Private Debt

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2 Disclaimer

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4 List of Abbreviations

Where abbreviations are jurisdiction specific, the relevant jurisdiction is shown in brackets and where it is unclear as to what an abbreviation may refer, further information is shown in brackets.

AAL, Agreement Among Lenders
ACS, Authorised Contractual Scheme (United Kingdom)
AIF, Alternative Investment Fund (European Union)
AIFMD, Alternative Investment Fund Managers Directive (European Union)
AIFM, Alternative Investment Fund Manager (European Union)
AML, Anti Money Laundering
ARR, Annual Recurring Revenue
ASC, Accounting Standards Codification (United States)
BDC, Business Development Company (United States)
CDLI, Cliffwater Direct Lending Index
CFT, Countering the Financing of Terrorism
CLO, Collateralised Loan Obligation
DTTP, Double Tax Treaty Passport
DSCR, Debt Service Coverage Ratio
EBA, European Banking Authority (European Union)
EBITDA, Earnings before Interest, Tax, Depreciation, and Amortisation
EEA, European Economic Area
ELTIF, European Long-Term Investment Fund (European Union)
ESG, Environmental, Social, and Governance
ESMA, European Securities and Markets Authority (European Union)
€STR, Euro Short-term Rate
GAAP, Generally Accepted Accounting Principles
GAV, Gross Asset Value
GDP, Gross Domestic Product
GDPR, General Data Protection Regulation (European Union)
GP, General Partner
HMRC, His Majesty's Revenue and Customs
IFRS, International Financial Reporting Standards
ILP, Investment Limited Partnership
IRR, Internal Rate of Return
KYC, Know Your Customer
LBO, Leveraged Buy-Out
LPA, Limited Partnership Agreement
LP, Limited Partner
LTAF, Long-term Asset Fund (United Kingdom)
LTV, Loan to Value
M&A, Mergers and Acquisitions
MFN, Most Favoured Nation

NAV, Net Asset Value
OEIC, Open Ended Investment Company (United Kingdom)
OTC, Over the Counter
PIK, Payment-in-Kind
RCF, Revolving Credit Facility
RTS, Regulatory Technical Standards (European Union)
SaaS, Software-as-a-Service
SCL, Subscription Credit Line
SEC, Securities and Exchange Commission (United States)
SOFR, Secured Overnight Financing Rate (United States)
SPV, Special Purpose Vehicle
U.K., United Kingdom of Great Britain and Northern Ireland
U.S., United States of America

5 Executive Summary

The focus of this paper is mainly on private debt funds structured as closed-ended, collective investment vehicles in the form of investment limited partnerships for institutional investors.

In private debt lending, the lender is not a bank but rather a private debt fund or asset manager; the borrower is typically a non-investment grade company which is not listed on a public stock exchange; the debt is not traded on a public exchange; and the loans are generally senior secured.

The appeal of private debt funds to institutional investors is multi-faceted and includes: (i) a desire to receive what might be a reliable stream of income because of private debt lender's focus on the most senior part of corporates' capital stack; (ii) an illiquidity premium which is higher than that for the same risk in public markets; (iii) a preference for the lower volatility offered by private debt funds relative to public debt markets; and (iv) the floating rate of interest which provides a measure of protection against inflation and interest rate risk relative to fixed rate lending.

Apart from other private debt lenders, the main sources of competition for private debt lenders are the high yield fixed income markets of the United States of America ("U.S.") and Europe and the floating rate leveraged loan market. Private debt lenders can in general: (i) execute faster and provide more flexible terms than banks albeit at a higher cost in terms of the margin over the floating rate of interest; and (ii) provide greater transaction privacy relative to public markets.

The demand for private debt loans comes from private equity firms engaged in leveraged buyouts, from both private equity firms and companies engaged in bolt-on acquisitions in mergers and acquisitions, refinancing of existing borrowings, growth financing, and dividend recapitalisations. Looking to the supply side, in the last two years, more than twenty asset managers that have either launched a private debt lending operation or bought one.

As of September 2023, the gross annual yield on a portfolio of senior secured private debt loans is likely to be 12% or more. Returns of 12% or more are equity-like returns, yet they are returns for investing in the senior secured part of the capital stack of companies provided loan losses can be avoided. The current gross annual unleveraged yield on a portfolio of senior secured private debt loans is historically high. It reflects the current historically high reference rates[1] and a somewhat higher spread than normal.

The performance of the Cliffwater Direct Lending Index[2] ("CDLI") provides an indication of the historic pattern of returns from private debt lending. In the calendar years from 2005 to

[1] Examples of reference rates include the secured overnight financing rate ("SOFR") in the US and the euro short-term rate ("€STR") in the Eurozone.

[2] Source: Cliffwater 2023 Q2 Report on U.S. Direct Lending.

2022[2], the total return on the CDLI ranged from a low of -6.5% (2008) to a high of 15.79% (2010) and had an average annual return of 9.31%.

While the 'higher for longer' interest rate environment is likely to lead to losses on loans, the historic performance of the Cliffwater Direct Lending Index[3] provides some pointers as to the potential size of realised credit losses. In 2009, they hit a high of 6.91%. Over the three calendar years 2008, 2009, and 2010, cumulative realised credit reached 10.16%. More recently, in 2020, the COVID-19 era, realised loan credit losses reached 3.30%. Long-established private debt firms with experience across a number of credit cycles and in managing workouts are perhaps likely to suffer lower losses than the more than twenty asset managers that have either launched a private debt lending operation or bought one in the last two years.

Private debt lending is increasingly expanding beyond senior secured loans and now provides: (i) stretched senior loans combining elements of both traditional senior debt and mezzanine financing[4]; (ii) unitranche loans, a single loan agreement removing the need for separate senior and separate mezzanine facilities; (iii) mezzanine loans; (iv) payment-in-kind loans which grant the borrower the option to make an interest payment in cash or to increase the amount of the loan by the interest payment; (v) unsecured debt; and (vi) distressed debt.

Unlike shareholders, debt holders have limited upside. Underwriting mistakes that lead to loan losses are expensive in terms of their impact on returns. Loan underwriting is now more important than at any time in the last 15 years or so given that those years were predominantly characterised by historically low interest rates. The main areas of focus of the private debt fund manager in underwriting a loan are likely to be the industry sector in which the borrower operates, the borrower's cash flow, the quality and stability of the borrower's business, and the strength of the loan covenants that can be negotiated.

When measured as a percentage of expected return, relative to exchange traded funds, fees for investing in private debt funds are relatively high possibly reaching as high as 25% of expected return.

With the advent of Long-term Asset Funds in the United Kingdom of Great Britain and Northern Ireland ("U.K.") and the European Long-term Investment Fund in the EU, the opportunity to invest in private debt funds is increasingly opening up to retail investors.

While banks are competitors of private debt funds in the provision of loans they also play a role in private debt funds by providing loans for leverage or subscription credit line funding to private debt funds.

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[3] Ibid.

[4] Mezzanine loans combine features of debt and equity and sit between a company' senior debt and its equity in terms of priority for repayment in a winding up. They allow already highly leveraged borrowers to raise capital without diluting existing shareholders' equity and without taking on more senior debt. Interest rates on such loans are higher than for senior debt to compensate the lenders for the risk. Lenders may acquire company equity via, for example, warrants to give them an element of upside if the company performs well. Private equity firms may use mezzanine capital to finance leveraged buyouts or to fund the growth plans of a company for which they act as sponsor.

Climate change risk and environmental, social, and governance ("ESG") factors are increasingly integrated into the credit risk underwriting process employed by private debt fund managers when evaluating potential borrowers. The purpose of such integration is to identify climate change risk and ESG factors that could potentially lead to a loss on a loan. The integration is likely to focus on the industry sector and within that sector the potential borrower with the aim of identifying exposures, considering their financial impact, and, where the exposures are capable of being mitigated at reasonable cost, assessing the commitment of the potential borrower's management team to mitigate the identified climate change risks and ESG factors.

Absent fraud, reports of a company's cashflows are probably one of the best barometers of its financial health. The higher the frequency of reporting of cashflows by borrowers the earlier and more likely a private debt fund manager will identify an obligor with a deteriorating creditworthiness.

Scale is a key competitive advantage and a barrier to entry to the private debt market and one that can help to limit mistakes that lead to credit losses. Scale encompasses sourcing of deals from attractive sectors, availability of capital to lend, deep and long-standing relationships with private equity firms and real estate professionals, underwriting experience, access to finance for leverage, access to industry experts, and having a highly experienced team of professional to resolve problem credit situations.

There has been a growing level of scrutiny of private debt funds by a number of central banks around the world in relation to the lack of visibility of concentration risks, liquidity risks, and synthetic leverage risks[5] and whether private debt funds pose systemic risk.

Careful tax planning is required in private debt lending, particularly in cross-jurisdictional lending. Unanticipated withholding taxes which are not reclaimable under any double taxation treaty between the two jurisdictions: (i) will reduce the IRR on a loan for a private debt fund; and (ii) may result in over hedging by any forward foreign exchange hedging transactions that were put in place before the discovery of the withholding tax issue.

In annuity reinsurance deals, cedants accepting private debt funds as collateral may be able to obtain a more competitive reinsurance price but this must be considered in the light of the potentially higher costs of valuing the collateral on a monthly basis.

The lack of reliable and standardised data available in private debt markets is making it difficult to compare private debt funds and integrate private debt into a wider portfolio of assets. The current state of data in private debt markets is likely to cause a typical investor to have to

[5] Synthetic leverage risks are risks associated with the use of derivative instruments to amplify returns beyond what would be possible from the use of the investment capital subscribed by investors in the fund. The risks include counterparty risk, liquidity risk, market risk, and for some types of derivatives the risk of unlimited loss.

engage in a significant amount of manual work to provide its underlying clients with geographical and sector exposures to private assets within their portfolio.

6 Private Debt – Definition

In private debt, the lender is a private debt fund, a large asset manager, an institutional investor, a wealthy individual, or a private company rather than a bank. The word *private* is used to indicate that the debt is not traded on public exchanges.

In this paper, we focus mainly on private debt funds that raise capital from institutional investors through collective investment vehicles such as closed-end funds and make, typically, senior secured loans directly to non-investment grade companies which are generally not listed on a stock exchange. Some private debt funds engage in mezzanine lending, distressed debt lending, and lending to special situations. Special situations lending generally involves lending to companies in financial distress often with the aim of taking control of the company using financial instruments such as convertible debt and a combination of debt and warrants.

7 Introduction

There has been a rapid growth in private debt or non-bank lender finance in the years since the global financial crisis. According to Preqin[6], a data provider, assets under management in the private debt market are expected to reach USD2.8 trillion by the end of 2028, up from an estimated USD1.6 trillion in 2023.

The growth in the private debt asset class has been underpinned:

- On the supply of capital side:
  - Up until the beginning of 2022, by falling interest rates which have driven institutional investors to look for illiquidity premiums in asset classes like private debt in the search for higher risk-adjusted yields than traditional fixed income securities offered;
  - In more recent times, the floating-rate nature and the seniority of private debt loans in the capital structure of borrowing companies has become particularly attractive to institutional investors in the current 'higher for longer' interest rate environment; and
  - There has been a reduction in finance available to middle market companies[7] from the banking sector due to the imposition of higher regulatory capital requirements and tighter lending criteria on banks under the Basel III and Basel IV accords. This supply constraint led companies to look for alternative sources of finance.

- On the demand for capital side:
  - Demand from middle market companies has been rising as private equity firms have been acquiring such companies using a combination of equity and debt finance to fund the acquisitions. Debt finance allows private equity firms to acquire companies with less of their own capital and has the potential to amplify the return on their equity. The assets of the target company are pledged[8] as collateral for the debt.

Private debt now plays a fundamental role in global loan markets. It is particularly in demand when borrowers require bespoke financing structures for specific investment opportunities and when private equity firms seek new financing structures that require bespoke financing solutions. Private debt lenders have responded to this demand with a wide range of debt finance

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[6] Source: Private credit boom will trigger a new squeeze. https://www.ft.com/content/b8e151c7-7302-4464-bc49-5091df86ec40 Accessed: 29 December 2023.

[7] In the United States, middle market companies are loosely defined by reference to their annual revenues. Middle market companies are companies which have revenues the range USD10 million to USD1.0 billion.

[8] Pledging the ownership of the assets to a lender allows the asset owner to retain economic rights in the asset unless a default under the borrowing agreement triggers a transfer of ownership to the lender. When the loan defaults, the lender then has the right to seize the assets, sell them, and use the proceeds to recover funds owed. Private debt lenders often require a pledge agreement spelling out terms and conditions such as restrictions on selling or transferring the pledged assets. A pledge is registered so it is enforceable even if the assets are later sold.

solutions. The U.S. private debt market is underpinned by institutional investors with long-term locked-in capital which are not required to mark their positions to market.

Some private debt firms provide loans to small U.S. companies, those with 12-month trailing earnings before interest, tax, depreciation and amortisation, ("EBITDA") of USD 5.0m or less, as they see banks becoming increasingly reluctant to lend to this segment of the market due to the costs involved in doing so and regulatory constraints. The loans may be for purposes such as the financing of real assets, working capital, or invoice factoring[9]. Private debt firms in this segment of the U.S. market argue that the lending is both short term and asset backed which underpins a high recovery rate in the event of default of the borrower.

7.1 Private Fund Lending Rate

Private debt funds generally charge a rate of interest on borrowed money equal to several hundred additional basis points, a spread, over a reference floating rate of interest. The spread charged by private debt lenders increases in times of greater economic uncertainty.

Secured Overnight Financing Rate ("SOFR") and euro short-term rate ("€STR") are examples of reference floating rates of interest. SOFR is the average rate at which institutions can borrow U.S. dollars overnight while posting U.S. Treasury bonds as collateral. Similar to a mortgage rate, SOFR is a secured borrowing rate in the sense that collateral is provided in order to borrow cash. Euro short-term rate ("€STR"), reflects how much banks located in the euro area must pay when borrowing money overnight from various financial counterparties ***without*** providing collateral.

7.2 Return & Risk Characteristics

Private debt returns are generally more income based than capital gains based. At the beginning of 2022, the gross annual yield on a private debt loan was of the order of 6% to 7% while the net-of-cash leverage of the borrowers, a measure of the risk of loan losses, might have been of the order of 6 times earnings before interest, tax, depreciation, and amortisation ("EBITDA"). At the time of writing, September 2023, the gross annual yield is likely to be 12% or more while net-of-cash leverage has reduced significantly.

Returns of 12% or more are equity-like returns; yet they are returns for investing in the senior secured part of the capital stack of companies provided loan losses can be avoided. The current gross annual unleveraged yield on a portfolio of senior secured private debt loans is historically high. It reflects the current historically high reference rates[10] and a somewhat higher spread than normal.

[9] Invoice factoring involves the purchasing of one or more outstanding invoices from the borrowing company for a fraction of the invoice amount with the private debt lender collecting payment from the borrowing company's customers at a later point such as within one to three months. Once the customer pays the private debt lender, it pays the remaining amount to the borrowing company. The private debt lender might charge a fee of the order of 3% of the face value of the invoice amount for providing the service.

[10] Examples of reference rates include the secured overnight financing rate ("SOFR") in the US and the euro short-term rate ("€STR") in the Eurozone.

Rising interest rates also have a downside as they are likely to lead to an increase in defaults on loans. Thus, for private debt fund managers, it is important not to lose the additional spread over the reference floating rate to loan losses.

Generally speaking, private debt is a floating rate asset class thus dampening the risk for investors of rising interest rates and providing investors with real returns in environments of higher inflation and recession.

Private debt funds generally lend to private, non-investment-grade companies and seek to mitigate the risk of such exposures through loan underwriting, loan covenants[11], diversification of lending across industry sectors, active monitoring of loan portfolios, and where required use of specialist workout teams to minimise loan losses.

To the extent that a private debt fund relies on leverage to potentially enhance returns, increases in borrowing costs for the leverage or reduced access to leverage are likely to impact its performance.

For investors in a private debt fund, the three detractors from returns are: (i) fees; (iii) an inability to originate high quality loans; and (iii) loan losses. The latter are magnified in the case of private debt funds relying on leverage in the hope of enhancing returns.

At the time of writing, despite one of the steepest rises in interest rates in decades, apart from the deterioration in the credit risk of commercial real estate loans, signs of credit deterioration are modest outside of idiosyncratic cases where a company's business model has been destroyed by rising inflation or rising raw material costs. A majority of companies have been able to pass on rising costs to customers. However, if interest rates remain at current levels, the EBITDA of an increasing number of borrowers rated B and below is unlikely to be sufficient to cover the interest bill.

7.2.1 Default – Depends on One's Definition

Court supervised bankruptcies, for example, Chapter 11 in the U.S., are very expensive processes and can end up destroying value for both borrowers and lenders. For those reasons, most borrowers and lenders tend to avoid court supervised bankruptcies if at all possible. Defining default as a court supervised bankruptcy is likely to give a relatively low rate of default.

If one defines default to also include alternatives to court supervised bankruptcy such as working with creditors and shareholders in a broadly consensual way to reorganise finances and operations without a formal court supervised bankruptcy, one will arrive a much higher rate of default.

[11] A borrowing covenant is a condition in a loan agreement that requires the borrower to fulfil certain conditions or which forbids the borrower from undertaking certain actions, or which requires the borrower to maintain certain financial ratios. If the borrower breaches a borrowing covenant without cure, the lender can call in the loan and demand full repayment of the outstanding balance.

Alternatives to court supervised bankruptcies include:

(i) Companies raising new equity capital or selling assets to pay down existing debt. While raising new equity capital dilutes ownership, it can substantially reduce a company's debt burdens.

(ii) Negotiating with the company's creditors to exchange existing debt which is nearing maturity for new longer-term debt thereby reducing the company's short-term debt burden giving it more time to improve cash flows.

(iii) Reorganising the existing capital structure of a company by, for example, exchanging existing debt for equity through a debt-for-equity swap or issuing new equity through a rights issue to pay down debt.

The alternatives outlined at (i) and (ii) change the debt-to-equity ratio, reduce leverage, and interest costs.

7.2.2 Opportunity to Manage Risk in Distressed Scenarios

If, for example, the leverage of the borrower spikes to the point where a loan covenant is triggered, the private debt lender and the owner or private equity sponsor are both incentivised to resolve the situation. This may involve, for example, equity capital being injected into the company and the private debt lender delaying interest charges in return for being able to charge more later when the company recovers. Compared with, for example, high yield bonds, there is a much greater opportunity to manage risk in private debt in distressed scenarios.

7.3 Regulation of Private Debt Lending

Broadly speaking, in the EU and the UK, commercial lending is not an activity that requires authorisation from a regulatory body. However, some jurisdictions have local law requirements and restrictions relating to the provision of credit by private debt firms.

The European Banking Authority ("EBA") has drawn attention to the fact that when no licensing regime is in place for certain non-bank lending activities, these may not be subject to Anti-Money Laundering ("AML") requirements.

The EBA has proposed to the EU Commission that all non-bank lenders throughout the EU be subject to AML legislation. However, when lending is done by a private debt fund such as an Alternative Investment Fund ("AIF"), the AIF is required to ensure that the borrower is screened for and passes AML and Countering the Financing of Terrorism ("CFT") checks.

7.4 Private Debt v. Bank Lending

To provide an introduction to private debt lending, we start by comparing and contrasting private debt lending with bank lending as readers tend to be reasonably familiar with bank lending. Table 1 below compares bank lending with private debt lending under a range of headings.

Table 1

Criterion	Borrowing from Bank	Borrowing from Private Debt Lender
Borrower	Banks tend to avoid smaller firms with few tangible assets and unsophisticated accounting systems. The latter makes a bank's due diligence difficult.	More focus on firms that are poorly served by banks. Such firms tend to be 'smaller'[12] firms which lack tangible assets, lack sophisticated accounting systems and which banks classify as risky borrowers.
Average Rate of Interest Charged	Bank loans are likely to charge lower interest rates probably due to the perceived strength of their borrowers' credit profiles.	Private debt lenders charge higher interest rates than banks partly because they are lending to borrowers who might not qualify for bank loans.
Flexibility	Although banks go through cycles of conservative and aggressive lending, their lending terms and conditions tend to be standardised. Banks may be somewhat reluctant to negotiate on certain aspects of their lending terms and conditions.	More likely to customise a loan to the needs of the borrower in terms of loan structure, repayment terms, and covenants. For example, private debt funds are more likely to facilitate such features as: (i) variable loan drawdowns; and (ii) loans that do not amortise over the loan term, rather the principal is repaid at the end of the loan term, a bullet structure.
Collateral Required by Lender as Security for Loan	Banks generally require collateral to secure a loan. Acceptable collateral tends to be restricted to tangible assets.	Private debt funds may be more flexible as to the types of acceptable collateral and may provide debt across the capital structure from senior secured through, second lien, to mezzanine and other quasi-equity structures.
Approval Process & Certainty of Execution	Bank approval processes will be based on due diligence on the borrower. Approval processes tend to be longer and more standardised than those of private debt funds.	The due diligence process of private debt lenders tends to be deeper and more searching than that of banks and it involves significant interaction with the borrower. Approval processes while highly structured within the private debt fund, may tend to appear less standardised to the borrower, offer more certainty of execution and possibly speedier execution.
Regulation	Bank loans are subject to a wide range of regulatory protection laws which grant certain rights and protections to borrowers. Bank lending is increasingly restricted by Basle III and IV which imposes asset concentration limits and covenant requirements which may inhibit bank lending.	Private debt loans are less regulated compared to bank loans.
Regulatory Capital Requirements	Banks are subject to significant regulatory capital requirements in part because of their liabilities to depositors. In the U.S., proposed new Federal Reserve rules will further raise the capital requirements for banks operating in the U.S. wholesale banking industry.	In the EU, the AIFM of an internally managed AIF would be unlikely to be required to hold more than 3bps[13] of the assets under management as regulatory capital. Not being subject to the same level of regulatory capital requirements may explain the greater flexibility offered by private debt funds compared with banks
Transparency	Bank loan portfolios are transparent to regulators.	In 2023, regulators noted a lack of visibility of concentration risks, liquidity risks, and synthetic leverage risks in private funds which might potentially alert regulators to links to other parts of the financial sector.
Liquidity of Loan Portfolio	Bank debt may be more liquid than private debt through processes such as securitisation.	Private debt lenders have a higher propensity to hold their loans to maturity when compared with banks. It is somewhat more difficult to find a buyer for shares in a private debt fund. However, tokenisation of private debt fund shares may provide secondary market liquidity for private debt fund shares.
Monitoring of Loans	Gustafson et al. (2020)[14] find that 50% of bank syndicated loan borrowers provide information to their lenders once a month or more.	Private debt funds have a greater frequency and intensity of: (i) monitoring the financial information of the borrower; (ii) checking compliance with lending covenants; and (iii) meetings with borrowers.
Leverage of the Lender	Banks are significantly more leveraged than private debt funds with leveraged provided by deposits and short-term borrowing.	Private debt funds are significantly less leveraged than banks and have a lower 'run risk' as the term of their lending is matched by the presence of long-term locked-in capital.

[12] Smaller in this context means that the loan size would be too small for a bank to syndicate the loan.
[13] Based on an initial capital requirement of €300,000, an own funds requirement of 0.02% of the value of the AIFM's portfolio in excess of €250m (subject to the cap of €10m set for initial capital and own funds), and assuming the AIFM chooses the non-insurance route to cover professional negligence risks which will give rise to additional funds equal to at least 0.01% of the value of portfolios of AIFs managed.
[14] Source: https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3518069_code1629977.pdf?abstractid=2831455&mirid=1

Criterion	Borrowing from Bank	Borrowing from Private Debt Lender
Leverage Limit and Interest Coverage Ratios Offered to Borrowers	Lower [Debt]/[12-MONTH TRAILING EBITDA] and higher interest coverage ratios are likely be demanded by banks when lending.	Higher leverage, [Debt]/[12-MONTH TRAILING EBITDA] ratio, is generally provided to borrowers and lower interest coverage ratios may be accepted.

8 Competition Faced by Private Debt Lenders

Aside from banks competing with private debt lenders, a private debt lender faces competition from: (i) public debt markets, namely the leveraged loan market and the high yield debt market; and (ii) other private debt lenders.

8.1 Leveraged Loan Market

Leveraged loans refers to lending to corporate borrowers that already have high levels of debt, low credit ratings, or high spreads on their debt in terms of basis points yield over equivalent government debt. There is no universally agreed definition of a leveraged loan. S&P Global defines a leveraged loan as a loan that is: (a) rated BB+ or lower, i.e., rated below investment grade; or (b) not rated BB+ or lower but has a spread over Secured Overnight Financing Rate ("SOFR") of 125 basis points or higher and is secured by a first or second lien. Under this definition, a loan rated BB+ that has a spread of SOFR+75 would qualify as leveraged, but a nonrated loan with the same spread would not. Therefore, judgment is needed when determining whether to classify a loan as a leveraged loan. Most leveraged loans are provided by a syndicate of lenders. Leveraged loans are mainly used for leveraged buyouts ("LBOs"), mergers and acquisitions ("M&A"), recapitalisations, or refinancing of debt. Leveraged loans are usually secured with a first lien against the corporation's assets and carry a floating interest rate of interest. The main investors in the leverage loan market are collateralised loan obligations[15] ("CLOs") and banks. The leveraged loan market is an over-the-counter rather than an exchange-based trading market.

