Financing the Economy 2018

The role of private credit managers in supporting economic growth

ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

Dechert LLP

lendingforgrowth.org

Contents

Foreword

Welcome to *Financing the Economy* 2018, the fourth edition in a series of papers analysing the global private credit industry produced by the Alternative Credit Council (ACC), the private credit affiliate of the Alternative Investment Management Association (AIMA). This edition is again produced in partnership with Dechert LLP.

We are delighted to be publishing this research at a time when policymakers are re-evaluating their approach to the non-bank lending sector. The Financial Stability Board recently announced that it will no longer use the term shadow banking in its work. We warmly welcome this move as the ACC, and this report in particular, have consistently argued that this term was an inappropriate label for distinct, legitimate, regulated and transparent business models. We hope that this research will continue to build on the successful dialogue between our industry and policy makers.

In past editions of this paper we have charted how private credit has grown from being a relatively niche industry to a fully-fledged global source of financing for mid-market corporates in particular. The sector remains on track to reach $1 trillion AUM by 2020. There are numerous data points and case studies throughout this report that demonstrate how private credit managers are supporting the economy in new ways, growing in areas like real estate finance, trade finance or asset-backed lending. It is also apparent that this growth is increasingly fuelled by allocations from institutional investors, with pension funds making up the largest group.

This is a significant vote of confidence in the sector and a sign that private credit managers have established themselves as a credible mainstream option for investors, in the same way that they have established themselves as a mainstream finance option for borrowers.

While the fundamentals driving the growth of private credit remain strong, the factors supporting that growth are facing several tests. The market remains extremely competitive with private credit managers working ever harder to compete for deal flow. This dynamic is evident in the continued pressure on deal terms, as well as the growing use of leverage in some parts of the market. Private credit managers are mindful that we are getting ever closer to the top of the credit cycle, if not the economic one.

As we look ahead to 2019, we and the industry practitioners are thinking hard about the risks that may lie ahead, not just for individual portfolios but for the sector as a whole. Our performance during a period of economic stress is likely to shape borrower, investor and policymaker attitudes towards private credit for years to come. Our ability as an industry to maintain good financial discipline and communicate not just with our immediate stakeholders but also the general public during this period will be a determining factor in ensuring a sustainable future for the asset class. This research aims at such an honest and transparent engagement on the part of managers and members of the ACC with the broader market and society at large.

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Cheyne Capital

Executive Summary

Financing the whole economy: Private credit is a globally established source of mainstream finance for borrowers around the world. Managers are increasingly lending to a far wider variety of borrowers outside of the mid-market than ever before: from smaller businesses and startups, to larger corporations and infrastructure projects. Nearly a third of all capital invested (by the respondents to this survey) supports non-corporate lending strategies, including asset-backed finance, trade finance, receivables, real estate and distressed.

Borrowers can access bespoke financing that offers far greater flexibility than traditional bank lenders. One in four private credit managers surveyed provide financing to companies with EBITDAs of over $75 million and over 40% surveyed are lending to companies with EBITDAs of less than $25 million. The tangible benefit of private credit to the real economy can be seen through the multiple borrower case studies presented throughout this paper.

Working with borrowers: Private credit managers are an important source of long-term finance for borrowers. A wider selection of financing structures as well as more competitive lending terms means borrowers of private credit now have more choice than ever when looking for financing, and thus more negotiating power. Borrower fees, loan coupons and covenants are a good measure of this, and the new data in this paper on all three indicates that borrowers of private credit are in a strong position.

Delivering for investors: The investor base of private credit continues to grow. Over 70% of all private credit committed capital[1] now comes from institutional investors. The diversity of private credit means that there are also attractive strategies for smaller or non-institutional investors such as family offices, which account for 5% of committed capital allocated to private credit. New findings in the paper indicate that 32% of capital committed to private credit today comes from North American investors. In new evidence that the European market is becoming a core region for private credit, 31% of industry committed capital comes from Europe (excluding the UK). Also, in Europe, insurers now account for twice the amount of committed capital when compared to North American counterparts.

Experience with lending: The majority of private credit managers that reported to this survey have long-standing experience of the sector. Nearly half of all respondents have been managing private credit for over 10 years, with experience across multiple fund vintages and loans.

Cautious optimism: Private credit managers expect continued growth across the asset class but are also preparing for the possibility of an end to the current credit cycle and tougher economic conditions for borrowers. Managers are preparing by lending at higher positions within the capital structure, and by avoiding or rotating away from cyclical sectors.

Use of financing: More than half of all managers and investors surveyed, prefer unlevered private credit strategies. Where leverage is employed by managers, it tends to be at relatively low levels although those levels have risen slightly over the past year.

Appropriate fund structures: Approximately two thirds of all managers surveyed have closed-ended commitment and drawdown fund structures. 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. This is a two-fold benefit for the financial system; (i) it provides a stable source of long-term capital for borrowers, and (ii) it mitigates against pro-cyclical tendencies in the credit markets and acts as a natural stabiliser.

[1]For the purposes of this paper committed capital refers to the total capital that has been allocated by an investor to a private credit manager. It includes both drawn capital (or deployed capital) and undrawn capital (or dry powder).

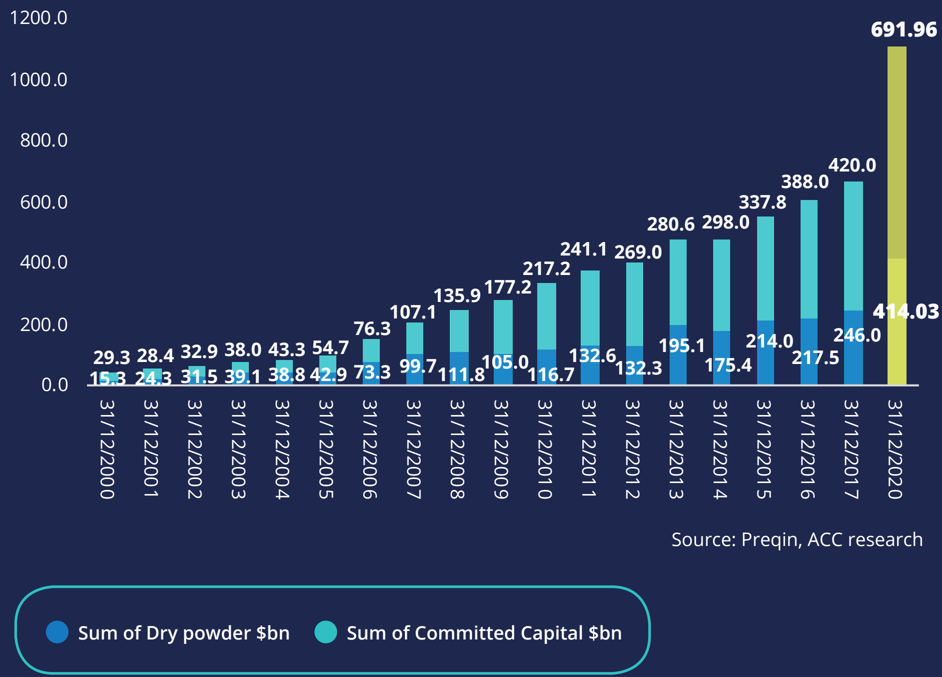
1 Manager Demographics

Financing the Economy 2018 draws its content from several different sources. The backbone of this paper is provided by a survey conducted by the Alternative Credit Council (ACC) and Dechert LLP (Dechert) of private credit managers. Almost 70 private credit managers responded to the survey; collectively they manage an estimated $470 billion in private credit investments, across a broad cross-section of jurisdictions and strategies.[2] The survey data was then explored by the ACC and Dechert in a series of roundtables and one-on-one interviews. Managers were also invited to submit case studies of how their firms are contributing to the real economy, which you can find throughout this paper.

Throughout this paper you will note we refer to large private credit managers and smaller private credit managers who count among the respondents that contributed to this paper. Where we describe larger managers, this refers to managers that have over $1 billion committed to private credit investments, while smaller managers are those that have under $1 billion committed to private credit investments.

The industry's total global assets under management (AUM) continue to grow. As we predicted last year, the industry is still on track to exceed $1 trillion in AUM by 2020, as shown in Figure 1. This capital is being put to work, with dry powder[3] as a proportion of industry AUM remaining below the sector's long-term average as shown in Figure 2.

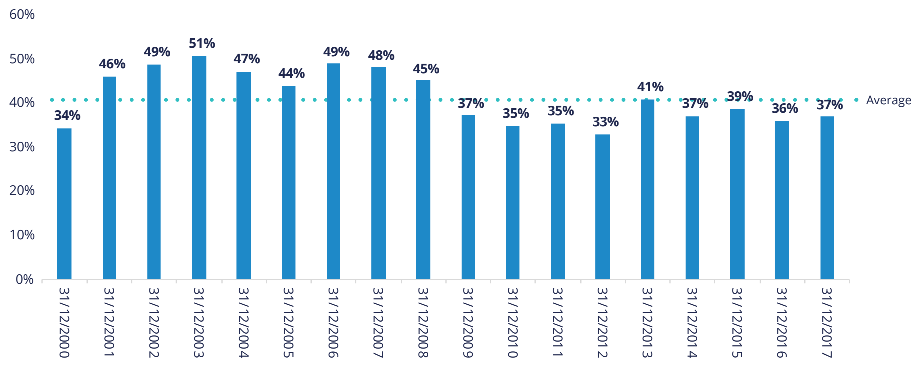
Figure 1. Global private credit AUM and breakdown of committed capital and dry powder



Source: Preqin, ACC research

[2] In this paper we use the term 'private credit' to describe all forms of debt finance provided by non-bank lenders.
[3] For the purposes of this paper dry powder (or undrawn capital) refers to capital that has been committed to a private credit manager but has not yet been invested.

Figure 2. Dry powder as percentage of global private credit AUM

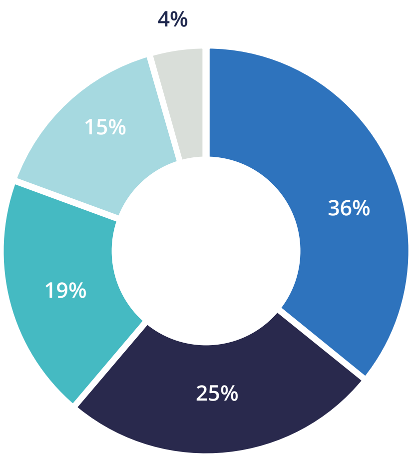


Source: Preqin, ACC research

Respondents to the survey are based around the world, as shown in Figure 3. The United States of America (US) and the United Kingdom (UK) remain key private credit hubs with the majority of managers located in those two jurisdictions. Europe (excluding the UK) is increasingly closing the gap on the more mature US market, while managers based in Asia-Pacific are also increasingly prominent.

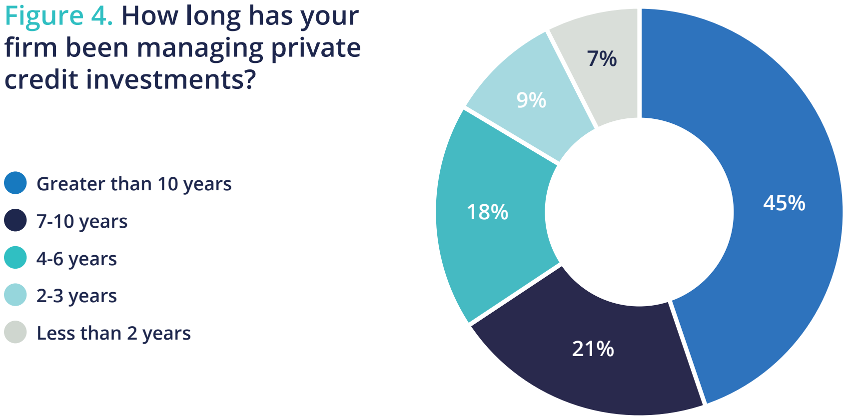
Figure 3. Where does your firm have its headquarters/primary asset management centre?

- US
- UK
- Europe (ex. UK)
- Asia Pacific
- North America (ex. US)



In the 2017 edition of *Financing the Economy* we demonstrated how private credit has become a mainstream source of finance. This theme is further supported by the findings from this year's survey. Two thirds of respondents have been managing private credit investments for over six years and nearly a half have been in private credit for over 10 years.

Figure 4. How long has your firm been managing private credit investments?



Case study

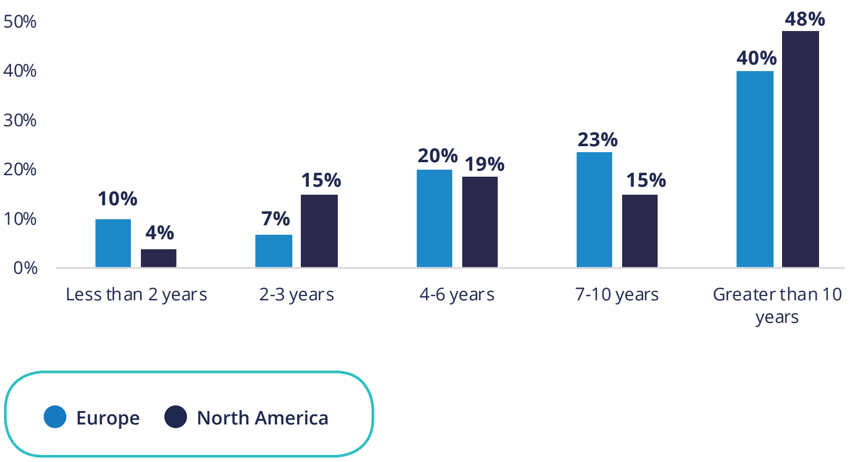
Macquarie and MUFG Bank provide £150 million in financing for housing development

Macquarie and MUFG Bank provided a long-term debt facility of £150 million in the form of a three-year revolving credit facility (RCF) of £30 million, a 40 year senior secured private placement of £50 million that refinances the RCF, and a shelf facility of £100 million for Shepherds Bush Housing Association (SBHA). SBHA owns or manages over 5,000 homes that are largely social and affordable in London, UK.

Our data (figure 5) suggests that Europe is home to more firms that are newer to private credit than North America. 10% of European managers who responded to our survey reported that they have been managing private credit for less than two years, compared to only 4% of North American respondents. Contributors to our roundtable discussions agreed that the European market has become an increasingly attractive proposition, which is likely driving newer managers to invest in the region.

Over the last year much of this growth has come from Germany, a jurisdiction in which we predicted imminent private credit growth in last year's *Financing the Economy*. Private credit managers tell us that the past 12 months have been a watershed for private credit in Germany, with German sponsors and borrowers increasingly embracing private credit.

Figure 5. How long has your firm been managing private credit investments? (by region)



2 Borrowers

Key takeaways:

- Private credit managers expect continued growth across the industry but are also preparing for the possibility of an end to the current credit cycle and tougher economic conditions for borrowers.
- Private credit managers are increasingly lending outside of the mid-market. Almost 25% of private credit managers provide financing to companies with EBITDAs of over $75 million and over 40% are lending to companies with EBITDAs of less than $25 million. This trend, first identified in last year's *Financing the Economy*, looks set to continue.
- Private credit managers continue to work with borrowers to provide tailored finance solutions. As well as benefitting from a greater choice of finance products, borrowers are also seeking more flexibility on loan covenants and driving a hard bargain on pricing.
- Private credit managers continue to develop additional loan origination pathways with non-sponsored lending continuing to grow in relative importance.

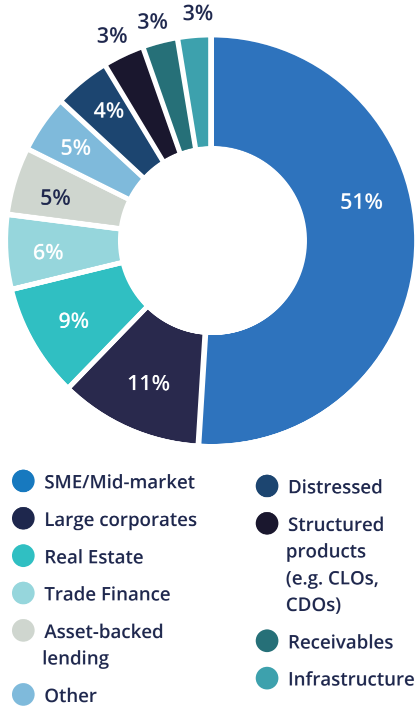
While small-and-medium-sized enterprises (SMEs) and mid-market companies[4] remain crucial to the private credit industry, private credit managers are increasingly providing financing to both smaller and larger companies. Further, private credit managers are increasingly relying on direct relationships and repeat business. Sponsored lending continues to be a significant part of the market. At the same time, competition in the market is enabling borrowers to achieve more flexibility on loan covenants and pricing.

Market condition trends in relation to covenants are being closely monitored by all private credit managers. When discussing the prevalence of looser covenants, private credit managers commented that the direct lending markets remained relatively more disciplined than the more liquid leveraged loan or high yield markets. Further, managers to whom we spoke stated that there is a floor which they would not go below in relation to deal terms, and that the due diligence processes employed by private credit managers mean that managers only invest in a small percentage of the lending opportunities that are available in the market. The managers with whom we spoke generally have experience in dealing with borrowers in stressed or default situations and so believe they are well placed to weather changes in the economic and credit cycle. While managers did not expect all funds to fare equally well in this scenario, there is a strong feeling that the sector as a whole would perform relatively well in any downturn. Managers are preparing by lending at higher positions within the capital structure, and by avoiding or rotating away from cyclical sectors.

