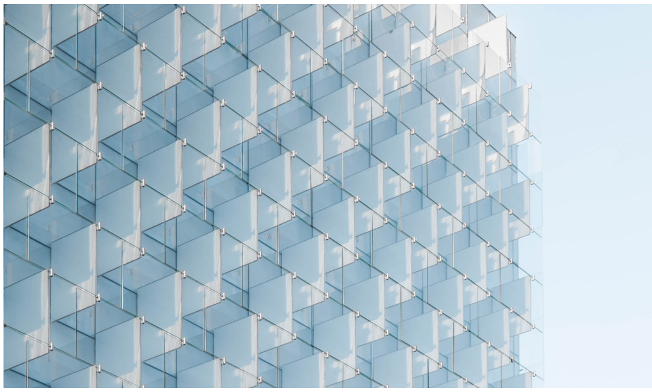
WHITE PAPER

January 2021

The Changing Face of Private Capital

Broadridge Data and Analytics



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OVERVIEW

As 2020 has ended, it's time to take stock of the good, the bad and the ugly that have so distinctly characterised the industry in this strangest of years. The Covid-19 pandemic has shaken up investors' notion of liquidity and safe havens, and plunged markets to new lows and subsequent new highs. There have been a few bright spots, one of which is the alternative investments segment.

Growth in the private market space has been strong with an average 5-year CAGR of 14.4% to Q3 2020. Although growth has slowed from the peak in 2019 as the pandemic puts a strain on otherwise strong fundraising momentum, investors (both institutional and gradually retail) are looking to allocate more into this segment. They are driven by the hunt for yield, income needs as well as low correlations to traditional asset classes.

From a fundraising perspective, the US is the clear leader – accounting for more than half of alternative assets. It is followed by China and the UK. From an asset class perspective, private equity accounts for the lion's share of total alternative assets (roughly 60%), with buy-out being the dominant strategy.

With private debt being one of the fastest growing private market strategies, we focus on this asset class within this whitepaper, especially the direct lending space as we expect a growth spurt both in demand and supply. The pandemic has added further impetus to the demand for funding. Other factors driving growth across the globe include regulatory tailwinds as well as the entry of new players into the market. This is true not just in the US and Europe but also increasingly in Asia.

For the rest of the white paper, we will be looking at three key themes that have characterised the direct lending space which we believe will continue to shape the growth trajectory in years to come.

1. **Impact of the Covid-19 pandemic on fundraising**

The pandemic had dampened the momentum in aggregate private market fundraising over 2020. Despite this, strategies such as private debt and infrastructure experienced growth greater than more established private market asset classes, highlighting investors' need for non-correlated returns. In the direct lending space, we have witnessed a decline in the number of deals and a rise in dry powder due to the difficulty in completing due diligence and deploying capital. While senior debt has dominated direct lending, we expect other strategies like mezzanine, distressed, special situations and hybrid structures to benefit from any dislocations in capital markets and pricing inefficiencies.

2. **Size matters**

The big are getting bigger as we saw nearly 50% of capital raised going to the 10 largest direct lending funds. As a result of this "winner takes all" effect, we see the rise of scalable and geographically diverse platforms with multi-channel origination, flexible capital access, strong track records and broad product capabilities. Traditional private equity leaders such as Blackstone and KKR are now all making waves in other alternative asset classes from private debt to infrastructure, real estate and beyond.

3. **ESG green shoots take root**

The ESG wave is sweeping across all geographies and asset classes as investors start to place significant emphasis on managers' ESG policies as selection criteria. According to a global investor survey by EY, alternatives managers have not kept pace with ESG demand, as fewer than a third offers or plans to offer ESG products. We look at the key obstacles deterring managers from offering ESG products but also aim to shed light on the ESG green shoots that are starting to take root in the direct lending space.

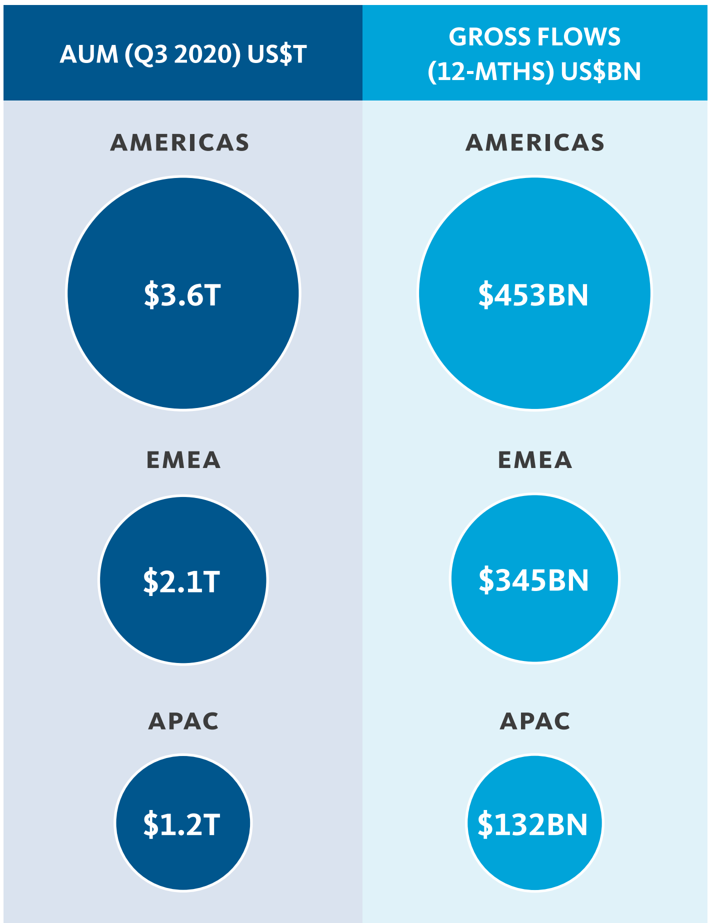
Market sizing

Private equity is the largest asset class enjoying the highest proportion of flows,with DB pensions being the biggest investors in private market strategies.