8.2 U.S. High Yield Debt Market

As of 30 June 2023, the U.S. high yield debt market had something of the order of 2,000 unique debt securities which had a value of USD1.34 trillion. The U.S. high yield debt market is primarily an over-the-counter ("OTC") market; there is no centralised exchange where the bonds actively trade. The largest borrowers by amount represent a sizable share of the high yield debt market. In contrast to leveraged loans, high-yield bonds, are not usually secured with a first lien against the corporate's assets, and high-yield bonds are fixed coupon bonds as in they pay a fixed rate of interest on the borrowing as opposed to paying a floating rate of interest. High yield debt issuers are normally established companies with credit ratings below investment grade in need of finance in excess of USD100m looking to reorganise their capital structures or the target of a leveraged buyout transaction. Because most high-yield bonds are unsecured, they are generally junior to leveraged loans within the borrower's capital structure. Mutual funds and exchange-traded funds dominate the investor base in the U.S. high yield debt market while pension funds, insurance companies, and clients of private wealth managers are

[15] A traditional CLO is a securitisation vehicle that is backed by a diversified pool of broadly syndicated senior secured bank loans to larger companies the debt of which is generally rated below investment grade. In the event of loan losses, the equity holders of the CLO suffer the first tranche of losses, if the equity is not sufficient to cover the loan losses, the subordinated or mezzanine debt holders of the CLO are next to suffer losses and only in the most extreme cases will the senior secured bond holders suffer losses. CLOs typically hold the most senior debt in a borrowing company's capital structure. CLO assets, the loans that it has bought, are typically floating rate. The debt of the securitisation vehicle is also floating rate to ensure matched funding. A CLO typically provides exposure to an actively managed diversified portfolio of somewhere between 200 and 400 leveraged loans.

also investors. Even when the U.S. high yield debt market is liquid and tradeable, trading costs are relatively high at around 70bps.

8.3 Private Debt Market

At the end of Q3 2023, there were reported to be more than 1,000 private debt funds. In the U.S. alone, it is estimated that there are over 300 private debt lenders the top 50 of which account for about 50% of private debt assets under management. Competition from high yield debt and leveraged loan markets puts downward pressure on the spread over the reference floating rate that a private debt manager can charge for a loan. Competition from other private debt lenders also puts downward pressure on private debt fund fees. Example 1 below illustrates the impact of the competition point.

Example 1: Impact of Competition Among Private Debt Funds

Mergers and acquisitions ("M&A") transactions are a key driver of demand for private debt. The number of M&A transactions in 2022 was down 50% on 2021. This reduction in M&A transactions combined with a lot of private debt fund assets seeking lending opportunities, led to: (i) a 25bp or more compression in the spread over the floating rate that private debt funds charged; and (ii) a move towards less 'lender friendly' terms in the loan documentation.

In 2023, banks tended to pull back from the syndicated loan market and tighten financing conditions.

When private equity sponsors have difficulty accessing the high yield debt and leveraged loan markets, this is potentially good for private debt investors.

In such circumstances:

(i) Private equity sponsors seeking to get transactions completed and companies with loans maturing in the near term that need to be refinanced are forced to consider private debt lenders; and

(ii) Private debt lenders can demand a bigger equity cheque[16] from the private equity sponsors.

Both of these factors are good for private debt investors in terms of both risk and return:

a. Private debt managers can charge a higher spread over the reference floating rate thereby increasing returns; and
b. Private debt managers are more likely to be able to negotiate a lower loan-to-value ("LTV") ratio as part of the lending conditions by requiring private equity managers to put more equity capital into target companies.

[16] Requiring the private equity firm to put more equity capital into the borrowing company to reduce the size of any potential loss given default by the borrower. More equity capital enhances the protection for the private debt lender.

Compared with other loan finance markets, such as the high yield debt market, private debt is seen as having a number of advantages for borrowers:

(i) faster, easier, and more certain deal execution;
(ii) no need to get a credit rating;
(iii) greater transaction privacy compared with the disclosure required in public debt markets;
(iv) lending fees and terms are known upfront;
(v) less exposure to interest rate risk and market risk *in the pre-funding period*; and
(vi) more relationship focused.

Further, the private debt direct lending market, which generally[17] provides senior loans to middle-market companies without the use of an intermediary, can now provide a private equity firm with loan sizes as high as USD2.0 billion. As a result of the above advantages, there has been a secular shift even among larger borrowers towards private debt direct lenders as a source of finance.

Companies seeking debt finance may opportunistically issue in both the high-yield debt market and the leveraged loan market or raise finance in the private debt market depending on such factors as availability of debt finance, pricing, and loan terms.

Private debt funds tend to avoid cyclical sectors where company revenues are highly correlated with gross domestic product ("GDP"). From a competitive perspective, this provides an opportunity for banks to provide loans to sectors like automotive, consumer, and heavy industrials. In reality, the attractiveness to borrowers of the private debt market, the leveraged loan market, and the high yield debt market tends to vary over time.

[17] Direct lending may in some cases include second-lien loans, unitranche facilities, and revolving credit facilities.

9 Benchmarking the Private Debt Asset Class

9.1 Introduction

When investing in an asset class, it is useful to have a benchmark index to provide an objective comparison between the risk and return characteristics of an investor's portfolio and that of a benchmark index.

A benchmark index will generally allow an investor to:

(i) Set realistic expectations for the likely returns and risk of an asset class;

(ii) Assess the performance of their portfolio relative to that of the asset class in the context of the macroeconomic environment;

(iii) Compare returns before fees and thereby assess the value added by the investment manager of the investor's portfolio.

The benchmark index ought to cover the different opportunities within the asset class to reflect the diversity within the asset class. If an investor's portfolio is under performing relative to the asset class, it may reflect deficiencies in the investment strategy rather than market conditions.

9.2 Cliffwater Direct Lending Index

The Cliffwater Direct Lending Index[18] ("CDLI") was launched in 2015. Using the quarterly U.S. Securities and Exchange Commission ("SEC") filings of business development companies[19], Cliffwater reconstructed the index back to 2004.

The CDLI seeks to measure the unlevered, gross of fees performance of U.S. middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain defined eligibility criteria. The CDLI index is calculated on a quarterly basis using financial statements and other information contained in the SEC filings of all eligible BDCs.

The eligibility criteria for BDCs for use in the CDLI index are as follows:

1. Regulated by the SEC as a BDC under the Investment Company Act of 1940.
2. Substantial majority (approximately 75%) of reported total assets are represented by direct loans made to corporate borrowers, as categorised by each BDC and subject to Cliffwater's discretion.
3. File SEC form 10-Q or 10-K, as applicable, within 75 or 90 calendar days respectively following the current Valuation Date.

Table 2 provides a description of the main characteristics of the Cliffwater Direct Lending Index and its sub-components as of 30 June 2023.

[18] Source of all information in this section: https://www.cliffwaterdirectlendingindex.com/about

[19] The primary asset holdings of Business Development Companies are U.S. middle market corporate loans.

Table 2

Name and Description of Index	Fair Value of Assets (USD bn)	No. of Loans	Yield %	Senior Debt %	Subordinated Debt %	Equity %	Other %
CDLI An asset-weighted index of directly originated middle market loans. The index is well diversified across industry sectors with weights not dissimilar to the market capitalisation weights for the Russell 2000 Equity Index with the banking sector excluded.	**284**	**13,025**	**11.57**	**79.6**	**8.6**	**7.3**	**4.3**
CDLI-S Comprised primarily of senior and unitranche loans held within BDCs. Created to address the comparative performance of senior middle market loans and the entire universe of middle market loans represented by CDLI. Loans in this index have lower realised losses and a lower rate of non-accrual compared to the CDLI index	**103**	**3,556**	**11.24**	**92.6**	**2.6**	**1.7**	**3**
CDLI-V Comprised primarily of venture-backed loans held within BDCs. Created to investigate the comparative performance of this lesser-known type of lending against the entire universe of middle market loans represented by CDLI.	**7.4**	**641**	**14.48**	**93.5**	**1.0**	**5.5**	**0.1**

10 Returns from Private Debt

10.1 Valuation of Private Debt Funds

In relation to the valuation of private debt funds, the key point to realise is that there is no absolute certainty as to the value of a portfolio of private debt loans.

The stated valuation policy of the fund vehicle holding the private debt loans and the accounting standards applicable to that fund vehicle dictate the basis on which the valuation of a portfolio of private debt loans is determined.

International Financial Reporting Standards ("IFRS") 9 mandates the determination of the measurement of the value of a private debt fund loan. For private debt loans that meet the following criteria:

i. the contractual cash flows under the loan give rise to payments on specified dates;
ii. the contractual cash flows are solely payments of principal and interest; and
iii. the business model of the private debt fund is to hold the loan to maturity;

the loan is valued at amortised cost less cost less impairment[20].

Private debt fund investors generally require the net asset value of the funds in which they hold investments to be reported on a fair value basis consistent with U.S. GAAP ASC Topic 820 or IFRS 13. In the U.S., loan values are normally determined on a quarterly basis using, for example, Accounting Standards Codification ("ASC") Topic 820, Fair Value Measurement. Loans are highly illiquid assets and are classified as Level 3 assets for fair value measurement purposes as they lack readily available market prices or observable inputs for valuation.

Fair value is defined by both international, IFRS, and U.S. financial reporting standards as:

"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

The first step in deciding on the appropriate approach to use in estimating the fair value of a private debt loan, is to carry out a security coverage assessment to see if the debt is likely to be fully paid back. Fair value valuations therefore take into account the probability of default and the loss given default.

If the assessment reveals that the collateral value is sufficiently greater than the secured debt or the enterprise value of the borrowing company is sufficiently greater than the cumulative debt raking ahead of and *pari passu* with the private debt loan, a discounted cash flow valuation is normally used.

[20] Impairment occurs when an entity's asset value is deemed to be lower than the value at which it is recorded in the company's financial statements. The amortised cost conclusion assumes that the company does not apply the fair value option to eliminate an accounting mismatch. If it did, the loan would be valued at fair value recognised in profit and loss.

If the assessment indicates inadequate security coverage either a liquidation or a recovery approach will normally be used. A liquidation approach is used where the borrower has entered bankruptcy or is no longer a going concern and involves estimating the sale value of the assets on which the private debt loan is secured. A recovery approach involves estimating the proceeds of the underlying collateral available to pay the private debt loan taking into account its priority position of the loan in the capital stack.

To value loans in a private debt portfolio, a private debt fund manager would normally engage an independent valuation firm. Such firms take into account the individual characteristics of each loan and use assumptions and models to assess fair value. Changes in the credit spread on traded debt instruments such as bank loans and high yield bonds are used in assessing changes in the *fair value* of private debt loans.

The valuation of the assets, the portfolio loans, of a private debt fund involves a significant use of judgement. The typical steps in the valuation of a portfolio of private debt fund loans are likely to be:

(i) a valuation conducted by the portfolio manager based on up-to-date data from all of the portfolio companies;
(ii) a review of the portfolio manager's valuation by an internal valuation committee of the private debt fund;
(iii) an independent assessment of the value of the loans by an independent third party; and
(iv) an annual review of the valuation process by the auditor of the fund.

10.2 Components of Total Return from Private Debt

The components of total return from a private debt fund can broadly speaking be divided into three broad categories: income; realised net gain (loss); and unrealised net gain (loss). Table 3 provides a description of each component of the total return together with some comments.

Table 3

Component of the Total Return	Description	Comments
Income	Quarterly income driven by the level of the reference rate, for example, SOFR, and the spread over the reference rate charged by the private debt lender.	This is by far the largest component of total return. Over the lifetime of the CDLI to 30 June 2023, the annual income has ranged between 8% and 12% with an average of 10.77%[21].
Realised gains (losses)	Changes in the value of completed transactions.	Generally arise from writing down the value of the loan principal as a result of borrower default. The size of the write-down will be determined by the value of the collateral seized after default. Due to borrower defaults, in the long term, one would expect that net realised gains would be negative for loans. Realised gains may arise where the security package for a loan also includes warrants or equity participation.
Unrealised gains (losses)	Changes in the *fair value* due to a change in the market price of a portfolio of loans that do not arise from transactions in the loans. Reductions in fair value give rise to unrealised losses. Reductions in fair value may be reversed in the future and are not necessarily a permanent reduction in the value of the loan. Except possibly in cases where the loan security also includes warrants or equity participation, to reflect the probability of loan losses, *fair value* will tend to be below cost.	Historically, private debt valuations have tended to be conservative in nature in that unrealised losses have tended to exceed subsequent realised losses. Unrealised losses on a loan will either be reversed when the principal amount of a loan is repaid in full or transition to realised losses if the borrower defaults. Thus, over a long period of time one would expect that cumulative unrealised losses should be close to zero. Unrealised gains may be very large relative to the other components of return where the security package for a loan also includes warrants or equity participation.

Private debt funds may report their gross performance before fees alongside that of the CDLI, CDLI-S, or CDLI-V as appropriate to the segment of the private debt market they are targeting. In doing so, a private debt fund will break its total return down into the three components described in Table 3 to show how its income, realised gains (losses), unrealised gains (losses) compare with that of the relevant Cliffwater index.

The credit loss rate is defined as the [default rate] multiplied by [1 – [recovery rate]].

Example 2: Credit Loss

Assume that: (i) the default rate is 2.5%; and (ii) the loss upon default is 40% of the loan principal. Based on (ii), the recovery rate would be 60% of the loan principal. Therefore, the credit loss would be 2.5%*[100 – 60%] = 1.0%.

In the calendar years from 2005 to 2022[21], the CDLI realised credit losses ranged from a low of -0.89%[22] (2005) to a high of 6.91% (2009) and had an average value of 1.03%. The negative

[21] Source: Cliffwater 2023 Q2 Report on U.S. Direct Lending.

[22] The negative figure for realised losses arises from realised gains on loans where the security package included warrants or equity participation.

figure for realised losses in 2005 arises from realised gains on loan where the security package included warrants or equity participation. The two most severe periods of realised credit losses were: (A) The three calendar years 2008, 2009, and 2010, during which the CDLI posted cumulative realised losses of 10.16%; and (B) The calendar year 2020, the COVID-19 era, when realised credit losses reached 3.30%.

In the calendar years from 2005 to 2022[21], the total return on the CDLI ranged from a low of -6.5% (2008) to a high of 15.79% (2010) and had an average annual return of 9.31%.

10.3 Non-Accrual Rates

When a borrower stops making regular contracted loan interest payments, the loan is classified as non-accrual. A private debt lender must stop recognising interest income on a loan classified as non-accrual to reflect the doubt about the ability to collect future interest payments.

For a loan portfolio, the non-accrual rate measures the percentage of the total loan portfolio that is on non-accrual status. A rising trend in the non-accrual rate of a portfolio of loans indicates worsening credit quality in the direct lending portfolio as more borrowers are missing payments and are at risk of default. The non-accrual rate is a harbinger of future realised loan losses.

Private debt lenders may place loans on non-accrual status when payments are more than ninety days past due, or when full repayment of principal and interest is in doubt.

The non-accrual status of a loan can change back to accrual status if the borrower starts making regular payments on the loan again or if the loan is restructured. In such circumstances, any uncollected interest while on non-accrual may have to be written off.

According to the Cliffwater 2023 Q2 Report on U.S. Direct Lending, the non-accrual rate expressed as a percentage of par value as of 30 June 2023 was 3.1% for CDLI-V, 1.4% for CDLI, and 0.6% for CDLI-S.

10.4 PIK Interest

PIK stands for "payment-in-kind". Interest is classified as PIK interest when interest owed by the borrower is capitalised and rolled into the principal loan amount rather than paid out in cash. Some loans may have a PIK element combined with a requirement to pay an amount of interest in cash on a quarterly basis. For example, there may be a requirement to pay 2.5% of the total loan amount annually in quarterly instalments. Generally speaking, PIK interest represents increasing levels of credit exposure to the borrower and is not as desirable as cash interest payments. Rising levels of PIK interest may be a harbinger of future credit losses.

10.5 Other Sources of Income from Private Debt

In addition to the spread charged over the floating rate, a private debt fund can generate income from origination fees and prepayment fees.

Origination fees vary somewhat driven in part by the level of competition from banks and other sources of debt in the jurisdiction of the borrower but might range from 1.5% to 3.5% of the amount borrowed.

Prepayment fees are charges imposed on borrowers which repay their loans before the maturity date specified in the loan documentation. Prepayment fees compensate a private debt fund for the potential loss of interest income arising from early repayment. Prepayment fees tend to be highest in the first year following the granting of the loan and decline thereafter. A typical pattern of prepayment fees might be as outlined in Table 4.

Table 4

Year	**Prepayment Fee (Percentage of the Outstanding Loan Repaid)**
1	3.50%
2	2.25%
3	1.25%

There was a noticeable increase in prepayment fees between the beginning of 2022 and the beginning of 2023 possibly due to the increased risk of prepayments in a high interest rate environment and a desire on the part of private debt funds to be compensated for the loss of the higher spreads when a loan is repaid early.

11 Sourcing of Private Debt Loans

The low interest rate environment in the decade to the end of 2021, provided an opportunity for: (i) private equity firms to take public companies private; and (ii) companies to expand their business operations and together with their private equity sponsors to engage in leveraged mergers and acquisitions.

At the same time, the private debt market attracted significant funds for investment in loans and competition among private debt lenders increased. The result was:

(i) An expansion in the leverage ratio, [Debt]/[12-MONTH TRAILING EBITDA], of borrowing companies;
(ii) A rise in the multiple of [Enterprise Value]/[12-MONTH TRAILING EBITDA] paid for target companies; and
(iii) Downward pressure on the spread over the reference floating rate charged to borrowers.

In recent times, the majority of private debt deals in Europe have been: (i) backed by a private equity firm, referred to as a sponsor; and (ii) are generally related to mergers and acquisitions.

Private debt fund managers that work with private equity firms, particularly those with strong investment teams, proven track records of generating returns, and networks of advisers, partners, and executives, have access to a wide range of lending opportunities allowing them to be highly selective in their choice of borrowers.

Other sources of private debt lending opportunities include direct relationships between private debt managers and companies and off-market deal flow from banks with which private debt fund managers have relationships.

Having diverse sources of private debt lending opportunities means that a private debt lender is not solely reliant on M&A transaction activity for lending opportunities. Private debt firms with "boots on the ground" continuing to engage with companies they have been calling on for several years are less dependent on M&A transactions as a source of potential new lending opportunities.

11.1 Sponsored v. Non-Sponsored Private Debt Lending

Table 5 compares the issues faced by private debt lenders as between a borrowing company which is funded by a private equity firm, "Sponsored", and a borrowing company where there is no private equity firm involved, "Non-Sponsored", under a number of headings.

Table 5

Issue	Sponsored	Non-Sponsored
Origination	Origination is generally through direct relationships with private equity firms but may also come through intermediaries.	Origination is generally through intermediaries but may also arise from a direct relationship. The private debt lender needs to be familiar with the intermediary or the company to ensure high quality referrals.
Execution: Providing the Loan to the Borrower on Time	A significant amount of due diligence information may be available from the private equity firm which is likely to speed up the underwriting of the loan. If the loan is required for a merger or acquisition, there is likely to be a fixed deadline by which a decision must be provided.	The private debt firm will lead the due diligence process and determine the data and other requirements which the borrower must provide. The execution timeline is likely to be significantly longer because the borrower would not be in the same league of experience as a private equity firm arranging borrowing.
Pricing, Covenant, and Risk	In view of the competition orchestrated by the private equity firm among private debt lenders and the experience of the private equity firm in dealing with private debt lenders, the spread over the reference rate will tend to be lower and the loan covenants somewhat weaker than in the non-sponsored case. Private equity firms may also specify a list of approved financial institutions to prevent what they regard as potentially troublesome financial institutions from buying the private debt of the sponsored company and using their position as a debt holder to influence the business strategy of the sponsored company. In the event that a restructuring is required, it is likely to be sponsor friendly rather than in the best interests of the sponsored company. From the perspective of the sponsored company, it may wind up in a situation where the approved financial institutions are unwilling to lend to what they perceive as a company in trouble, and it is unable to raise debt from sources not on the list.	The private debt fund ought to be able to achieve a stronger covenant and a higher spread over the reference interest rate than in the sponsored case. The higher spread is not unjustified as, generally speaking, non-sponsored borrowers are riskier than sponsored borrowers. If there is a downturn in the borrower's performance, management's behaviour is more difficult to predict than for sponsored borrowers.
Independence of Management and Shareholders	Private equity firms generally recruit and put in place a highly professional management team. While management may hold up to 10% of the equity capital, there is likely to be little in the way of any other significant overlap between members of the management team and shareholders.	There is more likely to be some overlap between the management team and the shareholders. There may also be key-man risk present where the two groups overlap.
Access to the Board, Management, and Performance Data.	Board and management access may be more difficult because of the involvement of the private equity firm but the quality of information is likely to be better. However, the frequency of reporting might be lower. The private debt firm ought therefore to ensure that it has appropriate access to information and strong legal rights under the loan agreement if the borrower faces a stress scenario.	Significantly better access to the board and management. However, the private debt fund manager may have to expend resources to specify and obtain financial and other information of the quality that a private equity firm would provide.

Issue	Sponsored	Non-Sponsored
Interaction with the Management of the Borrowing Entity	The private debt lender will have less interaction with the board and management and therefore less likely to understand the background to decisions. The private debt lender will have to rely on the private equity firm for oversight.	The private debt lender will have more interaction with the board and management and better access to information and therefore understand the business more. The access and review of information is likely to consume more of the private debt fund's resources.
Dealing with Adversity	In a downside scenario there is the possibility of the sponsor providing additional capital. However, (i) dealing with a highly experienced private equity firm is likely to be challenging and adversarial; and (ii) it will be more difficult for the private debt lender to take control of the situation and realise its security.	In a downside scenario it is unlikely there would be another source of additional capital. The private debt manager ought to be able to react to early warning signs more quickly and realise its security because of the lack of experience of the borrower in dealing with such situations.
Level of Competition	Roughly 90% of private debt lending tends to be to sponsored companies. Therefore, lending to sponsored companies is much more competitive for private debt fund managers. Further, where a private debt lender sources a significant volume of loans from a small number of private equity firms, the private debt lender's desire to maintain deal flow may allow these private equity sponsors more discretion in a restructuring should a borrower get into financial distress.	Lending to non-sponsored companies is not as competitive as lending to sponsored companies.

12 Broad Outline of Borrower Characteristics

For companies seeking loan capital, speed of execution is likely to be important. Borrowing from a single private debt lender is likely to be faster, involve fewer agreements, and be less onerous than borrowing from a bank which may have to syndicate the loan amount. Borrowers are willing to pay a premium spread for a direct lender's ability to commit to a transaction, certainty regarding the documentation of the loan terms, certainty as to the cost of capital, speed of execution, privacy, absence of any requirement to obtain a credit rating, and for flexibility relative to the syndicated bank loan market and public bond markets.

Private debt funds tend to understand the borrower's business significantly more than bank lenders and can tailor a loan to the characteristics of their borrowers' circumstances.

Relative to bank lenders, private debt funds can offer borrowers a whole menu of capital structure options to choose from ranging from senior secured to mezzanine debt as well as possibly facilitating a higher ratio of [Debt]/[12-MONTH TRAILING EBITDA] leverage.

The following factors will tend to increase the spread over the reference floating rate charged by the private debt lender to the borrower:

- The leverage, [Debt]/[12-MONTH TRAILING EBITDA], of the borrower.
- The loan-to-value ratio.
- The security ranking of the loan in a winding up and the associated security package for the loan.
- The point on the scale from amortising loan to bullet repayment of the loan.
- More borrower friendly covenants.
- The speed of execution.

12.1 Purposes of Private Debt Deals

12.1.1 Leveraged Buy-Out

A leveraged buyout ("LBO") is a financial transaction in which an entity, often a private equity firm, acquires a company and finances the purchase by using a significant amount of debt while pledging the assets of the target company as collateral for the borrowed funds. The aim of the acquiring entity, which is frequently a private equity firm, is to improve the margins and grow the profitability of the target company through its controlling stake in the target company. The improved margins and growth in profitability and possibly the sale of some assets of the target company are expected to repay the debt and, at the same time, provide a return to the private equity firm acquiring the target company. The broadly syndicated loan market led by banks has tended to be the main vehicle for financing LBOs. However, between June 2022 and the beginning of February 2023, not one of the 37 publicly quoted companies in the U.S. and Europe which announced that they were being taken private was financed by banks and the

broadly syndicated loan market. All these deals were financed by private debt funds or by equity investment[23].

