IN INSIGHTS

SPONSORED BY: SS&C | ADVENT

MAY 2024

HEDGEWEEK

PRIVATE CREDIT: TRENDS, TECH AND FUTURE TRAJECTORY

EXPLORING OPPORTUNITIES AND OPERATIONS IN A GROWING ASSET CLASS

EXECUTIVE SUMMARY

The rapid expansion of private credit investing has been an unmissable theme on Wall Street since the pandemic. This Hedgeweek report, supported by SS&C Advent, explores the continuing growth of the alternative asset class: the opportunities for managers, the interest from allocators and the operational complexities to consider.

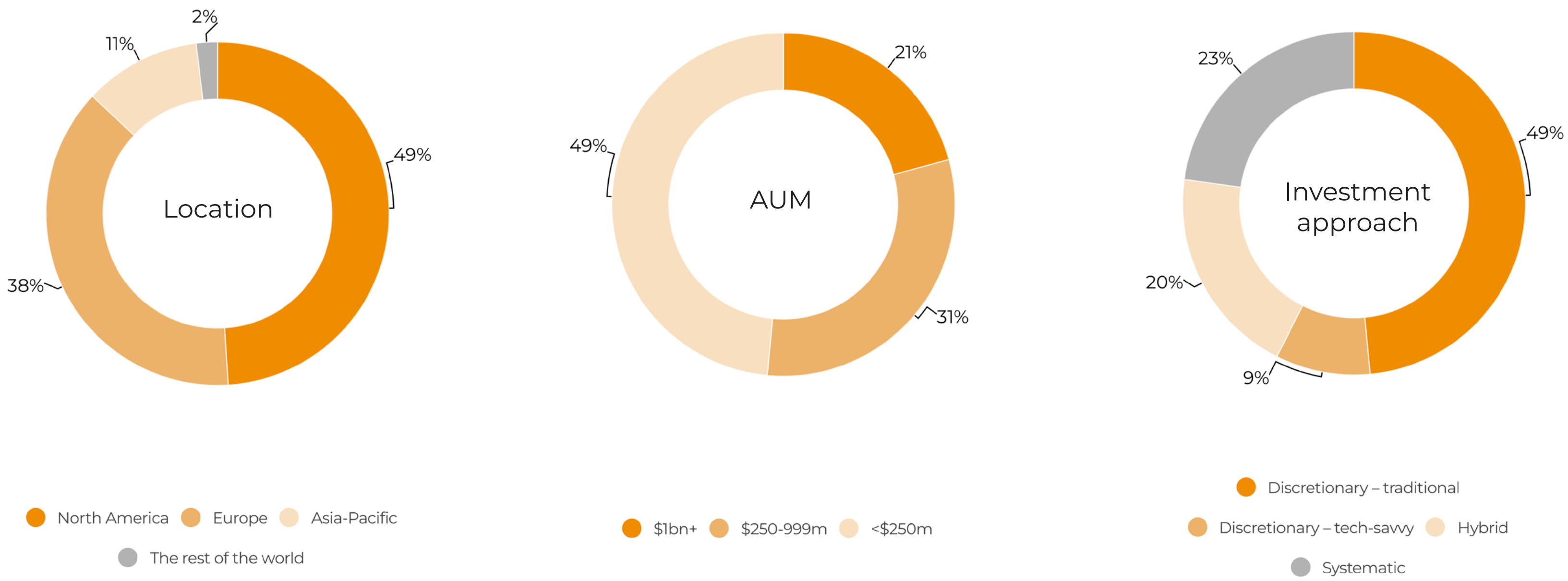
What next for this booming sector? Which middle and back-office questions should be foremost for practitioners in this area? This data-driven report will draw on expert contributions and survey responses to focus on private credit's growth and the key trends behind it in Part I; followed by a focus on operational questions and what the future holds in Part II.

A note on language: the terms private credit and private debt are often used interchangeably in the industry. For consistency, this report will reference private credit only. AuM data is derived from Preqin and sizes the sector at $1.6trn. Though the pace of growth may have slowed – after the sector's doubling in size since 2019 – most expect further expansion. This report aims to arm industry practitioners with informed insights and useful context to help them navigate this next phase of growth.

WILL WAINEWRIGHT
HEAD OF HEDGE FUND RESEARCH

CONTENTS

Breakdown of respondents to Hedgeweek's Q1 Hedge Fund Manager Survey by firm location, size, and approach:



METHODOLOGY

A key source of data in this report is the results of Hedgeweek's hedge fund manager survey conducted in Q1 2024. Further insights in this report were gathered during interviews in April and May 2024 with named and unnamed industry sources, and additional third-party research and intel.

KEY FINDINGS

1

Direct lending is hottest area of private credit

A survey by Preqin found that 67% of respondents said direct lending presented robust opportunities in November 2023, up from 40% in November 2019. Its dominance in Q1 was overwhelming, responsible for 77% of fundraising across all private credit sub-strategies. But many GPs rely on manual processes, which can be complex, spreadsheet-based and open to error...

2

... So getting your middle and back-office on point is vital

These loans come with huge quantities of data, which often have to be harvested from multiple hard-to-use PDFs. Trying to digitise that data for various purposes – middle-office reporting and back-office accounting and reporting – should be a big focus, says Aani Nerlekar, Senior Director, Solutions Management and Consulting at SS&C Advent.

