



Is Private Debt the New Hedge Fund?

WHITEPAPER

Growing interest in, and satisfaction with private debt contrasts with some well-publicized investor doubts about the cost of investing in hedge funds and the risk-adjusted returns on offer

Private debt's booming

Its stable, attractive risk-return profile has seen assets under management triple in a decade—with the Alternative Credit Council (ACC) predicting the sector will reach \$1 trillion by 2020.¹

The growing popularity of private debt (i.e. debt investments not financed by banks, and not issued or traded on an open market) contrasts with more widespread investor reservations about the cost-adjusted returns currently on offer from the hedge fund industry.

So could private debt funds continue to gain on, and potentially supplant, hedge funds in the investor community's alternatives toolbox?

Private assets on the rise

Preqin's most recent figures show private debt assets under management hit a record \$769 billion as of June 2018, up from \$275 billion in 2009.² Assets are expected to climb further in 2019, with a third of the investors surveyed by Preqin planning to increase their allocation through the coming year. Almost half intend to expand their allocation over the longer term, while only 5% aim to decrease it...compared to the 21% that signaled they will reduce their allocation to hedge funds.³

This uptick reflects widespread investor satisfaction with the asset class: more than 90% of respondents to Preqin's H1 outlook felt "private debt met or exceeded performance expectations in 2018."

Growing interest in, and satisfaction with private debt contrasts with some well-publicized investor reservations about the cost of investing in hedge funds and the risk-adjusted returns on offer. While few institutions have followed the California Public Employees' Retirement System's (CalPERS) example and divested from the hedge fund sector completely, many are questioning the money they pay and what they get for it.⁴

The Preqin survey reveals the extent of the issue. More than half the hedge fund investors canvassed said they were disappointed with the performance of their portfolios in 2018. Just 8% felt the investments exceeded expectations. And only 37% believe performance in 2019 will be better than last year.

Hedge Fund Research figures show a bounce back in 1Q19 performance, with the index gaining +5.7%. But an extended period of volatile returns and underperformance has bruised confidence. Investor outflows in Q1 totaled \$17.8 billion, marking the fourth consecutive quarter of net asset outflows.⁵

Meanwhile, the 561 new hedge funds that launched during 2018 was the lowest level since 2000.⁶ During the year, 659 funds liquidated.

Private debt attractions

Private equity firms have been at the forefront of the private debt financing boom. Institutional investors have followed their lead, and now account for over 70% of the

capital committed to the growing number of private debt funds coming to market.

Pension funds, with their long investment horizons and need for stable returns, have become the most active institutional allocators to the sector. But foundations, endowments, family offices, insurance companies and wealth managers have all cottoned on to the attractions.

Who is investing in private debt?

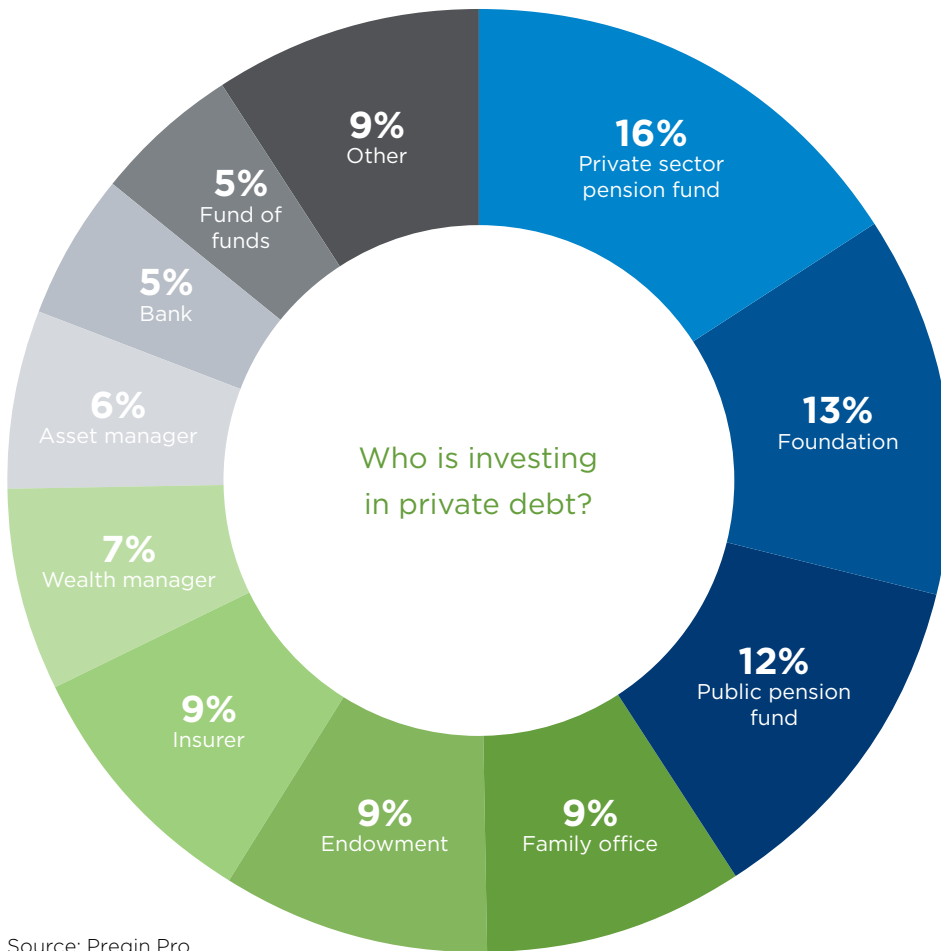
And those attractions are compelling.

