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FOR THE WORLD'S PRIVATE DEBT MARKETS

FUND SERVICES REPORT

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PRIVATE DEBT INVESTOR
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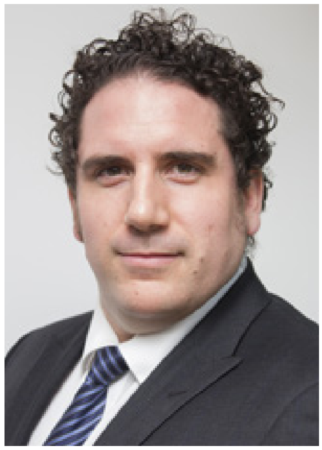
EDITORIAL COMMENT

New approaches in a new age

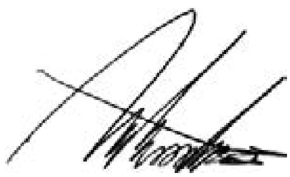


In May last year the European Union brought into force one of its most significant pieces of legislation in 20 years: General Data Protection Regulation. This dictates that businesses across Europe must take a stricter view on protecting the information they hold, the aim being that people have more control of their data. The regulation has teeth too: infringements can incur fines of up to €20 million or 4 percent of a company's annual turnover, whichever is higher. Google was made the most recent example in January when it was fined €50 million by the French regulators over its lack of data transparency. But it's not just tech giants who should fear GDPR, the regulation reaches across all sectors that rely on data. Private debt managers, and the companies that serve them, are not immune.

GDPR is just one example among a slew of new factors putting additional pressures on managers and their back-office operations. However, it encompasses two broad themes that are driving the need for dynamism in the fund services industry: technology and regulation. In many ways, the first of these has made life easier for managers through the development of new platforms, data automation and artificial intelligence. On the other hand, it has fast created new security threats and new responsibilities that managers and regulators alike are scrambling to respond to. The increased availability of information – and development of better tools to capture the information – also means investors have greater expectations surrounding transparency and reporting. These trends are creating opportunities for the fund services industry as more managers look to outsource back office functions, so they can focus on their core business.

In this report, we don't only explore ways in which fund services providers are responding to a growing demand for technological and regulatory expertise, but also look at how the fund services industry have evolved with the asset class. In many ways, the true disruption in private debt has only just begun with these latest advancements. New innovations like blockchain (or, to be more specific, distribute ledger technology) and political factors like Brexit may still bring with them more upheaval and regulatory oversight. With so much uncertainty ahead, private debt managers will need to become more dynamic and creative, and fund services will have a big role in supporting that.

Enjoy the report.



Andrew Woodman

WHAT DO YOU THINK?
HAVE YOUR SAY
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The top 5 themes in fund services

Private debt has become increasingly dynamic and versatile, demanding that fund service providers supporting the asset class be equally nimble. **Andrew Woodman** considers the issues of the day

1. A MORE DIVERSE ECOSYSTEM

With the growth of the private debt market in recent years, and the accompanying growth in competition, managers are under more pressure to differentiate. LPs are also looking for more diversity in their private debt exposure. There has been a gradual increase in demand for private debt linked to real assets alongside traditional corporate debt (which makes up roughly two-thirds of the market). The trend is highlighted by State Street's Cesar Estrada who, on p. 12, notes that more managers want to engage with fund administrators who understand the underlying assets and can serve their needs. He says: "The underlying assets and the new ways we keep track of those investments can carry operational and accounting challenges that need to be addressed."

More managers – particularly larger ones – are also diversifying into more specialised fund structures. As private credits managers move into areas such as BDCs, or seek to launch open-ended vehicles alongside traditional commingled funds, service providers will need to respond to demands for outside expertise. ■

2. INCREASING NEED FOR THIRD-PARTY SOLUTIONS

The growing need for outsourced fund services is a well-established phenomenon and inextricably linked to the trend above. Increasingly, managers are turning to a range of fund administrators and professional service providers as they ramp up activity across multiple jurisdictions and diversify their offering.

Fundamentally, the desire to outsource is driven by the need for increased efficiency; outsourcing administrative functions allows managers to focus on their core business. Another layer of complexity driving up the need for service providers is arguably increased oversight from investors. Fund administrator SANNE's Stephen McKenna points out on p. 22 that as the asset class has matured, managers are experiencing more targeted due diligence from investors. This has, in turn, seen a rise in requests for specific information and reporting, increasing the burden on the manager. This observation is supported by the result of a recent survey by sister title *PFM* (p. 10) in which most respondents reported increased demand upon back office functions as a result of more investor due diligence. ■

3. INVESTOR DEMAND FOR TAILORED SOLUTIONS

Separately managed accounts have been rising in popularity in traditional private equity since the global financial crisis. SMAs offer institutional investors writing large cheques a way to create a customised investment programme on a discretionary basis. For the investor, these provide more favourable economic terms and allow greater flexibility to co-invest alongside manager-sponsored funds. As the private debt investor base becomes more sophisticated, there has been growing pressure on managers to provide customised fund solutions. By setting up SMAs, larger institutional LPs are also seeking greater transparency and specialised fee structures that are not available in a traditional commingled fund.

The rise of SMAs has also brought an added layer of complexity in terms of fund governance and reporting. This is where third-party service providers have a role to play in supporting managers (as they work to meet additional demands brought by an SMA investor). According to the Alternative Credit Council, this trend is particularly prominent in the European market, where managers are more open to such arrangements. ■

4. INFORMATION SECURITY CONCERNS

In the 21st century, cybersecurity seems like a perennial focus for the fund services industry, and for good reason. Not only is the landscape constantly changing as cybersecurity professionals respond to evolving threats, but the expectations placed on managers by regulators are growing. This has been happening on both sides of the Atlantic.

Without a doubt, one of the biggest bits of regulatory news to hit the industry – indeed all industries – in 2018 was the EU General Data Protection Regulation which came into force in May. The legislation ensures companies hold greater responsibility – and far more serious consequences should they not comply with disclosure rules – in the case of a data breach. But Europe is not alone in its drive to hold companies more accountable for their data security. As detailed on p. 6, the SEC, through its new Cyber Unit, has put the industry on notice that cybersecurity is a priority. And yet, despite publicity surrounding cybersecurity, the consensus still is that many in the financial services industry are under-performing on this issue. ■

5. THE RISE OF FUND-LEVEL FINANCING

Unlike other alternative asset managers, most private credit managers do not use fund-level leverage, and when they do, they do so in a fairly conservative manner. According to *Financing the Economy 2018*, a report published by law firm Dechert alongside the Alternative Credit Council (explored in more detail on p. 8 and p. 14), around three-quarters of managers that do use fund-level leverage report levels of debt to equity lower than 2-to-1. However, there are parts of the industry using higher levels of leverage as financing of loan portfolios becomes more sought after.

Another notable trend that has become prevalent in private debt over the past two years has been the use of subscription financing – borrowing against investor commitments to fund deals. Today, around three-quarters of managers are using such subscription facilities for terms of up to one year. The industry is at a point that the practice has now become standard procedure for many managers. ■

CYBERSECURITY

The false economy of complacency

Increased scrutiny has made cybersecurity more important than ever for fund managers, but vital steps to avoid disaster need not be costly or complex. **David Turner** reports

In 2017 the SEC Division of Enforcement created its first new unit in eight years: the Cyber Unit. This team – about 40-strong, according to SEC watchers – deals with all cyber issues, including cybersecurity, as well as computer-based market abuse and cryptocurrencies: the medium for most cyber criminals trying to extort money from corporate victims.