3

Strong operations go hand in hand with the opportunity

Managers who can capitalise on the private credit opportunity from an investment strategy perspective and also meet the operational challenge will be best placed to prosper in the years ahead. Global trade group Aima and its Alternative Credit Council arm highlights "strong ongoing monitoring, proven in-house restructuring capabilities (especially with 2008 experience or similar) [and] independent third-party valuation" as priorities.

4

Biggest funds – and North American – eye tech changes

Hedgeweek's survey of industry has revealed that North American firms are more likely than those in other regions to be considering outsourcing more of their services, while the biggest firms are most likely to be reviewing their in-house technology. The findings point to the US and Canada as the key hub for the asset class, as well as the steep operational burden facing $5bn+ firms.

RISING TIDE

The private credit market's expansion has been one of the most eye-catching stories on Wall Street since the pandemic. This section explores the factors driving growth in the asset class.

The private credit market has boomed since the pandemic began in 2020. The advent of Covid-19 and its impact on global supply chains combined with the subsequent Russian invasion of Ukraine to usher in a new inflationary era, and with it one of the quickest increases in interest rates ever seen.

For a strategy that flourishes when interest rates are higher, the opportunity presented by new market conditions was obvious, and allocators quickly pushed private credit up their agenda. Managers took note, enhancing their offering with renewed business development, new products and an eye on M&A opportunities.

The private credit market entered this era with $819.8bn under management at the end of 2019, surpassed $1trn for the first time in 2020 and reached $1.65trn at the end of Q3 last year, according to Preqin – a doubling in less than four years (see Fig. 1.1).

US giant BlackRock, one of many American asset managers betting on the strategy's continued growth, describes private debt as "lending (largely to corporations and small businesses) done outside of the traditional channels of bank lending and the public (syndicated) debt markets."

Private credit opportunities opened up after the 2008 financial crisis, as banks dialled down their risk appetite and asset managers stepped in to new lending opportunities to earn a fresh return stream. But the pandemic turbo-charged growth.

Nicolas Roth, Head of Private Markets Advisory at Swiss manager UBP, highlights the impact of the pandemic. "Due to the sudden shutdown of the economy and the various subsequent closures, several businesses came out scathed, with depleted cash levels, unable to face current liabilities," he says.

"This fueled activity on the rescue finance side, and managers provided flexible capital solutions to borrowers, providing an essential lifeline to some companies. Thanks to agility in their operations, managers were able to play defense, supporting stressed businesses by waiving covenants and allowing amendments to terms to shift later to offense when deploying into new situations. It is highly probable that the pandemic was the stress test a number of investors have been waiting to make up their mind on the resilience of private credit and helped drive allocations higher."

That continues to be the case. Though rates were widely assumed to have peaked at the end of last year, new data and policy signals in Q1 indicate "higher-for-longer" might be back on the agenda.

"We do not believe private credit has peaked," adds Roth. "The structural tailwinds of the non-bank lending sector have not changed over the past few years, and it is unlikely that the regulator will change course anytime soon."

UBP describes the "big four" sub-strategies within private credit as mezzanine, real estate debt, distressed debt and direct lending. It is keen on private credit strategies that are

Fig. 1.1 Private credit market AuM

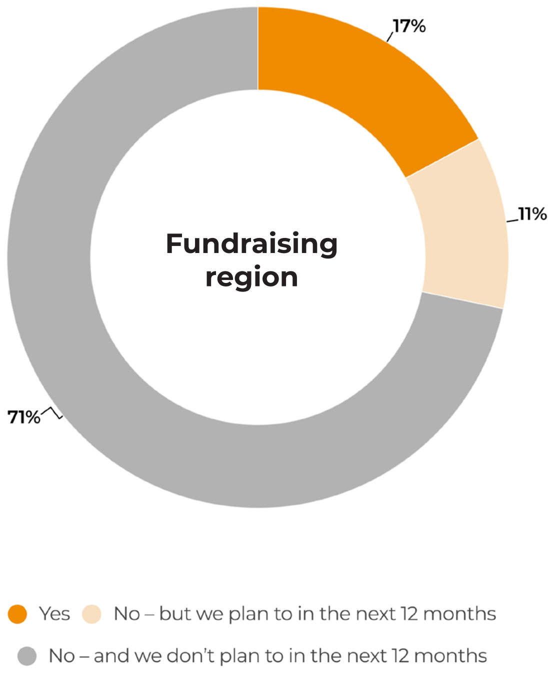
Source: Preqin. Year-end figures, except 2023 (end-Sept)

“

We do not believe private credit has peaked.

Nicolas Roth
Head of Private Markets Advisory, UBP

Fig. 1.2 Has your firm launched a private credit fund in the past 12 months?



Source: Hedgeweek Hedge Fund Manager Survey Q1 2024

not reliant on rates falling quickly; are less leveraged; and are not expected to face headwinds in the coming years. "From a risk reward point of view, probably less mainstream and more niche-like strategies are the most attractive now, as long as the structuring and covenants are not compromised," says Roth.

There continues to be a strong appetite among GPs to start new products (see Fig. 2.2). Almost a third of respondents said they either launched a private credit fund in the past 12 months (17%) or plan to (11%). New product launches and deal-making by the largest firms (see box out) are the key drivers of expansion on the manager side.

