2020 PREQIN GLOBAL **PRIVATE DEBT** REPORT

SAMPLE PAGES

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Contents

Executive Summary

Assets under management in private debt have once again hit a record, but the asset class has become more nuanced

Arguably the youngest asset class in the private capital universe, private debt has soared to incredible heights since the Global Financial Crisis (GFC). Assets under management (AUM) have grown consistently each year and, as of June 2019, reached a record $812bn. Private debt is now the third-largest asset class in private capital, ahead of infrastructure and natural resources.

The market has continuously expanded ever since the GFC, when banks retrenched from serving the middle market as they derisked their balance sheets. Private debt firms swooped in to capitalize on the void in the middle market. Over 4,100 investors now make allocations to the asset class. Demand has given rise to a record 1,764 fund managers now active in the space – up from 1,604 at the beginning of 2019 and over twice as many as five years ago – and a significant pool of capital available for them to put to use.

And put it to use they have. In tandem with growth in AUM, dry powder had been rising for the past five years; but in 2019, dry powder levels flattened somewhat, rising by only $4bn, from $292bn at the end of 2018 to $296bn as of December 2019, despite an 8% increase in overall AUM.

A total of 151 private debt funds closed to raise a combined $104bn, down from $110bn in 2018 through 210 fund closures, which in turn was down from the record $132bn secured through 220 fund closures in 2017. The 10 largest funds closed in 2019 raised 36% of total capital, an increase of seven percentage points in comparison to the previous year, highlighting the existence of capital consolidation as investors are increasingly drawn to larger, more established fund managers.

The uncertainty surrounding the current economic and credit cycle is undoubtedly a key consideration for many players in the private debt industry. In a low-yield environment, investors require fund managers with the capability and resources to adequately deal with distressed loans, and therefore may be drawn to more experienced managers with stronger track records in the event of a market downturn. Newer managers can still offer opportunity in these times, however; indeed, first-time fundraising made up 9% of total capital raised in private debt in 2019, up from 7% at the end of 2018.

Looking ahead, investors are upbeat about their private debt portfolios. A significant 91% of investors we spoke to will either maintain or increase their allocation to private debt over the longer term. That said, challenges lie in wait. While investors may be seeking downside protection, private debt has not been tested through a full market cycle. This is where managers will want to provide more transparency around investment decisions, to convince stakeholders of the value the asset class can deliver even if there are difficult times ahead.

Private Debt Megatrends

Key themes shaping the private debt industry

Competition for Deals

As AUM continues to rise, the challenge for managers is to find value in an increasingly competitive deal-making environment.

Capital Concentration

The larger fund managers are absorbing more industry capital as investors seek out established managers for downside protection.

Rise of Covenant-Lite

Covenants on loans have become looser as managers attempt to circumvent heightened competition in the market.

Market Slowdown

A market slowdown is widely believed to be on the horizon and stakeholders in the industry are preparing accordingly.

ESG

ESG is the hot topic in alternatives. We are seeing a structural shift in the attitudes of private debt investors toward ESG.

Data Pack

The data behind all of the charts and tables featured in this report is available in Excel format at no extra cost. This data may be used in marketing materials, presentations, or company reports with appropriate accreditation to Preqin.

Selectivity Is Key in Private Debt

Churchill, the private capital affiliate of Nuveen, on the key opportunities in the private debt market and the importance of selectivity and diversification in portfolio development

In which areas are you seeing the most attractive opportunities in the private debt market?
We are focused on investing in directly originated senior secured loans to private equity-backed, traditional middle-market companies ($10-50mn of EBITDA), which we believe provide an attractive risk/return opportunity for investors. These assets can offer yields in the 7-8% range, along with reasonable leverage, solid loan-to-value, and financial covenants.

With record private equity capital fundraising and over $600bn in expected refinancing activity over the next several years, the opportunities for directly originated, middle-market senior secured loans are expected to remain attractive for larger investment platforms that can access the highest-quality investment opportunities. We also believe private equity is increasingly reliant on direct lending, as direct lending dry powder in North America is currently $70bn – just 16% of buyout dry powder.

Additionally, many investors believe a market correction is imminent, and the downside protection that senior middle-market loans can provide is often a key draw. Notably, historical performance data suggests that middle-market loans exhibit less risk, as measured by default and loss rates, than the closest comparable investment option, which are non-investment-grade, broadly syndicated loans.

