FEATURE:
EUROPE’S MID-MARKET LENDERS
GET FLEXIBLE

TECHNOLOGY:
DIGITISING THE
INVESTOR EXPERIENCE

DEBT CAPITAL MARKETS:
SUCCESSOR AGENTS:
WHAT MAKES A MODEL EXAMPLE?
Dear readers,

Can calm waters be spotted beyond the Covid-19 storm? In this issue of Sensus we examine how different sectors and asset classes are beginning to see the shape of their future as the pandemic mist clears.

While private debt is eyeing new opportunities, and credit managers raise funds in anticipation of special situations, real estate is facing a radical shake up. Forced to reassess operating models, technology architecture and data strategy, greater efficiency and less complexity look set to be the outcome of this overhaul. Meanwhile, private equity managers are targeting distressed firms that will thrive again while traditional private equity investors are turning their attention to lending funds.

In alternatives we have seen firms with automation technology in place move fairly seamlessly into ‘business as usual’ mode. For those without, the scale of disruption experienced is driving a growing demand for modern technology and increased digitisation. Covid-19 has been an eye-opening moment for the alternatives industry and, as the post-pandemic world begins to take shape, firms may recognise this crisis as a catalyst for improvement.

As we approach the end of third quarter, and six months after the initial shock of a near-global lockdown, we are at the ‘lessons learned’ stage. The corporate world is adapting to a changed landscape, economies are beginning to open up again and students are heading back for the next academic year. With so much thrown into turmoil it is good to see the seeds of normality, even a new normality, begin to grow.

Doug Hart
Chief Executive Officer,
Alter Domus
Traditionally insurers have invested in equities, bonds, real estate debt and other fixed income assets for their own portfolios, while allocating capital to external managers for non-traditional asset classes such as private equity, infrastructure, bank loans and PERE to construct their portfolios. But as insurers’ price sensitivity to management fees grows, the prospect of directly sourcing deal flows and outside capital is driving many to look to direct investments in real estate, debt, and equity to complement their externally managed strategies. Greg Myers and Luke Newcomb, Managing Directors at Alter Domus, discuss the road ahead.

The direct investment approach comes with clear advantages. In addition to freeing insurance companies from management fees, it allows them to gain more control and transparency over their investments. But this new approach does have its challenges, as most insurance companies do not have the back-office framework to support these types of loans, especially when it comes to reporting. According to Luke Newcomb, the challenges go beyond reporting to outside entities. “Many insurance companies also struggle with the complexity of direct investments and the requirements of corporate reporting. And because of the nuances of the private debt market, many of their accounting teams don’t have the right tools to meet those deadlines effectively.”

IT’S ALL ABOUT THE SYSTEMS

Insurance companies often use technology systems that are designed to automatically reconcile bond-based assets or equity portfolios linked to a trustee, custodian or prime broker. But investing in other assets, such as direct bank and real estate loans, requires different technology. For instance, direct investments are not traded via a common depository (DTCC or Euroclear) or a stock exchange (NYSE, NASDAQ, etc.) Instead, ownership is often evidenced via legal agreements as opposed to shares tracked by stock or bond transfer agent, so the existing framework cannot automatically reconcile the loans. The bottom line? Direct investment loans and real estate debt do not fit into their existing systems.

In addition to reconciliation, insurance companies participating in direct investments must satisfy their own internal accounting, management reporting and regulatory reporting requirements as well.

Those challenges leave insurers with few options: Either make a hefty investment in hiring additional staff and deploy new systems and technology, or partner with a service provider that can help manage and minimise those challenges in a low-risk and cost-effective manner.

FUND MANAGEMENT FOR DIRECT INVESTMENTS

Instead of paying to develop these capacities in-house, specialist providers like Alter Domus can allow insurers to augment their staff and systems with the professional services they require. No more manual reconciliations—and no need to bring on additional staff or revamp technology systems. Instead, insurers can maintain a sharp focus on managing and monitoring their investments.

Greg Myers says using one platform for all their data increases productivity. “Many insurance companies hire multiple investment managers and have internally managed portfolios or specially managed accounts (SMAs). They then have to figure out how to incorporate that varying data into their system, making for a logistical nightmare,” Myers said. “But by using our debt capital market services, they’ll have access to one platform where they can consume and share data, irrespective of who the manager is.”

NEVER LOSE SIGHT OF YOUR DATA

Real-time access to data and reporting is critical for insurers making direct investments. CorPro, Alter Domus’ proprietary web-based portal system, provides them with nonstop access to their fund and asset-level financial data. It also makes sharing that data easy. Data and communications—with customisable branding—are easily distributed through the secure portal.

This constant ability to access data and share it securely provides insurers with the information they and their partners need to make informed decisions. It also delivers company-wide transparency about operational workflows, which gives everyone the data they need to make informed decisions.

TOOLS FOR SUCCESS

“We want to give our clients the tools that will contribute to their success,” Myers said. “As insurers began asking us for a solution to help make direct investing more efficient, we analysed the need and pinpointed the problematic areas. Through our Cortland DCM Solutions, insurance companies making direct investments are able to conduct loan trade settlements on behalf of their managers, and receive ongoing loan administration, loan agency services, reporting, compliance and fund administration from a single source.”
SUCCESSOR AGENTS: WHAT MAKES A MODEL EXAMPLE?

The debt markets are experiencing a truly turbulent year with Covid-19 seeing the number of cash-strapped companies soar, many of which will not be able to meet their payment requirements or even be in a position to re-finance. Against this background, administrative agents may come under significant pressure as they strive to stay on top of a dynamic and uncertain situation. Joanna Anderson, Managing Director, Alter Domus, examines the pivotal role they play and the capabilities to look for when selecting a successor agent.

Administrative agents handle a variety of routine functions related to the administration of a syndicated loan. Additionally, they provide lender communication when deals close and throughout the life of the loan, monitor and distribute receipt of funds from lenders and borrowers, monitor and store collateral, record amendments, and comply with tax reporting requirements. In short, administrative agents play a critical role in underpinning a streamlined and compliant service.

At the end of 2019, outstanding leveraged loans totaled almost USD 2 trillion, of which USD 1.3 trillion belonged to institutional investors, according to Middle Market Growth. But since the onset of Covid-19, growing numbers of companies are coming under severe pressure in servicing loans. Between March 5 and April 9 of this year, businesses drew down USD 215 billion on existing revolving loans. Many companies also deferred or modified cash payments to save cash or tapped PPP loans if they were eligible. No one knows what the long-term effects of the pandemic will be, but Fitch Ratings recently revised its default forecast for U.S. leveraged loans. It now predicts a 3-point increase over its previous prediction of 5 to 6 percent. That amounts to about USD 80 billion, which is higher than the previous high of USD 78 billion in 2009.

What does this mean for borrowers, syndicated lenders and the professionals who represent them? While it is difficult to predict how this might play out, it seems likely that borrower defaults on debt service payments or loan covenants could trigger the resignation or removal of an administrative agent. This will disrupt the orderly administration of a credit facility and require replacement by a successor agent.