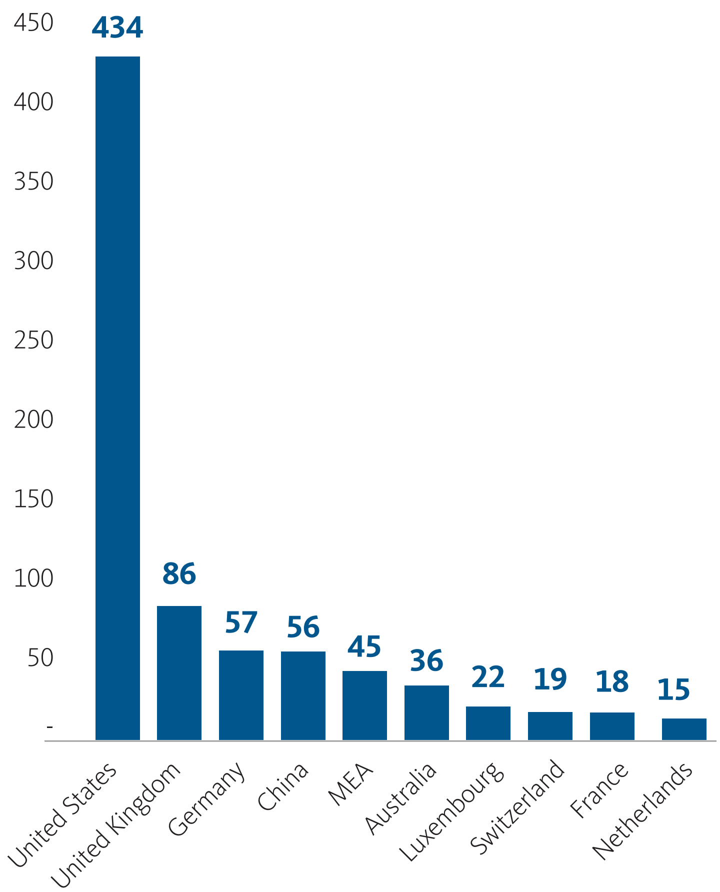
TRACKING US$8.2TRN IN GLOBAL PRIVATE MARKET ASSETS AS OF Q3 2020

More than half of the assets we track are sourced from the United States, followed by China and the United Kingdom. Private equity is the largest asset class enjoying the highest proportion of flows, with DB pensions being the biggest investors in private market strategies.

Client location



Top 10 countries by 12-month inflows US$BN — Q4 2019 – Q3 2020



Key takeaways

- The US holds the largest share of the private market, accounting for more than half of assets sourced, followed by the UK and then China.
- Private equity is the leading strategy of the analysed asset classes, with buyout funds holding the most assets.
- US DB pension funds are the largest investor by client type across all the observed asset classes, with their highest market share in private equity.
- The 12-month gross inflows are reflective of the AUM holdings, with the US leading, followed by the UK and China.

PRIVATE MARKETS FUNDRAISING OVERVIEW – Q3 2020

Private equity inflows over a 12-month period, with US DB pensions making up the bulk of the observed flows.

Key takeaways

- The US led total fund inflows into private market investments, followed by UK and then Germany.
- US DB pension plans (both private and public) represent the strongest flows into all private market asset classes across all observed client types.
- Of the observed asset classes, private equity saw the strongest inflows with buyout being the leading strategy.
- Private debt and infrastructure were the fastest-growing markets over the 12-month period to Q3 2020. 12-month inflows in these asset classes represented 4.6% of their total AUM. This proportion was bigger than private equity and real estate (the larger overall markets in terms of AUM), where 12-month inflows represented 3.4% and 3.6% of the total market, respectively.
- In the rest of the white paper, we will be focusing on direct lending within private debt to explore how the strategy has seen growth driven by both demand and supply factors. We also explore how our three key themes have and will continue to shape the growth in years to come.

12-month gross flows overview

	Private Equity	Real Estate	Private Debt	Infrastructure
Gross flows (US$bn)	638	205	135	112
Top 3 Strategies	Buyout: 288 Early Stage / Venture: 155 Growth: 83	Opportunistic: 53 Core: 45 Value Added: 40	Direct lending: 59 Distressed: 30 Special Situations: 21	Value Added: 26 Core Plus: 24 Debt: 22
Top Channel by Region	US-Public DB: 85 CN-AM: 30 UK-AM: 25	SG-SWF: 13 US-Private DB: 12 GER-DB Other: 8	US-Private DB: 12 UK-AM: 10 AUS-DB Other: 3	MEA-SWF: 11 US-Private DB: 7 CN-SWF: 6

Americas EMEA APAC

Source: GMI Institutional

Notes: Only infrastructure non-listed, real estate non-listed, private equity and private debt are included.
Top channel by region shows the best selling channel in each of the 3 regions.

DIRECT LENDING LEADS PRIVATE DEBT FOR BOTH AUM AND GROWTH

We divide direct lending into 12 main segments, split by four types of loan structures and three investment regions. North America senior debt makes up the bulk of private debt AUM.

While private debt is still a small component of alternative asset demand, we focus on this asset class in this white paper, especially the direct lending space, as we expect a growth spurt both in demand and supply. The pandemic has added further impetus to the demand for funding.

