E X P E R T Q & A

As private credit continues to thrive in Europe, Tavneet Bakshi, head of EMEA at FIRSTavenue says funds terms are still evolving towards greater alignment of LP and GP interests

Investors want a shared vision

Q In the current market, what are the fund terms that matter most to investors?

We are not seeing any dramatic changes, but the increasing trend is a focus on stronger alignment through fund terms. That manifests itself in several ways, specifically in the private debt space, where the fund fee has probably been the area of most focus. A number of allocators and consultants are very keen on making sure they are paying for what they get, so there is ongoing pushback on fees on committed capital in favour of fees on invested capital. That trend has been around for a few years.

In the more esoteric, opportunistic strategies, fund managers have managed to keep their pricing power, but even there we see pressure on headline fees on committed capital. In Europe, a number of special situations managers are still able to maintain fees on committed capital, but they are also targeting higher returns and employ a more private equity-like approach to their investments.

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There is still scrutiny around the GP commitment – these days there are more questions on the level of that commitment and also what goes into that, who makes that up, where it comes from and whether it represents the right level of risk sharing. There is definitely a growing aversion to a GP commitment in kind, where forward fee income forms part of the GP commitment. The abiding theme really is around alignment when LPs are talking through these terms.

Use of leverage has continued to split opinion. There are two facets to this: short-term borrowing through the use of subscription facilities; and term debt that is longer in duration and greater in size. Subscription facilities have received a lot of attention over recent years, particularly where GPs were 'overusing' to delay drawing capital and boosting IRRs.

We tend to see more specific language in side letters specifying a cap or time limit to the use of such facilities and increasingly GPs are pro-actively stating caps in their legal documentation. Longer-term debt needs to be considered in the context of the underlying strategy and the overall risk profile of the investment. We regularly hear investors ask for levered options where the underlying investments have a senior and likely secured profile. However, there has been increased caution as to the terms of leverage applied, the recourse of that leverage and whether there is a significant mismatch between debt terms and investment duration.

Q What are the bones of contention when it comes to fee levels?

When it comes to investment-level fees – deal fees and origination fees – there remains a preference that income should offset management fee expense and that all investment-related revenue should go into the fund.

Back to the alignment point, LPs want to see changes where GPs are keeping some or all of that origination fee and only filtering through the investment return into the fund. This is probably more prevalent in the US than in Europe, where we tend to see GPs contribute all fees to the fund.

Investors continue to focus on hurdles/preferred returns and catch-ups. These days there just isn't a structured fee model that works for everyone and so LPs are spending the time to model out return scenarios to try and understand what happens and where the sensitivities lie if the GP is not necessarily achieving the target.

We are seeing this become standard practice in the due diligence and the fee negotiation process, particularly for the lower-returning debt strategies. More generally, there is downward pressure on the preferred return and a movement away from 100% catch-up for the GP.

"We are seeing more focus on asking for the accounts and asking GPs, particularly newer GPs, to share their budgets"

Q When it comes to due diligence, how closely are investors looking at fund manager accounts?

We certainly see more proactive requests for the accounts with LPs asking GPs, particularly newer GPs, to share their budgets. LPs are also spending time with CFOs looking at how the manager is budgeting for business expenses.

The process continues to get more sophisticated with more scrutiny. It is harder to launch in this environment, and I do believe that's why we are seeing more and more teams lift out and set up on new platforms rather than setting up on their own. The cost of raising capital from institutional LPs has clearly gone up. ■

Q What are the current themes in the secondaries market? How are concerns over fund-led processes playing out?

For debt specifically, there really is quite a bifurcation in the secondaries market. There is a cohort of believers who think that private credit secondaries are only going one way in terms of levels of volume and attractiveness of opportunities, and that is up. Then there are also a number of very sophisticated investors and players in the market who think it's just too early to think about a meaningful private credit secondaries market.

We think it's an interesting space and we are already seeing opportunities in that market. At the moment, it tends to be more mixed in terms of whether flow derives from GPs restructuring or LPs reallocating their portfolios. There is no clear trend of one leading the other, but if you look at private equity, the LP-led secondary process has become quite plain vanilla. It's a brokerage market almost, whereas the GP-led secondaries opportunities require more structure and value-add.

There's no reason why the private credit market won't follow the same route, but it's just very early relative to private equity. One challenge is that in credit, typically there is a shorter hold to maturity – whereas private equity might have a 10-year hold over a position, debt investments could have an average of three to five years. That means when we think about effective secondary credit portfolios, diversification is a big factor. We are already starting to see flows and have been for some time, so we expect that to increase next year. Perhaps not a hockey-stick increase, but just incrementally more flow and more players entering the market.

Q How are investors protecting themselves in anticipation of a downturn?

There is a macro and a micro answer to that. At a macro level, it's picking your spot in terms of subsectors within private debt that you are going to be exposed to. That means we are definitely seeing an increased demand for more opportunistic strategies that can take advantage of dislocations in the market through a downturn yet also deliver interesting returns if we continue to have a benign or slow deterioration of the markets.

From a micro perspective, it is making sure you are not paying through the nose in the face of market conditions that don't allow your GPs to meet their projected returns.

That's the driver for so much more modelling on what the fee expense could look like in all scenarios – making sure the pricing is right so there's not a lot of bias benefit to the GP if things go wrong. Additionally, investors are keener to diligence a GP's capability to manage difficult market environments – what happens if things go wrong. We see more questions from LPs about how assets will be managed, how returns will be protected and how GPs will actually ensure that they are not losing money. This can be an advantage for GPs on a larger platform or with the ability to roll out teams to focus on restructuring and workout processes if required.