ADMINISTRATIVE AGENTS FEEL THE FALLOUT

As the consequences from Covid-19 and the lockdowns become clearer, we are likely to see more restructurings. That may lead to the resignations of more administrative agents. In general, when a company is able to pay its debts as they come due, it is common to have the same administrative agent for both or all tranches of debt. But if there is a default, or dispute between the company and/or its creditors and there are tranches of debt with shared collateral, each group may desire to have its own administrative agent. Additionally, if a company goes into bankruptcy, the successor agent can act as a Debtor-In-Possession (DIP) agent stepping in to help facilitate and administer the exit facility. Other factors that may prompt the resignation of the agent include:

1. The lenders may determine there is a conflict of interest with the exiting agent, or have a disagreement with them, and seek their removal.
2. The agent has no financial stake and does not want to continue its role as agent during a restructuring process.
3. The agent may want to preserve a close corporate relationship with the borrower or sponsor and step aside as the agent during or after the restructuring.

“When we act as a successor agent, we are truly a neutral party that has no financial stake. Our job is to facilitate the transaction and provide a service—not look after our own economic interests.”

Joanna Anderson
Managing Director

SEEKING A SUCCESSOR AGENT

While syndicated lenders have many options when selecting a successor agent, it is important to identify those with certain capabilities and the key skills necessary to step seamlessly into this critical role.

Multinational capabilities: An agent with the scope to provide a solution for borrowers and lenders when the existing administrative agent of a syndicated bank loan steps down or is replaced on US, European and Asian based credits.

Experience: A successor agency team comprising seasoned credit professionals who have experience on both the buy and sell side with workout and restructuring expertise.

Facilitator of processes: An agent that can facilitate the restructuring process and demonstrate a comprehensive understanding of the dynamics of a syndicated bank loan. A proven track record of developing positive and cohesive relationships with management teams, lenders, and professionals will ensure a smooth, seamless transition.

Timely trade processing: A fully responsive agent with a commitment to closing bank loan trades promptly is critical for large syndicated bank loans.

A smooth transition from the bank to the successor agent prevents lenders from worrying about the availability of data, professional relations, or anything else. An experienced successor agency team will have the capacity to accommodate lenders who may want to retain their attorney as the agent’s counsel. Initial steps in the transition period will see the successor agent conducting KYC compliance procedures, executing the successor agent agreements and launching a data site to mirror the former agent’s data site. At Alter Domus we aim to make this transition as seamless as possible.

Joanna Anderson
Managing Director
Ten years after private debt funds began the systemic shift in provision of debt away from banks, the industry is maturing but now faces its first real test in the Covid-19 economic crisis. We brought together a virtual roundtable where industry experts debated why this will be a defining time for the market, both confirming its role as an alternative source of debt capital and probing managers’ abilities in a downturn.

2019 PERFORMANCE
2019 was an active year, continuing the systemic shift in the provision of debt from banks to private debt managers that began in 2008. The year saw a proliferation of strategies, as new investors entered the market and deployment of credit funds accelerated. All of this pointed to a growing maturity, especially as investors diversified away from the core strategies of senior loans and special opportunities towards niche strategies, such as aviation, shipping, healthcare, liquid credit and CLO retention funds. There were signs of surplus capital compressing prices, as well as leading to covenant-lite deals and higher leverage. Yet the more established and selective private debt managers still found attractive transactions in which to invest.

“In the last six months we started seeing real compression coming into our transactions,” noted Salvatore Ruocco, Finance Director at Permira Debt Managers. “But it wasn’t too challenging for us. As ever, sponsors prefer established players over new entrants. We saw a few ‘cov-lite’ deals but we didn’t really participate in those deals.”

In the mid to low end of the market, there was little sign of excess capital chasing transactions. “The opportunity remains attractive if you can be selective and stick to your discipline, but going forward it will be interesting to see how the market performs in the downturn,” said Paul Shea, Founding Partner at Beechbrook Capital, which lends to Europe’s small and mid-sized businesses.

As the market matures, the structuring of funds is evolving as well. There’s a move towards launching funds onshore, especially in Dublin and Luxembourg, but also in the UK and Delaware in the US. This shift is partly due to institutional investors’ preference for well-regulated onshore jurisdictions, as well as the desire of funds to secure EU passport rights.

“Looking at the investors that are coming into the funds, also the BEPS and substance issues around where people are, seems to drive the desire for one jurisdiction or another,” explained Spencer Wells, Sub-Regional Head of Europe at Alter Domus. “But we’re definitely seeing more movement than we’ve seen since 2009 towards Luxembourg and Ireland for the funds focused on European assets.”

There’s also more interest in semi-open-ended funds, as managers don’t want to be endlessly on the road raising capital. This leads to questions around carry and redemption.

“There are a number of different ways of achieving this that managers have explored,” said Alex Amos, Partner at Macfarlanes. “And, of course, when it comes to liquidity and redemptions, now is the kind of market to really test those provisions and we’ll have to see what the results are.”

PEOPLE
Alex Amos
Partner at Macfarlanes

Spencer Wells
Sub-Regional Head of Europe at Alter Domus

Paul Shea
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IMPACTS OF COVID-19

In February and March 2020, Europe’s lockdowns put economies into suspended animation threatening the creditworthiness of even the most robust companies in the most affected sectors. For private debt managers, the frequency of communication grew – with private equity sponsors, limited partners and other stakeholders.

“The big thing is obviously making sure that portfolio companies perform in the short, medium and long term,” said Shea. “And we’re spending a lot of time with all the different stakeholders – equity, management, other debt providers, suppliers – to ensure that the businesses manage and have a prosperous future, so it’s been unwanted but a very interesting time.”

Portfolio management functions are scrutinising companies – including monthly cashflows – seeking to make sure they can survive the economic crisis and have a prosperous future when normal levels of economic activity resume. They have made cash injections to ensure businesses have sufficient liquidity to weather the crisis, and managers such as Permira have formed dedicated restructuring teams.

As some funds hit their year-ends on 31 March, valuations have been hard to assess. While financial markets were signalling the difficulties to come, the economic downturn had not hit companies’ daily operations and cashflows at that point but clearly would do.

Looking to the future, though, credit managers have started raising money for special opportunities that should emerge at the end of 2020 and in 2021. “Credit managers have been raising capital for strategies that were designed specifically for this kind of market, not necessarily to deploy immediately, but perhaps towards the back end of this year and in 2021 when it’s felt that the real opportunities in the special opportunities environment might start to emerge and that has kept us very busy,” explained Amos.

“The big thing is obviously making sure that portfolio companies perform in the short, medium and long term.”

Paul Shea
Founding Partner at Beechbrook Capital

OPPORTUNITIES TO COME

Governments in Europe and the UK are thought to have done a good job in mitigating the impact of the economic shutdown, but they need an exit strategy. With banks already overloaded with debt there will be a need for finance from private debt funds. But companies will already be highly leveraged, so managers may have to be flexible and be prepared to consider convertibles, preference shares and equity.

This is an unprecedented environment with plenty of potential difficulties. For example, while government loans have proved a lifeline in terms of liquidity, they would rank ahead of private debt in insolvency. So, Permira has sought to get private equity sponsors to inject fresh capital instead. Whether the sponsors of portfolio companies can follow their money will depend on where they are in their fund life cycle, but as Ruocco explained, they would obviously prefer for fresh capital to be injected as part of a balance sheet restructuring. The primary approach at Permira has been turning to the sponsors first.