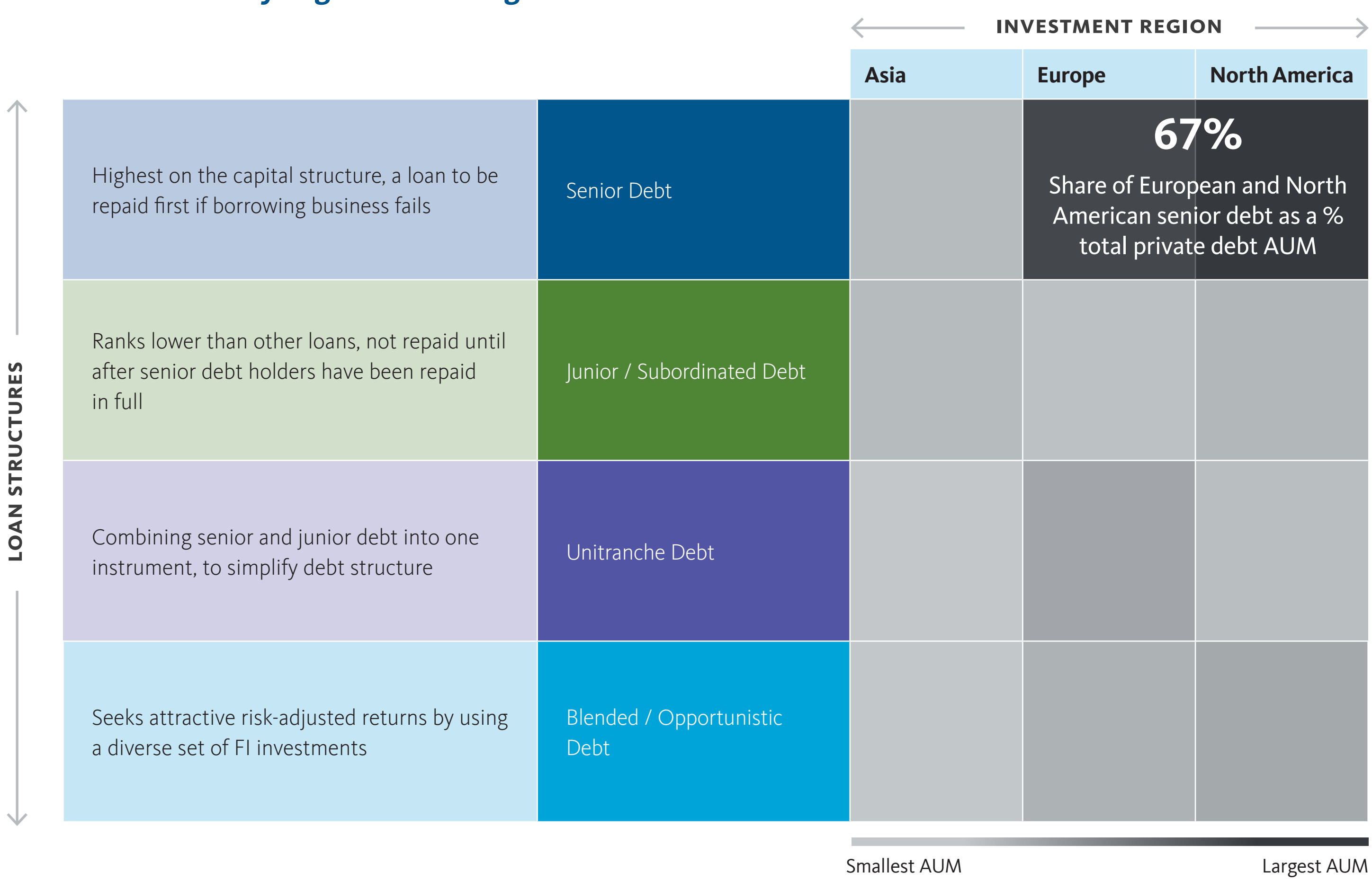
Other factors driving growth across the globe include regulatory tailwinds as well as the entry of new players into the market. This is true not just in the US and Europe but also increasingly in Asia.

What is Direct lending?

Direct lending is when a transaction occurs directly between the lender and the borrower without the use of an intermediary (eg a bank). This is accomplished by going directly to private equity sponsors or owner/operators of middle-market companies, commercial projects or commercial real estate to originate loans.

Direct lending typically focuses on mid-market firms. A mid-market firm typically has 1,000-2,000 employees and around US$10m-US$500m in revenues. We have also observed a further segregation of mid-markets into lower middle-market firms (typically US$5m-$100m) and upper middle-market firms (US$500m-US$1bn).

