GLOBAL PRIVATE DEBT

INSIGHTS 2022

ESG AND TECHNOLOGY MARK A NEW ERA FOR PRIVATE CREDIT

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EXECUTIVE SUMMARY

The geopolitical and economic landscape has shifted significantly in the 12 months since TMF Group & Private Equity Wire published the Global Private Debt Insights Report 2021. One might expect that the looming threat of recession, high inflation rates and conflict in Europe would all contribute to dampen the outlook of the sector. However, the second edition of our annual private debt survey, conducted throughout the second quarter of 2022 presents a much more nuanced and positive outlook of the sector.

This study, focused on key industry stakeholders and asset allocators, points heavily to the continued growth of the alternative lending sector, with the overwhelming majority of participants expecting their credit allocations to increase or remain stable in the coming 12 months. Close to half of all participants expect their own allocation to credit to grow by more than 20% during the remainder of 2022 and into the new year.

Given increased uncertainty in financial markets, it is perhaps unsurprising that investors are somewhat more pessimistic on the potential returns available from the sector in the mid-term. Survey participants indicate an average forecast return of approximately 7.5%, which if achieved, would represent a slowdown on prior year rates of return. In last year's study, more than 40% of managers were anticipating a return between 10 and 14%. However, that outcome should be viewed in the context of when this survey was conducted in early Q2 2022 at the onset of conflict in Ukraine.

Similar key operational threads have arisen in 2022 versus our prior edition. Unsurprisingly ESG is an area where our survey findings demonstrate a wide spectrum of approaches among investors. It is clear from the data that the industry does not have a consistent methodology around the gathering, interpretation and application of ESG data, with numerous interesting trends emerging in this space.

Operational efficiency remains a critical area of focus among private credit managers. The march toward outsourcing back-office administration looks set to continue as managers seek a scalable operating model. While close to 70% of our audience expect to leverage additional technology solutions to manage their portfolio.

- Based on the survey it would appear that the outlook for private credit markets is strong as the majority of respondents (69.3%) plan to increase their allocation to these assets.

- The size of allocations is also expected to increase with a considerable 37.4% planning to grow their investment by more than 20%.

- However, despite the strong investment appetite, return expectations are somewhat muted, given the historic returns the asset class has generated. The vast majority (68.7%) anticipate the asset class returning 7.5% or more over the course of the year. This contrasts with data from Pitchbook showing the rolling one-year horizon IRR for private debt reached 19.0%.

- The growing momentum in ESG is clear as the majority of respondents have incorporated these criteria into their investment decisions - 49.4% do so across the board and a further 21.7% have integrated these factors to some extent.

- But private credit investors are willing to take advantage of the benefits technology solutions have to offer. Almost seven in 10 (68.5%) plan to leverage technology to dynamically monitor their portfolio.

INTRODUCTION

Private credit investment has risen to the fore, in the wake of lacklustre returns elsewhere in fixed income markets, as investors sought alternative sources of yield. However, given the rising interest rate environment and higher inflation, these instruments can now provide investors protection as they aim to keep their portfolios stable amid persistent expectations of high volatility.

The responses to this survey were gathered prior to the start of the war in Ukraine. Therefore, it is worth noting that this devastating event has exacerbated the volatility in credit markets and resulted in significant uncertainty across the industry.

However, the outlook for the sector remains reasonably positive (in the context on the war) as investors signal rising allocations, strong anticipated returns and broadening teams of experts.

The industry has echoed these trends as large global firms have bolstered their private credit teams. In May this year, Fidelity added 12 members to its private credit segment and M&G reportedly hired two leverage and acquisition finance bankers in its direct lending team in Frankfurt.

METHODOLOGY

This study includes responses gathered from 127 investors. Of them, 41% were based in North America, 40% in Europe and 7% in Asia Pacific. The rest of the sample was spread across Latin America, the Middle East and other parts of the world. Over half of the respondents are private equity or private debt managers with a further 17% being hedge fund managers.

INVESTMENT, EXPOSURE AND PERFORMANCE

Private credit strategies got a boost as banks transitioned away from traditional middle-market lending after the global financial crisis. Private equity sponsors quickly saw the advantages of the asset class for their financings. This vote of confidence accelerated opportunities for private credit managers," comments Ken Kencel, president and CEO, Churchill Asset Management in the 2022 Preqin Global Private Debt Report.

Holdings of private credit are prevalent as the majority of respondents have some allocation to the asset class. The most common allocation is sized between $1 million and $99 million and 26.8% have investments of this size. Holdings of over $1 billion are cited by 15.7% of respondents, where 11.0% say they have between $1 billion and under $5 billion invested here.

The growth indicated by these findings is further supported by data from the 2021 Pitchbook Private Debt Report, released in February 2022. The report shows globally, managers raised $191.2 billion, which represents a 12.1% YoY gain and the second-highest annual tally on record, which was the almost $202 billion registered in 2017. "Investors continued piling into these funds despite the puzzling macroeconomic environment due to a confluence of factors including negative real yields on government bonds, lower-than-expected default rates, accommodative monetary and fiscal policy, and positive recent performance by private debt as an asset class," Pitchbook outlines.

"As an asset class, it has performed strongly during the recent upheaval and offers timely benefits for investors looking for strong growth opportunities at a time of constrained mainstream lending," details a report by AIMA outlining the intentions of US investors for the first half of 2022.