Unfortunately things seem likely to get worse for the corporate world before they get better, leading to higher leverage. If credit funds find themselves holding equity (after debt-for-equity swaps), investors will need to adapt from a tax and structuring perspective. “Any credit fund will anticipate the possibility of holding equity, but not at the scale that could emerge over the next few years. What might that mean for investors from a tax and structuring perspective?” asked Amos.

Seeking agility to take advantage of new opportunities that may emerge, some managers are looking to set up platform structures so that they can quickly launch a new compartment to take advantage of any opportunities that arise, he added.

But there is cautious optimism about the opportunities for debt funds. “There’s some doom for certain sectors of the economy, but in other sectors the direct lending space remains highly attractive for the next two to three years, and potentially longer,” noted Shea.

It’s likely to be a time when private debt managers’ reputations are made or broken. “While we have a good track record, investors will just remember this crisis. Obviously we hope we’ve structured our portfolio correctly to weather it.”

Salvatore Ruocco
Finance Director at Permira Debt Managers

“While we have a good track record, investors will just remember this crisis. Obviously we hope we’ve structured our portfolio correctly to weather it.”
The market for Collateralised Loan Obligations (CLOs) has not escaped the challenges of the current economic environment. While CLO issuance enjoyed a record year in 2018, carrying real momentum into 2019, Covid-19 has impacted both issuers and managers in 2020. This, together with new developments in the regulatory space has seen issuance for the first six months dropping by around 50 percent compared to the previous year. As a result, CLO managers may be seeking to reduce costs. Matt Jerrell, Managing Director at Alter Domus and Randall Reider, Director of Business Development at Alter Domus, discuss how to strike a balance between cost reduction and maintaining standards.

As current market conditions see CLO managers increasingly reviewing their operational costs, many are turning to outsource service providers which can be a cost-effective solution for time- and budget-conscious managers. However, the knowledge and skillsets required to handle the operational components of issuance and management tend to be rare in the market, and it can be difficult for fund managers to find experienced professionals who not only understand loans, CLOs and their covenants – but also how to monitor them.

The operational part of the role of a CLO manager encompasses a unique and varied skillset – from dealing with clients, regulators, rating agencies, managing liquidity, allocations, internal reporting and monitoring pipelines. Many of these tasks must be done in a timely manner, and it is imperative that all requirements under the CLO governing documents are met and followed.

“As recently as 10 years ago, there weren’t many options when it came to reputable outsource service providers,” notes Jerrell. “While there is a fair amount of relatively niche processes for CLO managers to juggle, many of these are recurring and quite clearly defined. Therefore, it makes sense to offload them onto a firm that regularly handles these types of operations for clients.”

A former CLO manager himself, Jerrell takes a practical approach towards outsourcing of back and middle office functions. He explains, “Good people in this field are not only rare, but tend to be expensive as well. Outsource service providers with global coverage offer the benefit of established teams of experienced professionals throughout the US, Europe and Asia… typically in lower cost locations than where managers sit. These teams not only benefit from working with a wide variety of clients applying a range of different strategies, but can also leverage this experience when working with other clients in the same sector.”

ENSURING COMPLIANCE THROUGH SPECIALISED IT SYSTEMS

Due to the particular nature of CLOs, managers need to demonstrate to regulators that their operations meet specific criteria in terms of technology and eligibility – a level of compliance not found in average funds. At the same time, some of the outdated communication practices still prevalent amongst underlying assets can make it challenging for managers to meet tight and frequent reporting timelines.

“While there is a certain amount of nuance between deals, there are also many similarities as all CLOs are assessed by a handful of rating agencies. For first time or start-up managers, it’s crucial to quickly gain awareness of operational best practice – or to partner with a firm that offers it,” says Jerrell. “Working with an external service provider gives managers the flexibility to scale their service level as required, from half an FTE to an international team, all supported by the pooled knowledge and resources of an experienced global network.”

“Another major requirement these days is the need for a strong technology platform,” adds Reider. “To ensure compliance with rating agencies’ operational reviews, it’s important that fund managers choose partners with technology experience specific to the CLO sector. Providers that work with these types of funds on a day-to-day basis are more cognisant to the technology issues faced by CLOs.”

“Working with an external service provider gives managers the flexibility to scale their service level as required, from half an FTE to an international team, all supported by the pooled knowledge and resources of an experienced global network.”

Matt Jerrell
Managing Director

STRIKING BALANCE BETWEEN THE RIGHT PARTNER AND FAIR PRICE

Outsourcing provides a variable cost solution to what is normally considered a fixed cost – giving clients the flexibility to scale their service levels as they grow, while focusing on their core business. Reider continues, “With support and resources available around the world, global service providers can offer a 24-hour support model that can significantly speed up time of delivery. This presents a distinct advantage that most start-up managers will find challenging to match in-house.”

“With many CLO managers dealing with the impact of changes to the ratings of their underlying assets, it’s becoming more challenging for them to source appropriate investments,” summarises Jerrell. “Working with the right outsource service provider gives managers the freedom to concentrate on managing their portfolios, while leaving more routine daily operations and reporting in the hands of a highly experienced, professional and specialised team.”

DEBT CAPITAL MARKETS

A CLO STRATEGY
FIT FOR THE FUTURE
Lenders and borrowers have collaborated to amend many loan agreements, avoiding defaults for now. Juliana Ritchie, Director at Alter Domus in the UK, examines the critical role of facility agents.

Something strange is happening in Europe’s debt markets. Despite the coronavirus pandemic plunging Europe and the UK into a historic recession with the kind of drop in business activity normally only seen in war, there have been few defaults on loans so far in 2020.

The default rate for European leveraged loans reached 1.7 percent in June 2020, according to Fitch Ratings. While an increase from 0.8 percent in December 2019. It is still a low level. Additionally, Fitch’s loan default forecast for all of 2019, it is still a low level. Additionally, Fitch’s loan default forecast for all of 2020 is 3.8 percent, up from pre-pandemic forecasts of 2.5 percent, but still small given the severity of the recession.

It is no secret that many of Europe’s mid-sized corporate borrowers have struggled to service their loans. Conversations with facility agents across the market suggest that most of Europe’s mid-market borrowers have needed to raise additional liquidity or adjust lending facilities – often as a matter of survival. But, so far, lenders and borrowers have collaborated, and defaults have remained rare.

In April and May, there was a flood of activity as loans were amended. These unprecedented volumes stress tested the infrastructure behind the loans market, exposing any weaknesses in facility agents’ technology. For instance, communicating through online portals rather than by email facilitated the processing of large volumes of requests, minimising logjams.

For some lenders, administrative issues proved an unwelcome distraction. “If the lender can focus on the credit and they’re not having to worry about the administration of the loan, then borrowers can get their funds in a timely fashion, because often all these requests are coming in a really narrow window,” explains Ritchie.

**MASTERING THE PRACTICALITIES OF LOAN AMENDMENTS**

At the start of the pandemic outbreak in Europe, the UK regulator, the Financial Conduct Authority, issued guidance recommending that lenders defer payments on personal loans and residential mortgages, setting the conciliatory tone for the corporate market. With many debt funds managed from London, that influenced their approach.

With their income evaporating, many of Europe’s mid-market businesses were able to raise additional liquidity or adjust their credit facilities. As is well known, the tourism, hospitality, retail and leisure industries have been severely affected. In the tourism industry, borrowers have been allowed to make payments in kind, or to compound or capitalise interest. Some have negotiated a postponement of reporting requirements until 2021, and others have put their annual financial statements on hold until further notice.

