# Private Debt Investor

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**EXTRA**
The key fundraising data from H1


## Why firms are puzzled over replacement benchmarks

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# Private Debt Investor

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# Insight

## Performance **Companies are coping well, even if they're not out of the woods yet**

In the early months of the pandemic, it would have taken a brave forecaster who predicted that default rates would be where they currently are, ***writes Andy Thomson***.

The most remarkable aspect of the latest Proskauer Private Credit Default Index for Q2 2021 is that – far from the Armageddon that might have been expected – companies are resisting distress even better than they do in what might be termed 'normal' times.

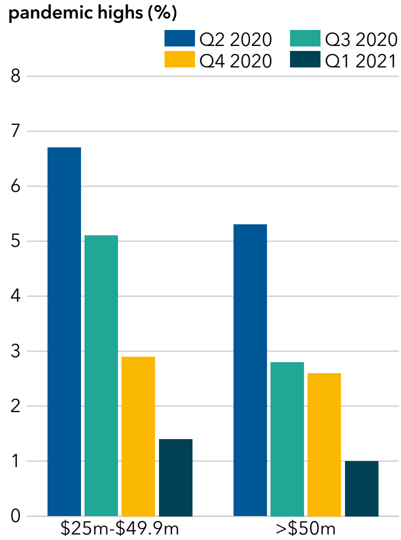
The average historical default rate is typically assumed to be somewhere around the 2 percent mark, whereas the index shows the latest rate for senior secured and unitranche loans standing at a very modest 1.3 percent. If there were fears of a default crisis, what has transpired is closer to the opposite – rarely has the figure been this low.

"Default rates have continued to decline as the economy re-opens," says Stephen Boyko, co-chair of Proskauer's corporate department and private credit group. "We are seeing plenty of liquidity in the market and our clients remain bullish about the health of their portfolios."

It seems clear, for now at least, that any imagined parallels with the global financial crisis can be dismissed. The pandemic has presented challenges to businesses, but nothing on the scale of the devastation seen in 2009.

Unsurprisingly, perhaps, the leaders of the world's private markets investment firms are defiantly ebullient. Over a year into a brutal health crisis that is still wreaking devastation in some parts of the world, just shy of 80 percent of respondents to our *Private Funds Leaders Survey 2021* said they felt either positive or very positive about their operating environment when compared with the previous 12 months, while 74 percent were equally optimistic when comparing their fortunes with those of the public markets. Meanwhile, a mere 5 percent of those running private markets funds believe ongoing covid-related uncertainty will have a significant effect in the near term.

**How defaults have come down from pandemic highs (%)**




Source: Proskauer

### Healthy picture

This healthy picture coincides with news that, in the UK, so-called 'bounceback' loans – a form of state-backed emergency government financing – appear to have returned many companies to the straight and narrow. The UK Office for Budget Responsibility predicted in December that as much as £19 billion (€22 billion; $26 billion) of taxpayer money might be lost through the scheme, but the latest estimate is around £5 billion.

Reflecting on the encouraging signs for bounceback loans, Simon Fry, a partner at boutique advisory firm ReSolve, cautions: "What will be key in telling us if the default rate will continue to stay low is how companies prepare for when the government support fully stops."

Memories can fade quickly, and the 8.1 percent default rate reached in the second quarter of last year already seems like a distant memory. Few will be expecting rates to climb that high again in the near future, but Fry's words are a useful reminder that no one really knows what lies around the corner.

> "We are seeing plenty of liquidity in the market and our clients remain bullish about the health of their portfolios"

Stephen Boyko
Proskauer

There has been a lot of talk in the market about how sponsors and lenders have worked together impressively to steer portfolio companies through the tough times. But as with covid, the first wave is not necessarily the last or biggest.

Therefore, no one should be assuming just yet that the bullet has been dodged. A study from corporate and fiduciary services firm Ocorian found that 47 percent of capital market investors with direct lending strategies were lacking confidence in their ability to manage loss recoveries, "which could have serious implications if default rates rise as pandemic-driven government support schemes are withdrawn". This was particularly true of European managers and those that had been around for less than 10 years.

Optimism in the current environment seems appropriate, though it should be of the cautious variety. ■

↑

*"Investment in less liquid and alternative assets can support good retirement outcomes for UK investors and we welcome the government's recognition of this in the prime minister's letter to the UK investment industry"*

***Jack Inglis**, chief executive of the Alternative Investment Management Association*

## Ups & downs

*"Akin to a Hitchcock plot, we do not know with certainty what the future holds as we look to manage life with virus variants and an increasing role of big government"*

*Taken from Dial M for Market, KKR's credit market review for the second quarter of 2021, authored by **Chris Sheldon**, the firm's partner and head of leveraged credit*

↓

## The big numbers

The difference between first and fourth quartile, an Australian pension steps up a gear and investors are happy with private debt performance

### $167m

The difference between first- and fourth-quartile performance in any given year for an average size fund, according to Cliffwater's study of US state pension performance

### 13.2x

Median enterprise value to EBITDA ratio for US buyouts in the fourth quarter of last year, according to Pitchbook

### A$15bn

Target private debt investment total for AustralianSuper over the next three years, representing a tripling of its current level of exposure

### €1.5bn

Close for Eurazeo's fifth direct lending vehicle focused on European SMEs

### $1.06bn

Total amount of private debt secondaries in the first half of this year according to Setter Capital, compared with $360m in the first half of 2020

### 80%

Of investors happy with how their private debt portfolio performed during the first half of this year, according to a study by the Alternative Investment Management Association

### 2/3

Of institutions planning to invest further in private credit to meet their target allocations, according to the Alternative Investment Management Association

# Trend watch **Ares writes record-breaking green loan**

Ares Management, the largest private debt manager in the world, has written a groundbreaking £1 billion ($1.4 billion; €1.2 billion) direct loan with a margin linked to ESG targets. This is the first time the firm has included ESG-linked terms in a direct loan, and it is the "largest private credit-backed sustainability linked financing to date", the firm says.

Funds managed by the firm's European direct lending platform are serving as sole lender on £1 billion of facilities to RSK Group, a UK-headquartered environmental and engineering business. The deal is notable both for its size – unusually large among direct lending deals – and for its sustainability angle.

The facilities include an annual margin review based on the achievement of sustainability targets, "which are broadly focused on carbon intensity reduction and continual improvement to health and safety management and ethics", the firm says.

### Carlyle flags buoyant CLO market

Lauren Basmadjian, Carlyle Group's co-head of liquid credit and head of US loans and structured credit, is expecting industry issuance of collateralised loan obligations to hit a record this year.

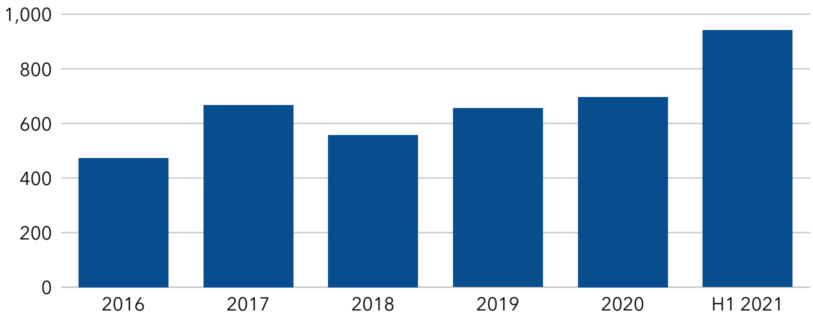
"It feels like we're in the beginning of a new credit cycle," Basmadjian tells *Private Debt Investor* after Carlyle reported that first-half fundraising for the firm surged nearly 50 percent on the same period a year ago. Basmadjian says CLO issuance for the entire industry has already set records in 2021, with Wall Street estimating it will hit $130 billion-$140 billion this year.

Carlyle reported that fee-related earnings in global credit surged 25 percent, to $46 million in the first half of the year, partly driven by increased management fees from strong CLO origination activity over the past 12 months.

### Fund size keeps growing

The size of the average private debt fund shot up in the first half of 2021 as a relatively low number of funds from large managers took the lion's share of capital. With numerous multibillion-dollar debt funds closed so far this year, the average size sits just below $1 billion. The covid-19 pandemic is thought to be leading more LPs to commit capital to large managers that they know well. ■

**Average private debt fund size is close to $1bn ($m)**




Source: PDI

## ALLOCATION • WATCH

### ■ Teachers' Retirement System of Louisiana

The pension has approved a $125 million commitment to Blackstone Tactical Opportunities IV, launched in Q1 2021 with a $4.5 billion target. The Tactical Opportunities series invests globally across a variety of sectors with the strategic focus on equity, debt and mezzanine investments in special situations.

### ■ Ohio Police & Fire Pension Fund

The pension has approved a $50 million commitment to CapitalSpring Investment Partners VI. CapitalSpring's sixth fund is seeking $750 million in commitments targeting the branded franchise restaurant sector in the US through credit tranching. The pension had previously committed to the fifth fund in the series.

### ■ Montana Board of Investments

MBOI has committed $125 million across two private debt vehicles, per its August 2020 investment board meeting documents. It comprises $75 million to GoldenTree Distressed IV and $50 million to Centerbridge Special Credit Partners IV. Both are re-ups.

### ■ Connecticut Retirement Plans and Trust Funds

The organisation confirmed $425 million-worth of commitments to private debt at its July 2021 investment advisory council meeting, a contact says. It comprised €150 million each to ICG Europe Fund VIII and Strategic Value Special Situations Fund V, and $125 million to BIG Real Estate Fund II. ■

# Financing **How lenders are adapting to today's favoured sectors**

Out of a crisis comes innovation, and one of the distinctive features of the pandemic from a business point of view has been a bifurcation between sectors that have flourished and those that have struggled, ***writes Andy Thomson***.

Businesses in the healthcare, software and technology sectors have found themselves favoured perhaps more than any others. However, private debt managers wanting to support these types of companies have faced a challenge. Many lenders, especially those of a more generalist persuasion, have become used to financing businesses with long track records and strong profits.

Many of the best performing companies today may well lack both. Their main priority has been growth, and many have flat or negative earnings before interest, taxes, depreciation and amortisation.

Yet no one should assume that this makes them unbackable. "They may not be typical leveraged buyout candidates, but these businesses can still represent a very good credit risk as they have a lot of other positive characteristics," says Xenia Sarri, a managing director in the capital advisory group at investment bank Lincoln International.

In recognition of this, many more lenders are now considering lending against recurring revenues rather than EBITDA. This is not exactly a new phenomenon, having been an option in the US for around a decade.

**4-10%**

**Senior loan default rate in the wider market over the past six quarters**

> "These businesses can still represent a very good credit risk as they have a lot of other positive characteristics"
>
> Xenia Sarri
> Lincoln International

What is striking is how much more popular it has become. Sarri says Lincoln had typically been involved in four to five recurring revenue financings in the software sector each year but, over the past 12 months, the figure rose to 20.

A greater proportion of deals are happening in Europe, where they have only taken root over the past few years, and estimates put the number of lenders prepared to do such financings at around 75, compared with approximately 40 a year ago.

## Misconceptions

One of the misconceptions around this type of financing is that, by eschewing traditional metrics, it must be inherently riskier.

But, according to Sarri, the recurring revenue deals Lincoln has seen have typically involved loan-to-value ratios of around 20 percent, compared with 50 percent in the wider leveraged loan market, and debt multiples of around 2x annual recurring revenue.

While senior loan defaults have been in the range of 4-10 percent for the wider market over the past six quarters, in the software sector the range was 0.4 to 3.5 percent. Recoveries in default also tend to be stronger due to the likely presence of valuable intellectual property and significant equity cushions.

Given these attractive characteristics, it is not surprising that many lenders are taking a closer look. In the fast-changing environment of the past 12 months, 'sticking to the knitting' has seemed a less viable approach.

The dislocation opportunity in the early months of last year was an example of fund managers needing to be adaptable and quick off the mark. Those qualities are still required to take advantage of today's opportunities. "There's more liquidity than ever before and a lot of innovation around financing structures," says Sarri. ■

# Secondaries **In conversation with Dechert's Michael Wong**

**Q Private credit secondaries seems to be maturing – is that your impression too?**

That's certainly what we've been seeing and consistent with a notable uptick in the secondary mandates we've been instructed on.

We've seen the private credit secondaries market grow significantly over the past 24 months in three areas: an overall increase in the number and size of secondary transaction mandates; a general increase in the number and size of specialised secondary funds that have come on to the market; and an increase in the prevalence of GP-led secondary transactions as a percentage of overall secondary deal volume in the market. The increase in GP-led secondary transactions has resulted in more diverse and complex secondary deal structures, which is dictated by the bespoke commercial objectives of the GP and the existing LP.