PRIVATE CREDIT MARKETS

Lending to SMEs and the mid-market remains crucial to the global private credit industry. As shown in Figure 6, half of respondents' capital is allocated to SMEs or mid-market borrowers. This is a similar finding to previous *Financing the Economy* surveys, reinforcing our view that the (partial) replacement of banks by private credit managers is a permanent shift. While the total volume of capital allocated to private credit strategies has increased, the distribution of capital across different subsets of the private credit market has remained broadly consistent. This suggests that there are multiple engines of growth for private credit. Subsets of private credit such as real estate debt, asset finance and trade finance tend to be the preserve of managers who specialise in these markets. Lending in these instances tends to be secured against real assets such as property, goods or plant and machinery, meaning that managers need to have in-depth knowledge of these markets.

Figure 6. Percentage of global industry committed capital allocated to individual private credit markets



[4]For the purposes of this paper we use the European Commission's definition of an SME as a business or company that has fewer than 250 employees and either an annual turnover not exceeding €50m, or an annual balance-sheet total not exceeding €43m. We use the common understanding of mid-market companies as companies with $10m-$70m EBITDA per annum.

Regional and size splits

Turning to our regional data (figures 7 and 8), investments in distressed debt (albeit a modest population represented in the analysis below) are considerably more popular among North American managers than European ones. This may be because North American managers, and their investors, are simply more comfortable and experienced with the strategy. The continued difficulties faced by European banks to offload their non-performing loan (NPL) books, along with fragmented creditor protection frameworks across Europe, means that the market for European distressed debt remains less attractive. This may change in coming years as policymakers continue to encourage a more active NPL market in Europe.[5]

Case study

CVC Credit Partners provides financing to Spanish invoice-discounting operator for second time

In August CVC Credit Partners provided a second round of financing to the Gedesco Group (Gedesco) following a deal in 2015 to support the growth of the business. Headquartered in Valencia, Spain, Gedesco is the largest independent specialist invoice-discounting and factoring operator in the country. The business has more than 25 offices across Spain.

Figure 7. Market allocations of average private credit fund (by manager size)

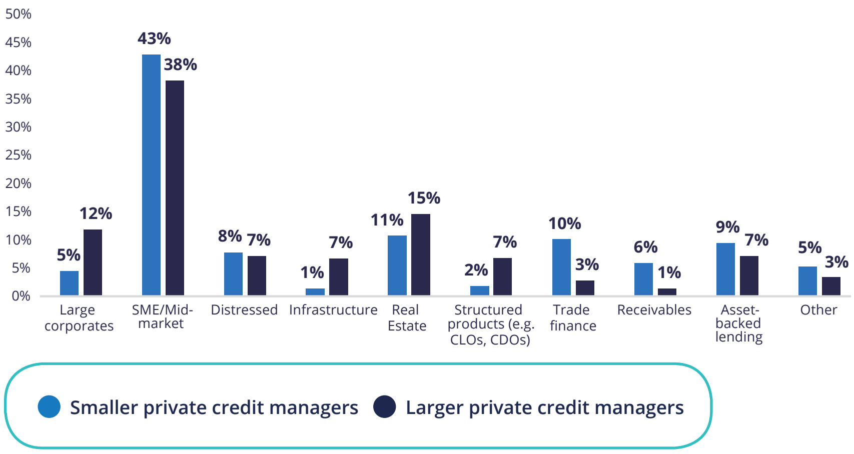
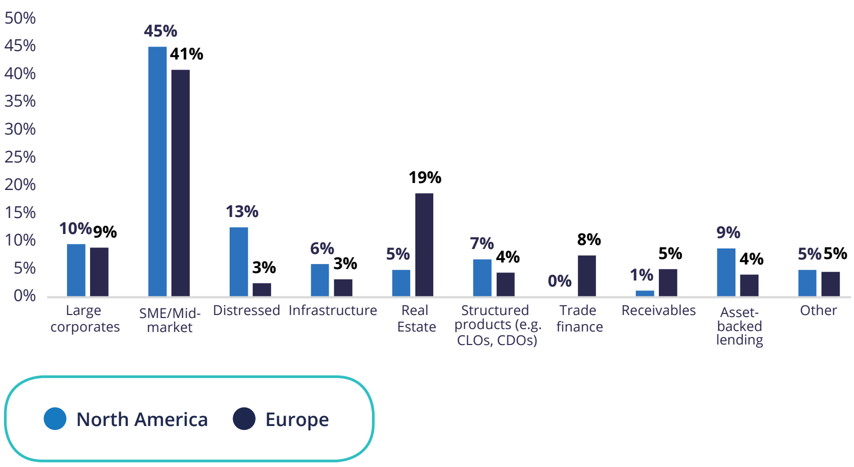


Figure 8. Market allocations of average private credit manager fund (by region)



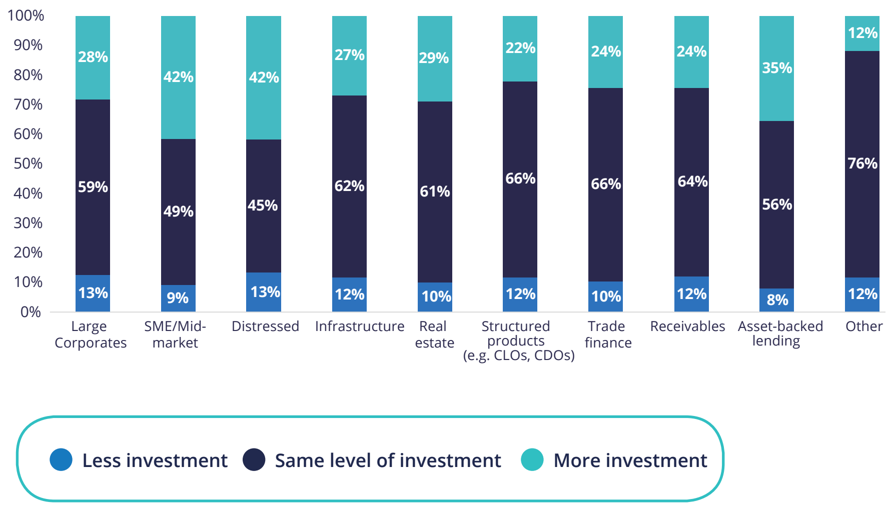
[5] In March 2018, the European Commission presented a package of measures to address the risks related to high levels of NPLs in Europe.

EXPECTATIONS

When asked whether they plan to deploy more, less, or the same amount of capital to the various private credit markets (Figure 9), respondents were clear: more respondents predict increasing their allocation than decreasing it across every sub-sector of the private credit market. Optimism is highest in relation to SME and mid-market lending, as well as distressed and asset-backed lending. Examining the respondent data on a net basis (subtracting the number of respondents planning 'less investment' from those planning 'more investment'), a third of respondents plan to increase allocations to SMEs and/or mid-market companies over the coming three years. This may be because, as one private credit manager put it, "borrowers are more open to alternative funding than they were five years ago".

Respondents also anticipate significant growth in the distressed debt market. When pressed on this point, managers identified the expectation that interest rates would rise making it harder for some borrowers to meet their existing loan commitments or to refinance. Further, various indicators,including the sheer length of the current credit cycle, suggest that the economy is entering a period where continued economic growth may be less certain than in the recent past.

Figure 9. How do you see your investment in these private credit markets changing over the next three years?



This optimism in the industry is accompanied by an acute awareness that we are in a long credit cycle that could perhaps be nearing its end. Many of the conversations we held with managers centred on their firm's preparedness for a downturn and their expectations as to what the reaction would be in the private credit market. Sound underwriting was singled out as the key first defence mechanism against deteriorating credit conditions. As one private credit manager explained, identifying a strong company and matching the lending structure to its cashflow provides protection even if the "environment around it is about to collapse".

The second line of defence cited is being proactive when monitoring loans and engaging with borrowers. This is where a sound operational set up and discipline in data gathering, monitoring and management becomes key. Our previous research shows the industry is increasing its focus on upgrading operational infrastructure to integrate data from their borrowers with other relevant datasets to support risk monitoring. Managers also stressed the importance of risk mapping and stress testing of their portfolios. This type of forward-looking assessment would typically consider how borrowers may fare under more challenging (but plausible) market scenarios, and how this would affect managers' overall portfolio.

The third line of defence cited was having adequate workout resources and expertise. Having access to staff (either in-house or via third parties) with knowledge of default scenarios and restructuring is becoming an increasingly relevant consideration for managers and one they use to differentiate themselves from their competitors.

Moving into the distressed debt market also provides opportunities for managers to finance a larger population of borrowers. As one private credit manager explained, any bank removing distressed debt from its loan book would provide an opportunity for a private credit manager to develop a relationship with borrowers who have previously only used bank financing.

A borrower's inability to repay a loan is often less a reflection of that borrower's financial strength, and more a reflection that the loan was made on the wrong terms. For many borrowers in distress, debt refinancing may also be preferable to giving up equity.

Case study

Clients advised by Allianz GI provide financing to infrastructure project

Clients advised by Allianz GI provided €400m of financing to an Italian infrastructure project supporting the construction of parts of the Venice ring road. The motorway assets are an essential link in the Italian and European motorway system and are vital for international trade between western, central, and eastern Europe.

Regional splits

There is a difference of approach regarding allocations to certain categories between North American and European respondents. As shown in Figure 10, on a net basis, 38% of North American respondents anticipate they will deploy more capital to distressed debt over the coming three years, compared to 24% of European respondents.

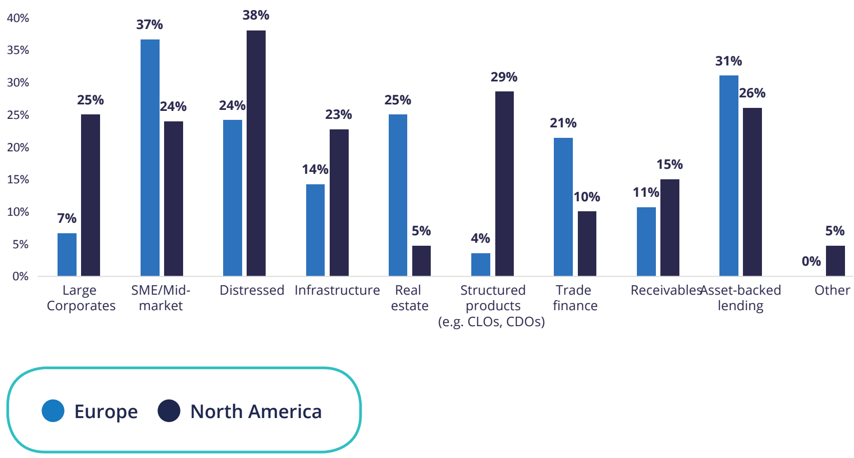
One example of where there is an even larger disparity in allocations to structured products, where 29% of North American respondents plan to deploy additional capital, compared to only 4% of European respondents. In Europe, appetite for these products remains low amidst greater regulatory restrictions. Many private credit managers with whom we spoke support improvements in securitisation frameworks to help reinvigorate this as a source of finance for borrowers. Despite recent revisions to the EU Securitisation Regulation, European respondents seem to be reserving judgement for the time being. In the US, meanwhile, the removal of risk retention requirements for some collateralised loan obligations is likely an important factor in driving optimism around structured products.

Case study

OCP Asia provides funding for Australian house-and-land project

Hong Kong based OCP Asia provided a $70 million loan to Welsh Group to fund a new house-and-land project in Melbourne, Australia. The financing will support the development of 400 lots and an apartment site in Melbourne. OCP Asia previously provided a $105m loan to finance Welsh Group's development of a 1300-lot house-and-land estate, also in, Melbourne.

Figure 10. How do you see your investment in these private credit markets changing over the next three years? (Net percentage of 'more investment' responses, by region)



BORROWERS BY SIZE

As shown in Figure 11, the average borrower EBITDA[6] reported by all respondents is $44 million, up from $38 million in 2017. We also see an increasing dispersion of borrowers' EBITDAs. In 2017, 39% of private credit managers reported an average borrower EBITDA of between $25 million and $75 million; this year only 32% of respondents reported the same. Instead, private credit managers are increasingly lending to smaller companies,those with less than $25 million EBITDA,and larger companies, with over $100 million EBITDA, as shown in Figures 13 and 14.

Figure 11. What is the average EBITDA (in USD millions) of your firm's borrowers?

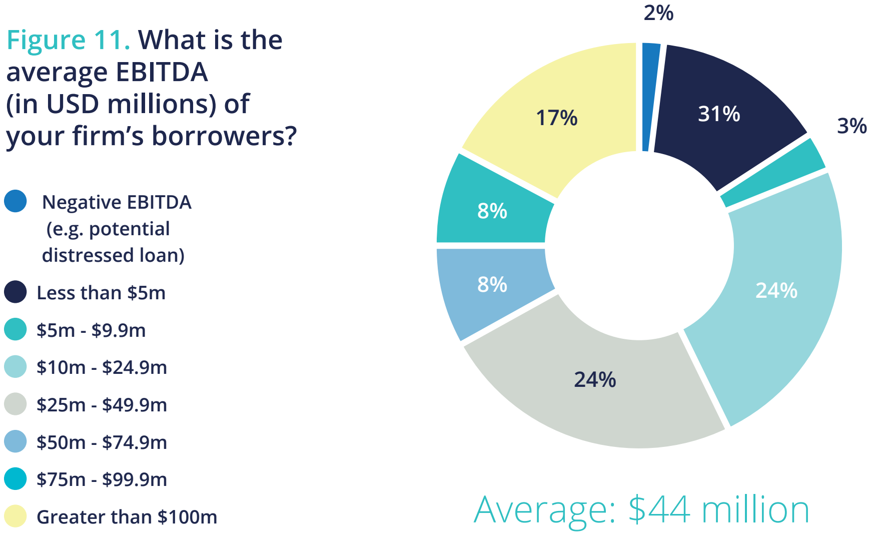
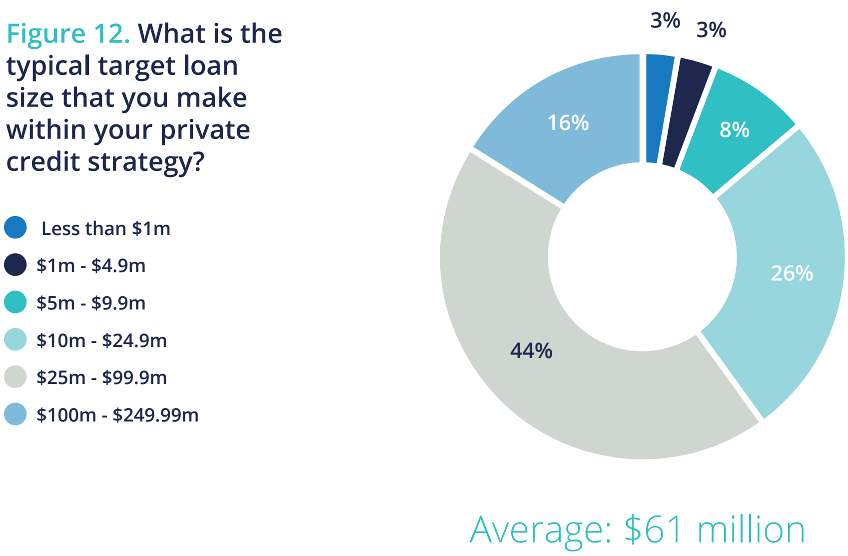


Figure 12. What is the typical target loan size that you make within your private credit strategy?



[6]EBITDA based on either GAAP or IFRS accounting standards and excluding any addbacks

As per Figure 13, 17% of respondents reported lending to companies with EBITDAs of more than $100 million, more than double the number reported in 2017. This is a clear indication that the private credit industry is increasingly able to take on the deals that were once entirely the domain of banks (a trend discussed in *Financing the Economy* 2017). Moving closer to loan sizes seen in public bond markets.There has been a trend since 2016, for private credit managers to lend to companies with under $25 million in EBITDA, as shown in Figure 14. Those firms gain access to the capital they need to support their growth without surrendering any equity, and benefit from tailored finance solutions.

