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# Welcome to the private debt show

## Analysis of the growth in private debt fundraising




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## Key takeaways

- Private debt funds raised $118.7 billion in commitments in 2017—the most of any year on record. This represents a CAGR of 20.5% since 2009, more than 2.5x the 8.1% CAGR of private equity buyout funds.

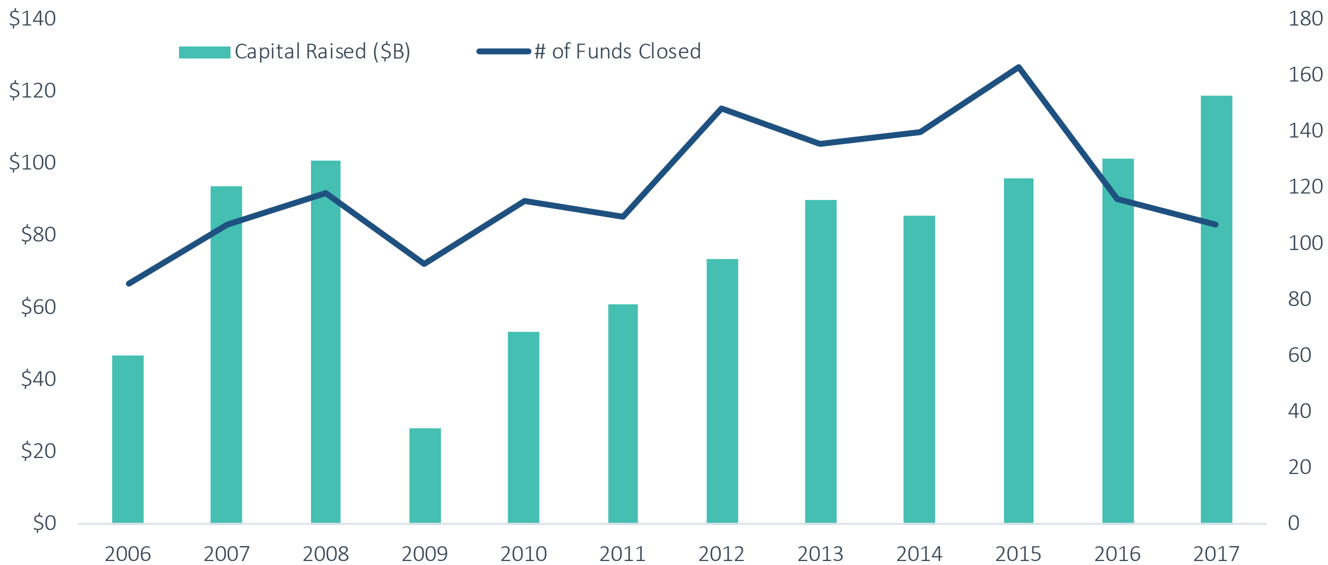
- Fundraising growth has been underpinned by a variety of sub-strategies, though the expansion in direct lending vehicles is most notable. $52.6 billion was raised in direct lending funds in 2017. Opportunities have grown primarily due to regulations that cultivated the demand for financing from nonbank lenders, as well as the development of alternative asset space more broadly.

- The proliferation of private debt means that more lenders are competing on price and terms, leading to unprecedented levels of cov-lite loans and the use of add-backs to make issuers seem more creditworthy. This heightened competition will surely benefit borrowers; however, these perceived benefits for borrowers translate into a riskier return profile for lenders and their limited partners.

## Dissecting the recent explosion in private debt fundraising

Over the last decade, fundraising for private debt vehicles has in many ways mirrored—and in some cases even exceeded—the exponential growth of the broader private capital industry. Private debt funds closed on $118.7 billion in commitments in 2017—the highest total of any year on record. This represents a CAGR of 20.5% since 2009, more than 2.5x the 8.1% CAGR of PE buyout funds.