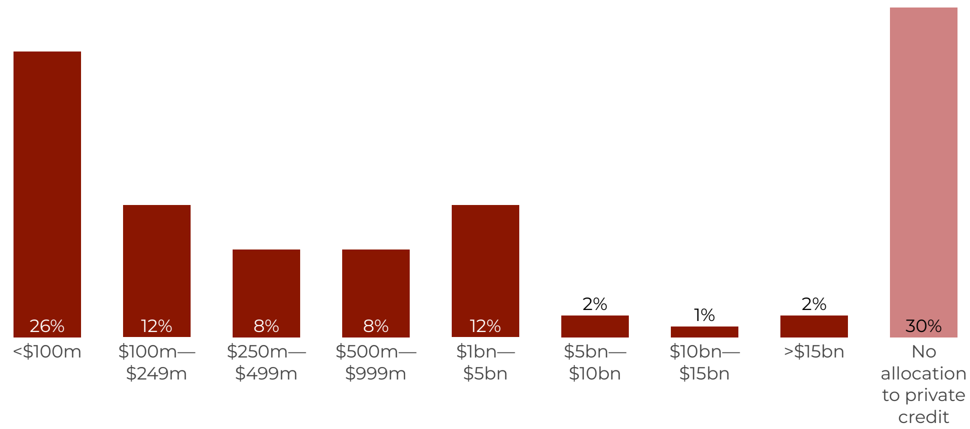
However, it is worth noting that almost three in 10 investors (29%) currently have no allocation to private credit. This hesitance could be driven by a number of factors, including the investors' risk tolerance, current investment focus and their liquidity requirements.

The outlook for debt markets is strong as the majority of respondents (69.3%) plan to increase their exposure to these assets. Around a quarter (25.2%) plan to maintain their current holdings and a marginal 5.5% say they will decrease their investment.

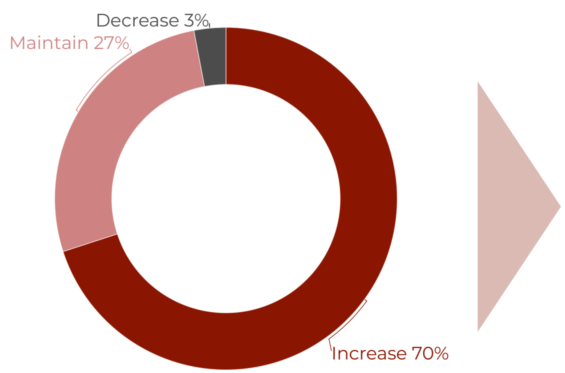
Considering where this money is expected to go, a report by McKinsey suggests LPs have increased their exposure to earlier-stage private investing. "Venture capital (VC) continued to attract capital on the back of a decade of strong performance but was outpaced by growth equity. With increased funding for VC and companies remaining private for longer, the investable universe of growth companies has expanded substantially. PE firms have moved to fill the space, and the supply of growth equity vehicles has evolved: in the last ten years, six of the ten largest buyout managers have launched a growth vehicle. Today, VC and growth equity combined make up 47% of PE fundraising, just shy of buyout's share," the firm's Global Private Markets Review 2022 details.

Specifically in relation to private credit, a

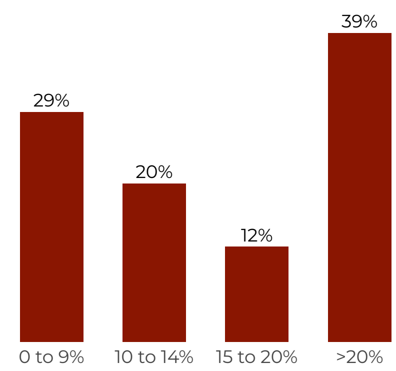
Q1. How much committed capital (excluding dry powder) have you currently allocated to private credit (broadly defined as investments in loans, bank debt etc.)



Q2. Are you looking to increase or decrease your exposure in the debt market?



Q22. By how much will you increase your exposure to private credit in the next year?



considerable portion of respondents (37.4%) plan to grow their investment by more than 20%. This is the largest percentage represented in the data showing a distinct trend for rising investment in the space.

These statistics mirror those quoted in the AIMA report in which 40% of respondents said they were likely to increase their private debt/credit holdings.

Respondents' return expectations for private credit can be considered muted, given the historic returns the asset class has generated. The vast majority (68.7%) anticipate the asset class returning 7.5% or more over the course of the year. Just under a third (31.3%) on the other hand, expect a return which exceeds 10%.

This outlook is cautious as despite the volatility caused by the Covid-19 pandemic, private debt has garnered robust returns of late. The Pitchbook data shows the rolling one-year horizon IRR for private debt reached 19.0%. Direct lending lagged but still generated a significant 12.3% return. The data provider said: "Debt strategies with more equity-like characteristics, such as mezzanine and distressed debt funds, buoyed the performance of private debt overall, while direct lending—which relies more on steady interest payments from portfolio companies—experienced more modest gains."

However, as with all investment markets, risk exist which could scupper investors' return potential. According to respondents, the prevalent concern revolves around default risk. In the view of 27.7% broad defaults as were seen in 2008 are the main worry when investing in private credit markets.

This concern may be interpreted as investors pre-empting the potential market turbulence highlighted earlier. Data from Proskauer shows default rates have been on the decline, dropping from 1.5% in Q3 2021, 1.3% in Q2 2021 and 2.4% in Q1 2021.

