



Financing the Economy

The role of alternative asset managers
in the non-bank lending environment

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Foreword from the AIMA Alternative Credit Council

I am delighted to introduce on behalf of the AIMA Alternative Credit Council (ACC) our new paper, “Financing the Economy.” This research comes at a very important time - as alternative credit funds and the use of non-bank finance becomes increasingly prominent across all aspects of lending.

Non-bank finance is very much part of the mainstream in the US and funds that provide direct lending tend to operate largely in the US. Outside of the US, bank deleveraging in Europe is creating an opportunity for institutional and private investors to expand direct lending to a range of sectors, and there are plenty of new approaches and structures emerging.

Increased activity from capital markets as opposed to lending through traditional bank lending channels has produced material benefits. Included among these are increased market liquidity, a greater diversity of funding sources and a more efficient allocation of risk among investors.

Non-bank lending can greatly mitigate the systemic risk associated with direct lending by banks. Levels of leverage used by funds in their portfolios are close to negligible. Alternative credit funds, typically, are investing on behalf of sophisticated investors who understand and can absorb potential losses. Unlike bank depositors, these investors cannot instantly withdraw their capital, given funds tend to be closed-end in nature. Finally, alternative funds are often specialists in dealing with stressed and distressed assets so complexity is something they are prepared for. Rather than selling assets and collateral in a panic, they are capable of expertly managing default situations.

Amidst historically low interest rates, a dearth of true yield opportunities from investing in fixed income is hampering the ability of pension funds to deliver on their basic objectives. Consequently in recent years, the appetite of institutional investors for private debt exposure has developed aggressively, as the risk-adjusted returns on offer make this one of the most attractive investment strategies of recent years.

Governments acknowledge the need to develop a more diversified lending market in Europe and the role of non-bank lenders in doing this. In its recent Green paper on Europe’s long term financing situation¹, the EC argues that the reverberations of the financial crisis provides an important opportunity to diversify Europe’s credit markets. Further it confirmed that, in order to truly revive the economy, it will be necessary to improve the blend and overall resilience of different funding sources.

Removing structural barriers to entry in the lending market will increase diversity of supply of credit, boost the resilience of the financial system and drive better outcomes for consumers and businesses.

AIMA’s Alternative Credit Council was established in late 2014 to provide general direction to AIMA’s executive on developments and trends in the alternative credit market. We hope that our combined work will help ensure a sustainable future for this essential sector. Our collaboration starts with this research, which is now the third paper in a series of work that explores the thesis that facilitating greater capital markets, and by association, hedge funds enhances economic growth for the long term. The research is ultimately for the benefit of both policy-makers and market participants, and continues AIMA’s commitment to improving the industry for practitioners and investors alike.



Stuart Fiertz, Chairman
AIMA Alternative Credit
Council and President
Cheyne Capital.

1 European Commission. “Green Paper: Long Term Financing of the European Economy.” March 2013

Introduction

The source of funding for the real economy matters. Capital market financing contributes more to economic growth than bank lending by creating opportunities and an economic environment that fosters better economic management and investment in risky but often innovative projects. AIMA's own research² has shown that growing combined stock and bond markets by one-third could fuel a long-term real growth rate in per capita GDP of approximately 20%, as stock and bond market liquidity allows for cost-efficient re-allocation of capital across industries. We've decided to go further and look at various components of the capital markets. We examined the role of activist funds in the equity space and have now turned our gaze to the debt markets.

Private debt strategies have grown dramatically in popularity in recent years buoyed by both increased investment from investors into these funds as well as increased demand from smaller businesses for alternative sources of funding.³

Across Europe's lending landscape, a quiet revolution is taking place in the way companies secure their finance. Amidst tighter banking restrictions and subsequent overall reduced levels of bank lending, the past two years has seen a significant rise in alternative asset managers jumping in to bridge the financing gap via non-bank lending. These alternative lenders consist of a wide range of non-bank institutions with different strategies including private debt, mezzanine finance and distressed debt. Hedge funds have also increased their exposure to this sector through a variety of investment strategies that can be termed "alternative credit", which include but are not limited to direct lending, private debt, securitisation and capital relief.

As of the end of 2014, figures for Europe reveal over 350 transactions have been completed by 36 alternative lenders in just over 2 years.⁴ Deal flow has continued to grow, as the volume of deals done by direct lending funds in Europe

2 Capital Markets and Economic Growth, Long-term trends and policy challenges, AIMA (2014).

3 We define private debt as investments in or strategies related to loans (whether by funds themselves or bought on the secondary market); private debt securities (securities privately placed with or issued directly funds or a group of funds, including forms of private securitisations); other instruments with debt or hybrid debt characteristics used for the financing of companies or projects by asset managers. Further, we consider distressed debt investments, mezzanine financing, real estate and infrastructure financing as well as other forms of opportunistic and short term lending such as bridge financing to all fall within the definition of private credit.

increased 43% between 2013 and 2014. It is estimated that there are now around 40 active direct lending funds (up from 18 reported in 2012) and a further 81 new funds out in the market looking to raise £50bn. Increasingly, banks are also teaming up with alternative lenders to provide more flexible structures and there remains a strong role for them in the new lending environment.

Indeed, some of Europe's largest institutional investors are helping to bridge the financing gap for the SME⁵ (Small and Medium Enterprise) sector by investing in alternative credit funds or taking a more direct approach and doing it for themselves. Direct lenders enjoy a growing credit portfolio across a wide range of businesses as well as providing support to a broad variety of infrastructure projects.

Arguably, the role of non-bank finance is never more important than today. A recent survey⁶ by the European Central Bank showed that mid-market corporates continue to report a reduced supply of bank loans for the fifth consecutive year, while access to direct bank finance for SMEs is increasingly difficult. In contrast, the AUM of US loan funds has tripled since June 2012 while growth has been even faster in the EU with AUM rising fivefold over the same period (albeit from a lower base).

Private debt financing today accounts for approximately 6% of the total estimated funding for SMEs. Given bank lending to SMEs is likely to continue to decline, funding from the private debt industry as an overall percentage of total SME funding in the European Union could reach levels of between 15% – 20% within the next five years.*

Alternative credit hedge funds, and the wider hedge fund industry, are part of the wider asset management sector, not the banking industry and as such should not be included in any part of the shadow banking discussion. Hedge funds must be

authorised and are the subject of strict regulation across all major financial jurisdictions. Further, they are subject to significant micro-prudential operational standards and organisational requirements such as conflict of interest and conduct rules, the protection of client assets as well as prudential regulations on liquidity and risk management.

In this latest research piece, we explore the development of private debt investment and the increasingly important role asset managers are playing as participants in non-bank finance. To help us in our understanding of this area, we conducted a global survey among a variety of alternative credit participants throughout late 2014.⁷ The objective of the survey was to gather information about the funds and managers who participate globally in private debt and to contribute to the debate around asset management involvement.

Special thanks are due to AIMA's Alternative Credit Council for its support in the production of this paper. We hope that this publication will help to improve understanding of the private debt sector and be considered a trusted source for you to learn more about this increasingly influential area of capital market development.



Jack Inglis, AIMA CEO

4 Deloitte Alternative Lender Deal Tracker which tracks primarily mid-market deals across Europe with up to €350m of debt.

5 The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50m and/or an annual balance sheet total not exceeding €43 million.

6 April 2014, Survey on the access to finance of small and medium sized enterprises in the Euro area, ECB.

7 We are grateful for the support received from Simmons & Simmons in drafting the questionnaire for this survey.

* Source: AFME's Bridging the Growth Gap Report, Preqin, AIMA private debt survey.

Demographics of survey participants/ methodology

Asset management firms that participated in this survey account for assets under management (AUM) of approximately \$530bn (using the midpoint of the provided AUM response ranges).⁸ Using the same methodology, these managers allocate approximately \$85bn to private debt investment strategies.

The majority of participating firms in the survey are located in the UK or North America, which are considered to be the two most developed regions for private debt investment (figure 1).

The full spectrum of asset management firms are represented including traditional asset managers, private equity firms and hedge funds (figure 2). Just under half of the respondents are hedge funds or fund of hedge funds investing predominantly in fixed income and credit (figure 3).

While firms of all sizes are represented in this survey, the average respondent (credit lender) is a medium to large asset manager holding a significant investment in private debt. Over 55% of the responses are large asset management firms (with \$5bn or greater in AUM – figure 4) while 50% allocate \$1bn or more in AUM to alternative credit strategies (figure 5). Smaller firms (with \$500m or less in AUM) are also well represented in this survey.

⁸ If a manager chooses a response option of between \$20bn and \$50bn in AUM, it is assumed they have \$35bn in AUM.