Figure 13. Percentage of respondents allocating to companies with EBITDAs in excess of $100m

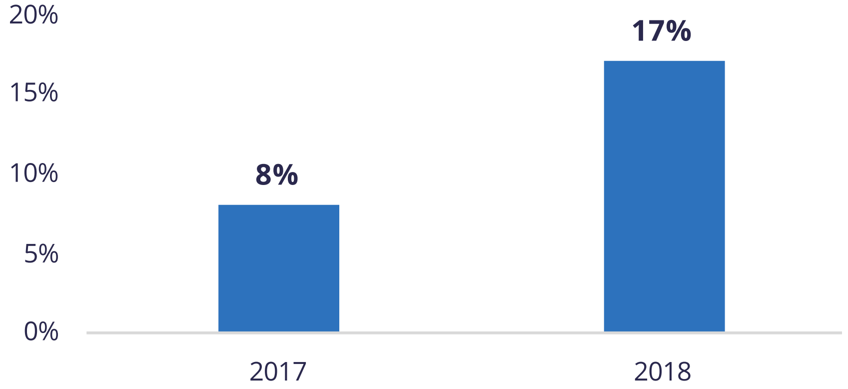
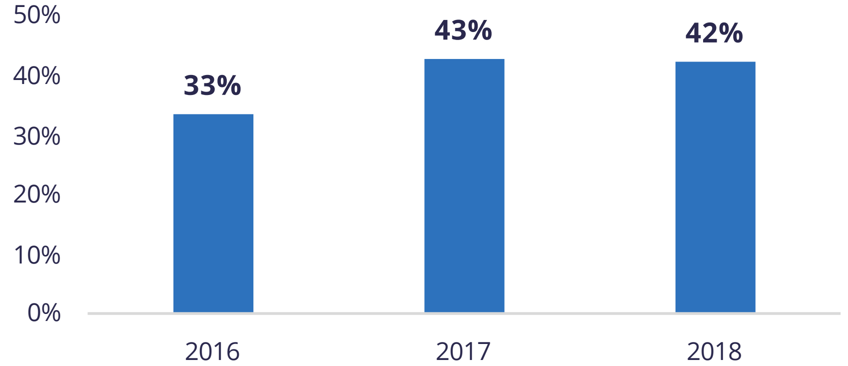


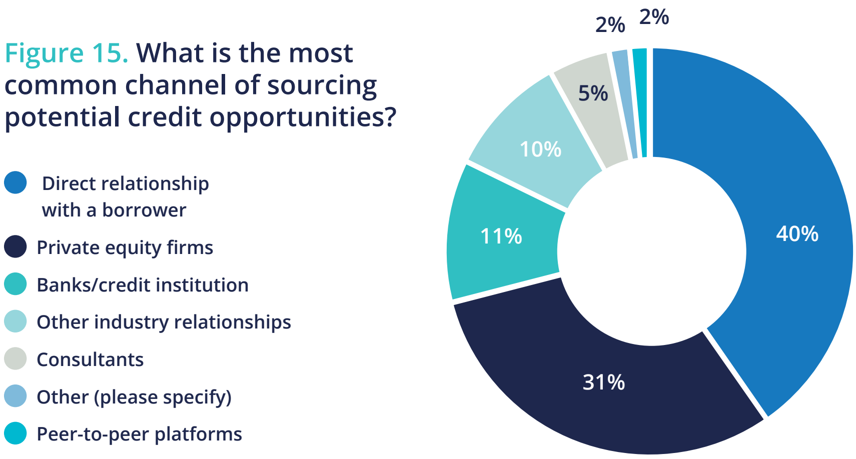
Figure 14. Percentage of respondents allocating to companies with EBITDAs of less than $25m



LOAN ORIGINATION

As shown in Figure 15, the most common way of originating lending flow is through direct relationships between private credit managers and borrowers; 40% of respondents report using such channels. As the private credit industry matures, managers are increasingly in the position of providing multiple rounds of funding to the same borrower, a trend identified in last year's *Financing the Economy*.

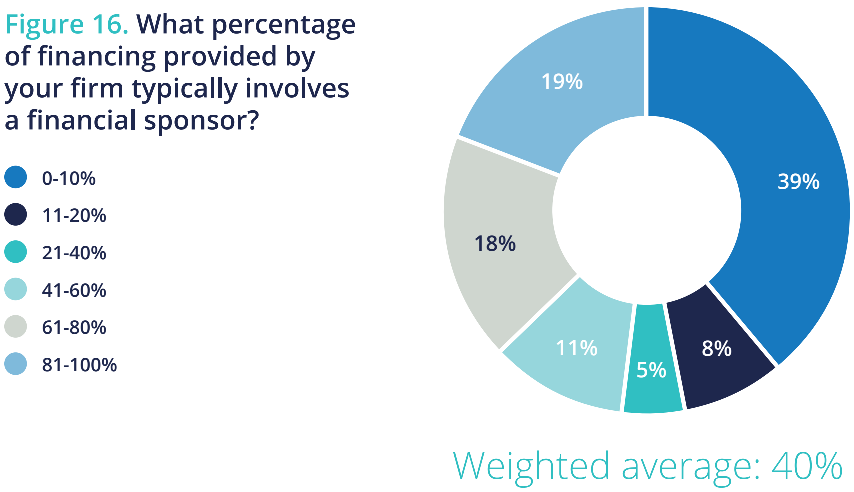
Figure 15. **What is the most common channel of sourcing potential credit opportunities?**



Sponsored lending[7] has traditionally been an important source of deals for the private credit industry but its relative importance has been declining year-on-year. Last year we reported that 55% of all private credit managers typically work with a financial sponsor. This year, however, we estimate that roughly 40% of private credit deals (by number) involve a sponsor. This supports the hypothesis proposed in last year's *Financing the Economy* that non-sponsored lending is a potential growth area for the industry.

Several of the managers we spoke with felt that this finding may understate the role of sponsored lending in the market. It was also noted that non-sponsored lending requires managers to invest resources into loan origination teams, and that this may not be an option for all managers. The volume of capital that has been raised by private equity firms over recent years suggests that there could soon be a greater number of sponsored lending opportunities.

Figure 16. **What percentage of financing provided by your firm typically involves a financial sponsor?**



Case study

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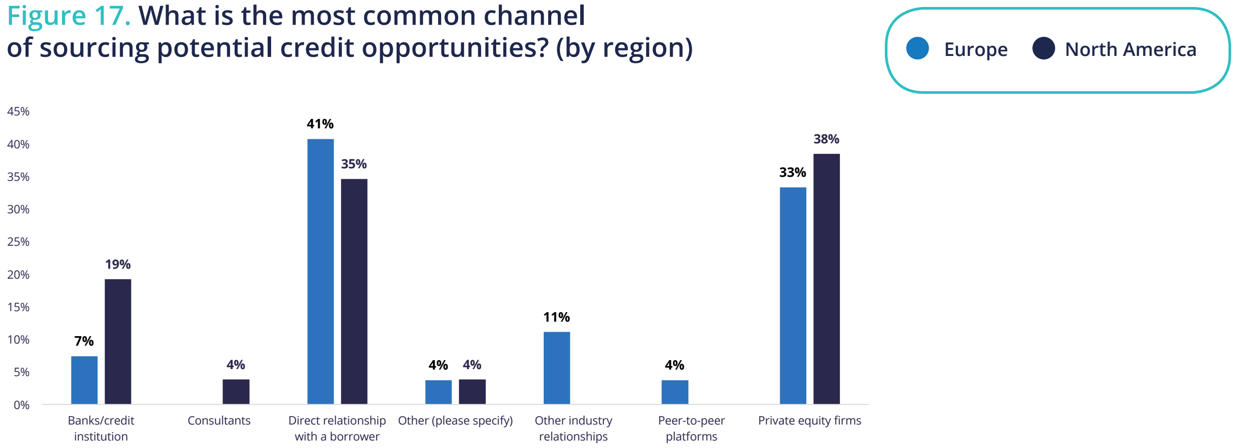
[7] Sponsored lending describes loans to borrowers where a private equity sponsor owns equity in the borrower.

Regional and size splits

North American and European private credit managers source their loans in different ways, with 38% of North American respondents reporting that private equity firms are their most common channel, while 41% of European managers reported that direct relationships with borrowers was the most common channel.

Figure 17. What is the most common channel of sourcing potential credit opportunities? (by region)



BORROWER TERMS

Private credit remains a borrower's market. Borrowers have both a greater choice of lenders and more negotiating power. Borrower fees, coupon quantums and covenants are a good measure of this; our data on all three indicates that borrowers of private credit are in a strong position.[8]

As shown in Figure 18, almost four times as many respondents report that arrangement fees are decreasing rather than increasing. Twice as many respondents reported financial covenant protection weakening rather than those that reported strengthening over the past year, as shown in Figure 19. We also see a mixed picture on the headroom provided to borrowers against their financial covenants as shown in Figure 20. While the picture on loan coupons is more nuanced, a third of respondents report that coupons have lowered over the last 12 months.

Loan covenants are a key means by which managers can manage credit risk and protect their interests. Covenants do not, however, exist in isolation; less stringent covenants do not necessarily equate to less robust lending practices. Private credit managers with whom we spoke highlighted how the ability to identify and analyse viable credit opportunities was more critical than ever. The sophistication of market research, due diligence and credit risk assessment processes are all becoming crucial differentiators. Further, while private credit managers may be showing more flexibility around covenants than in previous years, there are still risk baselines they will not cross.

This is indicated by the relatively high proportion of private credit managers (60%) who report no change in financial covenant protection during the last 12 months (see Figure 20).

Case study

Clients advised by Allianz GI provide financing of €45m to construction company

Spie Batignolles is a mid-size construction company with sales of €1800m and 7,000 employees. The company was seeking a finance provider to expand and consolidate its market position. This financing was provided by Allianz GI alongside some shorter-term bank financing.

[8] These findings are in keeping with other industry research. For instance, a recent paper by Preqin found that 63% of private credit managers believed that lending terms became more borrower-friendly in the preceding 12 months. See: Preqin, "*Private Debt Fund Manager Outlook*" 2018.

Figure 18. How has your coupon for a potential loan changed over the past year?

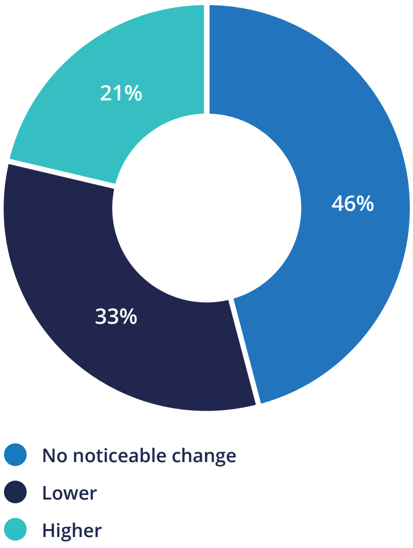


Figure 19. How have your arrangement fees changed over the past year?

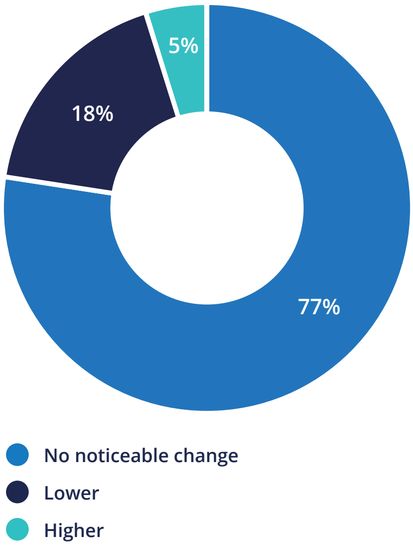


Figure 20. How has financial covenant protection changed over the past year?

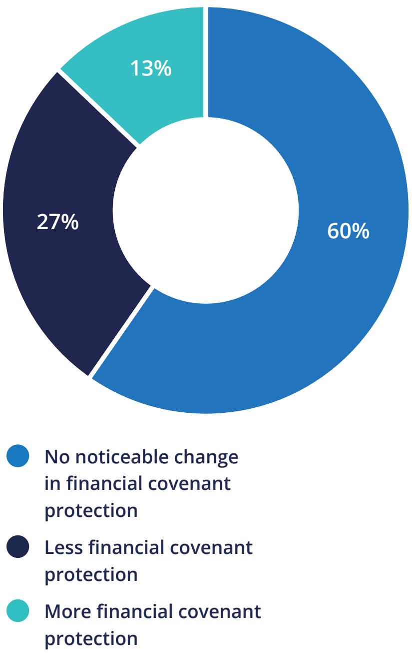
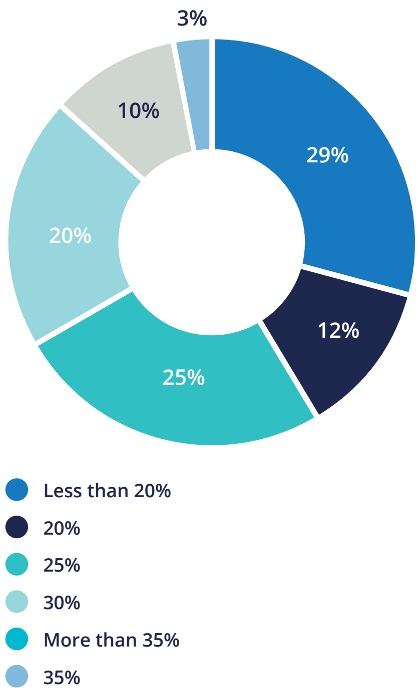


Figure 21. What is the typical headroom provided for borrowers against their financial covenants?



Regional and size splits

As in other matters there is regional variation around changes to financial covenant protection. As shown in Figure 22, 38% of North American respondents report less financial covenant protection over the past year, while only 8% report greater protection. This compares to 26% of European managers reporting less covenant protection, and 11% reporting greater covenant protection. When we compare the use of covenant terms between larger and smaller managers, as shown in Figure 23 we see that 44% of larger private credit managers' report that covenants have lessened over the past year; only 4% of smaller managers reported the same.

Figure 22. **How has financial covenant protection changed over the past year? (by region)**

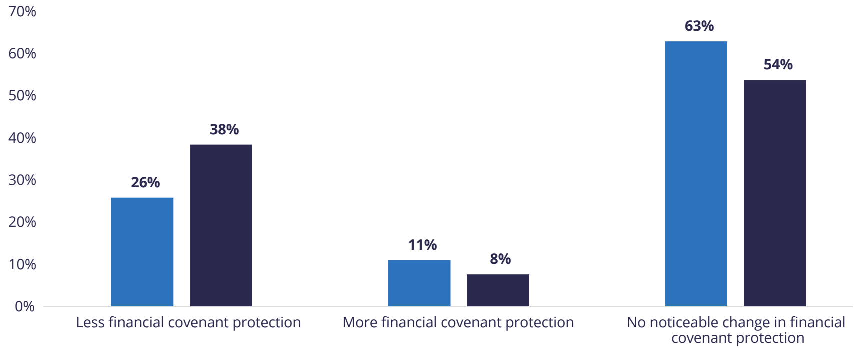
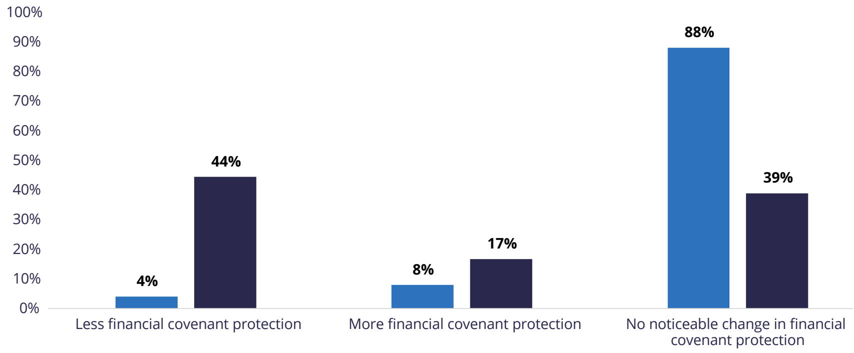


Figure 23. **How has financial covenant protection changed over the past year? (by manager size)**



CONCLUSION

While SMEs and mid-market firms remain central to private credit lending, private credit managers are moving beyond these markets. The flexibility of private credit facilitates bespoke financing to borrowers at all stages of development as well as to more established blue-chip companies. This competition between private credit managers benefits borrowers, a greater proportion of whom can now see private credit as a mainstream source of finance.

We also continue to see specialised managers providing finance to niche markets. This ensures that borrowers in these markets are able to source finance from lenders who know their industry and are able to work with them on tailored finance solutions.

3 Investors in Private Credit

Key takeaways:

- The investor landscape of private credit is becoming increasingly diverse, with a wide range of investor types, both institutional and otherwise, committing capital to private credit.
- The majority of capital committed to private credit comes from North America.
- There is still a significant number of investors committing capital to the industry for the first time, indicating that opportunities remain.
- Investors of all types have a choice of positions in borrowers' capital structures to match their risk and return appetites.
- Private credit managers are flexible when it comes to working with investors: a strong majority are willing to run separately managed accounts.

INVESTOR DEMOGRAPHICS

Our data indicates that 38% of capital committed to private credit comes from North American investors. A further 31% of industry committed capital comes from Europe (excluding the UK) in another sign that the European market is becoming a core region for private credit.

Investment in the private credit sector is also becoming more institutional. As shown in Figure 24, over 70% of all private credit committed capital comes from pension funds, insurers, and sovereign wealth funds. Such investors may have been drawn to private credit as an alternative to their traditional fixed income allocations in the years following the global financial crisis, as investment-grade corporate bond yields (along with government bond yields) collapsed.[9] Private credit can also offer investors a range of risk/return profiles. For example, senior secured debt backed by ample collateral can offer low but attractive yields, while unsecured, unitranche[10] or leveraged loans can offer stronger yields to investors who are willing to take on more risk. What began as a cyclical trend is now a structural shift: an increasing number of institutional investors now have specific alternative credit allocation categories in their portfolios.[11]

Private credit equally remains open to smaller investors such as family offices. Our analysis indicates that on average, they account for 5% of capital committed to private credit, as shown in Figure 25. Family offices are typically seen as more flexible and, along with high-net-worth individuals (HNWIs), tend to have greater risk appetites than their institutional peers. Further, such investors tend to make smaller commitments, and thus do not face the institutional investor challenge of finding funds large enough to accept them. One more category of investor reported by our respondents is worth highlighting: employees and staff. Notably, over 70% of respondents reported that their staff had invested capital with them. This shows an alignment of interests between private credit managers and their investors.

Regional and size splits

Insurers account for 38% of committed capital to European respondents; twice the percentage allocated to their North American respondents. As mentioned in the first section of this paper, European insurers are becoming increasingly interested in allocating private credit to fixed income components of investors' portfolios.