Stephen A. Boyko, co-chair of Proskauer's Private Credit Group commented in a press release: "While defaults are at historic lows, we believe we are entering into a period of increased turbulence in the market, given inflationary pressures, supply chain issues, labor shortages and projected interest rate increases."

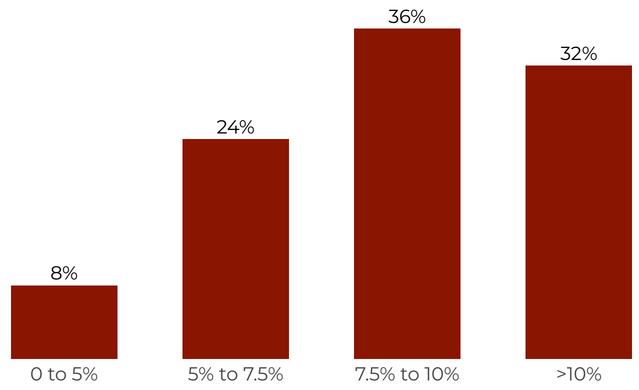
In fact, in the survey, a further 25.3% of investors outline interest rate risk as a key issue. But with risk comes opportunity.

"Private credit investors, while being mindful of short-term headwinds, remain patient and focused on meeting long-term investment objectives, and ensuring broad diversification across portfolios and compensation for the risk taken," notes Karen Lam, Director, Private Credit at M&G Investments, "Nevertheless, careful structuring of private credit investments can further help to mitigate against downside risk in portfolios – with strong origination capabilities and flexibility to invest across the full breadth of the asset class also important when it comes to ensuring selectivity over deals."

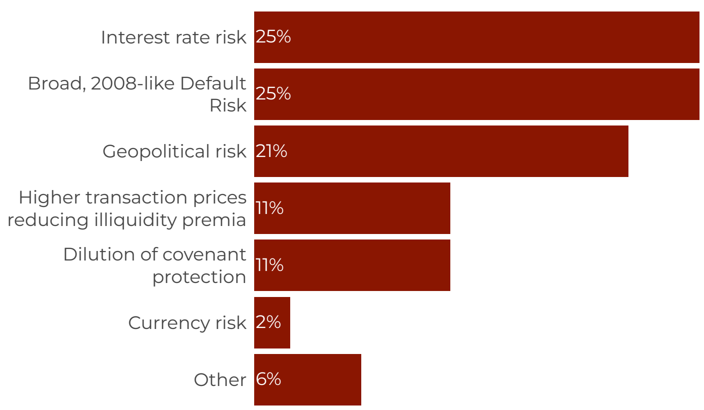
Geo-political risk is the third most worrying for private credit investors. Even prior to the Ukraine-Russia war breaking out, tensions between the US and China had been causing apprehension among investors. This concern is now likely to be more acute given the context of the conflict in Ukraine.

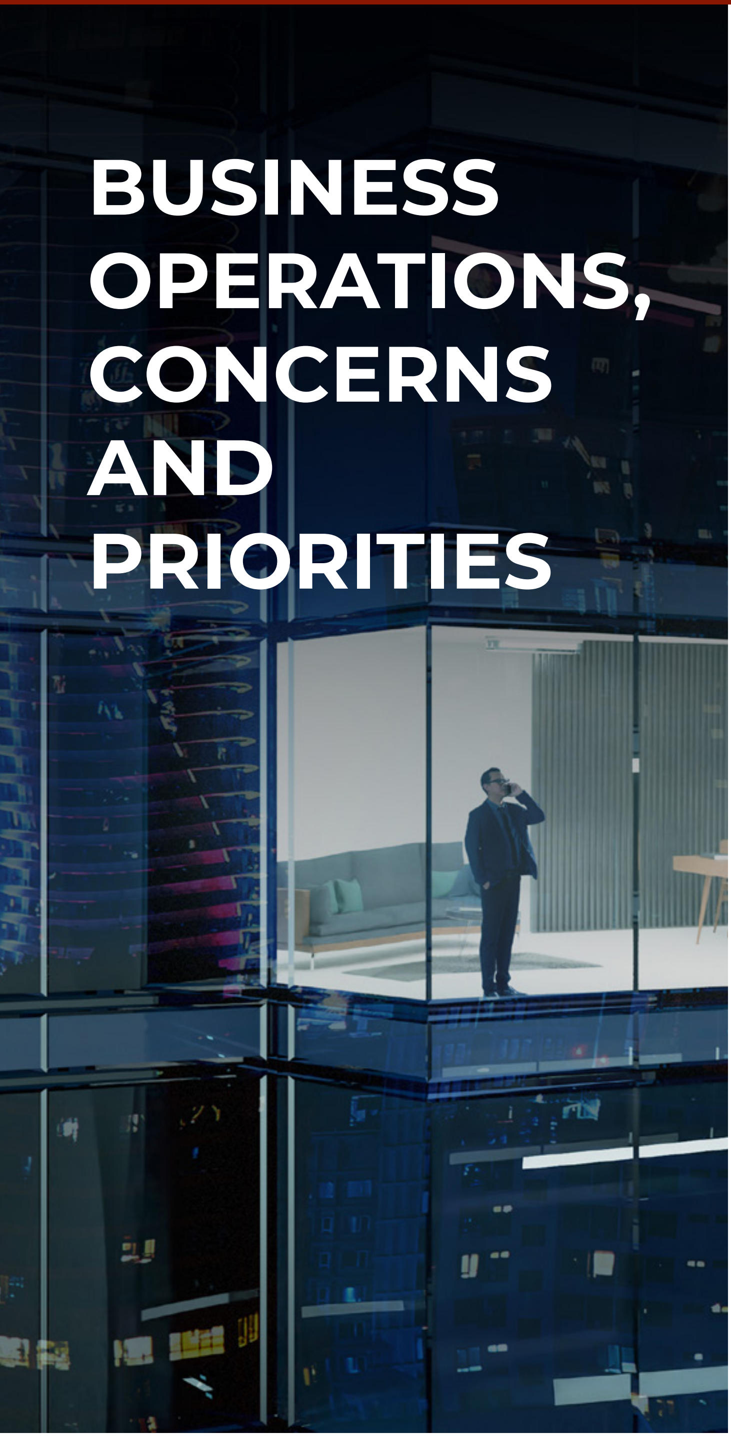
A further 25.3% outline interest rate risk as a key issue.