The rush in April and May to amend loan agreements and provide additional liquidity highlighted the importance of practical issues such as agile systems. If deals are amended to include part payment, deferred payments or compound interest, for instance, computations must be quickly updated. Operating through a portal also improves efficiency and security.

“Other agents have had cyber security issues where people can intercept either notices or banking details by email,” says Ritchie. “Using a portal minimises IT issues and security issues.”

**A WAVE OF RESTRUCTURING TO COME**

Looking forward, it seems unlikely that the low level of defaults can continue forever. A point will come when it is clear that loans can no longer be amended and companies will have to restructure their loans, although the exact timing of this is unclear.

“When banks still have cash to lend and the direct lenders still have liquidity, they’re likely to fund any tricky deals that they might have to put liquidity into,” notes Ritchie. “Probably people will stumble through 2020 and we won’t see the results of all this until the first quarter of 2021.”

In the meantime, she expects to see some banks sell distressed loans in the secondary market. Debt funds with excess liquidity are likely to buy some of these loans.

“Some debt funds expect to be very busy in the next few months,” says Ritchie. “They’ve raised funds from their investors that they need to invest. Loans are cheap to buy right now, and they see it as an opportunity.”

As banks sell down their loans, there will be a need for independent facility agents that can coordinate the actions of all a borrower’s remaining creditors over the course of a restructuring that could take several years.

“It’s likely that in 2021 the rate of defaults in Europe’s mid-market will no longer defy the reality of recession. Then lenders, borrowers and facility agents will move to a new phase – the frantic initial phase of amending a flood of loans to offer short-term relief will move on to the longer-term negotiation of restructurings.”

Juliana Ritchie
Director

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**“While banks still have cash to lend and the direct lenders still have liquidity, they’re likely to fund any tricky deals that they might have to put liquidity into.”**
As one of the most complex asset classes to manage, real estate fund managers have been debating how to simplify operating models for years. But now the time for talk appears over, as the coronavirus pandemic has spurred many firms to focus on the adequacy of their technology, and how to enhance their operating models. Anita Lyse, Head of Real Estate at Alter Domus, examines the road ahead for real estate.

When the pandemic struck, asset managers moved to a virtual model overnight. Broadly speaking, they did so without mishaps. From there it has proved just a short step to turn the crisis into an opportunity, using it as a catalyst for improvement.

Some real estate managers are now embracing technology, created confidence that we do not need to go back to where we were pre-Covid-19,” explains Anita Lyse, Head of Real Estate at Alter Domus. “Let us try to build on that and take a step further. It has accelerated the thought process and for some it will accelerate decisions on data strategy, tech platforms or outsourcing.”

SIMPLIFYING COMPLEX MODELS

Even before the pandemic, there was a trend towards more outsourcing for well-rehearsed reasons. Real estate managers’ operations are often highly complex, stretching across international borders. They involve multiple layers of special purpose vehicles as well as different parties; and reporting must be consolidated across multiple jurisdictions, often with their own currency, accounting standards and regulatory compliance requirements. Administrating large regional or global investment structures therefore requires substantial resources. Middle and back offices have grown fairly large, to the point where they absorb a lot of management time, and risk taking the focus away from fund managers’ primary objective: Excelling as asset or investment managers. Additionally, they depend on robust multi-layered technology platforms that straddle all of a firm’s international entities, consolidating data and reporting. Then there is the challenge of complying with regulations all over the world.

Within Europe, and to some extent also Asia-Pacific, some of the mid-sized to larger managers have issued RFPs seeking an outsourced model. Both continents, and perhaps Europe in particular, characterise complexity, given the patchwork of nation states. Signs of this start to be seen in the US market as well and Lyse expects US managers to follow - if not accelerate - that same trend.

Firms are asking themselves several questions. Whether to outsource all the back-office tasks - investor servicing, reporting, compliance – with partial or full lift-out of staff? What kind of technology platform do we need? What is our data strategy?

“Covid-19 has accentuated the thought process around these questions,” says Lyse. “That does not mean that everyone will now embark on a transformational journey, but it has allowed people to take a step back and think about what to do. While these projects may have been aspirational pre-pandemic, they are now often put into action with a ‘let’s do it’ mindset.”

A TURNING POINT FOR OUTSOURCING, TECH AND DATA

Europe’s real estate managers already outsource a lot of their back-office functions, although at times in a piecemeal fashion. Those already outsourcing are now seeking more comprehensive solutions, including additional parts of the middle office, while others are on the brink of outsourcing for the first time. In the US, by comparison, there is relatively little outsourcing, due in part to a historic lack of administrators with solid asset class expertise and technology, but this is changing, and outsourced models are on the rise and expected to grow increasingly popular.

Turning to technology, Covid-19 has highlighted the importance of a robust, versatile platform. For instance, cloud-based solutions smoothed the move to working from home. The larger managers, especially, need a global, integrated platform, which can be hosted in-house, although at a cost. “As a manager do you want to bear that cost?” asks Lyse. “Not just the cost of developing but the maintenance, support and updates.”

Data strategy is also being reviewed, especially as investors, or limited partners (LPs), request more data sets to carry out reporting or manager oversight. Reporting is becoming more sophisticated; not just on financial performance but also increasingly on asset or portfolio level metrics around things such as ESG, risk indicators, exposure to different types of markets and so on.

“Real estate asset managers have used lockdown to review their operating models, leading many to issue RFPs that herald a quest for greater efficiency.”

Anita Lyse
Head of Real Estate
COVID-19 AND DEBT MODIFICATIONS: YOUR NEXT MOVES

There has been a lot of speculation in the lending sector about the ramifications that Covid-19 will have on debt covenants. Theories range from ‘business as usual’ to ‘economic catastrophe.’ Carlos Ferreira, US National Managing Partner for Private Equity at Grant Thornton, shines a light on what’s happening in the private equity market, the necessary steps lenders should take now, and what the future could hold.

WHICH PREDICTION WAS RIGHT?
While it’s still too early to definitively say which prediction will be right, the results of the second quarter point to a better lending environment than some thought possible. Many lenders were worried after the first-quarter results showed a lower activity volume, but the recently-ended second quarter has stirred some optimism.

“Recent conversations we’ve had with lenders have proven that portfolio companies are faring much better than they were expecting three months ago,” says Ferreira. He says that as a result, they’re expecting the growth which all three months from now, portfolio companies will still be performing well. But he points out that those that are doing well under these circumstances were operating efficiently and profitably before Covid hit. Those that weren’t aren’t doing as well.

Of the upward trend, Ferreira says, “The cost of capital actually came down in the last couple of weeks because the risk is perceived to have come down quite a bit which, frankly, is counter to what my initial thinking was.”

THE GREAT RECESSION VERSUS COVID-19
Comparing this financial crisis to the one in 2008, Ferreira sees a significant difference in the lending environment. In the former crisis, lending tightened so much that investors couldn’t get the funds they needed to continue managing current businesses or launch new endeavours. But this crisis is different. Lenders have the liquidity to lend, and are doing so with one caveat: the borrower must show a reasonable ability to succeed in the Covid 19 environment.