UBP's Roth advises that: "Managers new to this space must make sure they select a sub segment of the private debt space where competition is not too deep, otherwise winning deals will be extremely difficult without compromising terms. Making sure the origination pipeline is proprietary and hard to replicate is another key element to ensure the build-up of a robust strategy is not prone to cyclicality."

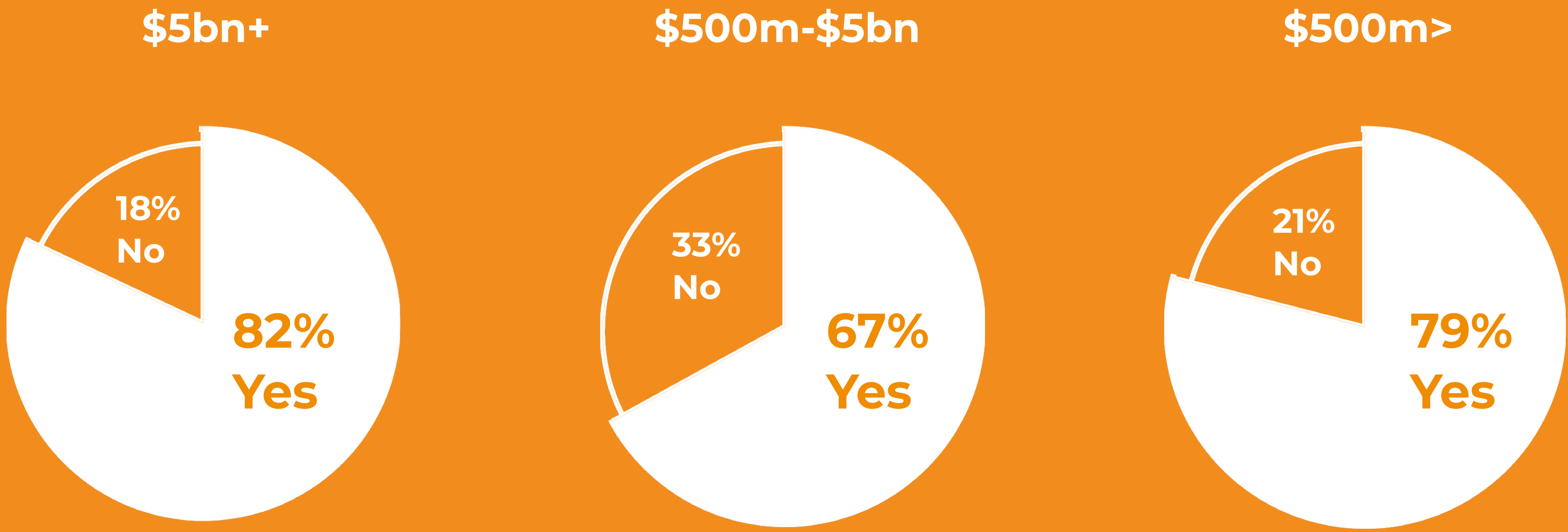
A big burden for the smaller asset managers, as opposed to the larger ones within the space, is sourcing; actually finding these borrowers, adds Brian Payne, Chief Strategist for Private Markets & Alternatives at BCA Research, a strategy firm working with LPs and GPs.

"For a small asset manager running a $400-500m, resources are limited and you can only loan so much when sourcing with a smaller

KEY FINDING

Biggest and smallest managers are most likely to be reviewing in-house technology

Is your firm actively reviewing its in-house technology?



Source: Hedgeweek manager survey

team. Bigger managers have an advantage in that regard," says Payne, previously an Investment Officer with the Teachers' Retirement System of Illinois, focused on alternatives.

There are many different processes and priorities to consider, which, combined, can boost governance, according to Aani Nerlekar, Senior Director, Solutions Management and Consulting at SS&C Advent.

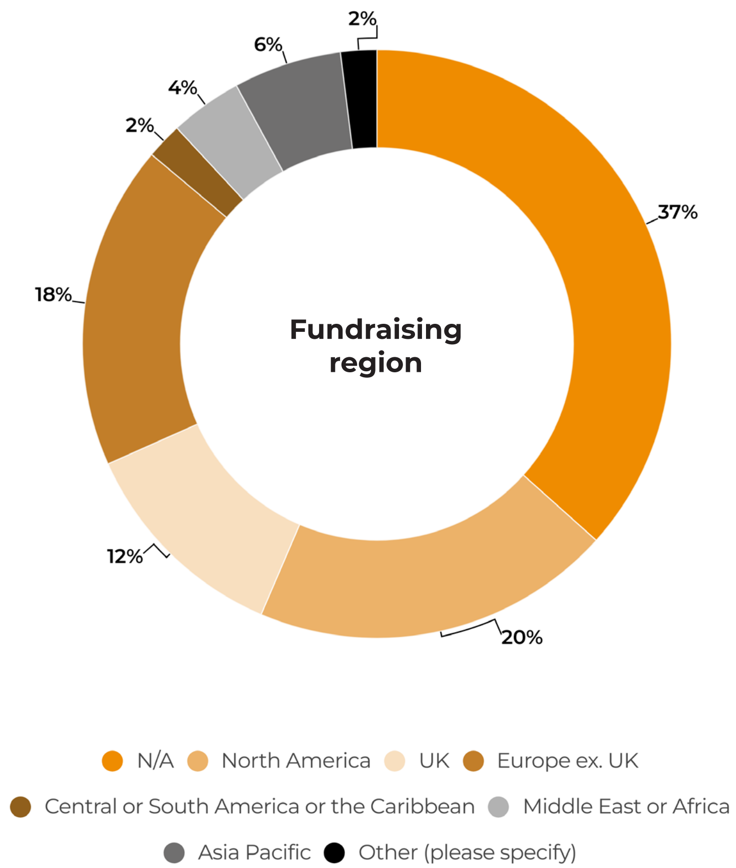
"Governance is at the heart of this operational process," he says. "These private loans are very complex, so hedge funds or private equity funds need to put in place complex fund structures to manage allocations to support these private loans."

