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Fee structures move for private debt funds

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As the private debt asset class matures, the growing trend for large investors to create dedicated pockets for direct lending out of their credit portfolios is driving down the fees managers can charge in the space. Claire Coe Smith reports.

Private debt has long fallen between two stalls for large institutions, who view performing loan funds as too illiquid to fit into their credit portfolios and too lowyielding for their private equity portfolios. In the wake of the credit crisis, debt funds benefitted from a high demand for their loans and a lack of competition for deals, and often slotted into private equity portfolios. Since 2010, however, much private capital has been raised for the strategy and the privateequity style 2-and-20 fee structures have come under pressure from increasingly sophisticated LPs.

Ben Schryber, who focuses on credit funds in the US for placement agent First Avenue Partners, says: “LPs once invested in direct lending funds out of their private equity buckets, but more LPs are now investing in these funds out of their more traditional fixed income allocations. LPs focused on fixed income are not accustomed to paying privateequity style fees and are largely responsible for the downward pressure. This shift is likely to continue and will continue to be one of the main forces driving middle-market lending funds fees lower.”

BLURRING LINES

The 2-and-20 fee structure that is common in private equity (but is now also subject to evolutionary pressure as the asset class grows and matures) contrasts with pricing models in private debt, and particularly for managers in the first-lien leveraged loan space who don’t underwrite deals and according to market sources charge as little as 1-and-5, or even 1-and-zero in rare cases.

David Waxman is a managing director of Azla Advisors, a placement agent focused on raising capital for GPs in the private debt space. He says: “The private debt market has subdivided into several different categories, and in the process we have seen different fee structures emerging, but there is still a lot of flexibility. We would say there are now four general categories, and the lines between them are blurred. Plus

quite a few managers play in a few areas and try to keep consistent fees across them all to suit themselves."

Azla's four categories begin with leveraged loan funds, who are lending to sponsors and typically return less than a 10 percent gross IRR. Next up are mid-market and unitranche direct lending funds, where gross IRRs may be 10-12 percent, and third is subordinated debt and mezzanine funds seeking returns of around 15 percent. At the top of the pack come the senior growth debt funds, which seek 20 percent-plus gross returns for investors, and can still command 2-and-20 fee structures, or more usually 1.75-and-20.

Waxman says: "That final group looks most like private equity, with the managers working very hard, a lot of handholding involved, and so the fees are more akin to private equity."

At the bottom of the scale, he says senior loan funds can often see management fees of 1 percent or lower, and carry below 10 percent of total asset value.

COMMITTED VS DRAWN

One further challenge has been the move by investors toward paying fees on committed capital, rather than invested capital as is the norm in private equity. Often believing it is easier to put money to work in the private debt space, LPs have only wanted to pay fees on their investments once the money has been deployed.

"When you move into the mezzanine loans and mid-market unitranche direct lending space, typically carry is 1.5 percent or 1.25 percent, and it is very often on invested capital as opposed to committed capital," says Waxman. "Or we do sometimes see hybrids, where 0.25 percent may be on committed capital and 1 or 1.25 percent on invested."

Ajay Pathak, a partner in the international funds practice at law firm King & Wood Mallesons SJ Berwin, says the question of which basis fees are charged on is often a flashpoint of negotiations between LPs and managers. He says: "There is pressure on managers to deploy capital sooner rather than later, and obviously with a debt fund that's more realistic than with a private equity fund.

"So we have seen some situations where the management fee is linked to deployed capital, and that does raise the question about the time between the launching of the fund and being able to close investments, and how that overhead is going to be covered," says Pathak. "In some situations we see people charge a flat commitment fee, but that is not the norm."

It is much more common to see fees based on invested rather than committed capital today than it was five years ago, advisers say.

But the shift towards fees on capital deployed is in many ways just another example of how greater sophistication among the investor base puts fee discussions firmly in the spotlight. As the fledgling private debt fund market matures, so it has become possible to classify different managers into different categories, and LPs have got wiser on the types of fees they should be paying to each.

