EXPERT Q&A

The growing popularity of private debt is forcing fund managers to look to external specialists for support, says Greg Myers, global sector head for debt capital markets at Alter Domus

Why outsourcing is on the rise

Q What are the challenges and opportunities facing private credit managers going into 2023?

It is difficult to generalise on this, but given there is so much more LP capital being allocated to private debt in the coming year, from institutional investors, high-net-worth individuals and retail, one of the biggest opportunities is surely outsized demand for private credit strategies.

The biggest challenge, on the other hand, is that those LP requirements are going to create operational and staffing issues, driving pressure to right-size credit management operations. The issue comes back to the legacy buy-versus-build dilemma, where managers are asking how much of the back-office function they should retain in-house, what makes better sense to be outsourced and, from a systematic perspective, how can they stay on top of all the regulatory, financial and investor reporting requirements that come with additional capital.

From what we have seen of the Great Resignation and all the new employment trends coming out of covid, getting staff is emerging as a major challenge for private credit managers. The question is whether that staffing risk is better laid off to specialist fund administrators and back-office outsourcing firms as opposed to building in-house infrastructure.

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Q How can fund administrators provide additional support, and what are the drivers behind increasing trends towards outsourcing?

A lot of the newer trends that we see coming into private credit are almost driving that requirement for outsourcing. We are seeing a lot of rated note feeder fund structures and asset-backed lending facilities within fund structures themselves, which require a trustee and a collateral administrator to handle the almost CLO-type reporting that is needed.

We have seen that not only do you need that traditional back office for tracking portfolios and doing financial reporting and accounting, but you also need that added layer of expertise around portfolio compliance to support the heightened level of reporting. In rated-note feeder funds, you have rating agencies and capital being issued to a rated-note feeder that, in turn, issues debt for investors, so that requires someone with the expertise to do investor reports that are more complex than most funds are used to.

A lot of insurers in the US have been driving demand for rated-note feeder structures, so US managers now commonly have to take that into consideration when launching funds. We are also finding a lot of demand in Europe for US credit fund structures, and a lot of European-based managers are getting demand from US-based investors, especially in the insurance space, that are looking at these structures. It has become very much transcontinental from both the LP demand and the manager requirement perspective.

Q When it comes to ESG implementation and reporting, how can third-party service providers assist managers dealing with data challenges?

ESG has been a pretty hot topic for some time now. We have developed a product that supports ESG reporting, and we are also working to address our own internal considerations around hiring practices and all the other elements of our ESG strategies.

ESG has become a much more pronounced element of due diligence for investors, and is also central to all ongoing reporting. Having an administrator that can support that reporting and track the different data points that are needed at both fund and portfolio company level is really valuable.

Q Rated-note feeder funds were a big theme that we saw in 2022. How do you expect that space to evolve through 2023, and why?

These structures are going to continue to be a driver of demand, particularly as the CLO market is all but frozen with very limited issuance of late. Essentially the rated-note feeder structure, if done the right way, can satisfy that demand for fixed income returns that a lot of insurance companies like, and also satisfy the capital relief that they seek from an insurance regulation perspective. As opposed to an LP interest in a fund, which needs to be treated as equity, these assets can sit a little bit higher up the balance sheet for insurance companies and allow them to take a stream of income and tranche it to satisfy different actuarial return metrics that they need to have in place.

The rated-note feeder fund has been around as a structure for about five years, but in the past year we saw a much broader adoption rate through new launches. Fund managers are increasingly building this possibility – if not eventuality – into all the fund documents and it is becoming a lot more prevalent in fundraising for managers that need to have that option as an initial consideration when going out to market.

> *"Getting staff is emerging as a major challenge"*

Q Finally, we have also seen a notable increase in demand for open-ended private credit funds in the past year. Do you expect that to continue, and what are the drivers of that trend?

Another thing we are seeing become a lot more commonplace is open-ended private credit funds, which we have not seen in such numbers in previous years. Lots more funds are considering evergreen strategies with different treatments for redemptions, creating more permanent capital funds that work alongside their other fund strategies.

For managers, the attraction of those structures is that they can have capital readily available for investment on an ongoing basis, rather than launching a closed-end fund and having to have 60-75 percent of that deployed before they can launch the next fund. It permits them to drive almost continuous marketing for a single product, and that is growing increasingly popular as an approach.

Going forward, we see these vehicles will continue to be part of the strategy for private credit managers, because they allow them to follow a specific strategy from a deployment perspective and create a little bit of predictability for their investors. Obviously they are typically dealing with the three-year ramp, the four-year hold and then the three-year harvest, across a 10-year fund life cycle.

It is easier to capture more stable returns for investors by taking a different approach, and it can provide really good opportunities for managers by having that callable base of capital that they can use to deploy. That is going to continue to be a theme for a long period of time, creating the ability to provide a little bit more liquid strategies, including evergreen funds that allow for redemptions. We expect that to be a much more broadly adopted strategy going forward, particularly for larger managers, who appreciate remaining outside the mutual funds and regulated funds space that is subject to much more stringent oversight.

There are still the remaining business development company structures and other things that are very much US-based and can be attractive to investors. The closed-end limited partnership structure has many strengths but as funds look to diversify their investor bases and address the increasingly sophisticated requirements of LPs, further evolution away from those historically dominant structures seems inevitable. ■