E X P E R T Q & A

Growing market complexity is forcing managers to re-evaluate the way they run their businesses – with potentially transformative effects for the credit industry, say IHS Markit's Elina Gokh and Jocelyn Lewis

How data is transforming debt

When responding to regulatory change, market complexity or the digitisation of fundraising, both managers and their investors are faced with growing data requirements. Elina Gokh, global head of WSO at IHS Markit, and Jocelyn Lewis, the firm's executive director for private debt strategy, give their perspective on the trends.

SPONSOR
IHS MARKIT

Q How do you see the private debt markets developing?

Elina Gokh: We're seeing increased need for data transparency, timeliness and accuracy. Managers need to track and monitor the impact of decisions on their investments, to understand their investments' risk profile, and to identify where additional time and attention is needed.

We're observing that the unique nature of private debt requires managers to tap into specialised skill sets to address complexity associated with the bespoke nature of transactions and leverage third-party technology to create scale and processes for this asset class, in recognition that it is similar to but different from the broadly syndicated loan market. Managers are finding that private debt requires more of a relationship-based business and is not as transactional as public credit or exchange-traded markets.

Jocelyn Lewis: The leveraged loan market is focusing on larger transactions and issuers that have previously tapped the syndicated lending market. This creates an opportunity for private debt managers to provide financing for the mid-market and upper mid-market. Those borrowers are benefiting from better terms than they would get in traditional syndicated loan deals, and private debt managers are investing in attractive ways. On the portfolio management side, internal teams require specialisation to track investment performance, manage KPIs and covenants, and get ahead of potential issues. The operational burden is tangible.

Q Data and digitisation will be big areas of transformation. How will these trends impact private debt specifically?

JL: The industry is maturing and becoming more professional, with risk/reward profiles attracting more capital from both traditional fixed-income or syndicated loan participants and from private equity managers. There's a strong desire across managers to create operational leverage to support their teams. Digitisation of data creates a better way to transition talent away from burdensome information requests and the monotony of updating asset management reports. Managers require best-in-class digital tools to improve operational efficiency and free up teams to focus on value-additive tasks, such as origination, execution, communication, relationship management, deploying capital and portfolio management, particularly with regard to identifying issues early on and mitigating downside risk in the existing volatile environment.

Also, private debt managers are looking to improve knowledge sharing within the firm, moving away from individual to institutional knowledge. We see, for example, more firms facilitating more informed decision making by leveraging a central database as the single source for permissioned information sharing.

EG: Obviously, there is a big infrastructure lift that traditional lending institutions need in order to take advantage of new technology. Private debt managers, on average, are more nimble and will be able to take advantage of tools that enable the parsing of credit agreements and borrower data and further facilitate straight-through processing of this data downstream. Streaming architecture will provide the way forward in data communications, with real-time, event-based notifications that provide transparency.

Q How might technology enhance the organisation of private debt funds?

JL: In the fundraising arena, the investor community is becoming more sophisticated, requiring additional transparency while being increasingly selective when allocating capital. As the number of managers grows, competition increases for capital allocation from investors. Investors are therefore taking an independent data-driven approach to manager selection, with questionnaires that focus not only on a manager's return profile and the associated drivers of investment returns, but on operational stability and scalability as more capital is allocated.

Managers need to stand out from the crowd, communicate their stories effectively, and build and maintain strong relationships with the investor community intermediaries and sponsors. Using digital tools to sift through investment opportunities enables them to quickly determine whether allocating time and resources to a deal is beneficial. Digital tools also help managers engage with their borrowers and investors in real-time to gather information from borrowers, consolidate it and provide portfolio transparency to investors.

EG: The trend in the past was that sophisticated managers built their own specialised systems to meet their needs. Now, managers realise that their value lies in credit selection and relationship management, so building bespoke systems is no longer a differentiator. The adoption of the cloud has also been impressive, particularly as it allows for a higher degree of resilience and enriched workflows.

Q Private debt funds and their investors are dealing with increasing choice. Will the market get more complex?

EG: Absolutely. There will be complexity on many fronts – deal structures, fund structures, operational structures and technology stacks. At the deal level, there will be complexity as a result of creative deal structures that is designed to align with risk tolerance. The more creative the deal structures become, combined with the increased volume of creative deals, the more complex the operating models will become to support and track these investments.

For example, multi-asset managers often work with multiple fund administrators, based on their specialisation, and require organisation of this data for accounting books and records. Accounting for items such as PIK interest, interest rate grids, effective interest amortisation and swing line lending are just some of the terms that add complexity to private debt. Also, for traditional buyside firms to provide agency functions for club deals, new skillsets are required. And looking ahead, the IBOR transition is one of the biggest transformations for the market, as the different currency jurisdictions and central banks are in the midst of concluding recommendations that will fundamentally impact deal-structure, interest-calculation and cash-forecasting methodologies.

JL: If we see market consolidation like we did after the 2008 financial crisis – whether it is managers acquiring one another or selling portfolios – those legacy teams, practices and technologies built in-house will need to come together, with effective change management involving many moving pieces.

Q What kind of volatility do you see for private debt, and how well equipped are funds to cope with that?

EG: This asset class generally focuses on smaller, less-stable borrowers than the leveraged loan market. Coupled with covid-related volatility, we will see valuations continuing to be critical when comparing deals, borrowers and managers. Managers and LPs will also be paying attention to geographical and economic relief systems and how they impact the ability to borrow and grow investments.

JL: If you tie that volatility back to the importance of being able to manage your information and leverage technology to illustrate how all these changes will impact investment performance, you can see how useful that data can be for managing communications. If you are dealing with information at scale, you are going to need digitisation tools to help tell your story and maintain the trust of your investors and partners. ■