

APEX WHITEPAPER

The Factors Shaping the Private Debt Market



Introduction: The ups and downs of private debt

The market conditions of the past 18 months have provided a real-life stress case environment for private credit and real assets strategies, with resilience being put to the test in many ways. The Covid-19 pandemic has enhanced many of the dynamics that were already at play, such as the growing importance of ESG in shaping investment decisions, the change in the financing landscape with non-bank lenders showing their essentiality, and the key role played by technology, both from business continuity and product enhancement perspectives.

Unsurprisingly, the Covid-19 pandemic had an impact on private debt¹ fundraising, with 2020 totals down by 10% on 2019. That said, with 200 funds raising a total of \$118bn, 2020 was still a very active year. The fundraising process did take a hit and became more protracted, with more time spent in market to reach the finishing line. Infrastructure funds, by way of an example, took an average 21 months to reach close – 24% longer than the previous year, according to Preqin data.

From a business opportunity perspective, the special situations, credit opportunities and distressed debt universe is the one that most benefitted from these market conditions, perhaps unsurprisingly. The number of special situations funds in market has risen sharply,

with 79 funds in raising stages at the beginning of 2021, a fivefold increase on January 2020. The proportion of private debt managers active in distressed debt and special situations markets also grew considerably in 2020; distressed debt fund managers accounted for 17% of the market, up five percentage points on 2019, and the proportion of managers active in special situations rose by four percentage points, to 19%.

Going large was also a feature of both fund raising and deal activity. The pandemic's induced flight to quality saw LPs turning to experienced managers, meaning larger assets under management (AUM) volumes are concentrated among fewer players. Across the top ten private debt funds having reached close in 2020, the

minimum size was \$2bn, with the largest fund reaching close at \$11bn. As for individual deal sizes, the largest private debt deal of 2020 topped \$4bn (Apollo-Hertz).

With a backdrop of prevailing low interest rates and subdued default rates, private and infrastructure debt is anticipated to remain an attractive alternative to public markets. Many investors remain bullish with nearly half of those surveyed by Preqin saying they expect to increase their allocation to private debt, and 93% intending to commit as much or more capital to infrastructure as an asset class in 2021 as in 2020. Private debt AUM are expected to continue rising at a forecasted CAGR of 11.4%, increasing from \$848bn at the end of 2020 to \$1.46tn by 2025.

Historically, fund managers competing for assets in private debt largely consisted of North American private equity firms, such as Blackstone Group, KKR, and Oaktree Capital Management. But in recent times, more mainstream fund groups from across the globe have turned to the asset class. This is particularly the case for Europe-focused AUM, which now makes up just under 30% of the total, up from just over a quarter five years ago.

According to PitchBook's Global Private Debt Report, direct lending is set to continue being the strategy that draws most interest; managers raised \$33.5bn across 28 vehicles in the first half of 2021 globally, already three-quarters of the amount raised during the whole of 2020. Infrastructure debt will be playing a key part in funding what is commonly referred to as the "infrastructure gap": many assets across both social and economic infrastructure remain underinvested against governments' own standards. The G20 Global Infrastructure Hub estimates that global infrastructure investment needs will rise to \$94tn by 2040 to keep pace with economic growth and meet the Sustainable Development Goals (SDGs). The annual shortfall, according to its main forecast, will rise from around \$460bn in 2020 to around \$820bn by 2040. Closing the gap would require annual infrastructure investment to increase from the current level of 3.17% of global GDP to 3.7% – and meeting SDGs will increase this need to closer to 4% by 2030.

In this report, we take a look at the ups and downs of the private debt market from different expert perspectives, discuss some of the lessons learned and what lies ahead in terms of new challenges and opportunities.



Neil Syers Chief Financial Officer, Hayfin

Neil joined Hayfin at its inception in 2009 and is the Group's CFO .

Neil has over 20 years industry experience having previously being Finance Director at Gandhara Capital Management Group, and working at Henderson Group PLC (Janus Henderson) and in the Investment Management Group at Ernst & Young.



Alessandro Merlo
Managing Director - Head
of Infrastructure Debt,
UBS Asset Management

Mr Merlo joined UBS Asset Management in 2014 and leads its infrastructure debt platform. Based in London, his focus includes capital raising, investment origination and credit analysis. He is also member of IDP investment committee.

Mr Merlo has 17 years of experience in infrastructure finance having also worked at Moody's, Citigroup and Intesa Sanpaolo in the UK, France, Italy and Turkey.



