View from the inside

As the US private debt industry has evolved, so have the demands on mid-market managers. **Tim Houghton** and **Mike Fredian** of Cortland, part of Alter Domus Group since March 2018, offer *PDI* a fund administrator's take on the market

Tim Houghton

Q There is a lot of dry powder in the private debt market right now, what impact do you think this is having on mid-market lenders?

Tim Houghton: That combination in any market is likely to push credit standards, leading to higher risk and lower overall returns. We are hearing anecdotally from our clients that deal sourcing and putting capital to work is challenging and they need to be creative on how they structure deals. Many say they have become opportunistically more aggressive in underwriting and structuring in order to compete and win deals.

Q Are you seeing more managers focusing on specific sectors or niche strategies in a more crowded market?

TH: We have a number of sector-specific clients in energy, renewable energy, technology, etc. But I wouldn't say we're seeing a wholesale rise in sector specific funds. In fact, with the challenge being to find deals I think managers are casting a wider not a narrower net to ensure they are seeing attractive dealflow.

Mike Fredian: I would agree – most of our new clients are looking to do deals where they can. If they have relationships and can do a deal in a sector they know they are going to go ahead and do it.

TH: There are clients with sector-focused funds and then there are clients who are more focused on capital structure – such as having a senior fund, a mezzanine fund or some hybrid. If anything, more recently we have seen clients raising opportunistic funds, who want to have the ability to take advantage when there is some sort of market dislocation or a gap in pricing that occurs.

Q How do you think increased competition in the market has impacted deal making?

TH: The feedback we are hearing is that managers are working hard to find deals they like. We know the supply of lenders is increasing – we see new entrants regularly, and we know the supply of capital is increasing from the fundraising prints. You don't have to be a market commentator to see that pricing and leverage are in the borrower's favour.

Q Are you still seeing first-time managers entering the mid-market space? What kind of opportunities are they pursuing?

MF: We are talking to a few contacts who are developing a new direct lending fund or looking to enter this market. I think one of the biggest challenges for them is deciding how they are going to structure the operations of the business. In order to put money to work quickly and to compete from a cost perspective, it's hard for them to spend time and capital to build out their middle and back office and as we walk them through what can be outsourced efficiently they quickly get comfortable with it.

TH: I think that is one of their major concerns. Take, for example, an insurance company in the US launching a direct lending platform. They have already been a big lender, they know how to do that, but they haven't carried out any middle market direct lending in a fund format. So, they decide to hire some originators in the Chicago market, which is a very middle market-centric lending market with lots of experienced bankers, to deploy capital into a fund structure and pursue traditional middle market deals. They will need to be focused on sourcing and nurturing relationships with private equity firms. We offer an operations solution that allows them to concentrate on putting money to work and winning deals versus managing the back office. And they get that – puts their focus where they want it to be.

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Q What kind of regulatory and administrative burdens do mid-market lenders typically have to deal with and has this burden increased?

TH: Middle market lenders acknowledge it is a less regulated function than when they were working inside commercial banks or insurance companies, but the regulatory powers that grew out of the global financial crisis and Madoff are certainly impacting the lending landscape. From a regulatory standpoint, middle market lenders are registered investment advisors and so have custody responsibilities, reporting responsibilities and so on.

The nature of funds today, post-Madoff, is that you will have an independent arbitrator of value, an independent set of records, independent cash management, an independent fund administrator, and so forth. But beyond that, they are not under the same regulatory burden from an underwriting standpoint as when they were in banks. It is worth noting that we also serve clients who are banks and the banks are under the same if not growing regulatory pressure.

Q Many PE firms are moving into mid-market lending by creating their own credit arms. What challenges or advantages are associated with this approach?

TH: From our perspective, so many private equity fund complexes at this point have an associated debt strategy that it's clearly more than just a trend. It's a regular occurrence for us to be speaking with one of them starting a debt strategy. So, I think it's fair to assume the advantages to a PE firm of having a lending structure outweigh any disadvantages. The advantages are straight-forward: growth in assets under management, providing existing LP base with access to this highly desired asset class, and flexibility to shift up and down the capital structure, to name a few.

As for the pure-play debt managers, many of our clients are in this category and we see strong dealflow from them so we can surmise they are doing well. Many are closely aligned with private equity firms and sponsored deals are their focus. Our non-sponsored lending clients are also growing rapidly, so we would conclude the same for them. ■

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