PEI Alternative Insight

PRIVATE DEBT INVESTOR

THE GLOBAL GUIDE TO PRIVATE DEBT

The practitioner's handbook to navigating the asset class

Edited by
Daniel Roddick, EPIC Private Equity

Sponsored by

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PennantPark

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London EC2Y 5DN
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About EPIC Private Equity

EPIC Private Equity LLP (EPE) is an FCA regulated investment and advisory boutique established in 2001 with three business lines: Placement and Advisory, Capital (private equity investment) and Administration.

Placement and Advisory. EPE's placement division assists private equity and private debt managers raise capital from institutions worldwide and advises on the restructuring and sale of debt and private equity portfolios. With a specialist niche in alternative credit, EPE has advised managers in Europe and the US across the spectrum of debt strategies from senior direct lending to mezzanine and venture debt.

EPE also advises corporates, management teams, investors and other stakeholders on M&A, debt and equity capital-raising, buy-outs, public-to-private transactions, operational and financial restructuring, turnarounds and distressed situations.

Capital. EPE partners with management and entrepreneurs to invest in UK SMEs, taking control or minority positions across growth, buyout, distressed, PIPE and secondary portfolio transactions. The current portfolio consists of companies in consumer, retail, healthcare, support services, industrials and media sectors with an aggregate annual turnover of circa £150 million.

Administration. EHM International, an affiliate of EPE, provides accounting and administration services. It has a team of 20 employees including accountants, administrators and operational service providers, with total assets under administration exceeding $1.8 billion and offices in London, India, Hong Kong and Guernsey.

About the editor

Daniel Roddick, Managing Director of EPIC Private Equity LLP (EPE) founded the placement business for EPE in 2012 having previously worked as an independent consultant to a number of private debt and equity managers. Prior to this, Daniel worked at Campbell Lutyens and McKinsey and Co. He read Engineering, Economics and Management at the University of Oxford, has an MA from the Royal Academy of Music, and is a CFA charter holder. □

Daniel.Roddick@epicpe.com
www.epicprivateequity.com

About PennantPark

PennantPark is headquartered in New York, with offices in Los Angeles, Chicago, Houston and London. PennantPark's core competence is middle market direct lending. Since being founded in 2007 by Art Penn (former co-founder and managing partner of Apollo Investment Management), PennantPark has invested more than $5.3 billion in 462 transactions across 413 companies, sourced from 155 different sponsors. Today, PennantPark manages $1.8 billion in various vehicles, including business development companies, private funds and separately managed accounts. PennantPark's long-term trusted partner approach, conflict-free business model and diversity of capital pools allow it to provide borrower clients with solutions across the capital structure including first lien, stretch senior, unitranche, second lien or last out, subordinated debt, mezzanine, and equity co-investments. □

Introduction

By Daniel Roddick, EPIC Private Equity

It gives me enormous pleasure to be introducing PDI's second book on the private debt market, *The Global Guide to Private Debt*, a follow up to last year's publication *Understanding Private Debt in Europe*.

Last year's publication was primarily about building the case for private debt in Europe – that is, why an investor should invest in the asset class. But today most investors are no longer asking themselves *whether* they should be investing in private debt, but *how* they should be investing. If there is one overarching theme to this book, it is about the diversity of the market and how to navigate the myriad of different offerings available for an LP. Essentially, LPs are grappling with three fundamental questions: "What return targets am I after?" "What level of risk am I willing to tolerate to get there?" And, most difficult of all, "How in practice do I achieve that blended risk-return target?".

And I do not envy the LPs who are having to answer these questions. After all, how can you begin to map the market and realistically differentiate between, for instance, the mid-market/lower-market, sponsored/non-sponsored, senior/unitranche/subordinated, US/Europe, corporate/real assets, and so on? Nonetheless, these are the decisions that LPs are having to make given the number of managers currently in the market. And we have again reached a new high in the number of funds looking to secure capital. According to *Private Debt Investor Research & Analytics*, there are today 490 private debt funds in the market looking to raise $244 billion, of which 136 are based in Europe raising $60 billion. "It's a fundraising blitz", one bleary-eyed LP told me recently.

In *The Global Guide to Private Debt, we* realise that we set ourselves somewhat of an ambitious task with such a grand title. And so we looked to get as broad a balance of private debt opinions as possible in an attempt to really understand the trends in the market. We started by approaching a cross-section of institutions to glean some insights on where the money is flowing. We begin therefore with the accounts of six investors on how they are allocating their capital, grouping these into the LP perspectives section of the book. A seventh account is included as a Q&A interview at the end of book.

Given that we confined ourselves in the first volume to the European market, we begin our GP perspectives section with chapters on the US market as well as Asia, a region that is gaining growing interest from LPs. And as investors look to broaden their focus beyond mid-market corporate debt, we have included chapters on real estate debt and venture debt. We also take a look at the distressed debt market.