Floris Hovingh Managing Director, Alvarez and Marsal Debt Advisory

Mr Hovingh joined The Alvarez & Marsal Debt Advisory team in May 2021 as MD where he raises debt capital from alternative lenders for borrowers. Prior to that, he was Partner and Head of Alternative Capital Solutions at Deloitte and founded the Deloitte Alternative Lender Deal Tracker.

Mr Hovingh's experience in debt capital markets spans 20 years, working in London as a debt advisor at A&M and Deloite, and as a leverage finance banker at HBOS and NIBC.



Agnes Mazurek Private Debt Consultant

Ms Mazurek has been working for Apex Group since May 2021.

She has over 20 years of experience in private markets, gained on the sell side and the buy side. Most recently, she set up the debut infrastructure debt fund of Kommunalkredit and the infrastructure debt business of Macquarie Asset Management for Continental Europe. In the past 10 years, she had led 35 infrastructure debt transactions to financial close, across EMEA and APAC.

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How have private credit and infrastructure debt managers overcome the challenges of the period?

Neil Syers, Chief Financial Officer at Hayfin, reflects on some of the recent challenges and opportunities debt managers have been presented with, and how resilience can be looked at through multiples lenses.

"We have multiple strategies in private credit that allows us to be resilient and move between market environments. At one end of the spectrum, we have the more conservative direct lending strategy, focusing on capital preservation and strong current income, and at the other end, we have special situations, which is more opportunistic, with much more complexity and where credit may be scarce," says Syers.

"Our liquid credit business trades more actively than private credit but is designed to be both resilient and opportunistic during down markets. We have both open-ended fund products and CLOs through which we can manage more short-term mark to market volatility, and take advantage of market conditions. For example, when Covid started impacting markets last year, we had a list of names we liked but which were trading too high. We then got to a level where we could underwrite them and started to trade them. This is resilience from an opportunity point of view.

"Then we can flip between doing direct lending into secondary trading as a business, which is another form of business resilience through a different lens. You've also got the portfolio resilience which is looking back at the portfolio and how it's been impacted – raising questions like are there short term/medium term liquidity needs? What needs a special level of attention is required, and so on and so forth. So backward-and forward-looking resilience in terms of looking at the portfolio."

For infrastructure debt managers like Alessandro Merlo, Head of Investment Infrastructure Debt at UBS Asset Management, the past 18 months have provided plenty of fresh and useful insights in terms of asset performance. Infrastructure debt managers had the opportunity to deliver on that pitchbook line "importance of quality of portfolio monitoring" in an unprecedented way, with performance of assets, in the transportation sector in particular, being put to the test.

"While infrastructure sectors have performed differently in the face of Covid, they have been generally resilient and have come out strong. Digital infrastructure ¬– data centres, telecom towers, fibreoptic networks – benefitted from the crisis which provided an environment to reinforce their

essentiality. The resilience of renewable energy is driven by our re-thinking of how we use scarce resources and consume energy, a trend that had started before the pandemic and will continue," says Merlo.

"The transportation sector has been the most vulnerable. What we are observing based on our own portfolio, but also hearing from other market players, is a sub-segmentation of the transportation sector based on Covid impact. Airports have been hit hard and continued pressure on the aviation sector can be expected over the next few years, with volumes hit severely and having recovered very little with the release of restrictive measures.

"The ground transportation traffic has been more resilient. On toll roads we witnessed the impact of the Covid restrictions during the worse part of the pandemic, but as soon as restrictions were lifted there was a strong rebound last summer and we expect that to be the case this summer too. Looking back at road transactions, 2020 summer traffic was higher than 2019, with the proportion of private car usage in the transportation mix having increased," adds Merlo.

With travel bans and face-to-face meeting restrictions in place, personal contact and onsite due diligence that have traditionally been part of any new allocation process, in particular for first-time managers, have not been possible. As result, first-time managers have struggled in a difficult fundraising environment, with many investors favouring more established counterparts. That said, there was cause for optimism among the strongest of the first timers who were able to make their mark.

First-time private debt fundraising as a proportion of total fundraising declined slightly during 2020, compared with 2019, to just 10% of the total (Preqin). The percentage of funds closed that were first-time funds was also down, by four percentage points, to 20% of the total. Despite this, the average size of first-time private debt funds grew to its highest-ever level. First-time funds secured an average of \$333mn, up from \$298mn in 2019 (Preqin), suggesting more capital is being shared among fewer first-time managers.

The same capital consolidation trend was also observed in infrastructure, where the top 20 funds secured nearly three quarters of the capital raised in 2020, and the amount raised by those outside the top 50 at its lowest share since 2012 (Pregin).