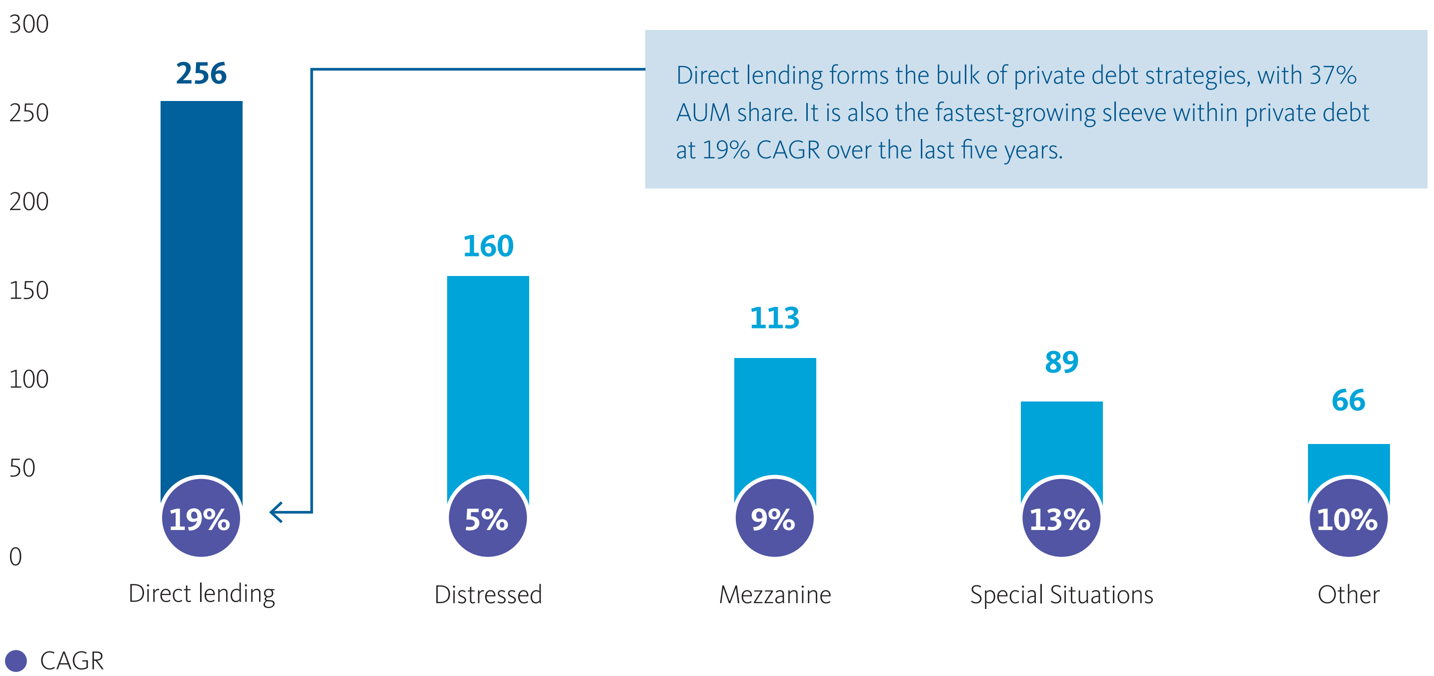
Framework for analysing direct lending



Source: Broadridge Institutional GMI, Preqin

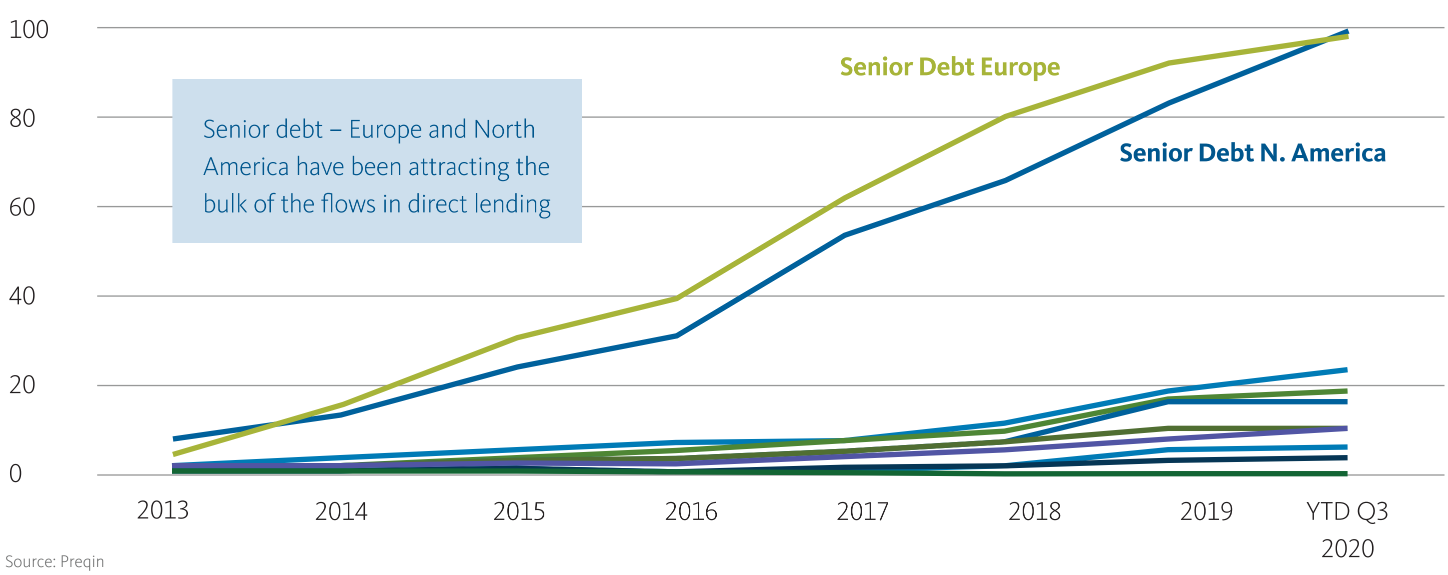
AUM share of direct lending within private debt, Q3 2020, US$BN

It is the most established component of the private debt market



Source: Broadridge GMI Institutional. Figures representing Americas, EMEA & APAC

Cumulative funds raised by direct lending strategies 2013-Q3 2020, US$BN



Source: Preqin

Impact of Covid-19 pandemic on fund-raising

The pandemic had dampened the momentum in aggregate private market fundraising over 2020. Despite this, strategies such as private debt and infrastructure experienced growth greater than more established private market asset classes, highlighting investor's need for non-correlated investors.

