The Rise of Private Debt

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The rise in demand for private debt has been aided by an ultra-low yield environment and bouts of extreme volatility in Europe's public bond markets in the years since the financial crisis. A short-term freeze in bank lending to the real economy in the crisis of 2008/9 was followed by a prolonged period of retrenchment by banks, particularly from longer-dated or riskier lending, in order to deleverage and meet stringent new capital requirements imposed by CRD IV. The post financial crisis shift from traditional bank funding models towards alternative lenders has been particularly rapid in the mid-market as SMEs continued to need fresh capital to refinance their existing loans and raise new ones to fund their business growth, hence a dislocation and funding opportunity presented itself.

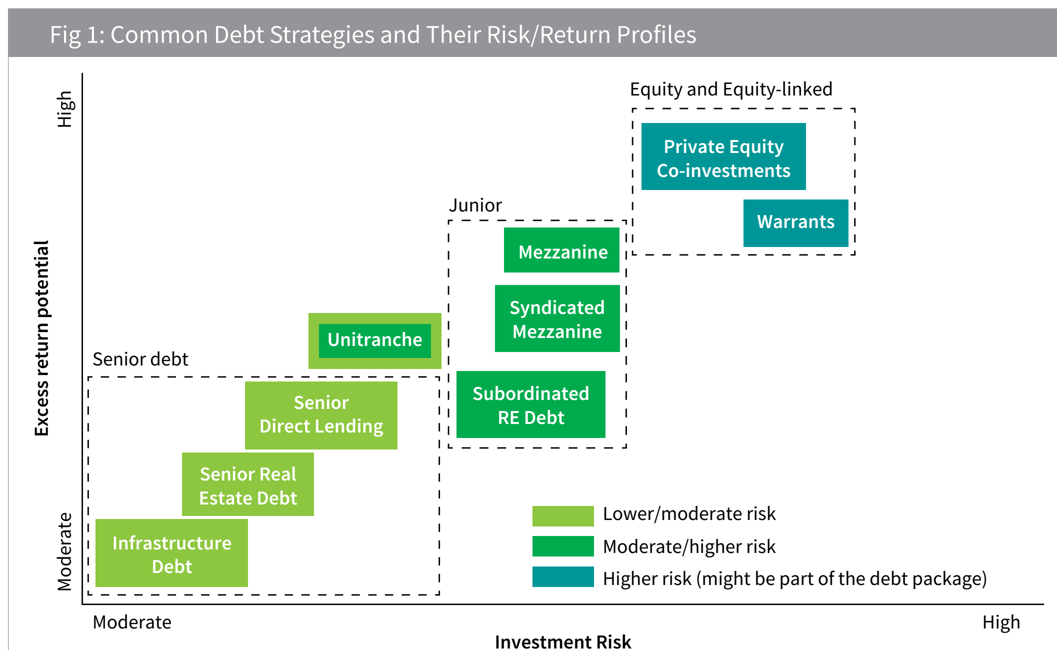
Europe is heavily reliant on small to medium sized enterprises (mid-market companies) for economic growth, which makes maintaining a robust funding environment for the mid-market crucial for the region. However, lending to the mid-market has its practical challenges due to lack of quality data and underdeveloped evaluation and credit scoring methodologies.

Private lending market landscape

Private debt funds come in numerous forms and pursue a wide range of strategies with different risk/return profiles. Such funds extend loans or specialise in the purchase of already existing positions, provide senior secured lending, subordinated and unsecured financing instruments or mezzanine lending. Alternatively, unitranche lending defines a single block of financing by a private debt fund across various layers in the capital structure, from first lien to subordinated, hence potentially making the private debt fund a single source of debt financing to a business. At the high end of the risk/return spectrum private debt funds may apply distressed-for-control-strategies, or invest in other complex enterprise strategies.