Across our survey, smaller private credit managers draw a larger proportion of their capital from HNWIs and family offices. This divide is likely caused by the fact that institutional investors tend to make larger allocations and often have internal policies preventing them from representing over a certain percentage of a manager's assets. Family offices and HNWI, meanwhile, can be more flexible.

Case study

LendInvest completes £16 million development deal in UK commuter town

LendInvest completed a £16 million financing deal with established development finance borrower, Yogo Group. The deal was completed in three weeks from initial introduction to site purchase. The development finance loan will fund the part-conversion and rebuilding of an historic building, as well as the construction of new units.

[9] https://www.businessinsider.com/10-year-isnt-the-government-bond-yield-you-should-be-focusing-on-2018-5?IR=T
[10] A combination of a senior tranche of debt and a junior tranche of debt in a single loan with a blended return.
[11] Gapstow Capital Partners, *How do U.S. Public Pension Plans Allocate to Alternative Credit?*, October 10, 2018.

Figure 24. Investor region breakdown as percentage of total private credit AUM

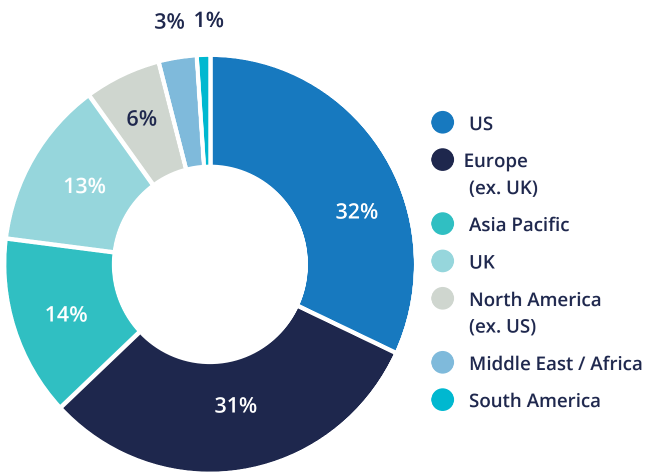


Figure 25. Investor type breakdown as percentage of total private credit AUM

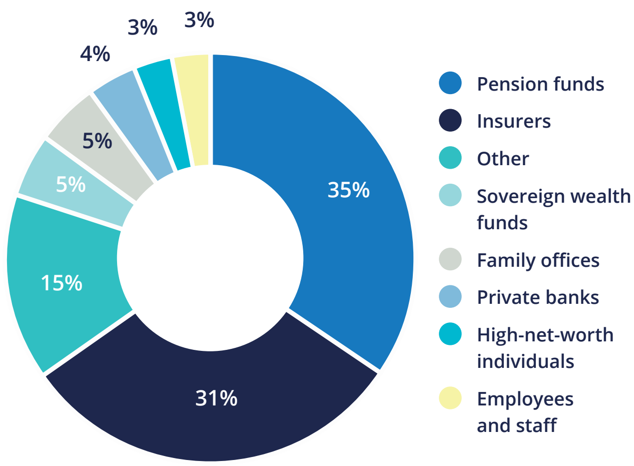


Figure 26. Investor breakdown (allocations to private credit managers)

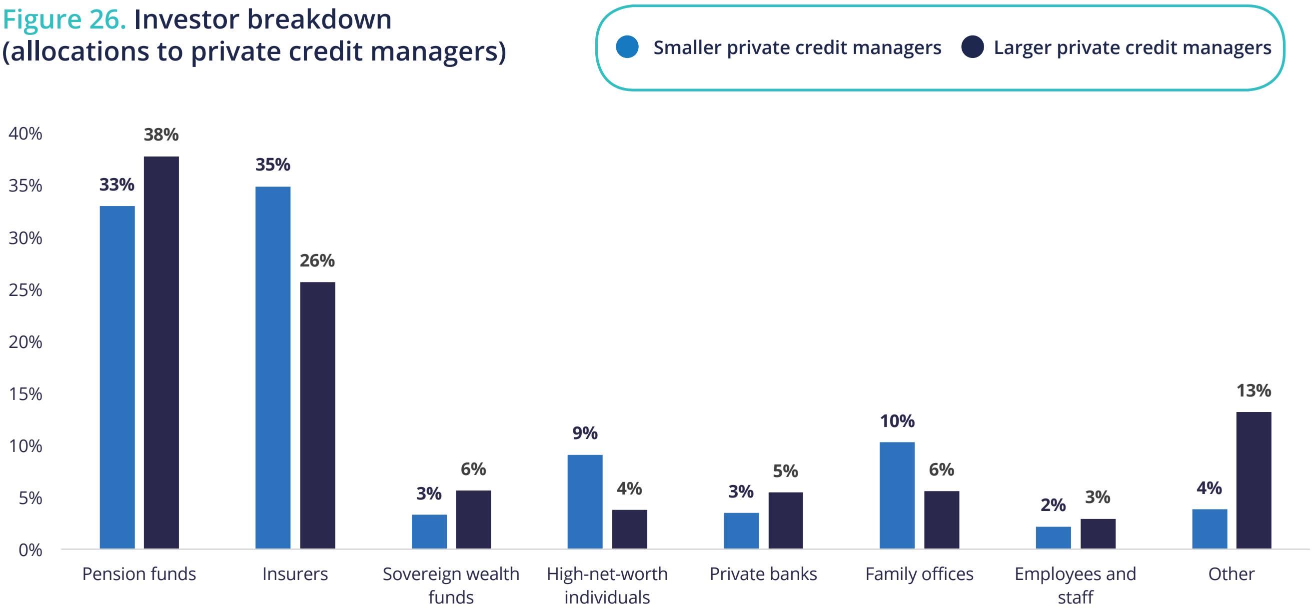
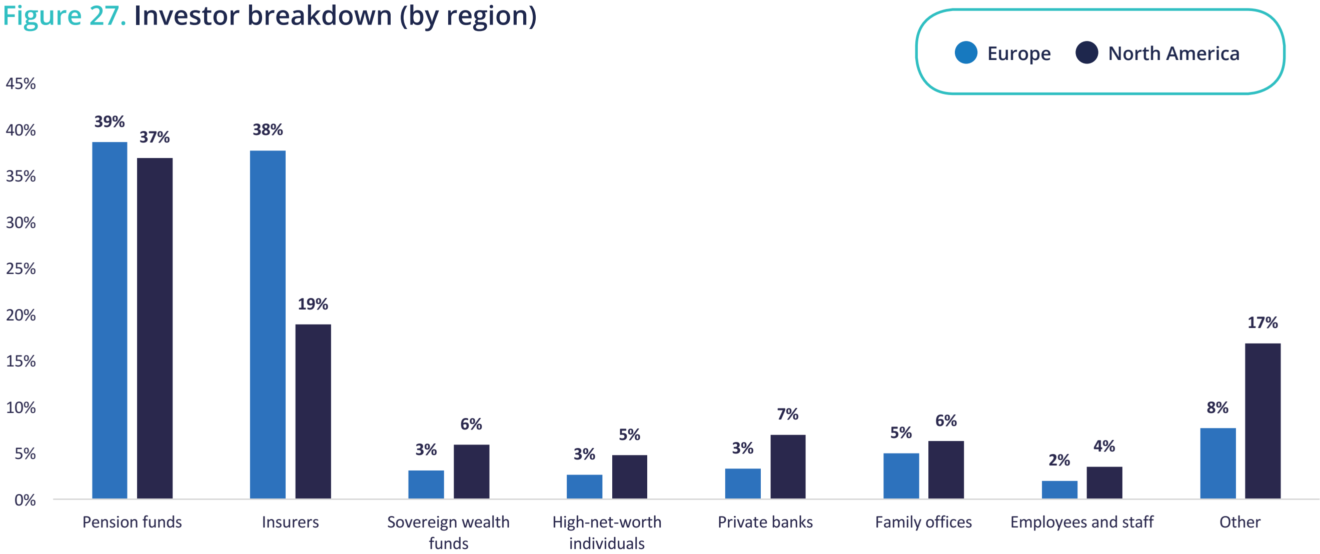


Figure 27. Investor breakdown (by region)



INVESTOR EXPERIENCE

Investors are increasingly familiar with private credit and how to integrate the strategy into their overall investment portfolio. As shown in Figure 28, more than half of all respondents report that less than a fifth of their investors were allocating to private credit for the first time; an average of 25% of respondents' investors are on their first allocation to private credit. As private credit managers with whom we spoke explained, investors in private credit find the uncorrelated returns and illiquidity premium on offer very attractive in the current climate.[12] An investment in private credit can also offer a wide variety of risk and maturity profiles, depending on the capital structures in which a manager invests, and the type of lending activity undertaken.

Private credit investors continue to show a preference for higher positions in the capital structure, with more than 40% of capital allocated to senior secured debt strategies (Figure 29). This preference is likely due to many investors still placing greater value on the loan's security rather than the potential to make an outsized return, as well as the stage the economy finds itself in the credit cycle.

Case study

Adamas provides financing to Chinese eco-resort

Adamas provided senior secured bridge financing for the finalisation of Naked Stables, an eco-resort in a province outside of Shanghai, China. The wider area has been used as a summer resort historically, but development there has been limited. The project has contributed to the revitalisation of the historic summer vacationing area.

Figure 28. What percentage of your investors are first-time allocators to private credit?

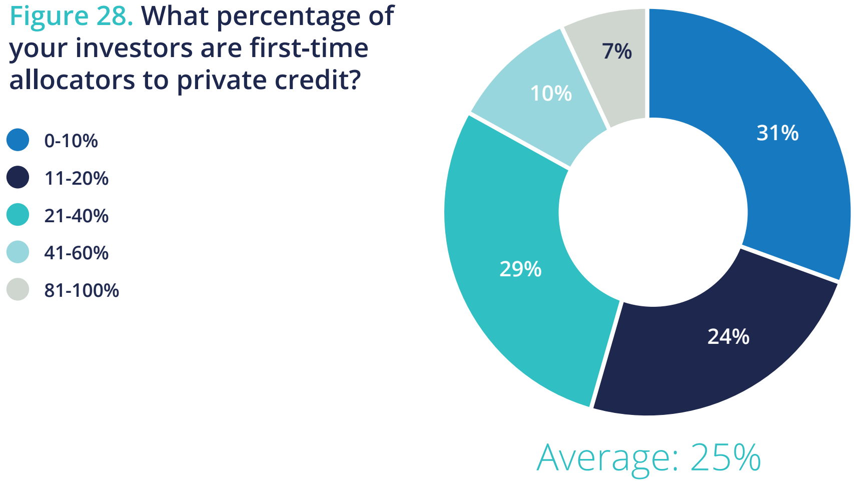
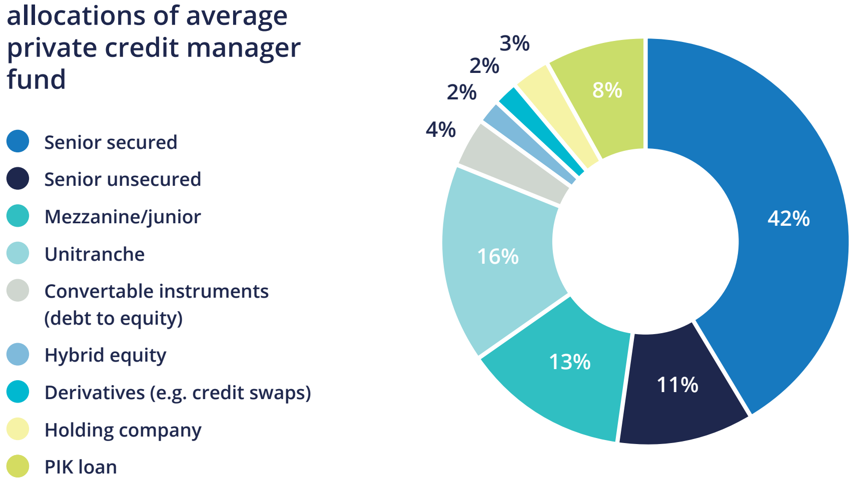


Figure 29. Capital structure allocations of average private credit manager fund

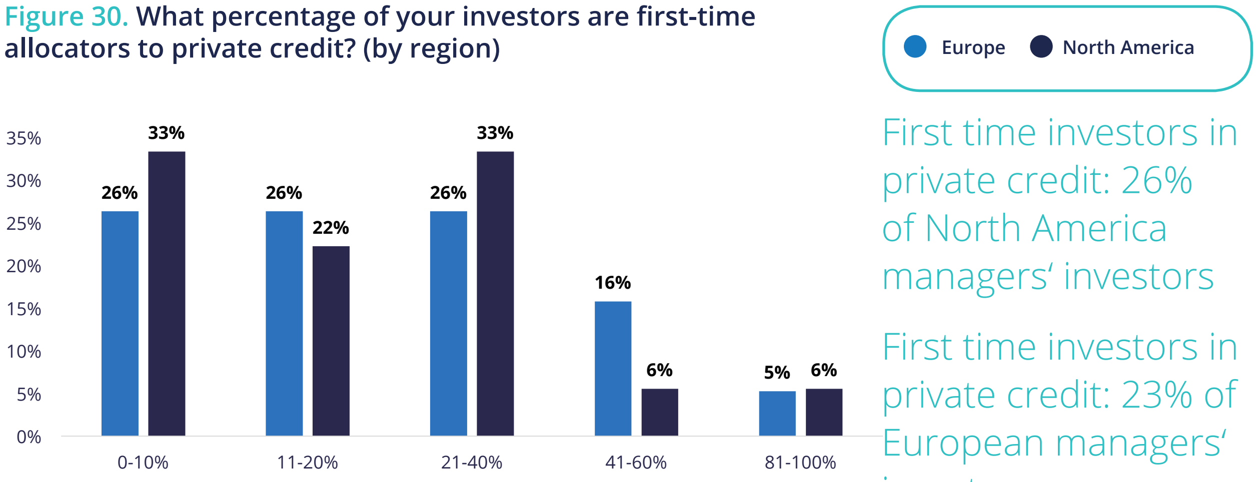


[12] A returns premium earned by committing capital to investments for an extended period of time.

Regional and size splits

There is reason to believe that private credit has room to grow in both of its largest regions. On average, the percentage of first-time investors in North American and European private credit managers is remarkably similar: 26% and 23%, respectively. This suggests that there continues to be a strong pipeline of first-time investors in both of these regions.

Figure 30. What percentage of your investors are first-time allocators to private credit? (by region)

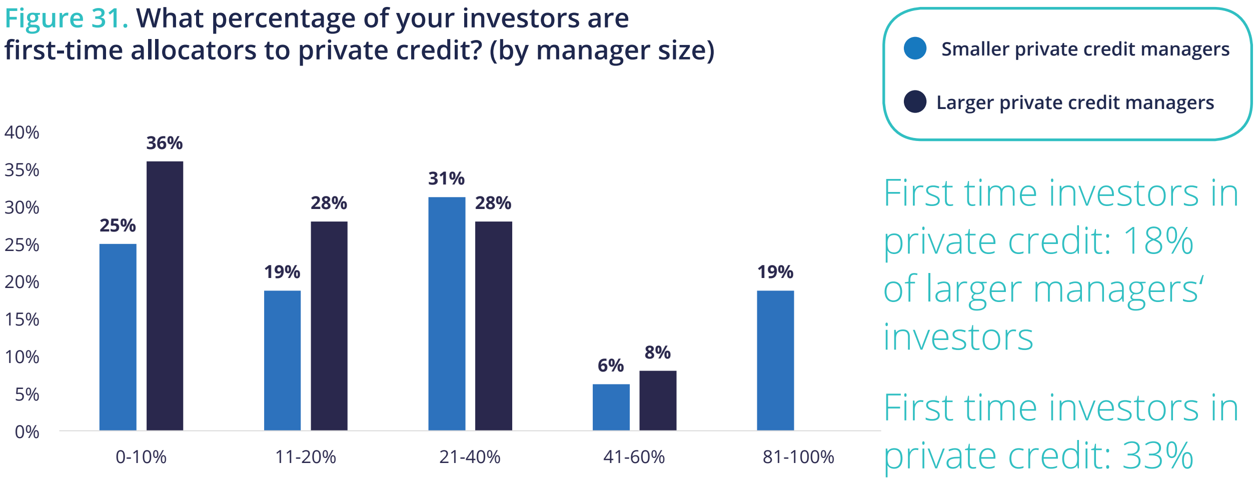


First time investors in private credit: 26% of North America managers' investors

First time investors in private credit: 23% of European managers' investors

When we compare larger and smaller private credit managers (Figure 31) there is a much starker divide. On average, only 18% of investors in larger private credit managers are first-time investors in private credit, compared to 33% of investors in smaller private credit managers. It is not unreasonable to assume that a first-time allocator to private credit would want to start with a relatively small allocation and increase it over time; smaller private credit managers tend to have lower minimum allocations. As such smaller private credit managers may provide an important entry-point for investors.