Figure 1: Headquarter locations of participating firms

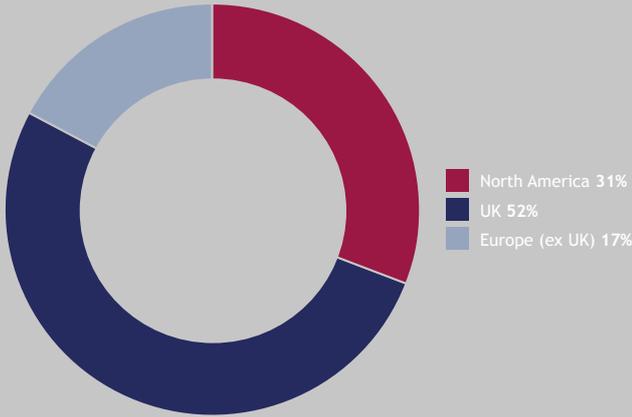


Figure 4: Distribution of participating firm AUM

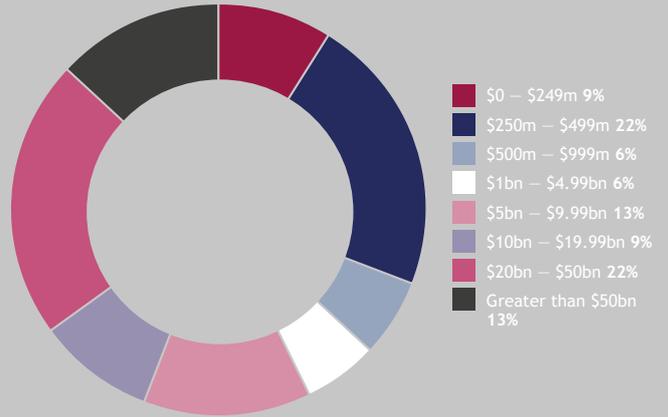


Figure 2: Investment classification of participating firms

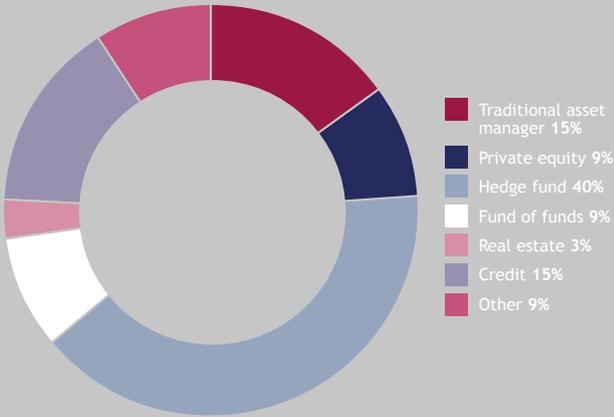


Figure 5: Distribution of AUM mandated for alternative credit investment

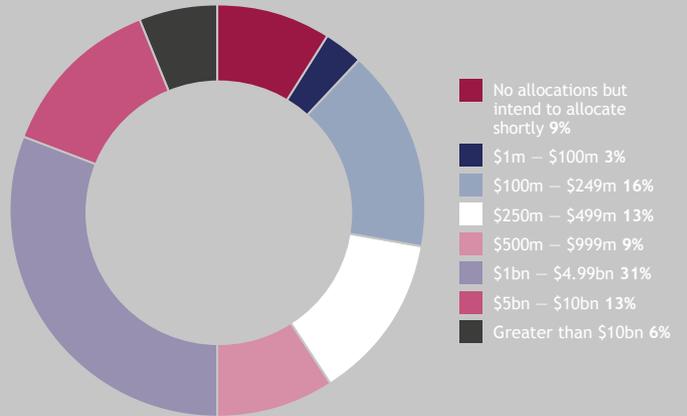
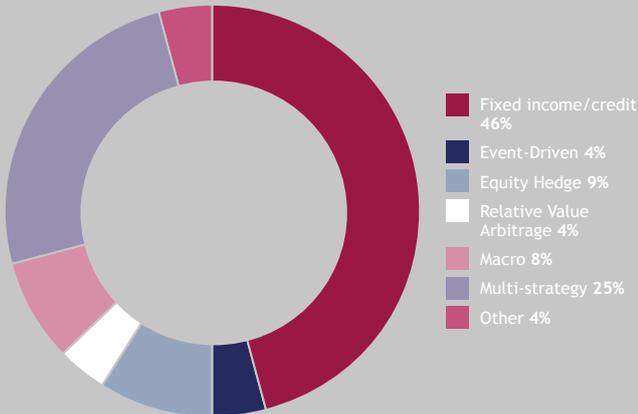


Figure 3: Primary strategy of participating hedge fund firms



* %s on graphs are rounded up and thus may not always aggregate to 100%

Key findings from the survey

1 Asset managers are playing an increasingly crucial role in financing the real economy

The global financial crisis and subsequent bank reform has led to a diminution of capital and reduced lending opportunities available to the private sector. Arguably nowhere has this dearth of lending been more challenging than in the European lending market. In stark contrast to the US lending market where 80% of all corporate lending is carried out in the capital markets (through the issue of equity or bonds), almost the same percentage of the total of European lending is bank financed.⁹

Among the borrowers that are particularly feeling the brunt of forced bank retrenchment are the small and medium sized enterprises (SMEs) that have traditionally relied on banks for investment. While many firms have started to issue bonds (high yield, investment grade) as a way of raising finance, this alternative only applies for larger companies as capital markets do not have the appetite for buying into bonds where the size of the firm is comparable to an SME.

Amidst these restrictions, the alternative lending market continues to grow, and direct lending (non-bank finance) is fast becoming a permanent feature of the lending market. These alternative lenders consist of a wide range of non-bank institutions with different strategies including private debt, mezzanine finance and distressed debt.

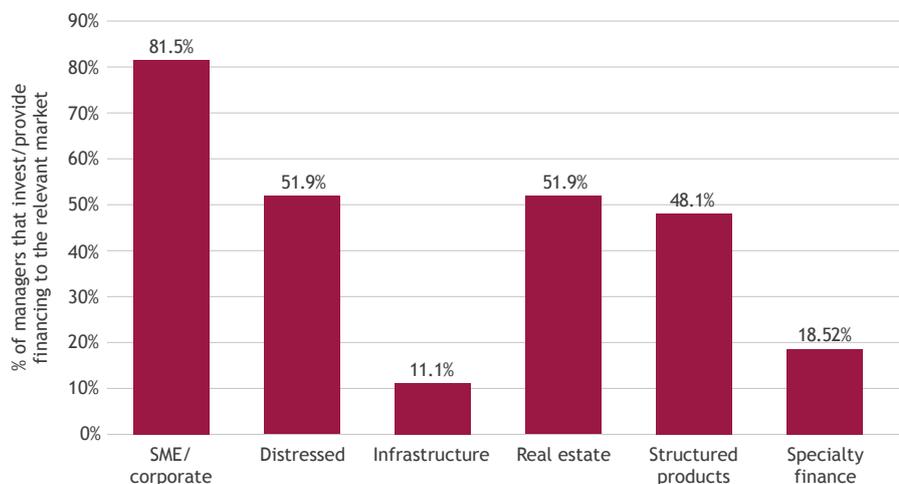
Hedge funds have increased their exposure to this sector through a variety of investment strategies that can be termed “alternative credit”, which include but are not limited to direct lending, private debt, securitisation and capital relief.

Adding support to this opinion, over 80% of the managers in this survey are lending to SMEs and their equivalent or larger corporates (figure 6).¹⁰ The ECB estimates that SMEs account for 99.8% of all businesses and for 66% of all employment in the EU, while in the U.S an estimated 200,000 SMEs employ 65% of the work force.¹¹ Over 50% of managers surveyed are investing in distressed debt and providing finance to struggling companies that would otherwise likely fail.

82%

of managers surveyed are lending to SMEs

Figure 6: Private debt markets that managers participate in

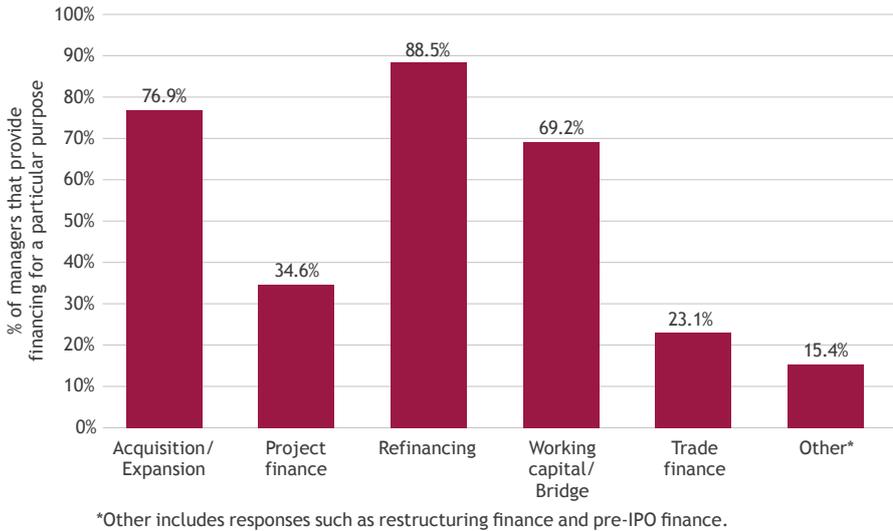


⁹ EIF, “Institutional non-bank lending and the role of Debt Funds”, Working Paper 2014/25

¹⁰ In the EU, the category of SME is defined as enterprises with fewer than 250 persons and an annual turnover not exceeding €50m and/or an annual balance sheet not exceeding €43m (Article 2, Annex of Recommendation 2003/361 EC)

¹¹ United States. Census Bureau. Washington: GPO, 2007. Print.