The unit is headed by Robert Cohen, a highly respected SEC official, and staffed by "the cream of the crop", according to Sam Waldon, litigation partner at US law firm Proskauer in Washington DC, and former assistant chief counsel in the SEC's enforcement division. Within enforcement, he describes the broader topic of cybersecurity as the SEC's top equal priority for the current chairman, Jay Clayton, along with retail. As a result, in the SEC's rolling system of investigations of investment advisors, "cyber has become a big part of the examination".

"[THE FCA] IS BEGINNING TO SEND THE MARKET THE MESSAGE, 'WE ARE TAKING CYBER VERY SERIOUSLY ... IF WE DO NOT THINK YOU'RE TAKING ADEQUATE PREPARATION IN RELATION TO YOUR CUSTOMERS, WE TOO WILL FINE YOU'"
David McIlwaine

The ramping up of the importance of cybersecurity dates to 2014, when the SEC issued a cybersecurity risk alert. This, and other guidance documents since then, make clear that financial services firms must have a formal cybersecurity programme, with someone responsible for evaluating what the firm is doing to prevent cybersecurity incidents.

This is not to downgrade the importance placed on cybersecurity among financial regulators in Europe, since the EU's General Data Protection Regulation came into force in May 2018. Under these rules, a company that suffers a serious breach of data must tell the regulator and any individuals involved within 72 hours or risk a maximum fine of €20 million or 4 percent of global turnover – whichever is greater. It must also disclose the data taken, how sensitive it is and the volumes involved.

Prompted in part by GDPR, financial regulators have begun to show much greater interest in cybersecurity. In the UK, lawyers note the joint enthusiasm of three parties – the Information Commissioner's Office, the Bank of England's Prudential Regulation Authority and the

Financial Conduct Authority – in stressing the dangers of cyber-crime.

"The FCA has really ramped up its consideration of cyber," says David McIlwaine, partner at London-based law firm Pinsent Masons and specialist in ICT and outsourcing. "It's beginning to send the market the message, 'We are taking cyber very seriously; we don't just leave it as the preserve of the ICO. If we do not think you're taking adequate preparation in relation to your customers, we too will fine you.' "

The FCA also makes clear its view that many firms are not doing a good job in this field. In a review of asset managers' and wholesale banks' cybersecurity practices published in December 2018, it found that most boards did not understand cyber-risks well, and that many risk and compliance departments had limited expertise.

Optimistic fund managers might note there have been few high-profile public examples among their peers of successful hacking: many had information on their clients disclosed in the Panama Papers incident of 2016, but the leak came from Mossack Fonseca, a now extinct local law firm.

HUMAN ERROR

However, beyond the public gaze, lawyers on both sides of the Atlantic say they are familiar with successful hacks at fund manager clients. Few of these hacks have relied on state-of-the-art techniques, it is generally much more basic than that.

"Usually the breaches I've seen have not been real technical hacks in the way I imagined hacks happening, where someone was an expert at writing computer codes. Instead they've been cases of human failure," says Waldon, who reports seeing several such instances since leaving the SEC for private practice last year.

He cites cases where someone takes an email address purporting to be that of someone at a client company, but which is in reality slightly different: such as two "v"s instead of a "w". The email requests the fund manager to change the wiring details for money from the usual account to another one at a different bank, from where the money is siphoned off. This is a form of "phishing" that involves hoodwinking a person rather than an IT system.

Waldon's experience underscores the importance of maintaining what experts call "basic cyber hygiene": training staff in good practice, ensuring IT hardware and software are kept up-to-date, and so on.

James Rounds, associate partner and cybersecurity expert at EY, the professional services firm, in London, says that for the small and mid-sized businesses that account for most fund managers, basic cyber-hygiene provides "the greatest cost-benefit ratio".

This, plus one more practice: spending money on software that automates labour-intensive tasks, such as monitoring security event logs. In other words, smaller fund managers, which make up of the bulk of managers within private debt, need not despair: there is much they can do, even with slender resources.

But training in cyber-hygiene must vary depending on the person, say experts, because canny scammers will tailor cyber-attacks to the person being scammed.

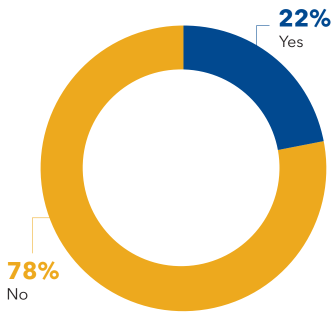
Valerie Abend, managing director of the financial services security practice for North America at Accenture in Arlington, Virginia, gives an example: a scammer might send a fake CV from a fake female applicant to a female HR manager. An emotionally engaging email says, as Abend imagines it: "My friend told me that your organisation really cares about diversity and inclusion" – a sensitive topic in fund management, where most of the fund managers are men. "I'm a woman seeking to make a change in my career. I would love it if someone could take a look at it."

Embedded in the resume is malware, and the fund manager is breached. ■

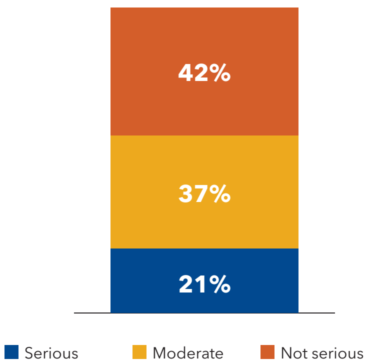
A MATTER OF WHEN, NOT IF

A 2018 survey of private fund managers by EY revealed that more than one in five had been victim to a cybersecurity breach

Has your firm recently experienced a cybersecurity breach or incident?



If yes, how serious was the breach or incident?



Source: EY 2018 Global Private Equity Survey

"USUALLY THE BREACHES I'VE SEEN HAVE NOT BEEN REAL TECHNICAL HACKS IN THE WAY I IMAGINED HACKS HAPPENING, WHERE SOMEONE WAS AN EXPERT AT WRITING COMPUTER CODES. INSTEAD THEY'VE BEEN CASES OF HUMAN FAILURE"

Sam Waldon

FUND FINANCING

Walking a fine line

The use of subscription line financing by private debt managers has been an area of controversy, but market experts say its rise is inexorable. **Aaron Woolner** reports

Subscription line financing has been a feature of the private debt market for some time, but the practice was thrown into the limelight in 2017 when the Institutional Limited Partner Association published a nine-point guide pushing for improved transparency around the practice, among other issues.

While the ILPA guidelines may have generated negative publicity for sub-line financing, the practice continues in the private debt sector. A December 2019 report by the Alternative Credit Council in conjunction with law firm Dechert, found that 43 percent of private debt managers had self-reported using sub-line facilities with a duration of up to 12 months or more.

Others are convinced that the practice is far more widespread than that. Jeff Johnson, head of subscription finance at Wells Fargo, says sub-line use – at least among his firm's clients – is a near universal practice.

"The influx of sub-line facilities for the private debt sector hasn't really changed in the last 12 months, but has instead become part of the standard operating procedure for a debt fund manager over the course of the latest cycle," he says, noting that most investors strongly support using subscription facilities. "There is a smaller segment of LPs that do not like sub-line facilities. This hasn't changed. The same investors that are vocally averse to sub-line facilities today were the ones opposed to their use five years ago."