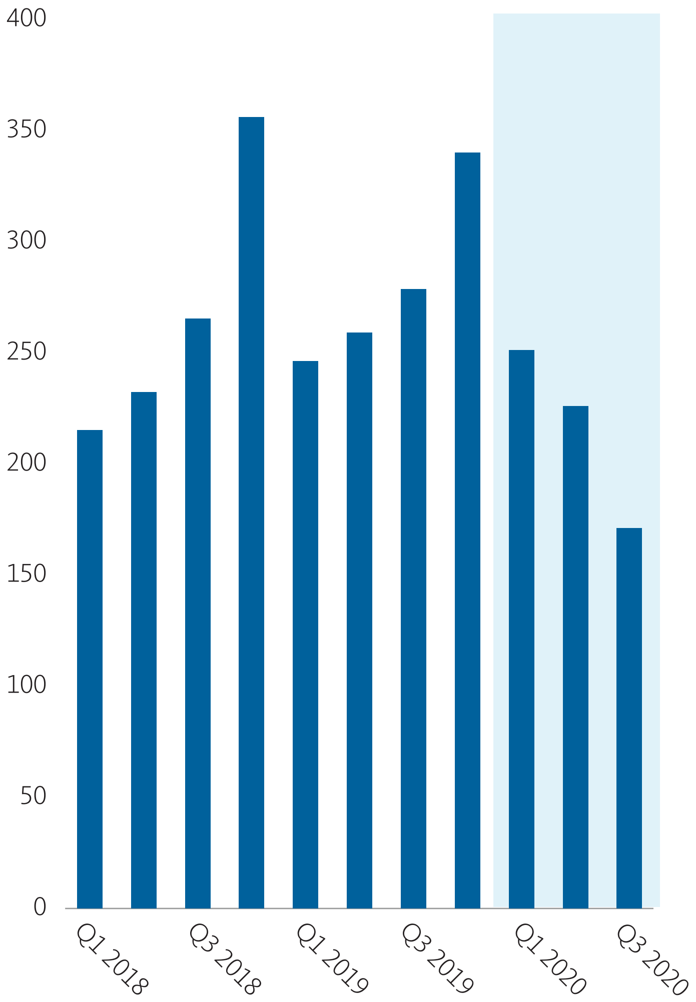
COVID-19 PANDEMIC PUTS THE BRAKES ON FUNDRAISING MOMENTUM

The pandemic had dampened the momentum in aggregate private market fundraising over the year. Despite this, strategies such as private debt and infrastructure experienced growth greater than more established private market asset classes, highlighting investors' need for non-correlated returns.

Although funds raised are significantly lower in 2020 compared to the previous year, European funds have started eating into the share of North America's fundraising dominance since the start of 2020. This is due to an increase in PE buyout deals, especially the larger fund closings such as CVC Capital Partners Fund VIII (US$24bn, July 2020).

Covid puts strain on fundraising

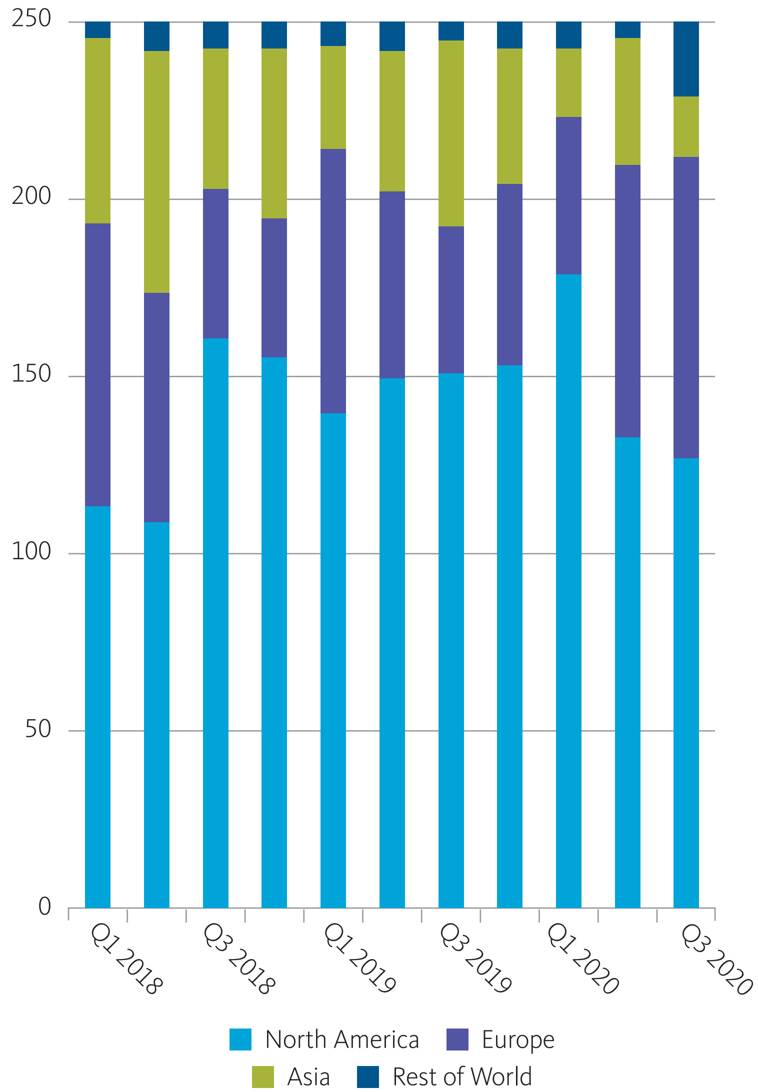
CAPITAL RAISED – Q1 2018-Q3 2020 – US$BN



Source: Preqin

Europe funds gain marketshare as a result of PE buyouts

SPLIT BY GEOGRAPHICAL INVESTMENT FOCUS



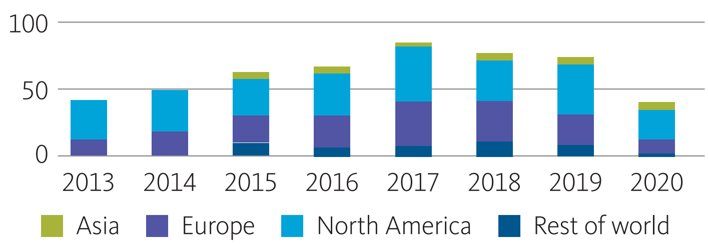
Source: Preqin

IMPACT OF COVID-19 PANDEMIC ON DIRECT LENDING

Crisis to benefit lenders with ample dry powder and extensive product capabilities to offer hybrid structuring as well as expand into opportunistic/distressed situations.

