is awareness that true specialization is distinguished by its ability to boost investment performance, with Blueprint Capital Advisor’s Brad Southern stating, “The kind of deep expertise that produces sustainable outperformance in these sectors is often concentrated in independent specialist managers that focus entirely on these sectors. Their expertise ideally includes operational and ‘hands on’ experience in their borrowers’ businesses.”

This sentiment was reiterated by Theodore Koenig, president and CEO at Monroe Capital, who also added that even a downturn in the market can be seen positively. “There have been a lot of capital inflows into private debt over the last few years. We believe a significant portion of this capital is opportunistic and asset gathering as opposed to true credit specialist like Monroe. Manager selection will be proven important as the managers who have been opportunistic asset gatherers, less prudent on underwriting and diligence will be exposed. We think this will create tremendous opportunity and we will probably see some leave the space or some consolidation of managers.”

EXHIBIT 9

Q Do you anticipate increasing interest in private debt fund managers who can demonstrate a focus on a specific sector(s) in the coming years?

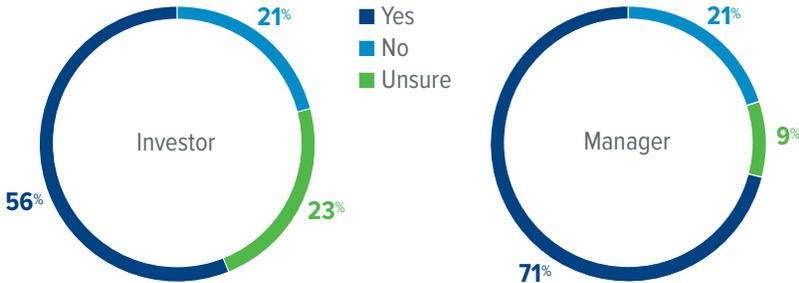
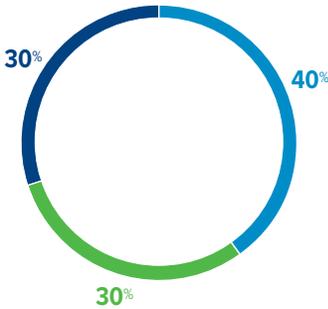


EXHIBIT 10

Q Are you more likely to allocate to managers pursuing “specialty finance” strategies?



Source: SEI Preqin Private Debt Survey.

“We differentiate ourselves on products. We seek to understand what it is investors want, and build products accordingly. It’s all about catering to the audience, whether it is family offices or pension funds, but catering to the audience.”

- Ken Aseme
Indigo Global Advisors

With industry giants dominating the so-called sweet spot of \$20 million to \$50 million loans, any new player must aim to occupy a specific niche. Concentration of assets is also proving to be an inevitable fact of life, and differentiation is critical to competing on what are effectively the margins of the business. In addition to specialized expertise, this strategy is likely to require additional diligence. As a reward, investors may find a way to regain some control of credit quality in an environment where 80% of new leveraged loans are now classified as covenant-lite.²² Because many investors have not yet moved beyond the mid-market corporate lending market, they will also see diversification benefits by incorporating niche strategies into their private debt portfolio. This is no small consideration at a time when performance concerns are mounting as “... large capital flows into a squeezed portion of the market [are] creating downward pressure on returns and upward pressure on risk.”²³

Specialization can take many forms. It might refer to geographic expertise in a market like India. Alternatively, it can reflect deep knowledge of the arcane details found in something like the aircraft leasing business. Emerging applications of technology are yet another area ripe for specialist expertise. In any case, traditional specialization is increasingly joined by even more niche strategies as managers move away from direct lending and explore asset-backed deals featuring nontraditional assets such as royalty streams. These opportunities come with their own challenges, as Ed Robertiello, managing principal at Blueprint Capital Advisors noted, “Institutional investors are accustomed to seeing the more traditional gross and net exposure or Sharpe ratios, which niche managers more commonly do not produce. Even credit ratings, typical duration calculations, and other fixed-income types of analytics do not exist in the niche space because these are private loans. ... Niche managers often struggle to provide traditional risk analytics and portfolio metrics for some of their strategies; that’s an area where better analytics and reporting mechanisms can certainly be useful.”

Investments strategies, however, are only one of several ways to stand out in the crowd. Customization is another. Investors are increasingly eager to find the perfect fit for their needs, whether this means dialing in a specific income stream or applying an ESG screen with certain criteria. Managers that can accommodate such requests are better positioned to win their business. Customized portfolios will never completely replace pooled products, but as long they can efficiently be managed without adversely affecting the investment process, they are likely to become even more popular. They are already centerpieces of some corporate strategies. As Indigo Global Advisors’ Ken Aseme emphasized, “We differentiate ourselves on products. We seek to understand what it is investors want, and build products accordingly. It’s all about catering to the audience, whether it is family offices or pension funds, but catering to the audience.”