Figure 7: Purposes of financing



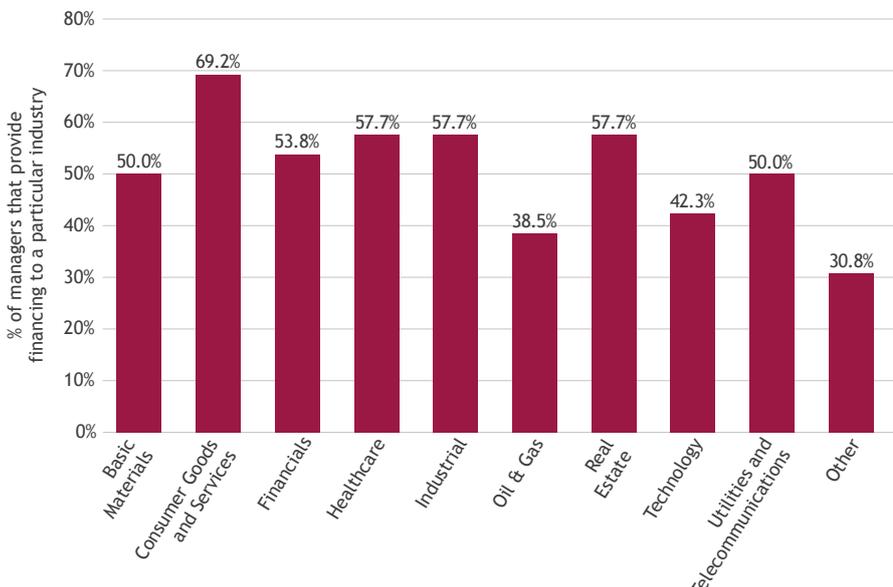
95% of the managers surveyed provide financing for acquisition/expansion or refinancing purposes while 77% provide financing for both purposes (figure 7). Purposes of financing relevant to borrowers such as access to bridge financing (short-term cash for the maintenance of operations) or as a means to improve their working capital (acquire inventory or pay off accounts payable) also rate very highly among their reasons for seeking capital in the absence of bank support.

M&A activity is expected to deliver an even higher volume of transactions in the coming years, as firms look to invest large volumes of dry powder, which will further fuel demand for un-constrained and bespoke debt which favours alternative lenders.

95%

of the managers surveyed provide financing for acquisition/expansion or refinancing purposes

Figure 8: Manager industry preference

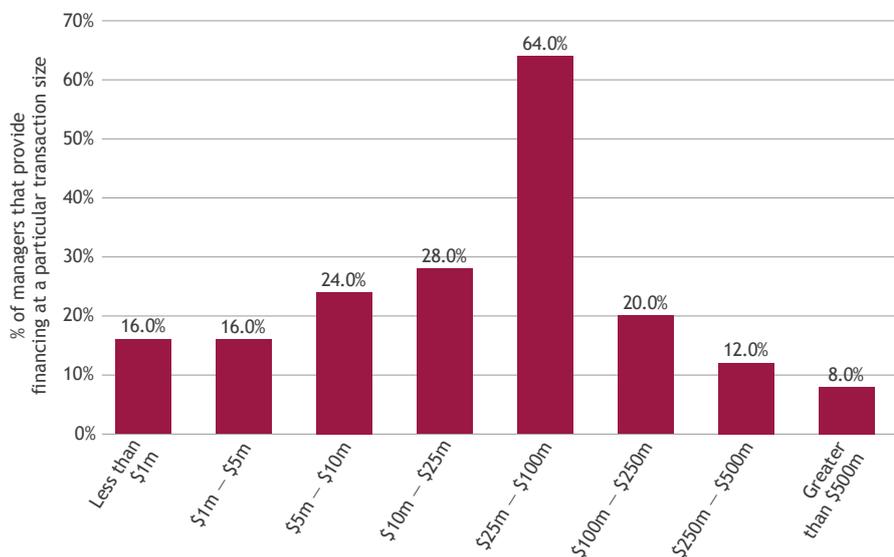


The managers polled are active in providing finance across a variety of industry sectors. One of the more popular industries that managers lend to is the consumer goods and services industry (figure 8). This particular industry is vital to the performance of an economy as consumption is typically responsible for more than 50% of a country's GDP. In the UK, for example, household consumption expenditure accounted for 65% of GDP in 2013.¹² Traditionally these industries have relied on borrowing from the banking sector. But, as banks have moved out of lending to this area, it is notable that direct lending has become a prominent borrowing alternative, and is fast becoming a permanent feature of the lending market.

The target transaction size by managers participating in the survey is typically below \$100m with the range of preferred investments between \$25m-\$100m (figure 9). These transaction sizes are indicative of companies that are considered too small for the public corporate bond market as most new issuances tend to be in excess of £100m.

Managers are generally providing finance to borrowers (who have an EBITDA) of \$25m or less. This is highlighted by 50% of the responses in figure 10 below, adding further support to the opinion that asset managers are financing companies that are too small for public bond financing.

Figure 9: Managers' target transaction size



Financing terms are being extended to companies in multiple regions although a bias exists with the UK, USA and Western Europe the most popular regions, likely supported by a favourable climate for direct lending. 76% of respondents provide financing to UK-based companies (figure 11). It has been suggested that European mid-sized businesses will need to raise \$3.5 trillion in debt over the next five years,¹³ while EU banks will need to reduce their asset base by \$2.6 trillion. It is thus vital that asset managers continue to extend financing to companies in the key economies of the EU.

¹² Data taken from the World bank (2013)

¹³ The Squeezed Middle, June 2013, S&P

Figure 10: The average size of the borrowers by EBITDA

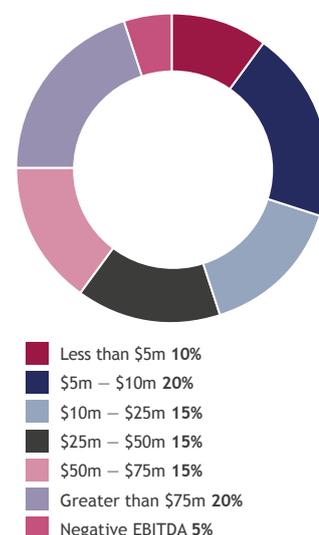
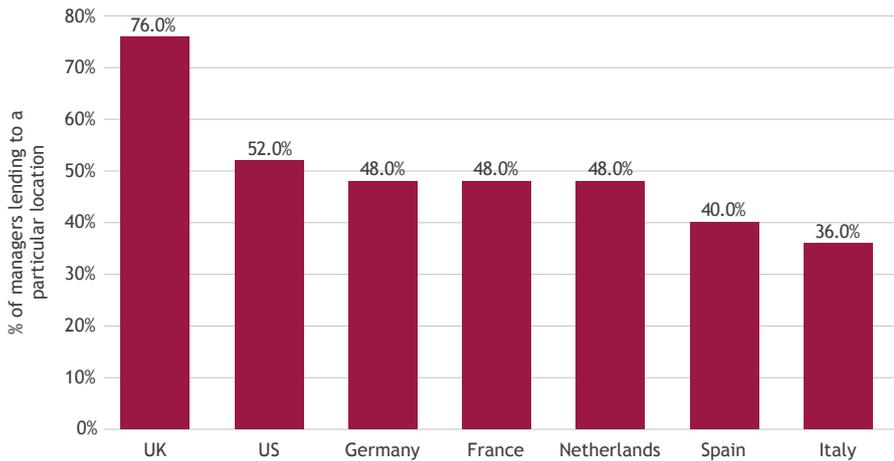


Figure 11: Where the managers provide financing (most popular locations)



Almost 80% of companies financed by asset managers have obtained bank financing either prior to the financing from the asset manager or during the involvement of the manager (figure 12). Further, companies are seeking to diversify their sources of funding and access the solutions (including the longer terms) that asset managers are able to provide. While this blend of financing is very much mainstream across the US, the gradual diversification of debt financing is positive for the European economy where bank lending comprises approximately 80% of all external long-term financing. The significance of having a diversified credit market beyond bank financing is that the overall risk in the system diminishes and exogenous bank-related shocks such as those that occurred in 2008 are better absorbed.

Of the remaining 20% of companies that have been unable or may not have attempted to secure bank finance, it is important to understand that this may not necessarily be due to them having poor credit, but more that the bank in its lending capacity only has so much risk-based capital available to underwrite or hold this type of risk. Loans that are not bank approved, per se, should not necessarily be deemed “loans of last resort.”

An increasingly popular trend in recent years is banks and non-banks’ lending alongside each other.¹⁴ In most cases, commercial banks will retain the primary customer relationship and continue to provide less capital-intensive products and services.

