

The Golden Age of
Private Credit?

Opportunity in Uncertain Times

LAYING THE OPERATIONAL FOUNDATION
FOR SUCCESS

While surging inflation, fast rising interest rates, recessionary fears and geopolitical uncertainty are weighing on the performance of traditional assets, private debt “is uniquely positioned for both reliable income and risk-adjusted returns,” notes alternative research analyst Preqin’s most recent Global Private Debt Report.¹

Private debt (or private credit—the terms are used interchangeably) found a fertile environment following the Global Financial Crisis. For growing companies, it filled the lending gap left by retrenching banks. Investors in turn enjoyed attractive returns that far exceeded public debt yields. A decade of strong and consistent growth averaging 13.5% annually followed, bringing assets under management to an estimated \$1.2 trillion by the end of 2021, according to Preqin figures.¹ And the firm forecasts growth will accelerate to a CAGR of 17.4% between 2022 and 2026, taking AUM to \$2.69 trillion, higher than real estate and second only to private equity and venture capital in the pantheon of private capital asset classes.¹

Private attractions

Key to private debt’s attraction is its ability to provide investors a higher-yield alternative to public debt markets, with relatively low volatility. The floating rate nature of loans can also offer a hedge for resurgent inflation. That combination, notes the Preqin report, is especially alluring to institutional investors seeking to match their liabilities with a level of returns that public bond yields have long been unable to meet. And with inflation fears and

geopolitical risks provoking extreme volatility in global bond and equity markets, Preqin expects investor appetite for safer investments such as direct lending to continue to grow.²

Family offices are also upping their commitments. Faced with high inflation, flagging central bank liquidity, rising interest rates and geopolitical instability, they are reducing their fixed income allocations and ramping up investments in private debt, private equity and real estate, notes the UBS Global Family Office Report 2022.³ The report found private debt is now the most popular source of unconventional yield to replace fixed income in the US and Western Europe, “as loans’ relatively high floating rates and low correlations with public markets appeal in today’s market environment.”³

Private debt’s attractions have been reflected in the fundraising environment. Preqin’s figures show aggregate capital increased 14% in 2021 to \$193.4 billion, with a pronounced rise in the number of funds gathering commitments of more than \$1 billion. As of Q3 2021, there were 689 private debt funds in the market, targeting an aggregate \$290 billion, although the Q1 2022 Preqin Quarterly Update noted fundraising had slowed down on the same period the previous year.

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Mixed prospects

Not that the outlook is all rosy. The surge in funds and capital has heightened competition, putting downward pressure on yields and covenant safeguards, especially in the mature US market. Meanwhile, the latest Coller Capital Barometer found one in three North American investors, and one in five European investors believe rising interest rates will lead to more defaults in their private credit portfolios.⁴

Conditions could get sticky as the economic environment darkens. Yet the looming challenges will throw up possibilities too. Indeed, the Barometer reported that more than half of investors still see attractive opportunities in private credit funds targeting North America and Europe in the next two years. Europe—a region that has relied heavily on the traditional banking system historically—could be a particular focus.

“Several large Europe-focused funds have materialized in recent years – a trend we expect to continue as managers look to differentiate themselves and find new market dislocations outside of the saturated North American market,” noted Preqin’s Global Private Debt Report. Funds are also looking to the much smaller and less mature Asian market for dislocations, it added.¹

Operational challenges

Private credit managers, especially those with expertise and a track record in distressed debt and special situations, could be well-placed to take advantage of any opportunities that result from the deteriorating economic and financial landscape. But with a number of PE firms eyeing the private credit space to capture more of their clients' alternative allocations, and traditional asset managers looking to the private capital markets to meet investor demand for diversification, competition for investor capital and investment talent is bound to intensify.