FORWARD THINKING
Many traditional private equity investors are seeing the current environment as ripe with opportunity. They are moving into different types of vehicles and creating lending funds to put capital to work as a debt instrument instead of initiating a buyout. For instance, these firms may create Private Investment in Public Equity funds (PIPEs) or start tech funds to provide funds to companies in need of medium-term liquidity.

Some of the largest opportunities lie in current low-interest rates, increased buying prospects due to new carve-outs and divestitures, the availability of distressed firms that will thrive again in the future such as those in the hospitality businesses, the addition of credit funds, and a new look at minority investments.

UNDERSTANDING LOAN MODIFICATIONS
According to Ferreira, not all portfolio companies are doing well. Companies that responded quickly to the crisis and immediately cut costs, accessed liquidity, and had frank conversations with their lenders are faring much better than those that didn’t take these steps. In addition, Ferreira explains that the presence of Covid-19 is accelerating the demise of some businesses that were struggling even before the pandemic hit. For instance, large corporations that traditionally relied on huge office spaces to support staff are now in competition with companies that have undergone a technological transformation and equipped workers with the tools they need to work from home.

The massive reduction of expenses will make these leaner businesses tough competitors.

In the past, lenders might have forced restructuring or bankruptcy if a business was struggling, but now that the US government stepped in with PPP and the CARES Act, borrowers have other funding options. Additionally, the Federal Reserve and the FDIC issued guidance to lenders to work with borrowers that were stable before Covid-19 but are struggling now. That means lenders need to understand loan modifications for those borrowers.

According to Ferreira, lenders and managers have a few options when it comes to debt modification in this environment. First, they can right-size the balance sheet by converting a portion or all existing debt into a different type of instrument. For instance, they can convert a portion of senior debt to sub-debt versus a convertible one, transferring the debt into different amounts of sub-debt tranches.

Other options are to purchase the borrower’s business and its assets through a section 363 bankruptcy sale, or the lender can offer loan forgiveness and write off a portion of the loan while right-sizing the remaining loan amount on the balance sheet. Finally, the lender could find another lender with a different risk profile and sell the loan at a discount.

BE AWARE OF TAX CONSEQUENCES
When modifying a loan, it benefits both lenders and borrowers to reduce potential tax consequences. A distressed borrower doesn’t need the added pressure of owing unexpected taxes, and lenders want to help ensure that borrowers can meet their remedied commitments.

The key point to watch for is whether or not the IRS considers the modification a “significant” one. When a modification is deemed “significant” by the IRS, it is considered a new debt instrument, and that can potentially trigger a taxable transaction. For instance, when a lender forgives a portion of a debt, the cash-strapped borrower may have to pay taxes on income that they never received. That’s why it’s so important that modifications are meticulously planned, ideally with an advisor who understands the bright-line tests the IRS uses to evaluate the deals.

The cost of capital actually came down in the last couple of weeks because the risk is perceived to have come down quite a bit which, frankly, is counter to what my initial thinking was.”

Carlos Ferreira
US National Managing Partner for Private Equity
at Grant Thornton

ANALYSING CURRENT PORTFOLIOS
Given the uncertainty of the timing of the economic recovery, lenders need to understand a borrower’s financial position. Lenders can gain this knowledge in a few ways. The most important aspect of this process is communication. Borrowers should inform lenders when taking cost-cutting measures and other actions that will strengthen their business’ financial position. And lenders should verify that all pledged collateral, liens, and assets are owned by the proper parties in the event it becomes necessary to claim them. Finally, it’s smart for lenders to develop relationships with other lenders that are open to high-risk portfolios in case a sale becomes necessary.

GET THE HELP YOU NEED
Not all lenders and managers have the back office staff to effectively manage loan servicing and modifications. And that’s where a third-party administrator can help smooth the process. For instance, they handle regulatory and reporting compliance, have cybersecurity procedures in place, and are experts at business continuity planning and technology disaster recovery planning—which all helps to mitigate risk in this uncertain environment. However, it’s important to analyze a company before hiring them in order to ensure they are a financially sound administrator, one that has credibility in the market, is cost-effective, and offers robust technology to its clients.

Managing debt involves many administrative tasks such as loan tracking, the management of debt covenants and modifications, trade settlements, syndication, and acting as an agent. A third-party administrator can not only reduce the back office burden but also help ensure that lenders understand their position each step of the way.

Using a third-party administrator allows managers and lenders to concentrate on growth. But during trying times such as these, it makes more sense than ever to outsource your back office. This is especially true because the use of loan modifications—and all the complications that come with them—will take the place of traditional restructuring during this crisis.
Record-breaking fundraising numbers in 2019 highlighted investors’ increasing appetite for alternative investments. But while the sector has seen rapid growth, evolving regulatory and market pressures have created new challenges in terms of operating costs. As alternative asset managers rush to launch new products to meet soaring demand, challenges around cost optimisation have come into sharper focus. Maximilien Dambax, Group Product Head of Fund and Corporate Services, and Courtney Thomas, Head of Client Portals, examine the role technology can play.

Alter Domus’ recently published technology report shows that some 58 percent of alternative asset managers believe technology will help address the particular challenges they face. And transformative technologies—portals and communication platforms—are widely regarded as the most effective ways to address their growing concerns. From the report’s overall conclusion, it seems clear that digital technologies are set to transform the alternative investment universe for asset managers, investors and regulators alike.

DRIVING FORCES BEHIND DIGITAL TRANSFORMATION

From data protection to asset administration at scale, strong data management systems are critical in supporting asset managers as they tackle today’s complex challenges. But asset managers alone are not driving the need for digital transformation—investors and regulators are also playing their part in reshaping the alternatives landscape.

ASSET MANAGERS SEEK A COMPETITIVE EDGE

As investment strategies become increasingly sophisticated, institutional investors’ expectations for clarity and transparency at every level of their portfolio holdings—performance, ESG, fees—grow accordingly. As noted in our technology report, transparency and enhancing the investor experience are identified as key challenges currently facing fund managers. Many managers are seeking ways to deliver a more informed and proactive service to their investors through faster response rates and improved data access.

INCREMENTING INVESTOR DEMANDS

Today’s asset management community manages investor relationships across a diverse spectrum of asset classes, fund vehicles, vintage years and jurisdictions. The result is a mix of complex and inefficient communication. Streamlining investor communications in a consistent, secure, and consolidated manner can go a very long way in enhancing the overall investor experience. Improved platforms can reduce time spent during the investor onboarding period. They can also increase investor portfolio transparency, ensure a secure communication channel from a cybersecurity standpoint and provide a truly customised experience.

GROWING REGULATORY PRESSURE

While Anti-Money Laundering (AML) and Know Your Customer (KYC) regulations are designed to target criminal and terrorist activities, they also impact significantly on the investor onboarding experience and requirements. Enhanced due diligence prerequisites enforce the use of systematic and well-documented steps in establishing new client relationships. These regulations, combined with the General Data Protection Regulation (GDPR) in Europe and the Foreign Account Tax Compliance Act (FATCA) in the United States, have increased regulatory pressures on managers and their investors. Digital transformation provides a solution for meeting these dynamic requirements.

“IT seems clear that digital technologies are set to transform the alternative investment universe for asset managers, investors and regulators alike.”