Interestingly, despite the negative publicity generated around the use of sub-lines by the ILPA guidelines, Johnson credits the focus on transparency from both managers and investors as the driving force behind the increased use of this type of financing by private debt funds.

"If I had to pick one factor behind the increased use of sub-line financing by private debt managers then it's probably the greater transparency," he says. "Sub-line financing essentially came out of the shadows as a result of the ILPA-generated publicity."

> "IF I HAD TO PICK ONE FACTOR BEHIND THE INCREASED USE OF SUB-LINE FINANCING BY PRIVATE DEBT MANAGERS THEN IT'S PROBABLY THE GREATER TRANSPARENCY"
> **Jeff Johnson**

Johnson is backed in his view by Gus Black, a London-based partner at law firm Dechert. When the guidelines were published by ILPA there was pushback from the legal sector and Black still takes issue with the implication that the use of sub-line facilities is financial engineering, rather than a legitimate instrument. But he says the ultimate result of the guidelines was greater understanding of the practice by investors.

"When ILPA got involved in the guidance on sub-line facilities, there was significant media reporting around negative investor sentiment for sub-lines, because of concerns around managers gaming returns to juice up their IRR," Black says. "But what was much less reported, but equally valid, is that investors really like these facilities because then they only have to worry about two drawdowns a year and are not being constantly pestered by managers."

Black notes that the ILPA guidelines are only recommendations, and that managers don't have to follow them to the letter. "There are many cases where it would be appropriate to depart from them, but what it does do is put the issue firmly onto the investors' radar. It was already on the radar of sophisticated investors."

In any case, Black says the increased use of sub-line financing simply reflects a broader trend of investors looking to diversify their asset base. He also points out that a minor driver behind the increased use of sub-line financing is private equity managers moving into the credit sector.

"You have private equity managers who have diversified into credit and are already using sub-line financing in equity strategies, so think why not use it in the context of their credit business, particularly as this sector often requires more rapid drawdowns, on shorter timelines, with a greater deal frequency than their private equity strategies?" he says.

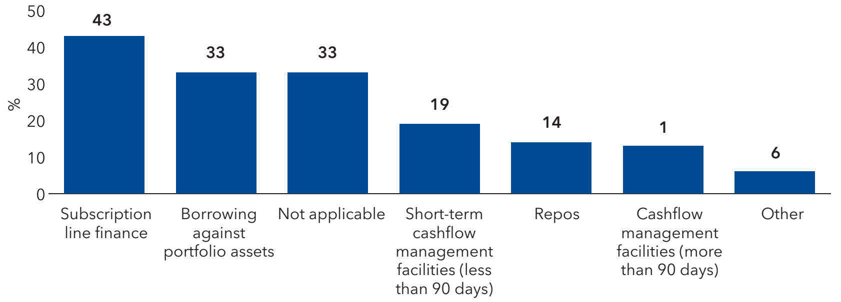
"What is driving the growth of sub-line financing is the combination of the need for quickly available capital and the comfort that investors, and managers, have with these facilities – particularly when the cost of such financing is relatively cheap."

This point is echoed by fellow London-based lawyer Leon Stephenson, who says that the management structure of private equity firms lends itself to applying the same financing strategy to different parts of the business.

"More private equity firms moving into credit is one reason for the expansion of sub-line financing in the latter sector," Stephenson says. "With the big private equity funds, often the CFO for the equity business also runs the firm's credit fund. These CFOs have relationships with the banks from the PE fund and it makes sense that they leverage off those to finance the credit fund as well."

ANOTHER KIND OF LEVERAGE

Almost 70 private debt managers were asked to select which of the following types of financing leverage their firm used with respect to their private credit strategies



Source: Financing the Economy 2018 survey, Dechert/ACC

GROWING TIMELINE

But while Stephenson may view the rise of the sub-lines as inevitable in the private debt sector, he still has reservations. According to him, sub-line duration has expanded dramatically, and what was once seen a short-term financing tool is often being used for much longer periods.

Indeed, the ACC/Dechert report noted that over half of respondents had used sub-lines for periods in excess of six months (26 percent) or 12 months (24 percent). According to Stephenson, this is a significant difference and underlines the need for transparency by managers around their use of leverage.

"Sub-lines are now being used for a period which is in excess of the original times, which were normally bridging loans of 30, 60 or 90 days," he says. "As soon as you have these facilities that are out there for six months or a year, that becomes a powerful tool for the fund manager, because what it can do is effectively get financing right at the top of the fund level without using the underlying assets as recourse."

Black agrees, saying that while sub-lines are themselves not problematic, they could be if they are used for periods of 12 months or more and start to resemble another form of financing. "The issue is: how much is the line blurring between simple vanilla short-term financing that's money repaid every 90 days, and cash that is longer term and actually used to lever the portfolio?"

Johnson is less concerned about the issue of duration, saying that longer periods could be attractive, depending on the underlying strategy deployed.

What is, and isn't sub-line financing, may still be a topic for debate, but according to Johnson, the continued expansion of sub-line facility use by private debt managers is inevitable as part of the secular shift that has driven the expansion of the private debt market over the last decade.

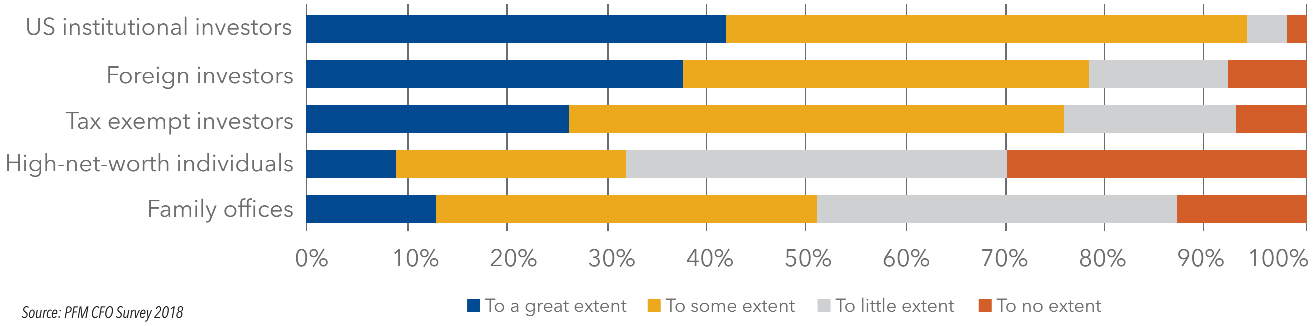
"An important factor behind the expansion of sub-line facilities in the private debt sector is the growth of AUM in that market," Johnson says. "Ten years ago, private debt was a fifth the size of today, so the increasing number of sub-line facilities lent in dollars, and number facilities, is more a function of the growth of the private debt market in general, rather than anything that is specific to sub-line financing itself." ■

CFO SURVEY

Doing the homework

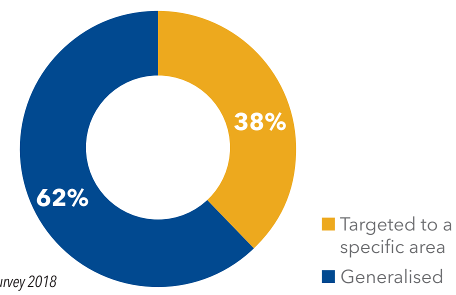
Highlights from *PDI* sister title *PFM*'s survey of CFOs reveal an increased interest in due diligence and back office functions among investors

OVER THE LAST 3 YEARS, TO WHAT EXTENT HAVE THE FOLLOWING INVESTORS CONDUCTED GREATER DUE DILIGENCE, THUS INCREASING DEMAND ON THE BACK OFFICE?