What advice can be given to first-time managers or those looking to diversify away across the space?

For Floris Hovingh, Managing Director at Alvarez and Marsal Debt Advisory, data holds the key to success for new entrants. "Compared to a decade ago, the direct lending market has become very data driven, especially when fund raising. The bigger the track record of data a manager has to present to back up their statements the better. Fundraising investors feel safe in numbers," says Hovingh. "To add to that, finding your first cornerstone investor who believes in the team and is willing to stick their neck out is one of the hardest things, but often the only way to get going as a credit manager and build that early-stage track record."

Although not as mature as private equity, the private credit market is now fairly commoditised, so having points of differentiation to offer as a first-time manager is also key, adds Hovingh. "Find a niche where you can be relevant. This is important to prove your ability to source deal opportunities and convert them. And of course, having local coverage and a strong risk assessment team in place are essential."

Alessandro Merlo concurs on the challenges faced by first entrants into private credit and the importance of standing out from the crowd. "Infrastructure debt is a large market, but it is a crowded space. A good understanding of segmentation is essential.

"We decided to focus on a primary market mid-size, offering an alternative/complementary to bank lending. The European infrastructure debt market is worth €100bn in financing per year, but 85% still comes from banks. So we ask ourselves what can we do to compete, not against direct lenders, but against banks. In short, we see ourselves as having different drivers: we are not in the business of churning capital, so we can really lend long term, and be patient. We also see ourselves as more aligned with the borrower and not trying to cross sell expensive banking services that are not needed. That key question therefore is the one that holds the winning factor: how to take away market share from banks."

Having spent a decade on the sell-side originating infrastructure deals before moving to asset management, Private Debt Consultant, Agnes Mazurek, shares that same advice. "When you set up a new business, it is very much

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Alessandro Merlo

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your credibility and market reputation you bring to the table. Asset management is an intuitu personae business. But it is also a very competitive business where you need much more than just following a trend set by other managers, no matter how visible your organisation's brand.

"In my experience, having trusted advisers and service providers are essential. And I agree with Floris Hovingh that a cornerstone investor is a must for a first-time fund, especially if you are not scoring high on the innovation front.

"As for how alternative credit positions itself vis-à-vis bank lending, I believe creativity is the answer, rather than head-to-head competition on the same products," continues Mazurek. "Understanding where you as an asset manager are better positioned than banks is key. This has been shown by the success of direct lending funds who have taken advantage of bank lending appetite being constrained by regulation and the need to keep their balance sheet size in check. Sub-investment grade/ junior infrastructure debt which commercial banks are not keen on, but which borrowers need is another example."

Where do you see opportunities for private credit in emerging markets?

Private credit is no exception to the commoditisation and heightened competition observed in the financial services industry. In a mature market, with a trend towards AUM concentration among fewer managers, emerging markets where private debt activity has recently been increasing could be part of the answer for players seeking to use the differentiation angle. While private debt markets are not as developed in Asia as they are in the US or Europe, it does offer up growing opportunities to managers – with or without a track record. For instance, in early 2021 there were 44 private debt funds² in market focused on Asia, up from 38 at the beginning of 2020 (Preqin), and this trend is likely to continue accelerating.

According to McKinsey's Global Private Markets Review 2021, the US still attracts the most interest, and by a considerable margin – 60.5% of total private debt AUM globally, and also was the market that grew the fastest last year (7.9%) – but long-term growth has been highest in Asia (17.4% CAGR since 2015). Neil Syers agrees with that, adding that Hayfin have recently established a desk in Singapore, with deal flow access and LP access being two key drivers.

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For infrastructure debt, the picture of the opportunity is less clear, as Alessandro Merlo points out. "There are a lot of financing needs in emerging markets – i.e. non-OECD market – that's clear. Less clear is whether there is an appetite from LPs to enter that market.



"My clients, large European pension funds and insurance companies, have very little exposure to emerging markets and certainly not to illiquid products. I am facing limited appetite to invest in long dated, closed end funds that invest in emerging markets. From a deal flow perspective, there is an opportunity there but it remains unclear whether the LP community is ready. There is a regulatory angle attached to that: for European insurance companies there is a beneficial capital relief to invest in infrastructure debt, one of the conditions required is that loan is to a borrower located in an OECD or EU country."

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To put things into perspective, as of January 2021, there were 54 private debt funds raising \$11bn of AUM to target LatAm, Africa, Middle East and Australasia. This is one tenth of the European market.