The multiple types of strategies and their common risk/return profiles are described below:

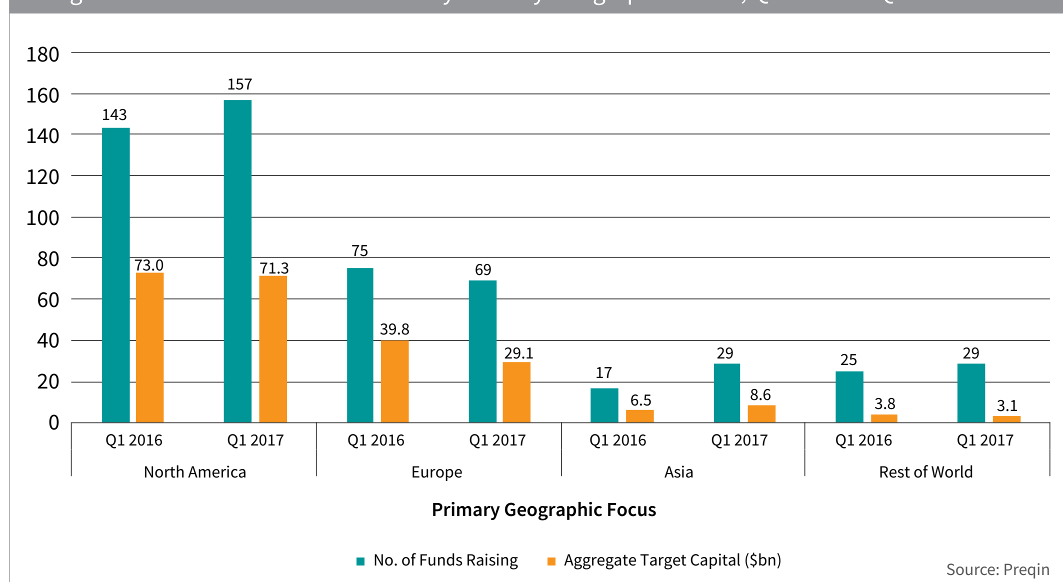
Fig 1: Common Debt Strategies and Their Risk/Return Profiles



Growth drivers in private debt markets

The benefits of private debt extend beyond higher risk-adjusted returns. These debt instruments and funds can play a variety of roles in an institutional investor's portfolio and act as a good diversification tool due to historical low correlation benefits. The asset class also has a number of other merits, such as natural credit enhancements, relative appeal versus traditional debt, for example High Yield, and its position as a hybrid / cross-over asset.

Fig. 2: Private Debt Funds in Market by Primary Geographic Focus, Q1 2016 vs. Q1 2017



Source: Preqin

Natural credit enhancements

Direct lending offers a significant degree of structural protection. Before a loan is made, a detailed due diligence process is undertaken, and various scenarios are envisioned and tested to evaluate how the company might perform in differing market conditions, including whether they would still be able to meet all of their financial obligations. The access to company information and management facilitates very informed decision-making about credit risk.

The loans themselves have a tailored set of terms and covenants, and they can have a charge over the assets of the company that protect investors in the loan from the risk of loss with priority over other unsecured investors.

Relative appeal to more traditional debt asset classes

This form of debt is also the beneficiary of two inadvertent consequences of changes in mainstream bond market structure since the financial crisis.

With reduced liquidity in bond markets resulting from of lower sellside inventories and the restrictions on their proprietary trading since the financial crisis, there has been a material increase in the time it takes to unwind bond portfolios without incurring material price impact. This in itself has led to multiple regulatory consultations globally. These changes in the broader bond market structure have led certain asset managers to find relative appeal in private debt, which can compare favourably with bonds, especially if the liquidity profile of the two asset classes is less distinct.

Cross-over asset class

Private debt as a cross-over asset is particularly compelling after the multiple equity bear markets of the last decade turned conventional theory on its head as:

- Buy-and-hold investing struggled as equities were outperformed by bonds over a long period
- Actual returns diverged markedly from expected returns for most asset classes
- Diversification became less easy to achieve, as the correlation between historically lowly correlated asset classes continued to increase. These weaknesses have, in turn, promoted innovations in institutional investors' approach to asset allocation in pursuit of broader and more realisable diversification.

These factors combine to make it attractive for pension plans, insurance companies and other institutional investors to consider increasing their strategic asset allocations to alternative investments, including private forms of lending, which compensate for factors such as illiquidity and complexity and can serve as a valuable source of risk adjusted returns and diversification.