In situations where business models are extremely resilient and cycle tested, we also believe middle-market junior capital can be an interesting risk-adjusted return opportunity, whereby we are able to access tranches of junior debt securities yielding 10-12%, but positioned under 50% of loan-to-value. These opportunities have been increasingly prevalent, as middle-market sponsors are driving up enterprise valuations for safer assets and accepting a lower base-case return on equity.

Ken Kencel
CEO and President, Churchill Asset Management, a Nuveen company

How have you positioned yourselves in the event of a market downturn?
While we don't know exactly when, there will be an economic downturn at some point, and we believe senior middle-market loans provide investors access to attractive yields from relatively conservative assets with inherent downside protection.

We believe that Churchill is particularly well positioned for a downturn. In the current environment, it is essential to remain highly selective (closing 5-10% of deals reviewed) and focused on building diversified portfolios of loans with 1-2% position sizes, conservative leverage multiples, significant sponsor equity contributions, and at least one financial covenant per transaction. We have also developed a strong position in the middle market as a trusted partner to lead traditional senior and unitranche credit facilities, which gives us an important seat at the table in case a credit issue arises throughout the life of an investment.

Lastly, we remain focused on defensive sectors, such as healthcare and technology, while avoiding lending to borrowers in industries reliant on commodities and heavy cyclicals. And, ultimately, it is essential to align ourselves with top-tier private equity sponsors with decades of successful experience investing in the same industries.

Is the increasing presence of covenant-lite loans creating more risk for investors?
In the current market, we have seen more aggressive structures typically found in the larger broadly syndicated loan market continue to creep into the upper middle market, such as covenant-lite loans. We believe this trend will continue, until there is some sort of credit event that gives lenders pause.

We view financial covenants as being critical structural elements of credit documentation in the middle market. Covenants are intended to act as guard rails that provide an impetus for all parties to sit around the table and review financial performance, allowing for thoughtful, constructive solutions early on, often before more serious issues arise.

In general, Churchill targets loans with at least one financial covenant and has also significantly reduced exposure to the upper middle market (companies with over $50mn in EBITDA) in response to the market dynamics described above. Our core focus remains on the traditional middle market, particularly in companies with $10-50mn in EBITDA, as we believe that protection from covenants (such as an ongoing debt-to-EBITDA maintenance test) will serve our portfolios well in every phase of the credit cycle.

What are the main differences between European private debt opportunities and those in the US? From which regions are you receiving the most investor interest?
The European direct lending market is less mature when compared to the US, as alternative lenders began to emerge in reaction to the Global Financial Crisis. The European direct lending market is essentially where the US was about 10 years ago.

Banks in Europe have been aggressive about defending their market share, particularly with relationship sponsors, so direct lenders are driven to offer more unitranche financings, as well as more lower-in-the-capital-stack solutions, which are fundamentally riskier.

The markets in the US and Europe are also very different in size – over the past 15 years the volume of institutional leveraged loans in the US has, on average, been more than 6x greater than that in Europe. The pool of direct lending opportunities is substantially smaller in Europe, particularly as managers focus on the deals the banks are not doing. As a result, given the amount of capital raised, the pace of deployment is much slower compared to that of US funds.

On the other hand, if the US middle market were a country, its GDP would rank it as the third-largest economy in the world – ahead of Japan, Germany, and the UK.[1] US direct lending managers with scaled origination platforms and strong track records can really enjoy the benefits of this much larger market, which allows them to be highly selective and hand pick the very best deals for their portfolios. In our view, this gives investors access to better market dynamics and more conservative assets. Churchill's investment portfolio, for instance, consists of 100% senior loans to a diversified pool of middle-market companies backed by top sponsors – all with at least one financial covenant. At this point in the cycle, the risk/return for our credit profile is very compelling.

In terms of investor interest, we are seeing that Asian investors, in particular from Japan, have increasingly begun to adopt private debt strategies.

[1] *The National Center for the Middle Market*

Nuveen

Nuveen, the investment management arm of TIAA, is one of the largest investment managers in the world with $1tn in assets under management. Managing a broad array of assets across diverse asset classes, geographies, and investment styles, we provide investors access to a wide range of liquid and illiquid alternative strategies.

Churchill Asset Management, our private capital investment affiliate, is a leading capital provider for private equity sponsor-owned middle-market companies. With $19bn of committed capital under management, Churchill has broad experience in all aspects of the middle-market financing business, including origination, structuring, credit analysis, syndication, and deal monitoring and oversight.