The operational side of the equation, including top considerations facing managers, will be explored in greater detail in section two.

North America remains the top fundraising region for private credit (see Fig. 1.3). 20% highlight the US and Canada as their top target for new allocations, followed by continental Europe (18%) and UK (12%).

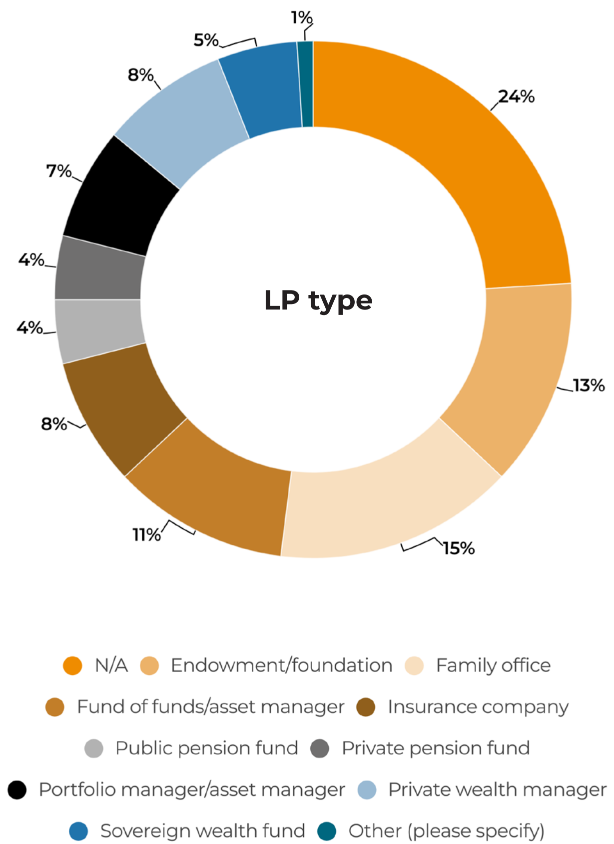
But it is a global story, with many regions and cities beyond traditional finance hubs looking to increase their footprint. Dubai Financial Market has launched a new platform to make it easier for local companies to access private credit, with Mubadala and Adia among many firms in the region growing their presence in the strategy. Payne highlights growing Middle-Eastern moves into the sector.

Fig. 1.3 From which regions have you raised capital for private credit in the past 12 months?



Source: Hedgeweek Manager Survey Q1 2024.

Fig. 1.4 From which allocator type have you raised capital for private credit in the past 12 months?



Source: Hedgeweek Manager Survey Q1 2024

> **"Being affiliated with a global bank and wealth manager can be a notable advantage.**

Family offices are currently the top target among GPs looking for new allocations, selected by 15%, followed by endowments and foundations on 13% (see Fig. 1.4). This reflects the shifting nature of the LP market in relation to alternatives.

High-net-worth individuals drove the expansion of hedge funds, private equity and other alts prior to the 2008 financial crisis, before pension funds became the dominant drivers of growth as the market institutionalised. Now there is a widely observed trend of pension allocations to alternatives – including private credit – levelling off, but inflows from private wealth channels, especially family offices, increasing, while the relative significance of endowments and foundations, particularly in the US, increases.

As with any sector which has seen rapid growth, there are risks on the horizon. A recent report by Bloomberg Intelligence (BI) highlighted that private credit lenders face margin pressure as rivalry from some US banks in the syndicated loan space intensifies, while Moody's Ratings has warned about an increasing number of problem loans. BI forecasts diminishing dividend growth prospects at private credit firms' business development companies amid slowing earnings expansion.

A recent FT headline declared "Big investors grow nervous about private credit boom" after fundraising levels began to dip from post-pandemic highs. Fundraising tracked by Preqin came to $30.6bn in Q1, having averaged $35.8bn since 2017.

UBS believes diversification into more niche areas of the private credit will be key to future growth. "Data is starting to show that the combination of... non-sponsor/smaller sponsor loans allows for higher pricing, lower leverage and more lender-friendly covenants," according to Baxter Wasson and Rodrigo Trelles, co-heads of the Swiss bank's O'Connor Capital Solutions.

"It is therefore possible for investors to diversify their private credit portfolios by incorporating such exposure; returns are typically uncorrelated with other credit holdings and exhibit diminished sensitivity to interest rate fluctuations." The access to sourcing networks this requires means "being affiliated with a global bank and wealth manager can be a notable advantage," UBS added. ■

Deals flow in private credit

As with any growth industry, both established and new entrants to the private credit market have been eyeing up deals to boost their position and capitalise on the expansion.