12.1.2 Bolt-On Acquisition M&A

In a bolt-on acquisition, a company acquires another usually smaller target company to integrate it into the acquiring company's existing operations for reasons such as to gain economies of scale and expand market footprint. A bolt-on acquisition generally requires debt finance to fund the acquisition and in some cases the costs of integrating the target business into the acquirer's existing operations.

12.1.3 Refinancing

In a refinancing deal, a company seeks to replace an existing loan with a new loan possibly with terms or conditions that more suit the borrower such as a lower interest rate, a more favourable schedule of repayments, or an extended repayment period. Sometimes, however, the refinancing may be one of necessity to maintain continued access to finance to say, support the continued M&A growth strategy of a company.

12.1.4 Growth Capital

Businesses supported by secular tailwinds such as software-as-a-service ("SaaS") businesses that create efficiencies or provide better ways to understand or manage the businesses of other firms need long-term capital to grow. Amortising loans are unlikely to be attractive to SaaS businesses because every euro or dollar repaid is a euro or a dollar that does not go towards financing the growth of their business, for example, funding research and development. Banks may not be willing to provide permanent loan capital with a bullet repayment profile for periods longer than five or six years because of their risk appetite on the one hand and their regulatory capital requirements on the other hand. SaaS businesses often need loans that don't amortise and that have a final maturity in excess of six or more years. In some cases, a private debt lender may provide this long-term bullet repayment loan to the borrower at a fixed rate of interest. To hedge its exposure to the fixed interest rate, the private debt fund is likely to enter into an interest rate swap, swapping fixed interest income for floating rate interest income with an investment bank.

Further, strong businesses with solid balance sheets and a proven track record of integrating acquisitions into their businesses can improve their competitive position in a cyclical downturn and may wish to borrow to acquire competitors.

12.1.5 Dividend Recapitalisations

From the perspective of the borrower, a dividend recapitalisation provides the company with a loan which allows shareholders to extract cash from the company without selling it outright to generate cash. In effect, the company borrows money to pay a special dividend to its shareholders. Dividend recapitalisations are sometimes employed by private equity firms with a controlling interest in a company where the private equity firm is looking to generate returns

[23] Source: H1 2023 GLOBAL PRIVATE DEBT REPORT.

on their investment. Dividend recapitalisations increase the debt burden of the borrowing company which must pay interest on and repay the borrowed funds. From the perspective of the private debt lender underwriting a dividend recapitalisation loan, the dividend recapitalisation loan increases the leverage, [Debt]/[12-MONTH TRAILING EBITDA], and perhaps reduces the financial flexibility of the borrowing company. It would be vital to ensure that the borrowing company's cash flow[24] can support the additional debt repayments.

Dividend recapitalisations provide short-term benefits to investors, but they create risks for private debt lenders when the performance of the borrowing company does not meet expectations. Example 3 below illustrates what can go wrong for lenders.

Example 3: Dividend Recapitalisation Lending – What can go wrong for lenders?
According to the Financial Times[25], in 2014, Phones 4U, then Britain's second-biggest independent mobile phone retailer which generated revenue by receiving commissions for selling handsets and signing up customers for mobile phone operators, was placed in administration after Vodafone and EE, removed their products from Phones 4U's shelves, thus depriving the company of a huge proportion of its revenue and profits. The owner of Phone's 4U, the private equity group BC Partners, decided to wind up the business. Before shutting down the business, BC Partners removed capital from the company after it sold the company's insurance subsidiary and, in 2013, the company borrowed £200m to pay BC Partners a special dividend. Following the pay-out, Phones 4U's debt was equivalent to 4x[12-MONTH TRAILING EBITDA]. BC Partners recovered 1.3x its original investment.

12.2 Private Debt Loan Structures

In introducing the different loan structures, it may be useful to review the capital structure of a typical company and the ranking for repayment of the different types of capital in a winding up.

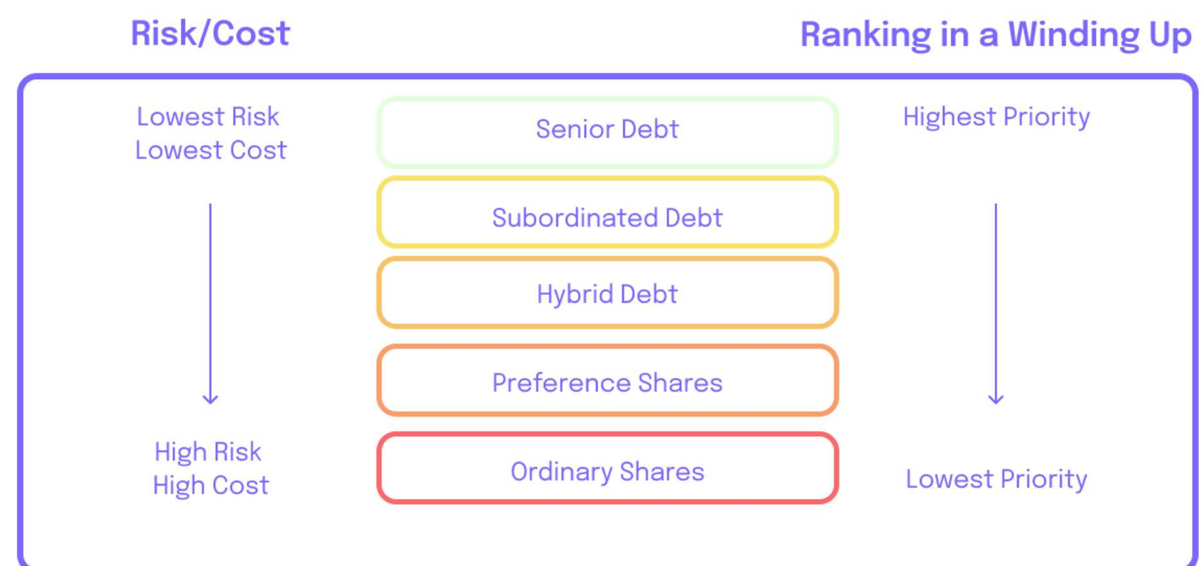
In the winding up of a company, in some jurisdictions, secured creditors having a fixed charge over assets of the company may be able to enforce their security outside of a debtor company's winding-up proceedings. Further, corporate insolvency law may provide that a sizable list of debts shall be paid in priority to other debts. The list of such debts varies by jurisdiction but may include expenses of liquidators and examiners, taxes due to tax authorities, unpaid wages of employees, and social insurance contributions. Such preferential debts may occupy a place above the claims of floating charge holders.

Leaving such jurisdiction specific features of corporate insolvency law aside, Figure 1 illustrates a simplified view of the different components of the capital structure of a company, the ranking of the different components of capital for repayment in a winding up of the company and their relative cost to the company.

[24] Cash Flow is generally broken down into three categories: Cash generated from the operation of the business; investing activities which covers all purchase and sales of long-term investments and assets; and financial activities which covers all transactions related to raising or repaying capital.

[25] Private equity, not the mobile operators, killed Phones 4U. Owners put financial interests over operational strategy. Jonathan Ford. Accessed on 28 December 2017. Available at: https://www.ft.com/content/8bfd2340-4169-11e4-a7b3-00144feabdc0

Figure 1



12.2.1 Senior Secured Loan

A senior secured loan to a company is:

(i) *Senior* in the sense that in the event of the winding up of the company, the senior loan holder has the highest priority for repayment of outstanding debts from the assets of the company; and

(ii) *Secured* in the sense that it is backed by specific collateral such as real estate, inventory, receivables, intellectual property, or valuable equipment owned and controlled by the borrower.

Upon the default of the borrower, the lender has a right to seize the collateral and sell it to recover the outstanding debt.

Compared with unsecured loans, senior secured loans backed by a charge over collateral are relatively lower risk and therefore carry a lower rate of interest for a borrowing company than an unsecured loan.

In times of market turbulence, senior secured loans do not fall in value as much as subordinated loans and senior secured loans exhibit lower volatility than subordinated loans.

Depending on the terms of a senior secured loan, private debt firms are more likely to find themselves in competition with banks or financial institutions when providing debt finance.

12.2.2 Second Lien Loan

In the context of private debt lending, a lien arises from a contract between a borrower and a lender. It is a security document which is executed whereby the borrower agrees to provide the security for a loan. It gives the lender a legal claim or right over the borrower's property or assets as security for a loan. Essentially, it gives the lender the right to take possession of

the property or assets if the debtor fails to fulfil their obligations under the terms of the loan agreement, such as failing to repay the loan or failing to meet other contractual commitments.

A second lien loan to a borrowing company is a loan that is subordinate to another loan, the "first lien" loan, in terms of repayment of capital in the event of a winding up of the company.

Second lien loans are similar to first lien loans in the sense that they are secured by collateral, however, in the event of the winding up of the borrower, the first lien loan lenders have a right to seize and sell the specified collateral to recover their debt before any other lenders. Thus, first lien loan lenders are repaid ahead of the second lien lenders in terms of being repaid out of the proceeds of the sale of the collateral. Second lien loan lenders are repaid only after the first lien loan lenders have received repayment of the loan outstanding to them.

Interest rates charged to borrowers seeking second lien loans are higher because of the higher risk that the capital will not be repaid in the event of insolvency.

In considering second lien loans, private debt lenders are likely to focus on: (i) the loan-to-value ratio of the combined first and second lien loans secured on the same collateral to ensure the borrower has sufficient residual equity in the property after repayment of the first lien loan; (ii) the volatility of the value of the underlying collateral; (iii) the debt service coverage ratio of the borrower; (iv) the use of the loan proceeds; and (v) the leverage, [Debt]/[12-MONTH TRAILING EBITDA], of the borrower.

The term of second lien loans is normally shorter terms than that of first lien loans.

12.2.3 Payment-in-Kind Loan

A payment-in-kind ("PIK") loan grants the borrower the option to make an interest payment in cash or to increase the amount of the loan by the interest payment. In a PIK loan, the balance outstanding to the private debt lender is allowed to increase over the term of the loan. In view of the ever-increasing balance outstanding to the lender, a PIK loan tends to carry a higher rate of interest than a traditional loan to compensate the lender for the potentially higher level of risk arising from the increasing exposure to the borrowing company.

A PIK loan may be attractive to: (a) borrowers with short-term cash flow challenges but with significant potential to generate cash flow in the medium term such as a distressed company being rescued and restructured by a private equity firm; or (ii) borrowers wishing to preserve cash flow to grow the business.

When a portfolio company of a private debt fund gets into what is potentially short term financial difficulties and when the incentive of the portfolio company and the private debt fund are strongly aligned, the private debt fund may waive a covenant breach and permit the portfolio company to switch to PIK interest instead of cash interest payments. This flexibility can provide the borrower with time to recover its financial position to meet its financial commitments to the private debt fund.

Mezzanine lenders tend to be more open to PIK loans than senior secured loan lenders.

Private debt lenders may charge a significantly higher rate of interest on PIK loans as compared to the interest rate charged on loans with regular cash coupons.

12.2.4 Mezzanine Loan

A mezzanine loan is debt finance that ranks for repayment in a winding up below senior debt but above the ordinary shareholders in the company. Mezzanine loans are generally secured loans, may also have an equity participation feature such as warrants, and have a longer term than senior secured loans to facilitate a company's cash flow growth plans. Mezzanine loans are often used in leveraged buyout transactions.

In view of their subordination of their rank in a winding up of a company, mezzanine loans carry a higher rate of interest than senior debt and may involve the payment of other fees to the lender. Further, to compensate the private debt lender for the risk of a mezzanine loan, the loan documentation is likely to incorporate one or more features such as: (i) warrants; (ii) a percentage of the increase in the value of the equity of the borrowing company between loan advance and loan repayment; and (iii) a right in certain circumstances to convert some or all of the debt to ordinary shares in the company as a way to provide the lender with a potential for additional return.

The security package for a mezzanine loan may involve a pledge[26] of the shares of the borrower and its subsidiaries, a negative pledge in relation to all of the borrower's assets, guarantees from subsidiary companies, and loan covenants that require a decreasing ratio of [Debt]/[12-MONTH TRAILING EBITDA] over the life of the loan or a minimum interest coverage ratio.

In some cases, a private debt lender may seek an irrevocable power of attorney from the borrower granting the private debt lender the right to create a mortgage over the principal assets of the company upon the breach of a borrowing covenant.

From the perspective of the borrowing company, a mezzanine loan can provide capital for acquisitions or growth without the need to raise additional equity capital which would dilute the ownership rights of existing shareholders. There may be some dilution of existing equity ownership in the future if the private debt lender exercises the warrants or if other circumstances give the private debt lender the right to convert the mezzanine loan into ordinary share capital.

The terms of a mezzanine loan can be highly flexible when compared with a senior secured loan and the negotiation tends to centre around meeting the needs of the borrower for the capital required, the security of capital, and the return on the loan for the borrower.

[26] A share pledge involves a shareholder pledging their ownership of shares in the company to the lender while the shareholder retains economic rights like dividends until default triggers transfer of ownership. If the loan defaults, the lender then has the right to seize the shares, sell them, and use the proceeds to recover funds owed. Private debt lenders often require a share pledge agreement spelling out terms and conditions such as restrictions on selling or transferring the shares. A pledge is registered so it is enforceable even if the shares are later sold. It is designed to align the shareholders' interests with loan repayment.

12.2.5 Super Senior Revolving Credit Facility

A super senior revolving credit facility ("RCF") is a loan arranged by companies for short-term borrowing requirements.

Its 'super senior' label arises because it ranks for repayment ahead of all other borrowings, even senior secured debt, in the event of a winding up of the borrowing company. The security for the RCF will be documented in the facility agreement and may involve a charge over a range of collateral including valuable assets, accounts receivable, and inventory.

The facility is 'revolving' in the sense that without having to renegotiate the terms of the facility, the borrowing company can draw upon the facility as needed, repay the loan drawn down as suits its cash flows, and draw down finance again as required during a term which might range from a few months to a few years.

The repayment schedule of an RCF is unlike a traditional loan in that the principal amount borrowed is not repaid in instalments of capital and interest rather the borrower makes periodic interest payments on the principal drawn down and has the flexibility to repay the principal as cash flows permit.

While there is a limit on the amount of credit that the borrowing company can draw down under an RCF, it is a reliable source of short-term credit for a company. An RCF is useful for businesses that have seasonality in their revenue streams or significant variations in their working capital needs.

An RCF is typically provided by a bank which charges a floating rate of interest on the debt drawn down, an arrangement fee for negotiating and providing the facility, and an ongoing fee for the undrawn portion of the facility. The floating rate of interest will be a reference interest rate plus a spread which will reflect the credit risk of the borrowing company.

12.2.6 Stretched Senior Loan

A stretched senior loan combines elements of both traditional senior debt and mezzanine financing.

The label 'stretched' refers to the fact that the larger portion of the total amount of financing provided in a 'stretched senior loan' structure is senior debt but there is also a relatively smaller portion which is subordinated debt or even equity share capital. Stretched senior loans carry a higher rate of interest than traditional senior secured debt to reflect the higher risk but a lower rate of interest than mezzanine capital.

In terms of their ranking for repayment in a winding up, stretched senior loans sit between traditional senior debt and mezzanine debt. Thus, stretched senior loans rank ahead of junior debt and equity capital for repayment in a winding up of the borrowing company.

To compensate private debt lenders for the risk involved in stretched senior loan provision, private debt lenders may be granted rights to a payment equal to a share in the growth in the value of the equity of the borrowing company upon maturity of the loan or a payment in the event of the sale of some or all of the equity capital of the borrowing company.

A stretched senior loan agreement is likely to include call protection and prepayment penalties.

From the perspective of a borrowing company, a stretched senior loan would allow the company to access a larger amount of debt compared to a traditional senior loan and avoid a rights issue which may dilute the ownership rights of existing shareholders.

Stretched senior loans are often a structural feature when the purpose of a loan is to finance a leveraged buyout as they are capable of reducing the equity capital contribution required by the buyer of the target company for the transaction.

The repayment and other terms of stretched senior loans can be tailored to the borrowing company's specific circumstances to better align with the borrowing company's projected cash flows.

12.2.7 Unitranche Loan

A unitranche loan facility is a type of financing where a company receives a single loan to cover all its debt obligations, rather than having multiple sources of loans or bonds at different interest rates and repayment priorities.

A unitranche borrowing facility is documented under a single loan agreement, removes the need for separate senior and separate mezzanine facilities, and thereby simplifies the debt layers in a borrowing company's capital structure.

The interest rate payable by the borrowing company on a unitranche facility is a single rate of interest which is a weighted average of senior and junior debt interest rates. The lender or lenders will of course require a security package for providing the facility, including, for example: (i) the right to have access to the board of the borrowing company as an observer at board meetings; and (ii) although unpopular with borrowers, some private debt fund lenders may demand warrants over equity in or equity in the companies to which they are lending.

A borrowing company may also originate a unitranche facility but defer the drawdown of the funds. Private debt lenders are likely to charge a higher rate of interest rate for such a unitranche facility to meet their internal rate of return ("IRR") targets. In addition, equity or quasi-equity instruments such as warrants may be demanded by the private debt lender to help it achieve its targeted IRR.

The interest margins for private debt funds on unitranche facilities are higher than on a combination of separate senior and mezzanine loans. Additional returns to the private debt fund may come from a schedule of declining prepayment fees over the first three years of the

unitranche loan which effectively locks the borrower into the higher margin loan for a period of typically three years. Some unitranche loans may have a make-whole premium which is designed to compensate the private debt fund any loss of interest rate margin on early repayment of the loan.

A unitranche loan may allow borrowers to capitalise their interest payments thereby increasing the loan outstanding over time, avoid an excess cash sweep, have a single leverage covenant tested quarterly, significant EBITDA addbacks when calculating the leverage, and borrower-friendly equity cure rights.

Banks can play a role in unitranche lending either by co-investing alongside a private debt fund or by providing facilities which private debt funds may be unable to, such as revolving credit facilities for working capital requirements, treasury facilities, and foreign exchange or interest rate hedging services. The revolving credit facility provided by a bank will be documented under the unitranche loan agreement. While the revolving credit facility usually ranks super-senior to the other lenders in the unitranche loan upon enforcement, the other unitranche lenders usually have a right to trigger acceleration and enforcement to protect their interests.

A unitranche facility may be facilitated by multiple lenders each of which may agree to receive a different interest rate on their share of the advance to reflect their different return, risk, and enforcement rights appetites even though a single interest rate is charged to the borrower for the facility. In such cases, the relationship between the different lenders will be documented under an agreement among lenders ("AAL").

The borrowing company is not a party to the AAL and so has no idea of the decision-making process among lenders or where the control rests among the lenders. In a restructuring, not knowing where the control lies among lenders makes it more difficult to negotiate a settlement to meet the interests of all the lenders compared with the separate senior and mezzanine loan structure where there is greater clarity as to the lenders' interests.

Private equity firms can now tap private debt funds for mega-unitranche deals.

12.2.8 Unsecured Debt Loan

As the label suggests, an unsecured debt loan is a loan that is not backed by the borrower pledging any specific collateral. Unsecured loans rank for repayment in a winding up with the general body of unsecured creditors. Unsecured debt is usually advanced to borrowing companies assessed to have strong, robust, and stable cash flows and a good credit history. Unsecured debt is usually advanced for relatively short periods of time.

As the loan is unsecured, it will carry a higher rate of interest compared with secured loans because of the additional risk for the lender.

12.2.9 Distressed Debt Loan

When loans are provided to a company which finds itself in financial distress due to factors like excessive levels of debt or declining revenues and when the company is unable to secure finance from traditional lenders like banks due to the risk of loan loss, the loan is described as a distressed debt loan.

Distressed debt lending is generally provided by private debt funds that specialise in distressed debt lending and that employ lawyers and workout specialists who have extensive experience in the nuances of distressed debt workout processes. Distressed debt lenders are often engaged in restructuring the borrower to turn it around and improve its financial performance which would allow the distressed debt lender to realise a profit on its lending.

Given the high degree of risk involved in distressed debt lending, the potential returns are significantly higher than in the other lending strategies described in this section.

In some cases, it may be possible to sell a distressed debt loan in the secondary market, allowing investors to buy and sell these debt securities. This market provides liquidity for distressed debt investments and enables investors to adjust their portfolios based on changing market conditions.

12.2.10 Other Types of Financing

Bridge Financing: Pending a company obtaining longer term financing, a private debt fund may provide short-term bridge financing.

Venture Debt: Private debt funds may also provide debt to companies funded by venture capital, so called venture debt. Such loans allow entrepreneurs to extend the time to exit without diluting ownership.

12.3 Trends in Private Debt

12.3.1 Investors' Preferences

Data from a November 2022 survey by Preqin quoted by Deloitte,[27] indicate that among investors intending to allocate to private debt over the following twelve months, the structures targeted are investments in distressed debt and mezzanine debt in roughly equal proportions.

12.3.2 NAV Loans

There is also an emerging trend among some private debt fund managers to provide loans to private equity funds. The security for such loans may be: (i) the shares in all or a subset of the diversified portfolio of obligors held by the private equity fund; or (ii) a credit facility secured on the capital commitments of LPs. The ratio of loan-to-value on such loans tends to be in the region of 10% to 20%.

[27]Source:https://www2.deloitte.com/content/dam/Deloitte/be/Documents/finance/Private%20Debt%20Deal%20Tracker%20Spring%202023.pdf

Private equity funds generate profits for their investors by publicly listing or selling the companies in their portfolios. In the current 'higher for longer' interest rate environment, publicly listing an investee company is not attractive for two reasons: (i) the initial public offering market is currently very weak; and (ii) valuations, aside from those of major technology companies, have fallen. Selling an investee company to another fund has become challenging because of the increased cost of borrowing which pushes up the weighted average cost of capital for a leveraged buy-out. This makes it difficult for the acquiring private equity owner to pay the selling private equity owner the price required to deliver the target return. Private equity exit transactions are reported to be at a 10-year low[28].

In such circumstances, private equity firms are likely to wish to avoid fire sales of their portfolios of investee companies. At the same time, investors in private equity funds are generally reluctant to provide commitments of new money to private equity fund managers until they see distributions from their current private equity funds. In such circumstances, NAV loans allow private equity fund managers to distribute cash to their investors.

From the risk management perspective of the private debt fund manager, NAV loans may allow the GPs of private equity funds to: (i) increase the leverage of an individual investee company beyond that which the investee company's existing lenders consider prudent; or (ii) access funding for their investee companies when other lenders are unwilling to lend due to tightening credit conditions.

In view of the three layers of leverage that a NAV loan creates, namely, the loans to the private equity fund's investee companies, other borrowings by the private equity fund, and a NAV loan, private debt fund managers will seek to restrict the loan-to-value ratio on NAV loans to the 10% to 20% range.

12.3.3 Asset Backed Finance

Traditionally, asset-backed finance has been a lending market dominated by banks. Now some private debt lenders are launching investment vehicles to target the asset-backed finance lending market. Other private debt lenders are entering into partnerships with banks faced with regulatory constraints to lend to the asset-backed finance market.

[28] Source: ft.com on 1 November 2023. *Private equity: higher rates start to pummel dealmakers.*

13 Loan Underwriting by Private Debt Funds

Unlike shareholders, debt holders have limited upside. Their return is limited to the following sources: repayment of capital lent, interest income, arrangement fees, and prepayment fees. There is no prospect of capital gain. Underwriting mistakes that lead to loan losses are expensive in terms of their impact on returns. Loan underwriting is now more important than at any time in the last 15 years or so given that those years were predominantly characterised by historically low interest rates.

Underwriting any loan is subject to an element of uncertainty as to the probability of a loss of capital. It is not like the game of roulette where there is no uncertainty as to the probability[29] of the outcomes; in roulette, the probability of black or red is 18/37 and the probability of green is 1/37. There is no scientific basis for calculating the probability of the price of an input commodity like lithium for a business in three years' time or the probability of supply chain interruption in the computer chip market due to a war in Asia in three years' time. Therefore, in underwriting private debt loans, the focus is on modifying the risk of a loss of loan capital advanced rather than in estimating the probability of factors leading to a loss of loan capital advanced. This is achieved in several ways including: (i) choice industry sectors to lend to; (ii) within chosen industry sectors, lending to the leading companies; and (iii) among leading companies in the sector, choosing those companies with a track record of successful strategy execution by the management team. The experience and judgement of the private debt lending team are critical in making the choices in (i), (ii), and (iii).

Ideally, mistakes should be benign, relatively small, and quickly reversible rather than large and possibly irreversible such as can occur when lending to companies that present "balance sheet risk". Banks and real estate companies present balance sheet risk. A rise in defaults accompanied by historically low recovery rates can rapidly diminish the value of a bank's balance sheet; inflation, a rise in interest rates and changes in society such as remote and hybrid working creating uncertainty about the demand for office space in the long-term can cause the value of real estate to fall dramatically.