Key among them: private debt promises sizable risk-adjusted returns and reliable income streams. Absolute Return Partners notes that at the most illiquid end of the scale, "annual yields of 7-8% are perfectly normal."⁷ Preqin's H1 outlook found almost half of investors in private debt are targeting an annual absolute return of 8%-12%.

In addition, protection of the principal is relatively assured (assuming the borrower remains solvent). The portfolio diversification on offer is a further sweetener.

Investors can also choose from a broadening selection of fund types, depending on each institution's risk profile and where it sees the best opportunities.

Preqin figures show direct lending continues to dominate the fundraising market, accounting for 41% of the capital secured in 2018. Other popular options include mezzanine, special situations, distressed debt and venture debt funds. The countercyclical nature of special situations



Source: Preqin Pro

and distressed debt funds means they are particularly likely to attract increased capital over the next 12 months, notes Preqin, as investors prepare for a market correction.

Borrower demand for private debt continues to expand too.

Traditional bank lending has contracted significantly post-crisis, as banks deleveraged to reduce risk and meet tighter capital requirements. But institutions and corporates still need financing. Private debt has flooded in to fill the gap, especially in the United States and parts of Europe, with interest increasingly spreading to emerging regions (notably China and Brazil).

Mid-market corporates historically formed the bulk of borrowers. But the market now extends to everything from startups and small businesses to large corporations and

infrastructure projects, notes the ACC. Private credit is funding an expanding array of activities as well, with nearly a third of all capital invested now being used in areas such as real estate finance, trade finance and asset-backed lending.

Why private debt is popular?

Investor appeal

- Delivers superior, guaranteed risk-adjusted returns.
- Provides reliable income streams to meet institutions' liabilities.
- Principal is (relatively) protected.
- Offers portfolio diversification.
- Investments can be aligned to institutions' risk-return profiles.

Borrower demand

- Fills the gap left by the pullback in post-crisis bank lending.
- Terms tend to be more flexible and bespoke than bank loans or public debt instruments.
- Can be used to finance a wide array of activities.

Risk and rewards

Inevitably, the attractions for fund managers and their investors are not without trade-offs.

Borrower risk

Private debt borrowers pay yield premiums because they may be too small or high risk for the public debt markets. For example, the ACC report notes that 40% of private credit managers are lending to companies with EBITDAs of less than \$25 million.

As we near the end of the current credit cycle, with the prospect of higher interest rates and tougher economic conditions for borrowers ahead, robust risk management capabilities will become ever more vital to guard against potential defaults. As the ACC report observes, experience in dealing with borrowers in stressed or default situations will determine how successfully managers can weather changes in the economic and credit cycle.

Growing competition

The influx of capital and launch of new funds is intensifying market competition.

Smaller firms and new lenders are finding it more difficult to raise money, with investors tending to favor fund managers with a proven track record. Funds are also having to fight harder for a limited number of deals. In response, private credit managers may be forced towards lower-quality transactions, with poorer terms (i.e.

