

## T A L K I N G P O I N T S

*The pandemic has accelerated many themes already evident in private credit, with growing allocations to the asset class and more capital gravitating to the largest managers, say Jeffrey Griffiths and Richard von Gusovius, co-heads of global private credit at Campbell Lutyens*



## Why capital is flowing into the top 30

### Q What themes have you witnessed over the past year in terms of LP appetite for private debt funds globally?

**Jeffrey Griffiths:** We have seen continued flows of capital into private debt despite the pandemic environment, with no significant pullback. There has been some slowdown in fundraising activity, in line with all alternatives, which is partly due to the weaker environment for transactions creating less need for managers to raise new capital. But investors have not pulled away from their plans to grow their allocations.

On the margin, some investors have become more cautious and delayed or slowed activities, but very few have

removed themselves from the private credit markets and gone elsewhere. Private credit remains core for a lot of institutional investors and is a place where they are looking to grow their exposures.

**Richard von Gusovius:** Many of the long-term trends we were seeing in the market have been accelerated by covid, including the amplification of the bar-belling of the investor appetite along the risk/return spectrum. Many investors have gravitated towards the

SPONSOR

CAMPBELL LUTYENS

senior end of the capital structure, increasingly preferring senior-only strategies, and developing a more prudent attitude towards unitranche strategies. Then there are others looking at strategies seeking higher return targets in special sits, credit opportunities and dislocation themes. So, we have seen a bifurcation into super-senior and distressed, with many investors also showing, due to travel limitations, a preference for backing GPs that they already know well.

Q **The total capital commitments of the top 30 private debt managers have increased from \$230 billion last**

*“North American investors are more risk-taking and are therefore going further down the capital structure”*

JEFFREY GRIFFITHS

### **year to more than \$300 billion today. What has driven that significant flow of capital into these top 30 funds?**

**RvG:** There are a number of factors that play into the hands of the larger managers at the moment. First, as private debt continues to grow its share of LPs’ allocations, the larger players are well positioned to take a disproportionate share of new allocations – as LPs do not see the benefit of additional GP diversification in direct lending, where differentiation is marginal. Differently put, it often doesn’t make sense to add a seventh or eighth direct lender to your portfolio because they are all doing much the same thing. So you give more to your existing relationships, as long as they do a good job.

At the same time, there is a benefit from limiting the number of relationships as it will allow you to drive better economic terms that way, including access to special co-investment rights and so on. Finally, when some of the very large institutional investors start to move 1-2 percent of their AUM into private debt, that is a lot of money to deploy and that also favours the large platforms.

**JG:** Many of the larger managers have been asking investors to re-up and are pushing bigger fundraisings. In a time of pandemic when we can’t travel and

grow relationships with new groups, there is a natural tendency towards existing relationships. We have seen the larger managers are well-placed to take advantage of a market like this, and as new investors are coming into private credit, they are also tending to make their first deployments with the more well-established groups. However, as funds get larger and larger, we can see their performance deteriorate. So it is often best for investors not to just focus on the big managers but also to get to know others that are at an earlier stage in their development, with the newer teams more aligned with investors for success.

### **Q Subordinated/mezzanine debt remains the most popular strategy for private debt investors, followed by distressed. Have you seen much shift in strategy by private debt investors through 2020?**

**JG:** In part this is driven by the data set. What we see in North America is that investors doing private credit tend to be investing from private equity or alternatives allocations, where the objective is a higher-risk, higher-return strategy. That puts private debt alongside private equity and other equity allocations. That in turn tends to induce them to seek returns similar to private equity, which would push them towards subordinated, mezzanine and distressed strategies over senior debt or unitranche. North American investors are more risk-taking and are therefore going further down the capital structure.

In Europe, investors are generally coming from a fixed-income background, where they are faced with very low yields that they are trying to solve through private debt. So, they are not looking for double-digit returns, but more like 7-8 percent.

That is likely to change, as the US markets are not immune to yield compression, and in fact we have seen that.