13.1 Review of Earnings before Interest, Tax, Depreciation, and Amortisation

Before getting into the details of the underwriting framework, let us review the concept of earnings before interest, tax, depreciation, and amortisation ("EBITDA").

In the U.S., public companies are required to file their financial statements in accordance with Generally Accepted Accounting Principles ("GAAP") which provide definitions for financial metrics.

The concept of EBITDA arose from a need by analysts to compare earnings across industries with different depreciation and amortisation schedules, different levels of leverage, and different taxation structures. However, it is not a GAAP figure and therefore it is not clearly

[29] Based on a European-style roulette wheel.

defined with the result that an EBITDA figure reported by an entity may be subject to a significant element of subjectivity as to its components.

Today, EBITDA figures reported by entities are in essence "adjusted" EBITDA figures which require close examination to assess the adjustments.

There is normally a limit on leverage provided for in many borrowing covenants. The metric to calculate leverage in such covenants is usually: [DEBT]/[12-MONTH TRAILING EBITDA]. Likewise, a borrowing covenant may specify a minimum interest coverage ratio of [12-MONTH TRAILING EBITDA]/[Interest Expense][30].

If a company's EBITDA figure can be calculated by subjectively 'adding back' to earnings costs that have been incurred, the amount of debt that the company can take on within the leverage limit can be increased and the interest coverage ratio will be inflated. Absent a vigilant review of such addbacks, they could multiply the intended purpose of an EBITDA figure by a factor of 1.25x or higher.

The costs that reporting entities add back might include:

(i) Cash expenses: Cash paid for costs that occur every year and that are not in reality in some sectors one-off in nature such as: (a) severance payments; (b) integrating businesses acquired by the company into the company; and (c) restructuring costs such as the costs of remodelling, closing, and opening retail outlets in the retail industry.

(ii) Non-cash expenses: Although the awarding of shares in a company to management and staff is a non-cash expense, it is nonetheless a compensation expense and should not be added back in calculating EBITDA.

Studying a trend in EBITDA figures in which such addbacks are included is likely to hide evidence of poor strategy, failures in operational execution, and poor cash flow growth.

Thus, adjustments to EBITDA are carefully reviewed by private debt lenders and frequently a number of the addbacks are disallowed for the purposes of calculating credit metrics like leverage and interest coverage.

One further point that private debt lenders are likely to examine in relation to EBITDA is the capitalisation of research and development expenses. When capitalised, such expenses are not captured in EBITDA; the EBITDA may therefore need to be adjusted downwards in certain circumstances.

[30] More usually, borrowing covenants specify the interest coverage ratio as: [EBIT]/[Interest Expense], where EBIT is earnings before interest and taxation as EBIT provides a better measure of the quality of earnings. Interest coverage ratios tend to reduce as interest rates rise.

As a proxy for cash flow available to service debt, private debt lenders often use [EBITDA] – [Maintenance Expenses]. This is a key metric for private debt lenders for a number of reasons including: (i) by subtracting essential maintenance expenses from EBITDA, private debt lenders have visibility on surplus cash flow to set debt servicing capacity and size of loans; and (ii) insert covenants into the loan agreement to put a ceiling on the amount of dividends a private equity sponsor can extract from the borrowing company, for example, the ceiling for dividends might be 25% of [EBITDA] – [Maintenance Expenses] ensuring there is sufficient cash flow available to repay the private debt lender.

13.2 Underwriting Framework

The main areas of focus of the private debt fund manager in underwriting a loan are likely to be the industry sector in which the borrower operates, borrower's cash flow, the quality and stability of the borrower's business, and the strength of the loan covenants that can be negotiated.

The ability to do extensive underwriting on a borrower by a private debt fund lender is enhanced by an ability to tap into senior experts, operational experts, and functional specialists in the industries in which borrowers operate.

At the end of the underwriting process, the private debt fund manager is likely to draw up a list of the risks facing a lender and the mitigant, if any, there is for each risk before making a loan offer.

13.2.1 Choice of Industry Sector

Private debt funds tend to focus on industry sectors with the following broad criteria:

- High EBITDA margins[31], strong pricing power allowing rising costs to be passed on to customers, and generating strong free cash flow[32];
- Low fixed costs, asset-light, thereby not requiring significant ongoing capital expenditure;
- Strong revenue growth supported by secular tailwinds and highly flexible variable cost structures;
- Recession resilient and non-cyclical with low exposure to input commodity prices; and
- Low risk of technological disruption and of product or service substitution.

Secular tailwinds include an ageing population demanding particular goods and services, rising average disposable income, and technological progresses improving the quality of goods or delivery of services.

[31] EBITDA Margin = [EBITDA] / [Total Revenue]. EBITDA margin demonstrates how efficiently a company can generate profit from its core operations before deducting interest, taxation, depreciation, and amortisation.
[32] Operating cash flow minus capital expenditure.

Non-cyclical businesses are characterised by factors such as: (a) the cost of the product or service represents a low proportion of their customer's overall outgoings while simultaneously leaving the customer in a vulnerable position without the product or service; (b) the product or service is purchased on a recurring basis; and (c) purchases are to a large extent not discretionary.

In assessing an industry sector, a private debt manager is likely to consider the measure of concentration within an industry sector by sales and by market capitalisation to assess whether the industry is more at the competitive or monopolistic end of the scale, examine the extent to which revenues in the industry are cyclical[33], and assess the maturity of the industry.

The criteria above will tend to tilt the focus of private debt funds toward non-cyclical service industries with high visibility of long-term income streams, resilient demand, or regulation underpinning their market structure such as:

- software and related services firms;
- business, infrastructure, and professional services firms;
- technology, media, and telecommunications firms;
- companies specialising in recycling, re-using, and repair;
- healthcare equipment and services firms[34]; and possibly;
- capital goods materials firms focused on net-zero, climate transition.

Sectors with low margins, limited pricing power, over-reliance on discretionary consumer expenditure, or high levels of exposure to input commodity prices are likely to be avoided as they will face challenges in a downturn or in a high inflation environment. Industry sectors like housebuilding, tourism & travel, and restaurants tend to be among the most cyclical and recession-prone sectors and data from these sectors are often watched for early warning signs of economic weakness. Commodity and mining companies are unlikely to be attractive borrowers for private debt funds because of the cyclicality of their earnings.

The tendency to limit lending to a small number of sectors may give rise to credit losses in the long term as the strategy lacks diversification of exposures which is a critical component of credit risk management.

Some private debt funds avoid lending to sectors that present 'balance sheet risk' such as real estate entities and banks. These are sectors in which the failure of one company may drag others down. When one bank fails, other banks experience a run on their deposits which risks bringing down other banks in the sector. Likewise, a fall in the price of real estate in one

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[33] Examples of cyclical industries include the automotive, consumer discretionary, construction, consumer durables, and travel & tourism industries.

[34] The sub-sectors of the healthcare sector that are of particular interest to private debt funds are those supported by secular tailwinds such as the aging population, medical advances in treatments for conditions, the growing public interest in managing their own health, and rising standards of living. The sub-sectors seen as attractive include medical devices, medical technology, life sciences, and certain types of pharmaceutical services.

segment of the property market is likely to have implications for other real estate in the same segment of the market.

13.2.2 Company Due Diligence

Within a chosen industry sector, private debt managers prefer to lend to companies with a leading position as identified by strong market share, good profit margins, dominance of the value chain, and an ability to pass on rising costs to customers. Other characteristics of a borrower that a private debt lender is likely to look for might include a combination of the following:

(i) sticky and long-standing customer relationships built on high satisfaction and brand loyalty among customers;
(ii) mandatory requirements for the purchase of the goods or services with prices indexed to inflation, and high costs of switching product or service provider;
(iii) proven profit resilience through economic cycles;
(iv) no one customer accounts for more than 10% of the company's revenue, the top ten customers account for less than 40% of the company's revenue, and the customer concentration is diminishing;
(v) a high percentage of sales covered by long-term contracts to provide cash flow visibility;
(vi) the ability of management to grow the share of existing customers' wallets and to capture new customers;
(vii) seasoned management team with an impressive track record of growing the company profitably and with good governance;
(viii) economies of scale which allow the company to have a cost advantage relative to competitors through, for example, proprietary production processes;
(ix) high barriers to entry underpinned by a combination of such factors as significant capital expenditure, strong technical know-how, an innovation pipeline, ability to penetrate markets rapidly, and demonstrated track record;
(x) strong competitive market position ideally where none of the company's competitors has the same market footprint or range of products for customers; and
(xi) presents only operational risk and little or no balance sheet risk[35].

In addition to revenue diversification, a private debt fund is also likely to look for diversification of profit within the customer base.

Although private debt funds tend not to lend based on assets, they are reassured by the quality of a company's assets and in particular its saleable assets.

A private debt fund manager will also examine such factors as:

[35] Banks and real estate companies present balance sheet risk. For example, a rise in defaults accompanied by historically low recovery rates can diminish the value of a bank's balance sheet.

- The demand for the company's products or services, the total addressable market, potential secular drivers of growth, and the extent of competition on the supply side of the products or services; sources and drivers of demand for the products or services and whether they are strengthening, weakening, or stable;
- Where a company uses raw materials in its production process, an analysis of the company's supply chain, the price of the raw materials, the extent of variation in the price of those raw materials, and the likely impact of supply chain disruptions and raw material price variation on earnings;
- The level and trends in headcount and independent research into how customers and suppliers rate the company overall and relative to competitors: and
- The extent of any cyclicality or seasonality in earnings and their implications for the variability of earnings.

13.2.3 Cash Flow Statements

Cash flow statements are also a vital part of credit risk analysis as they show the borrower's actual cash inflows and outflows, allowing a potential lender to assess the adequacy of cash being generated and the amount available to service debt. From a series of cash flow statements, potential lenders can calculate a trend in the debt service coverage ratio ("DSCR") of a borrower. The DSCR is the number of times the debt payments due are covered by cash flow.

A review of a series of cash flow statements spanning challenging periods for a company, such as the COVID-19 pandemic or the global financial crisis, provides potential lenders with a view of cash flow in stressed conditions.

The visibility of future cash flows such as arises from long-term contracts with the company's customers that have a low churn rate is also important in assessing the risk of default. In e-commerce enterprises such as software as a service ("SaaS") and subscription-based businesses, annual recurring revenue ("ARR"), gross retention, and net retention[36] are relevant metrics for the assessment of visibility on future cash flows.

Cash flow statements also provide potential lenders with insights into:

(i) Uses of cash generated from operations. Such uses may include paying down debt or investing in growth opportunities.

(ii) Tailoring the loan to the cash flow characteristics of the borrower including the loan amount to be advanced, interest rate, and repayment terms such as bullet repayment, and PIK features.

[36] Gross retention = [% of ARR from renewals].
Net Retention = [% of ARR from renewals] + [% of revenue generated from up selling and cross selling]

13.2.4 Management Due Diligence

The initial meeting with the management team or the private equity sponsor of the company is likely to follow the format of a detailed presentation to the private debt fund manager after which there will normally be a detailed question-and-answer session.

Discussions with management are likely to cover the strength and experience of the management team, the quality of their capital allocation decisions, their focus on cost containment, their track record in sustaining cash flows in different economic environments, the management's incentive to perform, and the corporate strategy with particular emphasis on acquisition strategy. The track record of the company in integrating acquisitions is also likely to be very relevant to the private debt fund manager.

The capital expenditure plans of the company are also likely to be high on the agenda as the private debt fund will wish to understand management's capital expenditure plan for both maintenance and growth capital expenditure. Private debt fund managers will closely examine capital expenditure plans to see how quickly capital expenditure is followed by revenue generation and to consider the impact of delaying capital expenditure when there is a downturn in the revenues of the borrower.

In terms of a review of the shareholder base of the company, the private debt fund manager is likely to have a preference towards companies with significant equity compensation, significant equity ownership among the management team, and evidence of the management team reinvesting in the business rather than granting themselves high dividend pay-outs.

Management due diligence will also involve background checks and a conflicts of interest analysis on each member of the senior management team.

13.2.5 Private Equity Sponsor

The private debt fund manager is likely to consider the experience of the private equity sponsor in the industry sector of the potential borrower and the extent to which the private equity sponsor is capable of providing and likely to be willing to provide further equity capital should the need arise. The higher the level of equity contributed by the sponsor and management team of a borrower at the outset of a deal, the greater the probability of further equity support in the event of a significant downturn in the borrower's business. Strong private equity sponsor relationships are likely to permit consistent loan underwriting in the face of strong competition from other lenders.

13.2.6 Financial Due Diligence

As a first step in financial due diligence, the private debt fund manager is likely to review the historical performance of the borrowing company focusing on:

(i) Profit and loss accounts: net sales, gross margin, operating expenditure, capital expenditure, personnel expenses, and capitalisation of research and development costs;
(ii) Balance sheets: tangible assets, intangible assets, working capital, and net debt; and
(iii) Cash flow statements: Operating cash flow, free cash flow, and net debt.

The above review may be undertaken by an accounting firm which will comment on the quality of earnings and its analysis of the net debt of the company.

The private debt fund will look for and carefully scrutinise the company's business plan. In doing so the private debt lender will examine: (i) a sources-and-uses table showing the loan and any accompanying equity capital as the sources as well as the proposed deployment of the capital raised as the uses; (ii) the pro-forma cash flow statement from the company based on the proposed use of the loan; and (iii) the company's free cash flow generation and any seasonality inherent in the cash flow generation. A review of bank revolving credit facility borrowings may provide an indication of the seasonal working capital needs of a company.

Normally, as part of its sensitivity analysis the private debt lender will generally adopt more conservative assumptions than those provided by the company in its business plan in relation to:

(i) The profit and loss account assumptions particularly sales and gross margin; and
(ii) The cash flows where the focus is likely to be on EBITDA, operating cash flow, cash conversion ratio[37], working capital projections, and capital expenditure.

Capital expenditure, repayments of maturing loans, and proposed dividends over the term of the loan are likely to be compared with sources of liquidity such as cash, cash equivalents, free cash flow, access to further equity capital, the availability of bank credit, and the range, value, and quality of saleable assets.

13.2.6.1 Cash Conversion Ratio

In this regard, the borrower's cash conversion ratio is likely to be closely scrutinised. The cash conversion ratio is a metric that measures how efficiently a company converts its accounting net income into free cash flow. The cash conversion ratio is calculated as:

[Free Cash Flow] / [Net Income]

where,

[Free Cash Flow] = [Cash from Operations] – [Capital Expenditures]

and

[Net Income] = [The company's total accounting net profit from its income statement]

[37] The cash conversion rate is a financial management tool used to determine the ratio of the operating cash flow minus capital expenditures of a company to its net profit after interest, tax, and amortisation.

By netting out capital expenditures, the cash conversation ratio measures how much actual cash the company is generating per unit of net income. Capital expenditures are often significant cash outflows for a business, so removing them allows the measurement of cash available for debt payments.

A higher cash conversion ratio means that for every unit of accounting net income, the company is able to convert more of it into discretionary cash flow. A low cash conversion ratio may signal deficits in working capital or high reinvestment needs.

13.2.6.2 Capital Ratios

On the capital side, the private debt fund is likely to focus on:

(i) Operating leverage and its appropriateness in light of the company's credit rating as assessed by the private debt lender;

(ii) Interest coverage, DSCR, and coverage for fixed charges;

(iii) The ratio of [Debt]/[Equity Capital]; and

(iv) Amortisation v. bullet repayments. Many private debt loans tend not to be amortised over the term of the loan rather the loan principal and any rolled-up interest tends to be repayable as a single sum, a bullet repayment, at maturity. The bullet repayment may need to be refinanced at maturity and that presents a refinancing risk for the private debt fund manager. The size of a bullet repayment which a private debt fund manager will underwrite depends on the size of the company's balance sheet, the quality of business, and the company's credit rating. Where the loan is amortised over the term of the loan, a detailed examination of the pro-forma cash flow profile of the business to the amortisation schedule is likely to be carried out by the private debt fund manager.

13.2.6.3 Other Financial Due Diligence Considerations

Other financial due diligence considerations include:

(i) A comparison of the company's key financial parameters such as [Enterprise Value]/[12-MONTH TRAILING EBITDA] and debt profile, interest coverage ratios, and leverage metrics against those of industry peers and publicly quoted companies in the same industry;

(ii) An examination of the historic variation in cash flows, a sensitivity analysis such as that described in Example 4 below, and a review of the private debt fund's margin for error in the transaction;

(iii) An examination of the capital structure covering senior debt, mezzanine debt, cash, capital expenditure, undrawn revolving credit facilities, equity and the associated reference EBITDA and consideration of the extent to which significant fixed costs could make operating profits more volatile. The key question will be: Is the capital structure appropriate for the nature of the profit stream?

(iv) Consideration would also be given to any off-balance-sheet items.

Example 4: Sensitivity Analysis – Private Debt Lending to a Hotel Group
Hotels have high fixed costs which include wages, property rents, cost of goods and services such as energy, marketing, and laundry costs and ongoing capital expenditure to maintain the quality of their product offering. While capital expenditure can be delayed during a recession affecting revenue, most of the other fixed costs are difficult to reduce in a recessionary period. Therefore, when underwriting a loan proposal for a hotel group, the private debt lender is likely to examine the following variables either for the borrower where the track record is available or for a comparable publicly quoted hotel group: 20-year history of the development of: (i) revenue; (ii) EBIT; and (iii) return on capital employed. The private debt lender may also examine items (i) and (ii) adjusted for the number of rooms available as this is unlikely to have remained static over a 20-year period.

13.2.7 Preservation of Capital in a Stress Scenario

Private debt fund managers will always consider a liquidation scenario. Large private debt fund managers generally employ or have access to a team of experienced workout specialists who develop a workout strategy and value a borrowing company. The costs of engaging the workout specialists are charged to the borrower.

One possible question a private debt fund manager may ask in such circumstances is: "*Would we be happy to own the company, run it, and would it generate an adequate return on capital employed?*"

The aim of such consideration is to see if the fund is likely to lose money in a stress scenario and to consider likely acquirers of the company in a liquidation scenario.

[Enterprise Value]/[12-MONTH TRAILING EBITDA] may be used as a guide to recovery value, and the assets, including off-balance sheet assets, available to support repayment of the private debt fund's loan to the company.

As a first step in planning for a liquidation scenario, the private debt fund manager may put in place ex-ante agreed strategic de-risking options. For example, where a loan is senior unsecured as opposed to senior secured, a close examination will be carried out of the unencumbered assets of the company as absent any valuable tangible assets or a sale to an acquirer which repays or takes over the loan, unencumbered assets are likely to be the source of funds to repay the debt.

The private debt fund manager is likely to draw up a list of likely acquirers of the borrowing company, identify why the borrowing company might be attractive to such a buyer, and consider whether the likely price to be paid by such a buyer would ensure repayment of the private debt lender's loan outstanding.

An increasing number of borrowings by companies tend to have bullet repayments at maturity rather than being amortising loans. Bullet maturities present a refinancing risk at maturity. The refinancing of the debt of a borrowing company which will mature during the term of the loan provided by the private debt fund is likely to be a key focus of the private debt fund manager because of the potential for a significant rise in interest rates to impact the borrowing

company's cash flows. Example 5 below illustrates the potential cash flow impact of having to refinance existing debt at a higher rate of interest.

Example 5: Refinancing: The Impact on Cashflow

In September 2022, the Swedish alarm company, Verisure Holding AB, a non-investment grade credit, raised EUR500 million in senior secured notes at par.[38] The notes paid a 9.25% coupon.

The EUR500 million raised was principally to refinance its maturing outstanding senior secured notes due 2023 which paid a 3.5% coupon.

The refinancing increased the annual debt servicing costs by EUR28.75m.

In the calendar years 2024, 2025, and 2026, a huge wave of companies will be seeking refinancing. Many of the existing lenders to these companies may be unwilling or unable to extend such loans particularly if the companies are exhibiting earnings volatility. This may present lending opportunities for private debt funds.

13.2.7.1 Jurisdiction of Borrowers

Some private debt fund managers restrict their lending to companies registered and operating in Canada, the European Union, Japan, the United Kingdom, and the United States. The restriction is likely to be motivated by considerations of familiarity with industry dynamics and market practices, economic stability, and respect for the rule of law in relation to the rights of lenders against borrowers. This can lead to lower risks for lenders in terms of borrower default and economic volatility. These countries tend to have stable and highly liquid currencies for which there are established over-the-counter forward foreign exchange markets for hedging foreign currency exposures. This can minimise currency exchange rate risks for both lenders and borrowers in cross jurisdiction lending and borrowing.

13.2.8 Conditions to be Satisfied Prior to Advance of a Loan

Where the underwriting process concludes that it is appropriate to advance a loan, there is likely to be a set of conditions that must be satisfied before the loan can be drawn down. These are generally referred to as 'conditions precedent' and are documented in the loan agreement.

The conditions precedent may include such requirements as: (i) acceptance of the private debt manager's engagement letter and binding term sheet; (ii) satisfactory "Know Your Customer" ("KYC"), AML, and CFT checks on the borrowing company; (iii) the borrowing company is not subject to any litigation; (iv) satisfactory verification of a range of financial metrics; (v) satisfactory results of (a) due diligence with a number of key customers of the borrowing company; (b) searches for liens; and (c) existence of subsidiaries; (vi) satisfactory evidence of the repayment of earlier borrowings which the borrowing company claims have been repaid; and (vii) satisfactory evidence that any regulatory authorisations or insurance policies which the borrower claims to have in place are actually in place and up-to-date.

[38] Source: https://www.verisure.com/sites/gv/files/2022-09/Verisure-Holding-AB-Proposed-Offering-Launch.pdf

13.3 Loan Agreement

A loan agreement will contain a set of definitions of various terms. One of the more important definitions is that of EBITDA as it is the basis of many loan covenants. As we saw in section 13.1, addbacks can multiply the original definition of EBITDA by a factor of 1.25x or higher so a clear definition of the permitted addbacks in the computation of EBITDA ought to be set out in the loan agreement.

Aside from the term of the loan, the drawdown schedule for the loan, the interest rate and manner in which it is to be calculated, arrangement fee, prepayment fees, and whether the loan is amortising or bullet repayment, Table 6 provides a summary of some of the possible key terms, or perhaps more accurately, restrictions, to be found in a loan agreement between the private debt fund and the company borrowing the money.

Loan agreements contain covenants that require the borrower to fulfil certain conditions or which forbid the borrower from undertaking certain actions, or which require the borrower to maintain certain financial ratios. If the borrower breaches a borrowing covenant without cure, the lender can call in the loan and demand full repayment of the outstanding balance.

To a private debt lender, the terms of a loan agreement are much more important than the pricing of the loan. A loan can always be repriced for risk if the borrowing company gets into difficulty by, for example, charging a higher interest rate or a fee for waiving a covenant breach. The holy grail of a loan agreement is to have a high spread over the floating reference rate, and strong downside protections on a loan to a lowly leveraged borrower with highly visible and stable cash flows. Many of the terms restrict the borrower's decision-making powers in relation to cash, assets, and acquisitions. When debt finance is readily available from alternative sources and competitors of a private debt fund, the private debt lender may have to yield on some of the terms of the loan agreement and the borrowing covenants.

Borrowers with strong track records are likely to be able to negotiate a relaxation of some of the restrictions. For example, a private debt lender may permit a borrower to engage in a joint venture where it can be demonstrated that the change in business strategy has been carefully evaluated and is unlikely to negatively impact the borrower's ability to repay the loan.

Table 6

Clause	Purpose of Clause
Limitation on Disposal of Assets	Asset sales and sales of parts of a business are likely to reduce EBITDA, which absent a reduction in debt, increases the [Debt]/[12-MONTH TRAILING EBITDA] leverage multiple. The private debt fund manager will wish to ensure that: (i) asset sales will be used to reduce borrowings in the underlying business; and (ii) other creditors further down in the capital structure are not repaid from asset sales ahead of the private debt fund. There may be a waterfall for the use of the proceeds of asset sales to repay debt and reinvest in assets. Some deals permit that after the waterfall of payments has been satisfied, the excess proceeds can be used to pay a dividend sometimes subject to a leveraged-based test.
Change of Control	In the event of a change in the ownership or control of the borrowing company, the private debt lender is likely to seek an option to require repayment of its outstanding loan amount together with any prepayment charges due. Care must be taken in the drafting of the change of control definitions to ensure that related persons and sponsor affiliates trigger a change of control.