Man Group bought a controlling stake in New York-based Varagon Capital Partners last year. In recent interviews the world's largest listed hedge fund manager has signalled they are open to more private credit deal-making if they can find the right fit.

"We're open to acquiring businesses, adding teams or individuals," head of discretionary Eric Burl told Bloomberg. "If we think it's something where we can add value and it's relevant to clients, game on."

Man Group CEO Robyn Grew has separately observed that the asset management industry is ripe for consolidation against a backdrop of higher borrowing costs and falling valuations of some private assets.

Fidelity International and T Rowe Price are among several major US asset managers expanding their private credit footprint through deal-making and/or product launches. Canadian firm Brookfield Asset Management recently said it would invest about $1.5bn in US-based private credit manager Castlelake.

Burl said it was a "massive opportunity" over the next five years. Such sentiment indicates the deal-flow will not dry up any time soon.

EFFICIENT GROWTH

The market opportunity in private credit is clear – but complex middle and back-office requirements in the asset class mean a strong operational approach is imperative

Any asset class that has doubled in size in four years – and is expected to grow substantially from here – will come with risks attached. Potential clouds on the horizon from a market opportunity perspective were addressed in section one. Section two will focus more on seemingly less exciting but equally important operational matters.

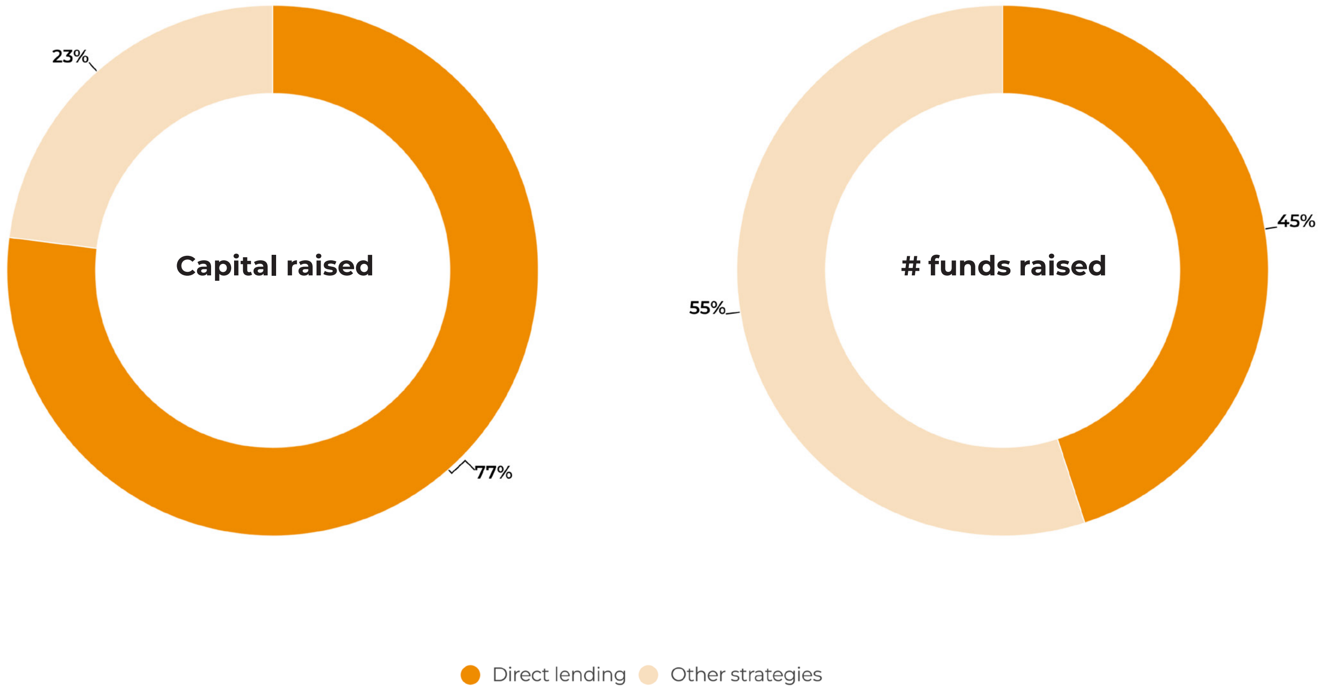
"Making no compromise on risk management and structure are obvious parameters to ensure long-term success," says Nicolas Roth, Head of Private Markets Advisory at UBP.

In practice this means a strong middle and back office, particularly in relation to handling the loans in an efficient manner. This is all the more imperative given that direct lending is currently the most popular sub-strategy of private credit, responsible for 77% of all fundraising in Q1, according to Preqin (see Fig. 2.1).

For more than three-quarters of the $30bn in private credit fundraising in Q1 to be direct lending demonstrates its current appeal to LPs, and underpins the fourth period of year-on-year growth in investor sentiment. Preqin's survey found that 67% of respondents said direct lending presented robust opportunities in November 2023, up from 40% in November 2019.

Its dominance in Q1 was more manifest in capital terms that individual fundraises: it closed 14 funds, compared to 17 in others, 55% of the total (led by special situations on five and mezzanine and venture debt on four apiece).