One permanent feature of the private debt market is the complexity of the regulatory environment, and, therefore, the importance for a GP of getting the right legal advice.

In the Legal perspectives section, two law firms specialising in advising debt funds in the US and Europe give their view of the pertinent issues for a GP about to embark on a fundraising.

One interesting development is how banks and alternative lenders are working alongside each other to finance companies. We have therefore included The bank perspective to understand how this co-existence works in practice.

Following the recent volatility in the currency markets, we have found FX to be one of the main concerns of LPs. Currency hedging, which can be done at a fund level or by the LP, has therefore become a pertinent issue and is also addressed in the book.

We finally look at first-hand evidence to back up the views of the market, with an empirical study of private debt performance, followed by the Second *Private Debt Investor LP Survey* to understand where capital is likely to be allocated in the months ahead.

Section I: LP perspectives

One of the challenges when discussing 'private debt' as an industry is that it encompasses such a broad range of different strategies. In Chapter 1, Tod Trabocco provides a summary of how Cambridge Associates divides the market firstly into capital preservation or return maximisation strategies, and then into its various sub-categories, giving an overview of each in turn. He also discusses the importance of understanding the nature of the investing activity in order to properly assess the underlying risk. For example, an investor should diligence whether a manager pursuing scale has the requisite managerial talent and processes in place to do so.

In Chapter 2, Edward Goldstein, David Zhong and Jake Van Koevering of Morgan Stanley Investment Management argue that an investor needs to equip himself with an understanding of all the debt sub categories in order to build an optimally diversified portfolio and minimise both credit risk and duration risk. In particular, the investor should not overlook the diversification benefits of an opportunistic portfolio, which can include such strategies as rescue or bridge loans, structured products, consumer credit, real estate debt, royalties and insurance-linked assets.

Sanjay Mistry and Tobias Ripka of Mercer Private Markets also stress the importance of diversification in Chapter 3. In order to avoid concentration risk, a strategic asset allocation plan needs to be well-diversified across several dimensions - managers, strategies, time/vintage years, asset class, sectors, and regions, among others. And to ensure sensible investment planning, investors need a clear overview of the investment universe, as well as a good visibility of the fundraising pipeline of top-tier funds.

There are a number of distinctions between the US and European debt markets, not only in the underlying investment opportunity, but also in the investment styles of institutions. Peter Schwanitz of Portfolio Advisors describes in Chapter 4 how each market has evolved to provide investors with the opportunity set today, and how the typical private debt portfolio composition differs between US and European institution. US institutions have a longer history of investing in alternatives, and their target returns in private debt are typically higher than those of their European counterparts, resulting in portfolios that tend to be more heavily weighted towards higher risk assets.

Matthias Unser of YIELCO Investments AG also discusses the differing risk appetites of LPs in Chapter 5. For any given risk tolerance, he explains how he advises his client base to sub-divide the opportunity set. For example, what are the pros and cons of a sponsored or non-sponsored fund? How do you compare the lower market to the upper end? And what are the costs and benefits of a regional strategy versus a local one? He also takes us through YIELCO's six key due diligence criteria for assessing fund managers.

One undeniable trend is the growing diversity of the investor base in the private debt market. Indeed, one of the most noticeable findings of our survey (see page 157) is the growing interest levels among family offices and high-net-worth individuals. In Chapter 6, Stefan Armonat and Silvan Roth of Woodman Asset Management, an adviser on the investment needs of family office clients, discuss the benefits of the private debt market to smaller institutions.

Section II: GP perspectives

Our GP section begins with a look at the US. In Chapter 7, Arthur H. Penn of PennantPark Investment Advisers takes a closer look at the composition of the US mid-market, which is today dominated by a limited universe of specialty lenders, credit funds and Business Development Companies. The continued demand for capital combined with the pull back by traditional lenders has created a supply-demand imbalance, representing an opportunity for mid-market lenders. Furthermore, default rates in the mid-market are lower than those for large corporate issuers. He looks at some of the softer reasons as to why this market has been such a success, including the collaborative nature of deal-making in this relationship-driven business, in addition to the more measurable factors such as the lower leverage levels, strength of the covenants and the equity support from sponsors.

Brett Hickey of Star Mountain Capital, in Chapter 8, takes a step down in size to look at the lower-mid-market in US. There are over 175,000 companies in the US, which have between \$10 million and \$100 million of revenue and, according to Brett, there is a lack of capital available, especially for those with less than \$15 million EBITDA. He argues that the higher interest rates, equity upside, lower leverage and tighter covenants more than compensate for the perceived risk associated with smaller companies, when compared to larger deals. In this market, non-sponsored deals are also more common, and relationships are key since these companies are generally not well covered by the main investment banks and other service providers.

