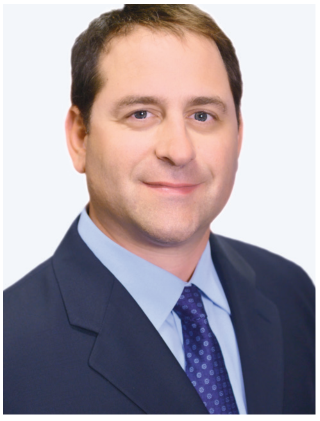
KEYNOTE INTERVIEW

Navigating the credit frontier




As more private equity firms launch their first credit vehicles or expand their initial offerings, Jay Cipriano and Chad Longenecker of SEI's Investment Manager Services division caution how complex administering these funds can be

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No one can fault a manager for looking to capitalise on the boom in private debt, but like any expansion, the older it gets, the greater the risk of a contraction. Even if growth continues, competitors will crowd the space, requiring greater skill and specialisation to stand out.

According to a recent survey of managers and investors sponsored by SEI, the private debt market is already experiencing these pressures. While the market is still expanding, its scale and increasing competition is creating more covenant-lite structures that favour borrowers and court risks.

While the report, *Private Debt: Preparing for the Unknown*, finds general and limited partners bullish on the sector as a whole, it stresses a note of caution about what comes next, and advises keeping an eye on mitigating risks, especially since LPs are less sanguine about those risks than GPs. Valuations are a top concern, as nearly half of LPs considered assets to be overvalued, and 60 percent expect a market correction within the year.

Fundraising has slowed in the first three quarters of 2018 as investors prefer the safety of established managers. The five biggest debt funds raised 66 percent of all capital committed in those nine months. That said, the market is expected to double in size by 2023, even after ballooning from $245 billion to $667 billion over the last 10 years.

The report finds both GPs and LPs agree that as the market matures, specialisation will increase, with nearly 71 percent of all respondents expecting more interest in specific sector expertise in the years to come, rooted in the idea that the more a manager understands about the borrower's industry, the savvier a lender they'll be.

And that savvy matters more as the market faces some dark clouds on the horizon. The US Federal Reserve announced that the private debt market may pose a threat to financial stability, while the rate of growth and the number of new entrants has many concerned about dwindling returns.

One way to address the current climate is for managers to place greater focus on expense management and productivity and take advantage of the transformative potential of technology. We sat down with SEI's

Jay Cipriano and Chad Longenecker to discuss how managers should move forward in a time of such uncertainty.

Q The market is expected to double in size by 2023. How should managers think about the private debt landscape?

Jay Cipriano: There's been remarkable growth in the last few years. In 2015 and 2016, the market grew by $100 billion each year and by $120 billion in 2017. That's driven by actual performance data, not just high hopes. Our report cites some impressive statistics. The pooled internal rate of return for all vintages from 2004 to 2016 was 8.1 percent, which included the impact from the financial crisis. Direct lending funds boasted a pooled IRR of 11.8 percent. With little correlation to benchmark indices, those direct lending funds look like smart diversification plays.

Chad Longenecker: But, with that growth comes greater competition. Private equity firms and hedge funds are launching plenty of credit vehicles alongside debt specialists, even as traditional lenders, like banks, may be coming off the sidelines. Most respondents – half of investors and 64 percent of managers – do not expect banks to reshape the private debt market, but can all these players co-exist and thrive?

JC: And while we're not predicting the future or implying a downturn in private debt would cause any sort of systemic risk, no one is making the assumption that some kind of correction isn't on the way.

Q What can managers that are entering the market for the first time, or are expanding their credit offerings, do to prepare for that uncertain future?

CL: A lot of new entrants to the space underestimate the operational burden involved in managing these funds. We've seen some private equity players in particular invest in top-tier front-office personnel for their credit funds, but not bulk up on operational capabilities at the same time.

JC: Those capabilities are available from providers like us that have serviced private equity and credit funds side by side already, and from operational staff at existing credit shops. Just as they comb private debt funds for investing talent, the more successful managers seek out operational talent as well. It's about building out the entire team.

Q What are the key differences private equity managers should be aware of in building that credit operations team?

JC: It's a volume play. The typical private equity systems and processes can't simply be reconfigured for credit. Private debt doesn't just need separate systems for accounting and the investment process, but performance reporting as well. These funds have significantly more events, kick off more income, require more calculations and distributions with that income, and all with multiple structures.

For private funds that administer their funds in-house, Excel won't be able to handle the volume, or if it can, the risks of error are substantial. This drives them to look for automated technologies just to keep up with the pace of transactions. Investing in those systems in-house can be expensive and cumbersome, not just to acquire but to maintain over time.

CL: That also means it can take longer to launch products and once done, slower to calculate performance and produce investor reporting. GPs often realise that they don't always have the time to craft solutions from scratch, so they partner with a third party because it's the most efficient way to get up to speed operationally and in a timely manner.