Q23. What are your annualized return expectations, broadly speaking, for this asset class?



Q24. What do you regard as the single most important risk to private credit markets this year?





BUSINESS OPERATIONS, CONCERNS AND PRIORITIES

When considering investor concerns and apprehensions more broadly, credit risk remains the topmost worry among respondents as 29.1% highlight this as being very important when considering their portfolio. Inflation risk is also on the mind of a quarter of respondents (24.7%).

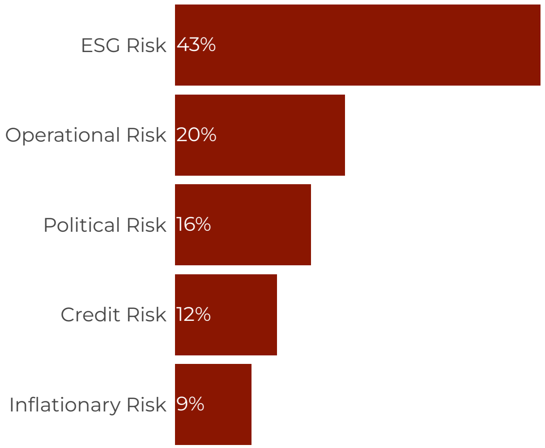
Though not the primary issue, operational risk is also cited by around a fifth of respondents (22.5%) as a factor which keeps them up at night.

Discussing the risks present in the private credit market, rating agency Moody's outlined concerns related to potential systemic risk in the space. "The opacity and growing scale of the private credit market make it possible for asset quality deterioration to advance rapidly – below the regulatory radar – and build to such an extent that cascading risks cannot be easily or quickly remediated," the report said . It also refers to, "Risks that are rising beyond the spotlight of public investors and regulators may be difficult to quantify, even as they come to have broader economic consequences."

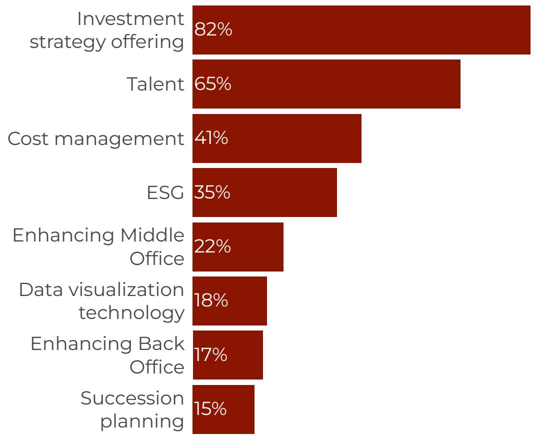
Therefore, investors have been cautioned to navigate the continued

> Investors should employ "differentiated sourcing advantages, expertise in fundamental analysis and a disciplined and consistent underwriting approach."
>
> **JP Morgan Asset Management**

Q7. When considering your portfolio and looking forward over the next 12 months, what keeps you awake at night?



Q15. What are your top three priorities?



> A robust loan administration function provides a solid foundation for private credit managers' future growth
> **AIMA**

evolution of private markets by employing, "differentiated sourcing advantages, expertise in fundamental analysis and a disciplined and consistent underwriting approach. This approach to investing, coupled with the floating rate nature of many private credit assets, should serve market participants well in the year ahead," notes JP Morgan Asset Management in its Private Credit Outlook.

Investor priorities reflect a myriad of objectives as they seek to diversify the strategies they offer, identify and retain talent and manage their cost.

The diversification or expansion of investment strategy offerings are revealed as investors' main priority with 80.9% saying this is their most pressing task. Talent is also a critical factor they are paying attention to as 66.3% outline this as their top priority – making this issue the second most prevalent mission among respondents. In third is cost as managing this aspect of the organisation is highlighted as a priority by 40.5% of respondents.