As we near the end of the current credit cycle, with the prospect of higher interest rates and tougher economic conditions for borrowers ahead, robust risk management capabilities will become ever more vital to guard against potential defaults.

more flexibility on loan covenants and pricing) and/or reduced returns.

Preqin's survey bears this out. It notes that 53% of fund manager respondents cite competition as the biggest challenge facing return generation in 2019.

Meanwhile, Patrick Marshall, head of private debt at Hermes Investment Management, London, points out that covenant-light loans now make up 86% of the large-cap market, and that the reduction in protections has spread in some cases to small- and medium-size enterprises.⁸ More relaxed covenants could be storing up trouble for when the harder times come.

Illiquidity

Private debt liquidity terms are longer than for public debt funds.

To avoid a potential mismatch between assets and liabilities, private debt funds often require a hold-to-maturity approach. The ACC survey, for example, found approximately two-thirds of managers have a private equity-style, closed-ended commitment and drawdown fund structure. The fund life then spans fund raising, investment, the holding of positions and profit taking.

"With these structures, the maturity of the capital committed to private credit strategies is matched to the finance that managers are providing to the real economy," notes the report.

However, it means the best yielding offerings will potentially tie up capital for several years.

Investor servicing demands

Along with these issues, private debt managers must contend with a progressive ramp up in due diligence examinations and ongoing servicing requirements from the growing cohort of institutional investors.

Customized portfolios and services are one way for managers to differentiate their offering and attract business in today's competitive landscape. For example, the ACC report notes that a sizable majority of private credit managers are willing to run separately managed accounts—an effort to meet investor calls for customized fee arrangements, and their demands for greater transparency and control over investments.

More generally, investors are calling for:

- Clear, frequent, often bespoke reporting (another manifestation of the onus on transparency).
- Watertight compliance capabilities.
- Technology and cybersecurity resilience.
- Robust business continuity and disaster recovery procedures.

Faced with such demands, fund managers' ability to shoulder the evolving operating burdens, and manage and control their clients' accounts efficiently will be crucial.

Operating complexities

Administering private debt—with the associated accounting and reporting obligations it brings—presents further challenges.

Private debt can be more flexible and bespoke than typical bank loans or public debt instruments, and may require specific operational expertise and technology capabilities to manage the risks and deliver the necessary services to investors.

Common complications/pain points include:

Combining debt and equity—private debt is often rolled up with equity-type arrangements. In such cases, the equity and debt need to be tied together from an accounting and reporting perspective.

Complex structures—along with public and private companies, borrowers commonly take the form of special purpose vehicles (SPVs), which bring heightened governance, exposure monitoring and transparent reporting requirements.

Hybrid funds—private debt offerings tend to be structured within closed-end funds. That requires an ability to account for hybrid fund structures, and look-through those structures to follow the cash.

Accounting standards—under the IFRS 9 standard, financial instruments have to be correctly classified and measured to ensure financial statements are more fair value-centric. Measurement could be either at fairvalue through other comprehensive income (FVTOCI) or fair value through profit or loss (FVTPL), with treatment varying depending on whether the assets are held for trading or lending purposes. Heightened deal competition is also leading to more flexible credit agreements for borrowers, and a compression in spreads. To counter the impact, fund managers will have to

Private debt can be more flexible and bespoke than typical bank loans or public debt instruments, and may require specific operational expertise and technology capabilities to manage the risks and deliver the necessary services to investors.

better manage the risks and improve their operating efficiencies if they are to prevent a debilitating squeeze on profitability.

Importance of systematizing

If the sector is to continue to grow, and avoid a painful fallout when the next downturn hits, private debt funds should follow the same path towards institutional-quality investment and operating robustness that the hedge fund industry has already undertaken.

Scalable, repeatable, resilient (and, where possible, automated) processes are vital. And the biggest step towards achieving that is an efficient systems infrastructure. Yet spreadsheets—with the operational and financial risks they bring—remain a common feature in the private debt world.

Loans in particular are suited to the sorts of templates that can be easily built in a spreadsheet, then tweaked to reflect each deal's specific terms. But the popularity of templated spreadsheets means any problems or errors that creep in (and inevitably they will) become ingrained, as they are reused and disseminated across the organization.

Similarly, flexible rounding rules for calculating interest in a spreadsheet can compound financial errors, adding risk and potential cost.