Fig. 2.1 Direct lending leads private credit popularity stakes in Q1



Source: Preqin

"We've been positive private credit for some time now, particularly on senior direct lending and mezzanine financing," says Brian Payne, Chief Strategist for Private Markets & Alternatives at BCA Research, who previously invested in alternatives for a US public pension.

But he sees a clear middle and back-office burden. "GPs need to get their operations and technology in line to handle the loans, particularly if they are new to the space," he says, even though it is "easier than other areas of private assets – like buyouts, for example."

A lot of systems in place and even under development at GPs rely on manual processes, which can be complex, spreadsheet-based and open to error given the quantity of data, often harvested from multiple hard-to-use PDFs.

Trying to digitise that data for various purposes – middle-office reporting and back-office accounting and reporting – should be a big focus, says Aani Nerlekar, Senior Director, Solutions Management and Consulting at SS&C Advent (see box out, page 19).

It is therefore unsurprising that outsourcing is on the rise. Almost a third (29%) of GPs are planning to outsource more of their functions and a further 16% are considering it (see Fig. 2.2). This propensity is strongest among larger firms, with 33% planning to and 22% considering it among $5bn-plus firms.

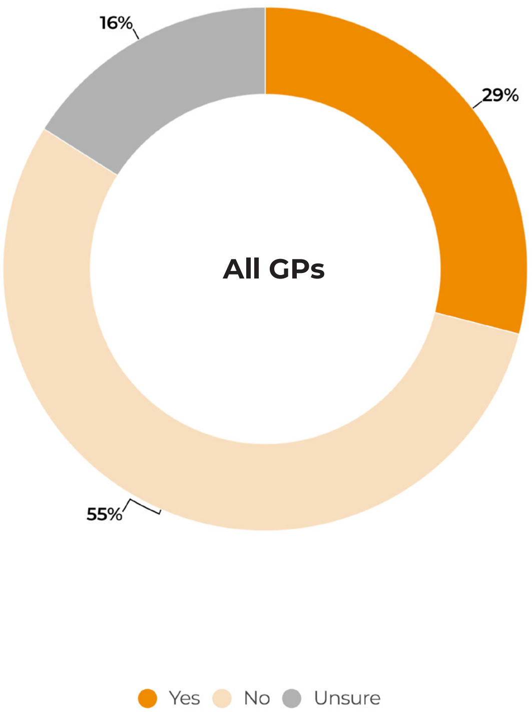
The proportion planning it drops from 33% to 25% among $500m-$5bn firms, but a much higher proportion – half – are considering it.

“

GPs need to get their operations and technology in line to handle the loans, particularly if they are new to the space.

Brian Payne
Chief Strategist for Private Markets & Alternatives at BCA Research

Fig. 2.2 Is your firm actively planning to outsource more of its business functions?



Source: Hedgeweek Manager Survey Q1 2024

Slightly more (30%) are planning to outsource more in the smallest size bracket but far fewer (11%) are considering it.

The propensity is also strongest among firms in North America compared to Europe and Asia (see key finding, page 17), which may relate to the region's position as the leading private credit hub.

Just a fifth of respondents say they are not reviewing their in-house technology (see Fig. 2.3). Opinion is roughly split across the front, middle and back-office, with about a quarter reviewing each.

Again, larger funds are more likely to. Almost a third (29%) of $5bn-plus firms are looking to outsource more of the back office and 26% the middle office, higher figures than for $500m-$5bn firms and $500m or less firms.

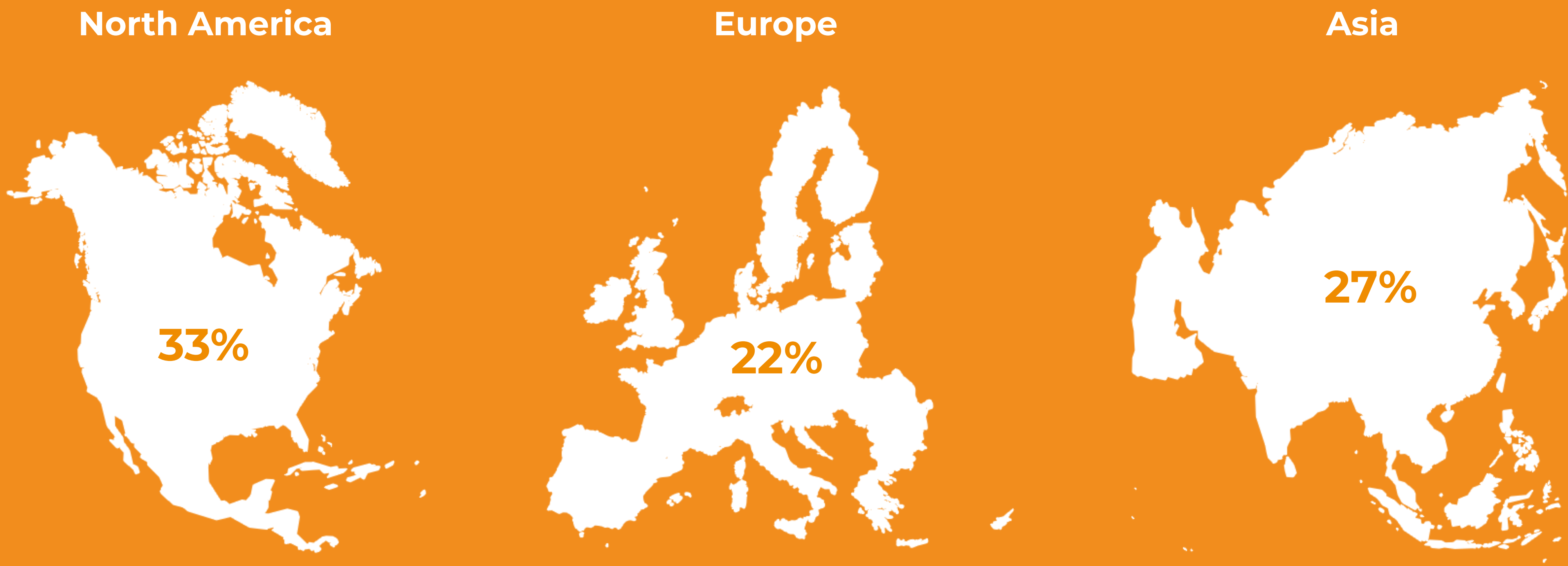
Expansion is widely seen as likely. Having doubled since 2019, according to Preqin (see section one), US asset manager BlackRock believes it could happen again, with a $3.5trn estimate of 2028 AuM revealed in a recent report.