**Q What was your role in the Ping An/Coller secondaries deal? How long did it take and what were the notable features?**

Dechert acted for Ping An as fund counsel and as seller counsel on the transaction. The legal component of the transaction was completed within approximately four months with the commercial processes and discussions occurring two months prior to commencement of legal documentation. The transaction sees the sale of interests in Ping An's credit fund of funds to Coller and another institutional investor.

The transaction is notable for being the largest private credit secondaries transaction at the

> "The increase in GP-led secondary transactions has resulted in more diverse and complex secondary deal structures"

time of completion, with a highly diversified portfolio covering 400 positions in over 250 companies, and spreading across a range of industries, such as professional services, healthcare and telecommunications.

**Q Would you expect Asia-based institutions to make increasing use of secondaries?**

Yes, we would expect to see increasing use of the secondaries market as the large volume of private equity funds and private credit funds that have been set up over the past years begin to mature.

**Q What are the key considerations, including potential pitfalls, for parties on either side of a secondaries deal?**

Key considerations include tax, disclosure rights to buyers and anti-money laundering. Buyers and sellers should conduct an in-depth tax analysis on the underlying funds' tax position and commercially agree on the payment of any tax or potential tax liabilities at the outset. In addition, if the buyer is a fund of funds or has other investors backing the transaction, the parties will need to map out the disclosure rights with the underlying credit fund managers. AML is also an issue and should be addressed early to avoid any last-minute hiccups – particularly in a transaction involving multiple underlying funds.

**Q What's your impression of the current state of the private debt market in Asia?**

I think it is growing substantially. Our experience is, given the economic environment which has been greatly affected by covid, many smaller private businesses are tapping into private funds (including hedge funds and traditional private equity funds) for capital, by way of debt, for short-term funding for their businesses and operations as bank loans are not always available.

During the past year, we've seen clients frequently investing in private debt issued by businesses in real estate, hotel and leisure and aircraft leasing, and we have been part of those. We expect this to continue and businesses will increasingly tap private funds as a funding source as they are less regulated and much more flexible with their offering. ■

Michael Wong is a partner at law firm Dechert in Hong Kong

## Editor's letter

# What will come after LIBOR?

Andy Thomson
andy.t@peimedia.com

As the deadline to replace the LIBOR benchmark for financial instruments including loans creeps ever closer, so too does the urgency with which banks and fund managers must make their preparations. In the UK, where there appears to be consensus on a suitable replacement, this looks relatively straightforward. But in the US, where there are a host of possible replacements, the picture is much more confusing.

In this month's cover story, starting on p. 10, Robin Blumenthal speaks to leading banking sources, lawyers, consultants and others about the competing merits and potential pitfalls of the different benchmarks. With vast portfolios of loan-related contracts waiting to be tweaked, finding a solution that works for everyone is a huge but vitally important task – and one that, as we discover, does not come without challenges.

**“Finding a solution that works for everyone is a huge but vitally important task”**

Also in the issue, we reflect on the fundraising data from the first half of this year and find there are few signs yet of a revival (p. 32). Investors are still being hampered by travel restrictions brought in due to the pandemic, meaning the capital they allocate tends to go to trusted managers. This ‘flight to safety’ is also reflected in their strategic choices, with senior debt notably increasing its share of the pie.

We also lift the lid on developments in the Canadian and Nordic private debt markets (see p. 24 and p. 26, respectively), examine growth prospects in venture debt (p. 22) and include guest features exploring the new asset holding company regime in the UK (p. 28) and things to consider when providing financing at the pre-EBITDA stage (p. 30).

**Andy Thomson**

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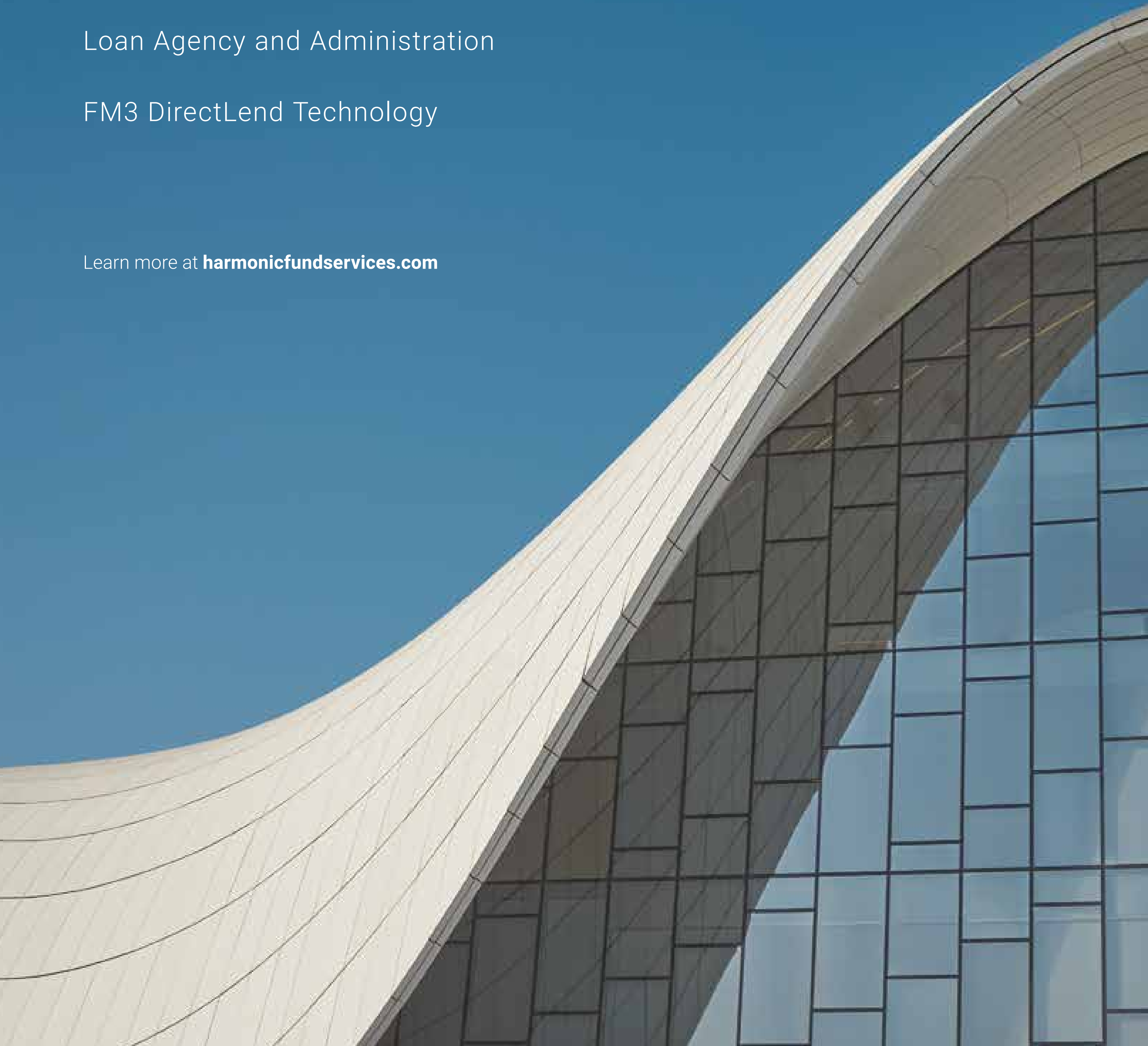


Private Debt Investor
Why firms are puzzled over replacement benchmarks

Cover story


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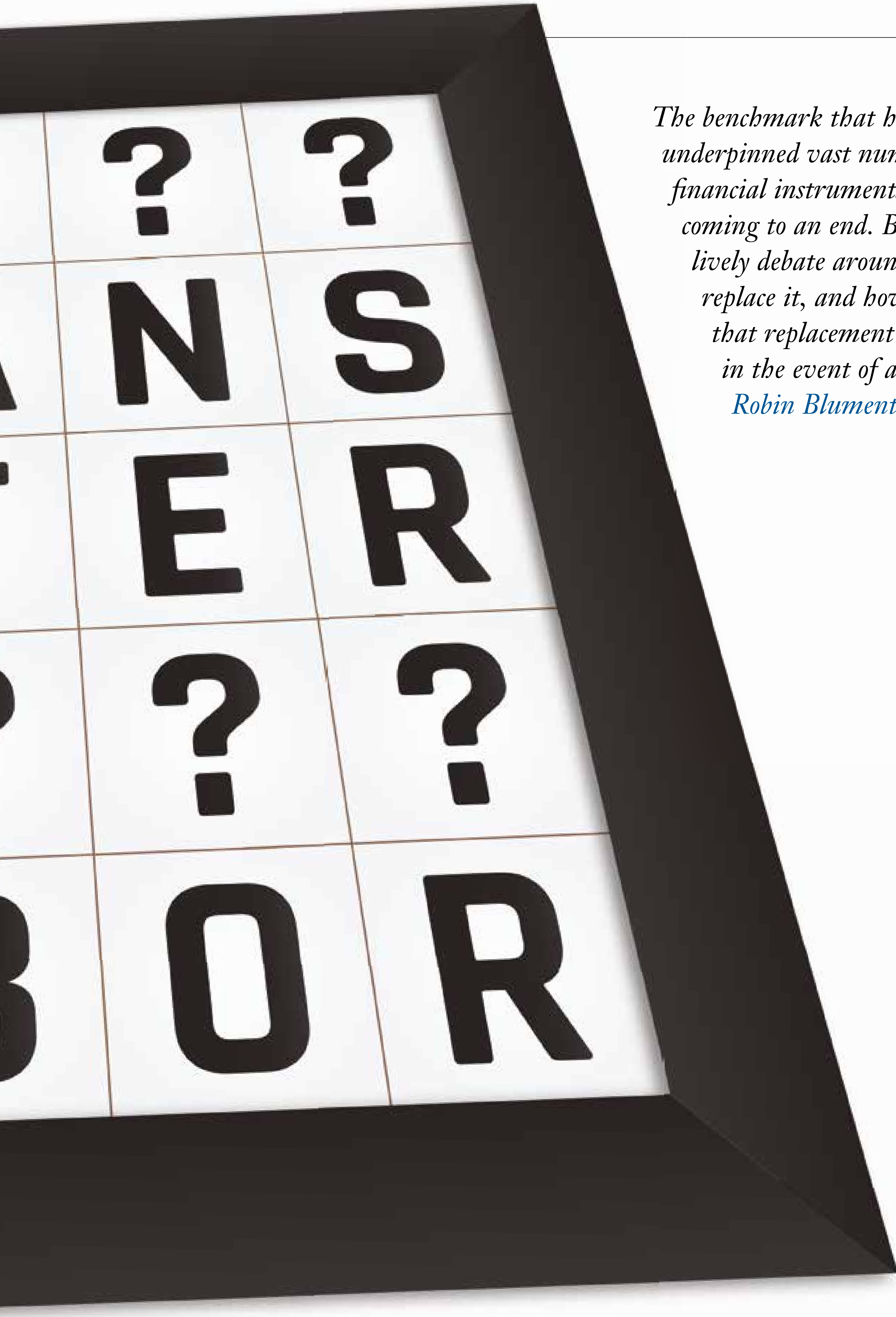



*The benchmark that has underpinned vast numbers of financial instruments globally is coming to an end. But there is a lively debate around what will replace it, and how suitable that replacement will be in the event of a crisis. Robin Blumenthal reports*

Call it the battle of the benchmarks. As much as US authorities have been eager to persuade the financial markets to adopt the Secured Overnight Financing Rate, or SOFR – the benchmark they have slated to replace dollar-based LIBOR when it is phased out for new contracts at the end of the year – it seems plenty of market participants are not buying into it.

There is a lot riding on a smooth transition. The London Interbank Offered Rate underpins hundreds of trillions of dollars of financial instruments – predominantly derivatives – and includes an estimated $6 trillion of commercial loans. Not exactly small potatoes.

Consulting firm Oliver Wyman has estimated that a typical US bank today has 20-25 percent of its balance sheet in LIBOR. When commercial real estate and mortgages are included in the overall tally, the consultant concludes that there are nearly $10 trillion of LIBOR-referenced loans outstanding in the US.

But LIBOR, an unsecured interest rate benchmark that is published daily, is refusing to go quietly, at least in the US commercial lending market. "So far, the rate that is going away is winning," said an Oliver Wyman presentation on the transition this summer. And that is because SOFR and LIBOR are not interchangeable.

"There's no question that SOFR is a more transparent and more liquid underlying market than LIBOR," says J Paul Forrester, a partner in law firm Mayer Brown's Chicago office. "The problem is that it's not comparable to LIBOR because it doesn't reflect many lenders' funding costs and is less credit-sensitive."

LIBOR, which came into existence in the late 1960s, is based on a poll of a small number of global banks. It is calculated daily by averaging what those lenders say they would pay overnight to borrow from each other, not what they actually paid. That has left it vulnerable to manipulation.