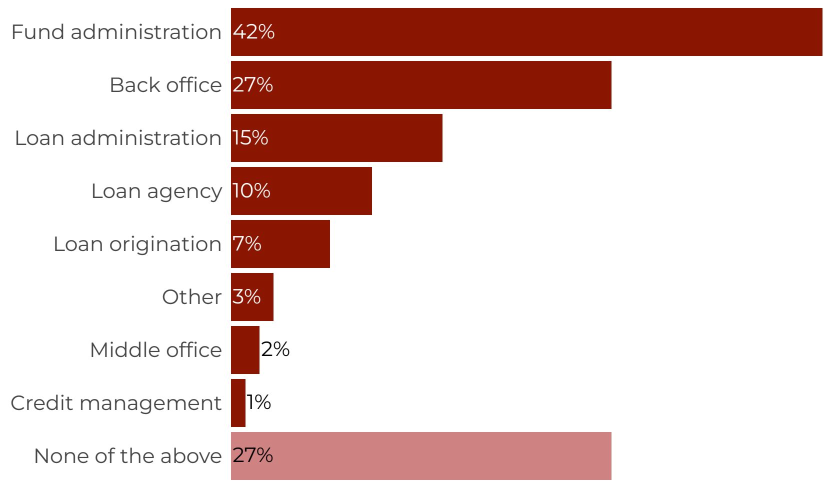
Outsourcing is often viewed as a tool to ease operational pressure. Fund administration is the main area earmarked for outsourcing as 39.3% of respondents say they can see themselves delegating this task to a third party.

Further, the prevalence of loan fund administration is also growing. A report by AIMA outlines how the operational infrastructure of private credit is still maturing and a manager's loan administration capabilities can provide a competitive edge: "A proper loan administration function allows private credit managers to easily and effectively monitor and manage their loans—a significant challenge in an industry that uses paper-based documentation and revolves around non-standard loans.

"A robust loan administration function provides a solid foundation for private credit managers' future growth, and allows them to balance that growth with the need to provide clients with bespoke lending solutions."

Some resistance to outsourcing more broadly persists as 27.0% say they will either not outsource any of the tasks under review or will keep everything in house.

Q6. With regards to your future operating model, which of the following do you envisage outsourcing?



ESG

Sustainability and environment, social and governance (ESG) factors have risen to the top of investors' agendas. The alternatives space has largely lagged the broader investment industry on these matters. However, investors are now facing significant regulatory and stakeholder pressure while more imminent ESG threats such as the real-world impacts of climate change, have kicked into high gear. As a result, this approach to investing is also taking hold in the private credit arena.

"Investors have become particularly focused on environmental sustainability, a potential win-win for private markets investors who support positive impact while driving returns. Firms can create value by transforming unsustainable business models into green ones and investing in companies scaling decarbonization technologies," says consultancy McKinsey.

The growing momentum in ESG within the private asset space is clear as the majority of respondents have incorporated these criteria into their investment decisions (49.4% do so across the board and a further 21.7% have integrated these factors to some extent).

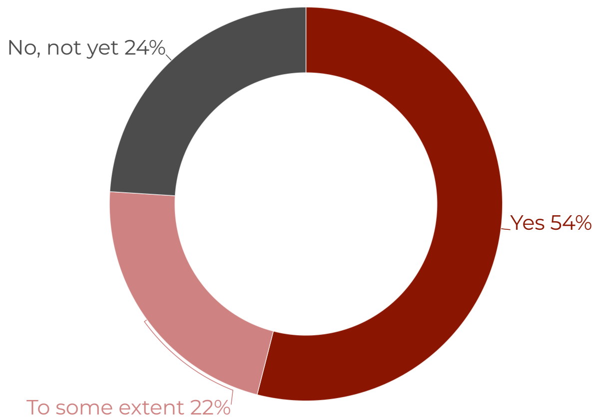
"Applying an ESG lens in private markets can add value for private equity investors while protecting lenders from default risks," writes Churchill in its private credit outlook, published in the first quarter of 2022 .

The data challenges within ESG investing are well-documented across the industry. These are, arguably more evident in private debt than they are in the public equities space.

Within public equities, several initiatives and frameworks have been put in place to move the industry towards standardised reporting, with third party ratings and outsourced providers also assisting in these endeavours.

"Integrating ESG considerations in the investment

Q16. Has your firm incorporated ESG criteria in its investment decisions?



process allows to build a more comprehensive risk framework that looks at long-terms risks which might otherwise escape some of the short term considerations typical of conventional risk assessment," outlines Flavia Micilotta, Director ESG Solutions, Fund Services at TMF Group.

Data collection and analysis in private assets is still in the early stages of development. The survey reveals almost half (49.4%) use their own internal or proprietary questionnaire to gather data from their portfolio companies. However, a further 31.3% have not yet chosen a way of tackling this.

"We've seen a lot of change over the past few years as lenders and investors have been gathering data and monitoring borrowers through more of a sustainability lens. This development has been happening quite rapidly in private credit, but we're also seeing it across the liquid credit markets, including in areas such as high-yield bonds and leveraged loans," observes Sonia Rocher managing director, private strategies, BlackRock.

An article by law firm McDermott Will & Emery details: "Various metrics demonstrate that businesses with an ESG focus have shown resilience throughout Covid-19 and are outperforming other businesses year on year. It is not always the obvious businesses that have an ESG focus. A deep dive into a company's credentials often shows that they do pursue sustainability campaigns, even if their business model doesn't immediately suggest them as being a leader in ESG."

In view of this, assessing the impact of ESG evaluations is critical.

