EXPERT Q&A

Investors are increasingly looking outside plain-vanilla direct lending, with the secondaries market of growing interest, say Tavneet Bakshi and Christian Allgeier of FIRSTavenue

Seeking out new strategies

Q Which credit strategies do limited partners like at the moment?

Tavneet Bakshi: We have seen a notable pick-up in interest for higher-returning credit strategies. There are several factors driving this trend, particularly with US LPs and more recently with European LPs. Over the last three to five years, many LPs in Europe have focused on building out their core private debt programmes, and direct lending has formed the bulk of that.

However, some of these portfolios are now extensive, so investors naturally look for something differentiated, and complementary to their overall private credit allocation.

A second consideration, which is probably the stronger driver, is where we are in the cycle. LPs are looking to benefit from opportunities that arise as the cycle begins to turn. This leads to stressed, situational and distressed investments.

SPONSOR
FIRSTAVENUE

Q Is there much interest in asset-backed lending?

TB: 'Asset-backed' is a real buzzword at the moment for LPs. We have noted particularly keen interest from LPs based in the US, where it is already a well-established strategy. It makes a great deal of sense, because financing is backed by hard assets, including real estate, machinery and telecoms equipment for example. The ability to perfect on tangible collateral should give investors more comfort around the return of principal, if the business itself is unable to make the interest and capital repayments.

Q What other niche strategies are you seeing?

TB: One example is SME lending and wholesale 'lending to lenders'. We are also seeing interesting opportunities in secondary purchases of non-performing loans, single name or small portfolios rather than the large portfolio acquisitions we witnessed after the global financial crisis in 2008.

Speaking more generally, there is an exciting evolution in private credit at the moment; it is no longer all about direct lending. Private credit strategies in Europe are far more diverse now than they have ever been. One factor behind this is the outpouring of talent from banks or larger asset managers, where managers have gained expertise in particular niche strategies that would have formed part of a wider offering. Some of these strategies were executed in more liquid structures and are now available in more appropriate closed-end structures.

Q At this point in the cycle, what country or regional angles do you see?

TB: Everyone has been bracing themselves

for what Brexit means for UK corporates. However, many funds with diversified geographical exposure are still quite happy to be overweight in the UK, because it is a friendly market for lenders. Having said that, there is a fair amount of competition in the UK between lenders.

Germany is also getting considerable attention, with many of the GPs we work with starting to increase their origination efforts here. Historically it has been quite well-served by its banks, particularly in mid-market lending. However, there is increasing room for private debt funds. On the one hand, the weakening economic health of Germany is getting a lot of press. On the other hand, there are many well-established, well-run companies with a long history that might need some short- or medium-term financing. Non-sponsored opportunities are interesting here. However, originators at private credit funds need to be able to build relationships with family-owned businesses in a non-threatening way, instilling confidence that they are not loan-to-own investors.

Opportunities in the secondaries market

Q How do you view the secondaries market?

Tavneet Bakshi: It is still early days for private credit secondaries, especially in Europe where direct lending has only been around for about nine years. However, because of the large amount of private credit dry powder allocated in recent years, there will be more and more opportunities in the future. We think these opportunities have already begun to grow, but do not know exactly when this will accelerate.

Q What are the relative strengths of buyer and seller when it comes to pricing?

Christian Allgeier: It all depends on the reason the seller has for divesting in the first place. An investor who wants to sell due to underperformance of the fund, for example, is more likely to find themselves in a position where they have to accept a large discount due to the time or situational constraints in place. However, if the seller is divesting because of a strategy shift, the discount they would be willing to accept would likely be smaller. Nevertheless, a challenge for the credit secondary market is that because it is still relatively young, the range of possible pricing for any given deal is much wider than for private equity, where the prevailing market price is relatively clear given the high trading volumes over the past decade.

TB: Direct lenders have deployed great sums of money, often at initial leverage levels that are higher than before. There has to be a point at which GP restructurings in private credit pick up and secondary offerings are part of the solution. There should also be plenty of room for plain-vanilla secondaries as LPs seek to restructure maturing private credit portfolios.

Q Are you seeing the growth of country-specific or regional funds?

TB: Local fund managers can achieve good returns. For example, some Nordic and French GPs have done well in their regions. The Nordics are well-served by local banking systems, and France is a 'proximity' market. Interesting deals can be hard to find if you are not on the ground, so I do buy into the idea that there is a role for specialists. However, generally speaking, it is hard to get country-specific exposure of meaningful size outside the UK, France and Germany. Fundraising can be challenging for country or region-specific funds because investors often want and need broader exposure and more diversification.

"There is an exciting evolution in private credit at the moment; it is no longer all about direct lending"

TAVNEET BAKSHI

Christian Allgeier: We know one fund of fund with an interesting solution; they invest in smaller, more niche managers as well as specialist regional funds, and thus have created a highly diversified fund portfolio with an almost pan-European focus. Moreover, from a performance perspective, they are able to beat single-focus credit funds with a lower risk profile and despite the double layer of management fees. They are able to do this by getting better economics via first closes, seeding GPs, using co-investments and acquiring private credit secondaries.

Q But are there sometimes advantages in being smaller?

CA: Yes, absolutely. When a manager has a multi-billion fund to deploy it is often not efficient for them to look at deals below €200 million, and given the limited number of deals of this size in the market these larger managers often find themselves either competing for the same deals (and getting less preferential terms/pricing as a result of that competition) or having to follow larger market trends. This can often lead to their performance being nothing more than a beta play. However, smaller managers with €1 billion or less to deploy can extract real alpha, because they have a wider range of opportunities available to them and so have a stronger negotiating position when finalising deal terms and pricing.

Q Many investors complain about the spread of covenant-lite terms. What is your experience?

CA: The GPs we work with have been very consistent on covenants. One is the minimum they accept, and they may want three or four, depending on the deal. However, in actuality the detail is what is important: how valuable is the covenant? If it contains too much headroom, the covenant can, in a sense, become worthless.

TB: The competition is perhaps less in the lower mid-market, and this may help to keep documentation tight. However, at the larger end of the market, there has certainly been some loosening of covenants. The coming years will unearth more evidence of where deployment haste has won over credit discipline. ■