Even Payne, who admits he has recently cooled on the space as more entrants come into private credit, retains an overweight weighting at BCA. "We are still overweight – it still looks pretty healthy, particularly in North America. But there are concerns around overcrowding as more entrants come into the space. The other reason we are cooling is an increase in recessionary challenges, which will favour entry into private equity.

KEY FINDING

North American firms are more likely to be considering outsourcing

Percentage of firms actively planning to outsourcing more of business functions?



Source: Hedgeweek manager survey

INSIGHTS

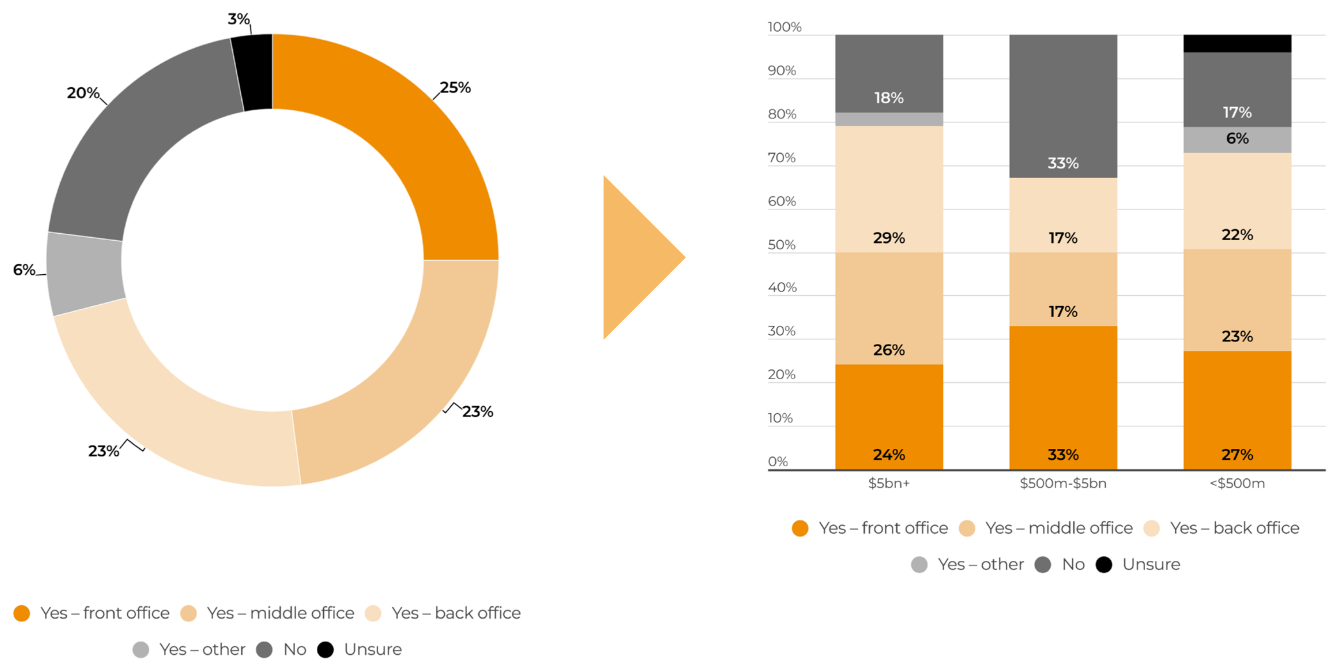
"We think longer term there are high single digit annual returns to be had in private credit, but see the illiquidity premium shrinking more because of the shrinking delta between regulations on banks and alternative credit providers."

The message from managers and others in the industry is that the sector is still maturing and practitioners should be alert to operational issues at every stage. The infrastructure to support the growth is still under development.

Global trade group Aima and its Alternative Credit Council arm, which represents a private credit membership, has identified the following as priorities: "Manager and loan-level transparency, strong ongoing monitoring, proven in-house restructuring capabilities (especially with 2008 experience or similar), independent third-party valuation, sustainability considerations, stress testing and contingency plans for a potential default cycle are paramount."