Pricing credit across the capital structure

Given the current limited nature of the secondary market for private debt, it is vital that the asset manager fully evaluate and price the credit risk associated with the borrower's risk/ return profile. They must also be able to illustrate this is correctly balanced on an ongoing basis via timely client reporting.

A significant influx of institutional capital into direct lending strategies over recent years has increased competition among lenders in parts of the market. This has led to pressure on transaction structures and margins, as well as a heightened prospect of mispricing risk, especially as leverage multiples rise. A fund with fixed return expectations is more likely to accept weaker structural protections or higher leverage multiples.

At the same time, certain areas of direct lending remain underserved and offer attractive value in comparison. Figure 3 below indicates the popularity of particular strategies.

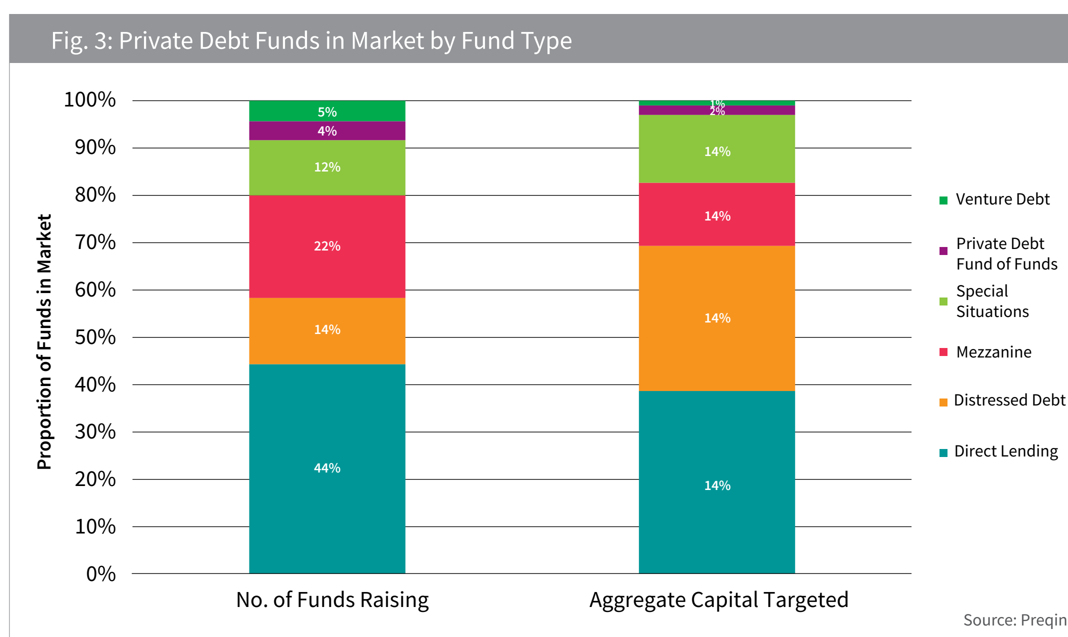


Fig. 3: Private Debt Funds in Market by Fund Type

Regulatory appreciation of the importance of the European SME market

With all this said, is there long-term political and regulatory support of the private debt marketplace?

Political initiatives such as the European Commission's Capital Market Union (CMU) are squarely focused on SMEs, with the key aims of CMU being elimination of barriers to cross-border investments and reduction in the cost of funding.

In its Action Plan for (CMU), the European Commission noted that bank lending accounted for 75 per cent of SME funding, while venture capital represents only 1 per cent of SME funding (versus 8 per cent in the US). Further, 35 per cent of SMEs did not get the financing they applied for. Hence, SMEs are one of two groups of funding recipients focused on in the Action Plan for CMU (the other group being infrastructure-related undertakings).

National regulatory bodies have also played their part in liberalizing markets. In April 2016, the Autorité des Marchés Financiers, France's financial watchdog, published proposals for a framework that will allow certain investment funds to grant loans directly to non-financial companies. At the same time, amendments to existing rules have allowed French insurance companies to increase their allocations to private debt.

Similarly, changes to the pension rules in the Netherlands have also enabled pension plans to increase their allocations in pursuit of uncorrelated absolute returns, which has led them to increase their allocations to private debt and start new activities such as direct residential mortgage lending.