Efficiency and scalability issues are another consideration. Building or reconfiguring a spreadsheet every time a new loan or piece of business is brought on takes time and resources. And whenever private debt positions need to be commingled with other assets, or other accounting systems, staff will need to manually import those positions into the general ledger.

As the business expands, and fund managers see a growth in deal volumes, spreadsheets' lack of operating scalability will become untenable.

Regulatory and compliance issues are a further factor. Investors and regulators want to see robust risk management, accurate and timely reporting, and auditable transaction processes. None of that is viable in a spreadsheet-oriented environment that depends on manual inputs and workarounds.

Automate to accumulate

Instead, as assets and transaction volumes continue to expand, and more investors take an interest in the space, a fit-for-purpose system has become a must-have for both specialized private credit managers and any multi-asset class funds that incorporate private debt.

A flexible solution with the functionality to accommodate loan administration and accounting, and that can track and report on the debt, will enable firms to efficiently monitor and manage their risks. Automating the downstream processes will be crucial in the battle to streamline operating costs and deliver valuable scalability.

And a controlled, auditable environment will enable fund managers to meet their compliance responsibilities, ensuring they can satisfy investors' due diligence expectations and improve their chances of attracting allocations.

While it may never overtake the hedge fund sector, the returns, income streams and diversification benefits on offer make private debt a compelling addition to investors' portfolios.

Conclusion

With such appealing fundamentals, private debt has the potential to become a mainstay of the alternative asset class. While it may never overtake the hedge fund sector, the returns, income streams and diversification benefits on offer make private debt a compelling addition to investors' portfolios.

Yet as players in the other alternative asset sectors have discovered, progressive institutionalization of the investor base comes at the cost of more stringent compliance, operational and service demands.

As industry competition intensifies, private credit managers will have to work harder to attract investor allocations. The success stories will be those firms that can support their clients with an automated, institutionalized operating environment. But the chance to profit from the growing opportunities private debt offers surely make it worth the investment.

1. Financing the Economy 2018 - The role of private credit managers in supporting economic growth, Alternative Credit Council and Dechert LLP, <https://www.aima.org/educate/aima-research/fte-2018.html>
2. 2019 Preqin Global Private Debt Report, Preqin, Feb 21, 2019, <https://docs.preqin.com/samples/2019-Preqin-Global-Private-Debt-Report-Sample-Pages.pdf>
3. Preqin Investor Outlook: Alternative Assets H1 2019, Preqin, April 2, 2019, <https://docs.preqin.com/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2019.pdf>
4. For example, the CIO of the \$90 billion Alecta pension fund, one of Sweden's biggest, called hedge funds "expensive black-box investments."
5. Hedge fund assets surge on HFRI 1Q performance gains, Hedge Fund Research, April 17, 2019, <https://www.hedgefundresearch.com/news/hedge-fund-assets-surge-on-hfri-1q-performance-gains>
6. New hedge fund launches fall to lowest level since 2000, Hedge Fund Research, March 22, 2019, <https://www.hedgefundresearch.com/news/new-hedge-fund-launches-fall-to-lowest-level-since-2000>
7. Private Credit Demystified, Absolute Return Partners, September 2018, <https://www.arpinvestments.com/ar/private-credit-demystified>
8. Commentary: Navigating the evaporating protections in the private debt market, by Patrick Marshall, Pensions & Investments, April 18, 2019, <https://www.pionline.com/article/20190418/ONLINE/190419841/commentary-navigating-the-evaporating-protections-in-the-private-debt-market>

ABOUT SS&C ADVENT

SS&C Advent, a business unit of SS&C, is helping over 4,300 investment firms in more than 50 countries—from established global institutions to small start-up practices—to grow their business and thrive.

Our Geneva® portfolio management and fund accounting system is the leading software solution for the alternatives industry. Geneva® is a highly scalable, true multicurrency and multi-asset class platform. It is designed to support complex investment strategies across international markets, with the ability to manage myriad fund, entity and legal structures, and fully support all transaction types and instruments, including private debt.

For more information on how Geneva® by SS&C Advent can help streamline your operations and position your business for growth, visit www.advent.com or contact advent@sscinc.com.

This communication is provided by SS&C Advent for informational purposes only and should not be construed as or relied on in lieu of, and does not constitute, legal advice on any matter whatsoever discussed herein. SS&C Advent shall have no liability in connection with this communication or any reliance thereon.

©2020 SS&C Technologies Holdings, Inc.