After a scandal involving collusion by some high-profile institutions came to light in 2012, regulators in the UK decided to hand over its administration to the Intercontinental Exchange Benchmark Administration from the clubbier British Banking Association, and to replace LIBOR with something more transparent.

SOFR, which the Federal Reserve Bank of New York began publishing in April 2018, is a broad measure of the overnight cost of borrowing cash that is collateralised by US Treasuries in the so-called repo market.

The secured rate is based on approximately $1 trillion of daily transactions between a diverse set of borrowers and lenders.

"One of the concerns with LIBOR was that $1 billion of transactions in the London market was dictating the rate on hundreds of trillions of dollars of transactions," says Roger Chari, a partner at Duane Morris who heads the law firm's LIBOR transition team.

**SONIA's the one**

In the UK, new contracts and loans based on LIBOR are well on the way to being replaced by the Sterling Overnight Index Average, or SONIA, which is based on actual trades in the UK overnight unsecured lending and borrowing market. The British benchmark is administered by the Bank of England, which publishes the rate every business day.

But the changeover has not been nearly as smooth in the US. The Alternative Reference Rates Committee, an industry panel charged by the Federal Reserve Bank of New York with leading the transition, is strongly

*"The risk is that the market's going to freeze up and lenders aren't going to want to be lending at the very time you need them to"*

**HARRIS SIMMONS**
**Zions Bancorporation**

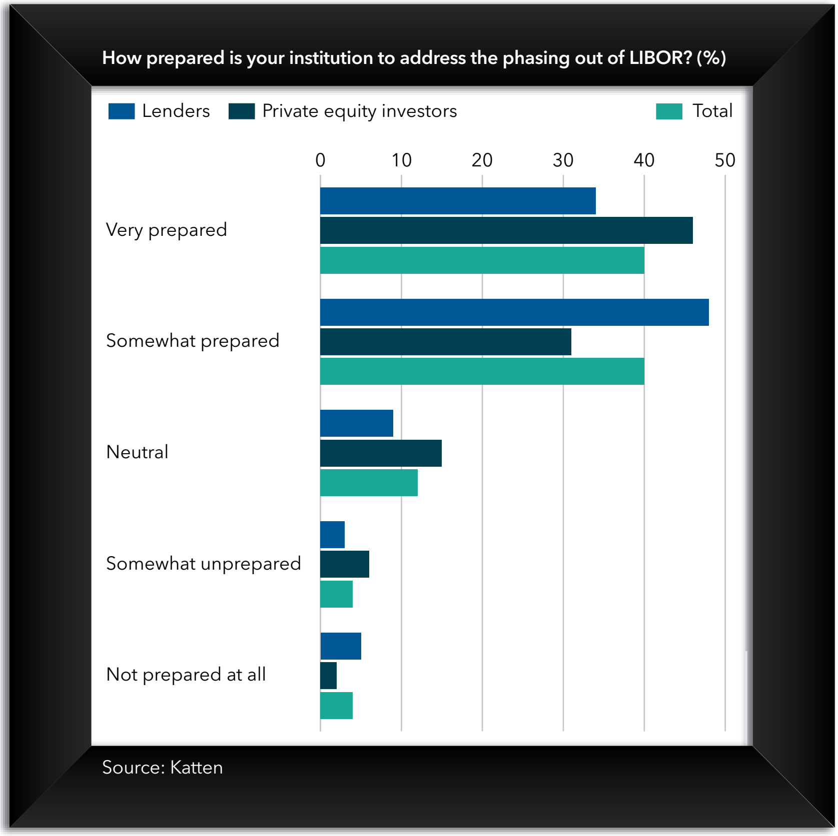
advocating for SOFR. The rates committee "is trying to do a rate for all seasons", says Adam Schneider, a partner in Oliver Wyman's financial services practice who also sits on the panel, known as the ARRC. "There was a rate for all seasons, LIBOR. Replacing it with a new rate that has different characteristics is daunting."

The main problem is that SOFR is a risk-free rate because it is based on overnight borrowing backed by US Treasuries, while LIBOR is sensitive to credit conditions. This means that if there is a market event and SOFR is the prevailing rate, the rate banks charge for loans will be likely to fall – since SOFR is risk-free and essentially a safe harbour – while their cost of funds will rise.

This is likely to lead customers to draw down their credit lines and could cause a serious mismatch between the cost of loans and the cost of bank borrowing in the market. As rates fall, borrowing from banks rises, even as it becomes more expensive and difficult for lenders to get funding.

"This is how markets behaved in past crises, and banks are wondering how to protect themselves if they lend with SOFR," says Schneider. All the stimulus that was injected into the system because of the pandemic, among other things, helped to push rates on 10-year Treasury inflation-protected securities to a record low of minus 1.132 percent at the end of July.

"It's perplexing to me that regulators would be endorsing SOFR as a reference rate for commercial lending," says Harris Simmons, chairman and chief executive of Zions Bancorporation, a Utah-based lender with more than $80 billion of total assets. In times of stress, when credit spreads are widening and market participants are "piling into Treasuries and repo rates are coming down, it seems to me that you set the stage for the equivalent of driving down the freeway the wrong way during a crisis".



Source: Katten

Moreover, if a risk-free rate such as SOFR predominates during a crisis, "the risk is that the market's going to freeze up and lenders aren't going to want to be lending at the very time you need them to", says Simmons.

Zions Bancorporation began adopting Ameribor, a credit-sensitive rate that is published on the American Financial Exchange, this summer as a substitute for LIBOR. The lender now has a number of clients with this reference rate incorporated into their loan agreements.

With LIBOR, both loans and bank funding costs move the same way during stress, creating more equilibrium. But with SOFR, the cost of money goes up and the price of loans goes down. According to Schneider: "Changing this dynamic will either mean not using SOFR – and there is pressure to use other rates – or restructuring lending products to provide banks with more protection," with fees or significant rate floors on loans.

Many banks are moving towards more recently developed credit-sensitive rates as an alternative to LIBOR. The CSRs include Ameribor; Bloomberg's Short Term Credit Sensitive Index, known as BSBY; and credit-inclusive term rates and spreads, known as CRITR and CRITS, that are published by IHS Markit. In addition, ICE is testing a dollar-based credit-sensitive rate.

## Banks hesitant

Unsurprisingly, just a few months away from the deadline to stop using LIBOR for new instruments, many banks are still hesitant to make the transition to SOFR. "A lot of people are trying to figure out what everybody else is doing," says Matt Hays, a partner in law firm Dechert's global financial practice who leads the firm's

LIBOR transition taskforce. "Nobody wants to be the first mover."

The lack of consensus on a preferred alternative is slowing down the transition.

Although there is an imminent need to move lending to new rates, "little lending is being done on any new rate", according to Oliver Wyman. Fund prospectuses are cautioning that the uncertainty surrounding a LIBOR replacement could create more volatility. One big issuer of collateralised loan obligations tells *Private Debt Investor* that as recently as this summer, leveraged loans were still being priced using LIBOR.

"The market still hasn't seen a SOFR syndicated loan," says Chari of Duane Morris.

That is partly because the ARRC took so long to endorse a forward-looking term rate for SOFR, which is crucial to remove uncertainty about rate changes for the large number of commercial and consumer loans with floating rates. Although there are seven different tenors for LIBOR, and much of the leveraged lending market uses term rates, SOFR was largely limited to an overnight rate until this summer.

The ARRC originally said it would recommend a term SOFR rate by mid-2021, but then reversed itself. It finally endorsed a term SOFR rate published by the Chicago Mercantile Exchange, the derivatives market operator, in late July. However, Oliver Wyman says that there will not be an ability to hedge term SOFR until at least 2023. Meanwhile, all the credit-sensitive benchmarks have term options.

Jim Aronoff, a managing director in the restructuring and dispute resolution practice of accounting firm CohnReznick, says that many of his clients believe LIBOR was not broken in the first place. "As bizarre as it sounds, a comment I hear very frequently is,

*"We expect a real dogfight between term SOFR and various alternative rates this fall"*

**ADAM SCHNEIDER**
**Oliver Wyman**

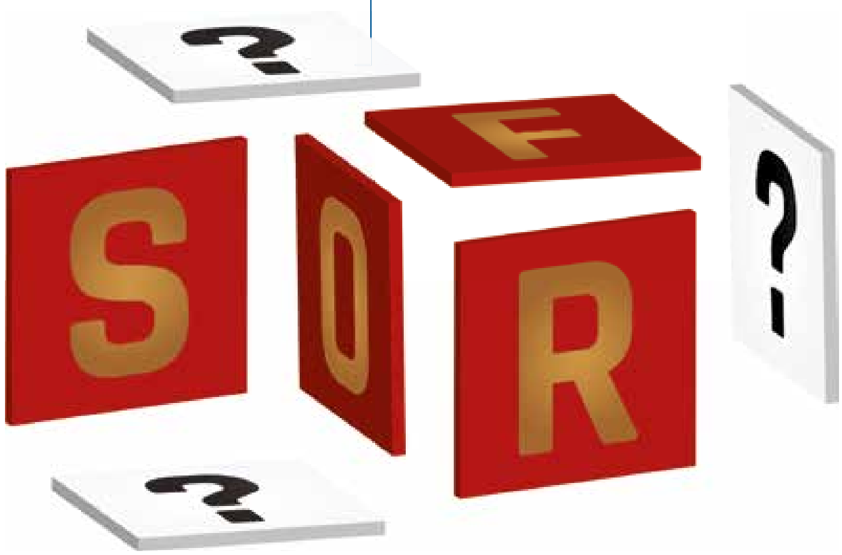
'I understand allegations of market manipulation led to concerns about LIBOR, but now that such concerns have been alleviated, can't better controls simply be installed?'"

Although the US Federal Reserve supports the use of SOFR, chairman Jerome Powell has testified before Congress that the ARRC's recommendations and the use of SOFR are voluntary, and that market participants should transition away from LIBOR "in the manner that is most appropriate given their specific circumstances".

Nevertheless, Treasury Secretary Janet Yellen at a meeting of financial regulators in June urged bankers and other market participants to avoid alternative rates that she said are not robust enough to underpin many other financial products. At the same meeting, the Fed's vice-chairman, Randal Quarles, who has strongly advocated for the use of SOFR, said "LIBOR is over".

### SOFR 'robust'

In a speech in June, Quarles said SOFR "rests on one of the deepest and most liquid markets in the world and is therefore likely to remain available even when other financial markets are disrupted". According to the



New York Fed's website, "during acute market stress in March 2020, SOFR volumes remained robust – while activity in term unsecured markets further dried up".

At roughly $1 trillion, daily SOFR trading in the repo market dwarfs the volume in both the overnight and term credit-sensitive rates. But the repo market relies heavily on trading by just a handful of banks, according to the Bank for International Settlements. By contrast, the American Financial Exchange, where Ameribor is traded, represents about 25 percent of US banks in terms of both assets and by number.

So far, there is "limited" activity in SOFR futures and derivatives, says Mark Cabana, head of US rates strategy at Bank of America. Cabana believes "there's enough trading activity" underlying the credit-sensitive rates to inform their indices.

He expresses concerns about how credit will be priced off SOFR versus an index that has credit risk. Cabana says that although the Fed has not said so explicitly, he thinks the central bank believes there is an advantage to having a rate it can easily control, and that the banking sector would be safer using a risk-free rate.

"The Fed from day one has hated the fact that a major international rate is being set by markets over which they have no control," says Mayer Brown's Forrester. "It does affect their ability to implement monetary policy." With SOFR, because the Fed can intervene in the US repo market through its open-market operations, the US central bank "can push rates around any way they want".

The Fed in late July launched a standing repo facility to provide liquidity to big Wall Street banks and other central banks to help stabilise markets experiencing stress.

Under the facility, primary dealers could exchange Treasury and other debt with the central bank for overnight cash

## A financial force of nature

**Richard Sandor came up with an answer to LIBOR. Other ideas are in the pipeline.**

Richard Sandor, the mastermind of Ameribor, a credit-sensitive alternative to LIBOR, along with the American Financial Exchange, the trading platform that helps set the new benchmark, has spent much of his career revolutionising the landscape for financial products.

It all began some 50 years ago, when Sandor, who was on sabbatical from the University of California, Berkeley, became the chief economist and vice-president of the Chicago Board of Trade. There he invented several interest-rate futures contracts and became known as the "father of financial futures".

The American Financial Exchange, or AFX, is Sandor's latest brainchild. He launched the platform for interbank lending and borrowing in 2015. It helps set Ameribor, which he created as "the anti-LIBOR".

Soon after the LIBOR scandals emerged in 2012, Sandor realised that the structure of the British benchmark was flawed and he began working on a substitute. In an interview with the Kellogg School at Northwestern University, Sandor said that "as with interest-rate futures, everybody thought a new [benchmark] was unnecessary".