Clause	Purpose of Clause
Permitted Payments	Permitted payments are designed to limit the amount of cash or assets that can be removed from the collateral pool of the private debt lender. The limits usually apply to the payment of dividends, payments to buy back shares in the company, repayment of subordinated debt, and acquisitions.
Restriction on the Creation of Further Debt	If the borrowing company is allowed to increase the level of debt finance, it may have implications for the potential recovery of the private debt lender's loan particularly if the borrower files for bankruptcy or becomes unable to service its debt.
Permitted Acquisitions	Acquisitions may require cash or additional borrowing by the acquiring company. The private debt fund will wish to limit the use of cash and further borrowings for acquisitions in cases where they may not be earnings accretive.
Limit on Transactions with Affiliates	Transactions with affiliates run the risk of weakening the borrower's financial position and hence the security for the private debt lender's loan. Such transactions may not be as transparent as those conducted with unconnected third parties and may not be conducted at arm's length in view of the relationship between the borrower and its affiliates. Transactions with affiliates could involve terms which are not in the best interests of the private debt lender such as: (i) the transfer of assets to an affiliate; (ii) the diversion of free cash to an affiliate which, in a winding up, may acquire the status of a preferential payment ranking ahead of the private debt lender; and (iii) creating liens over assets of the borrower in favour of an affiliate. The aim of the clause is to protect the private debt lender's right to repayment of capital and interest by restricting transactions with affiliates.
Line of Business Maintenance	When a loan has been underwritten, the private debt lender is advancing the loan on the basis that the borrower: (i) continues in line of business within the industry it is currently operating; (ii) its management team has a demonstrable track record of skill and experience in that industry; (iii) the financial projections are based on the nature of that industry and the borrower's position in that industry; and (iv) the value of the borrower's assets within its industry. If a borrower were to switch its line of business, all of these assumptions would no longer be valid and the risk of loan loss for the private debt lender may increase. The purpose of the clause is to ensure that the borrower's activities are broadly in line with the underwriting assumptions.
Limits on Liens	Designed to restrict the company's ability to secure future debt by creating liens over the borrowing company's assets. The limitation of liens would also include the granting of liens to tax authorities for taxes due but unpaid for liquidity reasons.
Limitations on Joint Ventures	Joint ventures increase a private debt lender's exposure to risks not envisaged at loan underwriting. They are likely to involve a change of business strategy, a diversion of management time from the core business, the pledging of the borrower's assets as collateral, the use of financial resources, a significant change in the projected cash flows assumed at underwriting, a move away from management's area of expertise, and possible liabilities arising from a failed joint venture. Any one of these changes might affect the borrower's ability to meet its debt obligations to the private debt lender or reduce the security for the private debt lender's loan. Therefore, borrowing covenants tend to limit joint ventures to protect the private debt lender's interests.
Negative Pledge	A negative pledge is a provision in the loan agreement prohibiting the borrower from creating security interests over specified property assets. It aims to prevent borrowers from creating fixed charges over their assets which are subject to a floating charge as to do so would give fixed charge holders priority upon enforcement even if created after the floating charge.
Share Pledge[39]	A share pledge involves a shareholder pledging their ownership of shares in the company to the lender while the shareholder retains economic rights like dividends until default triggers the transfer of ownership. If the loan defaults, the lender then has the right to seize the shares, sell them, and use the proceeds to recover funds owed. Private debt lenders often require a share pledge agreement spelling out terms and conditions such as restrictions on selling or transferring the shares. A pledge is registered so it is enforceable even if the shares are later sold. It is designed to align the shareholders' interests with loan repayment.
Board Level Participation	The private debt lender may seek a seat at the board table if certain financial parameters deteriorate or if certain other events occur. Quick action when the financial condition of the borrower starts to deteriorate can prevent loan losses.
Maintenance Covenants	A maintenance covenant requires the borrowing company to meet certain specified financial parameters when tested at intervals such as quarterly to maintain compliance with the loan agreement. As an example of a maintenance covenant, a borrower may be required to maintain a [Debt]/[12-MONTH TRAILING EBITDA] multiple of less than 3.5x when tested every quarter. If the borrower fails to do so, it is an event of default under the loan agreement. Other typical maintenance covenants include a minimum [12-MONTH TRAILING EBITDA]/[INTEREST] ratio, a minimum tangible net worth ratio, and limits on capital expenditure. Maintenance covenants are generally associated with loans to poorer credit-quality borrowers. For borrowers in cyclical industrial sectors where EBITDA can vary significantly, maintenance covenants may be very challenging to manage.

[39] The borrower hands over the asset or a document of title to the asset, for example, a share certificate for shares, to the lender. There is no transfer of ownership in a pledge.

Clause	Purpose of Clause
Incurrence Covenants Private debt fund lenders generally prefer maintenance covenants to incurrence covenants when lending to companies because of the tighter control and oversight provided by maintenance covenants.	An incurrence covenant falls to be tested only if the borrower is taking some specified action. Incurrence covenants don't have to be tested for compliance at some regular intervals of time. For example, a borrowing company is not permitted to increase its debt unless the borrower's [Debt]/[12-MONTH TRAILING EBITDA] multiple is less than 3.5x after considering pro forma treatment for the new debt. A borrowing company with such an incurrence covenant that proposes to raise new debt that would bring the [Debt]/[12-MONTH TRAILING EBITDA] multiple above 3.5x would trigger an event of default and so is unlikely to take such action. If the borrower's [Debt]/[12-MONTH TRAILING EBITDA] multiple rose above 3.5x as a result of a decline in EBITDA rather than as a result of the borrower incurring new debt, there would not be a default under this covenant as it is only tested when the borrower is raising additional debt finance. The range of actions that trigger the testing of an incurrence covenant typically includes payment of a dividend, selling assets or pledging them as collateral for a loan, and acquiring other companies.
Cash Sweep	Cash sweeps usually require the borrower to use excess cash to periodically repay debt ahead of schedule. The circumstances in which a cash sweep will arise, the starting date for the cash sweep to operate, and the percentage of excess cash to be paid to the lender will be defined.
Management Participation	Members of the management team may be required to put up a percentage of the debt finance from their own resources to more align their interests in the debt with those of the private debt fund.
Information Rights	Information rights ought to include access to members of the management team, financial statements, and budgets and specify the frequency of receipt of management reports, management accounts, and cash flow data.
Merger and Consolidation Restrictions	The private debt fund manager may be permitted to call in the loan at a premium to its nominal value when a specified event gives rise to a change of ownership or control of the company.
Other Asset Security	Where security is being granted to the private debt fund over all of the assets of the borrower, it is usually limited to a floating rather than a fixed charge.
'Most Favoured Nation' Status	A private debt fund manager is likely to look for most favoured lender provisions to ensure that it gets the benefit of any more restrictive covenants negotiated in respect of other borrowings permitted by the private debt lender and made by the company in the future.
Events of Default	The purpose of the events of default clause is to list the situations in which the risk of the loan not being repaid increases significantly and to allow the private debt lender in such situations to take a range of actions including: (i) charging additional fees; (ii) demanding immediate repayment of the loan; and (iii) initiating legal remedies to recover the loan outstanding. Events of default are likely to include some or all of the following: failure to make a payment under the loan agreement when due, litigation, a change of control of the borrower which has not been authorised by the private debt lender, misrepresentation, default under another loan agreement, breach of a loan covenant, significant change in or cessation of the business, cash distributions to shareholders which have not been authorised by the private debt lender, material adverse change, and the commencement of winding up proceedings by creditors.

Other general terms are likely to include: (i) maintenance of properties to protect the value of assets; (ii) payment of various types of insurance to provide for replacement of assets in the event of one or more insured perils and provide capital to fund claims against the company; (iii) payment of taxes to avoid future tax liabilities and associated interest and penalties which would reduce the value of the company's assets; and (iv) compliance with laws to avoid regulatory or other fines and reputation damage.

13.4 Loan Terms

While loan terms are specific to and constrained by the investment objectives and strategy of a private debt fund, the following aims to give readers an idea of possible loan terms for a private debt fund lending to middle market U.S. companies with an annual revenue in excess of

USD350m, 12-MONTH TRAILING EBITDA[40] of in excess of USD50m, and an enterprise value[41] in excess of USD200m.

13.4.1 Loan Type

A private debt fund may limit its lending to senior secured loans to companies sponsored by private equity firms. Private equity firms provide equity capital and thereby absorb the first tranche of any losses. Private equity firms tend to have ready access to further equity capital should the need and justification to bail a borrower out of financial difficulties arise.

Loans may be: (i) amortising with each instalment consisting of capital and interest; (ii) repayable by means of monthly interest payments in cash and one or more bullet payments, typically a single bullet payment at the end of the term; or (iii) PIK in nature with a single bullet repayment at the end of the loan term.

13.4.2 Debt Size

Debt size depends on so many factors including private debt fund size, loan purpose, credit risk of the borrower, private debt fund diversification considerations, leverage of the borrower, quality and visibility of the borrower's earnings, that it is difficult to provide a typical range for a private debt fund.

For the private debt firm described in the introduction to this section, debt size may range from USD75m to USD150m. Increasingly, larger debt sizes are seen, reflecting availability of funds but also increasing appetite from borrowers.

13.4.3 Leverage

Leverage tends to vary somewhat with the stability of the borrower's cash flows and its ability to pass on rising costs to its customers without any significant diminution in its revenues. In the current interest rate environment, a [Debt]/[12-MONTH TRAILING EBITDA] ratio of up to 4.0x might be permitted. In agreeing to a [Debt]/[12-MONTH TRAILING EBITDA] ratio, a private debt lender will also consider the implications of that ratio for the loan-to-value ratio.

13.4.4 Maturity

The maturity of the loans will vary with the private debt fund's strategy. However, in the case of private equity sponsored companies, the loan term will be restricted so as to be shorter than the term of the private equity investor in the borrower. Some private debt funds may limit the maximum term of a loan to five years.

13.4.5 Margin

The spread over the floating rate charged on a loan will depend on the private debt fund's assessment of the credit risk of the borrower, the size of the borrower's business, the leverage

[40] This EBITDA figure will be based on the private debt fund's permitted addbacks rather than the EBITDA figure prepared by the borrower which is likely to have a larger set of addbacks.

[41] Enterprise value is determined by the private debt firm. The borrower's figure for enterprise value is not used for this screening criterion.

of the borrower, and the yield on loans that the private debt fund is targeting. In the current interest rate environment, a private debt fund might target an unleveraged return in excess of 9% per annum while aiming to obtain above 12% per annum taking into account the leverage of the private debt fund. The figures quoted assume no loan losses and that the loan runs the full term with the borrower. The margin quoted would apply to cases where interest is paid in cash. A PIK-type loan would have a higher interest rate perhaps as much as 4% per annum higher.

Some private debt funds may agree to lend at a fixed rate of interest and enter into a swap transaction to convert the receipt of the fixed rate of interest from the portfolio company to a floating rate of interest.

Returns to the private debt fund can be boosted by arrangement fees charged to the borrower which may range from 1% to 3.5% of the loan amount.

While less relevant in the current interest rate environment, in a falling interest rate environment, a private debt fund would typically also include a floor on the reference rate set at something in the range of 0.5% to 1.0% per annum.

13.4.6 Purpose

A loan may be to finance an acquisition, to refinance existing debt which is maturing, to fund a large special dividend pay-out to its shareholders, or for any other agreed purpose.

13.4.7 Diversification of Exposures

The private debt fund is likely to wish to manage its exposure to any one borrower and may set a limit on such exposure in terms of absolute loan size and loan size relative to the net asset value of the private debt fund. For example, for the private debt fund in the introduction to this section, a loan to a single borrower might be limited to the lesser of 10% of net asset value and USD150m. Private debt funds may also wish to limit their exposure to borrowers with the same private equity sponsor and to borrowers in the same industry sector.

13.4.8 Call Protection

A borrowing company may experience a significant improvement in its cash flow or be able to refinance a loan on better terms and wish to repay the loan before the end of the loan term. Such a repayment of the loan is referred to as a prepayment.

Prepayments reduce the returns that a private debt lender anticipated. To prevent such loss of returns, a private debt lender may: (i) prohibit the borrowing company from prepaying the loan for a period, typically between 12 and 24 months, thereby locking in the stream of interest income for that period; or (ii) charge the borrow a fee to prepay the loan to at least in part compensate the lender for the interest income foregone as a result of the prepayment of the loan. Table 4 shown earlier and reproduced below illustrates a sample schedule of prepayment

fees expressed as a percentage of the loan outstanding repaid and the way in which prepayment fees vary with how early the loan is prepaid.

Table 4

Year	Prepayment Fee (Percentage of the Outstanding Loan Repaid)
1	3.50%
2	2.25%
3	1.25%

13.4.9 Covenants

The purpose of a covenant is to protect the value of a lender's claim on the borrowing company by ensuring that the borrower can service its debt obligations as agreed at loan origination. Covenants are not a substitute for detailed credit risk analysis of a potential borrower. A loose covenant structure may allow a management team and its private equity sponsor to utilise every flexibility in the covenant terms to extend the lifespan of a company at a time of financial distress and give rise to a lower recovery rate than private debt lenders have historically experienced.

A borrower on the other hand will tend to evaluate: (i) how covenants will affect its business activities; and (ii) how its future flexibility might be restricted. To balance the possibly conflicting objectives of the lender and the borrower in drafting the covenant package, a private debt lender needs to be fully familiar with the borrower's corporate organisation, capital structure, and business plan for the period of the loan.

During the recent period of historic low interest rates, some investors, particularly those in the high yield debt market, in their search for yield traded off covenant protections for yield.

13.4.10 Timing of Execution

The timing of the execution of a senior secured loan once approved by a private debt fund depends on the jurisdiction of the borrower, the law under which the loan agreement is documented, the nature of the security package, and any required regulatory approvals. A typical timetable might be in the range of 3-4 weeks.

13.4.11 Security Package

The security package for a private debt loan will vary from loan to loan. However, it may include some or all of the following items:

(i) Pledge over shares in the borrowing company and its main subsidiaries;
(ii) Guarantees from relevant subsidiaries;
(iii) Pledge over the bank accounts of the borrower and relevant subsidiaries;
(iv) A requirement for a debt service reserve account specifying the minimum amount of cash to be held in such account;
(v) Pledge over or beneficiary clause in the insurance policies of the borrower;

(vi) A pledge over shareholder loans requiring major shareholders to pledge their previous loans into the company as security. If the company defaults, the private debt fund manager can seize the shareholder loans to recover funds;

(vii) Pledge over government or other grants receivable;

(viii) Pledge over intercompany receivables;

(ix) Debt service reserve account that must be maintained at all times;

(x) Cash sweep that allows the lender to sweep or transfer all or an agreed percentage of available cash balances from the borrower's bank accounts toward repayment of the outstanding loan under pre-defined conditions or at particular points during the loan term; and

(xi) A requirement to grant a mortgage over certain property of the borrowing company in the event its leverage exceeds a set of pre-defined levels one for future year of the loan or if the interest cover ratio falls below a set of pre-defined levels one for each future year of the loan.

The pledges mentioned above are generally first ranking pledges.

Guarantees under security packages automatically cease upon the repayment of the loan to the private debt fund.

14 Private Debt Funds

14.1 Structure and Operation of a Private Debt Fund

The flow of assets into investment in private debt funds comes from two main sources, institutional investors and retail investors. The bulk of private debt capital is raised in the U.S. which accounts for something of the order of 60% to 70% share of private debt capital raised. This is followed by Europe accounting for something of the order of 20% to 30% share of private debt capital raised. The percentage share of private debt capital raised in Asia is in the low single-digit range.

14.1.1 Institutional Investors

An Irish domiciled private debt fund targeting institutional investors is generally a closed-ended, collective investment vehicle which is usually structured with the following features: (i) it is a common law investment limited partnership; (ii) it is a regulated investment fund authorised by the Central Bank of Ireland; and (iii) it is managed by an authorised alternative investment fund manager in the EU. Item (iii) of the structure allows the fund to be marketed to professional investors throughout the European Economic Area ("EEA") under the Alternative Investment Fund Managers Directive ("AIFMD").

In the context of private debt, an investment limited partnership ("ILP") is a partnership designed to invest in loans to companies for the purpose of generating returns for the partners. An ILP has at least one general partner ("GP") with unlimited personal liability which is responsible for managing the partnership and a number of limited partners ("LPs") which provide most of the capital but have limited liability and are not involved in day-to-day management of the partnership. The GP is usually structured as a limited liability company to avoid having unlimited personal liability.

The ILP invests the capital in a diversified pool of loans to companies. The investment strategy is outlined in the partnership agreement, but investment decisions are made by the GP. The LPs contribute most of the investment capital in return for partnership interests while the GP contributes typically 1% or more of the capital. The GP receives management fees, expressed as a percentage of assets under management, for its services in selecting and managing investments and may also receive incentive fees if the returns to the LPs exceed a hurdle rate. LP interests are generally illiquid and partners cannot redeem partnership interests before dissolution of the partnership.

In many cases, there may be a private debt fund manager appointed by the GP, but for the purposes of this paper the private debt fund investment manager and the GP are assumed to be the same entity.

The GP sources borrowers of the invested capital, selects attractive borrowers to which to make loans, negotiates and executes the loan agreement, monitors the loans on behalf of the fund, delivers the returns from such operations to the investors, and also invests in the partnership.

Where necessary, the GP will also renegotiate the loan agreement or execute a credit workout if the borrower gets into difficulty in repaying the loan.

From a taxation perspective, an Irish investment limited partnership is tax transparent in that the partnership itself is not subject to taxation on its income or gains. Rather, the LPs will be subject to taxation in the country in which they are resident and the country where the private debt borrower is situated. The latter taxation may be mitigated through relief under a double tax treaty between the country of residence of the LP and the country where the private debt borrower is situated.

Investors in a private debt fund, pension funds, insurance companies, private wealth managers, and sovereign wealth funds *pledge to commit* amounts of money to the fund to provide all or part[42] of the capital to make loans to borrowers; such pledges are generally called *capital commitments*. We use the phrase *pledge to commit* money to the private debt fund as the GP of a fund will call capital from the LPs at a point or points in the future to make loans to borrowers from the private debt fund rather than require all of the LPs capital commitments to be paid at the inception of the private debt fund. Pending capital calls, investors in private debt funds can continue to hold their capital commitments in other investment vehicles and potentially earn a return on them.

LPs are passive investors and have little or no say in the investment strategy of the private debt fund or its operation.

The operation of the private debt fund and the relationship between the GP and the LPs are governed by a limited partnership agreement ("LPA").

The companies to which a private debt fund lends money are generally referred to as *portfolio companies* and that is the term used in this paper.

Most private debt funds are closed-ended[43] investment vehicles.

14.1.2 Investment Period and Life of the Fund

The investment period and life of a private debt fund tend to vary with the complexity of the lending strategy. For example, a private debt fund engaged in senior secured direct lending might have an investment period of 2 to 3 years, a total fund life of 5 to 7 years, and an option to extend the life of the fund for up to two years via two one-year optional extensions.

There are perhaps fewer attractive opportunities to lend to distressed companies than attractive opportunities to provide senior secured direct lending. Therefore, a private debt fund lending

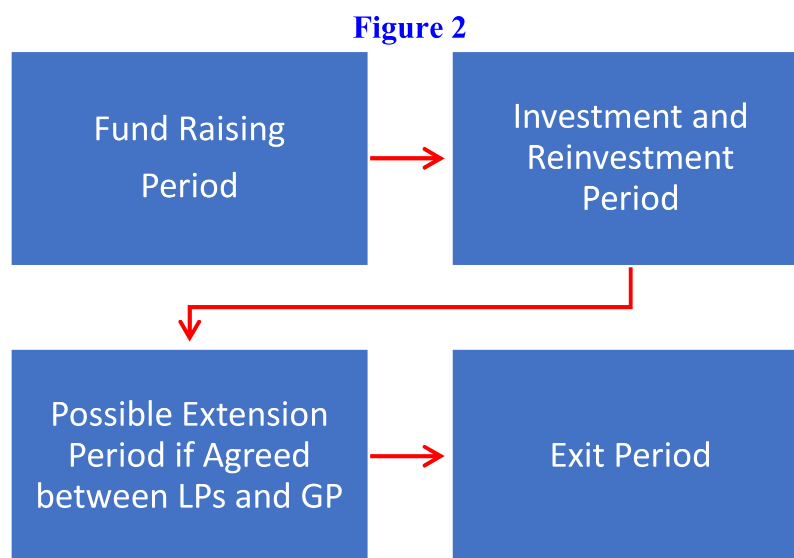
[42] In addition to the capital commitments of LPs, a private debt fund may supplement the capital to fund its operations by borrowing money.

[43] Closed-ended investment fund have a fixed number of shares or units available and once these are issued during the offer period, new investors cannot directly buy shares or units in the fund. Closed-ended funds do not permit their investors to redeem existing shares or units in the fund at the net asset value of the fund before the end of the life of the fund, but investors may be able to sell their shares or units in the fund to others if this is permitted under the limited partnership agreement.

to distressed companies may require a longer time period to find the fewer attractive lending opportunities arising and might have an investment period of up to five years, a total life of up to ten years, and an option to extend the life of the fund for up to a further three years via three one-year optional extensions.

There are generally three, possibly four, phases in the life of a private debt fund structured as an investment limited partnership for predominantly institutional investors. Figure 2 illustrates the phases sequentially.

Figure 2



Fund Raising Period

During the fund raising period, the private debt fund manager seeks binding commitments of capital from investors. During this phase, a GP may choose to have several fund raising rounds for a private debt fund before the private debt fund closes, and no new investors are accepted into the fund. The period may last anywhere from 6 to 18 months.

Investment and Reinvestment Period

During the investment period, the GP will actively source, underwrite, and where appropriate in line with the investment strategy, enter into loan agreements with portfolio companies. This phase may run for periods of between 2 and 5 years following the final close of the fund raising period. To fund these investments, the GP my borrow cash pending a call of capital from the LPs. During this phase, the GP may sometimes be permitted to reinvest the proceeds of repayments of loans made early on in the life of the private debt fund[44].

[44] For example, if the borrowing company is sold, say within a year of taking out the loan, the new owners may decide to refinance the debt. The capital repaid could then be used to make a further loan.

Possible Extension Period

Some private debt funds structured as investment limited partnerships predominantly for institutional investors may permit the GP to extend the life of the private debt fund beyond its expected termination date. The extension period may be from 1 to 3 years in length. The purpose of the extension period is to optimise the exit timing and maximise the value of some of the loans to portfolio companies where there is potential for appreciation in value over a longer period of time. If the extension period is approved by the LPs, the GP can hold assets past the original fund termination date and exit such investments at a more opportune time.

Exit Period

Once the investment period and any reinvestment period end, the private debt fund manager will not advance any further loans. The fund then enters the exit phase during which the loans to portfolio companies are repaid either in full or net of any loan losses and the proceeds distributed to the LPs after deduction of any applicable fees.

14.1.3 Capital Commitments

The LPs commit to contribute capital to a private debt fund over a certain period of time. It is on the basis of such commitments that the private debt fund can proceed with its investment activities.

14.1.4 Capital Calls

The private debt fund manager will periodically call for capital from the LPs principally to complete loan transactions with portfolio companies. Such requests for capital are known as *capital calls*. Typically, capital may only be called during the investment period of the private debt fund. LPs will typically receive a minimum of 10 business days written notice of a capital call.

14.1.5 Management Fees

The private debt fund manager of a private debt fund structured as a limited partnership with predominantly institutional investors will charge the limited partners a management fee. The fee may be structured as a percentage of capital commitments during a fund's investment period and as a percentage of invested capital in the post investment period of the fund. However, there is a trend among private debt funds to charge management fees on invested capital only.

Investors familiar with holdings in funds investing in listed equities or bonds are used to management fees being expressed as a percentage of the net asset value[45] ("NAV") of those funds. In private debt funds, it is more usual to charge the management fee on the gross asset

[45] The NAV is the total assets owned by the fund less its total liabilities. Total assets include the value of loans held by the fund, cash or cash equivalents, receivables like interest, and any other investments or assets. In calculating total assets, assets are marked to their current market values. Total liabilities include any fees, taxes or expenses owed by the fund, as well as liabilities like loans taken by the fund.

value ("GAV") of a fund. The GAV is the market value of the assets of the fund before subtracting any liabilities of the fund.

Management fees tend to vary with the riskiness and expected return of a private debt fund's strategy. For example, a private debt fund engaged in senior secured direct lending to sponsor-backed borrowers with 12-MONTH TRAILING EBITDA above USD50m might charge limited partners an annual management fee of 1% of total assets per annum while a private debt fund engaged in lending to distressed companies might have an annual management fee as high as 1.5% of total assets.

Private debt fund managers may offer all investors a discount of up to 50% on management fees for commitments of a certain minimum amount made before a certain date.

14.1.6 Performance Fees (Carried Interest)

The terms of a private debt fund structured as an investment limited partnership with predominantly institutional investors are also likely to provide for the LPs to pay the private debt manager a performance fee. This is a share of the profits of the fund once the returns to the LPs reach a specified hurdle rate.

Performance fees in private debt are normally referred to as carried interest and the hurdle rate may also be referred to as the preferred return.