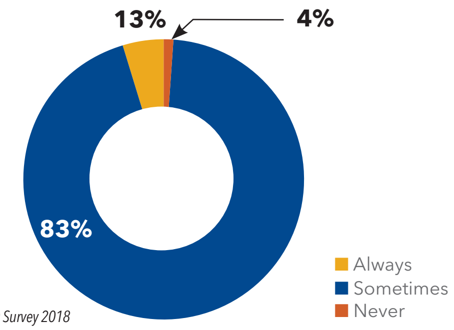
Source: PFM CFO Survey 2018

HOW HAS THE GREATER DUE DILIGENCE BEEN TARGETED?



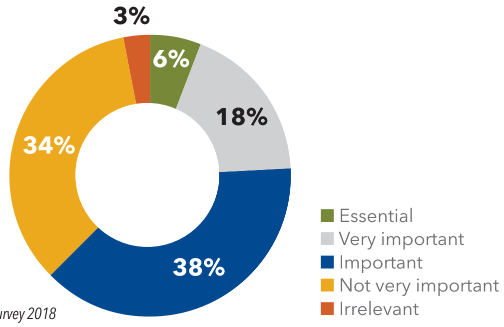
Source: PFM CFO Survey 2018

TO WHAT EXTENT DO LPs DEMAND TO SEE CFOs PERSONALLY DURING THE DUE DILIGENCE PROCESS?



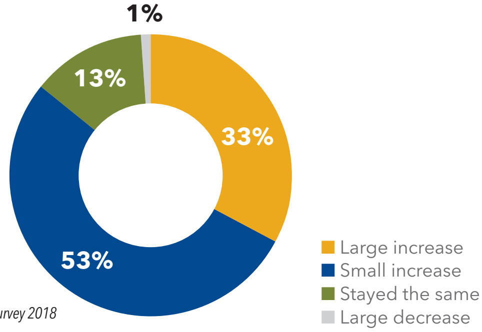
Source: PFM CFO Survey 2018

HOW IMPORTANT IS THE GP'S ABILITY TO OFFER BETTER REPORTING THAN THEIR COMPETITORS TO INVESTORS' DECISION TO INVEST?



Source: PFM CFO Survey 2018

HOW HAS LP INTEREST IN THE BACK OFFICE FUNCTIONS CHANGED OVER THE PAST THREE YEARS?



Source: PFM CFO Survey 2018

How to keep ahead of the game

As we near the end of the current cycle, the maturing private debt industry hits a crucial stage in its evolution. **Cesar Estrada**, State Street's head of product management for private equity and real assets fund services, explains how fund services will play a part

Q What trends are you seeing with your clients in terms of investment strategy?
This relatively young private market asset class continues to display a significant amount of activity and creativity across not only investment strategy, but also fund structures, institutional investor behaviour and distribution channels. As it relates to investment strategy, the broad theme we are seeing is the private credit investment universe continues to expand. Also, the specialisation of managers is starting to become much more apparent. Direct lending to mid-market companies tends to be the most popular investment strategy, but even as that continues to evolve and grow, different fund managers are subdividing it into tiers, such as the lower and upper mid-market.

Sponsored deals continue to be the bulk of what we see in private credit. Non-sponsored deals seem to be harder to originate, but they're happening. There are other forms of private credit with operational challenges that we're starting to see more of too. We now have real estate and infrastructure credit starting to pop up through some of the big real estate managers. We're also seeing distressed debt and all sorts of speciality financing as well.

Q Do you feel the industry is sufficiently prepared for a downturn?

"MANAGERS WANT TO ENGAGE WITH FUND ADMINISTRATORS DIFFERENTLY AND IN A WAY THAT RESONATES FOR THEM"
Cesar Estrada

We don't claim to have a crystal ball as to when there will be a downturn, but certainly a downturn must happen as everything operates in cycles. We've been working with private credit managers for many years, even before the financial crisis, and we believe they're here for the long-term. There's been a gradual shift over time into the more senior rungs of the capital stack in anticipation of a downturn.

When we look at what happened in the financial crisis, and we look at the US mid-market, for example, the default rates of mid-market private companies were relatively lower versus other areas. That's not to say a downturn won't impact these investments, but our clients are creative, and work to evolve their investment strategy to take advantage of opportunities the next downturn may bring.

Q Is the increasing diversity and innovation among private debt managers creating new challenges for fund services?
It does in several ways. As private credit branches out from being predominantly corporate debt into real estate, infrastructure and other areas, managers that have a legacy in these asset classes want to differentiate. They want to engage with fund administrators differently and in a way that resonates for them. They want to see that we understand the underlying assets and can serve their needs. At its core, the fund administration offering is similar across all private market asset classes, but the underlying assets and the new ways we keep track of those investments can carry operational and accounting challenges that need to be addressed.

Q Are clients more comfortable with outsourcing more responsibilities and are fund services providers expanding their remit?

One thing some of our most successful clients are doing to fully take advantage of outsourcing is associated with how they are leveraging their origination and underwriting platform more broadly across different product types. Some time ago, a manager would have had to pass on a $500 million deal or do it as a club deal, adding complexity. Today, they might do it themselves and then allocate it to different types of funds all under their brand.

In other words, a successful private credit manager who launched a series of private funds might now be launching a specialised fund with certain requirements. While some of those structures may be familiar to the manager – the LP structure, the carried interest and the waterfalls – something like a BDC, an open-ended fund, a Luxembourg fund or a new wealth management distribution channel could be unfamiliar. It might be new territory and have an additional requirement. We enable them to continue growing at a fast pace without investing in new infrastructure on their side.

Q What qualities are the private credit managers now looking for in a fund administrator?

I think clients are looking for a more streamlined model that allows them to not only have the fund administration, accounting and loan services – ideally with a single party – but also the banking, the custody and the financing.

As we've seen with the growth of our private credit book of business, I think we've become more intelligent about how we offer value to our clients. Banking is synergistic with accounting given the volume of transactional activity in a private credit portfolio and the need to sort through all of this, reconcile it and tag it for performance on a deal-level basis. Additionally, we're using our balance sheet to support key clients with their financing needs, such as subscription lines of credit and, more recently, asset-level financing.

> "OVER THE LAST FEW YEARS, INSTITUTIONAL INVESTORS HAVE GROWN FROM INVESTING IN THIRD-PARTY FUNDS, OR FUNDS-OF-FUNDS, TO DOING CO-INVESTMENTS AND FUNDS-OF-ONE"
>
> **Cesar Estrada**

Q How has the way fund services providers work with investors evolved?

Over the last few years, institutional investors have grown from investing in third-party funds, or funds-of-funds, to doing co-investments and funds-of-one. The degree of sophistication keeps growing in private credit. What we've seen is driven by significant appetite for exposure to North American private credit.