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In Focus: The Rise of Asian Private Debt

Private debt takes off in Asia as businesses expand and financing opportunity follows

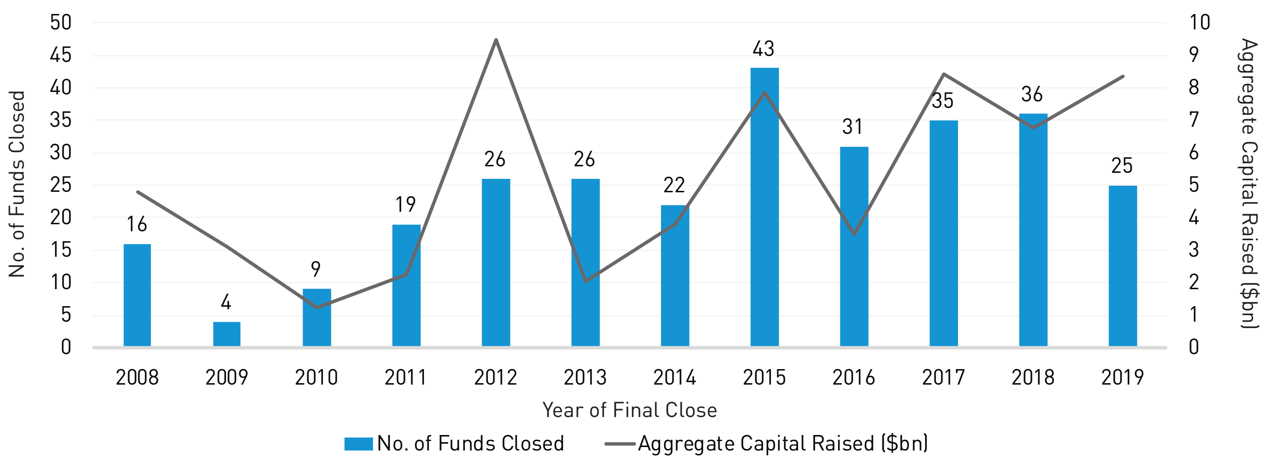
Traditionally a bank-financed market, Asia has endured much economic change in recent years, which has been accompanied by an increase in appetite for private debt funding. Rapid growth in innovation has created demand for credit in the mid-market borrower segment. At the same time, a swelling middle class has given rise to more opportunities in the private debt space – in a bid to expand businesses in order to capture the economic opportunity, the use of leverage has increased.

These factors have combined to boost growth in Asia-focused private debt AUM on a substantial level. AUM has increased consistently over the past six years, more than doubling from $27bn at the end of 2014 to $57bn at the end of 2019 (Fig. 3.18). Investor appetite for Asian private debt is rising across the globe as institutions look to diversify into newer markets in a bid to maximize yield. Domestically, the number of private debt investors located in Asia has also increased from 115 to 477 over the past five years.

A growing middle class in the region has inflated demand for private debt. Recent OECD figures predict that China and India will be home to approximately two-thirds of the global middle class by 2030.[1] This swelling middle class has in turn created growth in the SME market, which has led to robust fundraising. Aggregate capital raised for Asia-focused private debt funds more than doubled from $3.5bn in 2016 to $8.4bn in 2019 (Fig. 3.16), despite the fact that only three more funds closed in 2019 in comparison. Such consistent growth in the Asian middle class will undoubtedly give rise to more consumption-fueled growth, and gradually move Asian markets away from their historically export-driven economies and toward an increased use of leverage as businesses expand domestically.

[1] *https://oecd-development-matters.org/2019/05/07/look-east-instead-of-west-for-the-future-global-middle-class*