The percentage of the share of profits above the hurdle rate tends to vary with the riskiness of the lending strategy. For example, the performance fee above the hurdle rate might be of the order of 10% of the profits above the hurdle rate for a fund providing senior secured loans to companies while that for a fund providing loans to distressed companies might be as high as 20% of the profits above the hurdle rate.

The hurdle rates tend to vary with the riskiness of the lending strategy and might run from 5% per annum for a fund providing senior secured loans to companies while that for a fund providing loans to distressed companies might be as high as 8% per annum.

Some performance fee structures allow the GP to get a share of the total return and not solely on the return in excess of the preferred return. Providing the GP with a share of the total return is achieved by including a 'catch-up' clause in the limited partnership agreement. An example of the operation of such a clause is shown below in Example 6. The parameters and structure of a catch-up clause can vary significantly from one private debt fund to another.

Example 6: Performance Fee Catch-Up

Let's assume that LPs are entitled to all cash distributions until they have received the return of their original capital plus the hurdle rate of return which we shall assume is 8% per annum. Thereafter, the GP is entitled to a performance fee, say 12.5% of all distributions with a catch-up provision. In terms of the waterfall of payments arising from this catch-up structure:

1. LPs would get all of the distributions until their 8% return hurdle rate on their invested capital has been reached.
2. The GP would then get all of the distributions until it received 12.5% of the entirety of the distributions, the 'catch-up'.
3. Any residual profits arising after the GP has 'caught up' would then be split between the GP and the LPs according to a predetermined schedule such as 12.5% to the GP and 87.5% to the LPs.

14.1.7 Impact of Management & Performance Fees on Investor Returns

The combination of management and incentive fees taken from the total return in private debt funds varies widely pending on: (i) the level of leverage used by the private debt fund; (ii) whether the management fee is calculated on NAV or GAV; and (iii) the parameters and structure of the performance fee. While it is difficult to generalise, it would not be unusual to find that the combination of fees is equivalent to a charge of about 3% per annum of NAV. For a private debt fund with an expected return of 12% before fees, fees might represent something of the order of 25% of the gross return.

14.1.8 Other Fees

Aside from management fees and performance fees, a private debt fund structured as an investment limited partnership with predominantly institutional investors will be charged other fees including custody fees, regulatory fees, administrative expenses, legal fees, and audit fees. Again these fees will be fund specific, but a reasonable range for such fees might be 35 bps to 50 bps per annum of NAV.

Private debt funds using leverage will also be charged borrowing costs. It is not possible to give a range for borrowing costs as they depend on the level of leverage and the interest charged on borrowings which varies over time.

14.2 Private Debt Funds for Retail Investors

In the 2023 Global Wealth and Asset Management Report,[46] Morgan Stanley and Oliver Wyman expect:

> "*retail/wealth growth to continue to outpace institutional at 7.9% vs. 5.5%, propelling it to over 60% of global third-party*" assets under management by 2027

and report that:

> *Democratization of private markets for retail investors remains a key growth driver over the coming five years given improved access enabled by product innovation … advancements in technology (e.g., fund distribution and administration platforms), and increased commitment by GPs to educate advisors to help them sell these more complex products.*

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[46] Source:
https://www.oliverwyman.com/content/dam/oliverwyman/v2/publications/2023/october/Oliver_Wyman_Morgan_Stanley_Global_Wealth_and_Asset_Management_report_2023_The_Generative_AI_Tipping%20Point1.pdf, accessed 7 December 2023.

Private debt fund managers are seeking to diversify their investor base beyond institutional investors by tapping into high net worth retail investors. Equally, high net worth investors advised by their wealth managers are attracted to the historic risk-adjusted returns and potential illiquidity premium offered by private debt funds.

At the same time, EU and U.K. policymakers are keen to encourage a greater supply of long-term capital to support economic growth.

Traditionally, institutional investors invested in private debt via closed-ended structures such as investment limited partnerships. Retail-focused investment vehicles providing exposure to private debt need to carry a regulatory 'badge of approval' similar perhaps to the badge of approval for UCITS and have compliance rules for investment managers so that retail investors can have confidence investing in the private debt asset class. Provided retail investors fully understand the long-term and illiquid nature and can bear the risks associated with private debt lending, retail-focused investment vehicles can provide a useful diversification for an individual's investment portfolio.

By reducing the minimum percentage of the assets that a private debt fund must invest in long-term illiquid assets and permitting the fund to invest in UCITS and AIFs, semi-liquid[47] private debt investment vehicles can be facilitated. Further, by permitting investment in UCITS and AIFs, the drag on investment returns from holding cash in a private debt fund to provide liquidity for redemptions can be reduced and capital can be allocated to private debt funds structured as AIFs more quickly.

We examine two vehicles, one available in the EU, the ELTIF, and one available in the U.K., the LTAF, which allow retail investors to gain exposure to private debt lending with a degree of confidence.

14.2.1 European Long-Term Investment Fund ("ELTIF")

In this paper references to an ELTIF are references to an ELTIF investing in private debt.

In the EU, from January 2024, ELTIFs will provide a means for retail and professional investors with long-term investment goals to gain exposure to investments in private debt via a regulated investment vehicle and thereby diversify their investment portfolios.

The minimum investment amount may be below EUR10,000 if the investment manager of the ELTIF permits. Unlike private debt funds marketed to institutional investors, which have capital commitments and capital calls, a typical ELTIF is fully funded in the sense that investors are required to pay for their units in the ELTIF when they agree to invest in the ELTIF.

[47] A semi-liquid investment vehicle: (i) allows subscriptions on an ongoing basis; and (ii) permits limited redemptions at defined intervals of time with certain minimum notice requirements provided the asset-liability management of the fund is properly operated.

From a regulatory perspective, a private debt ELTIF is an EU alternative investment fund, managed by an alternative investment fund manager. An ELTIF must be authorised in an EU Member State in line with the Alternative Investment Fund Managers Directive ("AIFMD") and the ELTIF 2.0 Regulation and only such AIFs can use the term "European Long Term Investment Fund" or "ELTIF" in their name. ELTIFs are the only type of fund dedicated to long-term investments that can be marketed and sold in the EU to both professional and retail investors. ELTIFs can be marketed to institutional and retail investors throughout the EEA.

The EU regulatory environment in which ELTIFs operate requires compliance with a number of rules including:

A. Limits on the leverage of an ELTIF: ELTIFs that are marketed to retail investors must disclose their borrowings to investors and may not borrow more than 50% of their net asset value;
B. Diversification requirements: an ELTIF must invest at least 55% of its capital in "*eligible investment assets*[48]" and may not invest more than 20% of its capital in a single *qualifying portfolio undertaking*;
C. Prohibition on the use of derivatives for any purpose other than hedging; and
D. To qualify as an eligible investment asset, the maturity of a loan granted by an ELTIF to a *qualifying portfolio undertaking* must not exceed the life of the ELTIF;

In light of the different risk appetites, investment analysis skill sets, and investment time horizons of institutional investors relative to retail investors, the investment limits in A and B do not apply where ELTIFs are marketed solely to professional investors.

A *qualifying portfolio undertaking* is an undertaking that fulfils, at the time of the initial investment, the following requirements:

> (a) it is not a financial undertaking, unless: (i) it is a financial undertaking, that is not a financial holding company or a mixed-activity holding company; and (ii) that financial undertaking has been authorised or registered more recently than five years before the date of the investment;
>
> (b) it is an undertaking which:
>
> > (i) is not admitted to trading on a regulated market or on a multilateral trading facility;
> >
> > or
> >
> > (ii) is admitted to trading on a regulated market or on a multilateral trading facility and has a market capitalisation of no more than EUR1.5bn;
>
> (c) it is established in a Member State of the EU, or a third country provided that the third country:
>
> > (i) is not identified as high-risk third country;

[48] A loan granted by an ELTIF to a *qualifying portfolio undertaking* is an eligible investment asset.

(ii) is not mentioned in the EU list of non-cooperative jurisdictions for tax purposes.

Although ELTIFs provide access to investment in private debt for retail clients, this does not change the illiquid nature of private debt loans nor the effective requirement to have their money tied up for an extended period of time. Unlike UCITS, ELTIFs are not priced daily. Investing in an ELTIF which provides private debt offers the potential for the investor to pick up an illiquidity premium unavailable on liquid bonds.

ELTIFs can offer redemptions during their life cycle. This is in part facilitated by limiting the requirement to invest in long-term eligible assets to 55% of an ELTIF's capital, so that investment managers of ELTIFs can meet redemption requests by managing the liquidity of the fund by, for example, investing part of the ELTIF portfolio in UCITS eligible assets.

From an economic perspective, ELTIFs provide additional capital for private companies which helps to stimulate economic growth in the EU.

The revised ELTIF regulation covers authorisation, supervision, reporting requirements, marketing, disclosure, investor protection, and redemption rules. An EU regulatory technical standards ("RTS") will provide more details on redemption notice periods and policies, highest redemption frequency, minimum investment period, asset-liability matching mechanisms, and the disclosure of costs for ELTIFs.

The revised ELTIF regulation entered into force on 10 January 2024. The European Securities and Markets Authority ("ESMA") has published its final draft RTS setting out the minimum holding periods, maximum redemption limits, minimum notice period, and minimum holdings in liquid assets.

Many investment managers have commercial concerns about the requirement in the draft RTS to hold higher amounts of liquid assets as the length of the notice period for redemptions shortens. A requirement to hold a higher amount of liquid assets dampens returns while restrictions on redemptions constrain distribution opportunities.

The European Commission has not yet adopted the draft RTS and has the power to amend or reject the RTS. Decisions by asset managers as to whether to launch an ELTIF or not are likely to be deferred until the wording of the RTS adopted by European Commission is published.

14.2.2 Long Term Asset Fund ("LTAF")

In this paper references to an LTAF are references to an LTAF investing in private debt.

An LTAF is a type of authorised, open-ended[49] fund in the U.K. which is designed to invest in long-term assets such as private debt.

[49] Under U.K. law, authorised funds must be open-ended.

An LTAF is an alternative investment fund ("AIF") and is subject to the rules of the FCA's FUND sourcebook and other rules taken from the U.K. implementation of the AIFMD. The LTAF vehicle can be an open-ended investment company ("OEIC"), a unit trust, or an authorised contractual scheme ("ACS"). The authorised fund manager of an LTAF must ensure that in the context of the investment objectives and policy of the fund, the fund aims to provide a prudent spread of risk.

LTAFs are open for investment by professional investors, certified high net worth individuals, sophisticated investors, and subject to certain conditions and risk warnings, U.K. self-invested personal pensions, U.K. self-select defined contribution pension schemes, and to retail investors to whom units in a LTAF can be promoted without breaching the promotion of restricted mass market investments.

The risk warnings must clearly indicate that investment in an LTAF is a high-risk investment, the assets may take a long time to buy and sell, only invest if one can wait, possibly several years, to get one's money back, and that there is no protection against poor performance.

In naming an LTAF fund, its name must include "LTAF" or "Long-Term Asset Fund".

An LTAF investing in private debt would be required to invest more than 50% of the fund in unlisted securities and private debt loans. Borrowing by an LTAF is limited to 30% of its net assets.

The open-ended nature of LTAFs combined with the illiquid nature of the underlying assets gives rise to a mismatch between the underlying assets of the LTAF and the investors' right to regular liquidity.

For investment managers of LTAFs, liquidity risk management using a range of permitted liquidity management tools is a key component of the management of such a fund. The range of liquidity management tools available to an LTAF includes:

1. Notice periods on redemptions and subscriptions must be a minimum of 90 days;
2. Initial lock-in period;
3. Minimum holding period;
4. Limits on the number of units that can be redeemed on one occasion or over a period of time;
5. Side pockets; and
6. Deferral of redemptions.

The FCA views item 6 above, deferral of redemptions, as a last resort and not a tool to be relied upon in normal market conditions. The FCA also emphasises its expectations of investment managers that in managing the liquidity mismatch they ought to avoid selling assets at deeply discounted prices as a means of meeting liquidity requirements arising from redemptions.

The above tools and their use must be disclosed in the prospectus and accompanied by worked examples illustrating their operation and potential consequences for investors.

The management of liquidity risk is a central focus of the FCA authorisation process of an LTAF. The manager of an LTAF must: (i) be a full-scope U.K. alternative investment fund manager; (ii) possess knowledge and experience of the assets underlying the LTAF; (iii) understand the operation and management of the risks of an LTAF; and (iv) employ an appropriate number of staff with the skills and experience to operate an LTAF and manage its underlying assets.

To support a high level of understanding among potential investors in an LTAF and informed decision making relating to such an investment, the offering documents must disclose among other matters: (i) the investment objective and strategy; (ii) the management, performance and other fees payable by investors; (iii) liquidity management techniques; (iv) redemption terms; (v) valuation procedures; (vi) risk profiles; (vii) any preferential treatment of investors; (viii) due diligence undertaken by the LTAF to enhance investor protection; and (ix) the means and terms of subscribing for units in the LTAF. Such disclosures must be in plain language, fair, clear, and not misleading.

Unless the manager of the LTAF can convince the depositary of an LTAF and the FCA that it has the resources, methodologies, experience, and competency to value the underlying assets of the LTAF in accordance with reasonable industry practice, an external valuer must be appointed to value the assets of the LTAF. The assets of an LTAF must be valued on a monthly basis.

As an LTAF is a fund open to certain types of retail investors, under U.K. law, the manager of the LTAF must produce an annual assessment of value similar to that required for other retail funds in the U.K. On an annual basis, the manager must also assess how it has managed the LTAF in the best interests of the LTAF, its investors, and the integrity of the market. This assessment must be included in the annual report of the LTAF to investors. At a minimum, the assessment must address how the due diligence process has been conducted, how the manager has managed liquidity and conflicts of interest, and how the assets have been valued.

The U.K. implementation of the EU AIFMD sets out a number of requirements in relation to due diligence that an alternative investment fund manager ("AIFM") of an LTAFs must comply with including: (i) KYC, AML, CFT checks on potential investors and the source of their funds; (ii) carrying out due diligence and a risk assessment of the assets in which the AIF proposes to invest; (iii) conducting appropriate due diligence throughout the lifecycle of each investment made for the AIF including for example, monitoring of positions, performance, related party transactions, and changes in strategy; and (iv) ongoing regular reporting to the FCA.

Under the FCA rules governing LTAFs, investors must receive quarterly, half-yearly, and annual reports published not more than 20 business days, 2 months, and 4 months after the end of the periods respectively.

14.2.3 Retail Investors in the U.S. Seeking Exposure to Private Debt Asset Class

In the U.S., retail investors may gain exposure to private debt funds through a number of investment vehicles including interval funds, business development companies ("BDCs"), and crowdfunding platforms.

Interval funds are regulated under the Investment Company Act of 1940 and are SEC-registered funds that invest in private debt. Interval funds allow periodic repurchases of shares from investors. Liquidity is somewhat constrained due to the limitation of the percentage of the interval fund that can be redeemed at the periodic repurchase windows.

BDCs are publicly traded investment vehicles that lend to or invest in small or middle market private companies. BDCs invest in private or thinly-traded public companies, typically through debt investments but also through equity investments or hybrid instruments like convertible debt. BDCs are regulated under the Investment Company Act of 1940 and must register their securities with the SEC. BDCs are publicly traded entities which allow retail investors to gain exposure to investments in private businesses. At least 70% of a BDC's investments must be held in private and certain public U.S. businesses.

Crowdfunding platforms are online platforms through which retail investors can buy shares in specific private debt investments financing among other projects commercial real estate and private businesses. These platforms are registered as an Alternative Trading System with the SEC and the deals offered also follow SEC regulations around investor qualifications and risk disclosures. However, investors need to build their portfolio through individual loans. The private credit opportunities are pre-vetted, structured, and serviced by the platform operator through partnerships with originators.

14.3 Investors in Private Debt Funds

Pension funds, insurance companies, reinsurance companies, sovereign wealth funds, private wealth managers, foundations, and endowments are among the most active investors in the private debt market. Private debt funds therefore have a very diversified investor base. In the case of insurance companies, the results of a survey in BlackRock's 12th annual Global Insurance Report published in September 2023 covering 378 insurance investors spread across the globe representing nearly USD29 trillion in assets under management, indicate that 60% of respondents expect to increase allocations to direct lending[50].

Flows into private debt funds can be affected by a wide range of factors including:

(i) Foreign Exchange: For example, when the base currency of a private debt fund is very strong, it may be more difficult to raise capital from international investors. Further, significant foreign exchange volatility may also discourage international investors from investing in a private debt fund denominated in a currency other than that of the investors.

[50] Source: https://www.businesswire.com/news/home/20230927245223/en/ Accessed 20 December 2023.

(ii) Economic: Concerns over the economy in which the private debt fund is lending to portfolio companies may hold back allocations to private debt.

(iii) Investor Specific: For example, in the U.K., following the liability-driven investment losses of 2023, some U.K. pension funds may be over allocated to private debt due to the fall in the total value of their assets.

14.4 Appeal of Private Debt Funds

The appeal of private debt funds to institutional investors is multi-faceted; here we list the most likely reasons for such appeal:

1. A desire to receive what might be a reliable stream of income because of private debt's focus on the most senior part of corporates' capital stack underpinned by rigorous underwriting of loans, strong covenant protections, frequent monitoring, and experienced workout teams.
2. The private debt market seems to offer an illiquidity premium which is higher than that for the same risk in public markets thus giving somewhat higher risk-adjusted returns.
3. Institutional investors concerned about the volatility of public market debt investments may prefer the lower volatility offered by private debt funds. The lack of volatility is driven in part by the fact that the loans to portfolio companies are generally held to maturity by the private debt funds and therefore not traded.
4. Private debt funds generally lend at floating rates of interest thereby providing a measure of protection against inflation and interest rate risk[51] relative to fixed rate lending.
5. While continuing to have exposure to credit markets, a desire to diversify their portfolios across both public and private debt markets thereby achieving a wider spread of names, different types of debt instruments, and possibly some wider industry and geographic spread.
6. In view of the floating rate nature of private debt, it typically outperforms fixed income securities during periods of rising interest rates as the coupons paid on floating rate loans increase as the reference rate increases.

Let's illustrate point 6 above by looking at data provided by New York Life Investments relating to periods of rising interest rates in the U.S. showing the relative performance of a floating rate loan benchmark index and a fixed coupon benchmark index[52].

During the last 30 years, there were five periods of rising interest rates in the U.S., namely, February 1994 to February 1995, June 1999 to May 2000, June 2004 to June 2006, December 2015 to December 2018, and March 2022 to September 2023.

[51] When the interest rate is a floating rate, a portfolio of loans has little or no duration.

[52] Source: New York Life Investments: *The case for floating rate loans*.
https://www.newyorklifeinvestments.com/assets/documents/perspectives/investmentinsights-case-for-floating-rate.pdf

The Credit Suisse Leveraged Loan Index covers a diverse set of liquid institutional leveraged loans and provides an investable, floating-rate benchmark for below investment grade syndicated loans. In Table 7, this index is referred to as the Floating Rate Loans Index.

The ICE Bank of America U.S. Corporate Index is an index comprised primarily of publicly issued U.S. dollar denominated investment grade corporate debt with fixed coupon rates. In Table 7, this index is referred to as the Fixed Coupon Loans Index.

During each of the five periods listed above the Credit Suisse Leveraged Loan Index, the floating rate loan benchmark, outperformed the ICE Bank of America U.S. Corporate Index, the fixed coupon loan benchmark.

Table 7[51]

Period	February 1994 to February 1995	June 1999 to May 2000	June 2004 to June 2006	December 2015 to December 2018	March 2022 to September 2023
Rate Increase During the Period	300 bps	150 bps	425 bps	200 bps	500 bps
Floating Rate Loans Index	9.33%	3.09%	10.73%	16.04%	10.94%
Fixed Coupon Loans Index	-2.78%	-0.43%	6.01%	9.92%	-7.73%

14.5 Minimum Investment

The minimum investment amount for an institutional investor to gain access to a private debt fund structured as an investment limited partnership varies from fund to fund. For most institutional investors in private debt funds, the minimum investment is unlikely to be less than USD5.0m. In the case of a private debt fund structured as an investment limited partnership and investing in other private debt funds, a fund-of-funds, fed by feeder vehicles, the minimum investment amounts may be lower but unlikely to be less than USD1.0m

14.6 Diversification

The portfolio of loans provided by a private debt fund ought to meet certain minimum concentration limits in terms of the fund's exposure to foreign jurisdictions, any single obligor, any single industry, first lien loans, second lien loans, debtor-in-possession loans[53], payment-in-kind loans[54], coupon frequency, tenor, and fixed interest rate loans.

Example 7: Over Exposure to a Single Obligor

In November 2023, the Financial Times reported that Julius Baer: (i) was said to be one of the biggest lenders to an Austrian property group Signa; and (ii) would review its private debt business in the wake of the crisis engulfing Signa. Shares in Julius Baer initially fell 16% after it revealed that it was taking a CHF70m provision against losses in its private debt

[53] A debtor-in-possession loan is a type of financing provided to a company that has filed for Chapter 11 bankruptcy in a court in the United States and is operating under the protection of the court. The purpose of such loans is to provide the company with the necessary funds to continue its operations and facilitate the restructuring process while it remains in control of its assets and operations.

[54] Payment-in-kind loans permit borrowers to defer interest payments on their loans by choosing to increase the principal balance of their loans thereby allowing the outstanding balance on the loans to grow over time.

loan book. The total private debt loan book was reported to amount to CHF1.5bn and to be spread across 21 other counterparties. The chief executive of Julius Baer was quoted in the article as saying, "*We regret that a single exposure*[55] *led to the recent uncertainty for our stakeholders, we will review our private debt business and the framework in which it is conducted.*"

14.7 Role of Banks in Private Debt Funds

Banks also play a role in private debt funds by providing loans for leverage or subscription credit line funding to private debt funds.

14.7.1 Subscription Credit Line

Private debt funds often face a mismatch between the timing of:

(i) expenses such as due diligence on potential portfolio companies and the granting of loans to portfolio companies; and

(ii) receipt of capital contributions from investors, LPs,

whereby a private debt fund might need to complete loan transactions with portfolio companies before some or all capital commitments have been collected.

A capital call must follow certain administrative procedures and timelines including giving LPs notice of the capital call and granting them a period of time in which to send the capital called to the private debt fund. Further, LPs may prefer for capital calls to be aggregated and called at say, the end of the quarter.

Provided the LPA permits and subject to any limitations specified, the private debt fund may borrow money to cover timing mismatches between, for example, granting loans to portfolio companies and receipt of capital calls thereby giving the fund immediate access to capital. Such credit facilities are variously referred to as a subscription credit line ("SCL") or a subscription line facility. We shall use the former term in this paper.

The SCL loan is secured against the capital commitments of the private debt fund's investors. The security may involve assigning the right to call capital from LPs to the SCL lender which is providing such credit facilities to the private debt fund. The SCL lender's right to call capital from LPs will normally be limited to the amount of any SCL balance outstanding.

The size of the SLC that a bank or other lender will advance will depend on two main factors:

(i) the total amount of pledged but uncalled capital commitments of the LPs; and

(ii) the distribution of the capital commitments across the LP pool in terms of the number and amounts committed together with an assessment of their respective creditworthiness.

[55] Presumably for client confidentiality reasons, Julius Baer did not explicitly state the name of the counterparty.

Depending on factors (i) and (ii) above, the SLC could be as high as 90% of pledged but uncalled capital commitments of the LPs.

SCL is a financing arrangement used by private debt funds to manage these cash flow mismatches and optimise their investment strategies. SCL is a very common practice in the private debt industry. The extent to which it is used depends on the level of interest rates and borrowing provisions, the preference of the LPs, and the investment strategy of the private debt fund.

SCL loans are an attractive lending proposition not just for banks but also for funds that specialise in such lending as they generally carry a higher rate of interest than other bank debt over a similar short period of time.

The lender generally does not have recourse to the underlying assets of the private debt fund. The duration of SCL is generally short-term, up to 90 days, and is structured to match the anticipated timing of capital contributions from LPs.

The advantages of SCL include: (i) allowing the private debt fund to execute lending transactions quickly without having to wait for capital calls to be fulfilled; (ii) scheduling the frequency of capital calls to all LPs to better manage their liquidity and minimising the frequency of capital calls; and (iii) possible improvement in the IRR of the private debt fund arising from deferring the calling of capital from LPs.

SCL facilities are usually structured as revolving credit facilities which are drawable and repayable on demand. As such, SCL facilities come with both costs and risks.

Costs include interest at a floating rate plus a spread, fees for the unused part of the SCL which could be as high as 50bp per annum on the unused portion of the SCL, and arrangement fees of the order of 25bps of the SCL facility amount. Prepayment fees are not generally a feature of SCL facilities. A SCL facility may also accelerate the payment of performance fees to the private debt fund manager thereby decreasing the IRR to investors.