We have several very large and significant non-US institutional investors accessing this market in different ways. Some have, or are in the process of building, their own investment teams. What they're looking for from State Street is for us to be their infrastructure so they can focus on building their investment and origination team without having to focus on building an operation.

Recently we have seen several large investors taking a sophisticated approach by creating multi-manager fund structures to quickly deploy their capital as they try to catch up on allocations to private credit. They'll engage with different managers and create complex fund structures with different sleeves with different managers. What they want from us is to support those structures and deal with reporting, as well as work with their various fund managers and gatekeepers.

Q What role do you think technology will play in the future of fund services?

It's a long journey. Someone at a recent blockchain conference said something that resonated with me: when you're in the thick of technological change it seems more evolutionary; but when you look back eight years from now, it will look much more disruptive. The ability to produce, store and deliver data has always been important in the private credit space. The 24/7 availability of fund investment and investor data in today's global market is increasingly important to our managers and clients regardless of their location.

They're looking for more, including the ability to aggregate and produce data from various sources in a very easy, digestible manner. We have clients where we automate all their records and bring them together on a deal-by-deal cashflow basis with numerous data points so they can easily slice and dice performance data for multiple uses. As the industry evolves, we'll continue to develop increasingly sophisticated reporting solutions for our clients.

Q Does this make cybersecurity a growing concern?

For us, as a regulated large financial institution, it's critical to have a long-term risk-based strategy to safeguard our client's information. We have extended our cyber and information security to our global organisation and have aligned our operations – not only our internal subsidiaries but also our joint ventures – around a common framework. We continue to build our next generation of cybersecurity capabilities to enable secure business growth as we invest in people, processes and technology to protect our client's data. ■

FUND STRUCTURE AND FINANCE

Vehicles of change

Jiri Krol, deputy CEO and global head of government affairs at the Alternative Credit Council, explains the key findings from its recent survey on fund innovation in the private debt market space

The growing investor base for private credit is one of the most notable achievements of the asset class over the past few years. This success has been accompanied by an expansion in the requirements that private credit managers must meet to accommodate investors' needs. Private credit fund managers have responded with innovation, flexibility and by offering an open ear to allocators' needs.

In *Financing the Economy 2018*, published in November, the Alternative Credit Council and Dechert revealed new insights into the growth of the private credit industry and the developments of fund structures. The research drew on the findings of an industry-wide survey of private credit managers who collectively manage an estimated $470 billion in private credit instruments across a broad cross-section of jurisdictions and strategies. Below we highlight some of the key findings of our analysis.

PREVALENT STRUCTURES

Investor requirements and a manager's underlying strategy will always drive the development of the optimum fund structure. To provide finance to the real economy over the long term, the private credit industry generally adopts a private equity-style closed-end commitment and drawdown structure as being the most appropriate. Under this model, the fund life spans the raising of funds, investment, the holding of positions and profit taking.

Private credit funds tend to include more generous recycling (reuse of drawn capital) provisions than equity strategies where the likely tenor of underlying loan means that capital can be deployed efficiently multiple times during the lifetime of the fund.

From the research conducted, these structures appear to be more commonly used by larger managers. This may be down to the natural smoothing that can be achieved in larger funds and the greater operational complexity of operating these types of structures.

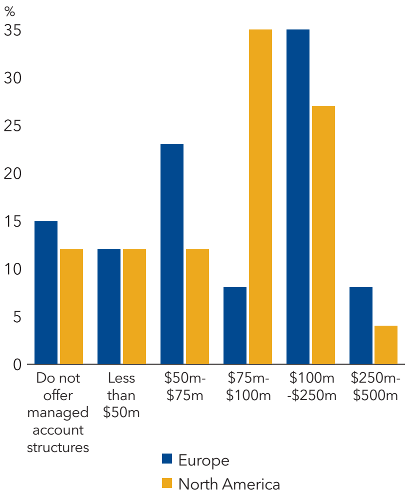
Open-ended fund structures can also be useful for funds investing in shorter term and liquid loans. This can be the case both where the loans have been sourced

"THE GROWING INFLUENCE OF INSTITUTIONAL INVESTORS IN PRIVATE CREDIT HAS PROMPTED PRIVATE CREDIT MANAGERS TO WORK WITH THEIR INVESTORS TO OFFER BESPOKE SOLUTIONS PRECISELY MATCHING THEIR SPECIFIC NEEDS"

Jiri Krol

OPEN IN EUROPE

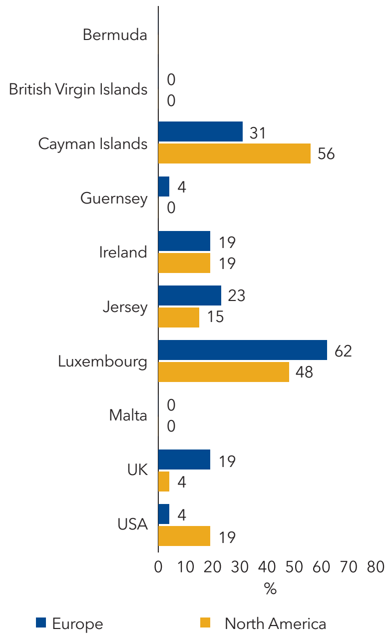
At what level are you able to offer a managed account structure for single investors? (By region)



Source: Financing the Economy 2018 survey, Dechert/ACC

THE LUXEMBOURG LEAD

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



Source: Financing the Economy 2018 survey, Dechert/ACC

by the fund itself or have been acquired from a third party. This structure allows liquidity to be aligned at the fund level with the terms of the underlying loans.

With both these types of structure the maturity of the capital in the fund is matched to the lending facilities that managers offer to the real economy. This both provides funding stability for borrowers and eases cyclical tendencies in credit markets.

INVESTOR CUSTOMISATION

The growing influence of institutional investors in private credit has prompted private credit managers to work with their investors to offer bespoke solutions precisely matching their specific needs. These can be attractive as they allow investors to have greater control over their investments, including a higher level of transparency and customised fee arrangements. By contrast, commingled fund structures – which consist of assets that originally come from multiple accounts that have combined into one account – cannot offer this level of customisation, even with extensive side letter provisions or the use of special investment classes. However, it is commonly acknowledged that managed account structures can bring with them additional complexity in terms of fund governance and fee arrangements.

Although a significant majority of managers in both Europe and North America continue to hold firm that such arrangements are not available, the results from our survey indicate that European managers, who may be in more aggressive growth mode, appear more open to this arrangement.

ATTRACTIVE DOMICILES

The findings of our research point to an industry that is becoming more settled in its choice of fund structures and domiciles. North American managers now display a strong preference for Cayman Islands-domiciled funds whereas their European counterparts appear to favour Luxembourg. We also see a preference from European managers to fundraise locally, where regulation, tax and legal factors contribute to making an onshore structure more appealing to investors. Other factors that typically impact the choice of domicile for a European fund include how it impacts an investor's ability to allocate, the simplicity of marketing the fund and how efficient the structure is in deploying capital.

Private credit managers continue to develop and improve fund structures and terms. Over the last year, however, the industry appears to have selected a closed-end commitment and drawdown structure as the model most suited to deliver long-term lending to the real economy. Similarly, while there are regional variations in which fund domiciles managers use, the industry seems to be more settled regarding its preference as to where it domiciles funds.