Investing acumen is only part of the equation. Firms also need an operational infrastructure that can account for increasingly complex fund structures and investment strategies, with a level of automation to support escalating transaction volumes and manage risk. This will become particularly important in the post-London Interbank Offered Rate (LIBOR) environment, as new standards coalesce around loan pricing and interest calculation methodologies as bank and non-bank lenders transition to the Secured Overnight Financing Rate (SOFR) and other risk-free rate benchmarks.

A strong operational backbone will be a major differentiator for fund managers. Firms seeking to raise institutional capital for private credit vehicles must meet rigorous operational due diligence examinations, demonstrate transparency for investors, and

deliver on their expectations for more insightful and regular reports.

That takes robust IT systems able to handle the data management, accounting, valuation and reporting tasks needed to run potentially multiple legal entities, each with their own LP-specific waterfall calculations. In a higher-risk environment especially, limited partners want to understand what managers are doing with their money. They expect detailed look-throughs from the investor level to the underlying assets and exposure in their portfolios, requiring seamless integration between portfolio management and investor accounting, ideally available in an all-in-one solution.

In the wake of the pandemic, investors also have a heightened interest in their managers' business continuity and disaster recovery plans. Having endured a global disaster that displaced both investors and managers from their everyday workplaces and lifestyles, funds will be under pressure to demonstrate operational resiliency and explain how they can continue to meet their obligations, indefinitely if necessary.

Challenges to fee structures

Another challenge in servicing institutional clients is the growing demand for highly customized fee structures. The old 2 & 20 model—2% management fees and 20% on performance—has fallen out of favor. Investors are pushing for lower fees and

more flexible arrangements, resulting in a proliferation of side letters. In the absence of automation, tracking the different fee agreements and delivering accurate waterfall calculations for each investor puts a huge burden on operations teams and is fraught with risk.

More customized terms that give investors the choice to opt in or out of investments also requires managers to account for 'deal by deal' carry within the fund, adding to the complexity.

Lower cost of ownership with hosted technology and additional services

Taking advantage of opportunities in this dynamic environment calls for a technology solution that can:

- Support a full range of complex private debt fund structures, including distressed debt.
- Provide transparency for investors and deliver industry-standard reporting.
- Account for multiple customized fee agreements and calculate investor fees.
- Ensure business continuity in the event of a disaster.
- Enable a smooth transition from LIBOR to SOFR-based pricing and interest calculations for both new loan originations and loans already on firms' books.

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Migrating to a platform that can meet all these criteria will pay dividends over the long term. However, it will entail some near-term disruption.

The easier and faster alternative for getting up and running on the optimal system is to outsource both the technology and certain operational activities and workflows.

The outsourcing option lightens your in-house IT burden, frees you from ongoing system maintenance and upgrades, and gives you the agility to launch new strategies or enter new markets without adding operations staff or infrastructure. Moreover, moving your core operational platform offsite has the added advantage of built-in business continuity.

In an era of rising public market volatility and pronounced downside risk, private credit is proving to be one of the more resilient sectors of the investment landscape. Fund managers that have the right operational underpinnings will be better positioned to take advantage of the unusual opportunities these uncertain times present.

1. 2022 Preqin Global Private Debt Report. (2022, January 12). Retrieved from: <https://www.preqin.com/insights/global-reports/2022-preqin-global-private-debt-report>
2. Preqin Quarterly Update: Private Debt Q1 2022. (2022, April 11). Retrieved from: <https://www.preqin.com/insights/research/quarterly-updates/preqin-quarterly-update-private-debt-q1-2022>
3. Global Family Office Report 2022. (2022, June 8). Retrieved from: <https://www.ubs.com/global/en/media/display-page-ndp/en-20220608-family-offices-search-diversifiers.html?caasID=CAAS-ActivityStream>
4. Collier Capital Global Private Equity Barometer, Summer 2022. (2022, June 8). Retrieved from: <https://www.colliercapital.com/sites/default/files/Collier%20Capital%20Global%20Private%20Equity%20Barometer%20Summer%202022.pdf>

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