

E X P E R T Q & A

*The asset class came through 2020 in good health, but investors will ask questions as they look to differentiate, says Tavneet Bakshi, partner and head of EMEA at FIRSTavenue*



## Still committed to credit

**Q As we enter 2021, how do investors feel about private debt as an asset? Why does it still remain attractive?**

We are hearing from our investor base that the asset class still has many facets that keep it relevant and attractive. The majority of private debt assets are in the direct lending space, where most investment structures are floating rate, sometimes with LIBOR floors, which helps protect investment returns when there is prolonged uncertainty in the broader economy. Even with the volatility over 2020, we still see an ‘illiquidity premium’ with the asset class vs public market equivalents.

As an asset class, private debt is maturing to the point where you can now do so much more under its umbrella. More investors are looking to private debt for contractual yields, senior secured positions and interesting

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differentiated return opportunities. The asset class has grown to cover infrastructure debt, real estate debt, special situations, opportunistic credit and, more recently, dislocation strategies. That allows an investor to think about private debt more holistically, with a goal of delivering diversified returns and cash yield while maintaining downside protection. The shorter duration timelines compared with private equity also make it attractive. Very few investors are reducing their private debt allocations, with most staying the same or increasing their commitments.

There are high hopes for the asset class this year because of its resilience. Although it is still early days, private debt managers have demonstrated their

ability to restructure loans and work constructively with sponsors. However, there is clearly more pain in the system, which will become more apparent if the downturn is prolonged and we start to see meaningful increases in default and loss rates. Nonetheless, funds have created a more transparent dialogue with LPs, who are happy recipients of covid stress test analyses and ‘traffic light’ insights into underlying portfolios.

**Q Has the crisis altered how LPs evaluate managers?**

The 2020 disruption did not really help emerging managers, as there was a flight to established platforms. We see that consolidation in the data, with assets remaining heavily focused in the hands of the top 15 managers globally. Uncertainty generally makes it more difficult for new managers to gain traction and with covid-19 that was

compounded by an inability to meet new contacts face-to-face.

That said, since late Q3, LPs have been more willing to start processes, virtually rather than in person, with managers they do not already know. LPs still need to deploy capital and it is clear that the traditional roadshow process will remain a challenge for some time still. Increasingly, investors seem more comfortable to look outside the mega funds for something differentiated, but they are not necessarily going into first-time funds or first-time managers.

Specifically relating to due diligence processes, investors seem to be using the opportunity of virtual DD to meet more members of investment teams earlier in the process. I've heard from a number of LPs that they have found virtual DD to be far more efficient in this regard. We've tended to see shorter meetings, but more of them within any one due diligence process. Referencing and taking comfort from knowing who else is backing the manager has taken more prominence in LP processes.

### **Q Which regions are most of interest, and why?**

US and pan-European strategies still dominate. Through 2020 we continued to see home-focused investing preference where dollar investors prioritised USD opportunities. European allocators also looked closer to home, partly due to foreign exchange and hedging cost considerations alongside just the inability of flying across the pond to meet managers.

We do see this changing, particularly where US investors have spotted the value proposition in European private debt. Within Europe, country-specific opportunities have received some attention. From country-focused non-performing loan managers to UK small and medium-sized enterprise specialists positioning themselves for Brexit opportunities, there is a growing universe of specialist GPs. The challenge is scaling into these opportunities.

On a separate point, this morning I was on a call with a structured credit fund focused on Central and Eastern Europe and a China-focused NPL manager. We have looked at emerging markets credit over the last few years but have yet to back a manager. Now, some of the more mature emerging markets could prove interesting, particularly where investors are able to get fairly high up in the capital structure with some meaningful equity cushion and have the ability to achieve returns equivalent to or better than US or European markets.

It is not clear whether the LP audience is quite ready for that – particularly in Europe, where many investors need more maturity in their private debt portfolios before reaching out into emerging markets debt. But, from an opportunity perspective, it is piquing our interest.