Global private debt fundraising




Source: PitchBook

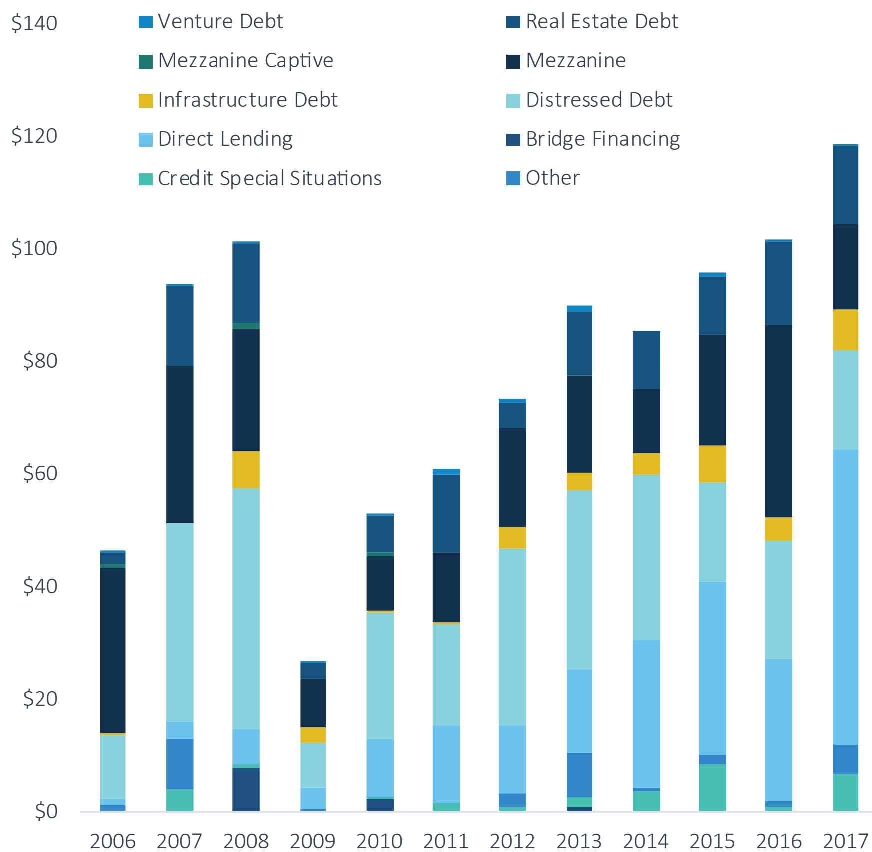
Growth in private debt fundraising has come from a variety strategies, though the steady expansion in direct lending vehicles is most notable. $52.6 billion was raised in direct lending funds in 2017—also the highest on record. This represents a CAGR of 39.4% over the $3.7 billion raised in 2009. Opportunities have grown primarily due to the regulatory environment discussed in the following pages, which cultivated the demand for financing from nonbank lenders.

While mezzanine fundraising decreased in 2017 to just $14.9 billion, 2016 set a record at $34.2 billion in commitments globally. The two taken together total the highest mezzanine fundraising of any two-year span since 2007 and 2008. These funds, of course, are commonly used in leveraged buyouts, the value of which has grown substantially since the financial crisis. As such, the use of mezzanine debt instruments[1], which are themselves often a hybrid between debt and equity, should continue growing along broader PE expansion.

Infrastructure fundraising set a record in 2017 too, totaling $7.2 billion in commitments. It's interesting to note, however, that four of the six infrastructure debt funds (and their parent firms) to hold final closes in 2017 are headquartered in the Asia-Pacific region, not the US, where a flurry of mega-funds (including equity vehicles) began fundraising this year in response to speculation about public-private partnerships on US infrastructure spending (though these funds will not show up in fundraising figures until they hold final closes, likely later in 2018).

1: Mezzanine instruments are subordinate to other debt on the company's balance sheet, but generally include warrants or other equity-like features.

Global private debt fundraising by type ($B)




Source: PitchBook

## Quantitative easing and the “reach for yield”

By now, financial professionals are very familiar with the stimulus measures enacted by central banks following the financial crisis. Bond prices have been driven up and yields down as the combined balance sheets of the Federal Reserve, ECB, and BOJ have swelled to $14.2 trillion. Institutional investors, still wanting exposure to debt and credit instruments but unwilling to accept lower rates of return, went looking for higher-yielding alternatives. Investors have been unable to satiate their appetite, with prolonged buying of risky assets pushing down high-yield credit spreads to their lowest levels since mid-2014.

With high-yielding opportunities in public markets being few and far between, investors have been forced to explore new strategies. Private debt funds, often operating as direct lenders to middle-market companies and sources of credit for leveraged buyouts, provided the higher yield that investors demanded.

Recent interest in private debt can’t all be attributed to quantitative easing though. Fundraising totaled more than $60 billion in both 2007 and 2008, before the recent deluge of central bank activity, indicating that there was plenty of interest in debt vehicles even before the crash. Long-time industry titans such as Apollo and Oaktree have been raising dedicated debt vehicles since the birth of the buyout industry in the 1980s. However, the private debt industry was less developed and more concentrated in the years leading up to the financial crisis, only gaining widespread recognition in the last decade; 32.2% of fundraising in 2008 came from the largest five funds, compared to just 22.1% in 2017.

## Post-financial-crisis regulations

*Basel III*

The Basel Committee for Banking Supervision has governed the international banking system since the 1980s, but its most recent regulatory framework, Basel III, has had the largest effect on private debt funds. The writers of Basel III, which was first released in December 2010, were surely informed by the Global Financial Crisis, which was still rippling through the world's economy at the time of its drafting[2]. In an effort to protect the banking sector—and thus the economy—by placing capital requirements on systemically important banks, Basel III restricted the lending ability of those banks and expanded market demand for nonbank sources of debt financing.