YEAR AHEAD

As we look ahead to 2019 there are some indications that liquidity considerations are becoming increasingly important to investors looking to allocate capital. There is a natural tension between this demand for liquidity and the illiquid nature of the asset class.

Although there are different views in the market, there is a strong sense generally that private credit managers should hold the line on this matter. Ensuring consistency between fund liquidity and the underlying assets has one of the main reasons behind private credit's success to date. Maintaining this will provide a strong foundation for further growth of the asset class. ■

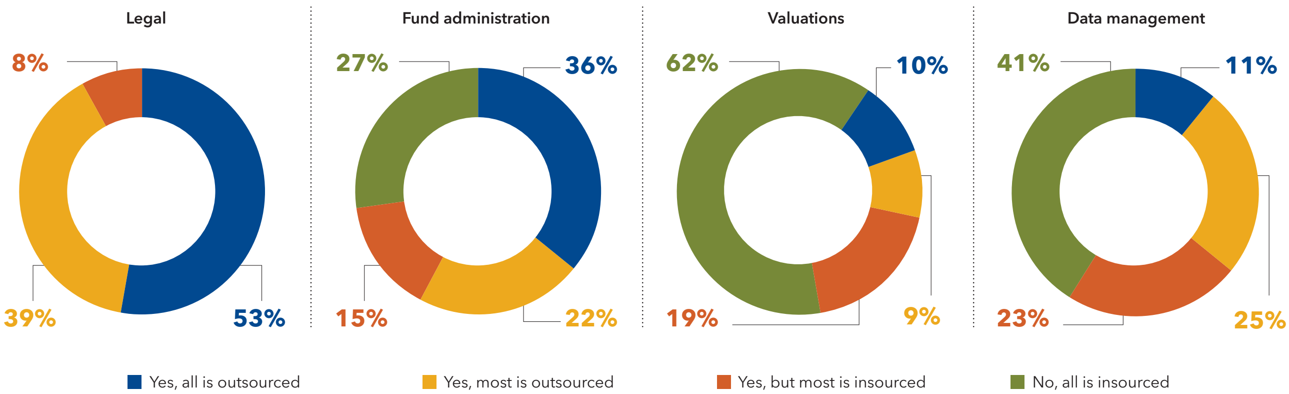
FEES AND EXPENSES SURVEY 2018

Who pays the bill?

A recent survey by *PDI*'s sister title *PFM* puts the spotlight on outsourcing trends among fund managers and who picks up the tab

IN-HOUSE OR OUT?

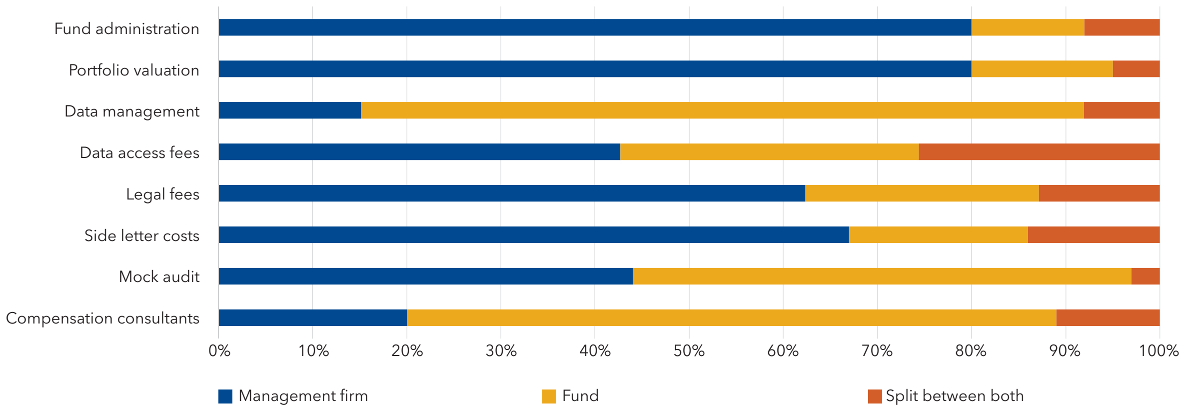
Do you outsource the following services to third parties?



Source: PFM

PICKING UP THE BILL

Who bears the cost of the following outsourced services?



Source: PFM

PASSING ON THE COST

If you are insourcing any of the above services, do you charge any to the fund in addition to management fee?

Source: PFM

TERMS AND CONDITIONS

"TECHNICAL BREACHES BY BORROWERS – SUCH AS LATE DELIVERY OF DOCUMENTS – ARE BEING USED TO HOLD BORROWERS' FEET TO THE FIRE"

Why lawyers are urging lenders to get aggressive

With documentation strongly in favour of borrowers, financiers are being told to look for excuses to redress the balance of power, writes **Andy Thomson**

The erosion of junior debt, looser covenants and less reliable cashflow projections are combining, in the view of some market sources, to produce an unholy brew of toxic ingredients confronting the leveraged loan market.

Research published last summer by Cambridge Associates revealed that, since the end of the credit crunch, far less junior debt is being included in deals – largely as a result of it being usurped by the unitranche product, which is often seen as a more user-friendly option by borrowers.

The significance of this is that junior debt helps to cushion senior debt holders from losses in the event of a default. The less junior debt, the quicker senior debt will start absorbing losses. Cambridge estimates that, as a consequence, recovery rates on defaults on leveraged loans may decrease from an average of 60-80 percent to between 46-70 percent.

This is against a background of various pressures which could make defaults more likely. One is the tendency for deal agreements to incorporate questionable assumptions of future cashflow – perhaps based around anticipated synergies, new contracts or revenue generation from initiatives not yet launched. These might uncharitably be described as "pie in the sky" assumptions.

The trend towards covenant-lite structures has been well documented, but certain provisions that have crept under the radar could be more damaging than those which have received more publicity. Cambridge highlights, as an example, agreements which allow the borrower to remove assets from a lender's collateral pool to generate more liquidity – leaving the lender with less collateral in the event of a default.