Maximilien Dambax
Group Product Head of Fund and Corporate Services
MEETING THE NEEDS OF ASSET MANAGERS, INVESTORS AND REGULATORS

Given the rapid pace of change in the alternatives sector, smart solutions must be developed for the challenges facing fund managers and their investors today. For example, Alter Domus’ Digital Subscription Fulfilment (“DSF”) application, part of the CorPro client portal, offers a secure, streamlined and simplified fulfilment process. It opens new doors to asset managers and investors with continuous access to a secure, customisable portal that includes a document library, a reporting database, dynamic dashboards and a digital operational workspace. The DSF application harnesses the real potential of transformative technologies to support asset managers in today’s dynamic environment.

CUSTOMISABLE REPORTS

The portal creates presentation-ready dashboards while also providing the manager with granular information through a self-service reporting platform tool, allowing them to directly generate reporting results through the accounting-engine agnostic tool.

REAL-TIME VIEW INTO OPERATIONAL WORKFLOWS

The DSF application provides a clear view into operational workflows to track progress between various workstreams and participants. A truly transformative model, the tool has bridged the gaps between asset managers, investors, and administrators. The collaborative digital onboarding platform works to connect all three stakeholders in real time.

“Digitisation in the alternative space has quickly become a reality with managers faced with a few simple options: Either step up to today’s demands, begin a never-ending game of catch-up by creating a piecemeal technology infrastructure, or risk obsolescence with the use of outdated tools.”

Courtney Thomas
Head of Client Portals

BENEFITS OF A DIGITAL INVESTOR EXPERIENCE

• Reduced risk of error with less manual data points
• Enhanced control and administration
• Increased transparency for investors and managers with distinct onboarding KPIs
• Scalability for large closes under tight deadlines

A new generation of portals with digital subscription features are poised to create an ecosystem where the needs of investors, managers and regulators alike are met. Not only do these types of portals provide well-organised, transparent data, they also provide an opportunity to streamline workflows and transform communication streams across the fund community as a whole.

“There’s no doubt that transforming the investor and manager experience is a challenging undertaking, but the real danger lies in doing nothing.”

Maximilien Dambax
Group Product Head of Fund and Corporate Services
THE PANDEMIC TAKES AUTOMATION ADOPTION TO ANOTHER LEVEL

The financial sector has responded to the Covid-19 outbreak with speed, decisiveness, and a willingness to embrace new technological capabilities to meet changing demands. From high street banks using bots to automate digital loan applications, to asset management firms increasingly automating back and middle office functions, a wave of new technologies is sweeping the financial services sector. Danilo McGarry, Head of Automation at Alter Domus, brings us up to speed.

Covid-19 has quickly become the single most impactful development in history with regards to the adoption of new technologies in the wider financial services industry. Added to robotics, machine learning and big data analytics, automation is a key component of this wave. “In the asset management space, the prevalent mode of thinking is that organisations really must automate as quickly and as comprehensively as possible to survive, with many firms now thinking that it’s actually a case of ‘automate or die,’” says McGarry.

THE GREAT LOCKDOWN ENABLED AUTOMATION TO THRIVE

Prior to the onset of the pandemic, the financial sector was already making significant progress towards greater adoption of automation technology. However, the depth, breadth and speed with which the pandemic has pervasively changed the way financial organisations operate has massively expedited integration strategies in recent months. According to a recent Forrester report, “the world has seen more digital transformation in the past months than in the preceding five years.” Meanwhile, a PwC survey with CFOs indicates that 40 percent of financial services firms intend to “accelerate Automation and new ways of working” as a result of the pandemic.

With the Great Lockdown earlier this year, its lingering aftermath, and the ongoing restrictions on international travel worldwide, remote work has quickly become the new norm. In light of this reality, financial organisations have quickly sought ways to plug new bottlenecks in how they operate. “The solution for many of these challenges has been to expedite adoption of technologies that automate core and value-added processes,” says McGarry. “Financial services firms have quickly realised that automation is the answer to many of the operational problems that Covid has created, including back and middle office workflows, improved regulatory compliance efficiency, and enabling full remote onboarding.”

THE PANDEMIC ACCELERATED AUTOMATION’S ROLE FOR TWO REASONS

While Covid has indeed been a trigger that increased automation adoption, there is a more specific development that enabled it to thrive. What the pandemic really did was allow organisations that already had automation technology in place to see how robust the technology really is. While firms’ human workers were adjusting to working from home, automated processes were functioning as expected at full capacity in the background. This showed financial service leaders the true power of automation as a singularly effective means to bolster business continuity planning.

Additionally, as CEOs and CFOs analysed their original financial predictions made in January for the 2020 calendar year, they saw that very few other strategies and tools would enable them to hit their end-of-year targets. If executed properly, automation delivers quick returns and subsequently generates a snowball effect on productivity, cost savings, and operational efficiency that lasts for years.

TOMORROW’S WORLD IS ALREADY HERE

With so many functions within financial organisations that are ripe for automation – especially operational protocols, data management, security measures, and regulatory compliance – the industry has naturally been able to benefit in particular from advances in automation technology. Companies have begun realising that the decisions they make today will shape many aspects of business and the future workplace. Experts believe that this is not only true for the remainder of the pandemic but is likely to remain true for years to come.

Before the pandemic, there was a slow but steady rise in remote work and other related trends, but COVID-19 has brought the future of work into the present day. According to a PwC survey, financial institutions reported that 29 percent of their employees worked from home at least one day a week pre-pandemic but that they expect this figure to jump to 69 percent after Covid. Many financial organisations see a range of benefits, including potentially higher productivity, lower overhead costs, and greater employee retention. Speaking about returning Barclays Bank’s work-from-home employees to offices after the pandemic, CEO Jes Staley said that “the notion of putting 7,000 people in a building may be a thing of the past.” With similar sentiments, Morgan Stanley CEO James Morgan has said that the bank would “need much less real estate” in future, with a nod to a continuation to a work-from-home setup for employees.

With more financial sector professionals working from home rather than in an office, companies are keen to enable them to be as productive as possible. This is where automation can come in, removing repetitive and time-consuming tasks from employees’ workloads and streamlining much of the core operational workflow. And with 60 percent of financial services organisations considering making work-from-home permanent, automation can play a role in improving employee engagement and contribute to enhanced performance.

COVID AND AUTOMATION: SPEEDING UP THE INEVITABLE

The financial industry was already on its way to greater automation integration before Covid. However, the sudden upheaval that the pandemic has caused has forced organisations to think and act fast to respond and chart a best route forward. Automation is the inevitable solution that so many financial institutions and firms have turned to for its practicality, effectiveness on employee and overall organisational productivity, and, not least, its impact as a significant cost-cutting measure. And while it has only increased in importance for financial services since the pandemic began, developers will create more advanced automation capabilities in the coming years. As and when automation addresses increasingly complex tasks that now require humans to complete them, its importance to financial organisations can only increase further.
While 2020 started off like many other years, by the end of the first quarter the world was facing a public health crisis that seemed capable of overwhelming hospitals, communities and businesses. Three months after most major economies had locked down and many organisations were operating a 100 percent remote workforce, Alter Domus conducted an in-depth survey. We listened to and learned from our clients’ responses – what worked, what didn’t and what could be improved?

