Direct lending attracts growing LP base

After several years of strong growth, the Direct Lending fundraising picture looks a little more mixed for 2016. However, the continued healthy appetite among limited partners and the development of their private debt programmes suggest that the longer term picture is still positive.

Times of upheaval create winners and losers and the financial crisis of the late 2000s is no exception. While banks have been forced to take a more cautious view of their investments and lending strategies in the light of Basel III capital requirements imposed on them, alternative lenders have stepped into the breach, providing companies and sponsors with debt offerings that range from private placements and more traditional senior debt through to unitranche, growth capital and structured equity. The growth of the market is evidenced by the global fundraising total seen in 2015, at US$36.0bn, up from just US$22.4bn in 2013 (see p. 23).

The US already had a well-developed non-bank lending market pre-crisis, but it's in Europe where growth has really taken hold for private debt funds over recent times. Indeed, in 2015, fundraising for Europe-focused Direct Lending vehicles surpassed that for North America-focused funds, with just nearly $19bn raised for the former over the year and US$14.9bn garnered by the latter, according to the latest figures (see p. 24).

Much of this growth was accounted for by some particularly large fundraisings in Europe, with three of the largest five funds of 2015 specifically Europe-focused and the other two with significant allocations to Europe.

An established part of the portfolio

While the figures so far suggest that 2016 may not be such a stellar year for Direct Lending fundraising globally and particularly in Europe – in part because fundraising totals are often lumpy in relatively nascent markets – the fact is that many limited partners now view Direct Lending as an important part of their investment strategy.

What may have started as a means to generate yield in a low interest environment for many investors has now become an established means of generating returns and for some a way of diversifying their portfolios. Since 2013, the fairway has broadened considerably in terms of both number and type of LPs that are interested in private debt funds.

"Most LPs have now heard the private debt story – in contrast to just a few years ago – and in some ways fundraising is like knocking on an open door," says Marc Ciancimino, Head of European Private Credit at KKR. *"Many LPs are very keen on the concept because they are looking for yield but with the added attraction of holding a senior position in the capital structure."* Indeed, KKR has recently reached a final close on its latest Europe-focused Direct Lending fund at US$850m, with total resources of US$1.3bn including leverage.

Mark Ciancimino
Head of European Private Credit at KKR

The range of funds now apparent in the market means that Direct Lending is an attractive area of investment for most types of investor, given the differing risk profiles and investment horizons of different strategies.

Wouter Mak at Credit Suisse Private Fund Group explains: *"Direct Lending funds provide LPs with a strong yield component and relatively robust downside protection. This is attractive to those with lower risk appetite and defined cash flow obligations, especially public pension plans, insurance companies and certain endowments."* Yet family offices, which traditionally have a higher risk appetite and are not seeking to meet future liabilities, are also looking to Direct Lending.

"For them, Direct Lending is seen as a good diversifier in their portfolios, balancing the risk-reward profile and providing a reliable source of cash flow," adds Mak.

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Wouter Mak
Director – Credit Suisse Private Fund Group

"We expect clients' allocations to private debt to continue to increase ... Many still have relatively small allocations, yet in order for private debt to have an impact on the overall portfolio, an allocation of 5% to 10% is recommended."

Urs von Büren
Swiss Capital Alternative Investments

More sovereign wealth funds are also entering the market and the increase in their appetite shows the direction of travel for many LP types: recent Preqin figures suggest that 35% of SWFs now invest in private debt, versus 24% in 2015.

And there is still plenty of scope for growth, with many still in the early stages of building out portfolios and exposure to the market. *"Even though allocations to private debt have increased, many LPs remain underweight in our view, particularly if comparing against the size of private debt markets globally,"* says Gregg Disdale, Global Head of Illiquid Credit at Willis Towers Watson.
"There is a lot of room for the asset class to grow substantially." Urs von Büren at Swiss Capital Alternative Investments agrees.
"We expect clients' allocations to private debt to continue to increase," he says.
"Many still have relatively small allocations, yet in order for private debt to have an impact on the overall portfolio, an allocation of 5% to 10% is recommended."

Gregg Disdale
Global Head of Illiquid Credit at Willis Towers Watson

"Even though allocations to private debt have increased, many LPs remain underweight in our view."

“For the early movers in this space, we’ve definitely seen yields come down and we are watching carefully as to where we are in the credit cycle in the US and Europe.”