Figure 31. What percentage of your investors are first-time allocators to private credit? (by manager size)



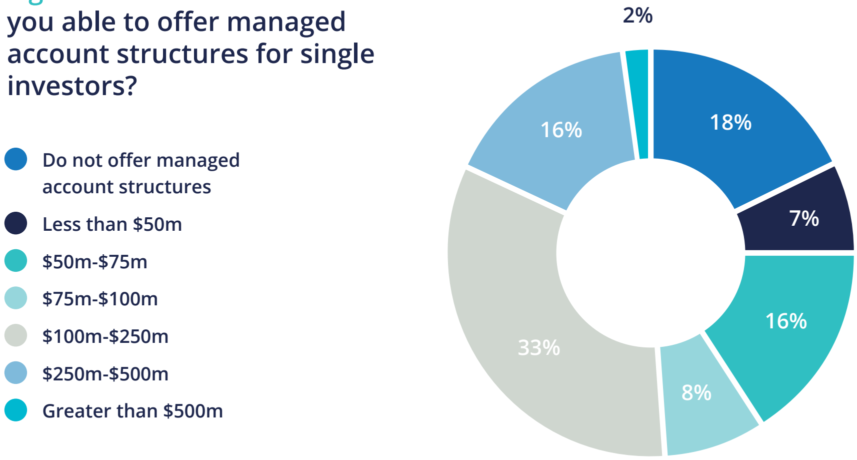
First time investors in private credit: 18% of larger managers' investors

First time investors in private credit: 33% of smaller managers' investors

MANAGED ACCOUNTS

The growing influence of institutional investors in private credit is evident in the use of managed accounts for single investors. In such arrangements private credit managers create bespoke investment accounts for individual investors. These accounts give investors influence over how their investments are managed and give them greater transparency. It is also common for managed accounts to feature bespoke fee arrangements. 82% of all respondents reported being open to the idea of managed accounts, as shown in Figure 32, albeit at different sizes.

Figure 32. At what level are you able to offer managed account structures for single investors?



Case study

Third Eye Capital provides Canadian retailer with $31 million senior-secured credit facility

Third Eye Capital provided Laura's Shoppe, a Canadian clothing retailer, with super-priority secured debtor-in-possession (DIP) financing when the company's previous senior lender forced a court-sanctioned restructuring process. To execute an operational turnaround, Laura's Shoppe needed a transitional debt facility from a lender who would not only support its plans but also help advocate it to various sceptical stakeholders.

CONCLUSION

As more investors commit capital to private credit (or increase their allocations thereto), the industry is catering to an ever-expanding list of investor requirements. The volume of allocations is in turn making the industry more appealing for a greater variety of investors, creating a virtuous circle.

The growing influence of institutional investors in private credit will have profound implications for the industry. Private credit managers may find their due diligence processes subject to greater scrutiny before gaining allocations. Whilst managers are adapting to meet these expectations, continued dialogue between investors and managers will be essential if private credit is to reach its full potential.

4 Fees

Key takeaways:

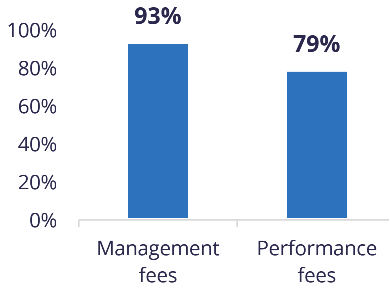
- Private credit managers offer a wide variety of fee arrangements; these arrangements are affected by, among other things, their strategies, risk levels, return expectations, and fund structures.
- Fee levels remain competitive across the sector; a quarter of all respondents report their management fees being lowered over the past two years.
- From the sample of managers that were polled, the average management fee charged is 1.29%, and the average incentivisation percentage is 15%. Over 80% of private credit managers would consider further lowering their rates for the right investor.
- The vast majority of private credit managers charge management fees only on drawn capital; preferred returns, hurdle rates and clawbacks are also popular in the industry.

There is no single traditional fee model in the private credit industry. Rather, private credit managers arrange their fees based on, amongst other things, the strategies they pursue and the loans in which they invest (and the concomitant targeted returns and risk levels), the type of funds they run (whether they are closed or open-ended), and the levels of leverage they deploy. This means that it can be challenging to describe 'typical' private credit fee structures. In general, the greater the target return, the higher the level of fees. At the same time, investors are often subject to lower fees for investing in closed-end funds invested in less liquid assets.

TYPES OF FEES

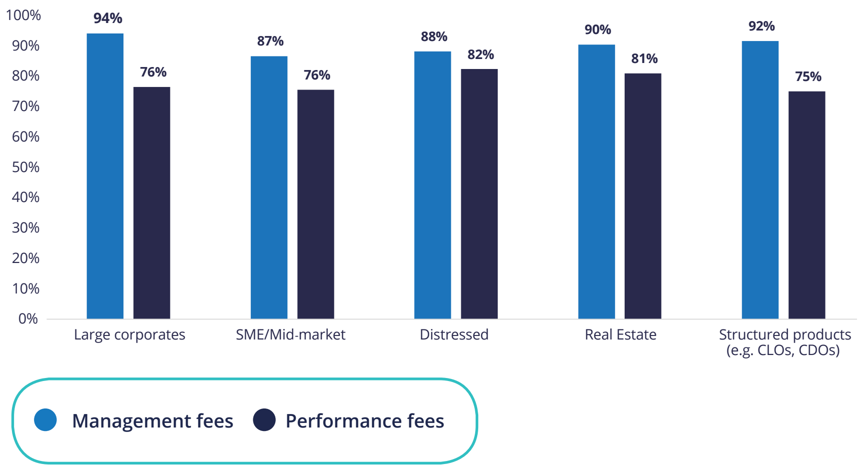
As shown in Figure 33, over 90% of respondents report charging management fees. In most cases, these fees are calculated as a percentage of drawn capital (see below). 79% of respondent reported charging a performance fee. These tend to be more common in funds with higher targeted returns. As such, they are particularly common in levered senior secured debt funds, as well as in mezzanine debt funds and distressed debt funds.

Figure 33. Which fees do you derive as a business from your private credit investments? (select all that apply)



To better understand how a private credit manager's strategy affects its fee arrangements, we split the results by the markets in which respondents report having a significant level of capital invested (defined for our purposes as over 10% of their flagship fund). Among the five most common strategies, those managers with significant loans to large corporates are most likely to charge management fees, As shown in Figure 34, a distressed debt focused manager is most likely to report charging incentive fees to reflect the additional work that is typically required to deliver outperformance in this type of investment strategy.

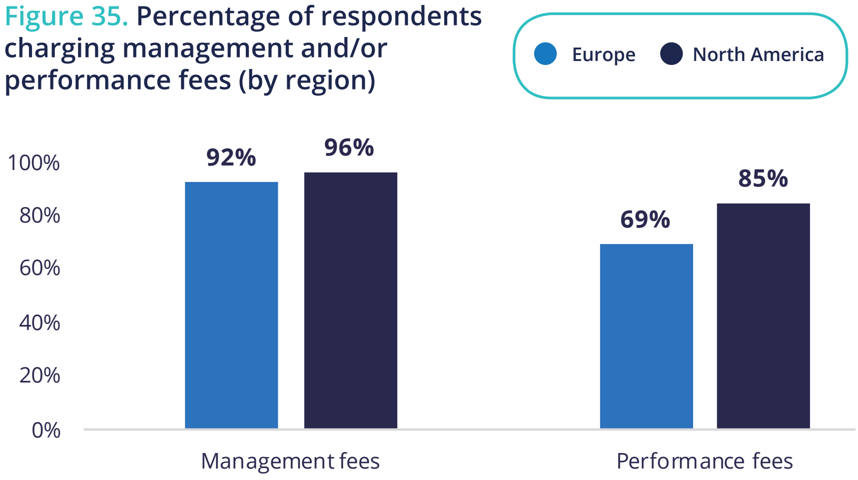
Figure 34. Which fees do you derive as a business from your private credit investments? (by manager strategy)



Regional splits

There is a significant difference in how likely North American and European managers are to charge incentive fees (figure 35). While 85% of North American respondents reported doing so, only 69% of European respondents do the same. This is likely a reflection of North American managers being more willing to invest in distressed debt (as shown in Section 1 of this paper), and use leverage (a trend explored in Section 4 of this paper) to achieve higher returns.

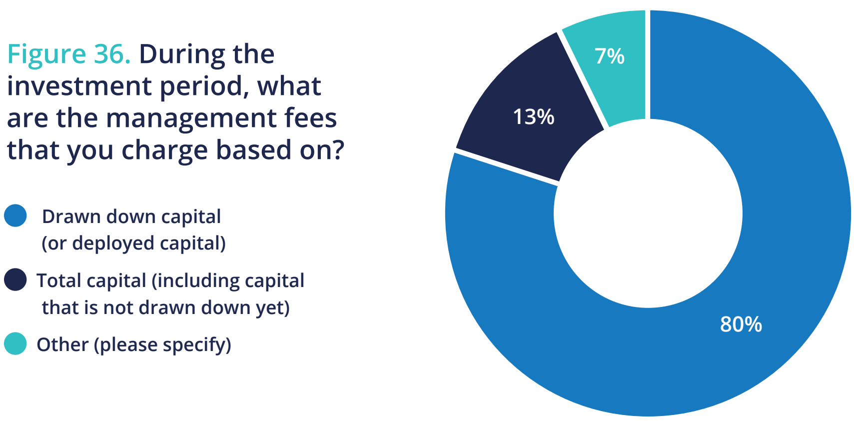
Figure 35. Percentage of respondents charging management and/or performance fees (by region)



COMMITTED CAPITAL

Private credit managers do not simply acquire capital commitments for the sake of collecting larger fees. A significant majority, 80% of respondents report that they charge management fees only on drawn capital, as shown in Figure 36, meaning that managers only get paid when they put investor capital to work in the real economy. This is a key selling point for the private credit industry when it comes to attracting investors.

Figure 36. During the investment period, what are the management fees that you charge based on?



Case study

Monroe Capital supports recapitalisation of USA brand implementation company

Monroe Capital LLC acted as lead arranger and administrative agent on the funding of a $25.5 million unitranche credit facility to support the growth and expansion of Atlas Sign Industries, Inc. (Atlas). Atlas is an international provider of brand implementation products and services.

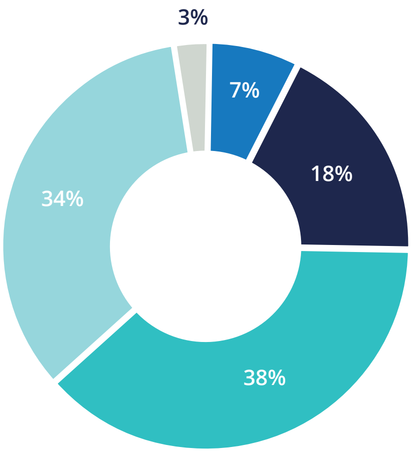
This arrangement can, however, create conflicting incentives. On the one hand, private credit managers are incentivised to identify better investment opportunities, to deliver maximum returns and ensure a high internal rate of return. This would argue for making only the highest conviction investments, with a greater likelihood that a portion of a fund's capital remains undrawn. On the other hand, investors expect their capital to be drawn down quickly and managers are incentivised to do this to earn fee income. As one private credit manager put it, investors "don't want their commitment sitting there [undrawn] for five years."

Some managers expressed concern that this may incentivise some market participants to make investments simply "in order to pay the bills," potentially leading to suboptimal lending decisions. Despite this concern, there is a collective view in the industry that this incentive helps underpin market discipline and robust lending practices. Several managers also note that this dynamic is encouraging investors to take a closer look at managers' loan origination and risk analysis teams. Again, this is seen as a positive development by managers, as it supports investors' understanding of risk when investing in private credit, as well as encouraging robust lending practices on the part of managers.

FEE LEVELS

Private credit continues to be a highly competitive industry when it comes to fees. As shown in Figure 37, nearly 40% of managers charge a management fee between 1-1.5% and only 3% of respondents report a management fee of over 2%. Further, as shown in Figure 38, a quarter of respondents report that their management fees have decreased over the past 24 months; only 9% report them increasing.

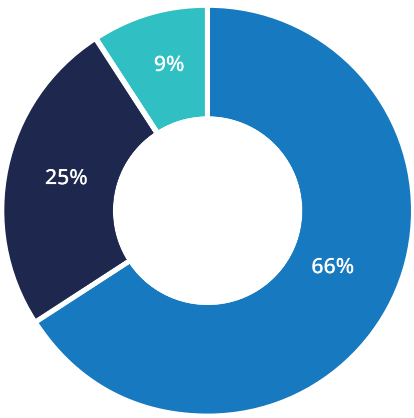
Figure 37. Private credit management fee levels



Average: 1.29%

- 0.01%-0.49%
- 0.5%-0.99%
- 1%-1.49%
- 1.5%-1.99%
- >2%

Figure 38. Private credit manager management fee level changes over the past 24 months



- Stayed the same
- Been lowered
- Been increased

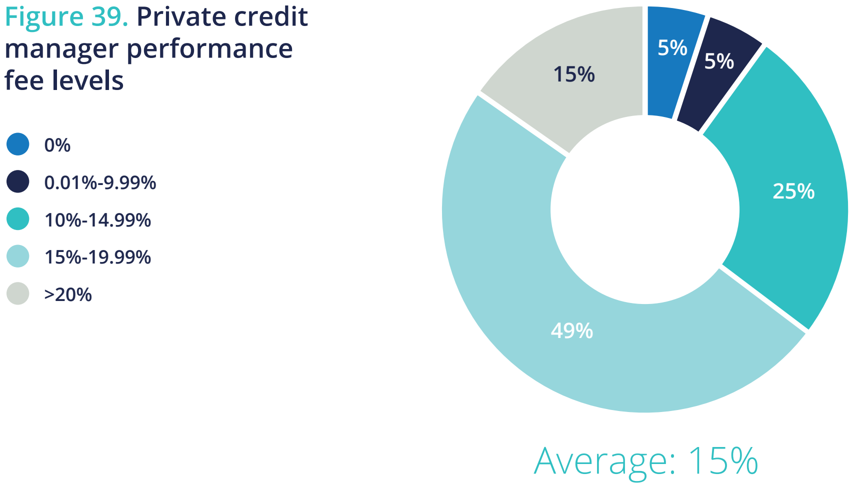
Incentive fee levels are also relatively low. As shown in Figure 39, almost half of respondents charge a performance fee of 15%-20%; only 15% charge a performance fee above 20%. As explained above, such fees are more common in higher return, higher risk funds. Their relative level is affected in large part by the targeted return of a fund, and thus the amount of risk it incurs.

Case study

Permira invests in Italian clothing brand

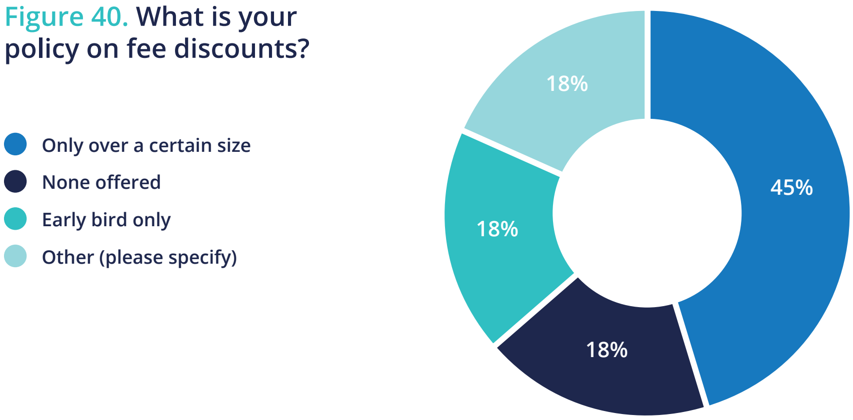
Permira Credit Solutions III (PCS3) invested in the senior secured floating rate notes of TwinSet, a luxury Italian women's clothing brand. This was a primary transaction with PCS3 acting as lead arranger. The deal was originated through a strong relationship with the sponsor, The Carlyle Group.

Figure 39. Private credit manager performance fee levels



Despite the already keen levels of fees, most private credit managers report a willingness to be flexible regarding their fees. Over 80% of respondents suggest that they would be willing to accept fee discounts of some type, with almost half of all respondents willing to do so for an allocation of the right size (as shown in Figure 40).

Figure 40. What is your policy on fee discounts?



This willingness to countenance lower fees may partially be explained by the fact that private credit has come of age at a time where we witness general investor pushback on fees across the broader investment management sector. This environment is also underpinned by several other factors.

At first, capital allocations to private credit were often made from the private equity bucket of an investor's portfolio, and thus investors may have been willing previously to accept higher, private equity-type fees. As investors become more familiar with the asset class, they may have begun to feel that that the investment risk does not necessarily require these levels of fees. As such they are driving a harder bargain to ensure they receive a greater share of the investment returns.

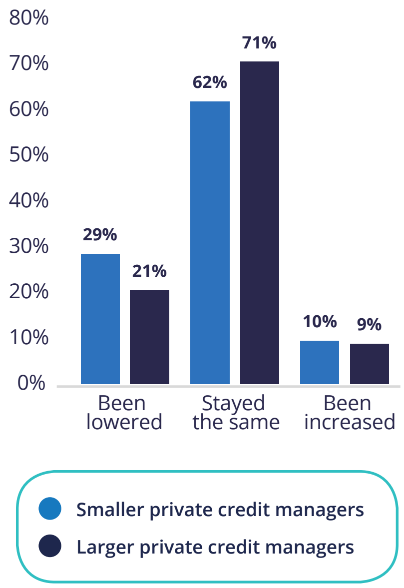
The higher fees synonymous with private equity are also being offset by lower fees related to fixed income investments. In the search for new forms of yield, investors are increasingly allocating to private credit from their fixed income bucket. Typically investors have paid much lower fees when allocating to fixed income, and consequently any allocations to private credit taken from the fixed income portfolio are having to meet the demands of more fee sensitive investors.[13] It is also important to remember that allocations made from private equity and fixed income allocations may be seeking different types of risk; this will affect what fee levels are deemed acceptable by investors.