SCL facilities expose the fund to a range of risks arising from the SCL facility agreement including the SCL lender's recourse to the pledged but unfunded capital commitments of the LPs and events of default such as a change of control in relation to the fund, deficiencies in reporting of data to the SCL facility lender, and errors in warranties and representations made to the SCL facility lender.

Table 8 illustrates some of the issues[56].

[56] The size of the impact of costs and risks is influenced by the combination of the SCL loan terms and the prevailing interest rate environment for borrowing.

Table 8

Potential Costs, Benefits, and Risks	LPs	GP
Costs	Interest and other expenses from the time money is borrowed for SCL until the capital contributions are received.	
Benefits	SCL has the potential to improve the internal rate of return ("IRR") provided by the fund by delaying capital calls particularly when the private debt fund performs well.	From the perspective of the GP of the private debt fund, SCL helps to accelerate investment management fees and performance fees.
Risks	Lenders generally demand security over capital commitments in return for SCL. SCL will reduce the investment performance of the private debt fund when portfolio companies default on their loans. SCL is a form of financial leverage and can therefore worsen losses at private debt funds in a downturn.	Risks are borne by the private debt fund and by the GP to the extent that the private debt fund pays performance fees.

In view of the costs, benefits, and risks of SCL to investors in a private debt fund, the offering documents of the private debt fund ought to disclose the details of SCL.

To protect the security of their loans, SCL lenders may place certain limitations on the timing and amount of capital calls made by a private debt fund. The principle is to ensure that the private debt fund manager brings in more equity before accessing more SCL funding.

Examples of the types of limitations placed by an SCL lender on a private debt fund manager in sequencing borrowings and capital calls during the life of the fund include:

(i) SCL lenders wish to ensure capital that is owed by the private debt fund to the SCL lender is received by the fund first before accessing more debt. SCL lenders therefore usually prohibit capital calls to LPs at the same time as drawing down on the SCL.
(ii) To confirm capital call receipts, a waiting period of between 5 and 30 days between the capital call and subsequent drawdown of an equal or lesser amount from the credit line is usually required.
(iii) Limits may be placed on the percentage of committed capital that can be called from investors at one time or over a certain timeframe.
(iv) The fund may need to maintain a predetermined level of cash to continue drawing down subscription debt.

14.7.2 Leverage

Leverage has the potential to enhance the risk-adjusted return of a private debt fund. The level of leverage must be prudent to manage both the costs of leverage and the risks of introducing leverage to a private debt fund.

The ratio of [Borrowings for Leverage]/[Net Asset Value] in a private debt fund tends to vary from [0]:[1] to [1.5]:[1] but tends to be at the lower end of the range because the aim of private debt funds is to protect investors' capital rather than maximise returns by using higher levels of leverage. An upper limit on leverage is usually set by the jurisdictions in which the fund is distributed or authorised; such regulation is unlikely to permit a leverage in excess of [2]:[1].

For investors in private debt funds, leverage can improve the internal rate of return and may offer taxation benefits, but it adds to the complexity of analysing returns as investors try to distinguish between the percentage of return that comes from fund finance and that which comes from loans to portfolio companies.

Best practice in leveraging private debt funds illustrates the importance of diversification and follows the classic actuarial principle of matching assets and liabilities by nature and term.

14.7.2.1 Diversification

Providers of leverage are corporate entities that are regulated. From time to time, lending criteria may change for individual corporate reasons or for regulatory reasons resulting in lenders reducing exposure to particular sectors, changing their collateral criteria, their loan covenants and terms, or substantially increasing their lending rates for certain types of borrowers. For these reasons, private debt firms aim to have a large number of different lenders diversified by industry focus and jurisdiction.

14.7.2.2 Asset-liability Matching

In terms of the actuarial principle of asset-liability matching, the assets in this case are the loans to portfolio companies while the liabilities are the borrowings to provide leverage to the fund. Matching by term requires that the term of the loans to provide leverage is longer than the term of the loans made to portfolio companies. This ensures that the repayment proceeds from the loans to the portfolio companies are available to repay the loans provided to the private debt fund to gain leverage.

Matching by nature requires that floating rate loans to portfolio companies are matched by floating rate loans from lenders providing loans for leverage. Care must also be taken to ensure that there are no interest rate floors in the terms and conditions of the floating rate borrowing to fund leverage as this is likely to reduce returns to private debt investors in a falling interest rate environment unless the interest rate floor is correspondingly applied to each loan to a portfolio company. Borrowing to leverage the private debt fund at a fixed rate of interest and lending to portfolio companies at a floating rate of interest has the potential to introduce significant risk and a loss of returns for private debt investors in a falling interest rate environment.

14.7.2.3 Default Triggers

Similar to the collateralised loan obligations ("CLOs") market, where there are no mark-to-market triggers in CLOs that force the selling of collateral in times of stress, private debt funds tend to avoid mark-to-market default triggers in the loan documentation for the loans that provide leverage to the private debt fund[57]. Instead, private debt funds tend to prefer default triggers related to the credit quality of the private debt fund.

[57] An increase in the loan-to-value ratio of a bank loan beyond a specified threshold level could allow the bank providing leverage to the private debt fund to demand cash from the private debt fund.

In private debt, the mark-to-market valuations of portfolio companies have a not insignificant element of subjectivity which may, in times of market stress, lead to price volatility. By contrast, credit ratings offer a slightly more objective measure of default risk and are less sensitive to short-term market stress. Further, credit ratings are perhaps an easier set of default triggers to both understand and implement. In a form of asset-liability matching, where the investment strategy of the private debt fund is to lend to portfolio companies within a specific set of credit ratings, there is a better match between assets and liabilities if the default triggers in the credit facilities align with those of the investment strategy.

14.7.2.4 Avoiding Revolving Credit Facilities

Some private debt funds avoid revolving credit facilities for a number of reasons including the fact that they are likely to: (i) be repayable on demand; (ii) carry higher interest rates compared to traditional sources of credit; (iii) require payment of fees of the order of 50bps per annum on the unused revolving credit facility; (iv) contain a material adverse change clause which grants the lender a high degree of subjectivity in deciding to withdraw the facility at any time; and (v) contain credit limits that may not meet the requirements of the private debt fund.

14.7.2.5 Structuring the Leverage Facility

To achieve the level of leverage specified in the fund offering documents as the loans to portfolio companies increase and the fund becomes more diversified, a very large private debt fund may structure the leverage facility as a loan to a bankruptcy remote, orphan special purpose vehicle ("SPV")[58]. While the SPV will hold loans made by the private debt fund to portfolio companies of sufficient value to collateralise the borrowing to achieve the desired level of fund leverage, the provider of leverage to the fund has limited recourse to the remainder of the fund's assets and no recourse to the LPs. The loan to the SPV is likely to be a term loan for a term longer than the longest term of the private debt fund's loans to portfolio companies including any period during which repaid loans may be reinvested.

Similar to SCL facilities, borrowing to achieve leverage comes with both costs and risks. Costs include interest at a floating rate plus a spread, fees for the unused part of the leverage facility which again could be as high as 50bp per annum on the unused portion of the facility, and significantly higher arrangement fees of the order of 125bps of the leverage facility amount. Unlike SCL facilities, prepayment fees are generally a feature of leverage facilities.

Leverage facilities introduce a further layer of administrative complexity as the leverage facility provider may require that loans posted as security meet certain conditions as to

[58] The SPV is a newly formed company established for the purpose of providing leverage to the private debt fund. As such, the SPV has no previous trading history so no debts or liabilities. The SPV allows for the de-coupling of a pool of assets which secure a deal from the credit risk of a private debt fund. The pool of assets will not be available for distribution upon the bankruptcy of the private debt fund. Leverage financiers take SPV risk rather than the credit risk of the private debt fund which improves the predictability of the outcome in insolvency of the private debt fund. If the SPV were a subsidiary of the private debt fund, there is a risk of consolidation upon the insolvency of the private debt fund; lenders may therefore prefer orphan SPV structures where the shares in the SPV are held on trust by a share trustee for the benefit of say, a charity. Thus, the SPV is not beneficially owned by persons connected with the transaction. The assets and liabilities of an orphan SPV are not included on the balance sheet of any of the parities to the transaction. This ensures that in the event of insolvency of any of the parties to the transaction, the assets of the SPV should not be accessible to any party other than the lender.

concentration limits and type as well as a possible requirement that obligors to be up-to-date on debt service.

In terms of the extent of leverage that may be achieved by a private debt fund, the leverage lender will determine the amount advanced to a private debt fund on a portfolio loan-by-loan basis. The amount advanced by the provider of the leverage on any individual portfolio loan is unlikely to exceed 70% of the amount of the loan made to that portfolio company. Taking the private debt fund as a whole, the ratio of

[Debt Provided for Leverage]/[LP Capital in the Fund]

is unlikely to exceed 1.5x.

14.7.3 Private Debt Collateralised Debt Obligations as a Source of Leverage

A collateralised loan obligation ("CLO") provides exposure to a portfolio of syndicated bank loans and leveraged loans, held in a special purpose vehicle which issues securities with different risk-return characteristics to investors. A CLO manager builds and then manages the portfolio of loans in return for management fees. The proceeds from the sale of the different risk-rated securities are used to fund the purchase of the portfolio of loans. Risk tranches range from the riskiest equity tranche to the lowest risk AAA-rated bond tranche. Credit losses on the portfolio of loans are suffered first by the equity tranche until it is wiped out, then by the junior debt tranches until they are wiped out, and only then by the AAA-rated tranche. Returns are highest for the equity tranche and lowest for the AAA-rated tranche. The Financial Times reports[59], citing the history of CLOs rated by Moody's, a credit rating agency, back to 1993, that AAA-rated and AA-rated tranches of CLOs have not suffered credit losses while A-rated tranches suffered losses on one occasion.

Instead of a CLO with exposure to a portfolio of syndicated bank loans and leveraged loans, managed by a CLO manager, a CLO-type structure may be constructed with exposure to loans originated by a private debt lender and managed by that private debt lender. Table 9 below compares traditional and private debt CLOs under a range of comparison headings.

[59] Source: Exuberance creeds in. https://www.ft.com/content/e73dac6f-e3de-417d-8a06-c009ecc43765?accessToken=zwAGDadgzRsQkdPnPaxv495BfdOKBsAJ7MQ3ZQ.MEQCIB2a6dSzqLMbPGVthwRvcYL1bmQiIKYXvuH86TkqpCKZAiBvkw6OoU32WD6aLGKTa76bE-dZFEMaTl4vlPhCw6Nlcg&sharetype=gift&token=707b9cbd-4d4d-4e38-9ae4-a9af98471b80 Accessed 29 December 2023.

Table 9

Comparison Heading	Traditional CLO	Private Debt CLO
Type of Loans Purchased by CLO	Syndicated bank loans (leveraged loans) purchased in the secondary market	Private debt loans originated by a private debt lender
CLO Investment Manager	Traditional CLO manager	Private debt lender that originated the private debt loans
Holders of Equity Tranche of CLO	Sold to investors with an appropriate risk appetite such as hedge funds	Retained by the private debt lender
Purpose of CLO	Generate management fees for the CLO investment manager	Raise finance for private debt lender possibly to replace loans from banks as a source of finance for a private debt fund

As a source of leverage for private debt funds, bank lending with mark-to-market default triggers in the loan documentation requires private debt fund managers to put up cash if the loan-to-value ratio rises above a specified level. By way of contrast, a private debt CLO will not be required to put up cash in the event of mark-to-market loan losses rather the private debt fund manager as holder of the equity tranche of the private debt CLO will simply suffer the earliest loan losses.

14.8 Tokenisation

To date, investing in private debt has been largely restricted to institutional investors whether by regulation, large minimum investment amounts, requirements for long lock up periods, absence of any realistic secondary market, limited liquidity, or other barriers to retail investment.

Fractionalisation of ownership of units in an AIF allows funds, that traditionally have had high minimum initial investment amounts, to be offered in more affordable tranches, expanding the potential market for funds investing in sectors like private debt and private equity. This allows investors to diversify their portfolios and gain exposure to a wider range of assets while enhancing liquidity. For example, when Hamilton Lane tokenised a global private assets fund the minimum investment was cut from US$125,000 to US$10,000.

In July 2019, Cadence, a U.S. blockchain-based alternative investment provider, launched a private debt investment platform which tokenises commercial debt and facilitates the trading of the tokenised debt on its platform.

14.9 Environmental, Social, and Governance Factors

Climate change risk and environmental, social, and governance ("ESG") factors need to be integrated into the credit risk underwriting process employed by private debt fund managers when evaluating potential borrowers. Indeed, in an article by Ed Moisson of IGNITED

EUROPE on 28 December 2023[60], states, "*Integrating environmental, social and governance analysis into private credit analysis has helped Fidelity International to avoid 92 per cent of defaults in the market, …*"

The purpose of such integration is to identify climate change risk and ESG factors that could potentially lead to a loss on a loan. The integration may operate exclusionary criteria, for example, the private debt manager may have a policy of not making loans to companies that derive a significant portion of their revenues from, say, oil and gas exploration, tobacco, pornography, controversial weapons, or other sectors that the private debt manager has identified as having material climate change or ESG risks.

Exclusions aside, the integration is then likely to focus on the industry sector and within that sector the potential borrower with the aim of identifying exposures, considering their financial impact, and, where the exposures are capable of being mitigated at reasonable cost, assessing the commitment of the potential borrower's management team and, where applicable, the private equity sponsor to mitigate the identified climate change risks and ESG factors.

The management team's commitment to mitigate identified climate change and ESG risks may be gauged initially by considering the depth of the team's engagement with the risks.

For example, the mitigation might range from:

(i) complying with regulatory requirements and considering the development of policies and metrics to measure and monitor the risks;
through
(ii) policies have been developed, staff have been trained so that there is a high level of awareness of the risks across the firm, metrics are being collected, and a person has been appointed who is accountable for the management of the risks;
to
(iii) ESG metrics are a standing agenda item at board meetings and the company's metrics are measured against the firm's targets and those of peers.

The private debt manager is likely to have a set of sector-specific checklists for climate change risks and ESG factors.

The evaluation of climate change risk and ESG factors tends to be qualitative in nature and involves a degree of subjectivity.

14.9.1 Climate Change Risks

In terms of climate change and ESG risks, a private debt fund manager is likely to focus on:

[60] Source: Fidelity says ESG helps avoid most private credit defaults https://www.igniteseurope.com/c/4367954/562904?referrer_module=searchSubFromIE&highlight=fidelity Accessed 2 January 2024.

(i) Physical risk, for example, the risk of riverine and coastal flooding in real estate lending and in relation to physical assets owned by the potential borrower;

(ii) Transition risk, for example, the implications for a borrower such as an airline of a shift from an economy with high greenhouse gas emissions to one with low greenhouse gas emissions where the borrower is required to pay increasing amounts of carbon taxes for carbon emissions which will impact margins or revenue to the extent such taxes cannot be passed on to customers without reducing demand; and

(iii) Litigation and reputation risks arising, for example, from allegations of 'greenwashing,' communities affected by wildfires filing lawsuits against an electrical power generation company based on the company's alleged role in its power lines sparking and causing a series of wildfires, or as we saw in December 2023[61], Toyota Motor's small car unit, Daihatsu, having to halt shipments of all of its vehicles after a safety scandal investigation found issues involving more than sixty models, including almost over twenty models sold under the Toyota brand.

14.9.2 Social

Table 10 sets out a possible range of social factors that a private debt manager might consider in evaluating a potential borrower and the reasons for considering those factors. Considerations will vary from one potential borrower to another. For example, for a healthcare company that is involved in the provision of treatments to patients, data governance, data privacy, product safety, and health & safety are likely to receive significantly more attention than some of the other social factors.

[61] Source: https://www.reuters.com/business/autos-transportation/toyotas-daihatsu-will-expand-production-halt-over-safety-scandal-nikkei-2023-12-20/#:~:text=TOKYO%2C%20Dec%2020%20(Reuters),dozen%20sold%20under%20Toyota's%20brand. Accessed 17 January 2024.

Table 10

Social Factor	Reason for Consideration
Data Governance and Data Privacy	Failure of the potential borrower to comply with the EU General Data Protection Regulation ("GDPR") can lead to fines of the higher of €10 million and 2% of the firm's worldwide annual revenue from the preceding financial year. Large fines reduce reserves thereby weakening the security of the private debt lender's loan. The customer privacy data security policies of the potential borrower need to be examined closely as a GDPR fine may have a significant impact on the potential borrower's reserves and future revenues if it gives rise to significant reputation damage.
Supply Chain	A potential borrower ought to have complete visibility along its supply chain and a diversified range of suppliers for business continuity risk management and also for reputation risk management purposes. Companies that use unscrupulous suppliers may face reputational damage, litigation, and fines if they deal with suppliers that employ child labour, have a poor health and safety record, engage in human rights violations, cause pollution in their communities, or damage the environment.
Working Environment	Unlike in the 'widget' economy, in the knowledge economy, it is difficult to precisely measure the output of staff. Staff output is a discretionary spending of thought, energy, and effort. It is difficult to contract for such output. The working environment for staff is very important for motivation. The trend in responses to staff engagement surveys may indicate issues that are affecting staff motivation and the cohesiveness of teams. Competition for talent in some industries, such as autonomous vehicle development, blockchain, and artificial intelligence, is intense. Potential borrowers in such industries need talent management programs such as training and career development plans to retain and attract top talent. Further, the importance of human capital management has risen since the COVID-19 pandemic. As part of its due diligence, a private debt lender may examine voluntary staff turnover rates to assess if they are above the industry sector norm and if so, the reasons for same.
Product Safety	Poor product safety may give rise to reputation damage and loss of revenue. A private debt lender may examine product recalls, trends in customer complaints and their resolution, product labelling, product or service advertising, and the extent of monitoring of suppliers and third-party service providers.
Diversity & Inclusion	Properly implemented diversity and inclusion policies are important for promoting social cohesion and essential for attracting and retaining top talent.
Customer Engagement	Customer engagement may identify 'pain points' in relation to a product or delivery of service which may provide an opportunity for product or service development. The trend in a company's net promotor score is an important barometer of customer satisfaction and it can uncover customers that are unhappy allowing the firm to contact them while customers who are advocacy hand-raisers might be turned into marketing assets.
Health & Safety	Failure to manage the health & safety of employees, the wider community who might be harmed by say, the escape of poisonous substances, and supply chain workers may give rise to safety violations with a host of consequential outcomes such as regulatory fines, criminal charges, litigation, reputational damage, and legal bills in defending such matters. Examining statutory safety and accident logs and looking for evidence of health & safety training may form part of the due diligence of the private debt manager depending on the industry sector.

Some private debt managers may use alternative data sources to gain further insights to risks which may not have been identified by potential borrowers. For example, an examination of LinkedIn may provide an indication of staff turnover while an examination of employee reviews on the employment website Glassdoor may give an indication of staff morale and evidence of the potential borrower's work culture.

Some private debt managers may operate exclusionary social criteria in relation to their lending. For example, they may have a policy of not making loans to companies that exploit child labour, make pay-day loans, sell firearms, or manufacture cluster bombs.

14.9.3 Governance

Private debt managers are likely to carefully consider the governance of the potential borrower under the headings and for the reasons outlined in Table 11.

Table 11

Governance Factor	Reason for Consideration
Board Diversity and Independence	Diversity in terms of gender, skills, background, age, and ethnicity is likely to bring a wider range of perspectives and expertise to boardroom discussions thereby avoiding the group-think of a heterogenous board. Indeed, research indicates a positive correlation between board diversity and financial performance. Further, diverse boards are more likely to identify risks faced by the company and find better mitigants for those risks.
Conflicts of Interest	Conflicts of interest are analysed to identify: (i) in relation to directors, executives, or major shareholders: (a) those engaged in transactions with the company which are not conducted at arm's length; (b) those engaged in other organisations the interests of which conflict with those of the company; (c) those with personal ties to customers or suppliers; (d) those holding investments in companies that compete with or supply the potential borrower; (e) those holding high profile media roles; and (f) those holding intellectual property rights critical to the company's operations; (ii) executives determining their own remuneration; and (iii) private equity or other investors with short-term objectives which conflict with the interests of a private debt lender providing a loan over a longer term. A private debt lender may expect to see codes of conduct and disclosure requirements in relation to conflicts of interest and independent committees to review and approve remuneration and transactions.
Risk Management	A private debt lender would expect to see a register of risks facing the borrower as evidence of management's awareness of risks and a set of policies for managing the risks identified including a succession plan. A private debt lender would expect to see a business continuity plan to address events such as physical damage to company property or equipment, loss of personnel due to terrorism or a pandemic, and cyberattacks, such as ransomware, because such events can disrupt business operations, leading to reputation damage and financial losses. Having a business continuity and recovery plan in place is a critical aspect of risk management. The plan should provide for data backup and recovery to ensure business continuity in the face of such misfortunes.
Data Security	Proper cybersecurity measures are essential to: (i) prevent service interruptions as may arise from ransomware attacks; (ii) safeguard customer information, financial records, and intellectual property from unauthorised access, theft, or data breaches; and (iii) promptly respond to cyber incidences to minimise disruption to customers. The financial implications of cyberattacks and data breaches include the following direct costs: (i) regulatory fines[62]; (ii) civil litigation[63]; (iii) responding to the attack; (iv) tightening cybersecurity by investing in network, data, and application security architecture; (v) increased cyber insurance premiums; and (vi) interruption to business leading to a loss of revenue; and the following indirect costs: (i) reputational damage; (ii) loss of customer loyalty; and (iii) decline in credit rating which will increase debt funding costs[64]. A private debt lender is likely to look for a combination of: (i) commercial-grade cyber security systems; (ii) regular penetration testing; (iii) regular cybersecurity awareness and training programs to recognise suspicious activities, report them, and reduce the probability of human errors that could lead to cyber security breaches; and (iv) a cyber security insurance policy to provide for financial loss and obtain access to cyber security expertise in the event of a cyberattack.
Business Ethics	Fraud, bribery, and corruption scandals lead to reputation damage, loss of trust by customers and investors, and possibly fines or sanctions. A private debt lender is likely to look for policies and procedures to prevent and detect fraud, bribery, and corruption. Annual mandatory training for all staff in relation to the prevention of such activities backed up by monthly compliance attestations from employees is likely to be a minimum requirement.

[62] In May 2023, Meta was fined EUR1.2 billion by the Irish Data Protection Commission for transferring user data from the EU to the U.S. in violation of GDPR. Source: https://www.bbc.com/news/technology-65669839

[63] In 2021, T-Mobile suffered a cyberattack which compromised the personal data of more than 75 million individuals. A class action lawsuit followed. T-Mobile agreed to settle with the claimants for USD350 million and to invest USD150 million in technology to improve data and cyber security. Despite the settlement and the commitment to invest in appropriate technology, the company suffered another cyberattack in 2022. Source: https://www.reuters.com/business/media-telecom/t-mobile-pay-350-mln-settlement-over-massive-hacking-2022-07-22/

[64] In 2017, Equifax raised USD-denominated debt with a maturity of 10 years at a spread of 150bps over U.S. Treasury yields. Equifax suffered a data breach that same year and the private records of more than 160 million users were compromised. In 2020, having been downgraded by one notch from its BBB+ rating the previous year primarily because of the costs identified above, the spread that Equifax had to pay on debt of the same term and currency had risen to 250bps over U.S. Treasury yields. Source: S&P Global Ratings 14 March 2020: *"Equifax Inc. Downgraded To 'BBB' On Rising Leverage And Expenses; Outlook Negative."*

Governance Factor	Reason for Consideration
Management Remuneration	Senior management compensation ought to be linked to the long-term performance of the company in terms of profit growth, returns to shareholders, and mitigation of ESG and other risks. Such compensation is likely to be in the form of stock options, restricted stock units, or other equity-based incentives where the awards vest over time contingent on the company's long-term performance and can be clawed back for poor financial performance or reputation damage. Senior management compensation ought to be determined by a committee of independent directors in line with shareholders' interests in a transparent manner which identifies the metrics used and the structure of the compensation package as a means of ensuring alignment with the goals of the company.
Tax Transparency	Transparent tax reporting, demonstrating compliance with tax laws, reduces the probability of tax fines, negative publicity such as from a public backlash and potential legal consequences. If a company's ethical and social responsibility practices are poor, it may affect the company's ability to refinance a loan risking the repayment of the private debt lender's loan.
Supply Chain Management	Supply chain management should include diversification of suppliers, plans to withstand, and recover from unexpected supply chain disruptions, blockchain technology to provides real-time visibility through the supply chain, and supply partners with 'skin in the game' incentives to supply.
Climate Risk and ESG Awareness	The board and senior management need to be aware of the risks to the company arising from climate change and a failure to manage social issues. The awareness must extend to policies designed to mitigate such risks.