As deal flow becomes more challenging, we expect more firms will rely on technology to help find, vet, negotiate and value opportunities. Investors in private markets are already accustomed to finding and scrutinizing unusual and hard-to-find data, but managers who leverage advanced technology may be able to leapfrog the competition. Only 9% of fund managers, for example, currently use artificial intelligence (AI) or machine-learning processes, but they will be joined by a further 26% over the coming five years.²⁴ It’s not hard to imagine this number going up if the cost of machine-learning tools continues to drop and benefits become more apparent. Investors are also “increasingly coming to expect that asset managers will leverage” artificial intelligence and alternative data.²⁵ The ability to acquire and understand alternative data will allow managers to reveal previously obscured correlations, predict behavior and reduce risk. In part because they are better equipped to handle greater volumes of information, the proportion of fund managers using 10 or more external data sources is projected to rise from 22% to 37% by 2023.²⁶

The trick, of course, is to harness technology to not only process more data but also make better decisions. Morgan Stanley Credit Partners' Hank D'Alessandro stressed, "There is virtually unlimited research you can do. It's possible to do due diligence forever. The key thing is exercising judgment about what's meaningful, when you've done enough, and where you allocate your time." At the other end of the value chain, static client reports can take a quantum leap forward by channeling data through a central repository into investor dashboards, where customized metrics provide investors with greater clarity. Many useful tools already exist, even if they haven't been marketed directly to private debt managers. Innovative firms will find ways to repurpose existing technologies to provide a superior (and increasingly digital) experience to their investors. Advanced analytics can be applied to enhance the sophistication and breadth of risk management, but the ability to effectively communicate risk factors in real time would be legitimately transformational.

Technology can also be harnessed to optimize operational processes. Given the pervasive sense that the current cycle is due for a correction, any additional resilience afforded by operational efficiency and cost control becomes even more important. Firms are already finding that it's possible to automate processes where automation once seemed impossible. The CFO of a \$1 billion mid-market manager pointed out, "You've got to automate as much as possible to make money. This whole business is purely data, it's not money. Money is just one element of the customer data. There's a market for anything that makes the job of staying on top of your portfolio easier, faster and with fewer people."

Dramatic improvements in quality and cost can be found in front-, middle- and back-office workflows. Service providers and other third-party vendors with up-to-date knowledge of operational best practices are available to help, and multi-asset managers in particular can find it beneficial to work with providers that have expertise and experience in all asset classes. Risk management and investor communications can also be improved by working closely with external firms. Tyler Fenelon, director of Private Debt at Guggenheim Partners underscored this by stating that they "... use a third-party admin and a third-party for all of our valuation work related to illiquid private debt assets. That to us is kind of two checks on everything that we're trying to do when it comes to how we think about valuing all the companies, because they're all illiquid. We like to offload as much of that to other parties to make sure that there's a real kind of independent voice. The admin is another check on our processes, which is to make sure that the manager is operating in the best way possible."



“There is virtually unlimited research you can do. It’s possible to do due diligence forever. The key thing is exercising judgment about what’s meaningful, when you’ve done enough, and where you allocate your time.”

*- Hank D'Alessandro
Morgan Stanley Credit Partners*



BOTTOM LINE: ALWAYS PREPARE FOR THE UNKNOWN

Prospects for the private debt market are undeniably appealing. Assets are expected to double by 2023, versus 58% growth for PE.²⁷ All of this capital is fueling a trend toward private markets. Indeed, the move away from public markets appears to be gaining momentum. In addition to the growing regulatory burden and heightened scrutiny that accompanies a stock market listing, more firms must weigh the growing availability of private equity and debt as they reconsider the cost-benefit analysis of going (or remaining) public. The 3,600 firms listed on U.S. stock exchanges represent less than half the number from 20 years earlier.²⁸ Delistings and a dearth of IPOs mean the number of publicly listed firms has declined worldwide as well, potentially driving valuations toward their peak for the current market cycle.²⁹

The growth in private capital is understandable, but is it sustainable? The credit business is cyclical, and there will inevitably be a contraction at some point. As this report is written, rates are rising, volatility is increasing and the global economy appears unsettled by the sacrifice of free trade on the altar of populist politics. The Federal Reserve recently flagged the private debt market as a potential threat to financial stability.³⁰ Another red flag includes the growing perception that too much capital is chasing too few deals, a trend that may force some GPs toward lesser-quality deals and lower returns. The sheer rate of growth and the rush of new participants are reminiscent of other investments prior to experiencing corrections. As Monroe Capital's Theodore Koenig dryly noted, "Having a team that can work on troubled credits in the portfolio will be important."