Whilst the above clearly demonstrates US non-bank lending market is much larger, the prevailing belief is the European credit cycle is at a much earlier and hence more favourable stage to the US.

Regardless of size and the strategy of the fund, firms engaged in private debt must employ best practices and follow key principles established by AIFMD and accounting protocols within their valuation processes or employ a third party valuation advisory firm to establish a robust framework for Fair Value, Negative and Positive Assurance or Impairment testing.

Valuation considerations (data, model infrastructure, expertise and efficiency)

All firms have valuation policies that outline the methodologies followed for a given asset class and an overview of their governance structure which enables them to meet their stated valuation objectives. This leads to common practices such as calibrating the transaction price to appropriate valuation methods and comparators. However, the way firms execute this in practice is extremely varied.

AIFMD Spotlight:

Independent valuations for internal valuation teams

Under AIFMD L1 article 19.4(b), valuations performed by the asset valuer, must be functionally independent from the portfolio management team and have a separate remuneration policy.

The asset valuer generates and delivers valuations to the valuation reviewer, who makes the final determination of asset values based on the manager's valuation policy. Final valuations are delivered to the valuation committee for approval.

Under AIFMD L22 article 71.3(d), the valuation committee defines and revises the manager's valuation policy. This should include the requirement to review individual asset values and compare these with values generated by an independent valuer. Under AIFMD L1 article 19.10, the valuation committee is responsible for ensuring that assets are properly valued, and that only approved valuations are used in NAV calculations.

External Valuer Framework

Under AIFMD L1 article 19.4(a), valuations are calculated by an external valuer, independent from the fund manager. The external valuer uses data obtained from the fund's administrator or from the fund manager.

The external valuer performs valuations and makes the final determination of asset values based on the valuation policy agreed with the manager's valuation committee. Final valuations are delivered to the administrator for input into the NAV calculation process.

Under AIFMD L1 article 19.10, the valuation committee is responsible for ensuring that valuations are performed in line with the manager's valuation policy and that these values are used in the calculation of the fund's NAV.

Providers of external valuer services also carry unlimited liability for any material losses caused by failure to perform or negligence.

Whilst IPEV guidelines and accounting standards are longstanding and hence generally understood, AIFMD is in its infancy and could change materially (both in technical amendments and practical implementation). However, the presence of AIFMD has definitely increased the acceptance in the industry of the use of third party valuation providers. The most common role of a valuation agent is to provide valuations into an internal validation process as governed by AIFMD. As execution of valuations must be formally segregated from the deal team or anyone remunerated by performance of the fund, those performing valuations need assistance. This is normally in the form of positive assurance or independent valuation. To do this well without the assistance of an independent third party is challenging even for funds with seasoned valuations analysts. Most firms have internal guardians of this valuation policy in the form of the internal valuation committee that challenges the valuation movements, approaches and rationales between valuation dates. Members of the committee are common touch points for third party valuation agent.

Governance and capital attraction

Many overseas real-money accounts view the AIFMD External Valuer policy as the highest standard of valuation governance and push the manager to seek an External Valuer to the fund. Though regulation compels people to change processes, business is clearly responsive when change delivers a commercial advantage to those who act and in this case that can manifest itself in being more attractive to overseas capital.

The vigorous governance expected under the directive is now seen by investors as a blueprint for good governance on the topic of valuation, even for firms that fall outside AIF classification. Firms should spend a significant amount of time documenting approaches, authenticating assumptions and adjustments—both quantitative and qualitative—behind the valuation provided by the third party. This is to the benefit of internal stakeholders, investors, auditors and regulatory bodies where applicable.

Valuation challenges

For asset valuations that would be considered level one or level two under, for example, IFRS 13, it's relatively easy to build a valuation approach, especially if there are regular transactions or volume behind firm bids and offers associated with an asset at a certain point of time. But with level three assets (such as private debt) one naturally has to incorporate different techniques in order to build a robust valuation process for the asset due to the transactionless nature of the assets (in secondary terms). Hence observed transactions are mostly in additional rounds of funding (new debt issuance), recaps or proxies to the portfolio company asset.

