Ryan and Sylvia will be hosting an exclusive LP-only post-conference **private credit investor workshop** following on from the conference, taking place from 2pm to 4pm on 28 June. Contact **ed.thatcher@euromoneyplc.com** for more information

Ryan Flanders
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Ahead of the **Institutional and Alternative Lending Conference** in New York on 27-28 June, **Ryan Flanders** from **Preqin** and **Sylvia Owens** from **Aksia** confront the key questions for **LPs seeking to invest in the burgeoning private debt market**, including:

- What are the most attractive sectors for prospective investors?
- How should investors allocate capital to private debt, whilst ensuring maximum liquidity and returns?
- How do you choose a GP to achieve the best underwriting standards amid a highly aggressive fundraising environment?

There seems to be a continued debate in where private debt fits within a LPs portfolio? What are your thoughts and observations?

Ryan – We track over 2400 LPs who have either invested in private credit historically and/or have future plans to at Preqin, and generally we see the allocation coming from the private equity portfolio. There are a couple themes driving this observation. Many legacy mezzanine and distressed debt allocations have been funded from the private equity sleeve. Also, the illiquidity profile of private debt has similarities to the illiquidity of private equity, although quite different. With that said, we have seen a number of different approaches. For example, we have observed distressed being bucketed in private equity and senior in the capital structure with no to low leverage on the fund included in the fixed income part of the portfolio. Last point, we have observed a growing number of investors carving out a specific private credit allocation in the portfolio that would include all opportunities in the space.

Sylvia – The low rate environment has led investors to consider alternate sources of current income generation, even if it means giving up near term liquidity. Over the past few years, many new private credit investments have been made within fixed income buckets, usually direct lending strategies that are used as a fixed income "substitute". Senior lending in particular can be attractive versus high yield bonds given the potential to exchange fixed for floating rate exposure (thereby decreasing sensitivity to interest rate duration), improve credit quality, and, at the same time, capture a premium to returns available in the public markets. Separately, many investors are opting to create opportunistic hedge fund/private credit sleeves which can include a wide variety of private credit strategies including real estate debt, real assets debt and corporate debt, along with other more exotic credit strategies such as royalties, marketplace lending, leasing, regulatory capital relief, and non-qualified mortgages. These allocations are designed to produce attractive risk adjusted returns, while reducing correlation versus high yield and equities. This has become a growing focus given low risk premia expectations across the equity markets.

What do you both consider private debt? There seems to be conflicting answers out in the market.

Ryan – The dominant topic within private debt over the last few years has been direct lending that has mostly been focused on leveraged, cash flow transactions with minimal underlying hard assets. That is probably warranted given the growth that the segment has seen over the time frame. However there are many options across the risk/return spectrum, featuring many investment profiles and underlying collateral for the loan (e.g. real estate, intellectual property, infrastructure, and many others.) On what we consider private debt at Preqin, we generally think about the illiquidity profile of the investment opportunity and as long as it is debt, not equity and not publicly traded, we would argue it is private debt.

Sylvia - We have a fairly broad definition of private credit comprised of 7 sectors: direct lending, distressed/ special situations, mezzanine, specialty finance, structured credit, real assets credit and real estate credit, with more than half of our research coverage outside of the U.S. When people comment that private credit feels "crowded" they often are referring to the onslaught of U.S. and European direct lending funds which, as Ryan mentions, have been actively fundraising over the past several years as the opportunity set has expanded. While we continue to see compelling options within the direct lending space, we are seeing many of the most attractive risk adjusted opportunities in the last 4 sectors (specialty finance, structured credit, real estate credit, real asset credit), along with EM/Asia strategies, simply because there is less capital chasing those deals.

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There has been much conversation about growth in the asset class. How much has it actually grown and why?

Ryan – We have seen the asset class grow 4x from nearly $150bn in 2006 to just under $600 bn as of last year. Much of that has been driven by the direct lending market which has grown from less than $10 bn raised in 2007 to $61 bn raised in vintage years 2015 and 2016 combined. We are also tracking 286 funds currently raising capital to the tune of $116 bn. This historic and continued growth are the result of themes that have curbed traditional bank lending post the Global Financial Crisis in mostly the US and Europe but with other locales becoming targets for non bank direct lenders such as certain parts of Asia. Lastly, we have seen a pickup in the amount of distressed capital invested and raised over the last few years. Drivers being some of the volatility in the energy and brick and mortar retail markets and anticipation of some sort of downturn given the extended recovery period the US economy has witnessed.

How does an investor new to private credit create an allocation to the asset class?

Sylvia – Every investor will approach this differently, depending on their governance structure and the reason for investing in private credit. The concept of private credit as an asset class is one that is gaining momentum across all types of investors as they seek ways to meet their required rates of return in a lower return environment. That said, there are a few high level factors that an investor may want to consider when contemplating a new allocation to private credit. First, what will be the source of capital- for example, will this be a new sleeve or replacing an existing allocation- and what are the target returns? Will it be cross asset class, and, if so, how will you decide whether certain asset types (such as real estate debt) will go into the private credit allocation or the traditional real estate bucket? Who at the organization will oversee this new allocation? We have helped clients to implement a variety of approaches, including team efforts where PMs from fixed income, private equity and even real estate will come together to work on this new allocation. Finally, it is necessary to measure the success of a program once it is implemented, so picking the appropriate benchmark is critical.

Are there are any diligence considerations unique to private credit?

Sylvia – Underwriting discipline and work out experience/capabilities are critical to the success of any private credit strategy. Given that many of these GPs are relatively new entrants to the space who lack pre 2008 track records, it is very important to diligence which GPs have demonstrated investing acumen (sourcing, consistent underwriting, patience and workout) and are not just opportunistically asset gathering. Identifying the realistic size of the target opportunity set is another consideration, in light of the rapid deployment of capital and aggressive fundraising, often with ever increasing fund sizes. There is always a concern of deterioration in credit underwriting standards when there are too many new entrants and capital chasing a given borrower base.

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