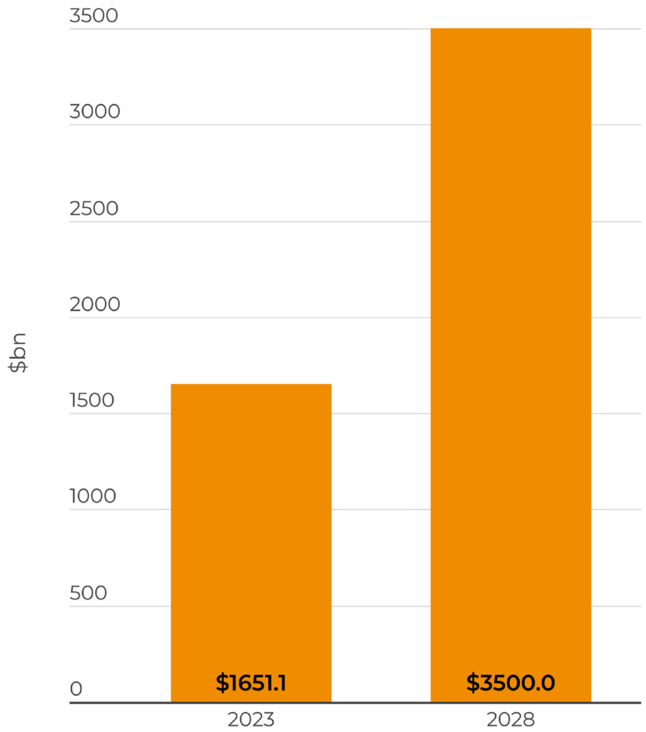
Managers who can capitalise on the private credit opportunity from an investment strategy perspective and also meet the operational challenge will be best placed to prosper in the years ahead. ■

Fig. 2.3 Is your firm actively reviewing its in-house technology?



Source: Hedgeweek Manager Survey Q1 2024

Fig. 2.4 Private credit market AuM - to double in 5 years time



Source: Preqin data, BlackRock estimate

AANI NERLEKAR

Senior Director, Solutions Management and Consulting at SS&C Advent

What operational and technological factors should be top of mind for managers in the private debt space?

A primary operational consideration is the ever-growing volume of loans, which tend to be managed manually via PDF. Trying to digitise that data for various purposes – middle-office reporting and back-office accounting and reporting – should be a big focus. The typical agent notices or credit facility agreements are created by loan agencies or agents, not your banks, so there isn't a standardised format for generating these PDFs. Firms need to use technology to easily digitise it and bring it all together.

So modernising that process with technology is also going to provide a lot of efficiencies, which is ultimately going to improve margins?

Yes. Imagine if somebody is reading a PDF and typing in data – there's a huge opportunity for user error. That's where technology will help improvements from an operational perspective. Investing in loans or private debt requires an efficient means of managing non-standardized loan data. With SS&C Loan Data, we can provide a loan market data solution for viewing, editing, and sending agent notice data directly into downstream systems for fast, straight-through processing and improved accounting accuracy. Modernising this manual process with technology and services will provide scalability to this operational process, ultimately leading to improved margins.

What has driven the recent expansion in private credit?

Recession fears have eased in the US and elsewhere. Interest rates have been elevated and people are trying to find alternative lenders. Since the pandemic, hedge funds and private market operators have been trying to develop new ways to get a better return for their investors. Starting to originate loans and writing their loans instead of buying loans in the market can help generate new alpha.

How do new entrants into the space compare in their approach to existing private debt operators?

Hedge funds are pretty sophisticated. However, for them, particularly smaller players, there is a high-cost burden in hiring the expertise, which outsourcing can ease. Many hedge funds are working with their front-end administrators or outsourcing providers to help them streamline this process. SS&C Geneva is the backbone of portfolio and investor accounting management within our fund administration offering, SS&C GlobeOp. The technology solution and fully outsourced service support all types of debt instruments and a full range of alternative asset classes, eliminating the need for multiple systems to account for different kinds of loans. Moreover, there is a lot of growth in terms of co-sourcing, where functions like digitising agent notices are left in the hands of a provider. Hedge funds are partnering with their administrators to evolve technology to support their funds' needs to manage this manual and complex asset class.

DRIVING GROWTH

Success levels in private credit over the next five years will be determined by two factors: opportunities and operations. Managers which can capitalise most effectively on opportunities presented in direct lending and other attractive areas, which continue to gain LP interest, will prosper. But that must be underpinned by a strong middle and back-office, and an awareness of how technology can drive efficiency and safeguard success.

Outsourcing and a continuous focus on latest practices in technology will be central to the latter. The opportunity is perhaps more straightforward. Private credit AuM has doubled in the past four years and firms such as BlackRock think it could double again between now and 2028. A renewed "higher for longer" rates outlook is supporting this opportunity set in the second quarter of 2024.

Alternatives continue to be in vogue as the 60/40 portfolio recedes in popularity. Private credit looks well placed to drive the next phase of growth.

HEDGEWEEK

CONTRIBUTORS:

Will Wainewright
Head of Hedge Fund Research
will.wainewright@globalfundmedia.com

Johnathan Glenn
Head of Design
johnathan.glenn@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Ince Saleem
Chief Revenue Officer
ince.saleem@globalfundmedia.com

Published by: Global Fund Media, Fox Court, 14 Gray's Inn Road, London, WC1X 8HN