Private credit managers are also drawing an increasing amount of capital from institutional investors. These investors, given their size, tend to have considerably more influence in fee discussions than any other investor types, and often succeed in getting a more competitive fee arrangement with the private credit managers to whom they allocate.

Regional and size breakdown

We also asked respondents whether their management fee levels have changed over the past two years. While the vast majority of respondents reported no change, 29% of smaller managers and 21% of larger managers reported that their management fees had been lowered over the past 24 months, as shown in Figure 41. Smaller managers understandably have more incentives to lower their management fees when attracting allocations. This is also evident in our finding that smaller managers are more likely to report a willingness to offer early bird fee discounts (see Figure 40). As one private credit manager told us, "if you're a first-time fund you're going to have to give some economic incentives". Smaller managers may, however, be able to mitigate this fee pressure by providing a more niche offering – for example access to a particular market or investment opportunity, as opposed to marketing themselves as a 'me-too' fund.

Figure 41. Private credit manager management fee level changes over the past 24 months (by manager size)



[13] Andy Thomson, *"Why Debt Fund Managers are Seeing Fees Slip Away," Private Debt Investor*, 2017. https://www.privatedebtinvestor.com/print-editions/2017-07/why-debt-fund-managers-are-seeing-fees-slip-away/

FEE ARRANGEMENTS

Private credit managers and their investors have a range of tools at their disposal to align their interests on fees and headline fee levels should not be judged in isolation. A low incentive fee without a hurdle or preferred return rate may often be worse for investors than a high incentive fee with a hurdle or preferred return rate. Our data indicates that hurdles and preferred return rates (arrangements in which managers do not collect their carried interest if returns do not achieve a certain threshold) are almost standard in closed-ended funds and are becoming increasingly common in open-ended structures as well. As shown in Figure 42, almost 40% of respondents report having a hurdle rate in their funds.

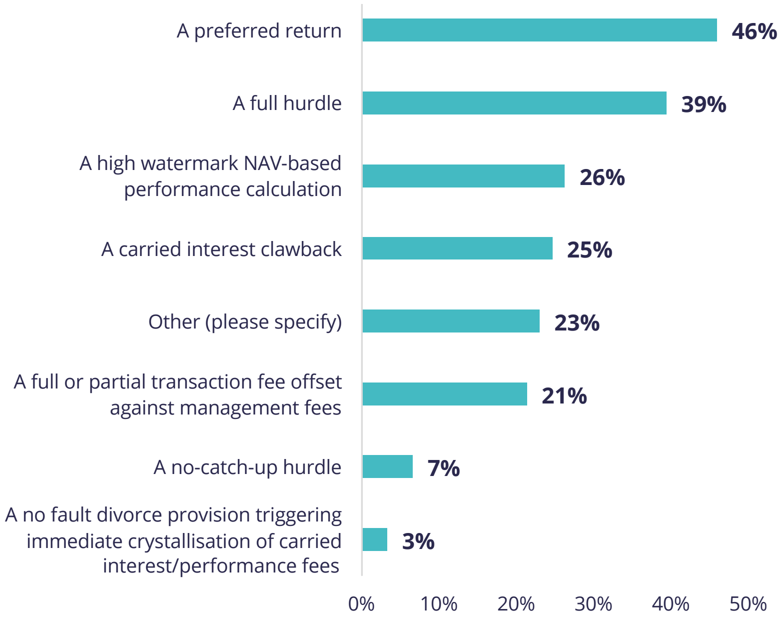
A quarter of all respondents also report having a clawback arrangement in place for their funds. Under such arrangements a manager is compelled to return a portion of its incentive fees should its fund suffer subsequent losses that result in the manager having been, in hindsight, overcompensated.

Case study

Cheyne Capital finances established UK housebuilder

Cheyne Capital provided a £35 million five-year junior loan to Larkfleet Homes, an SME regional housebuilding company headquartered in the East Midlands area of the UK, to finance its expansion plans and grow its regional presence.

Figure 42. **Private credit manager fee arrangements (select all that apply)**



CONCLUSION

Fee arrangements for private credit managers are intrinsically linked to the type of strategy and returns being sought by investors. Investors targeting conservative returns can expect different fee structures and levels than investors targeting higher returns. Managers can also use other tools to ensure an alignment of interest between them and their investors. The diversity of strategies within private credit also means that investors can choose the best private credit manager to meet the needs of their portfolios.

5 Fund-level Leverage and Financing

Key takeaways:

- The majority of private credit managers do not use fund-level leverage, in keeping with trends highlighted in previous editions of this survey.
- Those managers who report they use fund-level leverage to finance their lending activity do so in a conservative manner—close to three quarters of managers using borrowing against their assets report levels of debt to equity lower than 2-to-1.
- Larger managers that use leverage tend to employ higher levels of leverage than smaller managers.
- The terms of such asset financing are generally matched to the maturity of the underlying loan portfolios.
- There are some parts of the industry that are seeing higher levels of leverage being used, as financing of loan portfolios becomes more widely available and more sought after by certain types of investors.
- The use of subscription financing—borrowing against investor commitments—has also become prevalent, with nearly three quarters of managers using such facilities for terms of up to one year.

LEVERAGE - BORROWING AGAINST ASSETS OF THE FUND

The respondents to our survey are almost evenly split among those who do use fund-level leverage and borrow against their assets to increase their credit exposure and those who do not do so (figure 43). So while, overall, the use of leverage remains relatively modest, the average levels of leverage by those managers that do deploy it appears to be modestly increasing.[14]

This increase may be driven by the preference of some investors for senior secured positions within the capital structure. In an environment of fee and loan coupon compression, using leverage may be the only way to achieve a manager's desired returns while still investing in the most secure positions within a capital structure. Even with the modest uptick in the levels of leverage, however, private credit managers are still rather conservative as most of the financing used does not exceed a 2-to-1 ratio of debt-to-equity.

Case study

Biotechnology company secures up to €20m from Kreos Capital

ABIVAX, a biotechnology company harnessing the immune system to develop a functional cure for HIV, as well as treatments for inflammatory/ autoimmune diseases and cancer, signed a $23.41 million structured debt financing facility with Kreos Capital.

Figure 43. How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)?

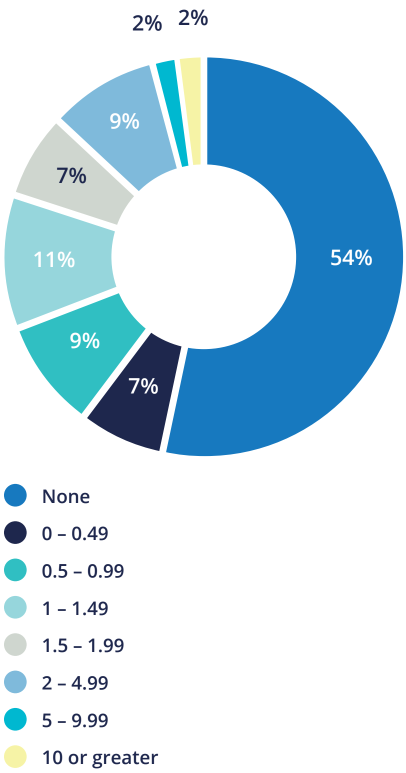
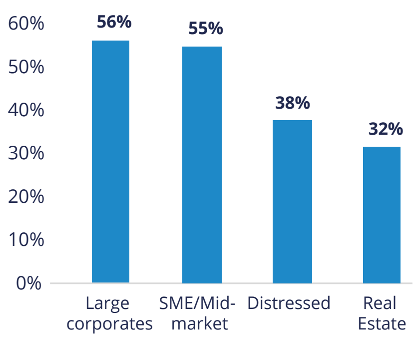


Figure 44. Percentage of private credit managers using leverage (by market allocations)



[14] For a detailed explanation of the use of leverage by alternative investment managers, see *Made to Measure - Understanding the use of leverage in alternative investment funds,* 2016, https://www.aima.org/article/made-to-measure-understanding-the-use-of-leverage-in-alternative-investment-funds.html

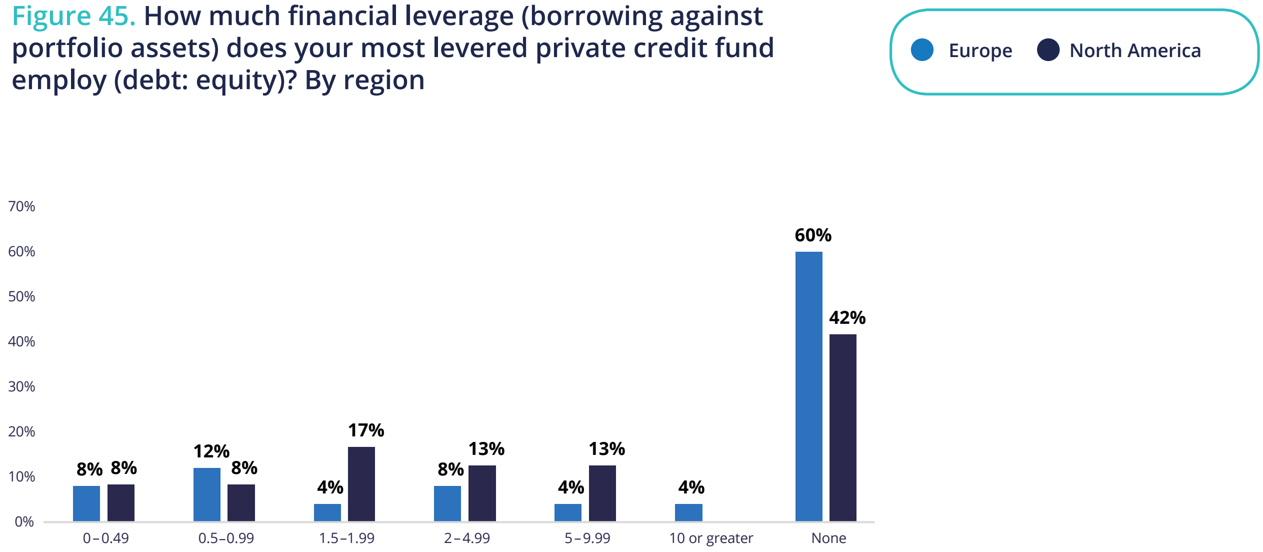
We also see that the use of leverage differs across the asset class, as shown in Figure 44 page 35. Less than 40% of respondents allocated to distressed debt report using leverage;[15] the number being closer to 30% for those respondents who pursue real estate deals. However, over half of all respondents with substantive allocations to large corporates, SMEs and/or the mid-market report using leverage. This may be a response to the compression of spreads, especially for mid-market lending, which makes it difficult for managers to achieve their desired returns without the use of leverage.

Regional and size splits

Consistent with last year's findings, North American respondents tend to use leverage more than their European counterparts. 58% of North American respondents' report using leverage, compared to 40% of European respondents (compared to 63% and 45%, respectively, last year). While North American private credit managers and investors have traditionally been more comfortable with the use of leverage than their European counterparts, there are signs that attitudes in Europe could be changing. While it is unclear whether this momentum will see the use of leverage in Europe become comparable with that of North America, it is likely that the use of leverage will become more prevalent in Europe in the near-to-medium term.

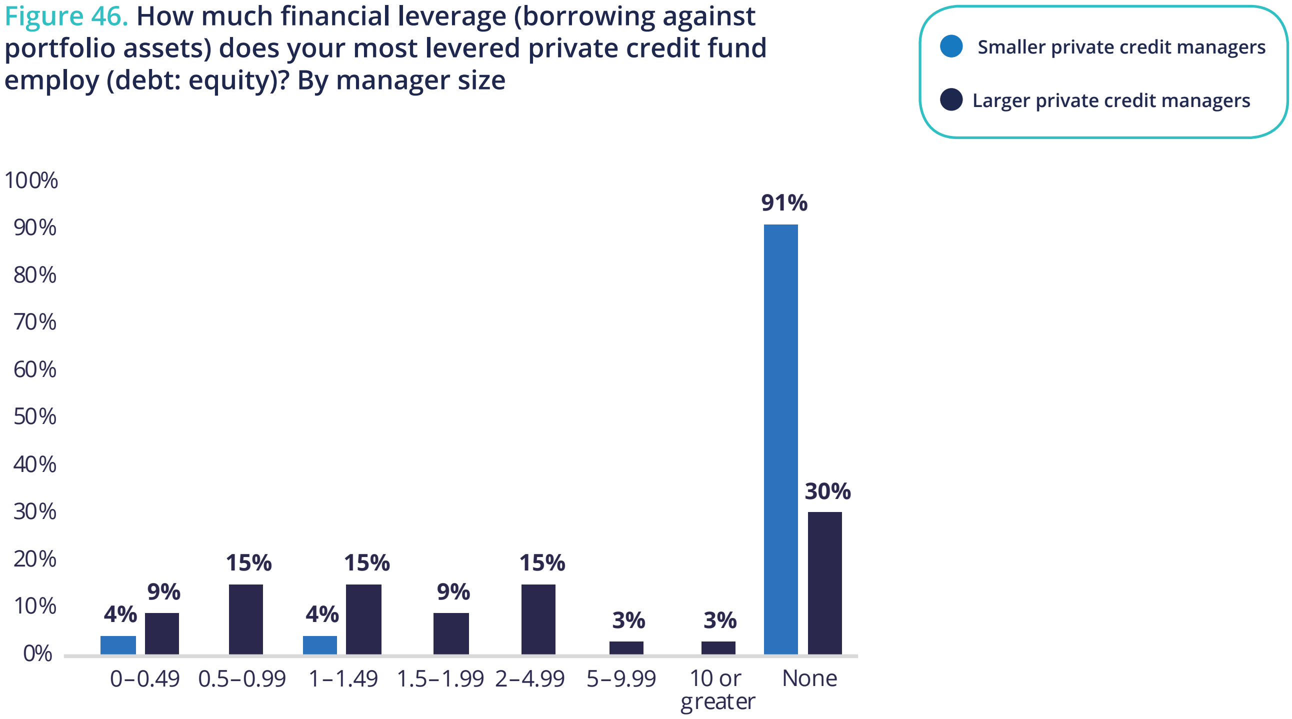
The divide in the use of leverage is even greater between private credit managers of different sizes. Less than 10% of smaller private credit managers' report using leverage; those that do use leverage report an average leverage ratio of debt to equity in the region of 1:1. However, from the population of larger managers surveyed, 70% of them report deploying leverage at almost a debt to equity ratio of 2:1.

Figure 45. How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)? By region



[15] where more than 10% of their flagship fund allocated to distressed debt.

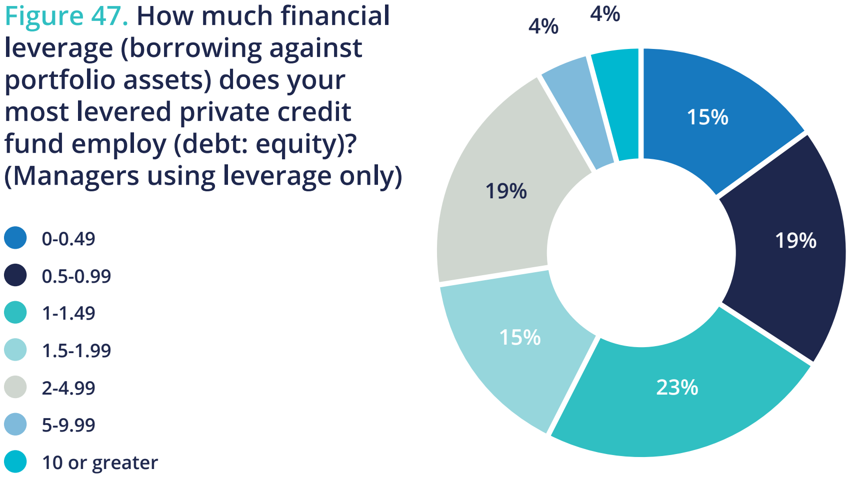
Figure 46. **How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)? By manager size**



LEVELS OF LEVERAGE

Those private credit managers who do use fund-level leverage tend to use relatively low levels. As shown in Figure 47, 72% of such managers deploy leverage at a level of less than 2:1. When deploying leverage, as shown in Figure 48, 66% of private credit managers also match this to the term of the underlying loans.