Private banks and investment banks could therefore also use non-bank lending partners to meet their customers’ credit needs without using up much needed capital. For banks, this effect would be to move their corporate lending function closer to a debt capital markets model.

Managers are generally not supplying short term capital (i.e. under 1 year), rather the financing loan term is typically 1–6 years in maturity, affording the investment companies stable funding in the mid-term (figure 13). Almost 35% of the managers surveyed provide financing terms of 4 years or more. This is in contrast to the banking model whose liability structure (deposits) is short term in nature and which as a result are naturally inclined to issue loans (a bank’s assets) with smaller durations. Almost the entire sample of managers currently provide committed term loans to borrowers while half provide revolving term facilities (figure 14). Revolving credit facilities, (which permit a company to drawdown, repay, and re-draw loans

Figure 12: Borrower use of bank financing

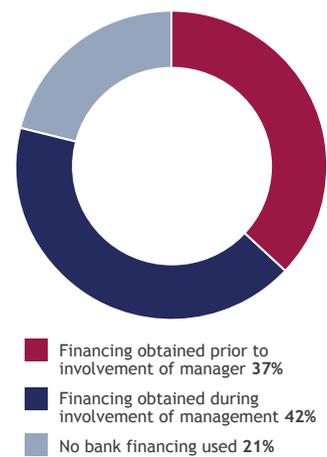
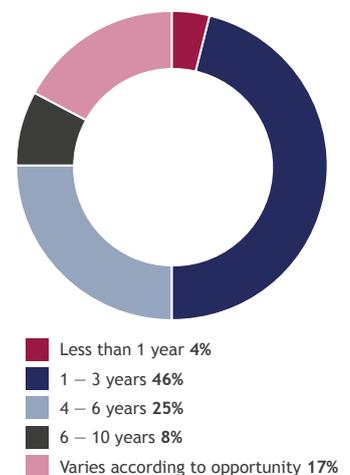


Figure 13: Managers’ preferred investment maturity



advanced to it), the preferred loan type for banks, are more often than not shorter term in nature than a committed term loan.

Private debt funds are embracing their role as financiers of small businesses. More funds have launched in recent years in response to increased demands for funding. For those managers operating a dedicated private debt fund (an overwhelming majority of participants), 48% of those funds have launched within the past two years (figure 15).

Managers engaged in alternative credit typically operate dedicated funds of the same. 80% of managers operate one or more dedicated funds while 52% are operating two or more dedicated funds as their preferred method for investing in alternative credit strategies (figure 16). This implies that asset managers are adopting a focused approach to the alternative credit sector and building up expertise. This preference by managers to have their alternative credit investments operated out of a dedicated fund marks a clear change from previous years where such investments were part of a multi-strategy fund operated by the manager.

The majority of managers also operate managed accounts, which is reflective of the strong institutional investor presence allocating to alternative credit. Institutional investors prefer managed accounts as their preferred investment structure as they offer them better control, can facilitate bespoke fund liquidity conditions, as well as offer greater levels of transparency and customisation.

Of the managers surveyed, there are few “smaller” funds (funds below \$250m in AUM) active in this strategy. It is likely that the esoteric nature of the strategy benefits larger funds that have built up the necessary operational capabilities and infrastructure to invest.

Many of these dedicated funds have only launched in recent years perhaps as a consequence of banks having decreased the size of their balance sheets and credit managers’ realisation that there is still plenty of capacity for investment left in this area. Investors also prefer to allocate to managers that have standalone funds dedicated to direct lending. The improving economic environment necessitates that more companies will need financing given the recovery or early expansion stage of the business cycle in most developed economies.

Figure 16: Investment vehicles utilised for alternative credit investment

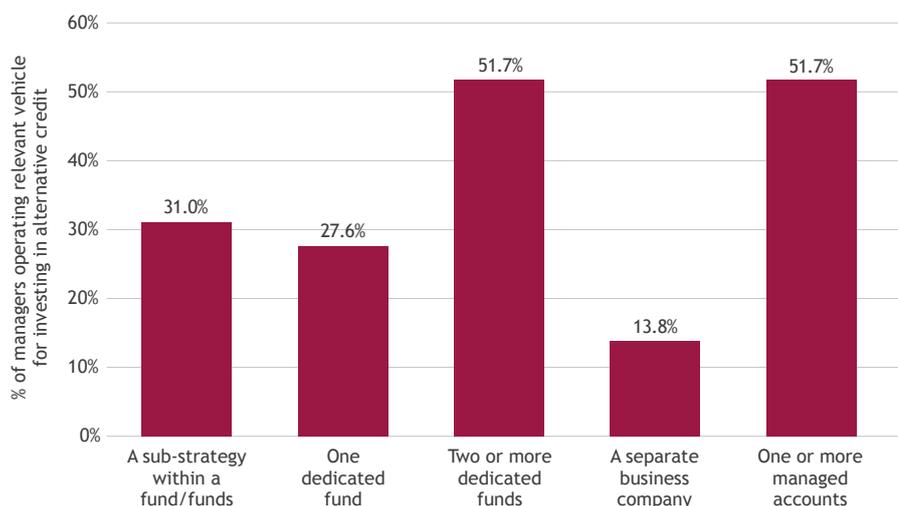


Figure 14: Structure of financing that managers provide

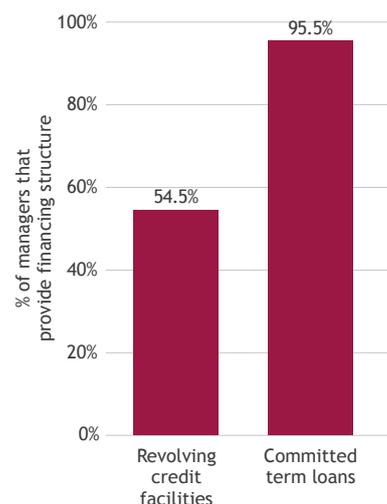
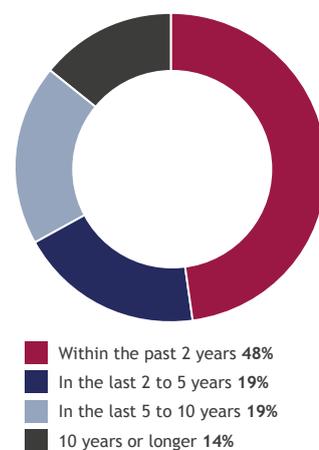


Figure 15: Launch date of dedicated alternative credit funds



2 Funds operated by private debt managers are structured to limit systemic risk

Regulatory concerns regarding asset management activity have centred on the issues of maturity and liquidity transformation.¹⁵ Maturity transformation concerns usage of short-term capital to fund longer-term loans, while liquidity transformation focuses on using liquid allocations from investors to buy harder to sell assets such as loans. Evidence from our survey demonstrates that managers are structuring their funds more like private equity vehicles rather than a typical hedge fund, which greatly reduces maturity and liquidity transformation risks.

Among the variety of alternative credit funds in our survey, 63% of funds are closed-end while approximately 50% are closed-end with maturities in excess of 3 years (figure 17).¹⁶ Investors are increasingly accepting initial long lock-up periods whereby the invested funds cannot be redeemed before the lock-up period expires.

Maturity transformation as defined in the context of a typical bank model involves taking a short term deposit and lending the money out over a longer term, as a consequence, banks tend to have much shorter liabilities and with the threat of a (deposit) withdrawal at any given time are therefore best suited to lend for only shorter periods of time. In contrast non-bank investors in the credit space, these being predominantly large pension plans, sovereign wealth funds and life insurers have the ability to match their liabilities in a more tailored and bespoke manner. Most of these investors have liabilities that stretch 20 plus years and can therefore guarantee lending for that term. Given their long dated liability profile, they are less vulnerable to the types of financial panic and runs on deposits witnessed by banks when the model comes under stress. Investors in credit investment funds, hedge funds and private equity funds provide stable, longer-term capital; and crucially these types of investors, unlike bank depositors cannot instantly withdraw their capital. Private debt funds do not borrow from central banks or possess guaranteed government deposits and therefore cannot and should not be expected to obtain government support in case their investments do not perform well.

Dependent on the fund offering and the type of instrument invested in, funds have a set of tools at their disposal to restrict or prohibit withdrawals under certain conditions. Hedge funds in particular are designed to ensure that investment strategies are capable of being carried out as intended. Further, certain restrictions are designed to avoid mismatches between liquidity offered to investors and that of the underlying assets in the fund. Among the measures available to help managers withstand periods of significant market stress are limits on investor redemptions through gates, the use of side pockets, the suspension of a fund's NAV or otherwise allowed by various fund offering documents.

For those funds that are open-ended, there is no specific tool universally used for managing liquidity mismatches (figure 18). The use of unencumbered cash is among the more popular measures (notice periods, gates and side pockets aside) employed by the funds in this survey.¹⁷ A fund using its unencumbered cash (holding cash that is free of any encumbrances and can be re-directed to meet any unanticipated needs) provides it with the benefit of not having to terminate various fund positions in order to meet redemptions. Other tools used to prevent liquidity mismatches include a full or partial match of liquidity – that is to say a full or partial match of the risk exposures of the fund's liabilities.