Looking further afield, Dr. Chris Heine and Nicholas Brooks of ICG give an overview of the Asian market in Chapter 9. They highlight the differences between individual country markets, discuss how it has evolved and offer their view on how this market is likely to evolve. A record, \$6.7 billion was raised for the region in 2015, and, as highlighted in our LP survey, we should expect to see further LP interest in the year ahead.

Real asset private debt is one area gaining interest from LPs with $23 billion raised to date in 2016. In Chapter 10, Paul House of Venn Partners explores the benefits of CRE debt as a potential source of yield and diversification from public and private corporate debt, with the added benefit of being secured on real assets.

Growth lending, while relatively established within the venture community, remains a niche credit strategy in the US, and an emerging niche strategy in other global markets. However, this nascent industry is growing in Europe and Israel and now spreading to markets as far afield as China and India. Craig W. Netterfield and Joyce Liu of Columbia Lake Partners in Chapter 11 take us through the reasons behind the growth and its future potential in financing sponsored growth companies around the globe.

Finally, in Chapter 12, we turn to the distressed debt market. Again, as highlighted in the special survey section from page 168, distressed debt strategies is an area of interest for LPs, and rightly so argues Thomas M. Benninger of Global Leveraged Capital. Leverage has been increasing following the 'binging' by many credit managers in the US, and a number of leading indicators suggest we are about to see the start of a non-investment grade default cycle in 2017. Looking at historical patterns, default cycles are typically preceded by two sets of impetus or shocks. So far we have only had one shock within this current cycle (the collapse of the oil price), but we are already seeing trends typically associated with the second phase of prior cycles. When the second impetus comes (be it a Chinese debt crises or political disruption in Europe), it will be 'swift and severe'.

Section III: Legal perspectives

The first of the two legal chapters looks at fund terms. In Chapter 13, Sally Gibson, Geoffrey Kittredge and Michael Sabin of Debevoise & Plimpton LLP, comment on how these are evolving and in particular how the terms tend to differ between private debt and private equity. They also discuss some of the differences they see between the US and Europe.

Chapter 14 turns to the regulatory minefield of the *Alternative Investment Fund Directive*. In particular, Alex Amos of Macfarlanes LLP, considers the options open to a US manager for fundraising in Europe.

Section IV: The bank perspective

It has, of course, been well documented how the banks' share of the overall lending market has fallen in favour of the alternative lending funds. But despite this, banks remain highly relevant in the private company debt markets. In Chapter 15, Stephen Quinn, Robina Barker Bennett and Ian Brown of Lloyds Bank, explain how banks are co-existing alongside debt funds. For instance, on the investment level, banks benefit from a lower cost of capital and are able to provide a broad range of banking products and services. They can also support the banking needs of private debt funds themselves, such as through fund-level borrowing.

Section V: Currency hedging

FX swings can have such a material impact on fund returns but, as James Stretton of JCRA explains, there are several ways of managing cross currency investments. In

Chapter 16, he takes us through the pros and cons of each of these using several typical scenarios.

Section VI: The evidence in support of private debt

Turning to the empirical evidence in support of private debt, in Chapter 17, Dr. Daniel Schmidt and Christopher Godfrey of CEPRES look at the role of private debt from a Capital Asset Pricing Model (CAPM) perspective. Using linear regression, they show that on a risk-adjusted basis, private debt can enhance the performance of a portfolio and provide downside protection in periods of volatility.

We also look at where LPs are deploying their capital. The LP survey in Section VI provides first-hand evidence of how the market has grown in size and sophistication. And comparing it to the results of the survey conducted in 2015 (published in *Understanding Private Debt in Europe*) allows us to observe trends over the last 12 months. For sure investors are continuing to put more money to work within private debt, and the LP base has also grown in number, in particular with an increase in family offices and high-net-worth individuals. European LPs are catching up with their North American counterparts in terms of levels and sophistication of their allocations. Furthermore, all the evidence suggests we should expect to see commitment volumes continuing in the year ahead – many investors are still below their allocation targets and they are optimistic about its prospects relative to other asset classes.

We end with a Q&A interview with Andreas Asche and Michael Kebbel of Talanx Asset Management, who share their views on the most compelling opportunities from the insurance company's perspective. They also discuss what risks keep them awake at night and how they try to mitigate against these.

It has been a pleasure, and hugely insightful, to compile the contents for this book. Thank you to all the authors who have contributed. Thank you, too, to our sponsors PennantPark Investment Advisers, and to the publishers, PEI. We hope you enjoy reading *The Global Guide to Private Debt*. □

Daniel Roddick, EPIC Private Equity LLP
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