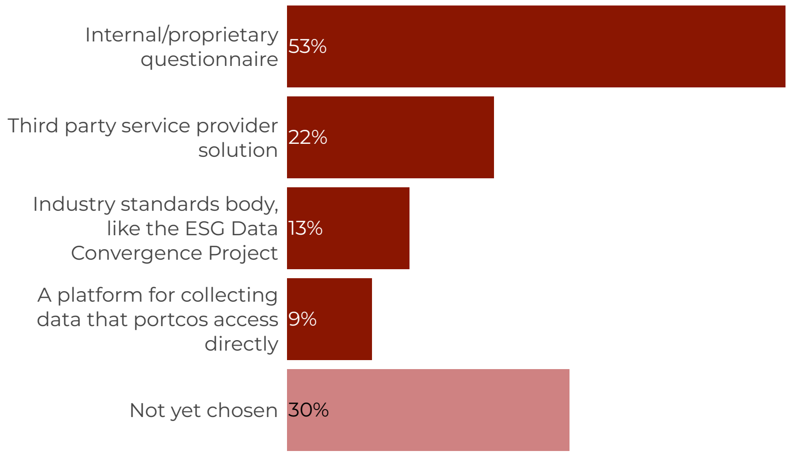
The reactions to this question were mixed given around a fifth of respondents sit at the opposite ends of the spectrum with 21.7% saying the impact of an ESG evaluation is significant while a further 22.9% say it is low. The largest portion of respondents are more ambivalent saying this assessment has a medium effect.

In a further demonstration of ESG still trailing in this area, 15.7% of respondents find ESG evaluations to not be relevant.

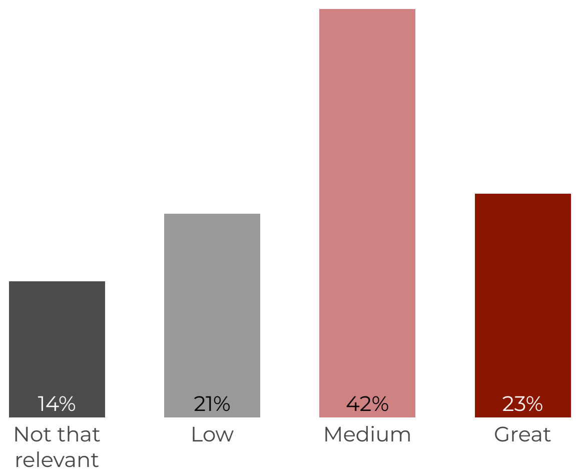
"Having a good overview of how companies are able to manage risks and opportunities, which arise from ESG, offers a perspective of how resilient a business is. A good quality evaluation of that is only possible if the data flow from companies to their investors is happening smoothly and the quality of the metrics looked at is truly significant and impactful," notes Micilotta.

Investors and portfolio companies are often highly burdened by

Q17. What internal or external solutions do you use for gathering ESG data from portfolio companies?

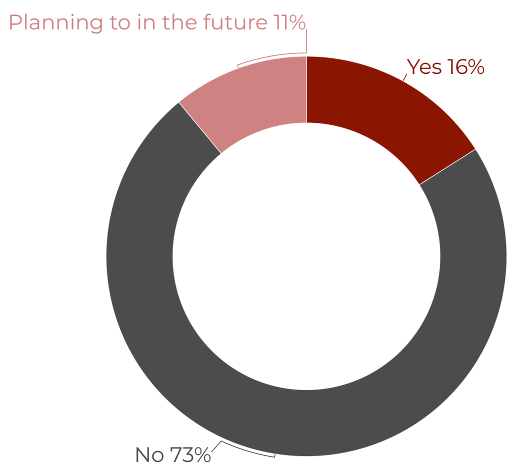


Q18. How would you assess the impact of a positive or negative ESG evaluation for investment decisions?



> The cost of keeping up with the latest back-office technology can be prohibitive
> **Jeremy Hocter, MD, Holland Mountain**

Q19. Do you outsource the ESG due diligence process?



administrative processes. And despite the potential upside of using ESG metrics to assess investment opportunities, no investor would realistically welcome additional reporting requirements.

This has given rise to outsourcing this process to third parties. However, the data reveals this practice is still in its infancy. Just 18.1% current outsource the ESG due diligence process with an additional 10.9% saying they plan to do so in the future. The vast majority (71.1%) still manage this process internally.

The McDermott, Will and Emery article outlines challenges when using ESG as a metric for investment: "For example, due to the way private debt transactions are underwritten and diligenced, lender education and diligence processes are relatively light on ESG specifics and such targeted diligence is rarely commissioned. A number of specific sectors may require certain environmental reports, but these aren't generally common. This gap at the diligence stage hinders private debt's ability to create more uniform reporting requirements and can be at odds with investors who require asset managers to demonstrate that they have considered certain ESG-related diligence on investments."

Jeremy Hocter, managing director at Holland Mountain writes in a thought-leadership piece: "The speed of technological improvements and demand for the latest systems can lead even the larger private funds houses to look more favourably at outsourcing opportunities. The cost of keeping up with the latest back-office technology can be prohibitive, and the time and effort required to implement and fully embed a new system often ends up as an unwanted distraction." However, he goes on to point out how outsourcing could potentially create an additional layer of complexity due to the simple fact of having more people, systems, processes and data included in the process. Considering the data challenges within the ESG space, this could be one of the drivers which has stopped private credit investors from delegating this task to a third party. But this could also be because this approach is not yet of highest priority.

PORTFOLIO MONITORING AND TECHNOLOGY

Moving beyond ESG-specific metrics, private credit investors are rigorous about monitoring the performance of their loan portfolio.