Figure 17: Structure of funds that invest in private debt

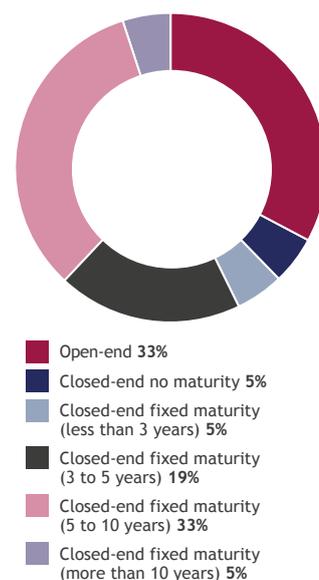
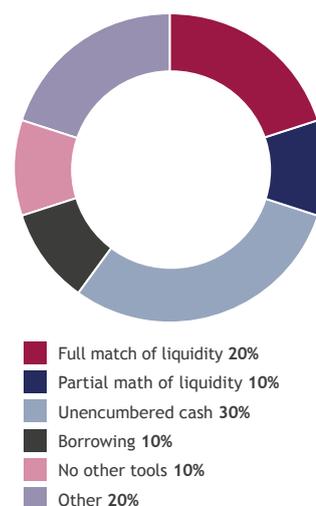


Figure 18: Principal tool used to manage liquidity mismatches for open-end private debt funds (aside from notice periods, gates and side pockets)



* Other includes holding liquid investments and having multiple investor types

¹⁵ FSB concerns around certain hedge funds being contributors to maturity transformation/liquidity transformation because of direct lending strategies or through the chain of credit intermediation in purchasing ABS.

¹⁶ A closed-end fund is a collective investment scheme whereby a fixed number of shares are issued (sold at one time) and the shares are not redeemable from the fund until maturity. The implication is that a fund can invest in more illiquid assets to match the longer duration of its liabilities.

¹⁷ An open-end fund is a collective investment scheme whereby shares can be issued or redeemed by the fund at any time. The implication is that the portfolio has to be sufficient liquid in order to meet redemption requests from investors.

Funds can control, manage and change their liquidity profiles ex-ante by aligning their redemption policies with the liquidity profiles of the funds and ex-post by potentially limiting or even suspending redemptions (and therefore lengthening their liability profile) depending on the market liquidity situation. The option to impose redemption gates is prevalent with over 70% of funds able to impose a gate at some level (figure 19).¹⁸ Redemption gates essentially limit the amount of redemptions from a fund in a specific period or by a specific date, thus ensuring that a manager does not have to sell off large parts of the portfolio quickly in order to meet redemption requests. This offers an extra level of protection during times of market stress.

Among the managers that participated in the survey, the use of side-pockets is not very popular – only 35% of funds utilise them.¹⁹ Among the fund structures that are open ended, all managers can utilise fund suspensions or redemption gates to some degree should they wish to. Further for these open-ended funds, notice periods are also very common with 87% of the funds in this survey able to utilise them, and almost two-thirds offering quarterly or longer notice periods (figure 20).

Most funds surveyed have a minimum investment/lock-up period. Around 50% of the respondent funds insist on a minimum investment period of three years, while just under a quarter of the funds have a minimum investment period in the range of 5 to 7 years (figure 21).

Figure 19: Possibility to utilise redemption gates among open-end private debt funds

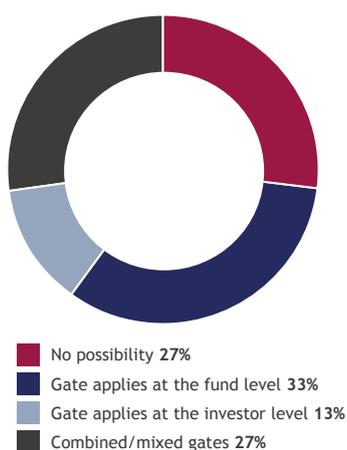
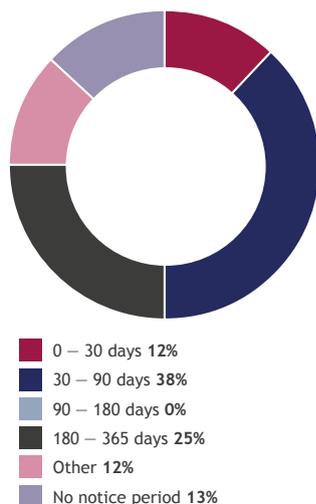
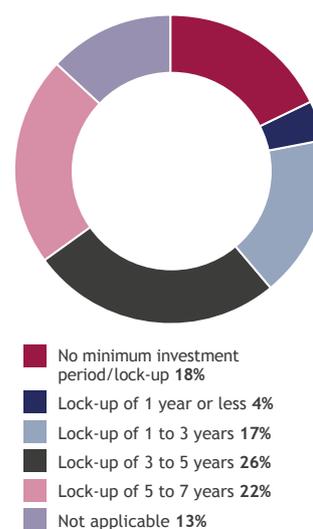


Figure 20: Length of notice period among open-end private debt funds



* Other includes holding liquid investments and having multiple investor types

Figure 21: Prevalence of minimum investment period/lock-ups among private debt funds

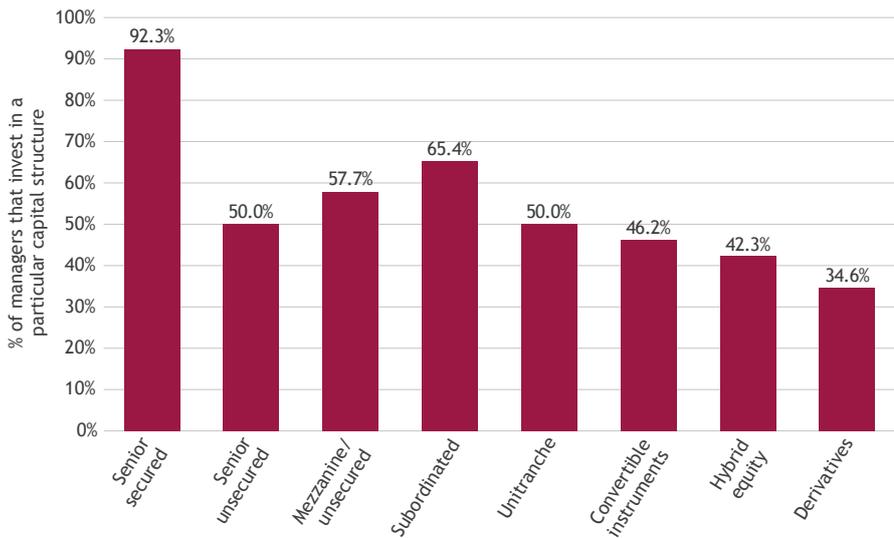


18 Redemption gates at the investor level independently limit redemptions for each of a fund’s investors. If the redemption gate is at the fund level, then only a certain % of the fund’s assets can be redeemed in a period. Redemption gates can also be mixed (on a number of levels).

19 Side pocket arrangements segregate illiquid or hard-to-value positions from the main pool of assets in a fund until such time as they are realised or are no longer difficult to price.

3 Managers are employing responsible risk management techniques

Figure 22: Capital structures that managers invest in

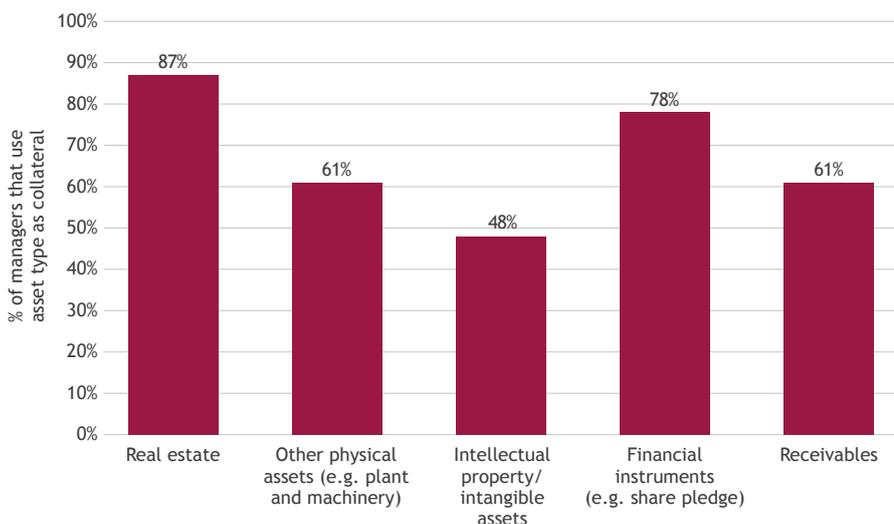


92%

of the managers surveyed invest in senior secured capital - a relatively low risk form of credit

Over 90% of the managers in the survey have a strong preference for their debt to be structured as senior secured capital (figure 22). By this nature, any investment in such a structure tends to be secured by collateral and is less risky than an unsecured investment. Half of the managers surveyed invest in a unitranche structure – a combination of senior and subordinated debt – which has become more popular since the financial crisis due to its comparative simplicity. Considered a lower-risk form of credit, it is now commonly used in mid-market leveraged buyouts and other acquisition-related financing across the US and Europe.