Turning cycles

Nevertheless, while LPs continue to be attracted to the Direct Lending space, there are signs that many are becoming more cautious in their outlook and/or are shifting their allocation strategies as we move through the credit cycle – global corporate default rates were at their highest since the crisis, according to S&P figures, with 57 issuers in 2016 to early May, reflecting the volatile oil & gas markets as well as a slowdown in economic growth in the US and China.

“For the early movers in this space, we’ve definitely seen yields come down and we are watching carefully as to where we are in the credit cycle in the US and Europe,” says Sanjay Mistry, Director of Private Debt at Mercer. *“There may well be increased distressed opportunities on the horizon, although we wouldn’t automatically consider these for our various private debt funds and client portfolios as their risk characteristics place them firmly in the private equity, rather than private debt, bucket.”*

“We are minded to be cautious in the current environment,” agrees Disdale. *“That means we are more likely to favour senior or whole loan/unitranche investments over mezzanine now, given where asset values currently are. Defaults are likely to pick up over the coming period, albeit from very low levels and we may see more investor capital gravitating towards distressed debt than we’ve seen over recent years.”*

The other issue many LPs and their consultants are currently watching closely is competition. The rapid growth in the number of funds in Europe is leading some to be cautious about some pockets of the market. Many of the fundraisings seen in Europe last year – such as those completed by BlueBay, ICG and Ardian were second or third funds in the Direct Lending space, but there were also many new entrants to the market (see p. 33). *“We believe we are in the last third of the credit cycle. Therefore, we are mindful of increasingly borrower friendly structures and terms, particularly for M&A transactions,”* says von Büren.

“In Europe, the significant increase in the number of managers and committed capital at this late stage of the cycle is a concern. This means that the importance of manager selection in the right segment of the private debt spectrum is intensifying.” For Swiss Capital Alternative Investments, he adds, its focus on investing via separate accounts helps mitigate this as it enables the firm to set investment guidelines on behalf of clients as well as exclude certain transactions and industries.

Sanjay Mistry
Director of Private Debt at Mercer

Focus on manager selection

These factors, as von Büren suggests, mean that investors are sharpening their manager selection criteria. ***"We've seen noticeably different behaviour among LPs when it comes to manager selection over recent times,"*** says Max Mitchell, Head of Direct Lending at ICG. ***"Two years ago, they were looking at a much broader church; now we're seeing a flight to quality as investors are seeking out managers with a more established track record as they look to invest in a less risky way – that's to the clear benefit of blue chip names."***

LPs are also digging deeper as the prospect of more players chasing the same deals starts looming in Europe. While the usual factors of experience, risk profile of the fund's strategy and organisational culture all come in to play, the difficulty assessing track records in a space where few funds can point to longevity means that LPs are honing in on particular areas in their due diligence efforts. ***"Our clients have largely been investing in debt funds with predictable cash flows, so mainly in the Direct Lending and commercial real estate space, where they are seeking returns of between 7% and 10%,"*** says Carolyn Schuster-Woldan, Partner at Lane Clark & Peacock.

Max Mitchell
Head of Direct Lending at ICG

"...now we're seeing a flight to quality as investors are seeking out managers with a more established track record as they look to invest in a less risky way – that's to the clear benefit of blue chip names."

"We tend to encourage our clients to think in terms of their risk budget when assessing private debt investment opportunities, to look at whether they are being appropriately paid for the illiquidity of credit funds."

The portfolio allocation conundrum

The fact that Direct Lending funds cover a wide variety of strategies, have different risk-return profiles and are illiquid yet usually provide regular cash flows has presented something of a conundrum for many LPs: where does it sit within their portfolio?

"Private debt can fit within various parts of an investor's portfolio because it's such a varied offering," explains Gregg Disdale, Global Head of Illiquid Credit at Willis Towers Watson. *"We tend to encourage our clients to think in terms of their risk budget when assessing private debt investment opportunities, to look at whether they are being appropriately paid for the illiquidity of credit funds. There are clearly some private debt opportunities that are more equity-like and that therefore fit in alternative allocations, but the majority tend to fit within credit/fixed income portfolios."*

Sanjay Mistry, Director of Private Debt at Mercer adds: *"Most LPs we work with put their private debt exposure into fixed income, although it does move around according to the debt fund's risk profile. So, for plain vanilla senior-oriented strategies, fixed income is more appropriate, while for higher risk strategies, such as subordinated debt or higher octane senior debt, alternatives is often a better fit."*

Yet as the market develops, investors become more accustomed to the different features of Direct Lending and as their allocations increase, it is likely that many will follow the lead taken by some of the more experienced LPs in the asset class by creating a separate private debt bucket. *"Some investors allocate across the whole private debt space,"* says Mistry.