14.9.4 Mitigation of ESG Issues

Where ESG issues have been identified, the private debt manager will need to decide whether:

(i) the issues can be mitigated relatively easily and within a short timescale and where the mitigation requires additional capital expenditure an assessment of its financial impact; or

(ii) the ESG issues identified pose a very significant risk of loan loss and preclude an advance of funds to the potential borrower.

Capital expenditure impacts cash flows. It is of particular importance for a lender in, for example, real estate lending where a building needs to be upgraded to a high standard of energy efficiency as tenants, particularly multinational tenants, prioritise renting buildings with high standards of energy efficiency.

14.10 COVID-19 Pandemic

It is interesting to study the impact of the COVID-19 pandemic on private debt funds. Private debt fund managers would have held extensive dialogue with portfolio companies to consider a wide range of requests including: (a) to increase the indebtedness of the portfolio company to permit access to government backed loans to provide working capital and facilitate other liquidity needs; (b) repayment holidays; (c) covenant relief; (d) extensions of the term of the loan facility to the portfolio company.

Where granted, these requests usually came with constraints being imposed on portfolio companies including: (i) restricting capital expenditure; (ii) no further drawdowns on committed credit lines from the private debt fund; (iii) demands for additional equity; (iv) an exchange of debt owed to the private debt fund for equity in the portfolio company; and (v) more frequent liquidity tests. In the period after the pandemic, many portfolio companies had higher levels of debt which was slow to reduce as profit margins were lower in the early phase of the recovery.

15 Credit Monitoring of Portfolio Companies

Absent fraud, reports of a company's cashflows are probably one of the best barometers of its financial health. The higher the frequency of reporting of cashflows by borrowers the earlier and more likely a private debt fund manager will identify an obligor with a deteriorating creditworthiness.

Depending on the portfolio company, monitoring is likely to cover trends in the categories shown in Table 12.

Table 12

Category	Reason for Monitoring
Cash Flow	A regular review of available cash, liquid investments, and saleable assets together with projected free cash flow, cash available from bank credit lines, and access to equity capital to compare it with cash requirements for debt maturities, dividends, and capital expenditure over the remaining term of the private debt loan so as to anticipate any potential for default or other financial problems.
Key Metrics	A regular review of coverage for fixed charges and interest expense and of the ratio of [Debt]/[Equity Capital].
Supply Chain	Bottlenecks in supply chains drive up the prices of inputs to the production process if demand remains steady and may lead to: (i) reduced earnings for the portfolio company if it cannot pass the increased costs on to customers; or (ii) a reduced rate of earnings growth for the portfolio company even if they can be passed on to customers.
Commodity Prices	Rising commodity prices put pressure on input costs which, if they cannot be passed on to customers, will impact margins.
Cost of Capital	If the cost of capital rises, margins may become squeezed if such cost cannot be passed on to customers.
Labour Shortages	Labour shortages drive wage inflation which squeezes margins to the extent they cannot be passed on to customers.
Productivity	Declining productivity impacts corporate profitability.
Inflation	Inflation reduces consumer expenditure which in turn reduces discretionary spending. Inflation also drives up companies' wage bills, energy costs, and in time rents. The revenues of portfolio companies in the retail, insurance brokerage, banking, mortgage provision, and subprime lending sectors are heavily affected by inflation as it reduces their earnings. Few companies benefit from inflation.
Climate Change Risk	Review of management's implementation of the mitigation of identified climate change risk.
ESG Risks	Review of management's implementation of the mitigation of identified ESG risks.
Collateral Asset Values	Falling values of collateral underpinning security for loans combined with falling earnings may trigger a default with a loan-to-value ratio that is greater than 1.0.

16 Barriers to Entry into the Private Debt Lending Market

Limiting mistakes that cause loan losses is a critical requirement of a successful private debt manager. Scale is a key competitive advantage and a barrier to entry to the private debt market and one which can help to limit mistakes.

By scale we mean a combination of most of the following factors:

1. First-class origination and sourcing pipeline providing a wider pool of deals to choose from across attractive sectors.
2. Availability of significant amounts of capital to lend permitting private debt lenders to:
    a. access larger borrowers where competition among private debt lenders is less than among private debt lenders to small and mid-sized borrowers; and
    b. finance larger deals and still retain a diversified lending portfolio.
3. Deep and long-standing relationships with
    a. private equity firms which permit consistent underwriting in the face of competitive pressures; and
    b. real estate professionals

    which allow the private debt firm to tap into their knowledge base.
4. Significant experience in underwriting, negotiating, structuring lending terms to secure wider spreads and call protection, and in resolving problem credit situations.
5. Access to finance for both leverage and subscription credit finance.
6. Large highly experienced private debt team with knowledge of hundreds of different portfolio companies across multiple different sectors.
7. Access to industry sector experts and investment professionals through perhaps associations with top-tier alternative investment firms.

Scale permits a private debt lender to leverage both financing and operating expenses making these aspects of a private debt fund more efficient in terms of fees and costs for investors.

Further, broadly speaking, providing finance to larger companies is somewhat less risky from a credit perspective than providing finance to smaller companies. Larger companies tend to have better management teams, higher levels of EBITDA cash flow, more diversified businesses by both geography and product type, better ability to provide key information for loan monitoring, more robust corporate governance, and perform better during periods of rising inflation or slower growth and inflation than smaller companies.

As an illustration of scale and barriers to entry in the private debt market, in the two-year period ending November 2023, it is estimated[65] that 40% of private credit fundraising was accounted for by just ten firms.

[65] Source: Private credit boom will trigger a new squeeze. https://www.ft.com/content/b8e151c7-7302-4464-bc49-5091df86ec40 Accessed: 29 December 2023.

17 Choosing a Private Debt Manager

Highly effective private debt fund managers have deep knowledge and experience of the sectors to which they lend, superior sourcing of lending opportunities, a rigorous due diligence approach in selecting borrowers to which to lend, and an experienced workout team for dealing with problem credits. There is a variation in the experience of private debt loan underwrites and private debt workout teams which inevitably leads to a dispersion of returns from private debt fund managers.

In conducting due diligence on private debt fund managers, investors are likely to consider at least the following main factors:

(i) The ability of the private debt fund manager to originate lending opportunities from multiple sources including private equity sponsors and direct corporate relationships and in doing so to provide corporate credit, mortgages, and purchase distressed debt and non-performing loans.

(ii) The trend over time in the number of deals being made by the private debt fund manager as a slowdown in deal-making is likely to lead to a longer time for an LP to get its money back.

(iii) The scale and experience of the private debt fund manager in managing a large portfolio of loans through multiple credit cycles are very important factors in the selection process. Scale is important for the management of concentration risk and diversification in a private debt fund. Look for an experienced team of multi-disciplinary executives that have worked together for several years with particularly strong restructuring skills and who have successfully managed potential and actual defaults in periods of severe economic downturn.

(iv) To gain a perception of the credit risk, examine the portfolio of investee companies or the investment strategy for evidence of elevated borrower leverage, a high level of EBITDA addbacks, lending to sectors with structural weaknesses, weak covenants, poor investor protections, and a high level of exposure to weak credits. In this regard, PIK loans require particular attention. Here is a small sample of due diligence questions a prospective institutional investor might ask:

    a. Has the private debt fund set a limit on the metric:
       [Balance Outstanding on PIK Loans]/[Total Balance Outstanding on All Portfolio Loans] ?
    b. What is the weighted average term to maturity of PIK loans and how does it compare with the weighted average term to maturity of cash interest loans?
    c. What proportion of the [Total Balance Outstanding on PIK Loans] is represented by each of the three highest PIK obligors?
    d. What is the minimum additional interest rate charged on PIK loans over and above that charged on cash interest loans?

(v) Look for ongoing and rigorous monitoring of portfolio companies and of trends in their industry sectors and for evidence of monitoring of maintenance covenants, restrictions on payments to equity capital holders, and control of collateral.

(vi) The management of the private debt firm in terms of the organisation of the people working in it as that will likely determine the ability of the team to invest. Look at the technology and the staff to support private debt lending spanning the key areas of loan origination, borrower due diligence, legal, taxation, accounting, compliance, administration, ongoing loan monitoring, risk management, administration, restructuring experience, and investor relations. The results of this area of due diligence are likely to be seen in the returns emerging for private debt fund investors;

(vii) How are the interests of the investment team and the LPs aligned? On the upside, LPs would expect team members to participate in the distribution of performance fees. On the downside, LPs would expect that team members participate through losses on the investment of their own personal wealth in the private debt fund.

(viii) How are the key members of the team 'locked into' the firm?

(ix) How long has the team been together?

(x) Conflicts of Interest Arising from Fee Structures: For example:

a. Where management fees are charged on gross as opposed to net assets, there is an incentive for a private debt manager to increase borrowing by the private debt fund which in turn leads to higher fees for the private debt fund manager; but higher risk for the investors;
b. Performance fees effectively amount to the GP obtaining a share of interest income. This structure runs the risk of the GP exposing investors to more credit risk to increase performance fee income; and
c. Low hurdle rates for performance fees combined with a GP catch-up may give rise to a divergence of interests between the GP and the LPs.

(xi) Are the terms of the private debt fund in line with what is generally available in the private debt fund market?

(xii) How does the firm's strategy appear in isolation and relative to the rest of the market?

(xiii) What is the return objective of the private debt fund and what market inefficiency is the strategy trying to capture?

(xiv) What level of risk is the private debt fund manager taking to achieve its objective? This might be informed by a line-by-line historical performance track record with a particular focus on problem credits and how they were resolved. Other indicators of risk for investors include:

a. Fund leverage: Lower fund leverage means credit losses don't have the same potential to destroy value; and
b. Leverage of portfolio companies: Examine how the private debt lender is protected, how it is protected, and the degree to which it is protected against loan losses. The latter may be considered by estimating the percentage default rate and percentage recovery rate to wipe out the equity cushions of portfolio companies.

(xv) The ability of the private debt fund manager to obtain SCL and fund leverage on very favourable terms.

All other factors being broadly equal, the choice of private debt fund manager is likely to come down to fees and fund terms.

18 Negotiating Private Debt Fund Terms

GPs in their desire to secure commitments for their investment thesis from LPs for a new fund may offer LPs investing at the outset of a fund preferential terms. Such preferential terms might include some combination of reduced fees, additional information rights, granting the LP a right to a seat on the fund's advisory committee, transfer rights, taxation provisions, redemption provisions, and liquidity rights.

Such preferential terms are typically documented in a side letter or via a 'most favoured nation' ("MFN") provision between the GP and the LP being granted preferential terms allowing the GP to incentivise strategic, large, or early investor commitments.

Under the MFN provision, after the final close of the fund, the manager is normally required to disclose all terms agreed in side letters to investors. Thereafter, each investor with an MFN clause in its side letter agreement can avail of any more favourable terms agreed with other investors subject to such conditions as having committed the same amount as, or more than, that investor. In some jurisdictions, there may be a regulatory requirement to ensure fairness and transparency by disclosing preferential terms on a timely basis and providing annual updates in cases where additional preferential terms are granted.

Apart from obtaining preferential terms as a result of the timing of an allocation to a private debt fund, preferential terms may also be offered by GPs to allocators based on the size of their investment in a private debt fund at any time during the fundraising period of a private debt fund. The negotiating leverage that an allocator has with a GP of a private debt fund when seeking preferential investment terms is likely to be low for a small family office and rather high for a multi-billion-dollar pension fund.

In August 2023, the U.S. Securities and Exchange Commission ("SEC") introduced the Private Funds Rule for all investment advisers to private funds. In relation to the issue of preferential treatment of some investors, the SEC now requires that it is prohibited to grant some investors and not others preferential treatment in relation to information rights and redemptions. Further, the SEC has mandated greater disclosure of other types of preferential treatment.

19 Regulatory Focus on Private Debt Funds

At the 2023 Managed Fund Association's global summit in Paris, regulators noted a lack of visibility of concentration risks, liquidity risks, and synthetic leverage risks[66] in private funds which might potentially alert regulators to links to other parts of the financial sector. There has been a growing level of scrutiny of private debt funds by a number of central banks around the world including, the European Central Bank, the Federal Reserve in the U.S., and the Bank of England, in relation to their interconnectedness and whether they pose systemic risk. For example, in May 2023, Ashley Alder, chair of the Financial Conduct in the U.K., said at the Managed Fund Association Global Summit in Paris[67]:

The key point is that opaque private markets exhibit vulnerabilities which make it hard to spot and contain problems, including those that may give rise to broader financial crises.

These vulnerabilities include very limited or fragmented regulatory coverage of firms and activities, as well as a lack of risk data being reported to regulators, or being made available to the market. Add to this a cocktail of concentration risks, liquidity risks and synthetic leverage risks, including the use of uncleared bilateral derivatives employing different margining practices.

In July 2023, the Central Bank of Ireland published a discussion paper entitled *An approach to macroprudential policy for investment funds*. There was a significant focus on leverage in private funds regardless of whether it arose from funds using debt to finance investments[68] or the use of derivatives to create exposures contingent on the future value of an underlying asset.

The concern expressed by the Central Bank of Ireland in the above paper was that deleveraging by funds over a very short time frame in response to adverse shocks can amplify those same shocks to the financial system.

The link between investment funds and other parts of the financial system was identified as being through the credit funds supply or through asset fire-sales and falling collateral prices. The concern is that such links can result in the transmission of underlying vulnerabilities in investment funds via shocks, to other parts of the financial system or the real economy.

While institutional long-term locked-in capital has reduced liquidity risks, regulators appear to be of the view that this has occurred at the expense of increasing the opacity of the private debt market, in terms of low visibility on investors, transactions, and borrowers. To assess the risks in private debt markets, regulatory authorities are likely to call for more data to analyse at the very least loan origination practices.

Table 13 sets out a summary of the arguments advanced by the private debt fund management industry as to why it is not appropriate to view the private debt fund industry through a bank prudential regulation lens.

[66] Particularly in relation to uncleared bilateral derivatives.
[67] Source: https://www.fca.org.uk/news/speeches/drive-data-non-bank-financial-intermediation-nbfi
[68] In the case of private debt fund, the use of leverage to finance loans to portfolio companies.

Table 13

Comparison Heading	Banks	Private Debt Funds
Source of Funds	Depositors provide a significant source of capital for bank lending.	Institutional and retail investors with an appropriate risk appetite for investing in private debt funds.
Nature and Term of Liabilities	Depositors can withdraw their deposits generally speaking, on demand. Short-term deposits fund long-term loans creating a significant asset-liability mismatch making banks vulnerable to runs on deposits and creating a form of contagion.	Long lock-up periods provide a secure capital base from which to conduct lending operations. Where private debt funds are not leveraged to any significant extent, losses occurring in one private debt fund are suffered solely by investors in that fund.

The private debt fund industry argues that as the underlying business models of banks and private debt funds are so fundamentally different, it is not appropriate to apply banking-type regulation to private debt funds.

20 Taxation

Where a private debt fund registered in one jurisdiction lends to a company registered in a different jurisdiction, there may be a requirement for the borrower to deduct withholding tax on interest payments and thereby pass the interest amount net of withholding tax to the private debt fund.

Unanticipated withholding taxes which are not reclaimable under any double taxation treaty between the two jurisdictions: (i) will reduce the IRR on the loan for the private debt fund; and (ii) may result in over hedging from any forward foreign exchange hedging transactions which were put in place before the discovery of the withholding tax issue.

Example 8: UK Withholding Taxes for Foreign Lenders

In the UK, a lender must be a 'Qualifying Lender' to receive interest without deduction of UK withholding taxes on interest payments. Assuming that there is a double taxation treaty between the UK and the jurisdiction of the lender, it would typically be necessary for:

(i) the foreign lender to obtain a 'Double Tax Treaty Passport' ("DTTP") from His Majesty's Revenue and Customs ("HMRC"); and

(ii) the UK borrowing company to obtain a direction from HMRC to permit it to make the interest payments to the foreign lender free of UK withholding taxes.

Broadly speaking, the key requirement for a borrower to obtain a DTTP is that the lender is beneficially entitled to the interest paid by the UK borrower in accordance with the double taxation treaty between the two jurisdictions.

Obtaining a DTTP from HMRC may take some time and allowance must be made in the deal timetable for the DTTP application to be processed.

21 Private Debt v. Public Debt

Table 14 compares private debt to public debt, high yield bonds, under a number of headings.

Table 14

Comparison Heading	Public Debt (e.g. high yield bonds)	Private Debt
Covenant	Incurrence based	Maintenance based covering leverage, capital expenditure, debt service coverage ratio, et al.
Coupons	Fixed	Floating (check for floors)
Variable Loan Drawdown	High yield bond principal is funded upfront by investors at issuance. The issuer may not draw down funds over time.	Private debt markets can deal with variable loan drawdowns which may be required by borrowers.
Typical Term	Five to ten years.	Three to five years.
Access to Management	Indirect.	Direct and significant access to management.
Privacy	Public debt markets require a significant amount of disclosure in relation to the borrowing entity.	Greater transaction privacy compared with the disclosure required in public debt markets.
Credit Rating	Typically, a credit rating is required from two agencies in the following list: Fitch, Moody's, and S&P.	No credit rating is required.
Yield	Lower yield than private debt.	Yield premium relative to public debt.
Information Rights	Quarterly and annual financial statements are required, often with compliance certificates signed by management.	Private debt lenders usually get management information on a monthly basis and so can provide investors with more transparency in relation to their investments. Some private debt managers may get daily cash flow information.
Availability of Data on the Obligor	The depth of reporting varies by issue, but regular financial data, operational statistics, covenant calculations (where relevant), and qualitative insights into performance are commonly reported.	A significantly greater level of detail and at a higher frequency.
Volatility	As public debt is traded, shock events like COVID-19 may cause investors' need for liquidity to move the market rather than changes in fundamental values.	Relatively lower volatility in private markets because the loans are usually held to maturity and are not traded.
Security Package	Not usually secured with a first lien against the borrower's assets. Ranking below senior secured thus generally subordinated to bank loans, Generally ranking ahead of unsecured debt.	Experienced lenders in private markets may be able to obtain better security packages and borrower covenants.
Enforcing Security	First Lien, Secured High-Yield Bonds Rank pari passu with the first-lien senior bank debt in the proceeds from collateral. Second Lien, Secured High-Yield Bonds Will receive proceeds from collateral only after first-lien senior bank debt has been paid in full. In both first and second lien secured high-yield bonds, the administrative agent under senior bank debt will decide which assets to foreclose upon, when to do so, and the manner of foreclosure. High yield bondholders will essentially have to tag along with the administrative agent in line with the inter-creditor agreement with respect to the collateral.	In private markets, experienced lenders may be able to get ahead of the market in enforcing security and disposing of it before the market is flooded with similar security for sale.

22 Private Debt Funds & Annuity Reinsurance

In essence, annuity asset reinsurance involves the ceding insurance company (the "Cedant") swapping longevity and investment risk for legal, credit, and operational risk. At its heart, it is a form of regulatory arbitrage as the reinsurer must be able to discount the liabilities at a higher rate of interest or hold a lower level of regulatory capital in respect of the block of business reinsured by the Cedant either on its own account or through one or more retrocessions. The higher rate of interest may come from investing in illiquid assets such as private debt funds which provide an illiquidity premium.

It is in the interests of the Cedant to mitigate the credit risk in a reinsurance arrangement from a risk management perspective. To this end, the reinsurer will be required under the reinsurance arrangements to post collateral usually to a custody account, hypothecating securities to that account, and creating a lien over such securities in the custody account in favour of the Cedant. Upon default of the reinsurer, the Cedant should be entitled to take possession of the collateral in the account and claim for any shortfall between the value of the collateral and the best estimate of liability under the reinsurance arrangement.

The reinsurance premium to be paid to reinsure a block of annuities is in part determined by the nature of the assets that may be posted to the Cedant's collateral portfolio by the reinsurer. All other things being equal, permitting the posting of more illiquid assets, such as participations, shares or units in private debt funds, to the collateral portfolio of the Cedant will tend to lower the reinsurance premium.

Where participations, shares or units in private debt funds are offered as collateral for an asset annuity reinsurance deal, for collateral monitoring purposes, the ceding insurer will require an independent valuation of the collateral and assessment of its credit rating at a frequency of no less than monthly by a valuation agent which specialises in the valuation of illiquid private debt.

The valuation agent must have access to the books and records of the private debt asset manager to verify the parameters and ongoing performance of individual loans. A specialist valuation agent is an added cost and an added administrative burden in annuity reinsurance collateral monitoring. The cost of the specialist valuation agent and administration over the likely long life of the reinsurance contract will need to be compared with the lower premium offered for accepting private debt collateral.

23 Data

At the outset, private debt funds were generally funded by a small number of institutional investors and the infrastructure for reporting on performance and fund composition was mainly manual. Every private debt fund manager has its own unique template for reporting to investors. There is a particularly high use of spreadsheets for data storage and valuation purposes while email is a very common means of communicating data from a fund's GP to its LPs.

As more institutional and high net worth individuals started to invest in private debt funds, the data collection, analysis, and reporting processes need to become more automated and LP specific. LPs need reliable and frequent data on investment returns, fees, deployment, portfolio holdings, portfolio ESG characteristics, and loan losses to name but a few data items and they need it in formats that allow the integration of private debt investments into their wider portfolio for reporting on return, risk, and exposures.

The lack of reliable and standardised data available in private debt markets is making it difficult to compare private debt funds and integrate private debt into a wider portfolio of assets. LPs need to report to their boards and their underlying clients. The current state of data in private debt markets is likely to cause a typical LP to have to engage in a significant amount of manual work to provide its underlying clients with geographical and sector exposures to private assets within their portfolio.

A significant amount of resources must be invested in automating boring data collection tasks, eliminating errors in data collection, and in data quality assurance before any comparisons of private debt managers can be made. This is a considerable challenge because of the volume of data and the complexity of data in private debt. Private debt fund data may come from an investor's internal systems and from external providers and it can be challenging to integrate these two sets of data for analysis purposes.

For retail investors, the lack of transparency and difficulty in obtaining private debt fund data is likely to delay the adoption of private debt investing by such investors.

24 Conclusion

'Higher for longer' interest rates, tighter lending criteria by banks, rising capital requirements for banks operating in the U.S. wholesale banking industry under proposed new U.S. Federal Reserve rules, and existing private debt lenders building their books in Asia are likely to fuel the growth in private debt lending.

M&A activity, a key driver of the demand for private debt loans, has slowed since the Russian invasion of Ukraine in the first quarter 2022 and is likely to remain challenged in 2024 due to the war in Gaza and the uncertainty as to the outcome of the U.S. election in November 2024.

Exit transactions by private equity firms are reported to be at a 10-year low. In the current 'higher for longer' interest rate environment, publicly listing an investee company is not attractive for two reasons: (i) the initial public offering market is currently very weak; and (ii) valuations, aside from those of major technology companies, have fallen. Selling an investee company to another fund has become challenging because of the increased cost of borrowing which pushes up the weighted average cost of capital for a leveraged buy-out. This makes it difficult for the acquiring private equity owner to pay the selling private equity owner the price required to deliver the target return. This is likely to give rise to refinancing and restructuring opportunities for private debt lending in 2024.

Many capital structures put in place in the calendar years 2019, 2020, and 2020, before the recent rise in interest rates, were financed at a time when reference rates such as SOFR were close to zero and may not be able to withstand the cashflow impact of the rise in interest rates. While such companies may be weathering the rise in interest rates, it is impacting the financing of growth initiatives. There may be a rise in PIK loans particularly to borrowers with short-term cash flow challenges but with significant potential to generate cash flow in the medium term. Further, from Q4 2024 and during 2025 there will be a wall of maturing loans in need of refinancing.

At the time of writing, despite one of the steepest rises in interest rates in decades, signs of credit deterioration are modest outside of idiosyncratic cases where a company's business model has been destroyed by rising inflation or rising raw material costs. A majority of companies have been able to pass on rising costs to customers. However, if interest rates remain at current levels, the EBITDA of an increasing number of borrowers rated B and below is unlikely to be sufficient to cover the interest bill.

Loan underwriting is now more important than at any time in the last 15 years or so given that those past years were predominantly characterised by historically low interest rates.

In recent times, investors' allocation to private debt funds has significantly increased the 'dry powder' of such funds. It was reported by S&P Global[69] that private debt firms have more than

[69] Source: S&P Global. Buying Time Post-Default with Private Credit. December 2023

USD400 billion in dry power[70] of which USD150bn is earmarked for distressed investments, special situations, and to support challenged portfolio companies if credit conditions weaken.

There is no 'all weather' asset class and private debt is not immune from losses. Although the historical performance of the CDLI index spans what was mostly a falling interest rate environment, it provides an indication of the size of potential size of loan losses in a stress scenario. Long-established private debt firms with experience across a number of credit cycles and in successfully managing the resolution of debt problems are perhaps likely to suffer lower losses than asset managers that have launched a private debt lending operation in recent times.

[70] Dry powder refers to the ready cash private debt managers have at their discretion to deploy opportunistically as debt market conditions change over market cycles. It is essential for capitalising on downturns.