Private debt managers: what risks stand in the way of reward

Peter Brown, Head of Private Debt for Aztec in Luxembourg and Ore Adegbotolu, Business Development Director, recently led a private debt webinar that discussed the risks that private debt managers have been navigating since the coronavirus pandemic. Here, Peter and Ore share several key takeaways.

Our panellists were:

- Peter Brown, Head of Private Debt – Luxembourg, Aztec Group
- Francois Decoeur, Partner, MV Credit
- Luc de Vet, Partner, ONE Group Solutions
- Neil Walker, Head of Institutional Banking, RBS International
- Ore Adegbotolu, Director of Business Development, Aztec Group

If you missed the session, you can access the original recording here.

The market landscape

The events of the last few months have effectively been the first real test for the private credit markets, and some important lessons have been learned. Amid the upheaval caused by the pandemic, private debt has continued to grow in significance, as bank's have retrenched further and investors have sought higher risk-adjusted returns in a low to no interest rate environment.

Nearly $120 billion of capital was raised in private debt markets last year, a decline of only 10%, and the smallest decline of all alternative asset classes. In terms of asset selection, some sectors – such as healthcare and software – have proven more resilient than others, and have continued to trade at extremely high multiples. Overall, since the global financial crisis, private debt has seen huge growth of 250% globally and around 600% in Europe, and is expected to continue to grow strongly in the coming years, rising to roughly $1.5 trillion by 2025.

However, despite the positive growth expectations, the investment environment is still far from straightforward. Investment cycles have been extended because of

that slowdown and refinance activity last year, meaning managers have been holding onto assets for longer. Central bank stimulus has flooded markets with cheap liquidity, making it increasingly challenging to generate meaningful returns. Unsurprisingly, liquidity and reduced merger and acquisitions activity has meant private debt market 'dry powder' has built up considerably. With an increase in deployable funds, and a shortage of assets driving pent-up demand, concerns around asset valuations are occupying investors' thoughts.

Risk management still centre stage

Within private debt markets, the key tenets of risk and portfolio management remain the same, even if current conditions remain far from normal.

A key early focus for debt managers – once the pandemic hit – was a deep dive assessment of the portfolio, with a view to identifying issues early on, enabling pro-active engagement with all capital providers to come up with collaborative solutions to meet the needs identified. Liquidity was the immediate priority, followed by adjusting covenant controls to provide headroom and time for businesses to trade through the challenges of the last year.

The short-term relief offered by equity injections, alongside additional lending from banks (in some cases utilising the government support schemes) and private debt funds, has kept many businesses afloat. As that support is gradually withdrawn, or falls due for renewal, the market will have a clearer idea of which businesses are on firm foundations, and which businesses might need more fundamental changes – such as refinancing some senior into subordinated debt, or putting in place debt-for-equity structures – where risk has increased.

Technological innovation is coming

With increasingly complex structures, a ramp-up in fund sizes and volume of transactions, there is a growing demand from managers, investors and regulators for more detailed and timely reporting at Fund and GP level. This has been brought into sharp relief in the last year, as investors have sought more regular updates on fund and asset valuation, as well as underlying portfolio performance, and more consistent asset level reporting across funds as a result of the pandemic.

The private debt market has in some quarters – perhaps unfairly – earned the nickname of being “spreadsheet land”, with many fund managers finding it challenging to get access to real-time meaningful data and therefore up-to-date insight , into valuations and fund level transactions for example, which is more common in the listed markets. However, this is already starting to change, as more fund managers and their outsourcing partners look to automate the way they report on these metrics, as well as underlying portfolio information and broader risk metrics.

While full artificial intelligence (AI) and process automation is still some way off, technology will help to create operational efficiencies within portfolio and fund level risk management. The provision of real time information and data, and converting that to real insight, is one of the biggest challenges that the private debt industry has to embrace in the years to come.

Portfolio management is still very much a people business

While technology is essential, the resilience demonstrated by the private debt market in the last year is due to the way people have rapidly adapted to the new environment, working flexibly and harnessing technology to communicate within teams, but also with borrowers and investors. Given the need for early and regular engagement with key stakeholders over the last year, the ability to adapt quickly is even more impressive.

One key aspect for managers has been ensuring people have the right equipment and other tools to collaborate effectively. However, maintaining engagement and understanding the impact of the new environment on each individual’s wellbeing has also been critical. The last year is likely to have a profound impact on the way we all work in the future, and the wider industry will need to embrace the benefits of flexibility to recruit and retain key talent.

At the same time, operational risks have increased significantly with people working remotely and payment fraud attempts have risen significantly. So, stakeholders need to be extremely mindful about their security measures, and establish robust protocols that protect them from vulnerability.

Structural risks to be mindful of

Finally, private debt managers need to be mindful of the 'unintended consequences' of the pandemic response, and how these could affect their portfolio companies. Clearly, the withdrawal of government support could leave some companies in urgent need of other forms of financing. The levels of dry powder available make this an opportunity as much as a challenge, although stronger performers will find private support much easier to come by.

Perhaps the more difficult question to consider is whether inflationary pressures will boil over as economies reopen and consumers start to make up for lost time. These pressures are certainly building, and it is worth remembering that many businesses that have benefited from interest rates at zero may be vulnerable should interest rates start to rise to offset inflation. Therefore, the importance of monitoring portfolio companies cannot abate, even if pandemic restrictions continue to ease.

Summary: several reasons to be positive on the future for private debt

To sum up, the fundamentals for private debt markets remain positive, and as an asset class it continues to offer a number of advantages for investors. In addition, the resilience demonstrated by portfolio managers over the last few months has been very encouraging, with them changing their working methods and recalibrating their risk criteria to meet the new reality. While government and central bank intervention has resulted in new challenges and risks, there will also be opportunities for managers to put capital to work. Therefore, there's every reason to believe private debt as an asset class will continue to grow rapidly, and be successful over the next few years.