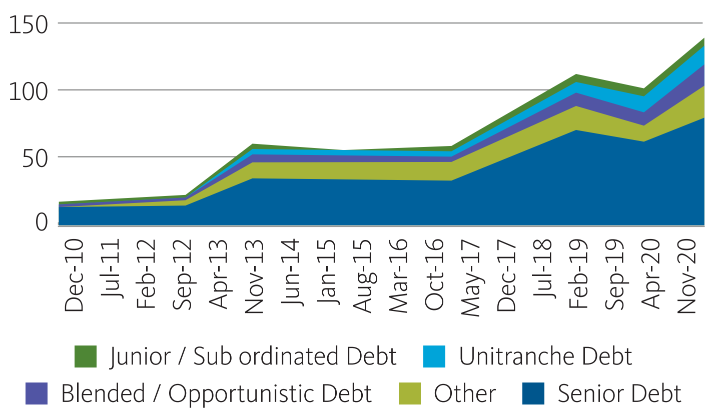
Fall in no. of deals, rise in dry powder

NO. OF DEALS – 2013-YTD Q3 2020



Source: Preqin

DRY POWDER (US$BN) 2010-NOV 2020

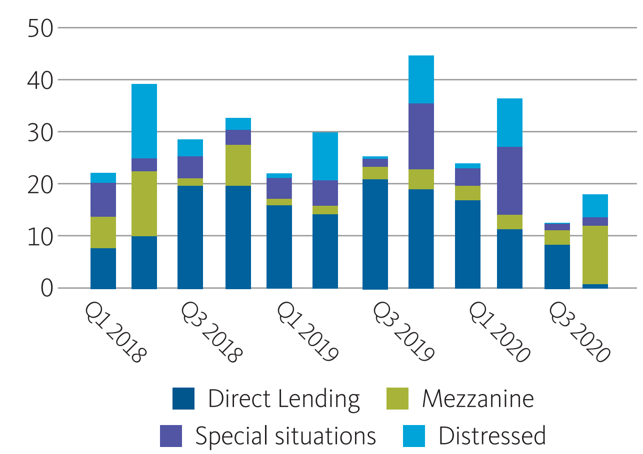


Source: Preqin

The flood of central bank interventions have helped financially strained companies borrow through public markets instead, which led to a fall in the number of deals completed. According to Deloitte, European numbers fell by 29% in the first six months compared to the previous year. Another reason was the difficulty in completing due diligence and deploying capital, which led to an increase in dry powder. However, leading managers believe firms will face more stress (especially lower middle market) if the pandemic extends due to less consistent access to liquidity. GPs will also focus on existing LPs to raise funds due to the difficulty in completing due diligence.

Mezzanine, distressed, special situations and hybrid structures to benefit

FUNDRAISING BY STRATEGIES – Q1 2018-Q4 2020



Source: Preqin

Although direct lending, especially for senior loans, has long dominated the market, the Covid-19 crisis has put disproportionate stress on the small and medium-sized firms – particularly those highly leveraged ones – compared to their more established peers. With an estimated 84% (US$1.9trn) of US leveraged loans, HY bonds and middle market loans (rated B+ or below) being issued privately, mezzanine, distressed debt and special situation players that are able to take advantage of pricing inefficiencies could benefit. In addition, there will likely be an increase in the repricing of assets given the current dislocations in liquid markets. As borrowers need more capital during steep contractions, lenders with ample dry powder, better sourcing networks and the ability to offer flexible products, hybrid structures of debt and equities will be the winners.

Size matters as “winner takes all”

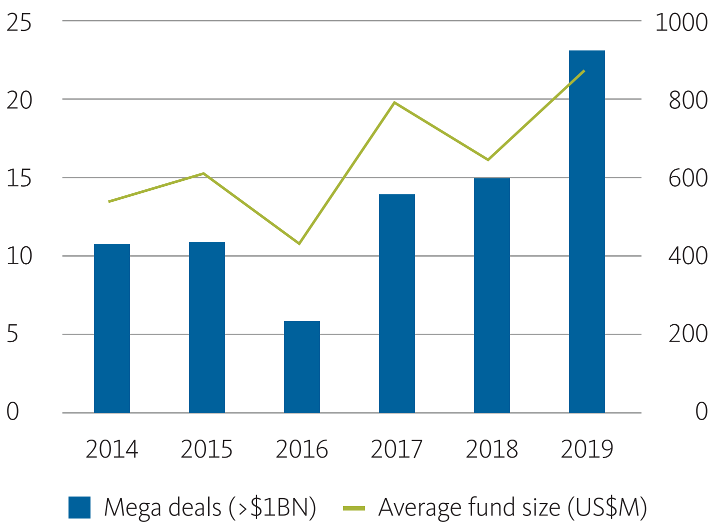
Scale matters as Top 10 funds account for 43%, 63% and 69% of total assets for blended, Unitranche and junior debt, respectively.

MULTI-BILLION DOLLAR RAISINGS BY TOP FUNDS AMPLIFY "WINNER TAKES ALL"

Scale matters as Top 10 funds account for 43%, 63% and 69% of total assets for blended, Unitranche and junior debt, respectively.

Rise of mega deals and further consolidation

NO. OF MEGA DEALS AND AVERAGE FUND SIZE



Source: Preqin

The definition of middle markets has expanded as the largest lenders turned their attention towards mega deals which are deemed to be less risky. They are able to back bigger deals (often to companies with revenues greater than US$100m) due to a flood of cash from MEA SWFs such as Middle Eastern sovereign wealth funds. The Covid-19 pandemic has further accelerated this shift and we expect the trend to continue as bigger lenders are able to offer better risk-adjusted returns due to superior access to deal flow and structuring. Here are some examples of firms with scale and their collaborations:

- **Apollo** unveiled a new direct lending partnership with **Abu Dhabi SWF Mubadala**, to target US$1bn deals with the aim to deploy US$12bn in just three years.
- **Mubadala** also struck a similar but smaller partnership in September 2020 with asset manager **Barings**, targeting European firms.
- The investment arm of **Credit Suisse teamed up with Qatar Investment Authority (QIA)** to launch a "multi-billion dollar direct private credit platform."