"And here, it doesn't really fit in either alternatives or fixed income and so they usually have a stand-alone part of the portfolio dedicated to it, although these do tend to be investors that have been in the market for a while."

It's a view shared by Henry Watson of Credit Suisse Private Fund Group. *"As LPs continue to build out their programmes, many who currently focus exclusively on buyouts are likely to develop an illiquid credit programme,"* he says. *"This would track the development of many LPs that are prominent in the space today."*

"Direct Lending is here to stay…It will become much more mainstream for investors. So far, it has provided some attractive returns and it's clear there is demand from SMEs that can't get financing from the more traditional sources. For investors, the opportunity is tangible."

Carolyn Schuster-Woldan
Partner at Lane Clark & Peacock

"Yet we do need to be cautious because if managers are taking more risk then that level of return becomes less attractive. We consider the quantum of leverage being used and at the quality and quantity of covenants."

She adds: *"We spend a lot of time assessing funds' sourcing networks and we want to see that managers can deploy capital in a disciplined way over a one to two-year period. We also assess managers' credit due diligence and look into their experience of work-outs from the previous cycle. This last point is particularly important if we are going into a period of increased defaults, but it can be hard to do because many of the funds are relatively new and haven't been through a more difficult economic environment."*

Fees and other terms also play an important role in helping LPs decide whether to commit to a fund, particularly as many are more accustomed to more traditional market fee levels. LPs and their consultants broadly welcome the shift away from private equity-style management fees on committed capital towards a model of fees on invested capital that has been seen across the Direct Lending space, although many would like to see further movement on hurdle rates and a closer alignment with fixed income-style levies.

Yet there is a caveat, says Mak. *"The market has become very competitive and there are some corners in Europe that are getting crowded,"* he says. *"The trend towards fees based on invested capital can create perverse incentives to put money to work, so mandates need to be sufficiently broad if terms are set this way."*

Future development

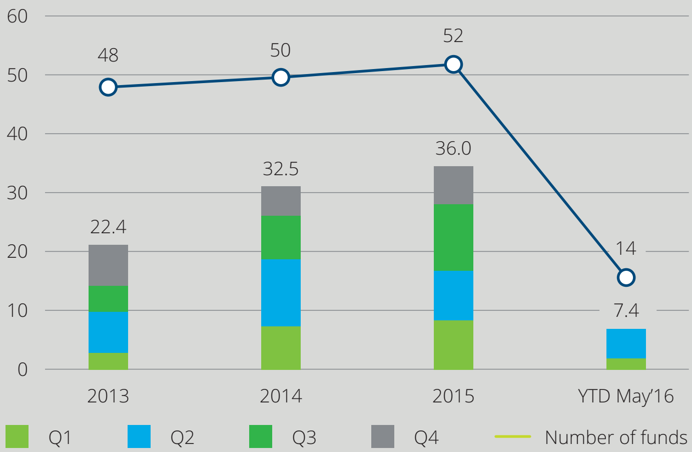
Looking ahead, many predict that there will be some kind of shake-out or consolidation among funds following a period of rapid growth. With LPs and their consultants focusing heavily in the due diligence on ability to source deals, it seems likely that those funds with proprietary deal flow that can avoid auction-style processes will be most successful in fundraising.

However, the longer term picture is brighter. Despite these concerns, the overall view among LPs and their consultants is that the Direct Lending space will remain an attractive – and permanent – area of investment. *"Just as we have seen a shift in many institutional investors of part of their public equities exposure towards more private equity investments, so we expect to see more fixed income shift towards private debt,"* says Mak.

And it seems that Europe in particular offers good prospects for LPs as it shifts from a bank-led financing economy to one characterised by a variety of alternative debt sources. *"Direct Lending is here to stay,"* adds Schuster-Woldan. *"It will become much more mainstream for investors. So far, it has provided some attractive returns and it's clear there is demand from SMEs that can't get financing from the more traditional sources. For investors, the opportunity is tangible."*

Direct Lending Fund raising

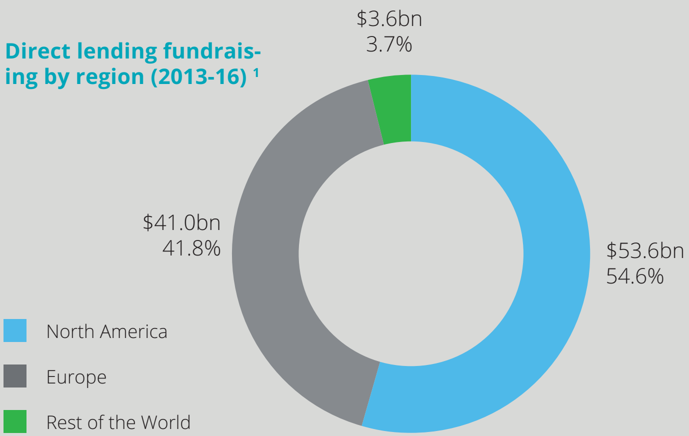
Global direct lending fundraising by quarter [1]