The maturation of the asset class means its managers will need to focus more on expense management and productivity than they had previously. History is littered with the demise of firms that waited too long to acknowledge change. Proactively seeking innovative approaches can spur growth and help optimize efficiency. As Ed Robertiello, managing principal at Blueprint Capital Advisors put it, "Technology is disrupting and enhancing many industries—private investing is just one of them. Some of the managers that we've met with have been developing bespoke systems to help them process loans and automate online loan applications. We've also seen strategies that depend heavily on technology, like peer-to-peer lending. Overall, we believe managers will use technology to their advantage and utilize it more and more over time, as it enables them to process more information."

Even if the business doesn't move to peer-to-peer platforms, the transformative potential of technology is impressive. Much of it can be attributed to our rapidly growing ability to digest and analyze massive amounts of data. Investment ideas, product customization, investor reporting, operational efficiency, portfolio integration, and security can all be improved. The largest GPs may be the only ones in possession of budgets big enough to support bleeding-edge technology, but it's smaller managers with a growing need to differentiate themselves who may benefit most from novel uses of technology. In fact, their position on the innovation curve may ultimately be correlated directly to their prospects for success. Rather than subjecting themselves to the uncertainty accompanying the inevitable downturn, they will want to remember that investments in the future are most likely to bear fruit if done thoughtfully when times are good.

Brad Southern, principal at Blueprint Capital Advisor asserted, “Traditional risk management data is often hard to come by in private credit. Many firms lack track records extending back to 2008 or even 2011. To assess how these managers may perform in a downturn, we have to apply a laser focus to their underwriting processes, sources of risk, pricing and terms. The challenge will only grow as we enter the later stages of the credit cycle.”

But there’s also a feeling that while managers need to pay attention to and address market changes, they don’t need to reinvent the wheel to succeed. As Sun Life’s Candace Shaw said, “I think what’s going to differentiate managers in the future is what has always differentiated them in the past. The manager who has strong underwriting skills and the discipline to not feel compelled to invest in the wrong opportunities, and who can communicate effectively with their investors as to why or why not they are choosing to deploy capital will succeed and survive.”

Specialist knowledge and operational excellence are paramount. A robust ecosystem of technology vendors and service providers already empowers managers and investors throughout much of the asset management industry in their quest for these two objectives. As the private debt business continues to grow and mature, its ecosystem will also flourish, with stand-alone systems, security and data experts playing larger roles. Even at the largest firms, it will become inadvisable to try and do everything in-house. For smaller firms, it will be impossible. The successful manager will be one that collaborates most effectively, combining internal expertise with external resources to create an innovative team capable of adapting to changing circumstances and executing a distinctive and resilient strategy designed to survive and thrive in all market conditions.

“The manager who has strong underwriting skills and the discipline to not feel compelled to invest in the wrong opportunities, and who can communicate effectively with their investors as to why or why not they are choosing to deploy capital, will succeed and survive.”

- **Candace Shaw**
Sun Life Institutional Investments (Canada) Inc.

ABOUT THE SURVEY

216 organizations, divided evenly between investors and managers, participated in the survey. Responses were collected in the summer of 2018 and followed with in depth interviews of selected participants. More information on the size, type and location of survey participants can be found below in Exhibits 11–15.

EXHIBIT 11

Location of headquarters (All survey participants)