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Floris Hovingh concurs with this analysis, seeing markets such as Africa as difficult to scale up for the private debt space as the private equity market is still in its infancy, with a lack of quality information and transparency there at the moment. Asia however shows much more potential. To put things into perspective, as of January 2021, there were 54 private debt funds raising \$11bn of AUM to target LatAm, Africa, Middle East and Australasia. This is one tenth of the European market.

In what way has the proliferation of technology affected the private credit space?

"Private credit asset classes are all demanding in terms of technology, but for different reasons", says Neil Syers. "In an open-ended liquid credit fund, the frequency of trades is higher, and you need to strike the NAV very quickly, so it is very automated. The importance of technology and automation in direct lending is driven by its structural complexity, where the allocation exercise that happens on the fund administrator side needs to be highly automated.

"Operational resilience is a key theme and major focus. For us, it has meant ensuring that the backbone of our business is robust, yet flexible in supporting our growth while catering to the dynamic environment we constantly need to adjust to. There has been a step change in the industry in the past 12 years and in our experience, the earlier you embed technology, the quicker you can grow.

"To add to that, you need to get the balance right between internalising vs externalising resources to allow you to take on the complexity of this asset class. We have over 250 SPVs today in addition to tax, compliance and structuring complexity, different investor demands from a highly geographically diverse LP base. To manage that, you need to get the right trusted partners that allow you to do so effectively."

Teaming up with the right partners, whether that is people or technology, is a recurring theme: "You cannot ignore how real the competitive advantage is of having the right partners or technology in place", says Agnes Mazurek. "When you make a new investment, it is not the end of your work as a manager, it is the beginning. Infrastructure debt, for example, is a very work intensive asset class, with long lead times from sourcing to execution of investments –

several months is the norm. Why would you waste all that effort by messing up capital calls or cutting corners on the quality of investor reporting?"

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governance (ESG) factors?

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Neil Syers

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How has the private credit space responded to the increased emphasis on environmental, social and

Looking into the future, private debt investments offer a clear avenue for putting sustainable principles into action due to the nature of the underlying assets. Preqin conducted a study with infrastructure fund managers in November 2020 to understand their views and motivations around ESG. The vast majority (83%) of respondents believe transitioning to a decarbonized energy generation will be the key driver of the infrastructure asset class over the next ten years, with updating aging economic infrastructure a distant second (50%).

While the past twenty months have seen regulatory headway in Europe such as the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation, prompting a shift in the way managers approach the incorporation of ESG principles into their investment strategies, there is still a long way to go. To the question of where they stand in the ESG-Implementation lifecycle, only 11% of fund managers replied "already mature", 53% being "in progress" and 26% still "in awareness raising mode". That said, ESG-related capital in private debt is heading in the right direction according to the McKinsey Global Private Markets Review 2021 – having grown by 23% per annum between 2015 and 2020.

"Historically we were thinking of the sustainability of the business we were financing mostly in risk terms", says

² Excludes infrastructure debt and real estate

Merlo. "Financing a business that is not sustainable in the long term can jeopardize its credit merits. Infrastructure in general, as a sector, has a very heavy footprint – emissions, space and resource utilisation – and in Europe it was built in an era when these were not prominent concerns.

"What we are observing today is a transition to a more sustainable infrastructure. We have a responsibility to make infrastructure more viable and sustainable in the long term and there is an industry-wide acknowledgement of that."

But what are the levers to make that happen, and how do fund managers avoid the pitfalls of a concept that carries such a 'feel-good' factor?

Lack of quality and of consistent data on ESG and sustainability is quoted by infrastructure fund managers like Merlo as the main challenge (71% of respondents in a Preqin survey) to the implementation of an ESG policy. "The problem of implementing an ESG strategy from a private debt perspective – asset manager or bank – is that we are not business owners and have limited ability to directly influence the decision of the company.

"What we can do as asset managers and lenders is to measure the impact of an asset or a business we finance and try to monitor it. Excluding certain businesses – power generation from thermal coal – which are risky from an ESG perspective is a start."

This is very representative of the views of the investor community: an overwhelming majority of investors

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(80%) state that they have or would turn own investment opportunities due to concerns over ESG risk.

"The direction we are trying to move towards is measuring the impact and financing businesses that have a positive impact." adds Merlo. "Renewable energy has attracted a lot of funding because they were seen as green. On the asset management side, we are trying to be a bit more sophisticated than just financing anything that has a green label on it."

Regulation-driven disclosures are helping, but do they provide enough of a driver for borrowers and equity sponsors? Is linking loan pricing to ESG performance the way forward, as has been seen on a few private debt funds? "We have started to see covenant relaxing linked to ESG performance, but I would not call it a trend, they are episodical and have a limited impact on economics of transactions, not in a way that - in my opinion - would change the behaviour of the company," explains Merlo.