The vast majority of businesses were impacted to some degree by the sudden disruption Covid-19 unleashed. However, one surprising figure that emerged was that only 1 in 5 firms felt they have been ‘strongly affected.’ Given the real pressure on operational activities and business structures, this is relatively low. Some companies will have responded better than others, moving quickly to implement business continuity plans and establish effective communication. Others may have underestimated the speed at which normal activities would be upended. While these survey responses reflect the immediate and short-term impact, it is expected that companies are likely to see permanent operational and governance change. This survey summary focuses on four key categories: challenges, people, technology, looking ahead.

COMPLEX CHALLENGES, NEW RISKS

Three areas were identified as key challenges faced by organisations – remote working; reassuring the workforce; risk management. Although dealing with problems that had simply never arisen before, overwhelmingly businesses put the wellbeing of their workforce at the centre of their response. New guidelines and communication formats were put in place as businesses responded to some enormously complex challenges. Stability and continuity were critical to ensure businesses could run as smoothly as possible as they were catapulted into a new world.

Managing the workforce remotely and reducing expenses are currently top of most organisations’ priority list. Performance in some specific sectors has slumped, and the fund industry may be facing some challenging questions. The investment landscape is still uncertain and any change in investor behaviour or expectations remains unclear. Against this background some 50 percent of our respondents see cost cutting as their top priority. However, there is one significant standout point. For one third of our respondents their top priority is to develop new offerings or products and are already scoping out opportunities. The sharp shock of Covid-19 may have profoundly shaken the fund industry but it is already looking towards new horizons.

KEEPING PEOPLE CONNECTED

When asked about how employees supported their workforce, nearly one third of firms appeared to have adopted a laissez faire approach. But from our own experience, we have seen a significant uptick in engagement, training and a commitment to supporting a home working environment. Flexible working hours, already a growing trend pre-pandemic, look set to be more widely adopted in the long term as nearly 70 percent of our respondents are committed to maintaining this approach. There is also a positive attitude towards shift rotations which may see staff returning to the office in teams to minimise contact. This sentiment is supported by two important figures: only 17 percent of respondents see a reduction of productivity levels as a concern while less than 10 percent felt the need to reduce working hours. This would suggest that the sudden imposition of working from home has been largely successful with employers confident that productivity levels did not drop, and the structures and format established are viable, certainly in the immediate future.

“It is expected that Covid-19 will leave a lasting impact on how business is conducted, with face-to-face interactions and travel heavily restricted. A substantial proportion of a firm’s employees working from home has quickly become normalised with some European regulators and tax authorities already seeking greater flexibility for teleworkers.”

Joanne Ferris
Chief Human Resources Office

“Since the early days of this crisis, we have seen organisations strive to return to a ‘business as usual’ position as quickly as possible. This determination has seen firms assess, analyse and act quickly facing a wave of complex new challenges. And while many seem to recognise the impact of Covid-19 on this year’s plans, 2021 remains unchartered territory.”

Doug Hart
Chief Executive Officer
face a world significantly re-shaped by further investment in technology-based automated processes with an identified a significant shift in thinking over the past five years. Our survey and how fast technology has developed It is perhaps an indication of how far seemed a surprising degree of resilience. pressure and have shown what may have responded well to this considerable clear that technology and IT systems never before. From our survey it seems to be seen, it appears that the initial response has been generally positive. TECHNOLOGY, RESILIENT AND ROBUST Technology has been the cornerstone of the pandemic response. Around the globe businesses large and small have been leaning on their IT infrastructure like never before. From our survey it seems clear that technology and IT systems have responded well to this considerable pressure and have shown what may seem a surprising degree of resilience. It is perhaps an indication of how far and how fast technology has developed over the past five years. Our survey identified a significant shift in thinking about automated processes with an increasing number of firms considering further investment in technology-based solutions: Adapting company strategy is a key factor for many businesses as we face a world significantly re-shaped by Covid-19. Restricted travel, considerably reduced physical meetings and the increased digitalisation of the workplace and beyond, may require a substantial re-think. Technology has a central role to play. Technology will have to be scaled up across many industries to meet the challenges of increasingly digitalised corporate operations and business models. However, operating in a fully digital landscape raises issues about data privacy, cybersecurity, electronic signatures. Regulators moved quickly to establish an initial framework to support this virtual new reality and it seems likely further guidance will be developed as we look to longer-term digital solutions. WHAT LIES AHEAD? Unsurprisingly cost containment is a recurring theme in this survey. What is perhaps surprising, however, is that only one third of businesses plan to cancel or defer investment commitments. In such unprecedented and uncertain times this seems a relatively low figure, but it does suggest that many companies are looking beyond the initial disruption and sweeping changes that have taken place. Attitudes to remote working seem to have been re-shaped with previous reservations overcome. Teams and businesses around the world adapted quickly and efficiently in unprecedented circumstances. “IT infrastructure and software seem robust and real resilience has been demonstrated. This is perhaps reflected in the fact that only one third of respondents feel the pandemic has made a long-term impact on their crisis management procedures. Again, this would suggest that business continuity plans held up well under extreme pressure. Regulators have for a long time demanded companies build strong, reliable disaster recovery policies - it is clear that many did.” Hendrik Kuhn Co-Chief Technology Officer There will inevitably be new regulations to accommodate entirely different ways of working, operating and behaving. From developing a more flexible tax environment for teleworking to defining extra safeguarding measures for liquidity management. Increased digitalisation, such as virtual board meetings and electronic communications may see governments usher in stronger regulatory frameworks in this field as businesses will rely heavily on technology, and IT security, to adapt. However, it appears unlikely that governments will want to introduce onerous or excessive new regulations at a time when many businesses may be struggling. Covid-19 is a health crisis and not the systemic financial risk we saw in 2008. The full financial impact of Covid-19 is still to hit. And when it does the overwhelming majority of our respondents expect it to hit hard. A global recession, liquidity management issues and a slump in consumer confidence and consumption are seen as the key issues on the horizon. However, while the economic outlook may look bleak the post-Covid-19 economic landscape is yet to take shape - and in that new economic era, new opportunities will arise. “Covid-19 has forced businesses to review their business models, crisis management plans and operational structures. Reality has shown that it is vital every component is able to withstand further sudden shocks as Covid-19 remains an unpredictable threat. We see a trend for a growth in outsourcing activities as firms seek a reliable and robust platform to maximise their response and efficiency in all circumstances.” Doug Hart Chief Executive Officer SHINING A LIGHT ON SERVICE PROVIDERS When firms reach the ‘lessons learned’ stage of the review into their initial response there is no doubt that the role of service providers will come under particular scrutiny. And that is how it should be. Third party administrators can provide stability and critical support both in good times and bad times. But their ability to provide assent support depends upon their calibre, resilience and depth of relationship with their clients. Service providers positioned as a true extension of their clients’ firms, can deliver streamlined operations and fully integrated solutions with the flexibility to shift in line with changing needs. While service providers can offer invaluable support, some can bring additional risk if their own resilience is weak. Covid-19 was an important stress test for outsourcing firms. But it was also an opportunity to demonstrate that organisations with a significant part of their operations outsourced were free to focus on steering their company, and their clients, through exceptionally turbulent times. “When the Covid-19 crisis hit, the spotlight shone firmly on service providers as their operational resilience was absolutely critical to the continuity plans of their clients. And despite being under enormous pressure themselves, typically third-party administrators responded very well. What is clear is that those service providers with the latest technology are in a stronger position to maintain delivery under extraordinary pressure.” Stéphane Bourg Chief Risk and Compliance Officer
Opening the discussion with a brief overview of upstream structures, Reynolds says, “Coming into Japan, Cayman structures are most commonly used. We generally see a Cayman General Partner and investors in Japan being Limited Partners.” In July, Hong Kong’s OSC regime was introduced, which created a number of advantages, but also a number of restrictions as well. In Luxembourg, the most commonly used fund coming through into Japan for asset acquisition is the RAP (Reserved Alternative Investment Fund).”