He set to work to prove them wrong. "We did this highly remarkable thing – we asked the customer what he wanted," Sandor says wryly. Over the course of the past 10 years, he and his team have visited 125 cities across the US, from Tupelo, Mississippi, to Green Bay, Wisconsin, to speak to bankers at community, regional and minority-owned banks to inform them of the creation of Ameribor and the AFX.

From that intelligence gathering, Sandor says, "things crystallised and we realised intuitively that we could help match institutions in high-growth areas with those in low-growth areas of the country and create a truly national market".

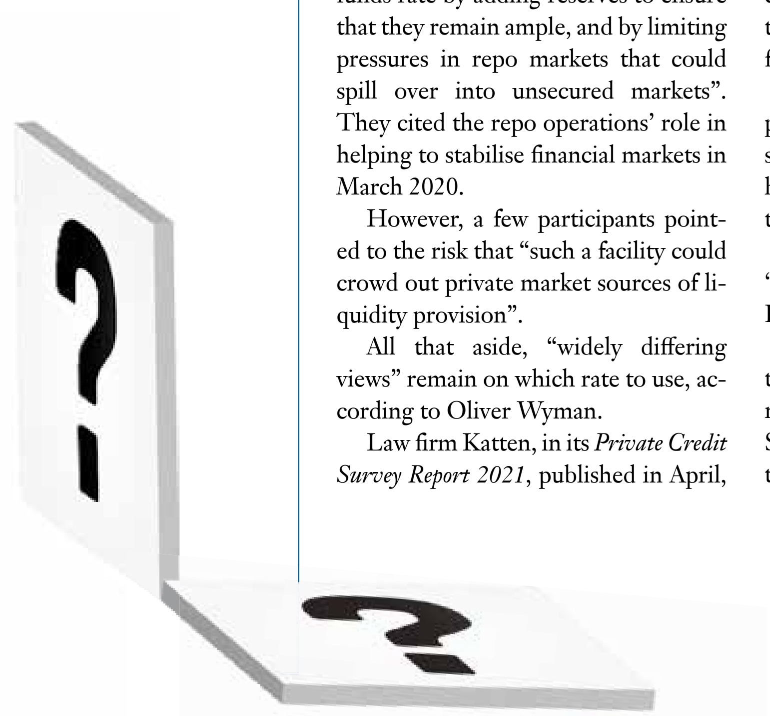
Efforts have paid off. AFX represents a full 25 percent of US banks with assets of $5.3 trillion. "We opened up the capital markets and democratised them so that minority-owned, regional and mid-sized and community banks would have access to liquidity that the large banks had, through a peer-to-peer fintech exchange," Sandor says.

Ameribor has the imprimatur of no less a personage than US Federal Reserve chairman Jerome Powell. He testified to a congressional committee that Ameribor "is a fully appropriate rate for banks that fund themselves through the American Financial Exchange or for other similar institutions for whom Ameribor fully reflects their cost of funding". He noted the benchmark "may not be a natural fit for many market participants".

Sandor shows no sign of slowing down. At a webinar the AFX hosted this summer, he said: "We're working on a real whopper… that involves trillions of dollars." Sandor tells *Private Debt Investor* that he is broadly looking into some sort of investment instrument, possibly related to a subset of banks on the AFX. Plus, he is "making a thrust into sustainability in banking". We'll be sure to stay tuned.

*"The problem is that [SOFR] is not comparable to LIBOR because it doesn't reflect many lenders' funding costs and is less credit-sensitive"*

**J PAUL FORRESTER**
**Mayer Brown**



**The LIBOR commercial lending market***

| USD LIBOR lending footprint | Approximate outstanding ($bn) | % LIBOR | Low ($bn) | High ($bn) |
|---|---|---|---|---|
| Syndicated loans** | 3,400 | 97 | 3,298 | 3,298 |
| Corporate business loans** | 1,650 | 30-50 | 495 | 825 |
| Non-corporate business loans | 1,252 | 30-50 | 375 | 626 |
| CRE/commercial mortgages | 3,583 | 30-50 | 1,075 | 1,792 |
| **Total** | **9,885** | | **5,244** | **6,541** |

*estimate based on industry and Federal Reserve surveys plus Oliver Wyman analysis
**some overlap exists between estimates of syndicated and corporate business loans
Source: Oliver Wyman

loans at a rate of 0.25 percent. The Fed, which set a $500 billion daily cap on the facility, first intervened in the repo market in September 2019, when "overnight money market rates spiked and exhibited significant volatility, amid a large drop in reserves due to the corporate tax date and increases in net Treasury issuance", according to the Fed's website.

In a briefing to the Federal Open Market Committee at its April meeting, recorded in its minutes, Fed staff noted that repo operations "have been a useful tool in controlling the federal funds rate by adding reserves to ensure that they remain ample, and by limiting pressures in repo markets that could spill over into unsecured markets". They cited the repo operations' role in helping to stabilise financial markets in March 2020.

However, a few participants pointed to the risk that "such a facility could crowd out private market sources of liquidity provision".

All that aside, "widely differing views" remain on which rate to use, according to Oliver Wyman.

Law firm Katten, in its *Private Credit Survey Report 2021*, published in April, said that a majority of the lenders and private equity sponsors polled admitted they were not very prepared for the LIBOR transition. All the replacement language in existing documents must be changed, at a significant cost of time and money, although in the US market participants generally have until mid-2023 to replace existing LIBOR contracts with another rate.

To prevent a flood of lawsuits, New York state enacted a law last spring to designate SOFR as a fallback in LIBOR legacy contracts that either do not have one or where counterparties cannot agree. And there is a move in the US Congress to reference some form of SOFR as a fallback.

But with the end of the year fast approaching, the majority of borrowers surveyed by Oliver Wyman say they have not yet even been approached by their banks to discuss available options.

"The trillion-dollar question is, 'What are people going to do?'" says Dechert's Hays.

"We expect a real dogfight between term SOFR and various alternative rates this fall," says Oliver Wyman's Schneider. It is unclear if and when there will be a winner. ■

KEYNOTE INTERVIEW

# Trust, collaboration and diversification: The three pillars of strong investor partnerships

*CIFC's Steve Vaccaro reflects on building a global credit platform that meets investors' needs irrespective of market conditions*

SPONSOR
**CIFC**

**Q CIFC has recently reached its 15-year anniversary and crossed $30 billion in assets under management. How do you reflect on those landmarks?**

As we've grown and crossed these landmarks there's some commonality around what has driven our success: nurturing a strong culture and having our people aligned with that culture. Achieving these milestones is not a one-person exercise – it's truly a team effort that requires everybody to be behind the stated goals that we're seeking to achieve. Further, self-assessment is critical, and you must be willing to be flexible and make changes. As we grow, we are continuously re-examining whether our processes and procedures continue to support our growth efforts or whether any part of them hinders our ability to scale and diversify the platform.

We have demonstrated that size does not necessarily diminish performance. That was a main consideration as we began to extend our platform. Being able to maintain performance not only in the face of growth but across market cycles has been a key contributor to our success. I'm also immensely proud of our people without whom none of our success would be possible. We've achieved quite a bit and there's much more to come over the next few years.

**Q You have diversified into numerous different strategies. How have you gone about that and are there are other areas under consideration?**

This is a question I get asked periodically by investors. Our approach to diversification has always been to remain true to our core competencies in corporate credit, and as we've grown, we have built on leveraging our individual product expertise that we've brought in-house across various strategies. CIFC is not a firm where we create silos. Our culture is collaborative and encourages teamwork among different disciplines, allowing each strategy team to gain value and information from one another.

Collateralised loan obligations have always been an important part of our business and make up the largest portion of our assets. We also manage total return loan and bond funds, long/short credit, structured credit, opportunistic credit and, more recently, multi-asset credit. We expanded our operations footprint into Europe and offer these customised client solutions globally. Our structures include commingled funds, UCITS and separately managed accounts. We provide different risk and liquidity profiles for our investors to suit their needs.

Looking ahead, we're always evaluating ways to expand into new areas and one particular focus is direct lending, which we view as highly complementary to our liquid credit businesses. We are in active conversations with multiple parties about the prospect of combining with CIFC and it is highly probable we will do so in the near term.

**Q How do you ensure you're maintaining the right culture as the business expands and diversifies into new areas?**

That's a critical question and at the core of our planning as we contemplate continued expansion. We moved into Europe and had employees geographically separated from the New York headquarters. Maintaining our culture and teamwork is absolutely first and foremost in our hiring practices and how we approach growth initiatives. We want people who want to be here and want to share our vision both in terms of how we run this firm and our goals of creating a best-in-class global alternative credit platform.

For us, that entails working together and having a 'firm first' attitude. Our different product teams don't sit in isolation from one another, they all sit together on one trading desk and there's a constant dialogue around risk and markets. It's about leveraging off one another, and working as a close-knit team, which is fundamental to our philosophy of how we want to continue to expand the business.

**Q With different strategies under one roof, how do you seek to ensure they complement each other?**

We believe in the fundamental premise that investors don't want to change managers when they want to reallocate within credit. A primary reason for this is trust, which is at the centre of our partnerships with our investors. Additionally, there is a significant time commitment that investors must make in order to evaluate managers, which makes it difficult for them to bring in a new manager every time the opportunity shifts in the marketplace. Therefore, we view a multi-strategy platform as an advantage, as it allows us to offer investors different risk and liquidity profiles and gives them the ability to stay invested on our platform and allocate between strategies when it's deemed necessary or appropriate. Having a large investor solutions team allows us to support all of our strategies globally.

On the investment side, we have cross collaboration across strategies, with expertise in one strategy providing information and support to others. In my opinion, the most important point about having multiple strategies under one roof is that it allows us to make better decisions. In difficult times, the more products you manage, the more information you have, and the more information you have, the better decisions you can make. There is always a relative value opportunity somewhere that can be exploited to the benefit of investors, which becomes easier to identify and execute with a large and diversified platform.

**Q Clearly, DE&I and ESG are vitally important areas for asset managers to consider. What are your thoughts on this, from a CIFC perspective and from what you observe in the wider market?**

For us, ESG is at the core of everything we do. It's how we invest and govern the firm. We have long recognised that ESG is an important consideration and good business practice. Our expansion into Europe, where ESG has been at the forefront for many years, reinforced this view. We are a signatory to the UN PRI and incorporate ESG into our underwriting and investment processes. DE&I is equally at the forefront for us, having a formal DE&I committee that's responsible for ensuring an inclusive workplace and upholding our core values. We've had these processes in place for some time; it's not new for us. I believe reflection and actionable feedback has allowed us to become a better firm.

Nonetheless, we recognise there has been a lack of industry co-ordination around these issues and we want to have a part in changing that. This past year, we established the CLO Initiative for Change, a philanthropic programme associated with our CLO issuance that is dedicated to supporting organisations that are striving for social, economic and environmental change. With our deal partners, we came together and made a collective donation of $145,000 to Black Girls CODE.

It is our intention to replicate this type of donation at least annually. More importantly, firms across the market are starting to address these issues as well, which was our hope. We strive to be a leader in the space and appreciate the recognition we have received from our peers, who've expressed a strong desire to replicate these efforts with similar initiatives.

We will continue to evaluate and evolve our practices around ESG and DE&I to ensure that they meet best-in-class standards.

### Q How did CIFC navigate the market uncertainty of the last year and what role did the government play in supporting credit markets and the economy?

I'm very pleased with how our funds have performed through this period, demonstrating CIFC's capacity to do well during an economic downturn. What we did was a basic blocking and tackling exercise of re-underwriting every name in our portfolio and trying to assess what each company's liquidity profile and access to capital might be. Based on this, we ranked the companies on their ability to succeed through the pandemic and tried to mitigate as much risk as possible. It was quite a herculean exercise that took several weeks to work through, and we were very active in the markets, buying and selling names, repositioning our portfolio to reduce risk.

I would say government assistance was absolutely critical in getting everyone through this unique period. It gave markets confidence and enabled them to remain open and function properly. It also allowed access to liquidity that was beyond what most people anticipated. Companies were able to gain access to sufficient capital to support them through the most difficult period and liquidity was the result of government policies being very accommodative at a critical point in time.

### Q What's investor appetite like today and how do you go about serving investors effectively?

As investors search for yield, it is apparent the traditional 60/40 model is broken. How do you find yield and acceptable risk that doesn't have high correlation? For us, being able to offer a platform with multiple avenues of accessing credit allows us to engage investors in solutions-orientated conversations. The CLO market is very much in favour and a lot of that has to do with how it has consistently performed through periods of stress over the last couple of decades. While sometimes there can be negativity around credit, I don't think many people envisioned how robust these structures are in terms of the protection they provide, the non-mark to market nature, the diversification, and the excess spread.

