E X P E R T Q & A

The LP appetite for private credit shows no signs of abating, with the asset class entering 2022 in good shape to deal with challenges ahead, say Alter Domus's Laurent Fudvoye and Greg Myers

Investor demand growing despite economic uncertainty

Q When it comes to fundraising in private debt, what strategies and regions are currently attracting the most investor interest?

Laurent Fudvoye: In terms of structuring, in Europe a key element to consider is that Luxembourg is no longer the only hub for putting in place private debt structures. Recently we have seen Ireland coming into the game, and a bit of the UK too, giving private debt players more options for setting up fund structures. Luxembourg has always been viewed as having a really good toolbox, but other countries are now proposing interesting features to support capital raising and deployment across Europe.

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In terms of European fundraising generally, the vast majority of the money is still coming from European institutional LPs, who account for the vast majority of the capital raised, with the rest mainly coming from the US. From a deal perspective, the classic Western European economies continue to be the focus, especially through direct lending. We are also seeing a growing number of conversations taking place around potential in the Nordics and Central and Eastern Europe.

Greg Myers: We have seen an increase in allocations by Asian investors into US funds. Many of them like separately managed accounts, but they will also go into co-mingled funds because they like the returns represented by the asset class. We are seeing a lot of our US managers raising funds in Europe to create an offshore component of their domestic business. There is still a lot of demand for yield in Europe and those investors appreciate the US dollar exposure from those strategies.

Q Why does the asset class remain so appealing to investors?

GM: We are seeing growth across all

private strategies, but the real advantage that private credit provides investors today is the fact that the vast majority of managers are experienced and know how to react should there be an economic downturn or impairment of credit quality of their borrowers. They know how to work through a default scenario and they are able to be nimble and work out resolutions of the debt in addition to creating yield.

LF: The asset class has been proven to perform whatever the economic cycle. Right now, we are looking at an inflationary period and most loans are structured using floating rates that provide protection on both sides if there is a change to interest rates. The asset class has strong structural downside protections that should deliver good risk-adjusted returns compared to other asset classes in the event of economic issues.

Q When it comes to performance, how do you see managers leveraging opportunities – and mitigating risks – as economies reopen?

LF: In Europe, banks continue to retrench from lending and the asset class has also proven its resilience during the pandemic.

We saw a lot of liquidity during covid as a result of government interventions which, added to the dry powder available, put pressure on managers to get capital to work. Selecting the right deals is key in an environment where there is plenty of money available and competition for opportunities.

In the coming months, we will see government intervention decreasing and more demand for additional finance, creating opportunities for private lenders to finance small and medium-sized entities, for example.

GM: Government stimulus is slowing down or ending, depending on the region, and there is pent up consumer demand for nearly everything in the economy. That means most businesses are trying to move into growth mode and have capital requirements to expand inventories or make acquisitions. There is no shortage of deals and when you combine that with the multiples that private equity sponsors are selling portfolio companies at, the need to borrow money is growing for the buyers on those deals. We expect this trend to continue into 2022.

Q What progress do you see private debt making on ESG implementation and reporting? Where should the ESG focus be this year?

LF: ESG is definitely now part of the investment process for managers in Europe, which was not necessarily the case in the past. Most, if not all, investment managers have ESG policies in place at the fund level, but one of the challenges is assessing ESG performance at the portfolio level. That is especially the case for direct lenders making loans to SMEs, because those borrowers can have difficulties when it comes to reporting and tracking those ESG metrics, which then have to be refined and reported at the asset manager level in a harmonised and frequent way. That reporting and verification is still in its infancy but is certainly a focus across all managers.

GM: This is presenting a real challenge for US managers, and especially for those that want to raise money in Europe. These managers have typically not tracked that level of data on their borrowers, focusing purely on financials and not supply chains, energy usage, carbon footprints and so on. This is an interesting new set of data managers are being forced to look at, and is an area where the US has been caught a little flat-footed.

> *"The asset class has been proven to perform whatever the economic cycle"*
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> **LAURENT FUDVOYE**

Q What do you see as the biggest challenges and opportunities for the asset class in 2022?

LF: We will see how the pandemic evolves. Managers are still focused on looking after their existing portfolios, and now we see inflation as a new challenge, whether in the short or longer term.

In terms of opportunities, there is a focus on the retailisation of the asset class, with some managers wishing to open strategies up to more retail-type investors using specific pooling vehicles. Another theme in Europe is venture debt, where we are seeing more and more players coming into the market.

GM: In the US, business development companies have been around for decades and allow retail investors access to private credit, but we are now seeing a drive into the Registered Investment Adviser space for private credit funds, establishing feeders that expose the asset class to small investors. I'm not sure the average private credit manager that is used to having 10 investors in a single fund is quite prepared for the reporting requirements associated with having 10 institutional investors and 1,000 retail investors, but this is driven by fee compression and creating a new revenue stream. The biggest challenge for every business right now is staffing and recruitment, with the efforts to keep competitors at bay by increasing salaries having an impact on costs. It will be interesting to see how that plays out, especially as it relates to inflation. ■

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