Figure 47. **How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)? (Managers using leverage only)**

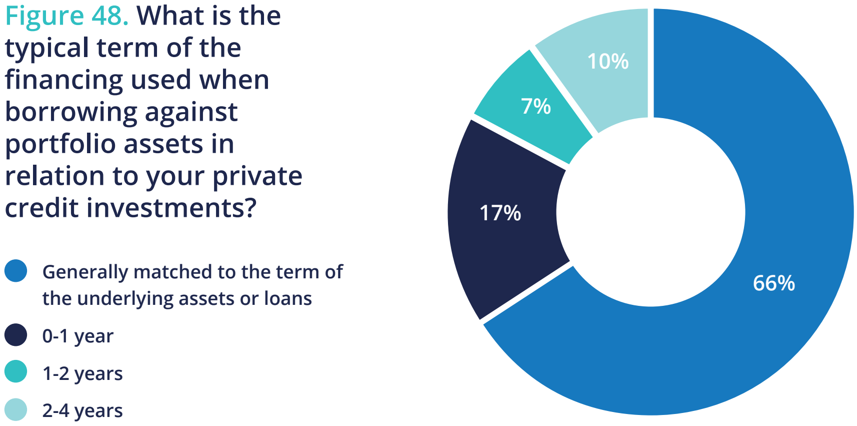


Case study

Ardian Private Debt provides additional financing for acquisition of freight exchange company

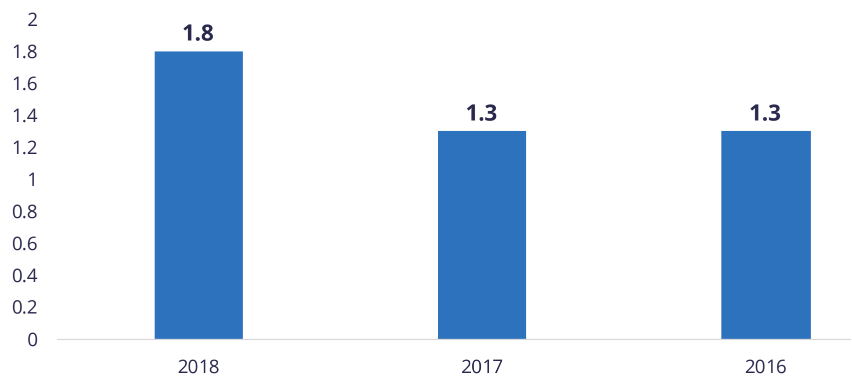
In September 2018 Ardian provided additional financing to Alpega, a leading global logistic software company, to support the company's add-on acquisition of Wtransnet, a leading freight exchange company in Spain. The transaction with Wtransnet will help increase Alpega's liquidity in terms of shipments and trucks for all freight exchanges in the group.

Figure 48. What is the typical term of the financing used when borrowing against portfolio assets in relation to your private credit investments?



However, as already noted, the average use of leverage has increased. As shown in Figure 49, in both 2017 and 2016, our sample of respondents reported an average leverage ratio of 1.3:1; this year they report an average of 1.8:1. The greater use of leverage and financing arrangements more generally has been driven by low interest rates across the market. Some managers we spoke to also described how providers of leverage were able to do so on overall very competitive terms.

Figure 49. How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (debt: equity)? (average level of leverage, year-on-year)



SUBSCRIPTION LINE FINANCE

Private credit managers have a wide variety of financing options available to them. In the section above, we mainly focused on leverage arising from borrowing against the assets that managers hold in their funds. Subscription line financing is another and almost as prevalent a form of financing used by managers however, it serves a different purpose. Subscription line financing allows managers to draw liquidity from the finance providers based on the capital committed by the managers' investor base. This technique is used as a tool to make the lending process more efficient and to bridge drawdowns if underlying loans need to be disbursed more quickly than drawdowns from fund investors permit.[16] As shown in Figure 50, over 40% of respondents report using subscription line financing.[17]

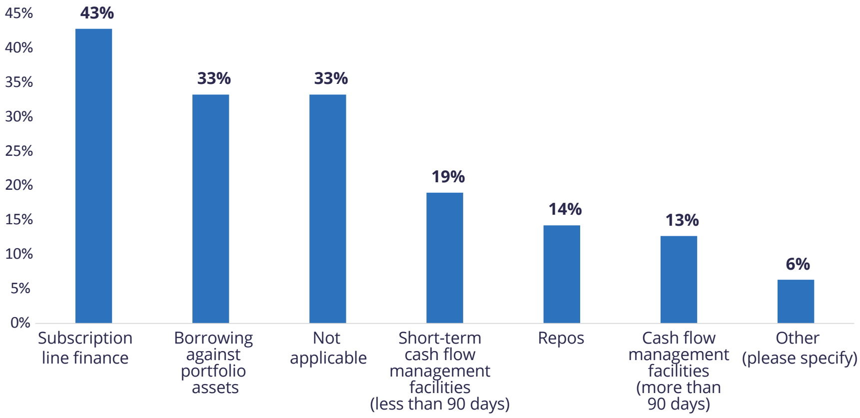
Case study

Cheyne Capital finances residential housing in London, UK

Cheyne Capital provided a £57.7 million whole loan to finance the conversion of an existing office building into a residential scheme in London, UK. The 20-storey office building is being redeveloped into a 258-unit apartment complex.

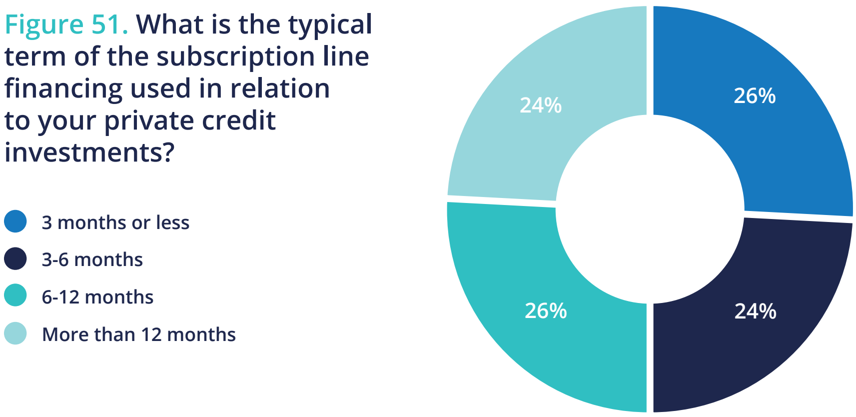
[16] For the purposes of this paper leverage is understood as a financial arrangement whereby a manager increases.
[17] For a more detailed examination of the use of subscription line financing in credit funds, see: Institutional Limited Partners Association, "*Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners*," 2017, https://ilpa.org/wp-content/uploads/2017/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf

Figure 50. Which of the following types of financing/leverage does your firm use with respect to your private credit strategies? (select all that apply)



The short-term, liquidity management nature of subscription line financing is highlighted by our findings on the typical terms for subscription line financing facilities. As shown in Figure 51, for managers using such financing, half have terms of up to six months, and only a quarter of respondents use subscription line financing with a term of over 12 months. For most private credit managers that employ such financing, it is a short-term arrangement used either for cashflow management or for investing in opportunities on tighter timelines than fund terms foresee.

Figure 51. What is the typical term of the subscription line financing used in relation to your private credit investments?



CONCLUSION

As private credit matures, managers are availing themselves of various financing techniques to increase their economic exposure, manage the deployment of capital or simply deal with various liquidity or cashflow management issues. Borrowing against fund assets to increase economic exposure has continued to a North American phenomenon with larger managers deploying higher levels of leverage than smaller managers. Where used, leverage levels are rising modestly but are still at levels which appear to be relatively conservative. Importantly is that there appears to be very little evidence of a financing mismatch as managers seem to match the financing terms with the maturity of their underlying assets.

Case study

Beechbrook Capital finances leading global executive search specialist

Beechbrook Capital's UK SME credit fund provided a unitranche loan to Leathwaite, a global human capital specialist with offices in London, New York, Hong Kong and Zurich. The investment will help Leathwaite to accelerate its worldwide expansion, launch new business streams and invest in proprietary technology.

6 Fund Structures

Key takeaways:

- The private credit industry continues to innovate on fund structures and terms, but has settled on a closed-ended commitment and drawdown structure as the most popular fund model to suit long-term lending to the real economy.
- There are regional variations in the use of fund domiciles, with managers open to using a range of jurisdictions in response to investor demands. The larger managers will frequently offer a range of entry points to the same underlying strategy.

The findings of this year's survey bear out many of the conclusions that were drawn in last year's report and point to an industry that is becoming more settled in its choice of fund structures and domiciles.

The Cayman Islands and Luxembourg continue to be the most popular fund domiciles, as shown in Figure 52, with the Irish market share remaining steady. Our respondents, however, appear to have been making less use of US domiciled fund structures over the last twelve months.

North American managers have a much stronger preference for Cayman Islands established funds than European managers, whilst European managers in turn favour Luxembourg fund structures, as shown in Figure 53.

This reflects what interviewees told us and the general market: European managers are more likely to raise capital closer to home, where a combination of tax, legal and regulatory factors makes an onshore structure more attractive to most allocators. The factors that will typically impact fund domicile will include the following:

- How easy is it for the fund to be marketed: in Europe, a European fund structure can provide access to a pan-European marketing passport.
- How it affects investors ability to allocate: LPs will typically view European funds more favourably as they give them better capital treatment (this is particularly true if those investors are insurance companies or pension funds).
- How efficient is the structure in deploying capital: whilst loan origination regimes have yet to be harmonized across Europe (and there is little sign of a move towards harmonisation), certain key markets provide greater flexibility for European fund structures. This, allied with a move towards locating both fund vehicles and any downstream investing vehicles in the same jurisdiction for both tax and operational efficiency has driven a move towards the key European fund domiciles.

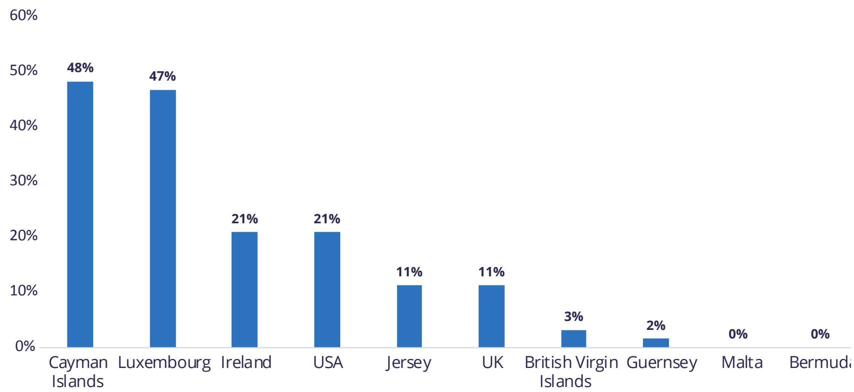
In the North American market, there is also a tendency for managers to consider non-US structures either for their principal fund vehicle, or as a parallel vehicle for their US fundraising efforts.

Case study

UK community housing secures financing from M&G Investments

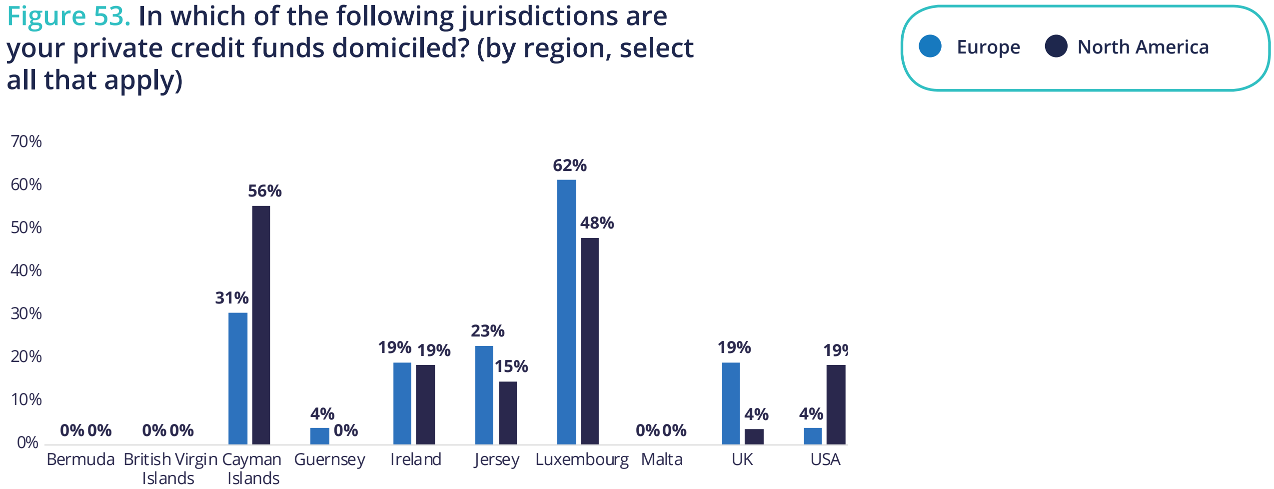
Watford Community Housing secured £65 million of financing from M&G, enabling the continued construction of 675 homes over the next three years in the UK. The 32-year financing secured by Watford Community Housing will facilitate its ambition of building 1,000 affordable homes by 2020, of which over 100 have been already completed.

Figure 52. In which of the following jurisdictions are your private credit funds domiciled? (select all that apply)



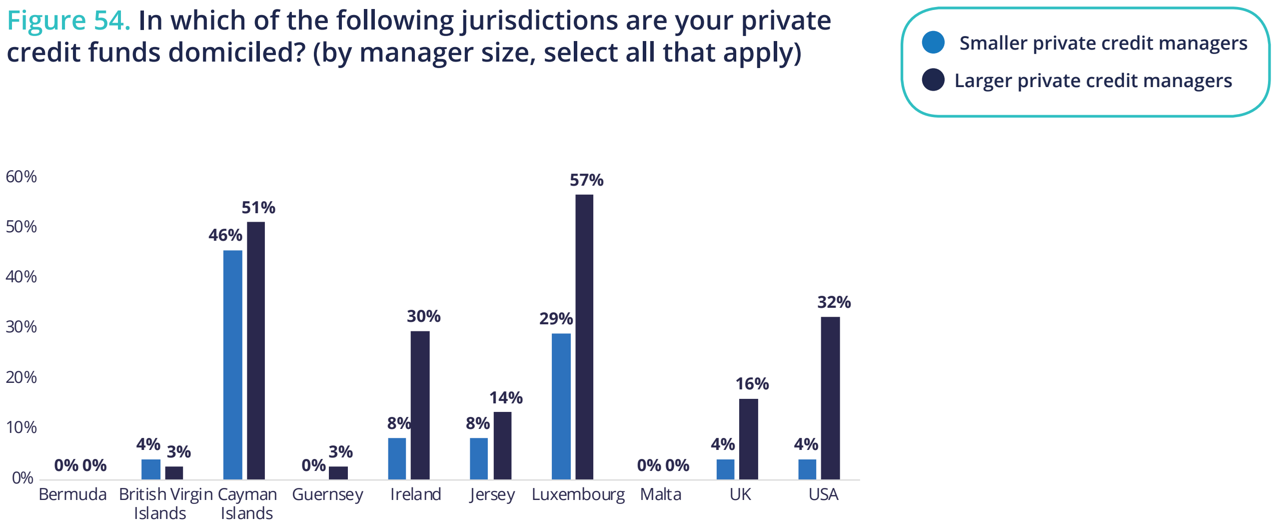
The UK appears to have enjoyed a spike in popularity since last year's report; we would expect the impact of increased Brexit planning to restrict UK structures to pure domestic credit strategies.

Figure 53. In which of the following jurisdictions are your private credit funds domiciled? (by region, select all that apply)



The considerable difference in popularity of Irish and Luxembourg structures between smaller and larger managers, as shown in Figure 54 (when contrasted with the relative equal use of Cayman Islands structures), may well be based on two factors – those jurisdictions tend to require overall greater operational and regulatory attention and, therefore expense, and are typically demanded by larger investors, which in turn will drive fund size.

Figure 54. In which of the following jurisdictions are your private credit funds domiciled? (by manager size, select all that apply)



As noted in Section 3, managed account structures continue to offer a route for investors to structure more bespoke investment strategies which, a comingled fund structure (even with extensive side letter provisions or use of special investment classes) is unable to offer. These structures can result in the same structural complexity as a typical fund structure, with greater complexity around governance and fee arrangements. Although a significant majority of managers in both Europe and North America continue to hold firm that such arrangements are not available, our survey results indicate that European managers, who may be in more aggressive growth mode, appear more open to such bespoke investment structures. Overall manager size appears to have little bearing on the inflection point at which such arrangements are available. As managers grow, these types of arrangement can become increasingly complex from a potential conflicts and allocation perspective.

Case study

Midcap Financial and Ares Commercial Finance provide $80 million senior credit facility to USA trucking company

MidCap Financial and Ares Commercial Finance (ACF) jointly provided an $80 million senior credit facility

to Action Resources, a specialised trucking and environmental service provider headquartered in Birmingham, Alabama, USA. The company operates 49 locations across 17 states with approximately 1,200 employees. The credit facility provided by MidCap and ACF was used to refinance Action Resources's line of credit with a commercial bank and expand the company's credit line.

Figure 55. At what level are you able to offer managed account structures for single investors?