Various techniques and sources of market data could be used to create proxies for a particular mix of risk attributes which form a Bespoke Beta very comparable in terms of aggregate risk to the portfolio company debt. Even then it's possible the valuer still needs to employ specific adjustments to best reflect the risks embedded in the deal structure. This could include sub-sector adjustments, credit ratings adjustments, duration adjustments, region of risk adjustments, etc. Bespoke Beta is normally achieved via tailored baskets of referenceable assets. Alternatively, it can be done using curves generated by multi-variant factor curves or term structures of comparable entities and then adjusting for the points of difference. All these techniques really act as mechanisms to incorporate a variety of views to create a robust valuation which draws on best available data and techniques in capital markets.

For senior mid-market loans, often the best place to find suitable discount factors is among syndicated or more visible mid-market loans. Alternatively, for mezzanine loans and distressed debt, methodologies may include Enterprise Valuation based on a market approach (multiples) or an income approach (DCF) to establish if the value breaks into the debt capital structure and if so how deep is the value break. If there is sufficient value in the equity classes and no break into the debt, the valuation agent (and fund policy) may choose to use a market approach again on the debt to account for dynamic credit risk reflected via the spreads of comparable assets. Within a given approach, the best practice is to corroborate multiple techniques and assumptions to gain a point of centrality to the valuation or justify the chosen methodology through a range of values. Having the ability to view asset valuation from multiple vantage points is clearly a benefit of Fair Value.

It's important to note that the key difference when dealing with private debt valuations is the heavily analyst-driven approach to valuation. Valuations analysts in the private debt space must have the aptitude to understand legal documentation of the deal, corporate finance theory, analysis of financial statements and disclosures and modelling skills to ensure these are appropriately captured at inception and throughout the life of the deal to assess divergence and degradation of performance. Due to the heterogeneous nature of investments, this requires significant access to the correct market data, model infrastructure, people and control oversight.

Although investment strategies change as attractiveness of the private debt investment continuum evolve and access to the market becomes easier, firms that are committed to quality of process and independence use third party valuation services.

Interview: Leon Sinclair, IHS Markit, and Mike Anderson, Head of Investor Relations, Pemberton Asset Management

(LS) Why is valuation such an important topic to Pemberton?

(MA) Establishing a reliable, consistent and rational methodology for valuing the underlying investments of our funds is extremely important to us. The methodology must be defensible to our regulators and our funds' auditors, but above all explicable and acceptable to our institutional investor base, which is increasingly focused on the transparency of valuations of the funds in which they invest.

Our private debt funds are all regulated funds in Luxembourg and have therefore adopted IFRS and value their investments at their fair value. As the funds invest in private loans which are not traded and for which there are no directly observable valuation inputs, we have to apply valuation techniques, essentially DCF, to value them.

To that end, it's essential to establish from the outset a rigorous and consistent approach to modelling the loan cashflows and, crucially, to the estimation of a discount rate for each asset, that would take account of the credit characteristics of each investment and link it to relevant market benchmarks. We were concerned to ensure that the methodology we adopted would reflect the characteristics of an asset class we felt was fundamentally stable in value terms, but would also capture asset-specific changes in credit quality and broader trends in the credit markets.

It was also essential for us to identify an independent valuation agent for our funds which could offer access to the broadest possible range of relevant OTC market data and research as well as in-house credit expertise and infrastructure, hence we partnered with IHS Markit.

(LS) How does this assist you in your interactions with investors whether it be in the form of governance benchmarking or fundraising?

(MA) We believe the combination of the sophisticated Advanced Internal Ratings model that we use to determine the initial (and subsequent evolution of) credit ratings of the assets in which we invest and our valuation methodology is a key source of differentiation for Pemberton compared with other private debt asset managers.

Our rating model is highly sophisticated, back-tested annually and is significantly more granular than equivalent public rating scales. Our investment case is intimately linked to the quality and accuracy of our internal ratings, so in turn sensitising our valuations to idiosyncratic risk via the valuation agent given their ability to track broader spread trends through independently sourced loan market data. The methodology is consistent but able to adapt to take account of additional emerging factors, such as possible effects of Brexit on UK/GBP denominated loans.

The combination of the two enables us to articulate the valuation policy, methodologies and approaches employed by IHS Markit in a way which is clear, intellectually sound and readily defensible, which clearly differentiates us in the market from some of our peers that don't do this.