Fig. 3.16: Asia-Focused Private Debt Fundraising, 2008 - 2019



Source: Preqin Pro

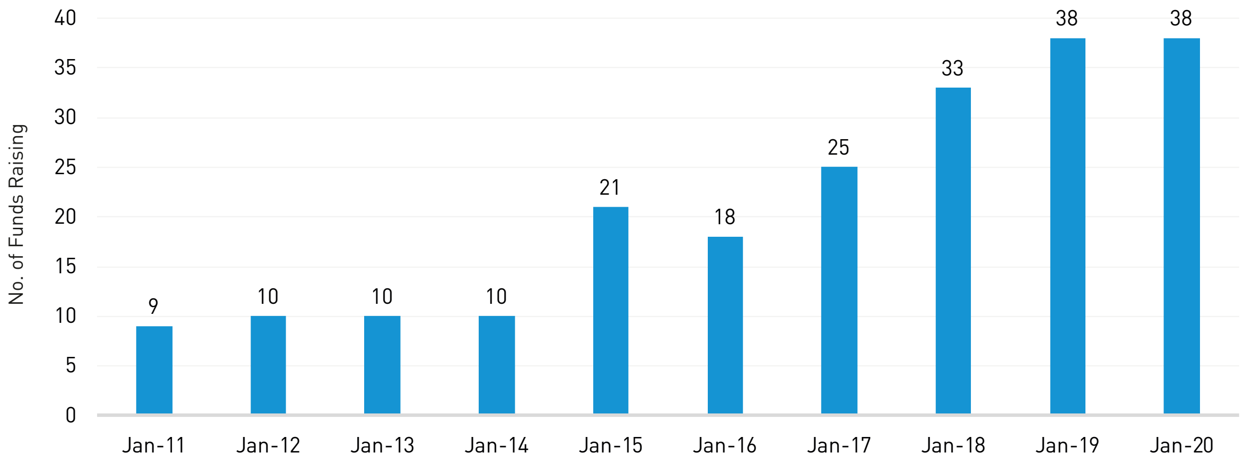
Large funds are also successfully securing capital: of the 25 funds closed in 2019 (which raised a total of $4.0bn), PAG China Special Situations Fund III was among the largest at $1.0bn. Managed by Hong Kong-based PAG Asia Capital, the special situations fund focuses on acquiring portfolios of Asian assets.

More Asia-focused funds are coming to market to access the new opportunities being created. At the start of 2020 there are 38 Asia-focused private debt funds in market; this number has generally risen for the past three years (Fig. 3.17). According to Neeraj Seth, Head of Asian Credit in BlackRock's Asia-Pacific Active Investments Group, India in particular offers attractive private debt opportunities due to this credit gap – the banking system lacks capital and the slow pace of recapitalization has kept banks challenged.[2] AION Capital Partners II – managed by Mumbai-based AION Capital Partners – is targeting $1.0bn and will invest in companies facing special or distressed situations in India.

Opportunity in Asian private debt will undoubtedly increase as the market gathers momentum. With more firms entering the space, manager selection will become a vital consideration for investors. Robust due diligence, an experienced and diverse workforce, and the ability to structure and monitor loans effectively will be crucial for fund managers if they are to reap the benefits.

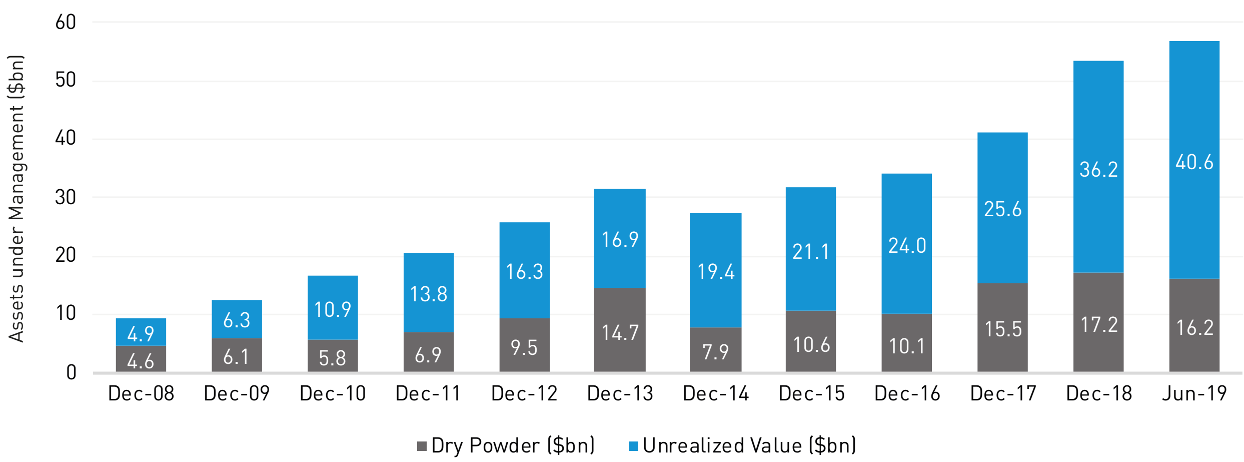
[2] *https://www.businesstimes.com.sg/magazines/wealth-july-2019/the-lure-of-private-credit-in-asia-pacific*