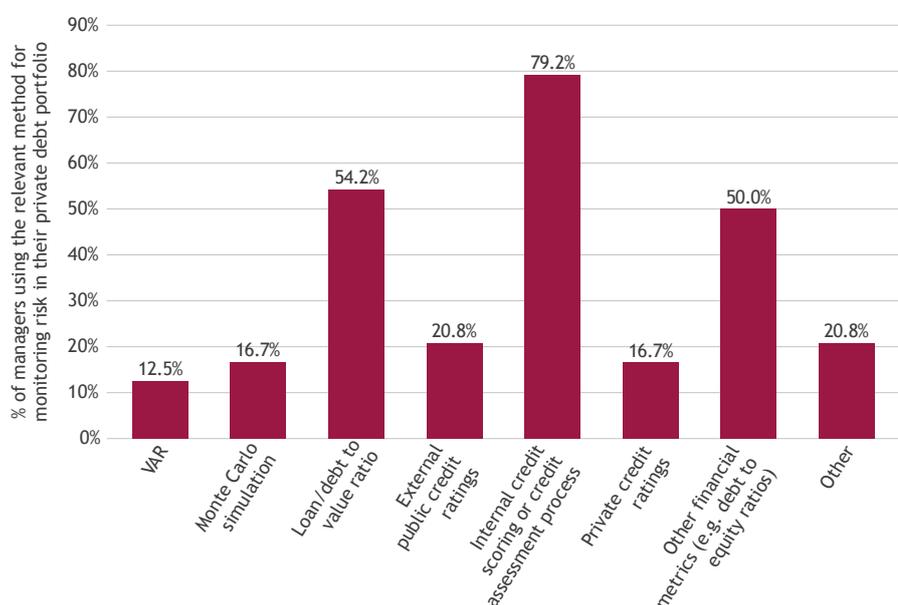
Figure 23: Collateral used in secured investments



20 The aim of the Liquidity Coverage Ratio (a key reform of the Basel Committee) is to ensure that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet their liquidity needs within 30 days

Among the preferred collateral used, managers are using a diverse range of assets to secure their investments and minimise on risk (figure 23). Real estate, the use of other physical assets such as plant and machinery and financial instruments such as pledging shares in the event of a credit event are the more common types of collateral used.

Figure 25: Methods used by managers to monitor risk in their private debt portfolios

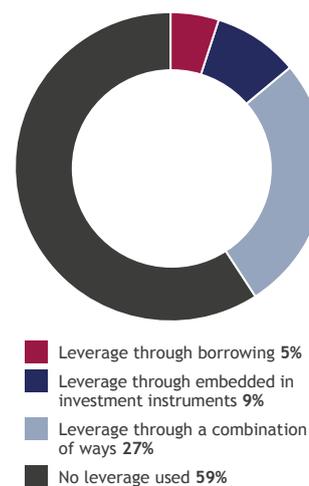


Bank reform including the tightening of banking restrictions have made it more expensive for banks to lend to middle market and SMEs. Further, additional rules as to how much capital banks must hold in reserve is likely to restrict bank lending to a limited percentage of their balance sheet and consequently higher leverage levels will be required.²⁰ In contrast, direct lenders tend to use all of their balance sheet, and consequently leverage levels are negligible.

Almost 60% of funds do not employ leverage (figure 24). Of those that do, 70% utilise leverage between 1x – 1.5x NAV. By comparison, an analysis of 20 leading banks yields an average balance sheet leverage of 16.4 times.²¹

Firms are using multiple methods for measuring and monitoring risk (figure 25). Internal credit scoring is the most commonly used method with 80% of managers using the method. Because the nature of the strategy requires detailed risk management techniques, it is reasonable that managers use in-house methods for monitoring risk in their private debt portfolios.

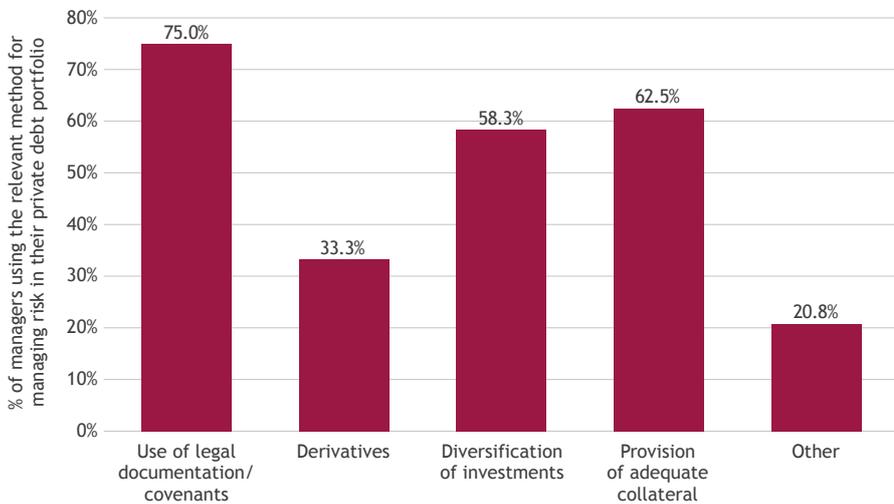
Figure 24: Private debt funds' use of leverage



²¹ Analysis by AIMA research, March 2015.

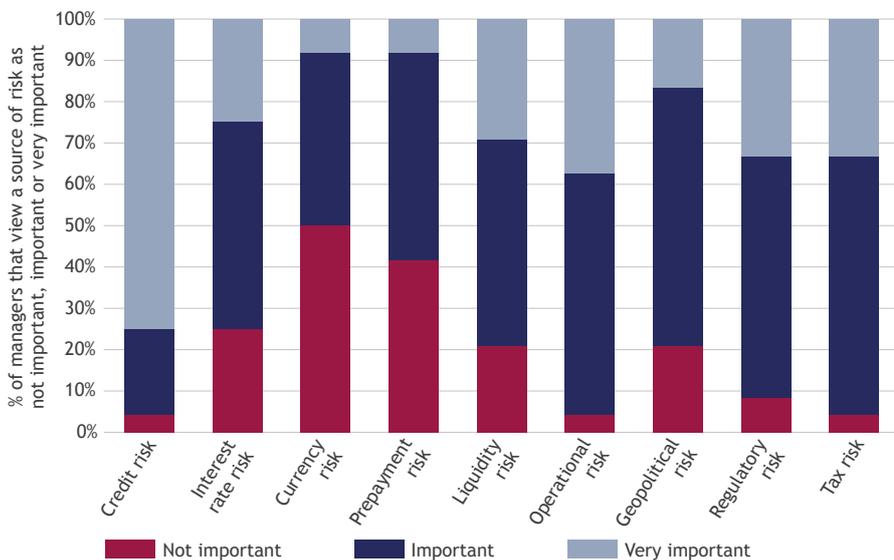
Covenants and collateral (in keeping with the strong preference for secured investment) are also very common for managing risk (figure 26). Derivatives are a less commonly used tool due to the difficulty in finding a good hedge for a non-traded security. Rather managers would have to create a cross hedge by taking a position in a different asset that they believe is highly correlated with their investment.

Figure 26: Methods used by managers to manage risk in their private debt portfolios



Managers view credit risk as their most important source of risk. Over 95% of managers view credit risk as being important or very important. Liquidity, operational, tax and regulatory risk are also important considerations (figure 27).

Figure 27: Manager perceptions of risks in private debt



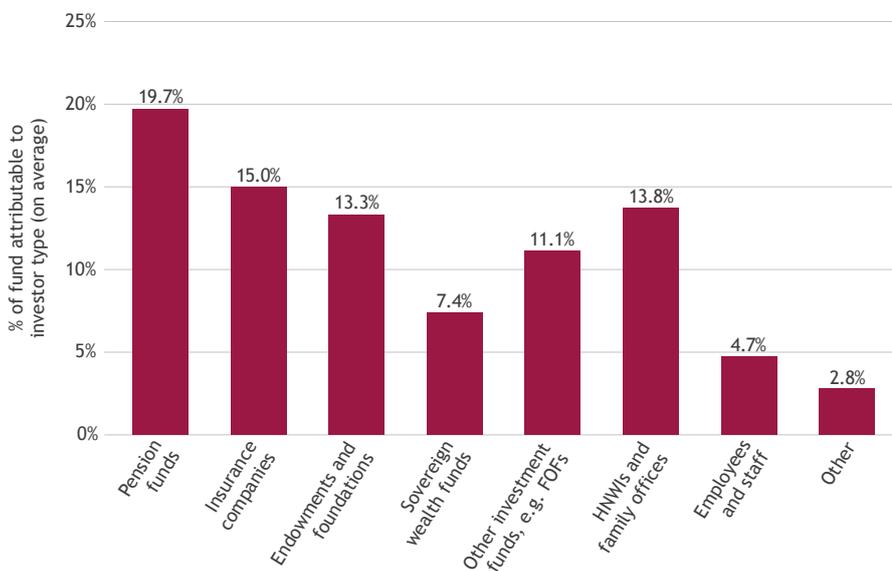
4 Institutional investors are helping to drive growth in the private debt market

A diverse array of investor types are investing in private debt funds, both institutional and otherwise. Looking across the investor base that allocates to the various private debt funds in this survey, pension funds and other institutional investors comprise the majority of all capital allocated to the sector (figure 28). In the US, large state pension plans and insurers in particular have been playing a key role in providing debt finance to all types of companies. Across Europe also, some of the continent’s largest institutional investors are helping to bridge the financing gap for the SME sector and are increasingly moving into the middle market segment offering an alternative to traditional bank finance. Given the relatively illiquid nature of private debt investment, these institutions are likely allocating to the strategy within the surplus segments of their portfolios as a means of making capital gains. Other institutional investors such as endowments and foundations also allocate significant capital to private debt funds. Employees and staff of these private debt funds have smaller investment (around 5% on average of a fund’s capital), which ensures an alignment of interest between the fund managers and the main institutional investors.