The CLO investor base really began to evolve and expand from niche to mainstream following the great financial crisis. The product itself has also become mainstream with banks and insurance companies at the top of the capital structure. It's become an attractive asset class for family offices and other alternative investors that are looking for yield. Overall, the investor base has shifted significantly from a trading to a 'buy and hold' philosophy.

> *"One particular focus is direct lending, which we view as highly complementary to our liquid credit businesses"*

During the pandemic, we observed that if you understood the fundamentals, you could get exposure at very attractive prices. The market has since quickly returned to pre-pandemic levels of health. Demand in 2021 has been fuelled by this challenging environment we find ourselves in, and the fact that returns from CLOs are really quite attractive. I don't see this fading and I think we're going to have strong demand right through to year end.

### Q What do you predict for the credit markets in general in the period ahead?

The economy continues to be strong as we work through the reopening. However, we still face the impact of the pandemic globally and resulting growth concerns. We have an internal debate on a daily basis about inflation – whether it's transitory or not and how much growth will slow once we get past the reopening. Taking a step back to look at the broader picture, we believe credit is fundamentally sound.

Our view is that over the coming period we're likely to see more price risk than credit risk. The default forecasts coming out of the banks and the various rating agencies have been tracking lower down and frankly tracking the actual results that we've been seeing. We're going to have volatility. However, I do not necessarily think we're going to have a material spike in credit risk. I believe credit is in good shape with robust liquidity, low interest rates and continuous cashflow generation. ■

Steve Vaccaro is chief executive officer and chief investment officer of CIFC Asset Management, a global credit specialist

# Raising awareness for venture debt growth

*Venture debt is a relatively unknown asset class, but recent rapid expansion signals a bright future. By John Bakie*

Venture debt is a small but growing part of the private debt landscape looking to fund small but high-growth companies to help them reach their next stage of development.

In the equity world, the role of venture capital is well established, providing funding for companies ranging from start-ups to those that are profitable and delivering risky but potentially lucrative returns to investors.

In the debt world, entrepreneurs are still getting to grips with the new array of financing options now being offered by alternative lenders. Despite this, recent research shows that use of debt among early-stage firms is remarkably high.

US venture lender Runway Growth Capital surveyed entrepreneurs on their experiences with venture debt as part of its *Venture Debt Review 2020* and found that more than 80 percent have used the product to fund their business. Furthermore, a majority said they feel venture debt has become more attractive in the past 12 months.

The amount of venture debt being issued has grown steadily too, with $25 billion of transactions in the US in 2019 according to data from PitchBook, against $135 billion of venture capital activity in total.

## Acceptance gains momentum

David Spreng, chairman, chief executive officer and chief investment officer of Runway, says: "We're seeing a continuation of a long progression to accepting venture debt and the pandemic has accelerated that process. We increasingly see mainstream business publications taking an interest in venture debt. We've also seen institutions such as the European Investment Bank say that debt is an important part of the venture ecosystem."

However, not everyone in the venture debt market is convinced that its profile is high enough.

Marc Helwani, founder and chief investment officer of specialist venture lender i80 Group, says he is doubtful that a majority of entrepreneurs have used venture debt.

"That said, things are getting better. Four years ago, no one had heard about us. When we speak to the largest VCs in the market, they're often amazed to hear this kind of product exists and want to know more about how to integrate it into their portfolio companies."

Helwani says venture debt is well understood by most VCs today, but often looked at as simply a supplement to equity funding rounds, which can prevent the asset class from reaching its full potential within the sector. "Entrepreneurs and VCs aren't looking at the big idea behind venture debt, which is that you can retain more ownership by raising it."

i80 specialises in offering venture debt to companies operating in financial services, providing them with debt capital to fund their activities via perpetual credit facilities. For example, it backs Canadian real estate specialist Properly, which buys and sells residential property. Instead of raising expensive equity finance to invest in new properties, Properly's facility with i80 allows it to borrow capital to fund property purchases more cost-effectively.

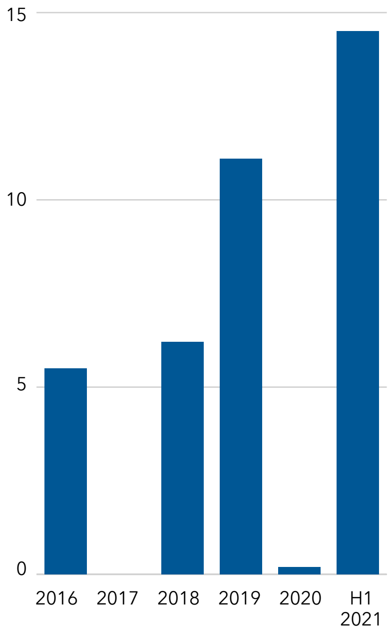
Runway's Spreng agrees that today the entrepreneur and VC community still has a poor understanding of how debt can fit into their business model: "There are still a lot of misunderstandings and misconceptions about debt. A lot of people still think debt is a bad thing to have on their books and others are using it more as a way to feel comfortable with their finances rather than to drive their business forward."

Ron Daniel, co-founder and chief executive officer of Tel Aviv-based venture lender Liquidity Capital, says entrepreneurs typically take debt with the closing of an equity round from a bank. "Today most venture debt is being issued in round B to round C and is mostly used to make the company feel more secure, using this money to feel better about the state of their capital," he explains. "But we think venture debt should be used for growth because if you spend $1 million to generate $3 million of revenue then that's an efficient use of the capital."

## Missing milestones

In Runway's survey of entrepreneurs, it found only a small number believe avoiding the dilution of an equity raise was the major benefit of using venture debt to fund their business. Instead, confirming Daniel's claim above, most feel venture debt is a way to extend company capital to reach an important milestone, or as a reserve of capital when unable to raise equity.

**The first half of this year saw record fundraising for venture debt ($bn)**




Source: PDI

Runway's report goes on to add: "While most founders claim to be comfortable using venture debt, they often do not understand when, how and why it should be used. Many see debt as a backup option when equity capital is unavailable, rather than a complement to their capitalisation strategy. Furthermore, there is a perception among entrepreneurs that venture debt is akin to taking a mortgage on your home, unaware it is lending against enterprise value, not assets."

> *"We're seeing a continuation of a long progression to accepting venture debt and the pandemic has accelerated that process"*
>
> **DAVID SPRENG**
> **Runway Growth Capital**

According to the survey, 81 percent of entrepreneurs expect there will be equity dilution of their business associated with missing milestones over the next 12 months, raising concerns about the cost of equity that could provide impetus for entrepreneurs to seek out cheaper solutions such as venture debt.

For venture debt fund managers, raising awareness of the asset class and how it can be used to benefit high-growth companies is a key priority in taking venture debt to the next level of development.

"Educating the VC funds is the best way to get the message out there," says Spreng, adding that engaging with the major legal advisers that serve the VC community is also important to raising awareness.

Helwani agrees that improving knowledge of the product among VCs is the best way to raise broader awareness among entrepreneurs. "What we're trying to do is spend as much time as we can with VC firms, we're in touch with around 100 VCs each quarter. If the market has a greater awareness of venture debt and what it can do then growth will become more organic."

Educational outreach is also important to bring more capital into venture debt funds from LPs. "We need to get the LP community to understand what we do. They're in search of yield and we can show that we can produce higher returns than conventional debt but with relatively low risks," adds Helwani.

Venture debt has seen huge development of its potential in recent years, rising from a relatively low base to having a value equivalent to almost 20 percent of the venture capital universe as a whole. However, the feeling in the industry is that there is still significant room for growth as both VCs and entrepreneurs like the product but need to develop more experience in using it as an effective way to prevent dilution of equity and help turbocharge a start-up's growth. ■

# Fund managers start to make inroads into Canada

*The country may be a relatively small private debt market, but the pandemic has been a game-changer in terms of its development. By Michael Haley*

For a long time, a handful of domestic banks have dominated the private debt market in Canada. But that is slowly starting to change. Fund managers, both local and foreign, want a bigger piece of the pie and are beefing up their presence in the country.

As private debt continues to surge worldwide, the market in Canada is still relatively small. Last year, Canadian private debt managers raised $3.52 billion, a mere fraction of the $122.3 billion raised by their US counterparts, according to *Private Debt Investor* data. Nevertheless, the figures have been growing rapidly in recent years.

"Private debt has become an asset class on its own," says Elaad Keren, senior managing director and head of mid-market private debt at SLC Management, the asset manager of life insurance giant Sun Life Financial. "People want to diversify their funding services and private debt is a good way to do that."

He notes that private investors' portfolios are more customisable now, and points to greater acceptance of private debt in Canada than in the past.

### Filling the void

"There's a lot more interest in the space, especially the Canadian space," Keren says. His firm manages more than $31 billion in private credit assets, according to its *2020 Sustainable Investing Report*, and deploys debt globally from its base in Canada.

> *"For a long time, there was a negative connotation of private credit having lots of fees but that is not the case anymore"*
>
> **JEFFREY DEACON**
> **Private Debt Partners**

Although banks have dominated the lending market, many have been pulling back from it lately, which benefits the private firms. In an article for the *AIMA Journal*, entitled 'Private credit through the pandemic and beyond' Belle Kaura, the chair of Alternative Investment Management Association Canada and chief compliance officer of alternative capital firm Third Eye Capital, writes of how "re-trenchment of banks is a global theme. Banks are getting more conservative. This creates a void that private lenders can fill as businesses adapt and rebuild in the aftermath of covid". Kaura also notes the emergence of secondary market opportunities as banks cut supply and offload non-performing credit: "This is a pivotal inflection point for Canada."

"Even though Canada is a smaller market than the US, we are still seeing the same trend that private debt is increasing," says Jérôme Marquis, managing director and head of corporate credit at Caisse de dépôt et placement du Québec, one of the country's largest pension plans.

Marquis says CDPQ's global allocation to private credit has more than doubled in the past four years to C$35 billion ($27.9 billion; €23.7 billion). "Competition is rising and it is definitely an area we expect will continue to grow," Marquis says of the market. "Another thing is that all companies want certainty of execution, which is one of many reasons why the private debt space is booming in Canada."

"I absolutely see [private debt] as a growth area, especially in Canada," says Claire Van Wyk-Allan, managing director and head of Canada for AIMA. "Just in the last year and a half we've seen many individuals branch off from firms to launch their own management firms, resulting in an increased number of fund managers."

The market's perception of private lenders in Canada is changing. "For a long time, there was a negative connotation of private credit having lots of fees, but that is not the case anymore," says Jeffrey Deacon, co-founder and managing partner of Private Debt Partners, a Montreal- and Toronto-based firm. PDP focuses exclusively on Canadian mid-market companies and deploys long-term, senior secured loans. This makes it stand apart from other Canadian firms with a global lending focus.

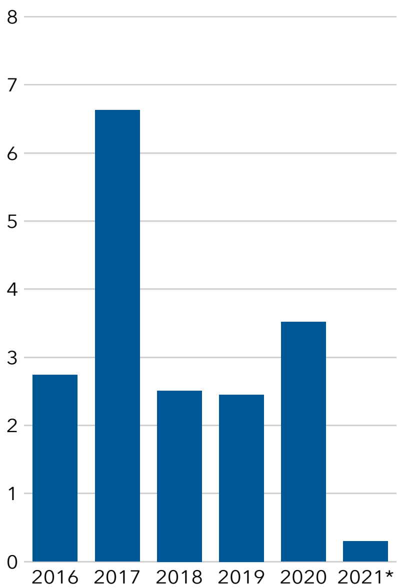
"There is still a long way to go but there has been a gradual shift in the industry," Deacon says, amid a recognition that private lenders give borrowers an option.

Private debt offers other features that banks cannot, notes Marquis: "We can provide additional flexibility around maturity, leverage and structure.

"CDPQ can also participate alongside a company's growth trajectory not only through private debt but also with equity instruments."

In the past few years, the pension has grown its private debt allocation at a similar pace to CPP Investments, the asset manager of the Canada Pension

**Ups and downs of Canadian private debt fundraising ($bn)**




*Year to date
Source: Private Debt Investor

Plan Investment Board and the country's largest retirement fund.

But private debt managers in Canada are not only competing with banks. According to the Canadian edition of the Alternative Credit Council's *Guide to Private Credit*, they often partner with banks on deals to better service clients when banks cannot lend anymore, whether because of deal size or because of the need for a faster turnaround on transactions than banks can offer.

Private lenders and banks partnering on transactions is one of the key factors fuelling the market. The country's 'Big Five' banks – Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada and Toronto-Dominion Bank – have controlled private lending for some time.

## Changing the landscape

However, experts say the pandemic has been instrumental in changing the landscape. Although for a long-time "bank lending was essential to driving the economy, during this pandemic, borrowers started looking beyond banks," says Van Wyk-Allan of AIMA. "Especially during the pandemic, a lot of the lending isn't coming from banks. It's coming from non-bank lenders in private credit."