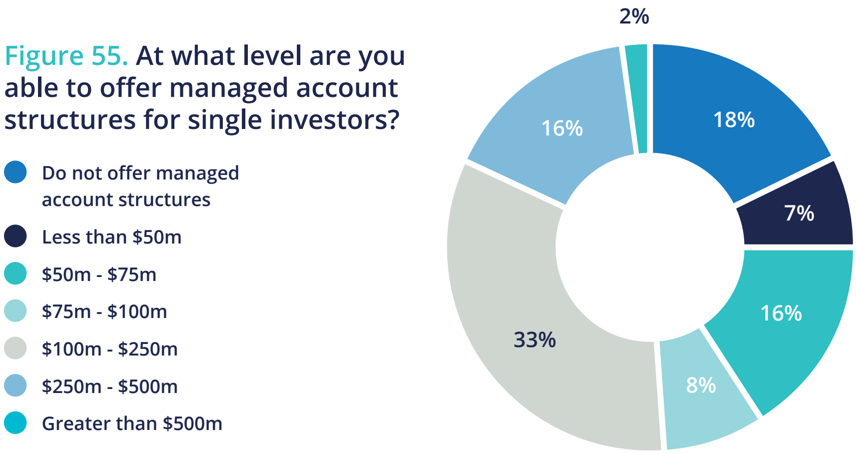


Figure 56. At what level are you able to offer managed account structures for single investors? (by region)

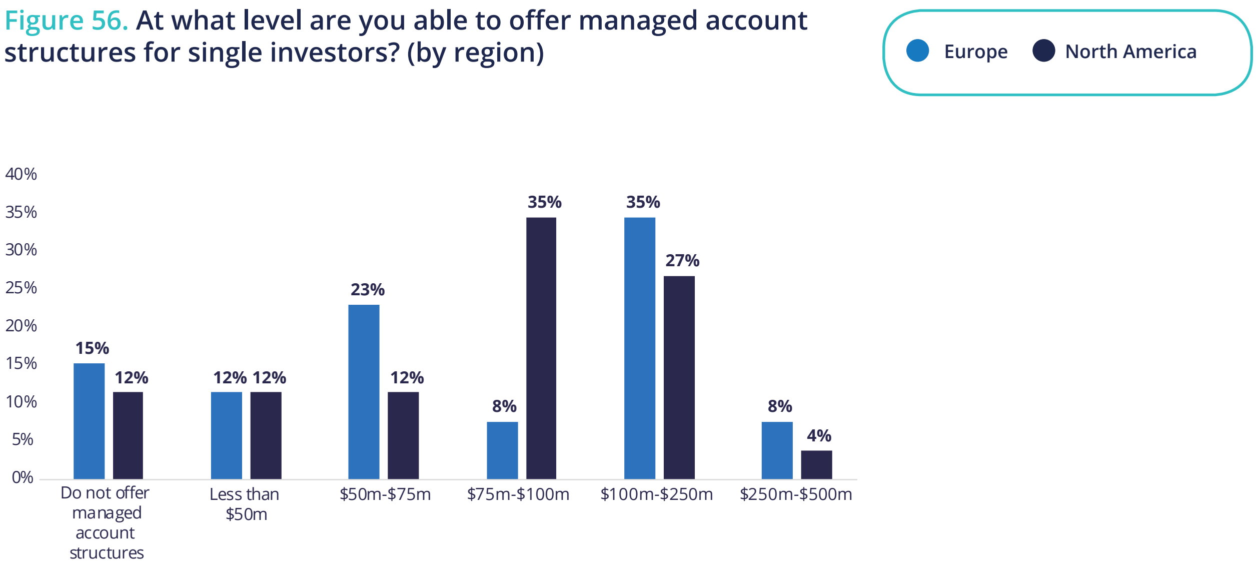
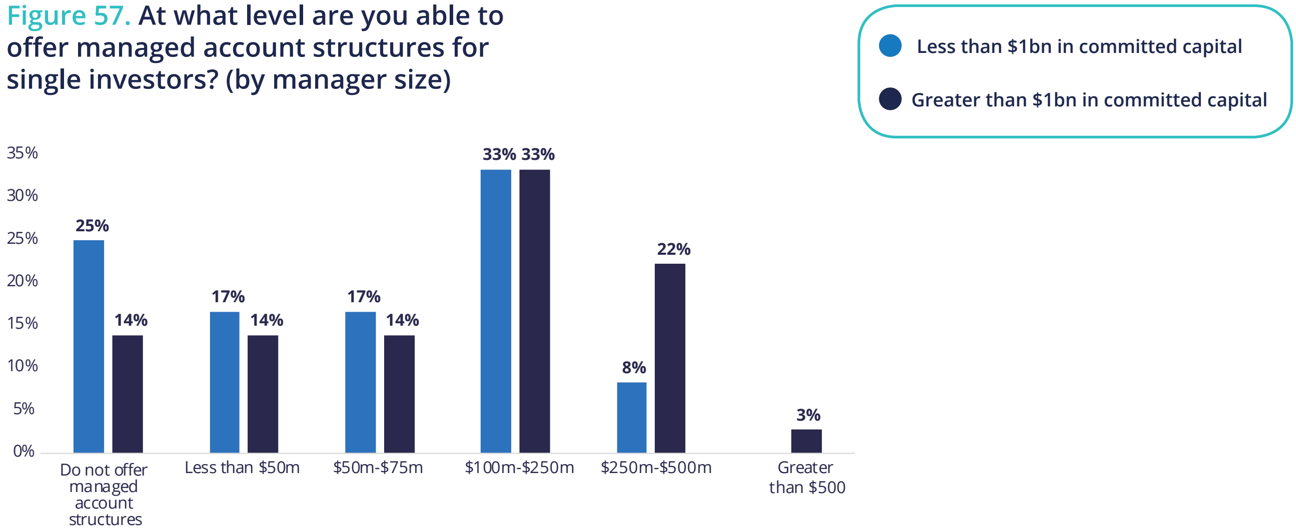


Figure 57. At what level are you able to offer managed account structures for single investors? (by manager size)



The ideal fund structure will be driven by a mixture of investor requirements and underlying investment strategy. A private equity-style fund structure—where the fund spans a capital raising, deployment, holding and realisation period, continues to be viewed by the industry as the most suitable model for a private debt strategy that focuses on providing long-term lending to the real economy. Private credit funds also tend to include more generous recycling (reuse of drawn capital) provisions than equity strategies if the likely tenor of underlying loans means that capital can be deployed efficiently multiple times during the lifetime of the fund. These structures appear more commonly used by larger managers and those based in North America. That larger managers use these more commonly may be down to the natural smoothing that can be achieved in larger funds and the greater operational complexity of operating these types of structures.

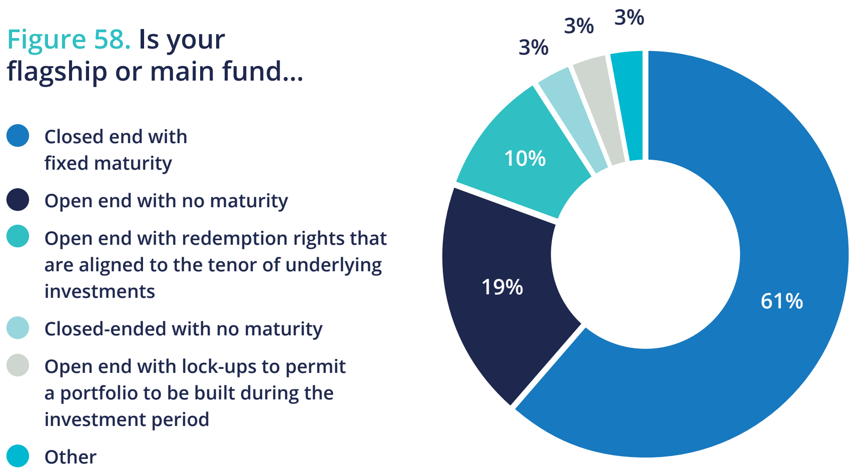
Open-ended structures, at around one-third of respondents, are more prevalent where the loans being invested in (either self-originated or acquired) have a shorter term and are marketable (liquid). This helps to ensure that liquidity at fund level can be matched to that of the underlying loan terms.

Case study

Pemberton provides $70 million finance package to UK animation and visual effects firm

Pemberton provided Cinesite with $40 million for general funding and acquisition finance purposes. Pemberton was supported by Barclays Corporate Banking, which provided $4 million of revolving credit facilities. Together, Pemberton and Barclays agreed a further $26 million in future flexible facilities. Cinesite Studios, headquartered in London, UK, produces feature animation and visual effects for the film and television industries.

Figure 58. Is your flagship or main fund...



7 Conclusion

The structural drivers for private credit success continue to fuel the expansion of the sector.

The experience gained by private credit managers, many of whom have gone through several credit cycles already, continue to confirm the sense that funding for certain types of lending activities is naturally more suited to the asset management model than the banking one. In addition, the risk-bearing capacity of the private credit managers and the long-term horizon of their end-investors align better with many of the funding needs of smaller and mid-sized corporates. Positive feedback from the borrower community is also reinforcing this perception.

Having delivered successfully on its basic promise, the private credit industry is poised to expand into a host of other areas of finance such as lending to micro-businesses, real estate lending or asset-based and trade finance. While this expansion provides a source of competition to existing incumbents, more often than not, it acts as an additional or complementary form of finance to what is currently available in the lending market today.

The sustained success of the private credit sector will flow from private credit firms developing and maintaining business models that incentivise sound underwriting and pro-active risk management. This will include the ability to work out difficult situations without losing the confidence of the borrower community while also mitigating the sharper impacts of credit and economic cycles. Our survey allows us to assess the progress or otherwise that the industry is making along these lines.

So far, the verdict is an encouraging one, especially regarding some of the issues the sector has had to contend with related to financial stability and the potential for the sector to serve as an anti-cyclical buffer. The strong and continuous preference for closed end fund structures that are aligned to the nature of the underlying fund's investment are in stark contrast to the extreme liquidity transformation of other financial actors.

While leverage is increasing, the data that we have been able to collect shows that most of the financing used to increase fund exposure is modest in size and, crucially, aligned with the maturity of the underlying assets. Further, given that a large portion of the industry's dry powder is dedicated to managing distressed loans and investments also shows that there is likely to be capital available in the system once the cycle turns.

This does not mean that managers will not experience potentially significant turbulence in the future, including sub-par performance or outright failures. Many private credit managers that we spoke to are thinking very hard about how to position themselves for a possible downturn in the credit cycle to better deal with the challenges that it may bring, but also in order to understand the opportunities that may arise.

Nobody is certain how the exit from the historically unprecedented liquidity support provided by the central banks in recent years to the economy will play out. The private credit model is expected to be sufficiently robust to deal with any potential future stresses to the financial system.

8 Case Studies

Adamas provides financing to Chinese eco-resort

Adamas provided senior secured bridge financing for the finalisation of Naked Stables, an eco-resort in a province outside of Shanghai, China. The wider area has been used as a summer resort historically, but development there has been limited. The project has contributed to the revitalisation of the historic summer vacationing area.

Clients advised by Allianz GI provide financing of €45m to construction company

Spie Batignolles is a mid-size construction company with sales of €1800m and 7,000 employees. The company was seeking a finance provider to expand and consolidate its market position. This financing was provided by Allianz GI alongside some shorter-term bank financing.

Clients advised by Allianz GI provide financing to infrastructure project

Clients advised by Allianz GI provided €400m of financing to an Italian infrastructure project supporting the construction of parts of the Venice ring road. The motorway assets are an essential link in the Italian and European motorway system and are vital for international trade between western, central, and eastern Europe.

Cheyne Capital finances redevelopment of residential block

Cheyne Capital provided a £105 million whole loan to Quintain to fund the redevelopment of a 150-unit residential block and an office building in London, UK, as part of the ongoing regeneration of that part of London.

Cheyne Capital finances residential housing in London, UK

Cheyne Capital provided a £57.7 million whole loan to finance the conversion of an existing office building into a residential scheme in London, UK. The 20-storey office building is being redeveloped into a 258-unit apartment complex.

Cheyne Capital finances established UK housebuilder

Cheyne Capital provided a £35 million five-year junior loan to Larkfleet Homes, an SME regional housebuilding company headquartered in the East Midlands area of the UK, to finance its expansion plans and grow its regional presence.

Ardian provides €320m in financing to industrial parts provider over a four-year period

Ardian Private Debt (APD) provided €220m in unitranche financing to Industrial Parts Holding (IPH) in 2013, to support the buyout of the company by PAI Partners. IPH is a leading European distributor of B2B industrial parts. Over the life of the investment, APD arranged a further €100m to support 58 further acquisitions by IPH during a four-year investment. During the life of APD's investment IPH significantly increased its European footprint.

Ardian Private Debt provides additional financing for acquisition of freight exchange company

In September 2018 Ardian provided additional financing to Alpega, a leading global logistic software company, to support the company's add-on acquisition of Wtransnet, a leading freight exchange company in Spain. The transaction with Wtransnet will help increase Alpega's liquidity in terms of shipments and trucks for all freight exchanges in the group.

Midcap Financial and Ares Commercial Finance provide $80 million senior credit facility to USA trucking company

MidCap Financial and Ares Commercial Finance (ACF) jointly provided an $80 million senior credit facility to Action Resources, a specialised trucking and environmental service provider headquartered in Birmingham, Alabama, USA. The company operates 49 locations across 17 states with approximately 1,200 employees. The credit facility provided by MidCap and ACF was used to refinance Action Resources's line of credit with a commercial bank and expand the company's credit line.

CVC Credit Partners provides financing to Spanish invoice-discounting operator for second time

In August CVC Credit Partners provided a second round of financing to the Gedesco Group (Gedesco) following a deal in 2015 to support the growth of the business. Headquartered in Valencia, Spain, Gedesco is the largest independent specialist invoice-discounting and factoring operator in the country. The business has more than 25 offices across Spain.

OCP Asia provides funding for Australian house-and-land project

Hong Kong based OCP Asia provided a $70 million loan to Welsh Group to fund a new house-and-land project in Melbourne, Australia. The financing will support the development of 400 lots and an apartment site in Melbourne. OCP Asia previously provided a $105m loan to finance Welsh Group's development of a 1300-lot house-and-land estate, also in, Melbourne.

Biotechnology company secures up to €20m from Kreos Capital

ABIVAX, a biotechnology company harnessing the immune system to develop a functional cure for HIV, as well as treatments for inflammatory/autoimmune diseases and cancer, signed a $23.41 million structured debt financing with Kreos Capital.

Third Eye Capital provides Canadian retailer with $31 million senior-secured credit facility

Third Eye Capital provided Laura's Shoppe, a Canadian clothing retailer, with super-priority secured debtor-in-possession (DIP) financing when the company's previous senior lender forced a court-sanctioned restructuring process. To execute an operational turnaround, Laura's Shoppe needed a transitional debt facility from a lender who would not only support its plans but also help advocate it to various sceptical stakeholders.

Pemberton provides $70 million finance package to UK animation and visual effects firm

Pemberton provided Cinesite with $40 million for general funding and acquisition finance purposes. Pemberton was supported by Barclays Corporate Banking, which provided $4 million of revolving credit facilities. Together, Pemberton and Barclays agreed a further $26 million in future flexible facilities. Cinesite Studios, headquartered in London, UK, produces feature animation and visual effects for the film and television industries.

Permira invests in Italian clothing brand

Permira Credit Solutions III (PCS3) invested in the senior secured floating rate notes of TwinSet, a luxury Italian women's clothing brand. This was a primary transaction with PCS3 acting as lead arranger. The deal was originated through a strong relationship with the sponsor, The Carlyle Group.

Macquarie and MUFG Bank provide £150 million in financing for housing development

Macquarie and MUFG Bank provided a long-term debt facility of £150 million in the form of a three-year revolving credit facility (RCF) of £30 million, a 40 year senior secured private placement of £50 million that refinances the RCF, and a shelf facility of £100 million for Shepherds Bush Housing Association (SBHA). SBHA owns or manages over 5,000 homes that are largely social and affordable in London, UK.

UK community housing secures financing from M&G Investments

Watford Community Housing secured £65 million of financing from M&G, enabling the continued construction of 675 homes over the next three years in the UK. The 32-year financing secured by Watford Community Housing will facilitate its ambition of building 1,000 affordable homes by 2020, of which over 100 have been already completed.

Beechbrook Capital finances leading global executive search specialist

Beechbrook Capital's UK SME credit fund provided a unitranche loan to Leathwaite, a global human capital specialist with offices in London, New York, Hong Kong and Zurich. The investment will help Leathwaite to accelerate its worldwide expansion, launch new business streams and invest in proprietary technology.

Monroe Capital supports recapitalisation of USA brand implementation company

Monroe Capital LLC acted as lead arranger and administrative agent on the funding of a $25.5 million unitranche credit facility to support the growth and expansion of Atlas Sign Industries, Inc. (Atlas). Atlas is an international provider of brand implementation products and services.

LendInvest completes £16 million development deal in UK commuter town

LendInvest completed a £16 million financing deal with established development finance borrower, Yogo Group. The deal was completed in three weeks from initial introduction to site purchase. The development finance loan will fund the part-conversion and rebuilding of an historic building, as well as the construction of new units.

CVC Credit provides term loan to finance plastic recycler's growth

CVC Credit's U.S. Middle Market Private Debt business provided a first lien senior secured debt facility to CarbonLITE Industries, LLC. Founded in 2011, CarbonLITE specialises in processing used plastic bottles into bottle-grade resin flakes and pellets that can then be used to manufacture new plastic beverage bottles and other products. CarbonLITE operates a 220,000-square-foot bottle-to-bottle recycling plant that processes more than two billion plastic bottles annually. CarbonLITE is growing rapidly, and the new term loan will allow it to increase production capacity, refinance existing debt, and provide a more flexible capital structure. This will allow CarbonLITE to continue its mission to preserve natural resources, reduce greenhouse gases, and diminish landfill problems.

About ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 140 members that manage over $350bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 80 members that manage $500 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

About Dechert

Dechert is a global law firm with more than 900 lawyers in 29 locations worldwide. Over 200 lawyers are dedicated to funds and financial services and 250 lawyers focus on finance matters. The firm has expertise across all major asset classes, fund domiciles and structures and provides expertise at every stage of the investment lifecycle.

We were the first and are the leading major international law firm with a funds practice that spans the key European investment fund centres – Dublin, Frankfurt, London, Luxembourg, Munich and Paris – as well as throughout the U.S., Middle East and Asia. As a result, our lawyers are in a unique position to give jurisdictional-neutral and unbiased advice about the right structures for raising and deploying capital both in Europe and beyond, with strong attention to tax efficiency and market terms.

Dechert is one of the most active law firms in the sphere of debt fund formation, representing a range of debt fund sponsors from large platforms to boutique and emerging managers. The firm's internationally recognised finance practice provides complex financings and deal structuring. www.dechert.com

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AIMA
THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

Dechert LLP