55%

of all capital allocated to private debt funds is provided by institutional investors such as pension funds, insurers and endowments

Figure 28: Investors in private debt (average allocations)



With the esoteric nature of some of the alternative strategies being invested in, typically allocators prefer to partner with hedge funds. Further, investors work with the relevant managers to road-test a particular idea, or to get a better understanding of a particular strategy before committing more significant capital or embracing the strategy fully.

Increasingly investors are also offering financial assistance to a broad variety of infrastructure projects. Pension funds and insurers are working side by side to put money into funds originated by banks which can take on structured debt, for example for financing aircraft or infrastructure projects – a practice already dubbed “syndicate to originate”.

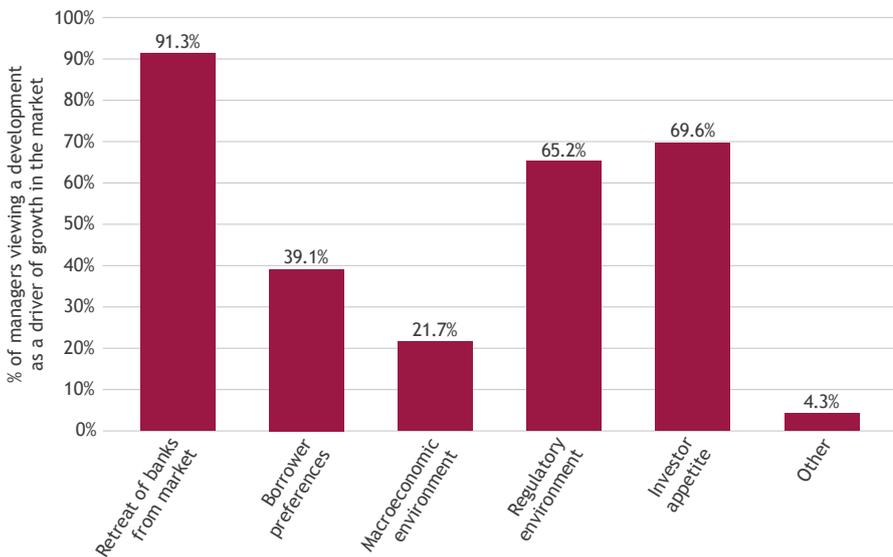
5 Manager perceptions of the private debt market

As mentioned in the first key finding, tighter banking restrictions (new capital and liquidity requirements) prompting a widespread retrenchment from the lending market has seen a significant increase in non-bank financing activities, including an increase in asset managers jumping in to fill the funding gap by launching direct lending funds.

91%

of managers surveyed cited a decline in bank lending as a major driver of growth in the private debt market

Figure 29: Drivers of growth in private debt

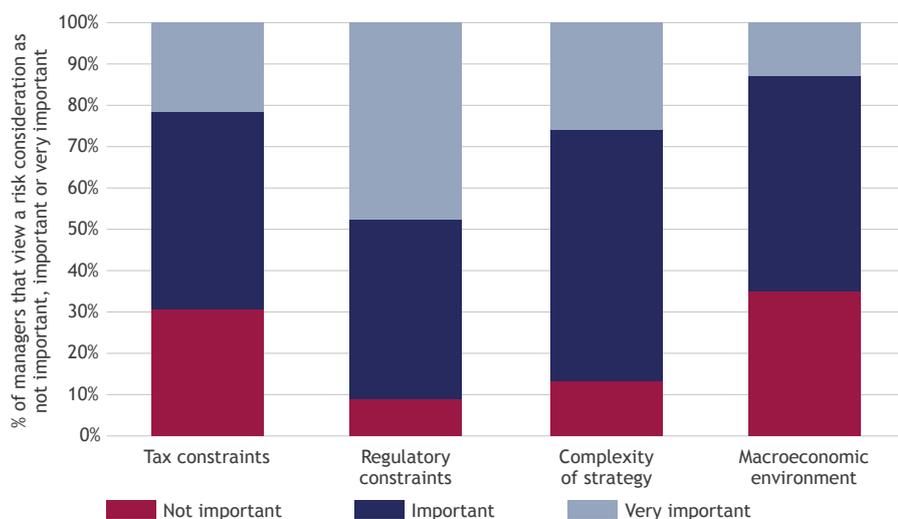


Amidst historically low interest rate environments (in particular across US, Europe and Japan) and by extension the low yield on offer from traditional fixed income products, investors are having to look further out the investment spectrum in their hunt for greater yield opportunities. In recent years, an investment in private debt has proven to be very attractive to some investors who are looking at ways to drive additional yield from their fixed income portfolios. Senior debt backed by ample collateral could offer low but attractive yields, while unsecured, unitranche or leveraged loans could offer stronger yields to investors with a greater risk appetite. Among the private debt strategies, direct lending is becoming increasingly popular as it is one of the most straightforward private debt strategies for an investment committee to understand and analyse.

There has been an increasingly widespread acceptance of the role direct lenders have to play, particularly in stretching leverage to support deals that are not attractive to banks. The performance of the individual perception of each of these lenders is dependent on the size of their footprint, fund size, and chosen strategies, which will ultimately define the performance of each portfolio.

Among the most important risk considerations associated with private debt involvement are constraints imposed on the sector by regulators (figure 30). Many jurisdictions restrict some or all activities associated with non-bank lending such as loan origination. The key challenge is to understand that asset managers are a useful complement to the banking sector. Today, hedge funds and private equity fund managers must be authorised and are the subject of strict regulation across all major financial jurisdictions and so certain concerns which may have been associated with their activity in the past should have been alleviated. Managers are now subject to strict operational standards and organisational requirements such as conflicts of interest and conduct rules, the protection of client assets as well as prudential regulations on liquidity and risk management. Furthermore, as already mentioned hedge funds are not large users of leverage (unlike banks) and can offer unique liquidity terms for its investors.²²

Figure 30: Manager perceptions of risk considerations associated with private debt investment



22 AIMA's paper in 2012 "the role of hedge credit hedge funds in the financial system: asset managers not banks" explores this discussion further. www.aima.org

Key regulatory and tax changes needed to improve the environment for private debt investment

Alternative credit funds are increasingly taking on a greater role in the lending market and direct lending funds will establish themselves as a key part of this evolution. Indeed governments acknowledge the need to develop a more diversified lending market in Europe.²³ Unanimously manager respondents to our survey believe a key to unlocking funding constraints across Europe will be to boost its securitisation market. As highlighted throughout this report, as a consequence of bank retrenchment and macro-economic conditions, it is becoming increasingly challenging for SMEs and middle-market companies to secure the necessary appropriate financing. While direct lending is proving invaluable, it is critical for all borrowers and lenders concerned that they are given access to finance via a fully functioning and efficient securitisation market and other forms of bond issuance are made available to borrowers of all sizes. It is clear that there is very much a two-tier market in terms of government support for EU SME lending. While countries across western Europe typically support and endorse lending to SMEs through a variety of schemes, elsewhere within the EU, support is not as strong which begs the question as to whether the size of pan-European and national government support programmes is large enough to contend with the riskier end of SME lending. Additional improvements that could be made to bank-lending would be improved SME data availability (to facilitate a better credit rating awareness) as well as the potential consolidation of SME support schemes. On similar lines, loan origination is still very much restricted to the banking sector across the EU to the detriment of SMEs and other borrower types. Even where loan origination by non-banks is permissible, many of its participants argue that it does not fit with their business model due to the need for local origination capabilities. This is likely to restrict the financing of SME lending to banks rather than capital market participants, ironically at a time when banks' lending capacity is restricted.

Finally, it is vitally important that greater clarity is provided around EU member states bankruptcy laws and that member states strive for a harmonised corporate tax regime comparable to the US system. The lack of a standardised environment in regard to legal systems, loss default provisions and the bankruptcy process has ensured that private debt markets across the jurisdictions are at different stages of development creating confusion for all concerned.

