EXPERT Q&A

Although many managers have faced considerable challenges, the UK's private debt industry weathered the challenges of the pandemic and came of age in 2020, argues Spencer Wells, regional director, Alter Domus

Showing strength in adversity

Q How has the pandemic impacted investments in the debt fund industry?

The impact of covid-19 has been pretty varied across investments in private debt portfolios. The virus sent shockwaves through the industry and for some companies there has been a dramatic impact, to the extent that the UK has now reached 5 percent unemployment.

Covid has wiped out some businesses, many of which were already struggling, particularly in areas like traditional retail and leisure. The key focus in portfolios has been the ability of companies to adapt, with the ones that were able to pivot online or quickly adjust their business models being most able to stay afloat. Some of the managers that we work with were heavily invested in leisure businesses and those have really struggled, while other assets such as telecoms and IT businesses have flourished. The investments that continue to work well for managers have had a real focus on liquidity, either provided through debt managers or engineered via carefully managed outgoings, thereby ensuring they maintained the cash to survive in the face of the covid uncertainty. Government support packages, including the furlough scheme, have also helped certain industries, but will come to an end in 2021.

Across the board, there has been real pressure on businesses to adapt and on managers to come up with support, keeping a much closer eye on investments and making sure any problems are identified and dealt with promptly.

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Q What do you expect to be the likely effects on performance for these funds?

Clearly, some fund managers will have been adversely impacted, but many of them were able to step in and deal with issues to help underlying companies. Some businesses have performed well, and those managers that were well diversified going into the pandemic have offset losses on some assets with good performances elsewhere.

When covid first hit we saw a lot of concern about valuations, with auditors putting pressure on managers to look closely at the valuation models used and adjust as necessary. A year on, now that it is apparent which companies have proved most resilient, valuations have become a bit clearer. There were also worries about going concern assumptions and a lot more questions about covid impact, tolerance and reporting.

I speak to a lot of managers who say that there will be an impact on the returns of their funds, with 2020 likely to stand out as a dud year. But most will weather the storm. The ones that survive will be the funds that had good disciplines, strong investor relations teams and diversified portfolios, and they may get opportunities in the coming year to swallow up some of the smaller managers that are struggling, with a wave of consolidation coming similar to what we saw in 2008. Some people will need to come out of the industry and sell down portfolios, particularly as government support starts to come to an end. Their portfolios have demonstrated the agility and flexibility of the asset class, proving their ability to do more to support companies than traditional bank lenders.

Q The year 2020 was a challenging one for credit managers. What would you identify as the biggest challenges faced by the industry, and how did managers adapt and respond?

There were various challenges that managers had to react to quickly, and the vast majority were able to adapt and respond. One challenge was the need to get closer to the portfolio. Whereas in the past they might have had certain measurements to monitor, last year they had to be checking on the underlying fundamentals and maintaining an ongoing dialogue with management teams. Portfolio teams were focused on existing investments rather than looking to new deals.

Managers also had to make sure all their service providers – including banks and administrators – were well set up to cope with the change to working practices. They had to monitor closely to ensure investors could keep being onboarded, payments could keep going out and cash could continue to reach LPs. We were really impressed by how well the industry adapted to working

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from home, and the increased dialogue that emerged between managers and service providers. Investors were asking more questions too, increasing pressures on investor relations and finance teams to respond in a timely fashion and upgrade quarterly reporting. Then there was work to be done ensuring funds themselves had enough liquidity, and that fund documents permitted sufficient flexibility to respond to the demands of the portfolio.

Q What reactions and additional demands have you seen from investors in private debt over the past year?

At the end of the day, investors are the ones that will suffer the impact on performance from covid, so they have been more inquisitive and dialogue has increased. Covid came at a time when investors were already asking a lot of questions around Brexit, ESG and issues like cybersecurity and resilience, and we saw them seeking more detailed information about plans for the portfolio, future projections and scenario planning.

The industry is dealing well with the increased demand from investors, who need more information in order to make wise decisions and assess the impact of covid on their portfolios. Information and transparency are becoming real differentiators in the debt fund world. Auditors have been supporting those efforts, so in general investors have found their requests satisfied. The volume of information flowing to LPs will only continue to increase.

Q Finally, where do you see the biggest opportunities for private debt next year and beyond, and what will those mean for service providers?

Covid has caused devastation to many individual businesses and specific industries but the debt industry has reacted well. Going forward, the managers that emerge stronger will now be able to embrace new opportunities to offer flexible debt solutions. The volume of dry powder in the market will create pressure on managers to do deals in 2021, and all our clients believe it is going to be a strong year for alternative lending.

Some fund managers will sell down positions this year, creating opportunities in the secondaries market, while the focus for primary deals will be on the selection process and learning the lessons of the past 12 months. Covid has accelerated the coming of age of the private debt market in Europe, with attitudes towards investor relations, technology, portfolio management and working with service providers all jumping ahead several years in a matter of months. There will clearly be issues to work through for individual managers. But, as an asset class, private debt has demonstrated resilience, flexibility and agility, and will ultimately emerge stronger having endured the challenges of covid.

Service providers like Alter Domus will continue to build the relationship with fund managers and evolve to support the ever-growing European debt market. The ability to show real support across fund administration and reporting, and investor relations, while also being able to support with agency services at the asset level will enable fund managers to cope with dealing with the further development within the debt fund industry. ■