*Dodd-Frank*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was the United States' own regulatory response to the financial crisis. Given that 66% of private debt funds are based in the US[3], it too has influenced private debt fundraising, though not in the same ways as the Basel III requirements.

One of the most pertinent components of Dodd-Frank for private market professionals is the controversial Volcker Rule, which limits proprietary trading and banks' exposure to equity positions in private equity and hedge funds. However, their lending to these funds is unconstrained if the debt instrument being provided does not include equity features (e.g., equity kickers or a rate tied to fund performance), according to Dwight Smith of law firm Nelson Mullins Riley & Scarborough LLP[4]. Nonetheless, limiting banks' exposure to PE created an opportunity for nonbank financial institutions to increase capital offerings to PE funds.

2: Smith, Dwight. The Impact of Dodd-Frank and Capital Requirements on Commercial Lending. 3 Aug. 2016
3: For funds that held a final close in 2017.
4: Smith, Dwight. The Impact of Dodd-Frank and Capital Requirements on Commercial Lending. 3 Aug. 2016

*Leveraged Lending Guidance*

US regulators issued guidance in 2013 for leveraged loan issuance at an upper limit of 6.0x EBITDA, further limiting banks' ability to participate in the leveraged loan market. Private debt funds were not bound by these restrictions and, therefore, were able in many cases to offer more comprehensive financing packages than traditional lenders. While the leverage guidelines were not strict rules and did not apply to all banks, the recent decision by the Government Accountability Office to roll back the guidelines will likely lead to a renewed interest in the leveraged loan space from banks, creating greater competition for private debt funds deploying capital. This rollback will also likely push debt/EBITDA levels past the already-frothy 5.8x recorded on US M&A transactions through 3Q 2017.

## Developments in alternative assets

Private debt funds are often viewed by LPs as just one part of a larger allocation to alternative assets. As such, commitments to these vehicles are somewhat influenced by trends in private equity, hedge funds, and real estate, among others. Private debt funds are, in some ways, a natural extension of the buyout industry from which they grew. Investing in private debt provides exposure to different parts of the capital structure, allowing investors to diversify exposure to private markets in a similar way that allocations are calibrated in a public market portfolio.

Private equity deal flow has ballooned in the last decade, totaling $578.4 billion in the US in 2016. These deals, most of which are leveraged buyouts, are dependent on significant portions of debt financing. Thus, the need for private debt grows along with private equity deal flow. In addition, strategic M&A has propelled to new heights, totaling $2.29 trillion in the US and Europe alone. These transactions had a median debt usage of 54.5% in 2016, which translates to more than $1 trillion in debt issuance.

Hedge funds have also served as a source of growth for private debt fundraising. Underperformance and drawdowns from hedge funds in recent years have led LPs to rejigger their alternatives portfolios, with a broad shift away from hedges funds and toward private debt and PE vehicles. Hedge funds have seen $2.5 billion in inflows YTD through 3Q 2017, but this hardly makes a dent in the $70 billion in investor outflows recorded in 2016, according to HFR. As hedge fund returns have foundered in recent years, many managers have moved their portfolios into less-liquid instruments in an effort to boost returns. Some have even gone as far as to launch private debt funds themselves.

Another trend affecting the alternative asset space in recent years has been the pressure on management fees. In response to this pressure, general partners have attempted to become "one-stop-shops" by offering not only private equity vehicles, but also private debt, hedge fund, and real estate strategies. For example, The Blackstone Group (NYS: BS) now has about as much AUM in credit strategies ($99.5 billion) as it does in PE ($102.5 billion), real estate ($111.3 billion), and hedge funds ($74.2 billion)[5]. By expanding their offerings, these managers are able to grow AUM and accommodate slightly lower headline fees without foregoing revenue.

## What does this mean for borrowers?

The proliferation of private debt funds in recent years will surely benefit borrowers. Everyone from PE firms to real estate developers to VC-backed startups will have more options when it comes to accessing financing. The buildup of supply means that more lenders are competing on price and terms, leading to unprecedented levels of cov-lite loans and the use of add-backs to make issuers seem more creditworthy.

What's good for borrowers, though, is riskier for lenders and their LPs. Fewer protections and lower rates could spell lower returns for general debt funds, while at the same time unlocking more opportunities for distressed debt and turnaround funds, highlighting the diversity of strategies within the private debt space.

5: As of 3Q 2017, according to the company's website.

## Methodology

*The data in this report includes all geographies and the following fund types: bridge financing, credit special situations, general debt (represented as “other” in the chart on page 3), direct lending, distressed debt, infrastructure debt, mezzanine, mezzanine captive, real estate debt, and venture debt.*