She explains that, increasingly, borrowers are small businesses operating in innovative industries that require large infusions of capital to grow as the world returns to normal. "It's important for Canadians to see this as a regular type of financing of not only the community but the economy," Van Wyk-Allan says of the country's view of the market.

The asset class is also crucial for many investors' portfolios in alternative assets. "Private credit managers are lending not only for providing returns but to diversify their portfolio and they absolutely see private credit growing," Van Wyk-Allan adds.

Andrew Edgell, who leads credit investments at CPP Investments, notes that private debt "has definitely grown as an asset class" and may be more attractive for companies seeking financing, as opposed to taking a more syndicated route with a bank.

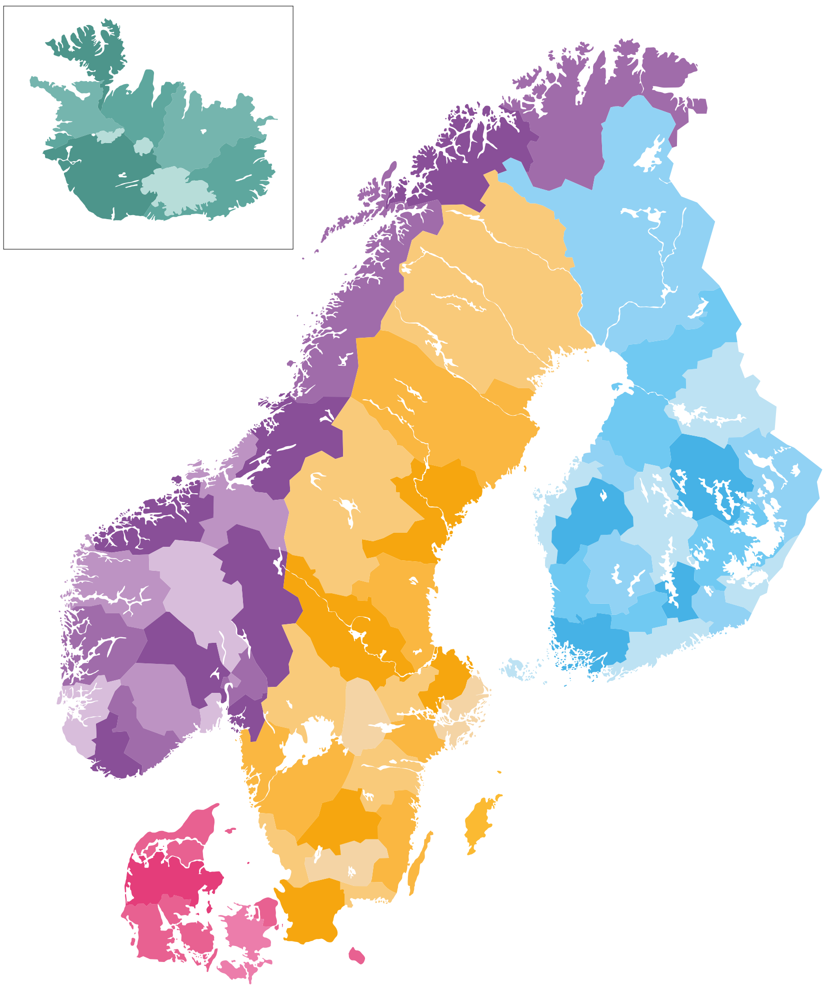
"The private debt path is still seemingly viewed as a good alternative [to bank borrowing] for bigger companies," he says. In the past two years, Toronto-based CPP has virtually doubled its private debt investment allocation to $40 billion in 2020, according to the plan's annual reports.

Raising awareness about private debt has also been key for many firms competing with the banks. Deacon says his firm's biggest obstacle was teaching borrowers about its lending solutions in an industry that is still dominated by banking.

"We found that the largest challenge was educating the market that our solutions exist and should be considered while looking at a bank," he says. "The big point we're seeing is that private lenders are now being recognised not just as an alternative option when the bank says no." ■

# How the Nordics learned to love direct lending

*From sacking offence to favoured option, the region has seen attitudes to private debt financing change dramatically. By David Turner*



Back in 2017 Victor Kihlgren, director for the Nordics at London-based fund manager Pemberton Asset Management, did a meet-and-greet with private equity firms from the region. They told him if they borrowed money from a direct lender such as Pemberton, rather than a bank, they would be fired.

Two years later Pemberton set up an office in Copenhagen, encouraged by a change of attitude. Kihlgren told *Private Debt Investor* at that time of "a shift in the Nordics… towards acceptance of direct lending".

Two years later still, he has detected a further shift, from mere acceptance to the active seeking of direct lenders. "We have seen several examples where sponsors say, 'I can borrow from a bank or pay two or three hundred basis points extra for a more flexible solution'."

Direct lenders cite financing of buy-and-build strategies as an example of where they hold an advantage because they are flexible. "In those cases, we're sought out by the private equity firms," says Kihlgren. "If they make a few acquisitions and the funding comes from a bank, the bank could very quickly run out of capacity. The bank also has to go back to the credit committee every time the company finds a new target."

Aided by this reputation for flexibility, direct lenders have experienced record demand. Pemberton calculates that its Nordic office has set new records nearly every month in terms of the number of deal introductions since September 2020, when the market reopened after a virtual shutdown.

This echoes what fund manager Ares Management has witnessed. "This is a tricky market: it's insular, every country is different and the banks have very strong relationships with clients," says Blair Jacobson, London-based partner and co-head of European credit, who says Ares is the region's biggest direct lender. "But our Stockholm team has been super-busy this year." Looking at the longer-term trend, he notes that in recent years Stockholm has been one of Ares' top-performing European offices in terms of deployment of capital.

Jacobson sees an added benefit, aside from dealflow. The sharp focus among local investors and operating businesses on environmental, social and governance issues has given the Stockholm office an expertise other European offices have been able to tap into.

The supply of deals for direct lenders has benefited from the relative resilience of the Nordic economy, which has protected revenue and allowed firms to bounce back better. By Q1, the national output of Sweden, the region's largest economy and the biggest source of direct lending deals, was down on the first quarter of 2020 by only 0.1 percent.

However, even the Nordic region has seen some corporate distress.

Ari Jauho, chairman of Certior Capital, a pan-European fund of funds manager based in Helsinki, says two types of business have fallen into trouble in the region. One is niche industrial companies selling components or highly specialist products; these businesses were not performing well even before the pandemic and have been tipped over the edge during it by the disruption to trade. Another is travel and leisure companies that had been doing fine, but which lost turnover when markets closed. Jauho sees opportunities for gross internal rates of return of around 15 percent from buying into these loans, renegotiating them and, where necessary, restructuring the companies with the injection of new money.

Direct lenders have seen some corporate distress in their loanbooks. Kihlgren says Pemberton has generally lent to defensive businesses that can rely on steady income. He cites a Swedish B2B software company, whose revenue stood up well in the downturn because it was subscription-based. In cases where a business was hit badly, "sponsors have been very supportive". They may have put in more equity to fund an interest payment that would otherwise have been missed, for example.

The growing opportunities in the Nordics – particularly Sweden and Denmark and, to a lesser extent, Norway and Finland – have attracted the interest of private debt investors that had largely ignored the region. This is less the case for distressed investors – the deals are too small for them, says Jauho – but more so for plain-vanilla direct lending deals.

However, local players enjoy the advantage of having built up credibility. This is all the more treasured because it can, says Carl Helander, head of Ares Credit's Stockholm branch, take a very long time. Since he set up the office in 2009, "we have done deals over the years, but it was really in 2018 and 2019 that we started seeing a significant increase". Helander believes local sponsors were put off by outsiders after London-based direct lenders that had taken the mezzanine tranche of deals "were quite aggressive in how they managed the process" in previous downturns.

> *"It's hard to compete against a bank offering a loan at 4 percent, which they do for the most plain-vanilla deals"*
>
> **MIKKEL SCKERL**
> **Capital Four**

He adds that a knowledge of the legal systems, business environment and softer attributes such as a shared culture all give local players an advantage. Aided by this and the increase in companies seeking deals, private debt investors with local offices say the market does not feel any more crowded than before.

The biggest regional rivals remain the banks. Strengthened by reform of the banking system before the credit crunch, they maintain a reasonably healthy competition against each other and all other arrivals – more so than in most of Europe. "Frankly speaking, it's hard to compete against a bank offering a loan at 4 percent, which they do for the most plain-vanilla deals," says Mikkel Sckerl, portfolio manager at Capital Four, a Copenhagen-based credit asset management boutique that lends primarily to Nordic companies.

"The small end of the market is still very difficult," says an executive at one direct lender. "Nordic banks are still willing to make and hold loans of up to €200 million."

## Banks show greater caution

Yet, the banks are not the indefatigable foes they once were. "The covid crisis has accelerated the long-term trend: the banks are becoming more cautious about the kind of deals they'll do," says Sckerl.

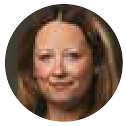
He credits this partly to the stricter capital rules that have hobbled bank lending across most of the world, but says there is added circumspection on credit risk due to the coronavirus: "The banks see the risk that's still out there."

Taking a historical view, he notes: "The gap in lending practices between Nordic banks and banks in the rest of Europe had been gradually closing already, but this trend has accelerated a little since the pandemic began."

Jauho echoes this: "Funds are gaining more and more market share in funding deals such as buyouts. That will continue after the pandemic is over – it's almost inevitable."

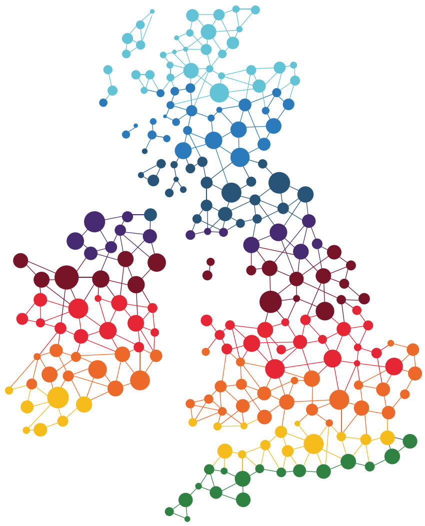
Funds will take over special situations and outright distressed even more, he thinks, as banks are not interested. Basel III rules make this too expensive, by compelling them to set extra capital aside to allow for the greater risk. Jauho notes that even for good credits, the banks are increasingly focusing on fee income rather than holding long-term debt – precisely what direct lenders are happy to do. ■

# UK rivals Luxembourg with new asset holding company regime

Guest comment by **Damien Crossley** and **Rhiannon Kinghall Were**

*A new UK framework may prove particularly beneficial for credit funds, encouraging managers to look closer to home to ensure tax efficiency*



Almost all credit funds make and hold investments via an asset holding company below the fund. Until now, the inflexibility of the UK tax rules has prevented all but the most determined from using the UK as an AHC location. Luxembourg and, to a lesser extent, Ireland, with their beneficial tax regimes, have become the 'go-to' locations.

In the government's first paper on the introduction of the new AHC regime it admitted that the "barriers, which do not exist in some other jurisdictions, are leading these entities to be located outside of the UK".

## Primary drivers

However, the introduction of the UK's AHC regime looks set to change this. While available for holding private equity, real estate and credit investments, we expect the UK AHC to be particularly popular with credit fund managers, especially those that have not yet established any significant presence in Luxembourg by way of employees on the ground and an office.

There are two primary drivers behind the introduction of the new regime. First, the AHC regime is seen as a key component of the government's wider funds review to strengthen the UK's financial services industry as a national asset post-Brexit. Second, it helps funds form a better narrative around economic substance (an increasing area of interest for investee country tax authorities) by ensuring the AHC jurisdiction is co-located with the fund management activity.

There are other added benefits for investment fund managers. The government intends for a UK AHC to be able to access the country's extensive treaty network with investee jurisdictions while only being subject to a minimal layer of tax, in line with the principle that investors should be no worse off investing in a fund than if they invested in the underlying assets directly.

To achieve this, the new UK AHC regime takes the best features of the Luxembourg regime but goes further and improves on the offering in a number of respects, including a broader exemption for capital gains on shares and simpler rules on sheltering pull-to-par gains on debt from tax.

Those that have either struggled to make the UK work so far or have only dipped their toe in Luxembourg will be pleased that the UK regime will help to reduce tax leakage and ensure that returns to investors are optimised.

Finally, as the UK AHC will be outside the scope of the offshore fund rules, it will be easier to ensure underlying capital gains are returned to investors in capital form for UK tax purposes.

One of the key attractions of the regime is that it is not Luxembourg. Always popular as an AHC jurisdiction, it has also become the jurisdiction of choice for private credit fund vehicles in the period since 2015.

However, this success has led to a degree of overstretch within service providers as well as a war for talent for managers needing to hire people to establish 'in country' substance. In addition to those practical issues, the tax regime in Luxembourg has become more complex over recent years following the implementation of the two EU anti-tax avoidance directives with a third, targeting shell companies, in the pipeline.