Largest funds by strategy, November 2020

	Fund name	Manager	Investment Region	Vintage	Fund Size (US$bn)	Commentary
Senior Debt	Ares Capital Europe V	Ares Management	Europe	2020	10.1	Leveraging on its previous success in raising one of the largest European credit funds on record, Capital IV
Unitranche	GSO European Senior Debt Fund II	Blackstone Group	Europe	2019	4.5	More than doubled its predecessor's fundraising, it will be used to provide loans to middle-market companies.
Blended/ Opportunistic	Direct Lending Fund III	Arcmont Asset Management	Europe	2018	6.9	BlueBay's private debt team spinout, focused on capital solutions to help turn around underperforming businesses
Junior/ Subordinated	Ares Private Credit Solutions	Ares Management	North America	2017	3.4	First junior debt fund for Ares, targets the junior capital needs of US upper middle-market firms, backed by PE firms.

SIZE AND SCOPE MATTERS AS CONCENTRATION OF CAPITAL RAISED INTENSIFIES

Critical to have a scalable and geographically diverse platform with multi-channel origination, flexible capital access, strong track record and wide product capabilities.

Seven key factors for success – direct lending

Factors	Description
1. Scale & Depth	Size maters as it allows players to explore a wider range of deals and to invest across the full capital structure of a business, across diverse geographies and sectors. It also allows lenders to commit and hold large positions in light of current market conditions and business cycle. In Europe, the ability to execute cross-border and multi-currency transactions is an important advantage.
2. Consistent access to Capital	Broad scope of business and strong partnerships with banks will ensure lenders can consistently access capital to offer comprehensive solutions
3. Direct origination/Structuring capabilities	Managers who are able to be lead investors can benefit from primary due diligence, the structuring of the covenants and loan documentation and additional control over investment outcomes. Those who are supported by highly sophisticated infrastructure and operations management capabilities can leverage on strong information warehousing, consistent communication and coordination.
4. Longstanding relationships	Incumbent relationships result in better knowledge of borrowers, better credit performance and a source of uncompeted deals, which makes it hard for new entrants to break down. Incumbents are also able to create organic growth opportunities within existing portfolios – giving them first and last look at potential investments.
5. Underwriting strength / Credit expertise	Important for managers to be able to analyse potential target's financials, accounting practices, earnings quality, customers, etc across industries and geographies to identify best candidates for investing and reduce default risks. In Europe, country expertise is important as each market tends to have its own bankruptcy laws.
6. Proactive portfolio management	Key for managers to have an integrated investment and portfolio management team which has regular reporting and dialogue sessions with borrowers to ensure opportunities are identified and early stress warnings flagged.
7. Proven track record across business cycles	Managers should be able to demonstrate via a tried and tested framework that accurately anticipates turning points in the credit markets to maximize harvesting of credit risk premiums, while significantly reducing downside risk – to improve risk-adjusted performance.

Source: Broadridge Insights, Ares Management 2018 Direct Lending Report, Marquette Associates, Preqin

47%

Of capital raised in the last 12 months to Nov 2020 was by largest 10 funds.

Rise in mega deals

Flood of funds from MEA SWFs result in >US$1BN deals and surge in direct partnerships, eg Apollo with Mubadala (Abu Dhabi), Credit Suisse with QIA (Qatar).

Rise in M&A

Armed with an increasing amount of dry powder, large private debt managers are looking to M&A for inorganic growth, eg Ares acquired SSG to expand in Asia.

ESG green shoots take root

An excess of $3trn has been committed to ESG funds since 2011 and we expect growth momentum to accelerate, driven by demand and supply factors.

ESG IS GROWING AS A KEY FACTOR FOR PRIVATE MARKET FUND SELECTION

An excess of $3trn has been committed to ESG funds since 2011 and we expect growth momentum to accelerate, driven by demand and supply factors.

ESG in private markets

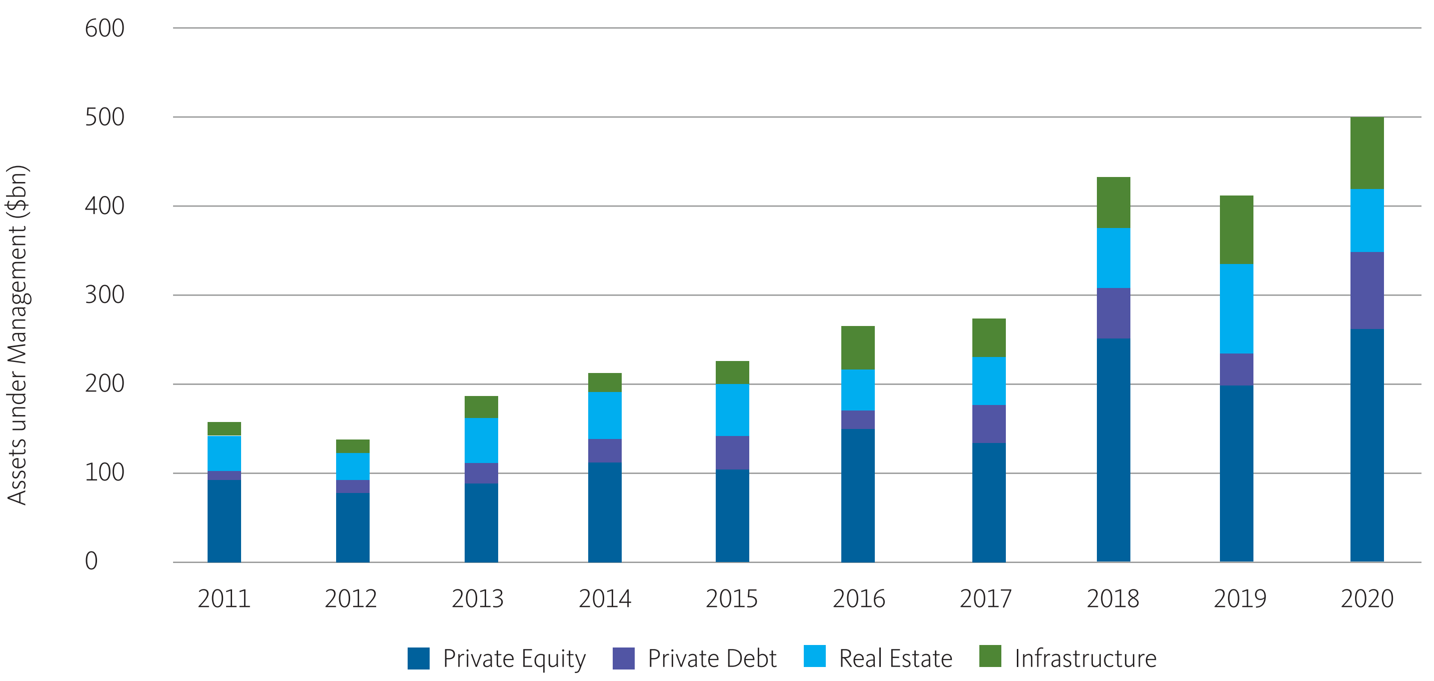
Much like public markets, we expect assets to flow to strategies where there is clear return potential from ESG investing. Greater clarity and specificity in ESG reporting at the company and portfolio level have provided the transparency for investors to make informed decisions.