So, is it still more of a lip service to ESG principles with debt providers not being in a position to push the ESG agenda in a meaningful way? Syers from Hayfin thinks differently: "ESG has always been an inherent part of the firm's approach to prudent risk management, which has now formalised itself into a separate ESG Committee. Formalisation has been driven by learning off other industries, private equity being one, but most importantly from LPs. A cultural shift has taken place. We can see it from investor restrictions which are getting tighter and tighter..

"If you rewind the clock to ten years ago, we were turning down investment opportunities because they did not sit quite right with what we were trying to do from a reputation perspective as a business. That was an ESG lens but the frameworks and policies have had to evolve over time.."

Agnes Mazurek also shares this perspective: "Ten years ago, when banks were still the almost exclusive source of funding for infrastructure projects, the ESG lens was very small and limited to environmental considerations: we would rate an asset before the provision of funding, in accordance with the Equator Principles, and it was a box ticking exercise, a couple of pages in a technical due diligence report, not a consideration in its own right. Borrowers would never accept any specific reporting or monitoring undertaking in the documentation, beyond a general catch-all clause about compliance with environmental laws. We have come a long way and asset managers, with their long-term perspective and fiduciary mindset, have been instrumental in this."

In summary: Key considerations going forward

Alternative credit asset classes have weathered the stormy waters of the past 18 months well. But it's not all been plain sailing, particularly for any newcomers entering the fray. Experienced managers have been able to pick the lion's share in a fundraising environment where few LPs were ready to take chances with GPs unknown to them. This more cautious approach is perhaps also reflected in the fact that managers have had to spend longer on the road (albeit virtually) before wrapping up fundraising for any given fund.

Demand has been fueled by banks pulling back from lending, although they still dominate the field. Regulatory constraints and balance sheet controls have played a factor in that – and are expected to continue to do so – limiting the ability of the banks to service the ever-growing demand for financing, in particular in the small and medium-sized enterprise and mid-cap space. This growing demand on the asset side matches the demand from the investor base, with direct lending expected to remain one of the most attractive private asset classes.



Aman Bahel

Managing Director, Head of Europe
- Business Development at Apex Group

Aman joined Apex Group through the transition of Deutsche Bank's Alternative Fund Services business, where he was part of the management team. Prior to this, he ran Strategy for Deutsche Bank's Securities Services franchise, leading inorganic/organic initiatives.

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In summary: Key considerations going forward

So, what advice can we take away from our panel of experts?

- 1. With the private debt market expected to expand and continue following a strong growth trajectory, the need to stand out from the crowd is increasingly important. Many managers are broadening and diversifying their propositions, with geographical diversification high on the list of strategic considerations. While investor demand for infrastructure debt, for example, is expected to remain focused on OECD countries for the foreseeable future, the ask is much wider for other private debt strategies, in particular direct lending, with Asia seen as a promising market going forward. That diversification is also seen as an important factor for ensuring future resilience.
- 2. To deliver on that diversification and growth, the right operational model is required to support those ambitions. Managing funds comes with a multitude of complexities - "tax, compliance and structuring complexity", some of those listed by Neil Syers – and trying to resource that in-house can be a challenge. Having a trusted partner in place can reduce operating costs, reduce risk, streamline processes and provide the flexibility to scale. To that point, it is essential that any partner has the global reach, but with all the necessary local knowledge, so there are no restrictive limitations or boundaries when exploring new geographical horizons.

- 3. Technology is seen as an important component to that operational model. The change in business practices over the last 18 months has only made the need for digital enablement across operational processes even greater. LP demands for increased transparency in reporting at borrower, asset and fund level, with more sophisticated KPIs, require not only robust systems and automation, but more importantly, a partnership-style approach where managers can leverage the creativity of the service providers and focus on fundraising and investment sourcing.
- 4. The focus on sustainable investments is gathering pace, not least because of measures like the EU's Sustainable Finance Disclosure Regulation imposing ESG disclosure requirements on fund managers. But there is still a long way to go. Unlike equity markets where ESG compliance can add value to the company and where shareholders can impose an ESG direction should they wish to, there is limited leverage for lenders to influence how ESG is embraced by borrowers. The availability of accurate and meaningful data to monitor and track ESG practices and performance is central to driving positive change. It's one of the reasons why we launched our ESG ratings and advisory product line, to help lenders and borrowers make the right decisions and drive positive change in the financial sector.

To find out how Apex Group can help you set up or manage your private debt fund, please contact us: contact@apexgroup.com

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