### Reduced costs

Those experienced with Luxembourg will appreciate the reduction in overheads and administration costs associated with running operations there, and those that had not quite got there will be relieved that there is another serious option to consider.

Overlaying this with the increased demand from investee country tax authorities for 'in country' substance and the difficulties and cost of establishing that in Luxembourg, the potential attraction of a UK AHC becomes clearer.

When you take the new UK regime and couple it with the non-tax reasons for why you might choose the UK as a jurisdiction, there is now a compelling offer on the table. The set-up and ongoing operational costs of a UK AHC will be cheaper and there is greater professional capacity to serve the needs of the AHC in the UK. In a post-covid world it will also be much easier to get a flight to London than to Luxembourg, meaning that the location will not create such a bind for non-resident directors attending board meetings. Jolly though a trip to Luxembourg can be, for those London-based executives facing the prospect of the return of their regular trips to Luxembourg, we suspect the attraction of the UK regime will be overwhelming.

*"When you take the new UK regime and couple it with the non-tax reasons of why you might choose the UK as a jurisdiction, there is now a compelling offer on the table"*

In the final months of consultation on the draft legislation there are a few points that will need ironing out. The government needs to ensure that the regime is straightforward to use and does not undermine the competitiveness of it by overwhelming the rules with complexity. In our view, the eligibility criteria need to cater for as many structures as possible and there needs to be ease of entry to and exit from the regime, the latter to soothe change-of-law concerns.

The withholding tax exemption may trip up ordinary lenders as currently it is drafted to provide only an exemption for payments made to investors in the AHC. The regime also needs to work for UK resident non-domiciled investors to ensure the UK AHC does not convert non-UK sourced assets into UK source.

However, we are anticipating that these issues will be resolved to ensure there is no material disadvantage between using the UK regime over a Luxembourg holding company structure and plenty of advantages.

The government is wasting no time on implementation. Ambitiously, the new regime is set to go live from 1 April 2022. The next few months will see the government undertake final consultation around the detail of the regime before further draft legislation is issued for review in the autumn and then finalised by early next year.

Early adopters of the regime are beginning to review their structures and consider how they can shift existing structures into the regime while others are beginning to plan how to use the UK effectively for new funds in the pipeline.

Fixing the tax treatment for UK AHCs is rightly seen as an important first step in recalibrating the approach the government takes with the asset management industry. It has been a fragile relationship over the past few years, and so it is hoped that given these reforms and in anticipation that the wider funds review (which is yet to be concluded) will deliver an equally encouraging approach, the outlook is more positive.

At the very least, these reforms will allow the industry to begin to fulfil its potential and grasp the opportunities presented from a post-Brexit and post-pandemic environment. ■

Damien Crossley is a partner and head of the tax group and Rhiannon Kinghall Were is head of tax policy at law firm Macfarlanes.

# The challenge of financing pre-EBITDA companies

Guest comment by **Aymen Mahmoud** and **Anh Lee** of McDermott Will & Emery

*Obtaining debt finance is generally not difficult for companies with strong revenues. But, for companies at a nascent stage of development, things are not so straightforward. There is, nonetheless, growing interest in the space*

In a world where credit has never been more abundant, borrowers with strong EBITDA track records are broadly able to avail themselves of relatively cheap credit in a low interest rate environment. However, for pre-EBITDA companies, it has not always been so straightforward. Even before March 2020 and the advent of covid-19, many businesses had yet to run a true cash EBITDA profit, instead showing promise by way of gross profit or even recurring revenue.

For them, the historic financing landscape did not include traditional money-centre banks, which have been driven by tighter regulations since 2008. Rather, it consisted more of venture capital and angel investor types, meaning their financing sources were often dilutive, intrusive or both. Even in a market where a significant proportion of private credit managers are actively trying to lend to companies with an EBITDA lower than £20 million ($28 million; €23 million) – and even into the pre-EBITDA positions – financing these growth companies can involve varying levels of complexity.

Pre-EBITDA companies are faced with a dual perception. On the one hand, they are viewed as inherently risky due to their net profitability, their significant outflows and cash burn and their expensive product development costs without promise of return. They also rely heavily on the integrity of their intellectual property, meaning that challenges to it can be extremely detrimental to their long-term viability.

On the other hand, these businesses are considered extremely attractive, primarily because of their growth trajectory, additive mergers and acquisitions opportunities and significant ability to generate new equity through an active scale-up market filled with liquid retail and institutional investors.

## Fierce competition

The past few years have seen a considerable increase in the number of these businesses being financed in the leveraged loan market, particularly through private credit funds. For the right business, competition to lend can be fierce.

Revenue-based or pre-EBITDA financing can (and often does) take the form of hybrid equity and debt financing. However, with growing competition, more transactions are being completed without any equity kicker or other upside element. It is a well-heeled area of lending in the US leveraged loan market, where a huge number of growth businesses have used these financings, but the European market has been more hesitant until recently.

As a result, while some features are common on both sides of the Atlantic, the absence of more standard terms in Europe and the comparative competition among European lenders to become involved in this more nascent type of lending can allow borrowers to ameliorate terms and optimise documentation on a range of issues. It is worth examining some of the features of these businesses, in particular compared with those that have taken out more traditional leveraged loans.

The minimum equity expected from lenders for this type of business is typically higher than that demanded of private equity-owned EBITDA-generating credits, and normally ranges from 50-80 percent rather than 30-50 percent. For private credit unitranche lenders (which provide the majority of these financings, especially in Europe) this provides comfort that their debt sits ahead of a significant cushion of equity.

Lenders will also expect significant security or collateral from the borrower when compared with the leveraged mid-market, where European collateral has been reduced to a small subset of assets in recent years. Of particular importance to borrowers is protection around IP, since many of these pre-EBITDA companies are technology companies with very valuable IP.

The other key collateral item is bank account security. Ownership may also be somewhat dispersed, and some internal restructuring may be needed to enable the business to provide proper collateral. In these instances, shareholder agreements should be looked at carefully to avoid immediate or future issues under a debt financing.

## Path to profits

From a borrower's perspective, these types of businesses are not often familiar with leveraged credit, particularly where it is not backed by private equity owners whose scale of borrowing offers a negotiating advantage. It is important to be familiar with the key business restrictions, particularly against key business strategies. For example, lenders will want to protect their return from these types of businesses. This should be contrasted with the extremely viable option of an IPO for the right technology business. Borrowers and lenders may debate the practice – common in Europe, though less so in the US – of making a prepayment from the proceeds of any listing.

One key consideration should be whether the business is expected to reach EBITDA-based profitability (versus gross profit) during the life of the financing. For some, it will be a mandatory requirement after a fixed period but, for others, it will be driven by the type of underlying revenues. One example of this would be a truly

*"Lenders will also expect significant security or collateral from the borrower when compared with the leveraged mid-market"*

recurring software-as-a-service revenue, which relies on an initial sale to drive starting revenue, retention revenue of customers that stay with the business and revenue expansion.

For those revenues that are retained and recur, the underlying business is viewed as having significantly more resilience than those with sales where customers might cancel their subscriptions after a short period. Compare this with a gross profit or gross margin business, which does not have truly recurring revenue, and it may be seen as a weaker credit. However, it is important not to overestimate the terminology because the private credit market is extremely sophisticated and undertakes vigorous and detailed credit analysis.

If, as noted, the business has significant underlying cash costs, this will drive certain key metrics. For example, any ability to pay in kind some or all of its interest may allow for accelerated research and development, which could offer a competitive advantage. This might be tempered by a more stringent (when compared with post-EBITDA financings) regime for the incurrence of debt, the argument being that if the first indebtedness cannot be serviced in cash, no further indebtedness should be incurred. Many of these pre-EBITDA financings impose greater restrictions around the payment of dividends. A dispersed, non-listed shareholder base will often not expect dividends while the company is in growth mode prior to a listing or a sale.

Once the business reaches an agreed EBITDA-based profitability, it will be said to have converted into EBITDA-based metrics or what is commonly known as 'the flip'. At this point, many of the operational restrictions will fall away, and many documentary optimisations (such as grower baskets) and new flexibilities may become available.

There may also be certain economic advantages to achieving the flip, such as a step down in interest rates as the risk falls. Of course, at this point, lenders may expect all their interest to be serviced in cash, unlike the PIK position.

Companies wishing to avail themselves of these financing packages will need to organise the information that lenders expect to see.

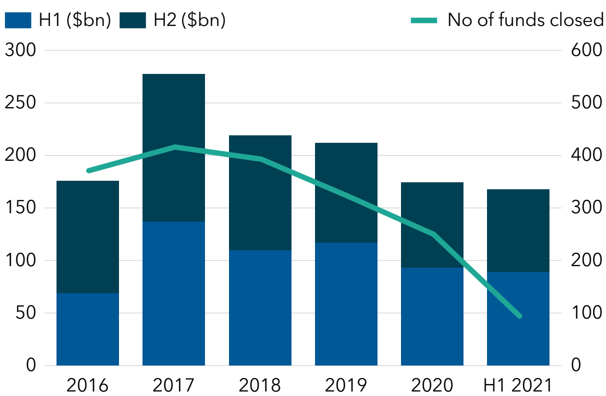
They will also need to work with advisers that are experienced, not only in dealing with the issues faced by pre-EBITDA businesses, but in helping strong businesses to use leverage without giving away too much in terms of economics and optimising flexibility to ensure maximum business opportunity, growth and profitability. ■

Ayman Mahmoud and Anh Lee are partners at law firm McDermott Will & Emery

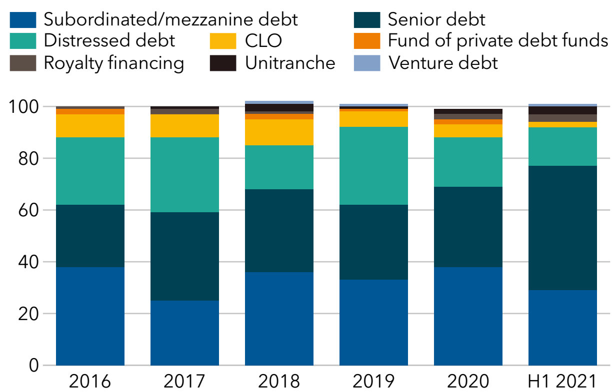
# No sign of a fundraising revival just yet

*Both the volume and number of private debt fundraisings fell further in the first half of this year, as investors sought refuge in senior debt. By Andy Thomson*

**Private debt fundraising**




**Strategy focus (%)**




While asset class observers have been watching closely for signs of a private debt fundraising revival, such an outcome proved elusive in the first half of this year. A total of $88.5 billion was raised globally during the period, the lowest first-half total since 2016. Even starker was the fall in the number of funds closing in H1 – just 94, compared with 250 in the whole of last year and 416 in the peak fundraising year of 2017. With private debt having emerged from the pandemic in better shape than many predicted, anticipation of a fundraising revival in the second half of 2021 does not seem unreasonable.

A flight to safety is normal in periods of volatility, and this is underlined by the manner in which investors have flocked to senior debt strategies during the pandemic. Perceived as the safest part of the capital structure, senior debt accounted for almost half (48 percent) of all limited partner commitments to private debt funds in the first half of the year. This is well above the long-term average, with the strategy accounting for between 31 percent and 34 percent of commitments between 2016 and 2020, respectively. The distressed wave has failed to arrive, and distressed fundraising fell to a five-year low in H1 2021.

**94**

**Number of funds closing in H1 2021, compared with 250 in the whole of 2020**

**$41bn**

**Amount of fundraising for North America-focused funds in H1 2021**

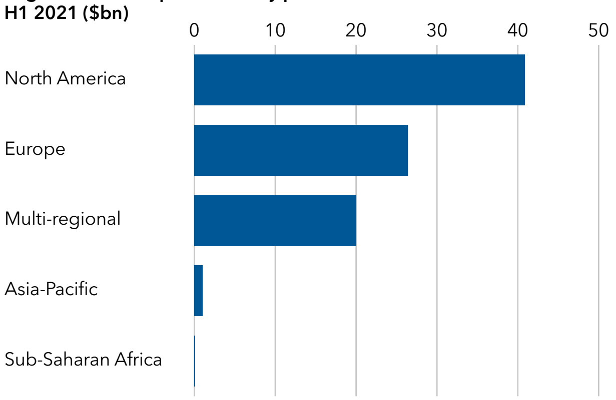
**$942m**

**Average size of private debt funds in H1 2021, up from the average of $697m for 2020**

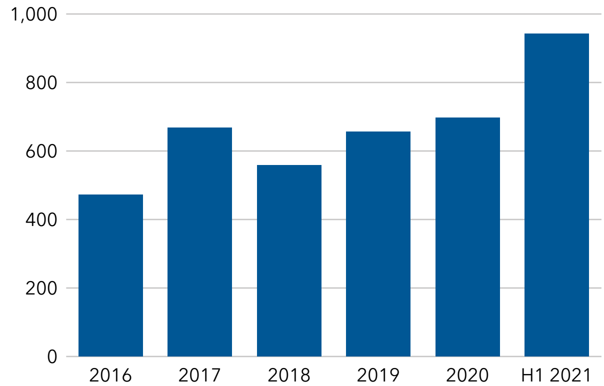
Last year, signs emerged that Europe was the new investor favourite as it briefly toppled North America from its pedestal as the recipient of most investor dollars. However, this trend was well and truly reversed in the first half of this year as North America accounted for almost $41 billion of fundraising compared with just over $26 billion in the Old World. It fits the theme of investors sticking with what they know in uncertain times, with the longest and most trusted relationships having been formed with managers in the world's most mature private debt market.