(LS) What are the potential opportunities you see to the real-economy and what are the potential hurdles you see in sector achieving its potential?

(MA) Pemberton believes that bank deleveraging in Europe presents a significant investment opportunity. This has been clearly observable in capital flows of the European banking system. Notably cross-border lending has declined by about 4tn EUR since 2008 and Pemberton believes that the mid-market companies' reliance on banks, coupled with the reduced cross-border bank lending activity, will provide an attractive opportunity for non-bank financers.

(LS) But it would also be correct to say you work very closely with local banks?

(MA)That's certainly the case. Despite the decreased cross border lending, middle market lending remains attractive in European banks domestic markets. To tackle this Pemberton has set up an Origination Team that has strong relationships with banks active in the European mid-market. This enables Pemberton to source opportunities to invest alongside Europe's leading mid-market banks, rather than in competition with them.

(LS) How responsive have corporates been to taking on a nonbank lender, are there any common areas of pushback?

(MA) Midmarket European corporates typically have longstanding ties to their banks and are not used to being exposed to alternative financing sources. Pemberton's approach to working with banks across the region facilitates corporate borrowers understanding to alternative financing by being introduced to a direct lending fund by their bank contact.

Corporates, especially continental corporates, are very focussed on the background and pedigree of the non-bank lender that will be providing them with capital. They want to know how they are likely to behave in difficult circumstances and to understand the quality of their underlying investor base. Assuming that they can get comfort in these areas, corporates are pragmatic, and are usually happy to borrow from a non-bank lender, albeit the timelines can usually be longer than those experienced on private equity transactions.

(LS) Do you feel the industry has the correct level of political support or do you feel this is something that needs to evolve over time to support the industry?

(MA) Access to financing has been restricted for mid-market companies since 2008. Despite political pressure and a range of government initiatives to encourage corporate lending, European banks consistently tightened credit standards and loan terms from 2007 to 2013, with standards easing only very marginally during 2014.

Pemberton's view is that the political landscape for alternative financers have improved lately as the conversations have moved from talks about shadow banks and instead moved to different ways of financing SMEs outside the standard bank route. Two specific examples of this are the British Business Bank and EIF who has financed several fund managers that lend to SMEs.

(LS) So essentially the tone has changed?

(MA) Yes it's changing. Over time, we believe that the regulatory and political landscape will remain favorable for non-bank lenders given the increasingly important role that they will have in supporting middle market corporates. With this non-bank capital being provided from long-term funding sources in the form of 7-10 year locked-up funds, the quality of the discussion with regulators will continue to become more positive over time.

(LS) How do you see the regulatory environment evolving with regarding to Risk and Valuation?

(MA) Valuation is already key area of focus for us under AIFMD and we can only expect the focus of regulators and investors will increase in the years ahead. We are extremely comfortable that we will be able to meet whatever additional requirements we need to as the market evolves.

About Private Equity Services from IHS Markit

IHS Markit is known for robust cross–asset valuations services and our innovative solutions in financial technology. We offer a range of services for the alternative market including:

- Independent valuation for privately held investments across the capital structure specifically hard to price, level 3 assets
- AIFMD external valuation service
- Negative and Positive Assurance
- Credit Assessments
- Suspended Share valuations
- Policy Advisory

Our unique approach combines our technology and analyst expertise, enabling us to deliver an efficient and scalable analyst led service. Our experienced analysts offer exceptional customer service providing succinct and transparent valuation reports to enhance our customer's valuation credibility at a competitive rate.

About Pemberton

Pemberton is a diversified asset manager, backed by one of Europe's largest insurers, Legal & General Group PLC.

Pemberton is focused on delivering attractive risk-adjusted returns for global investors and long-term capital for European borrowers, which provides growth capital for the wider economy.

Built upon a strong combination of banking and asset management expertise, Pemberton's skill lies in its ability to originate, select and manage diverse credit exposures through its pan-European platform. With an approach focused on risk transparency, Pemberton aims to bring clarity to complex credit markets for investors, borrowers and banks.

For more information, please visit our website at www.pembertonam.com

For more information www.ihsmarkit.com

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