Debt funds with a higher-yielding return profile tend to be able to resist downward pressures on costs. Says Schryber: "Where we have seen little movement downwards on fees is with managers that execute a

strategy requiring a private equity or distressed skill-set. LPs tend to be much more willing to pay more for hands-on, rather than passive, credit managers. Therefore, non-sponsored and stressed or special situations focused funds have felt the least amount of pressure on fees. Of course, because the return targets are much higher for these funds, LPs continue to invest out of their private equity, rather than fixed income, portfolios, where higher fees are more widely accepted."

In such circumstances, what investors are willing to pay for is partly the managers' underwriting their own deals, and partly the ability to behave like an active private equity or distressed manager as and when the situation requires it.

It's a less crowded segment of the market too, which also enables a greater degree of price inelasticity. "The skill sets needed for credit managers in the non-sponsored performing loan space are largely the same needed to invest in private equity," says Schryber. "If a credit
goes sideways or worse, the senior lender, with no private equity sponsor invested in the company, typically needs to step in and help improve the portfolio company in order to avoid default. There are very few qualified private credit fund managers that possess the sourcing, monitoring, and work-out capabilities needed to execute these strategies, though LPs have shown that they are willing to pay a significant premium for the proven managers that do."

HOW GOOD ARE YOU REALLY?

Demonstrating a track record is a challenge for managers in the private debt space, which remains a relatively young asset class. The vast majority of funds were set up post-crisis since 2010, in what is now a period of low default rates and a reasonably well-performing credit environment. Thus finding a team with a long-term track record in private debt remains the biggest challenge for even the most sophisticated investment teams.

"As an LP, you don't want to be invested in a manager that hasn't proven themselves through different market cycles, so a successful track record through the credit crisis is critical," says Schryber. "The proven and differentiated managers who have delivered their targeted returns for more than five years tend to have the highest re-up rates and have been most immune to the fee compression felt by the rest of the market."

Pathak says: "What is relatively new in the market over the last 12 to 18 months is a whole host of direct lending funds, mainly focusing on senior loans, and sometimes a mixture of senior and mezzanine, across a range of asset classes. In a lot of those cases the return expectations are lower than you might expect with a pure mezzanine fund or a distressed or loan-to-own fund, and so that is where there is the greatest pressure on fees."

The fee pressures evident in the market today apply very much to first-time funds, where managers are under the most scrutiny, because once GPs have shown they can deliver, investors typically come back for more in subsequent fundraisings.

The most successful managers are those that operate outside the increasingly crowded sponsored senior loan market, but have instead found ways of setting themselves apart. Some have done so by targeting smaller companies, typically underserved by current providers and more difficult to access from a sourcing perspective, and others have sought to differentiate by specialising in certain industry sectors, like energy. Fees for lower middle-market and more niche-focused funds have not come down in a meaningful way since

2010, advisers say.

Waxman says that as the market matures, the fluidity around fee structures has started to settle down as managers have tried to establish a baseline with LPs. He says: “The market is perhaps a bit more settled than it was a year ago. It’s the same themes as we were talking about then, but many more funds have been in the market and so we have many more data points.”

He adds: “For established managers, fee structures are becoming much less of a negotiation point. For newer managers, they do typically have to come in on the lower end of the spectrum in order to be attractive. But in this kind of market, LPs want to deploy capital with the high quality managers, and there are very few high quality managers in this space.”

TRANSPARENCY ON THE RISE

Pathak says catch-up is another area that has come up for negotiation. Typically, once the GP has paid LPs their preferred return, it enters a catch-up period in which it receives all the profits until the agreed-on profit split, as determined by the carried interest, is reached. Catch-up is typically 100 percent, but Pathak says 50 percent is becoming common for senior debt funds, and in some areas no catch-up is being agreed.

What is clear is that investors are getting smarter about the risk-return ratios that they are willing to accept in this space, and have worked out how best to deploy their capital in the asset class. As well as driving down fees, they are also increasingly switched on to how their fees are spent.

Pathak says: “Transparency on fees and expenses is a general theme, and because quite often we see the same investors investing across asset classes, so they have a similar list of things they are concerned about. To some extent investors want to ensure that where they have agreed a lower management fees, they are mindful of what is being charged to the fund, and that that is appropriate.”

As the wide range of investment styles and strategies among private debt and credit managers continues to offer investors a wealth of options, so the management fee structures on offer are getting more tailored to each differing return profile.

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