Q What role does the size of the fund play in tapping these resources?

JC: The larger, sophisticated managers have the staff and technology to handle a large multi-strategy, multi-asset structure, but some of today's biggest funds were early adopters of the outsourcing approach for credit. They understood the nuances and complexity involved in bringing a credit vehicle to market and found outsourcing to be the most efficient way to accomplish that.

CL: Large firms tend to outsource for expertise, while small firms typically do it for resources. Make no mistake, smaller firms may not have a choice but to rely on a combination of technology and outsourcing, given today's competitive landscape. The smaller firms tend to have specialised or niche strategies, which face what we call in our report the 'specialisation paradox'.

On the one hand, managers don't want to be limited to a certain kind of vehicle, but to be seen as experts in a broad array of products, and like having a diversified portfolio in the case of a downturn. However, they face competitive pressures to commit to a sector of expertise, and LPs are looking for a way to categorise the growing field of managers.

JC: Firms of all sizes and sophistication outsource, but this means that the smaller firms are under more pressure to devote their resources and expertise to mastering that niche and not waste the time or internal resources building operational systems and processes.

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Q Can technology play a role in improving the operations of firms that are already in the credit space with a fund or two?

JC: Technology can absolutely help streamline processes. For instance, we have a proprietary tool that automates the workflow for investor onboarding, shortening the sign-up and subscription process, and significantly improving the investor experience. Typically onboarding is done by hard copy and driven by the law firms. That could take up to 90 days or more; with a workflow programme like ours that digitises the entire process, it can take as little as a week.

Q As competition heats up in the credit space, adequately nurturing and sustaining investor relationships is even more crucial. What role can technology and outside experts play in satisfying LPs?

CL: One of the primary advantages of partnering with a third-party provider is to take basic blocking and tackling off the plate of in-house staff so they're freed up to focus on sourcing deals and handling LPs' needs and wants. In essence, you're leveraging the expertise of both parties to deliver a better solution to the market and better experience to investors.

JC: Offering an online investor dashboard, for example, allows a GP to grant investors access to statements and other fund data,

and enables them to communicate with the LP base in a more timely manner and with more efficiency. They can even upload market commentaries or periodic reports in video format.

As the market matures, LPs are getting more sophisticated and demanding. They want the ability to slice and dice data as they please, but there's a balance to strike. Pure data dumps aren't a shortcut to transparency. Instead, GPs are using technology platforms that ensure the information is meaningful, insightful and appropriate. Doing so then allows the investor relations team and portfolio managers to focus on higher value activities.

Q In a contraction or significant downturn, regulators will be more aggressive in supervising the industry. What can managers do now to be ready when a regulator comes knocking?

CL: This is where a robust workflow platform can make a real difference. Today's systems can map a manager's activity and provide evidence for what a firm did and how it's in line with the policies and procedures found in the fund documents. Additionally, having automated technology and sophisticated data management tools (whether in house or outsourced) enables GPs to produce more accurate and consistent regulatory filings across products, countries and regulatory regimes.

Q There's a lot of discussion about tech advances in the industry and how much the right solution can do. What role will data management and analytics play in how the market evolves?

CL: In our report, we found a slight disconnect between GPs and LPs on how much or how fast data analytics will change the private debt process. LPs were more bullish than GPs on what technology could do.

Half of all investors think better analytics will create more customised investment vehicles. More than half think data analytics will allow more types of investors to participate in the private debt ecosystem.

Still, managers believe there's only so much data can do; at a certain point, a human being has to make a decision. The most likely development in the next few years is the use of alternative data in credit scoring decisions.

Key questions

The cybersecurity threat landscape is constantly evolving as attackers develop new and creative ways for monetising compromise

Is your fund administrator simply consuming threat intelligence data, or are they actively producing actionable data that allows them to keep pace with or beat the adversary time and again?

Is your fund administrator actively mimicking the behaviours, methods, and tactics used by an adversary to test the effectiveness of the controls in place?

How does your fund administrator handle vulnerability, configuration, and patch management for all devices, including endpoints, servers and network infrastructure?

What independent controls testing is performed and does the fund administrator base their controls off a global or federal industry cybersecurity controls framework?

What methods and content are used for staff training and cybersecurity awareness education?

JC: At the end of the day, all of our tools and services are focused on making our GP clients' businesses better and more successful, freeing them up for higher level tasks, like optimising investment decision-making, sourcing and managing investors and finding the best way to explain the firm's tenets and vision. This is still a business built on relationships between the manager and the investor, and we strive to streamline as many tasks as possible to give the manager the time to make the most of those relationships. More than anything else, the health of the GP-LP relationship will be the crux for how a manager weathers whatever comes next. ■