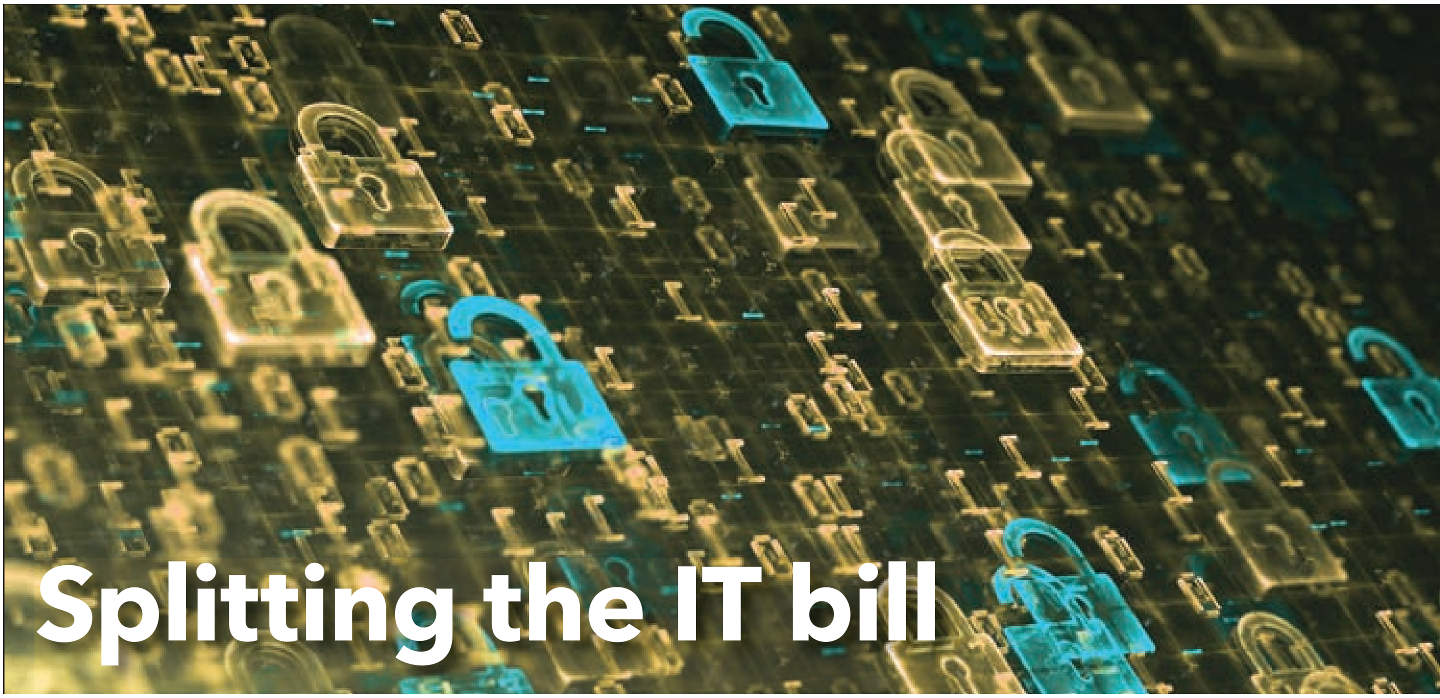
Some market sources accuse lenders of having sleepwalked into the current situation. There was no "sea change" event as such, but incremental steps have created arguably the most borrower-friendly environment in the leveraged loan market in recent memory. And that is why legal advisors are now urging lenders to wake up and smell the coffee.

FEET TO THE FIRE

What we hear is that lenders are being urged to find any route possible to renegotiate the documentation. Technical breaches by borrowers – such as late delivery of documents, tardy reporting and questionable capex items – are being used to hold borrowers' feet to the fire. Lenders are being told to focus on these breaches with alacrity and aggressiveness to try and claw back some of the creditor rights they have too readily tossed away.

Of the imbalance of power, one source told us: "These types of situations tend to find their own solutions, and the shortcomings can be addressed in unconventional ways."

Lenders may be gradually acknowledging this. Whether they can at least partially repair the damage will be intriguing to observe. ■



Splitting the IT bill

GPs should think twice before allocating too much of the IT budget to the fund, because LPs aren't inclined to pick up the tab, writes **Rob Kotecki**

While the data revolution may promise great things for the alternative assets industry, it never promised to do anything cheaply. Managing and securing that data can cost a pretty penny. But with the Securities and Exchange Commission making cybersecurity a priority, and limited partners demanding more information than ever before, few general partners are planning to cut their IT budgets anytime soon.

And GPs can't offload those expenses to the fund, at least without clear language disclosing what IT costs end up charged to investors. Cybersecurity is considered a cost of doing business, and most management companies pay for such programmes. The consensus among LPs is that all IT costs are part of the overhead, but, in practice, there are elements of the IT programme that the fund does end up paying. If the GP outsources its fund administration, the cost is passed on to the fund, which includes the fund accounting systems. But if the GP brings fund administration in-house, it will have to spell out what part of the tech solution is billed to the fund, and what is billed to the firm, as part of its overall infrastructure. But GPs should step lightly here. LPs might agree to certain terms to access top-tier funds, but these are not costs they're happy to cover.

> "IN ESSENCE, LPS DEEM TECHNOLOGY INVESTMENTS TO BE A BENEFIT TO THE GP"
> **Jennifer Choi**

SCEPTICAL SEC

And the regulator tends to agree. "The SEC is extremely sceptical of any attempt by the investment advisor to charge its own overhead costs back to a fund or any other client," says Greg Merz of Gibson Dunn. "In theory, if properly disclosed, the firm can bill its in-house administrative costs to the fund, but the regulator hates the practice."

And lawyers stress that costs related to cybersecurity and technology fall into the category of administrative expenses that the SEC, and many LPs, expect GPs to pay.

And in terms of cybersecurity, most GPs are paying for those initiatives.

According to the *pfm Fees and Expenses Benchmarking Survey*, 79 percent of survey respondents pay for the implementation of cybersecurity initiatives. Only 9 percent charge the fund. "It's a management cost," says Nabil Sabki of Latham & Watkins. "Some advisors may negotiate to lay off some of the expenses, but LPs push back on that."

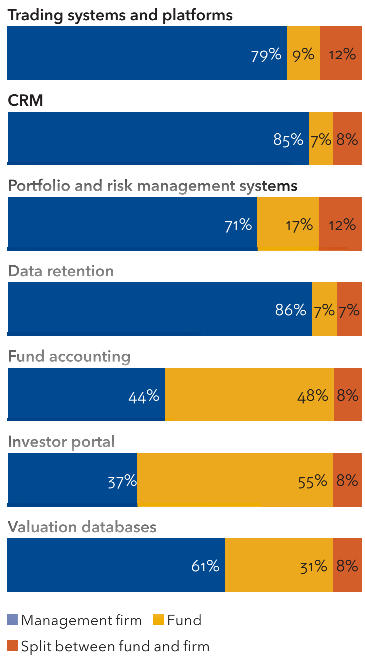
Jennifer Choi of ILPA conducted an informal poll of members to see if any investors were willing to pay for cybersecurity programmes or other technology costs. "In essence, LPs deem technology investments to be a benefit to the GP," says Choi. "It's an intrinsic aspect of operating as a best-in-class GP, and therefore, those costs should be covered by the management fee."

Although the survey did find that GPs charged other technology costs to the fund: 55 percent billed investor portals; 48 percent billed fund accounting systems; and 31 percent billed valuation databases. But there's a catch to those numbers. If the GP outsources its fund administration, the service provider has their own fund accounting and reporting software. "It's generally not controversial to charge the costs of an outsourced administrator to the fund," says Merz. But when GPs begin bringing administration in-house, the costs need to be itemised and clarified before being billed back to the fund.

"GPs need to be very specific in their disclosures around allocating the costs of in-house fund administration to their clients," says Merz. "And the SEC is more likely to question those costs. They'll test GPs on whether these costs are equal to the market rate for these types of services. Are they over-charging? Did they consider other alternatives?"

That doesn't mean that some GPs won't be able to negotiate attractive terms around technology costs with their LPs, even if regulators frown on the practice. But GPs headed to the negotiating table for their next fund should be wary of adding too much in tech costs to the investors' tab. ■

When your firm implements technology-driven systems covering the below, who pays the initial acquisition and ongoing costs?



Source: pfm Fees and Expenses Benchmarking Survey

A coming of age story

Stephen McKenna, co-head, private debt and capital markets at SANNE, digests some of the biggest developments in 2018 for a maturing private debt industry and what they might mean for the fund services sector in 2019

The start of the year often brings with it a feeling of renewed vigor and a sense of excitement for the challenges ahead. However, with a stream of elections in emerging markets, and Greece, Poland and Ukraine going to the polls in Europe – together with an expected continuation of trade protectionism and, of course, Brexit – 2019 feels like it is going to be another eventful year.