According to Reynolds, “All of these share a few strengths - they all claim to be strong with compliance on OECD and FATF (Financial Action Task Force), as well as AML and data protection requirements. This is a real driver for investors – fund structures need to be strong in these areas in order to attract large numbers of investors who form the backbone of their money coming into Japan.”

Turning to investment structures at the asset level, Reynolds notes, “Fund structures tend to differ based on the underlying asset class. For real estate, we will usually see structures utilising Special Purpose Companies (SPCs). Vehicles like the TMK (Tokutei Mokuteki Kaisha) or GK-TK (Godo Kaisha - tokumei kumiai) arrangements, a form of silent partnership, or a combination of both, are the most commonly used investment structures. Infrastructure funds are usually structured similar to a REIT, however there are certain exceptions such as solar energy - which tends to use GK-TK, and wind - which favours KK (Kabushiki Kaisha) or GK (Godo Kaisha) structures due to substance requirements. For debt funds, we may see an SPC used at the asset level, especially for distressed debt.” Ueyama adds, “For real estate, usually GK-TK structures or TMK structures are used. GK-TK structures are more flexible and costs are cheaper; however, many larger transactions utilize TMK structures. Decision making processes are clearer in TMK structures than GK-TK structures. A TK investor needs to be passive and cannot be involved in GK’s decision making process, while investors can participate in its decision making process for a TMK through shareholding. On the other hand, TMKs tend to have higher costs due to filing requirements and other procedures necessary for the TMK to receive the desired tax benefits. On the distressed debt side, theoretically, TMKs can be used, but – at least recently – I haven’t seen TMKs used for acquiring NPLs. Whenever you acquire a property by enforcing collateral, you need to amend the ALP (Asset Liquidation Plan). In the case of a TMK, this would be troublesome. As a result, managers may choose to use the GK-TK structure, which is more flexible than TMK.”

“A private equity fund can invest, as a limited partnership, in stocks, warrants and bonds in a corporation, as well as individual property rights – so the nature of private equity investments makes them conducive to the use of a limited partnership. As a TMK cannot hold more than 25 percent equity in another company, this could pose problems for a leveraged buyout, for example.”

Scott Reynolds
Country Executive Japan at Alter Domus

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Country Executive Japan at Alter Domus
For GK-TK structures, identifying two major issues with the advantage of a lower tax rate – less than for example through Singapore, can take percent owned by a Japanese company. The TMK needs to be more than 50 under tax law. However, in this case can be treated as a loss, subject to than 90 percent of its profits, dividends these tax-efficient structures in order to funds are always going to use one of around 13 percent. As you can see, through Singapore, you’re looking at down to 17% - 17.5 percent. If you come the blended tax rate for the whole structure in Hong Kong, Singapore or Luxembourg. In the case of Hong Kong, you can drive the fee simple properties after its establishment. If you are buying or selling real estate you can do it, but it’s complicated and there aren’t that many of them in the market that will do it for third parties. So funds will typically need to set up their own Type 3 licensed manager and Type 4 licensed manager, making it difficult to acquire fee simple properties in the GK-TK structure.”

Naoki Ueyama, Partner, Real Estate at Withers

Going into further detail about the differences between the two structures, Reynolds explains, “One of the main differences between the GK-TK and TMK structures is the Asset Liquidation Plan (ALP). The ALP is legally required to be prepared and filed prior to the TMK conducting any business, and it’s essentially the governing document specifying what assets can be bought and details of its finance that really plans out the life cycle of the TMK.”

Wheeler continues, “Generally speaking, there is no restriction on foreign direct ownership of property in Japan. A fund could acquire on its balance sheet and be the direct owner of a property, for example. However, generally, the tax rate is going to be higher for a direct owner than holding through the more tax efficient GK-TK or TMK structures.”

“The TMK structure can drive taxation down even further – especially if you make your investment through Hong Kong, Singapore or Luxembourg. In the case of Hong Kong, you can drive the blended tax rate for the whole structure down to 17% - 17.5 percent. If you come through Singapore, you’re looking at around 13 percent. As you can see, funds are always going to use one of these tax-efficient structures in order to increase their returns,” adds Tsujimura.

He explains, “If a TMK distributes more than 90 percent of its profits, dividends can be treated as a loss, subject to satisfaction of other requirements under tax law. However, in this case the TMK needs to be more than 50 percent owned by a Japanese company. Distribution from the TMK to offshore, for example through Singapore, can take advantage of a lower tax rate – less than 20-42 percent.”

Identifying two major issues with the GK-TK structure for use in real estate, Ueyama notes, “For GK-TK structures, the GK is the owner of the asset, while the TK investor cannot have any control over the asset – they only have the contractual right to participate in the profits and losses of the venture. That tends to be a problem for funds that have to explain to investors that they don’t own the underlying asset.”

“The other issue in using the GK-TK structure is that under the Real Estate Syndication Law, you are technically not allowed to use the proceeds of TK investments to acquire fee simple property. If you retain a Type 3 licensed manager and a Type 4 licensed manager you can do it, but it’s complicated and there aren’t that many of them in the market that will do it for third parties. So funds will typically need to set up their own Type 3 licensed manager and Type 4 licensed manager, making it difficult to acquire fee simple properties in the GK-TK structure.”

Once you go down the path of using a TMK to hold your assets, you’re going to incur greater cost in preparation of the ALP, as well as in relation to distributions. If you are using a GK-TK, you can pretty much do a calculation of distributable profits at any time throughout the year. As long as you have the right amount of cash and distributable profits, you can make a distribution. However with a TMK, it’s not so flexible. You must do a full financial close and divide your year into hard closes for each reporting period. This adds a lot of extra administrative work – as well as the related cost,” says Reynolds.

He adds, “Start-up costs are generally higher for a TMK than a GK-TK. For that reason, smaller investments are more likely to use a GK-TK structure, whereas larger investments will usually choose a TMK for better economies of scale.”

Wheeler amplifies this point, “Not only is it the cost, which is definitely more for a TMK vs a GK-TK, but it’s also the time it takes to set it up – which often prevents funds from using the TMK structure. It can take several months to actually set up a TMK structure, to file the ALP, and to get it to the point where the TMK can accept funds through the issuance of preferred shares. Unless managers have TMKs sitting on the shelf-or can purchase one in the market – it’s not something they can quickly employ to make an investment.”

Asked about the process for guiding clients towards a particular structure, Wheeler observes, “For a fund coming into Japan to make investments, we would want to know what the investment is, what the objective of the fund is, and what the expected profits/returns on the investment are. Smaller investments typically don’t justify the time and heavy cost of putting in place and maintaining a TMK structure. Even for a 5 to 8-year fund, there is a significant cost involved in maintaining that structure.”

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INTERNATIONAL INSIGHTS

Notably, it is generally prohibited for the TMK to conduct any business, and it’s essentially the governing document specifying what assets can be bought and details of its finance that really plans out the life cycle of the TMK.”

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