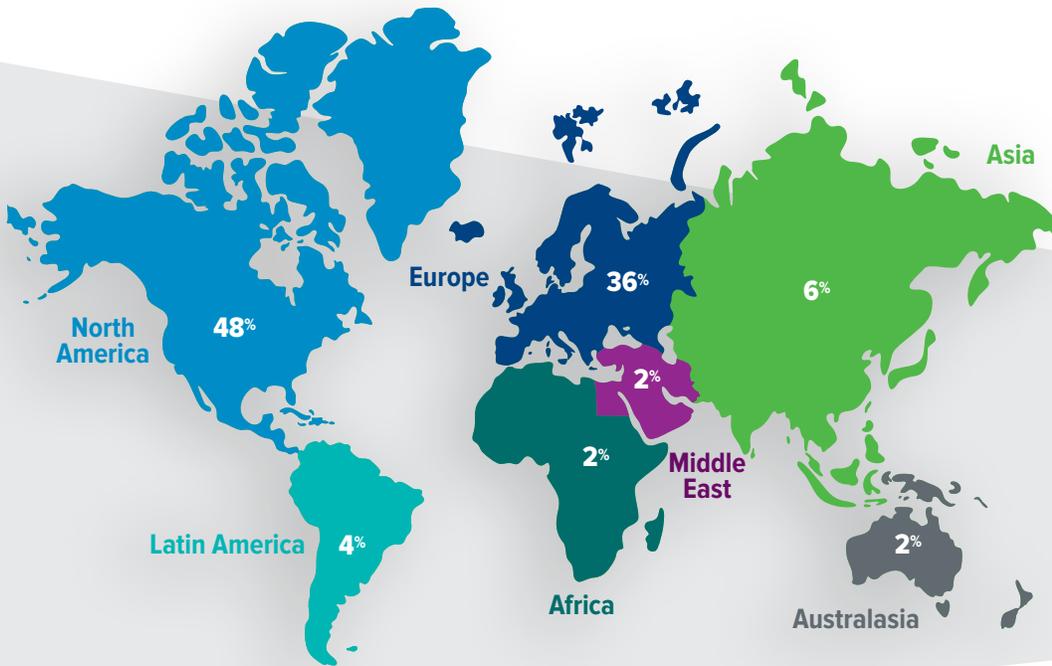


EXHIBIT 12

Type of investor

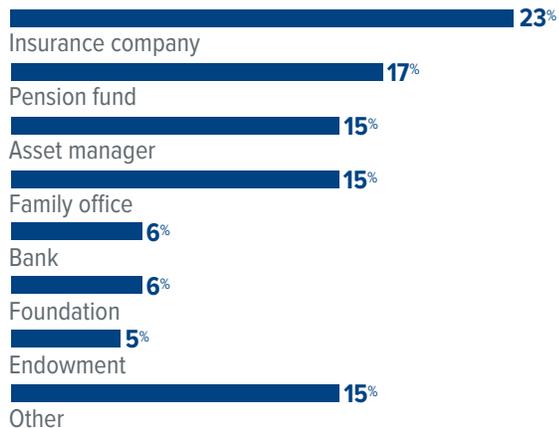


EXHIBIT 13

Investor AUM

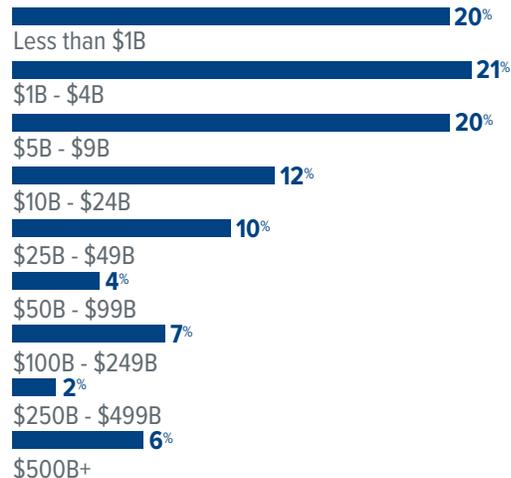


EXHIBIT 14

Primary investment strategy of managers

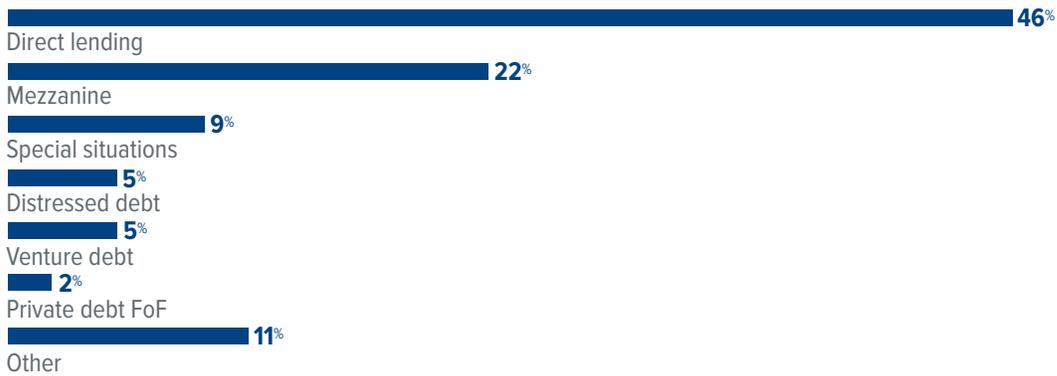
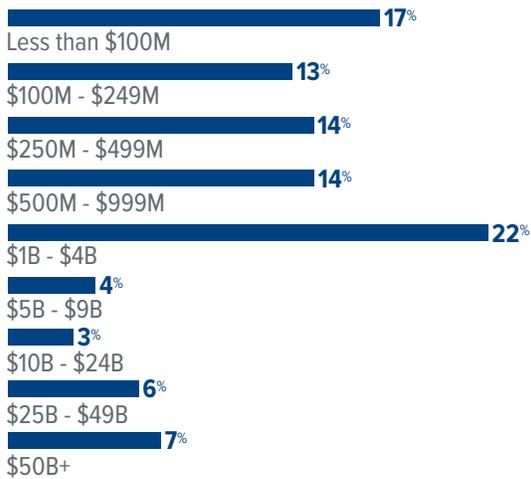


EXHIBIT 15

Manager AUM



Source: SEI Preqin Private Debt Survey.



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