Throughout 2018, we saw a number of large investors preferring to opt for a segregated mandate or managed account above entering into a fund directly. Alongside this trend was a noticeable increase in due diligence that the investors looked to complete before they committed their capital, including some very detailed due diligence questionnaires on the administrator. Although this is a valuable exercise it can also be a time consuming one. However, since most investors ask largely similar questions, one can reduce the administrative burden by maintaining a central database of FAQs and keeping this information up to date. It is probably also worth pointing out that the due diligence questionnaires appear to be a lot more tailored to the asset class than they might have been a couple of years ago.

The more targeted due diligence queries we have received is indicative of investors continuing to increasingly recognise debt as an asset class in its own right and invest into more strategies. As this continues, one would expect to see a continued flow of requests for specific information or reporting provided in a certain format for comparison purposes. As the market continues to develop, grow and become more mature, perhaps an ILPA equivalent reporting standard will be introduced into the debt space.

"THE MORE TARGETED DUE DILIGENCE QUERIES WE HAVE RECEIVED IS INDICATIVE OF INVESTORS CONTINUING TO INCREASINGLY RECOGNISE DEBT AS AN ASSET CLASS IN ITS OWN RIGHT"
Stephen McKenna

Once investors are on-board, either into a fund or through their own account, it seems that they increasingly like to receive their reporting through an online portal. Sending emails with statements attached feels like it will gradually fade away as we continue to see more and more emphasis on information security. We fully expect this trend to continue into 2019 and the use of interactive portals will be the norm in Europe as it already is in the US market.

THE GREEN AND THE GOOD

Continuing on the trends in reporting, a pleasing development has been the growing focus on Environmental, Social and Governance. The London Stock Exchange has issued guidance setting out recommendations for good practice in ESG. The global guide responds to demand from investors for a more consistent approach to ESG reporting, which is now a core part of the investment decision process. It was recently reported that Chicago Teachers considered managers' workplace diversity as a factor in their investment selection. In addition to being up to speed on best practice ESG reporting, perhaps the increased due diligence on administrators will expand further to consider administrators' positions on key ESG indicators as part of the selection process too.

The FCA also issued a discussion paper in December in relation to climate change and green finance. We will need to see what comes from this discussion and feedback but it could potentially result in further disclosure requirements and a standardised framework to improve investor understanding of an investment's environmental impact. Due to political pressure and advancements in technology, it is not surprising to see a few predictions being bullish in relation to the growth of the renewable energy market over the next few years. It will be interesting to see how much of a contribution debt plays to this market.

Our accounting team have been busy evaluating the impact of International Financial Reporting Standard 9 – a new accounting standard for financial instruments – since it will come into play for the December 2018 annual accounts currently underway. Full retrospective application is required, as is a detailed note to the financial statements showing the effect of adoption of IFRS 9. However, the comparatives are not required to be restated. Instead, the effect of adoption of IFRS 9 can be presented simply as a movement in reserves. Nevertheless, it might be preferable to elect to restate if this results in a clearer presentation by enhancing the comparability of the prior year information, but restatement is permitted only if it is possible to do so without the use of hindsight.

CONSOLIDATION PLAYS

Throughout 2018 it felt like there was a consistent move towards consolidating. We heard how there was continued capital consolidation; we saw joint ventures between managers and investment managers teaming up with banks. In the administration world, there has been continued consolidation with high levels of M&A activity and this is something we expect to see throughout 2019. As managers run increasingly complex, cross-jurisdictional products with higher substance requirements and more detailed reporting obligations, it is increasingly difficult for smaller firms to provide the services needed and to pay for the systems and infrastructure that is required to support these deals.

One area that is always worth looking at when considering upcoming challenges is the regulatory horizon. Adoption, implementation and roll out of new regulation can significantly affect our industry and there is a heavy schedule of future disrupters. In 2018 we saw substance rules introduced alongside the Anti-Tax Avoidance Directive in Luxembourg and General Data Protection Regulation, to name a few. The 5th Anti-Money Laundering directive is expected to come into effect by the end of 2019 and primarily deals with the use of digital currencies and advances in the financial technology space.

We saw several enquiries in relation to fintech and blockchain throughout 2018 and this growth area certainly feels like it will have an increasingly important role to play in the future economy. Therefore, the need to ensure that the supporting regulatory framework is up to speed is being addressed by the next installment of the AML directive. Administrators will have a key role to fulfil, as governance and robust controls will be fundamental to maintaining confidence in the industry.

Substance has also been an ever-increasing area of scrutiny and focus with the introduction of the EU substance requirements together with best environmental practices. One can be sure that this will continue into 2019 and beyond. The days of postbox companies are virtually gone from all but a few of the less professional jurisdictions. Now administrators need to take care that they are fulfilling the requirements and guidelines to avoid bringing any dispute about the domiciliation of a structure they are looking after. This includes making sure meetings are properly convened and held regularly, management and control is demonstrated, and books and records are maintained and completed to a high standard.

As a final thought, although fundraising slowed last year compared to the bumper 2017, it is widely believed that the private debt market will continue to grow over the next five years. Some predictions even show the market doubling in size over that time. Aside from the growth itself, it will be interesting to see how much our industry evolves and what contribution private debt will make to the future global economy. ■

> "IN THE ADMINISTRATION WORLD, THERE HAS BEEN CONTINUED CONSOLIDATION WITH HIGH LEVELS OF M&A ACTIVITY AND THIS IS SOMETHING WE EXPECT TO SEE THROUGHOUT 2019"
> **Stephen McKenna**

SAID AND DONE

Back office perspectives

From regulatory headaches and investor concerns to fund domiciles and cybersecurity, here are some on the top issues discussed by the fund services industry in 2018

"Cyber-risk is not just the responsibility of the technology team or your outsourced service provider. It's a shared responsibility of the organisation. It's got to come from the top down"
Eric Feldman, CIO of The Riverside Company, on how cyber responsibility starts at the top

"In cloud services, the security is baked in. So once you're on it, you're automatically receiving that benefit and the tools that you're using"
Prom Vatanapradit, head of technology at CCMP Capital, on the advantages of cloud technologies

"Those who have been preparing for it – many for the best part of two years – are also realising that the task is far from accomplished while the clock is ticking"
Eduardo Usturan of Hogan Lovells on how panic was setting in as GDPR approached

"I think that counsel who represent LPs are taking a harder line"
Julie Corelli of Pepper Hamilton recounts an LP objecting to travel expenses as part of deal origination costs

"We have people commuting into the city from three countries. We have to deal with traffic jams, but this is nothing compared to London or Paris"
Luxembourg for Finance's **Tom Theobald** shrugs off the growing pains in the Grand Duchy

"It used to be a very manual system – literally. When I arrived here, it happened to be one guy who had all of these manila folders in the back of his desk, and he would reach out when one of these issues would come up"
John Finley, Blackstone's chief legal officer, on how the legal landscape has changed

"A lot more funds are altering their LPAs and creating a more detailed procedure for fee and expense allocations. They've become a lot more transparent and detailed"
Tom Angell, partner at WithumSmith+Brown, on how GPs are reacting to LP pressure over fees