The average size of private debt funds has increased markedly over the past five years, from less than $500 million in 2016 to almost $1 billion in the first half of this year. Prior to the pandemic, there was already a tendency for limited partners to back a smaller number of trusted fund managers, and to write those favoured managers larger and larger cheques. In the new world of remote due diligence, this concentration of capital in the hands of an elite group has been exacerbated as investors shy away from taking a chance on new managers that they may not be able to meet in person.

**Region focus of capital raised by private debt funds closed in H1 2021 ($bn)**




**Amount targeted by funds in market by region, 1 July 2020 ($bn)**




In line with the popularity of North America as a recipient of investor dollars, no fewer than eight of the top 10 largest fund closes in H1 came from managers based in that region. With the likes of Ares Management, Goldman Sachs and Cerberus Capital Management topping the charts, only London-based Park Square Capital and Paris-based Capza were able to effectively challenge North American managers' dominance.

**Top 10 largest fund closes in H1 2021**

| Fund | Head office | Manager | Target size ($bn) | Current size ($bn) | Strategy |
|---|---|---|---|---|---|
| Ares Capital Europe V | US | Ares Management | 10.67 | 13.04 | Senior debt |
| Broad Street Loan Partners IV | US | Goldman Sachs Merchant Banking Division | 7 | 7.1 | Senior debt |
| Cerberus Levered Loan Opportunities Fund IV | US | Cerberus Capital Management | 0 | 4.4 | Senior debt |
| Ares Pathfinder Fund | US | Ares Management | 2 | 3.7 | Senior debt |
| CVI Credit Value Fund V | US | CarVal Investors | 3 | 3.6 | Distressed debt |
| Cerberus Institutional Real Estate Partners V | US | Cerberus Capital Management | 2 | 2.84 | Distressed debt |
| Apollo Accord Fund IV | US | Apollo Global Management | 5 | 2.34 | Distressed debt |
| Park Square Capital Partners IV | UK | Park Square Capital | 1.78 | 2.13 | Subordinated/ mezzanine debt |
| Kennedy Lewis Capital Partners II | US | Kennedy Lewis Investment Management | 1 | 2.1 | Subordinated/ mezzanine debt |
| Capza 5 Private Debt | France | Capza | 0 | 1.9 | Unitranche |

Source for all data: Private Debt Investor

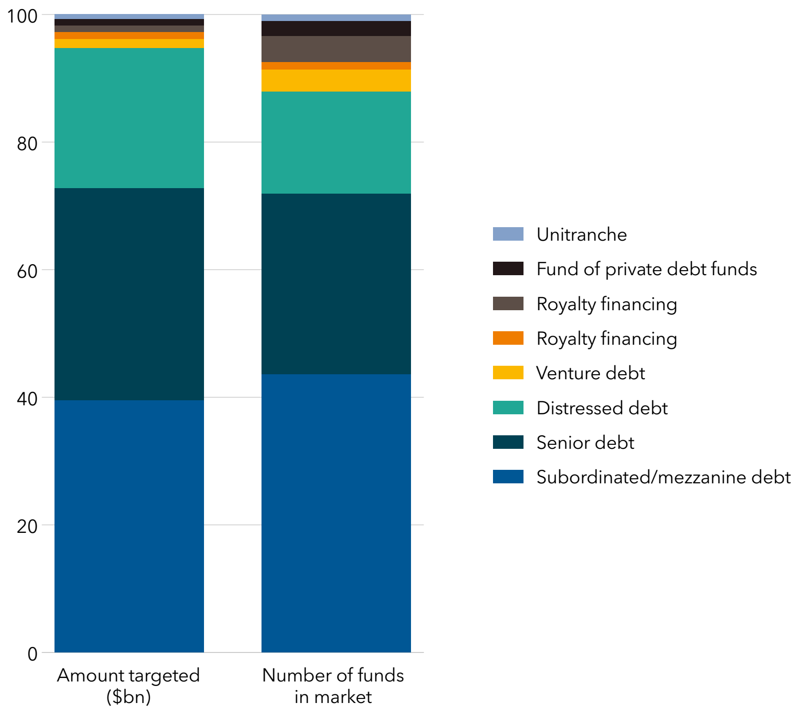
# Funds in market

*This month's measure of the pulling power of managers, regions and strategies in private credit*

**Ten largest private debt funds in market**

| Fund | Head office | Manager | Target size ($bn) | Current size ($bn) | Strategy |
|---|---|---|---|---|---|
| Oaktree Opportunities Fund XI | US | Oaktree Capital Management | 15.00 | 13.00 | Distressed debt |
| West Street Strategic Solutions Fund I | US | Goldman Sachs Merchant Banking Division | 10.00 | 6.40 | Subordinated/ mezzanine debt |
| ICG Europe Fund VIII | UK | Intermediate Capital Group | 8.32 | 2.97 | Subordinated/ mezzanine debt |
| ICG Senior Debt Partners 4 | UK | Intermediate Capital Group | 8.00 | 7.60 | Senior debt |
| GSO Capital Opportunities Fund IV | US | Blackstone | 7.50 | 3.74 | Subordinated/ mezzanine debt |
| AMP Capital Infrastructure Debt Fund V | Australia | AMP Capital | 6.98 | 2.65 | Subordinated/ mezzanine debt |
| Apollo Hybrid Value Fund II | US | Apollo Global Management | 5.00 | 3.20 | Distressed debt |
| Brookfield Special Investments Fund | Canada | Brookfield Asset Management | 5.00 | 2.40 | Distressed debt |
| Centerbridge Special Credit Partners IV | US | Centerbridge Partners | 5.00 | 0 | Distressed debt |
| Owl Rock Diversified Lending 2020 Fund | US | Blue Owl Capital | 5.00 | 0 | Senior debt |

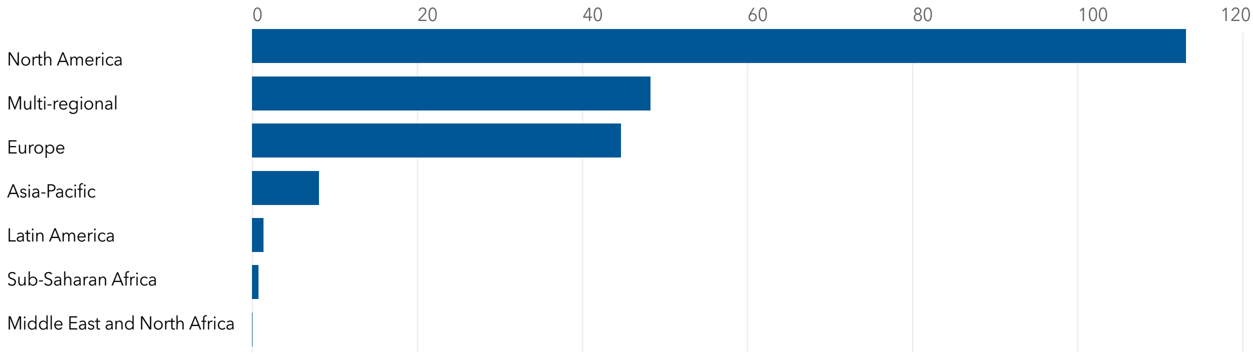
**Funds in market by strategy (%)**



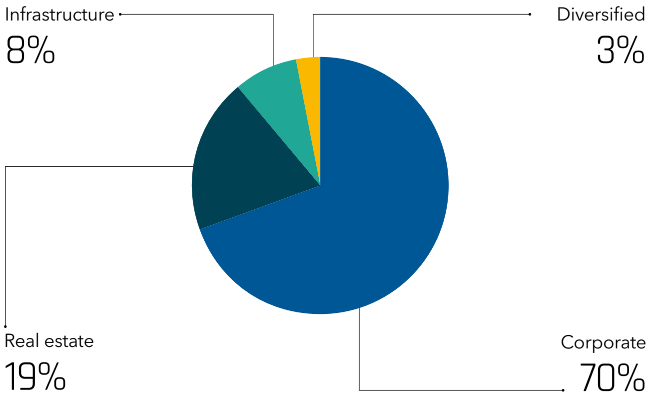

Source for all data: Private Debt Investor

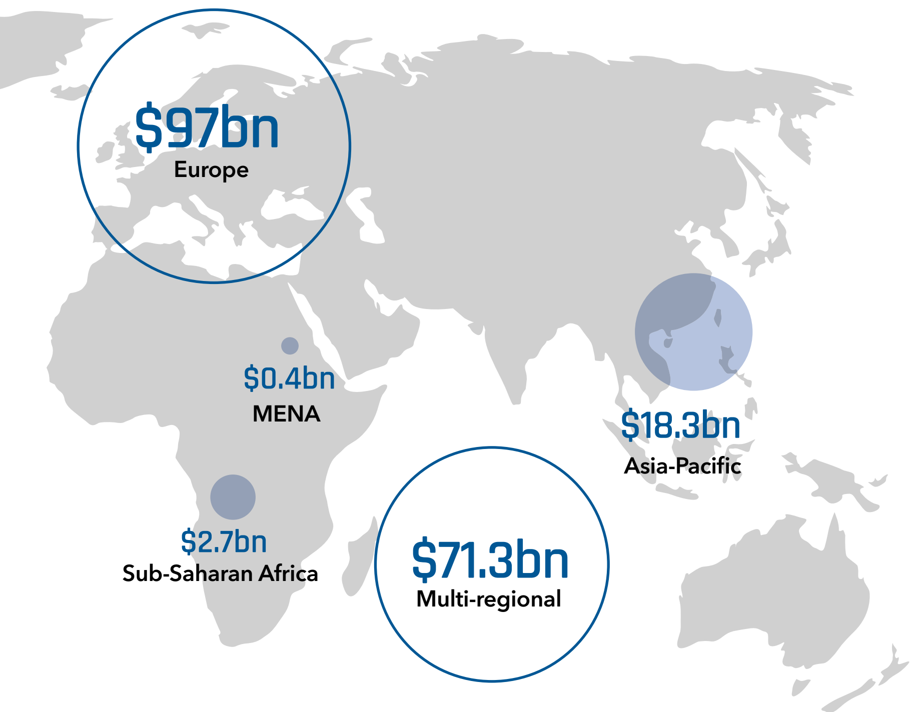
**Amount targeted per region by funds in market**

**Capital raised through interim closes of funds in market by geographical focus ($bn)**




**Funds in market by sector**




**$323.6bn**
Total amount targeted by funds in market

**858**
Number of funds in market

**559**
Number of managers with funds in market

**23%**
Percentage of total amount targeted by the 10 largest funds in market

**89**
Number of funds in market targeting $1bn or more

**41%**
Percentage of capital targeted by funds in market focused on North America

**$213.3bn**
Capital raised by funds in market through interim closes

# Is that a bubble I see forming?

## In the next issue we will be considering the likely effects of inflation on private debt

With the loosening of lockdown rules, a  splurge of economic activity has brought mixed reactions. On the one hand, the hit taken by GDP during the worst of the pandemic may be cancelled out by a surge of consumer optimism as vaccination programmes mitigate the effects of covid-19 and people feel sufficiently encouraged to spend the money they hoarded during 2020 and the first half of 2021.

On the other, it has turned what at first was a whisper of inflation into something of a crescendo. Perhaps because inflationary environments are few and far between, the prospect of one produces a reaction that might be seen as disproportionate. Even the Bank of England stands accused in this respect – when it predicted an inflation rate of 4 percent this year, it was swiftly rebuffed by economists canvassed by Bloomberg, who said the UK's central bank was being overly alarmist and who instead forecast a peak of 3.5 percent in 2022.

In the October 2021 issue of *Private Debt Investor*, our cover story will examine the type of inflationary environment we are in as well as the likely effects on the private debt market. Some say that with floating-rate loans so prevalent, the asset class may stand to benefit from inflation. Others say it very much depends on the type of strategy you're talking about and that experiences are likely to be mixed.

**Don't miss the October issue to find out more**