EXPERT Q&A

As private credit continues to see substantial growth in AUM, as more products are launched to increase competition and as capital continues to concentrate around the largest GPs, Jess Larsen, partner and head of Americas at FIRSTavenue, says others must adjust for a tougher environment

Preparing for fundraising challenges

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Q How do you see the current fundraising environment for private credit in the US?

Private credit continues to witness significant growth as an asset class, growing from $300 billion in assets under management a decade ago to $800 billion today, and it is expected to hit $1.4 trillion by 2023. As banks have retreated from the asset class, we have seen quality GPs coming into the space and raising new funds and products with new strategies, including many of the credit hedge funds and private equity firms pivoting into private debt.

There are currently about 400 private credit funds in the market fundraising, not counting pre-marketing, which is at a record high and is still projected to increase. Hence, the competition for LP capital is growing rapidly. At the same time, the LPs are favouring the larger GPs as LPs' private credit programmes are maturing and focusing on re-ups with the incumbent relationships.

In 2010, only a quarter of capital was going to the larger funds, whereas today more than half of the capital in the space is sitting with the 20 largest GPs. This means it is becoming progressively more challenging to start up new funds unless you already have a loyal LP backing that can anchor your new fund.

Q What challenges do GPs typically face when fundraising?

LPs have spent the last five or six years selecting which direct lending GPs they like to partner with, and therefore only a few new relationships are being added. These LPs have circa 400 GPs approaching them, yet there are only so many the LPs can conduct deep-dive due diligence on. In the end, they are likely to only invest with up to four GPs, of which two are most likely re-ups. This means it is highly unlikely they will enter into any more than two new relationships a year.

To further challenge the GP fundraising, the various high-profile pay-to-play scandals over the past decade have materially changed the way in which LPs and GPs

interact. Old-school dinners, lunches and sporting events are no longer acceptable means of relationship-building and LP engagement.

Q How can GPs adapt their offering to the current fundraising environment?

There is a clear trend of GPs coming back to the market much sooner than they have historically done, which serves to increase the number of GP managers in the market and consequently adds to the competition. Furthermore, the GPs are finding that the standard practice of limited LP interactions between funds is no longer viable.

Instead, a successful GP needs to be in constant dialogue with its LPs and needs to track the success of the dialogue in between fundraises to ensure a strong re-up rate on the next fundraise. All of which forces a re-think and restructure of sales teams as a result of the drop-off in some of those relationship-building options.

It has long been typical to structure your sales teams according to personal LP relationships, an unscalable and inefficient structure for the new paradigm they are facing. The more sophisticated GPs implement structures according to either asset classes, LP types, geography, outsourcing or a combination of the above, to match the complexity of their products and the rapidly changing fundraising environment.

GPs are also finding themselves required to pay much closer attention to the terms and fees they are charging versus the competition. As an example, the difference between charging on committed as well as invested capital versus invested only, which the market is moving towards, can be immensely hampering in attracting capital from both existing and new LPs. The same applies to American versus European waterfall and fee skimming.

To avoid being met with "you are the 140th direct lender to call me this year and I am not sure how you are all different", GPs must spend significant time before launching fundraises to precisely and concisely articulate the differentiating factors of their strategy versus the competition. Fund positioning work can make or break a fundraise.

Q What are LPs focused on when it comes to US private debt investing right now? What does LP demand look like?

"The timeframe for acting on private credit co-investment opportunities is a real challenge for some LPs"

If you go back six or seven years, mezzanine was the dominant strategy in private credit, and that continued up to 2017, where mezzanine and other subordinated strategies like unitranche were very much in demand. In 2017, LPs became much more concerned about where we were in the credit cycle and they were looking to reduce risk, hence they pivoted more into senior secured strategies higher up the capital structure.

Now, in 2019, the concern about the credit cycle is only increasing and there is even more tension out there in the system. That is leading LPs towards increasing their exposure to strategies such as asset-backed lending, whether that is in real estate or infrastructure, and we are witnessing a real uptick in special situations and opportunistic credit.

We are also seeing sophisticated LPs looking very much at the less crowded space of mid-market strategies, with the large GPs operating in the large cap market.

We have been positively surprised about the North American LPs' appetite for non-US strategies, in particular European strategies. Though it is difficult to call how Brexit is going to play out, it is certain it will create volatility and opportunities. For that reason, we are seeing an uptick in demand for European special situations. We are also seeing more LPs looking towards Asia, albeit to a lesser extent.

Q With so much competition, how can GPs clearly position their funds?

With so many GPs fighting for the LPs' attention, the old 'spray and pray' model is no longer viable as a means of achieving the best LP hit rate. Instead, managers are building a better understanding and analysis of which are the most relevant LPs to approach. GPs need to do careful research and then differentiate their strategy so that the pre-qualified LPs can quickly and clearly understand their strengths.

Co-investment is a dominant dialogue for LPs at the moment, but in the credit space – even more so than private equity – the timeframe for acting on co-investment opportunities is a real challenge for some LPs. Private credit does not offer the same length of decision-making as private equity and this substantially shorter timeframe can pose real challenges for LPs that like to participate in co-investments.

A lot of GPs are therefore beginning to think about having the right LPs on board if they are going to offer co-investment, and more generally looking to build a mix of LPs by type, size, geography and so on. Not all LP dollars are necessarily created equal, and GPs need to consider the appropriate mix for their strategies and growth plans.

Going forward, the fundraising process needs to be as process-driven as the GP's investment process. At every stage, the fundraising process needs to be continuously analysed to secure a clear understanding of success drivers and momentum levers to drive the fundraise to a successful close. An institutionalisation of private credit GPs' fundraising efforts is now inevitable. ■