Funds with final closings in Q1 2016 [1]

- Babson Global Private Loan Fund **$2,000m** *(Global)*
- SJC Onshore Direct Lending Fund III **$1,738m** (*North America*)
- White Oak Summit Fund **$1,330m** (*North America*)
- KKR Direct Lending Europe **$850m** *(Europe)*
- Twin Brook Capital Partners Direct Lending Fund **$596m** *(North America)*

Direct lending fundraising by region (2013-16) [1]

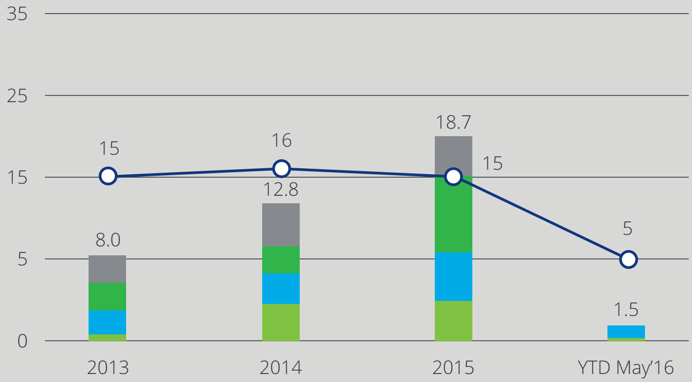


Largest funds with final closing in 2015 [1]

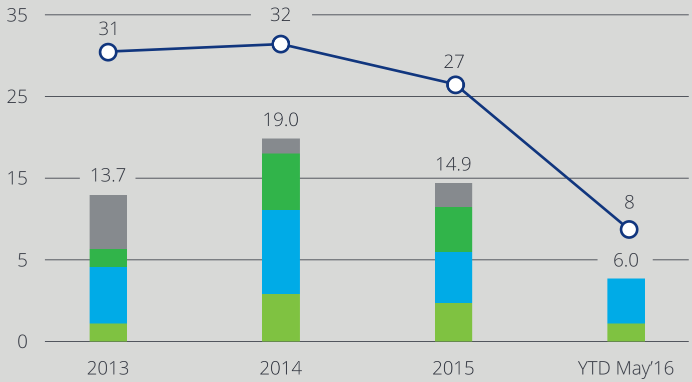
- ICG Senior Debt Partners II **€3,000m** *(Europe)*
- Ares European Loan Programme **€3,000m** *(Europe)*
- Park Square Capital Credit Opportunities **€2,100m** *(North America, Europe)*
- AXA Private Debt III **€2,000m** *(North America, Europe, Asia)*
- BlueBay Direct Lending Fund II **€2,000m** *(Europe)*

[1] Preqin, Credit Suisse Private Fund Group market knowledge.
Currency amounts are in millions.

Europe direct lending fundraising by quarter [1]



US direct lending fundraising by quarter [1]



Key takeaways [1]

- Fundraising for Direct Lending strategies slowed down significantly in H1 2016, raising only $7.4 billion, less than half of the capital raised in either H1 or H2 2015.
  - This slowdown was seen across all geographies but was most pronounced in Europe
  - Volatility in the capital markets in H1 2016 and the Brexit referendum have impacted fundraising activity
- A structural shift has however not been observed. Investors still have a strong and growing demand for Direct Lending products.
- The largest Direct Lending fund to be raised in H1 2016, is smaller than the five largest Direct Lending funds raised in 2015
- All five of the largest Direct Lending funds raised in H1 2016 were USD-denominated, while all five of the largest funds raised in 2015 were EUR-denominated
  - Points to a particular softening of the fundraising market for European Direct Lending in H1 2016 compared with the previous year
- Over 100 Direct Lending funds seeking aggregate commitments in excess of $40 billion remain in the market as of June 2016
  - European and North American funds together represent c 90% (each representing c. 45%) of the funds in the market by target size, with a larger number of smaller funds in the North American market

[1] Preqin, Credit Suisse Private Fund Group analysis, Credit Suisse Private Fund Group market knowledge.

Important Notice in relation to page 23-24

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