The LP Perspective: What next for allocations to private debt?

As part of the BVCA Alternative Fund Strategies Conference, Peter Brown, our Head of Private Debt – Luxembourg, moderated a virtual panel discussion alongside Stuart Hawkins of Ardian Investment and Claire Madden of Connection Capital. Together they explored the outlook for Limited Partner (LP) private debt allocations.

Moderator, Peter Brown (PB): I wanted to start by summarising some of the key fundraising and investment trends shaping private debt markets. Private debt has experienced huge growth since the global financial crisis, increasing 250% globally, while in Europe the market has risen 600%.

That said, fundraising dipped in 2020, down to $250 million, compared to the $360 million peak raised in 2017, and $300 million as recently as 2019. It's also worth mentioning that European private debt fundraising was on a par with the US during 2020, with both at around $43 billion.

Another important point to note is that the market for senior debt ticked up to 40%, with subordinated and mezzanine debt at 38% and distressed debt at 16%. So clearly, there's been an increased appetite for debt lower down the risk curve.

Finally, we've seen a significant increase in the amount of dry powder available for direct lending specifically (up 30% to $63 billion in Europe), as investors have found it more difficult to deploy funds, especially with government support place.

PB: Now the scene has been set, let's start by asking about the near-term investment opportunities in private debt, and how you each expect to see the market evolve?

Claire Madden (CM): Given the significant dislocation that happened last year, within private debt, people have been looking specifically at distressed and special situations. At present, our emphasis is on special situations, as we don't expect distressed debt to become a significant feature until the second half of 2021 and beyond. There have been a lot of sticking plasters placed onto corporates during this recent period, but there will be more balance sheet restructuring as businesses recover and start to move into their growth phases. From our perspective, it has been important to look at those funds where managers are really plugged into good deal flow, and have the necessary experience to approach special situations and make the most out of them.

Stuart Hawkins (SH): We've seen quite a lot of opportunity in the mid-market lending universe, which is really the core of private debt. When you take a step back, all the fundamental drivers of the private debt universe, including banking sector retrenchment and greater flexibility of capital, still exist. If anything, COVID has accelerated those issues, particularly during 2020, when banks were struggling to deploy capital at the same pace as they had been historically. The private debt community stepped into that space more, as the retrenchment began to accelerate. If you speak to the major private debt managers, they had a very big year in 2020 in terms of deployment, even off the back of less deal flow.

The other aspect has been geographic expansion. While the core private debt market really permeated from the UK, some geographies and cultures have adopted it quicker than others. Take the Nordic countries, for example. Historically, banks in the Nordic region had a very strong cultural position for a long time, with market participants much less accepting of private debt. But that is now changing quite rapidly.

PB: Are you seeing any new areas where private debt is playing a greater role, or will play a greater role in the future?

SH: Around the edges, perhaps. If you look at private debt as an asset class, one of the reasons why investors like it, and how private debt is pitched to them, is "stable returns, low risk". Which is really where the core focus for private debt will always be. And, frankly, there's enough wood to chop across Europe. Rather than attacking specific areas, such as asset-based lending and sponsorless lending to small and medium-sized enterprises, my perception generally is that funds will ultimately just raise bigger pools of capital as part of a broader mandate, and allocate more to pockets within their existing strategy. I think that's the direction of travel we can expect over the next few years.

CM: We operate very much at the smaller end of the market. We look for opportunistic strategies for our private equity investors, and have been providing more liquidity solutions for both LPs and General Partners (GPs). On more liquid debt strategies, we've been a regular investor in CLOs (collateralised loan obligations), because we like the risk/return profile, and it has been relatively resilient throughout this period. We only look for opportunities within closed-ended vehicles, to make sure liquidity at the firm level is the same as, or matches, the liquidity of the underlying asset.

PB: How do you expect COVID and the resulting economic fallout will impact private debt markets in the next few years?

SH: I think it is going to accelerate the retrenchment trend and grow the private debt market. Looking at COVID specifically, we're going to see more fund manager differentiation. A whole load of capital has been raised by all sorts of different managers who have come up with varying strategies, but most of this capital has been invested during a sustained up-cycle. This will be the first big test of that. As Claire noted, we've seen the COVID impact, but we haven't seen the macroeconomic fallout yet. That's still a year or two away, at least.

But ultimately, having some clear differentiation between fund managers can only be a good thing for the market as a whole. It means LPs can determine which fund managers have delivered returns while staying true to their risk profile, and which were taking on more risk than everyone thought they were.

CM: The real impact of COVID is going to come through once corporates have made it through the crisis and everything is beginning to grow again. That is when they will find out just how supportive their lenders are. As to how different managers approach their portfolios, I think there is a lot of opportunity. We have been seeing examples of where business owners with very good businesses – that may or may not be affected by COVID – are concerned with how much personal wealth is tied up in their business and want to do something about it. We are also seeing opportunities that can be structured to ensure a return from a debt instrument that bears limited risk, has very high security coverage, and also offers a very interesting equity upside with it. There are lots of opportunities on that front at the moment, particularly at our end of the market.

PB: When it comes to deal selection, are you already starting to see the risk/return dynamic shift, or will that happen later this year?

CM: Going back to bank retrenchments, it really presents an opportunity for a flexible funder to move quickly and provide a solution that borrowers are prepared to pay for, most likely through debt and equity instruments. This gives the funds provider the chance to generate really good, outsized returns. The key, of course, is for the provider to spot the opportunity in the first place. So, it's about being plugged into that deal flow, and having the experience to structure and diligence funding opportunities quickly and efficiently, to ensure the borrower's timeline can be met.

SH: Claire hit the nail on the head. Scale is becoming increasingly important. Not because scale in its own right matters, but because it plugs you into the deal-sourcing network across Europe that lets you uncover those off-the-grid deals that can generate that extra yield.

PB: A lot of commentators see this as the first real test for private credit markets. If so, who will emerge as winners and losers?

CM: It all goes back to looking at how managers support their portfolio businesses to get through the other side. The truth, of course, is that you can't do an awful lot if you've got a bunch of consumer-facing 'bricks-and-mortar' retail businesses in your portfolio. Even so, the quality of the manager comes through when they are facing difficult situations that test the rigour of their approach. Most investors understand it is better to support those businesses with long-term prospects, rather than walking away, even if it means some short-term pain.

SH: Everyone wants to hear how managers can deploy capital, but investors also want to hear how you plan to fix the issues. How have you built up your portfolio? What sectors have you been investing in? Have you genuinely been conservative?

Have you got the resources to deal with the problem cases on your book? There was a time where all those questions were brushed under the carpet. But now they will decide which managers to invest with.

Determining the winners will come down not just to the strategy, but who has the proven track record of working out companies through a cycle, because that influences the ability for managers to raise more capital going forward.

PB: Just to wrap up, why is private debt so attractive to investors?

SH: On a risk-adjusted basis, private debt outperforms most other asset classes that investors have access to. It offers good returns with a relatively low risk profile. It also generates a strong cash yield which, frankly, in a low interest environment, is particularly important. Investors are starting to understand how private debt offers exposure to an asset class they cannot access directly themselves, where they benefit from local teams and a skilled manager who knows how to generate a significant yield.

CM: Our clients all have quite high exposure to private equity. So, looking at the capital structure, private debt is really quite a nice place to be, and having no senior debt ahead of you really puts you in the driving seat. And certainly, on a risk-adjusted basis, the low interest rate environment makes it very attractive for clients to be making a meaningful allocation to this asset class.