We expect the US market to move more in the direction of European and Asian investors with a preference for downside protection, but that’s likely to be a gradual process.

### **Q Europe and North America continue to be the focus for investor appetite, with Asia-Pacific and the Middle East and North Africa some way behind. Is the impact of covid likely to change these dynamics at all in 2021?**

**RvG:** We continue to see North American investors focused on investing in North American assets and European investors looking to deploy in Europe, and I don’t think covid is going to change that. Globally, all investors wanted to talk about dislocation and distressed strategies for three or four months, but now they have made their bets and we will see how that plays out. The cost of capital among pension funds and insurance companies in Europe is lower, whereas American investors need to seek higher returns, so there are many reasons why that is a long-term trend.

We find it increasingly difficult to find offerings that will appeal to all investors globally, with appetite now really varying regionally. Asian investors, and particularly those coming out of Japan and Korea, are more in the yield-seeking camp with European investors. There are some shifts underway when you look at the Middle East, however, where there seems to be a move going on as investors consider more yield-orientated performing credit strategies. One of the most innovative groups in that region is Mubadala, which has recently teamed up with Apollo and Barings to create direct lending partnerships, and we see them setting the tone for a strategic play throughout that region.

### **Q How do you expect allocations to evolve in 2021 and what do you expect**

**to see investors focusing on?**

**JG:** The economic environment will result in some increased default rates and loss rates, which is actually a healthy development for the private credit market. Private credit managed through commingled GP-LP structures has not been in existence for long – senior direct lending only really started in its current form around 2010 – so we are going to get to see how funds perform in a more difficult economic climate. That will be helpful, because it will prove that many managers will have done a good job at protecting capital and creating resilience in their fund returns, and that is something that investors have been waiting to see. As the market is tested and comes out well, we expect allocations to increase still further.

The average pension fund is currently only allocating about 2-3 percent of total assets to private credit, and that is very low when you consider how natural it is as a market for most of these investors, which are looking for mid-to-high single-digit returns. A more natural allocation would be 5-10 percent.

**RvG:** Allocations will continue to increase into the asset class and, when it comes to strategy, the larger managers will look to continue to build new offerings. We will also see a growing trend towards specialisation, which is another thing that has been amplified by covid, where we have seen more



**Q North America continues to dominate when it comes to capital commitments by regional HQ of the top 30. Why is this, and do you expect it to change in the year ahead?**

**JG:** The top 30 is really dominated by North American institutions, and in the last five years we have seen a real geographic retrenchment where North American investors have favoured investing in North America, and the same with Europe. That was a bit different a decade ago, but there is a new preference to focus on home markets, partly because European total returns have come down as interest rates have fallen and the economic growth environment in Europe has been lower than the US. That was the case pre-covid, when the US market was attractive from a returns perspective. But now the interest rates have harmonised, that may change.

**RvG:** North American firms have long dominated private markets and I don't expect that to change. Houses like KKR, Carlyle and Blackstone recognised alternatives as an industry and have driven proliferation of strategies, seeing themselves as asset managers rather than investors. They have achieved a real scale advantage that allows them to absorb very large allocations, being a first point of call for new LP entrants, and move much more quickly into new areas like impact funds and cross-sell across their LP base, and that is hard to replicate.

*“Many of the long-term trends we were seeing in the market have been accelerated by covid”*

**RICHARD VON GUSOVIUS**

focus on healthcare and technology and the big investors seeking more specific exposure to those.

We will see ESG break through and be recognised by investors as not just something to talk about but a really good risk management tool. We now see more and more evidence that a company that fails to engage its employees and stakeholders presents a real economic risk, and I think good ESG companies will increasingly be able to attract lower costs of capital. That

means investors will take the ESG approach of their managers much more seriously.

Finally, I think we will continue to see the pulling away of the larger managers, and I expect European investors to start looking towards North America again to augment their portfolios, which is something that covid disrupted. How strong that trend will be remains to be seen, but I think European investors will see a bigger need to be in North America than vice versa. □