Fig. 3.17: Asia-Focused Private Debt Funds in Market, 2011 - 2020



Source: Preqin Pro

Fig. 3.18: Asia-Focused Private Debt Assets under Management, 2008 - 2019

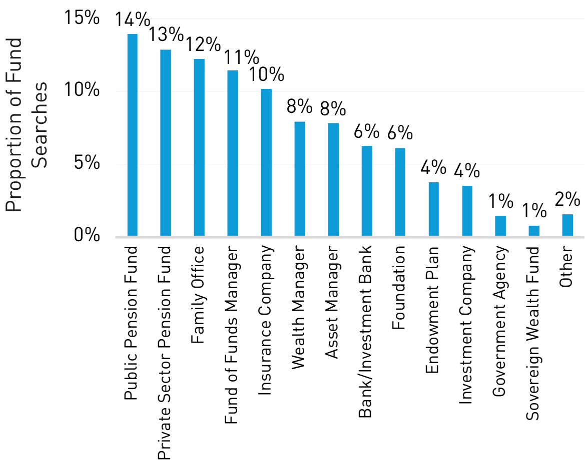


Source: Preqin Pro

Future Searches and Mandates

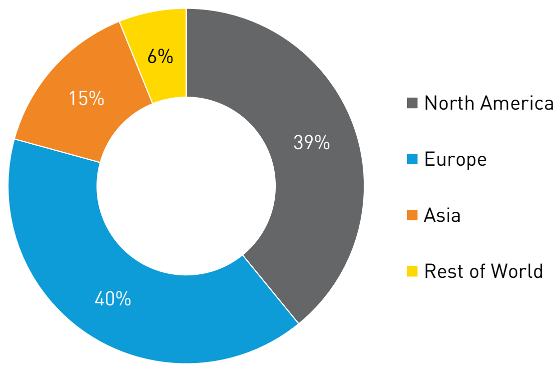
More Europe-based investors issued mandates for private debt funds in 2019 than North America-based investors

Fig. 5.4: Private Debt Mandates Issued in 2019 by Investor Type



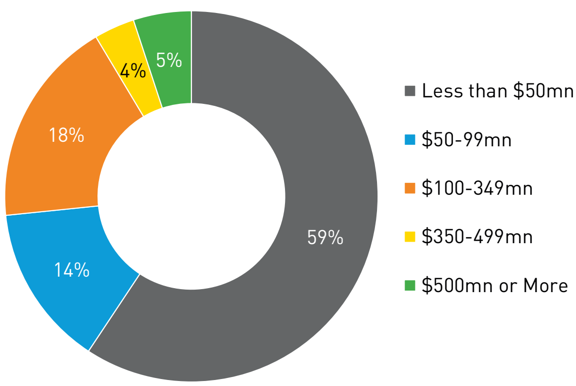
Source: Preqin Pro

Fig. 5.5: Private Debt Mandates Issued in 2019 by Investor Location



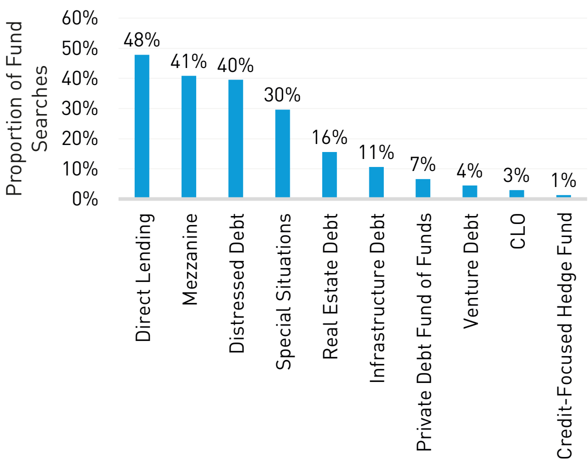
Source: Preqin Pro

Fig. 5.6: Private Debt Mandates Issued in 2019 by Commitment Size



Source: Preqin Pro

Fig. 5.7: Private Debt Mandates Issued in 2019 by Fund Type



Source: Preqin Pro