²³ Long Term Financing of the European Economy, EC, March 2013

Conclusion

The alternative asset management industry plays a vital role in the world's capital markets. Unlocking gains from market-based finance can produce significant benefits in terms of economic growth. Policymakers have an important role to play in this development as a number of restrictions hinder the activity of asset managers in the private debt space. However, it is crucial to understand that sometimes even well-intentioned regulatory intervention may lead to significant disruptions and hinder the activity it is meant to assist. The inability of the first wave of securitisation reforms to create a workable regulatory framework is perhaps the most visible example.

Asset managers are not banks and therefore need a different regulatory approach. Indeed, what most managers to the survey indicated is not a demand for a different approach to asset management regulation but a simple need to dismantle regulatory and tax barriers to direct lending by non-banks. Looking at intelligent, incremental changes such as permitting loan origination and associated services could go a long way in supporting economic growth. As our research shows, those jurisdictions which have provided for a greater diversity in the funding mix have been able to unlock significant sources of flexible capital, particularly for their SME sector.

Appendix: Case Studies

Asset Managers are providing finance to a number of private debt markets with the borrowers using this finance for a variety of purposes. Below are real world examples that detail asset managers providing finance to not only SMEs but also for various infrastructure projects and social housing initiatives.

Case 1: M&G Investments lends to a popular UK business

M&G Investments provided Caffè Nero with a £30m loan in early 2014. Caffè Nero had sought the funds as part of a refinancing package that would allow for greater flexibility and would provide diversification to its sources of financing. The loan will support Caffè Nero's growth objectives including expansion both internationally and within the UK.

The Financial Director of Caffè Nero said of the deal, "M&G joined later in the process and is the only non-bank participant in the senior debt club. The team was very quick in getting their heads around the business. The speed of the deal and responses were very impressive."

Case 2: York Capital supports Canadian infrastructure project

In December 2012, York Capital provided Cecon ASA, the Norwegian subsea installation contractor, with a \$107.5m in financing by way of a multi-tranche senior secured bond issue for the purpose of purchasing the existing loan with the Export Development Bank of Canada, providing incremental working capital and also funding the completion of construction of Hull 717 at Chantier Davie Canada. York also made available additional construction financing of up to \$175m for the completion of Hulls 718 and 719.

As part of the financing, York received detachable warrants representing a 15% pro-forma equity interest in Rever Offshore AS (Rever) – a 100% owned Cecon subsidiary with ownership of the three hulls and the construction contracts at Davie.

Case 3: Cheyne Capital provides a solution for an urgent transaction

Cheyne Capital (along with DRC Capital) provided a £170m loan in September 2013 to Queensgate Investment Fund to buy a serviced office provider with 28 properties across central London. Not long after the loan, Barclays took on £130m of senior debt from the two lenders secured against Queensgate Investments' Executive Office Group, leaving the original lenders each with £20m of junior debt from the portfolio.

A DRC Capital representative said that it was originally clear that the transaction was financeable in the senior market but not in the desired timeframe, hence it was necessary to underwrite it first and then syndicate it subsequently.

The end result was that Cheyne Capital were left with a mezzanine piece.

Case 4: Aviva Investors finances a new hospital in Scotland

Aviva investors co-lent £218m in senior debt alongside the European Investment Bank for the construction of a new 350-bed acute hospital in Dumfries and Galloway. The hospital will be completed in 2018 and will serve 150,000 people living in the south-west of Scotland.

Case 5: KKR invests in renewable energy project

As part of a £200m joint initiative with the UK Green Investment bank (managed by Temporis Capital), KKR provided an £8m loan to a wind farm in Scotland to finance the installation of three turbines. The initiative marks the first non-bank lending platform dedicated exclusively to the renewable energy sector.

The deal will assist in the UK's transition to a sustainable energy-based and greener economy. Further, the wind farm will be partly owned by the local community ensuring that the host community retains commercial benefits.

Case 6: Chenavari Investment Managers provides flexible funding to a UK-based SME

Chenavari Investment Managers provided Sceptre Leisure with a £20m of flexible funding comprising both senior debt and mezzanine finance to support the company through further growth. Sceptre Leisure specialises in the rental and operation of coin operated amusement equipment found in pubs and other businesses across the United Kingdom.

A partner at Grant Thornton who advised on the transaction, noted that a solution which did not involve the shareholders selling an equity stake in their business to outside investors was of great appeal.

Case 7: Pine River Capital provides acquisition finance for an aircraft parts dealer

Pine River Capital provided a \$26m loan to an American aircraft parts dealer for purchasing a target company. The loan was backed by the assets of the target company with the borrower assuming the liabilities. These assets consisted of a pool of aircraft parts, which the borrower would earn a commission to sell over time.

The loan benefited the aircraft parts dealer and allowed it to expand globally and enter new markets. Further, the company became a prominent participant in the aircraft parts space and the transaction provided other opportunities for future growth.

Case 8: Cheyne Capital finances real estate initiative

In early 2014, Cheyne Capital provided an investment loan facility of £22.35m to the Fusion Group for the conversion of a 15-storey office building in Bristol known as Froomsgate House into student housing. The funds helped Fusion Group finance the acquisition (purchase of the entire issued share capital of the company holding the freehold title of the property) and will finance the planned development of the property into student accommodation with at least 438 beds.

The development will benefit the students of Bristol where the supply of housing has seemingly not kept up with applications to study at the university. The average monthly rent per bed in Bristol is one of the highest in the UK for students and it is estimated that over 40% of students live in private rentals with less than 30% living in university accommodation or private halls.²⁴

Case 9: Avenue Capital provides acquisition finance to support growth in consumer loans

Avenue Capital acted as sole lender and agent in connection with the debt financing of the acquisition of Freedom Finance Nordic by H.I.G. Europe (H.I.G. Capital's European arm). Freedom Finance Nordic is the leading consumer loan broker in the Nordic region. Further aligning itself with the long-term interests of the borrower, Avenue Capital also invested in a minority equity stake in Freedom Finance alongside H.I.G. The debt facilities consisted of a unitranche acquisition facility and a revolving credit line.

Case 10: Proventus Capital Partners provides debt facility to Swiss company

Proventus Capital Partners, a Swedish investment company, provided a €23m junior debt facility to Bilcare Research AG ("BRAG"), who are a leading producer of packaging films. The facility will allow Bilcare Research to refinance existing debt and to also pursue its growth objectives. In addition, Proventus Capital Partners also invested in €65m senior facility arranged by Deutsche Bank. Proventus listed BRAG's strong market position in its industry and a diversified customer base as some of the motives for pursuing the transaction.

Case 11: Macquarie lends to Heathrow Airport

Macquarie, the asset management arm of the eponymous bank, provided £115m in inflation-linked financing to Britain's largest airport. The debt is unique in that aside from being inflation-linked, it has delayed settlement and is at the Class B level. Further, with a maturity of 2036 it is believed to be one of the longest Class B notes ever finalised.

The £115m forms part of a greater fund raising effort by Heathrow and will allow for continued investment in and development of the airport.

Case 12: Ardian provides acquisition finance for biotech expansion

Qualium Investissement, the private investment arm of French state-controlled Caisse des Dépôts, has received €92m from Ardian in unitranche financing to support the acquisition of IMV Technologies (a French biotechnology company). IMV Technologies is a pioneer in animal artificial insemination. Ardian had previously supplied the company with a mezzanine credit line and a subordinated debt facility.

Case 13: Muzinich & Co. provides bond financing for an Italian waste management company

Muzinich & Co., a global asset manager specialising in corporate credit provided €10m in bond financing for Eco Eridania SpA. Eco Eridania specialise in managing hazardous, medical and industrial waste. The financing which is in the form of a seven-year senior secured debt facility will support the company's organic and acquisition-based growth.

Case 14: Alcentra supports French prosthetics group

Alcentra invested in Menix, a holding company for healthcare firms manufacturing orthopaedic and dental implants in France. The funding which is in the form of a unitranche facility will support further expansion of Menix in the French and international prosthesis market.

Case 15: GSO Capital finances an independent oil and gas company

Blackstone's GSO Capital Partners provided \$500m to fund the drilling operations for 5 years of Houston-based, LINN Energy. The financing covers the cost associated with new wells drilled in exchange for GSO holding an 85% working interest in the wells. The deal takes some pressure off LINN's balance sheet during a period of energy price lows and will allow the company to drill more wells without needing to raise further capital upfront.



Alternative Investment
Management Association

About AIMA

The Alternative Investment Management Association (AIMA) is the global hedge fund industry association, with over 1,500 corporate members (and over 8,000 individual contacts) in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members manage a combined \$1.5 trillion in assets (as of March 2014). All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide. AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) -the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, www.aima.org.

About AIMA's Alternative Credit Council

The AIMA Alternative Credit Council – a group of senior representatives of alternative asset management firms – was established in late 2014 to provide general direction to AIMA's executive on developments and trends in the alternative credit market with a view to securing a sustainable future to this increasingly important sector. Its main activities comprise of thought leadership, research, education, high-level advocacy and policy guidance.

Special thanks also to Deloitte, and the UK Debt Advisory team (Alternative lender coverage) who provided their expertise on the paper.

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