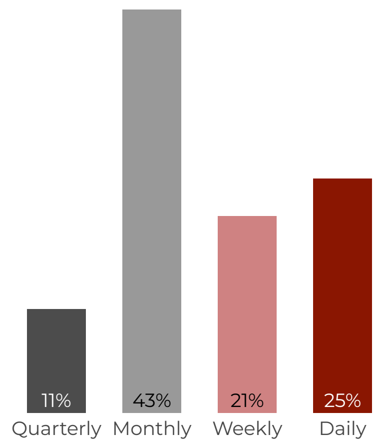
Monitoring performance of loan portfolios is of critical importance considering around a quarter of investors (25%) carry out this exercise on a daily basis. A further fifth (20%) monitor their loan portfolio's performance weekly.

Over half monitor the performance of their loan portfolio less frequently with 46% doing so every month and 9% every quarter.

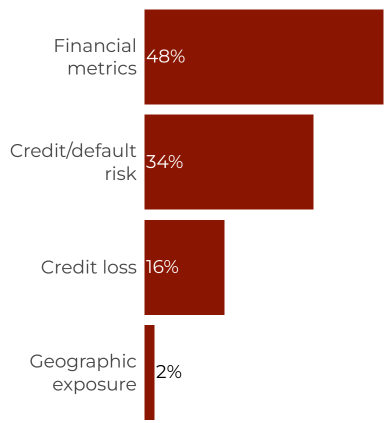
Keeping a close eye on performance can help investors reduce risk. In an article , Peter Salvage managing director credit risk solutions at BNY Mellon and Frances Barney, managing director head of global risk solutions explain that the Covid-19 pandemic has put additional pressure on credit and debt managers when it comes to measuring and reporting risk and performance. "If you and your shop can get this right, it can have a major positive effect on your daily experience, your investor communications, your costs and most importantly your track record," they say.

Managing a private debt portfolio involves many dimensions of complexity. These not only include the minutiae of the loans themselves, but also overarching data and reporting requirements. In view of this, technology solutions can drive efficiency and scalability while allowing the investment managers to focus on the value-add they provide to their clients. According to asset owners cited in the aforementioned AIMA report, technology

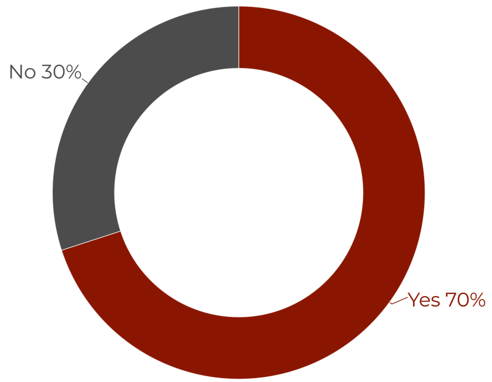
Q9. How often do you monitor the performance your loan portfolio?



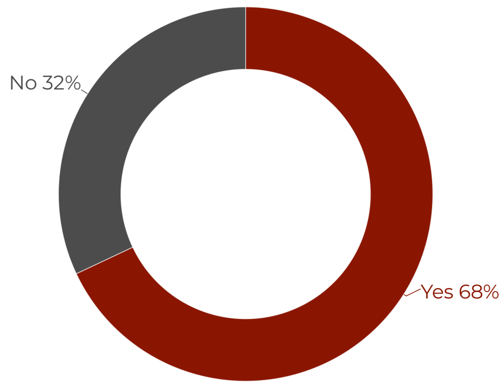
Q11. What are you most focused on when you are monitoring your investments?



Q10. Do you use technology to monitor the performance of your portfolio?



Q12. Are you looking to leverage technology to dynamically monitor your portfolio?



can provide improved transparency, product availability and higher quality data.

Financial metrics are the key focus of 47.2% of investors' portfolio monitoring exercises. A further third (34.8%) focus on credit or default risk. This mirrors the earlier finding which shows default risk is the prevalent concern among investors.

Respondents use a variety of methods to monitor the performance of their loan portfolio. The most prevalent, used by three quarters of investors (75.3%) is through regular discussions with management. Seven in 10 (70%) also review period company reports and two thirds conduct internal modelling.

This illustrates there is no single methodology which stands out in terms of the way performance is assessed. The fact that conversations are the topmost method applied also speaks to the highly qualitative nature of the aspect of private credit investing.

This qualitative dimension could preclude investors from using technology solutions in the private credit space. However, as technology and digitisation tools advance, private credit investors appear to be taking advantage of these developments. The majority (70.8%) are using technology to monitor the performance of their portfolio.

The McKinsey report highlights: "Natural-language processing tools are capable of ingesting and analysing written documents, including financial statements and memos, which can be particularly valuable in portfolio monitoring applications. A tool that collects data on portfolio-company performance from management statements, for instance, can facilitate faster and more efficient LP reporting."