### **Q Which strategies are most favoured by investors?**

We are coming off a frenzy of LP appetite for distressed, special situations, opportunistic credit and dislocation strategies over 2020. Investors will still focus on interesting opportunities that they can take advantage of through the current market turmoil and eventual recovery. But they are unclear how the pain will eventuate, and many question whether there really will be a distressed story. Many have opted for a more opportunistic or tactical approach. I would say there is still some diversion of views among LPs around combining public and private market investing in one structure.

In parallel, we also noted a growing appetite for direct lending alternatives, by which I mean strategies that can deliver a decent amount of income but remain fairly senior in the capital structure with a risk profile that does not take them into special situations territory. We are seeing more interest in income funds, designed to deliver high single-digit to low double-digit returns, with high cash distributions

and underlying assets that are fairly healthy. We have also started to see more sector-specific funds coming to market, particularly in healthcare and logistics, which are attracting attention from investors eager to understand the opportunity set post-covid.

### **Q What else is on the minds of debt investors?**

A lot of GPs have found they can now invest in companies with lower underlying leverage and achieve similar returns as pre-covid, so from a risk-adjusted returns perspective they are in a much better place. The focus on underlying leverage has been growing across the investor base and will continue, particularly in Europe.







LPs are also focused on trying to get a like-for-like comparison across managers, which goes hand-in-hand with the maturity of the asset class as investors scrutinise managers.

We spent a lot of time in 2018-19 talking about various approaches to EBITDA adjustments, the benefits of financial covenants in loan documentation vs cov-lite and so on. Those will be in focus again this year as we start to see which structures held up better than others through 2020.

ESG has become an important focus across the credit investor base and GPs are responding, working to understand how they can better achieve ESG alignment despite not owning the assets.

And finally, in fundraising I think processes are going to be longer but I don't predict a significant drop-off. Funds will be in the market longer, partly because of LPs' risk aversion but also because investors will need more time getting to know managers. In this sort of environment, the key is differentiation and showing proof of concept. Being able to come into a 2021 fundraising with your team intact, your track record strong and an opportunity set that is still conducive to your strategy is going to be a must if you are looking to raise capital this year and next. ■

## An exceptional history...

<p><b>Triton</b></p> <p>Triton Debt Opportunities II European Opportunistic Credit</p> <p>€744m    October 2020</p>	<p><b>CRESCENT</b></p> <p>Crescent European Speciality Lending Fund II Providing bespoke senior secured loans to growing mid-market, sponsor backed European companies</p> <p>€1.75bn    March 2020</p>	<p> <b>SUMMIT PARTNERS</b></p> <p>Summit Partners Credit Fund III North American, non-sponsored direct lending</p> <p>Undisclosed    June 2019</p>	<p><b>STELLUS</b> CAPITAL MANAGEMENT</p> <p>Stellus Credit Fund II U.S. Lower middle market direct lending</p> <p>Undisclosed    Sep 2018</p>
<p> <b>JUDO CAPITAL</b></p> <p>Judo Capital Australian SME Lender</p> <p>A\$140mn    June 2018</p>	<p><b>O'CONNOR</b></p> <p>O'Connor Capital Solutions Fund I Corporate and Asset-Backed Lending</p> <p>\$1bn    December 2017</p>	<p><b>CRESCENT</b></p> <p>Crescent Mezzanine Partners VII Global Large Cap Mezzanine Debt</p> <p>\$4.6bn    December 2016</p>	<p> <b>Freeport FINANCIAL</b></p> <p>Freeport First Lien Loan Fund III U.S. Lower Mid-Market Senior Lending</p> <p>\$518mn    October 2016</p>
<p> <b>PERMIRA</b></p> <p>Permira Credit Solutions II European Mid Cap Direct Lending</p> <p>€800mn    August 2015</p>	<p> <b>M&amp;G INVESTMENTS</b></p> <p>M&amp;G European Real Estate Debt II &amp; III Mezzanine &amp; Stretch Senior European Real Estate Debt</p> <p>£1.35bn    February 2014</p>	<p> <b>M&amp;G INVESTMENTS</b></p> <p>M&amp;G European Real Estate Debt Fund I Mezzanine European Real Estate Debt</p> <p>€343mn    June 2011</p>	

The above funds show a selection of our closings over the past 10 years

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