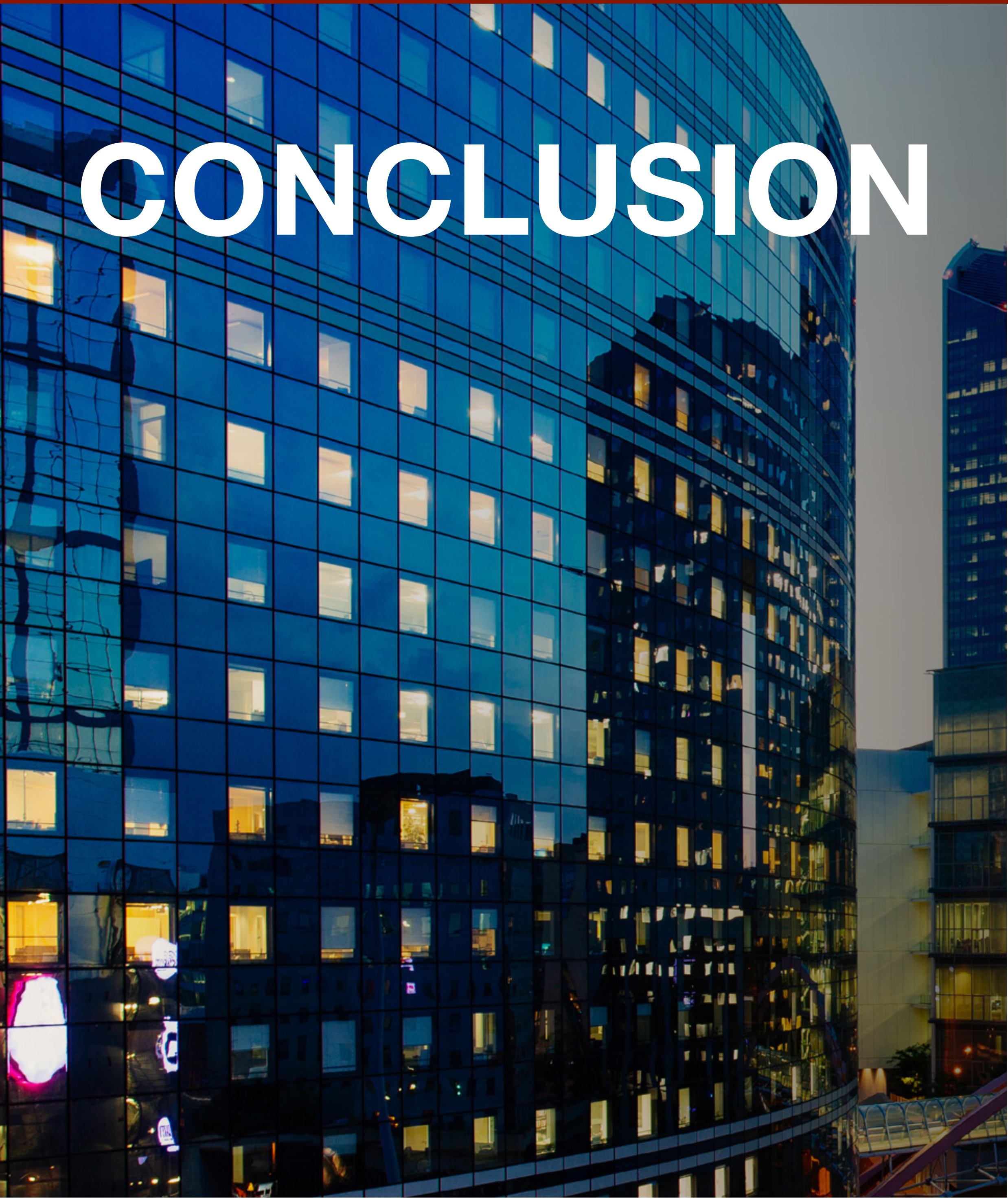
The deployment of technology solutions could be supporting the in-house methods investors are using to track the ESG characteristics of their investments, for example.

"For managers whose alternative investments tend to thrive during periods of market volatility or uncertainty, being able to accurately measure their positions by using scalable, comprehensive analytics is one of the most important factors in distinguishing a firm in what has become a crowded field," write Salvage and Barney at BNY Mellon.

And many are planning to take this further as 68.5% are looking to leverage technology to dynamically monitor their portfolio.

Digitisation, and with it the introduction of technology solutions, has allowed the alternative asset management industry to elevate its investment processes and thus provide a superior service to investors.

"Leveraging technology to optimise back office operations and to enhance performance data gathering allows GPs to focus their time on value added matters, while improving the standard of information available for LP reporting," says Andrew O'Shea, Global Head of Funds Services TMF Group, adding they look to TMF for a scalable tech platform to administer their debt portfolios and, increasingly, for a means of gathering consistent, quantative, performance data."



CONCLUSION

As the outlook for various large developed markets remains choppy, investment in private credit is bound to maintain its appeal.

The majority of investors are planning to increase their allocation to these assets although performance expectations are considerably cautious. The potential for broad defaults is the primary risk which could impact these returns, according to investors. While interest rate risk and geo-political concern are also causing apprehension.

The war in Ukraine is fuelling new risks, volatility and uncertainty, leading to rises in energy prices and supply chain disruption. However, broadly, private capital managers do not expect a significant, direct impact on portfolios.

Rising inflation and interest rates are likely to have greater repercussions on private debt portfolios. Investors may seek to benefit from certain characteristics the asset class offers such as variable interest rates and higher yields to offset volatility. The illiquidity premium these assets command can also assist in this regard.

Despite the risks, the industry has witnessed tremendous growth and development in the way the asset class functions. Managers are looking to diversify the strategies they offer, a plan which is also supported by increasing incidence of outsourcing elements like fund administration. The use of technology will further elevate the service managers provide their clients and see the private debt industry move beyond manual and highly qualitative processes to a model which is scalable and replicable.

The greater incorporation of ESG factors within the private debt space is another element which demonstrates the progress of the asset class. Although challenges around data gathering still exist, most investors now apply ESG criteria when making investment decisions.

This report shows the private debt asset class is expected to continue on its upward trajectory. Through managers' efforts in broadening their scope, investor appetite for these strategies and increasing support from service providers the private debt arena promises to provide confidence in the allocations made here.

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