Asset owners are making a conscious effort to select responsible investments. Seeking opportunities that are aligned with investor and enterprise commitments (ie the Paris Agreement) has become an important part of portfolio construction. The emphasis in private markets is still on generating returns vs investing for impact. A study by Preqin showed that only 25% of private capital committed to ESG funds is committed to impact (which has a perception of being lower yielding, higher risk).

Private equity remains the largest constituent of total raised private capital ESG-committed assets, followed by real estate. On the surface, many private market strategies possess similar investments to impact strategies, eg renewable infrastructure and social housing debt, but the primary objective is returns rather than generating impact.

The pandemic has given rise to significant growth within private debt, fuelled by low interest rates and market stress. Asset owners can be seen as angel investors for organisations that fall outside the government's support radar, and borrowers and portfolio companies are therefore more willing to comply with requirements on ESG from lenders.

ESG-Committed Private Capital Assets under Management by Asset Class



Source: Preqin Pro

Driver	Detail	Impact
Widespread adoption	An MSCI study on performance against the MSCI ESG benchmark indicated companies with a higher ESG rating exhibited better earnings growth and active returns than those without. The top third companies outperformed the bottom third companies by 2.56% in active return.	With the adoption of responsible investing slower in private compared to public markets, we expect 2021 to be a year of growth for the asset class. This is partly down to sufficient evidence supporting value creation through ESG, and test cases of long-term return generation within patient capital. ESG-committed capital has also grown steadily within private markets, from $128BN in 2011 to $468BN in 2020, with private debt the fastest growing.
Paris agreement	In line with the Paris Agreement aiming to limit global warming by 2˚C, investors have reevaluated portfolios against this target. Investors must scrutinise potential investments against this metric in order to meet this target by the end of the century. Global emissions must reduce by 5% per year to achieve this.	Initiatives such as the Paris Agreement have left investors hunting for opportunities to fulfil their commitments, while generating attractive returns. With this in mind, asset owners take advantage of covenant-heavy contracts, and benefit from GP relationships with portfolio companies to actively invoke change in organisations. They will aim to fund projects that help achieve their targets.
Focus on social solutions	MSCI research indicates a focus on environmental and governance impacts on stock value and competition, as well as reputation. Social issues, however, may impact across both. With a focus on social bonds over this and the coming year, and investors signing the UN SDG, social is a growth market.	Private market investors will begin to focus more on the 'S' in ESG due to better understanding. They will emphasise placing greater importance on social factors affecting investments. Social bonds rose to 15% of total bond issuance in FY20, up 10% from FY19, a metric that will translate into private markets.
ESG reporting	ESG reporting has become a key criteria for investors looking to make decisions on their portfolios. Whether this is from portfolio companies, or managers themselves, bodies such as the Task Force on Climate-related Financial Disclosures (TCFD) have enforced reporting for UN PRI signatories in 2020.	The quality of ESG reporting is a topic that has reached all members of the investment value chain (from borrowers and portfolio companies to managers and asset owners). Better quality reporting allows investors to make informed decisions, and better ESG-risk adjusted choices. Manager reporting on ESG matters will help to differentiate them.

Source: MSCI

ESG INVESTING IS SLOWLY BEING EMBRACED BY DIRECT LENDERS

Lack of comparable data on borrowers is the key obstacle to more widespread application of ESG in private debt, but early signs of shift are apparent.

Official figures are lacking but there is growing interest from investors for private debt to have an ESG angle, especially in Europe.

Key challenges include the lack of objective, consistent and timely publicly available data on private companies, that tend to be small to medium-sized firms. There is also less pressure from the public eye to “do good” due to relative lack of transparency in the private loan space compared to its public peers.

However efforts are ongoing to improve ESG application in the private debt space. First, steps have been taken to attempt to rectify the challenge of a lack of transparent data.

This is done via a combination of private and public data sources. In the private space, external rating firms like Sustainalytics have been used by companies to estimate the carbon footprints of small firms. In the public domain, unifying frameworks have been set by UN PRI, the Sustainability Accounting Standards Board, development finance institutions (DFIs) and regulators around the world.

Firms like Kartesia, a specialist direct-lending manager with AUM of €2.2bn, will come up with their own ESG questionnaires for borrowers based on the UN PRI framework. Last but not least, there is also increased pressure from investors for ESG clauses to be included in legal documentation.

Examples of notable firms

BNP PARIBAS
ASSET MANAGEMENT

BNP Paribas Asset Management

Its SME solutions team work with the Sustainability Centre to ensure that borrowers are assessed to evaluate their ESG practices. Use of tech also allows impact investing to be measurable and additive to other direct lending.

TIKEHAU
CAPITAL

Tikehau Capital

Strengthening its ESG set-up and industry recognition, eg Ranked #2 by Sustainalytics, out of 246 global assets managers and custodians; part of the France Relance recovery plan to speed up transition to a “greener” economy.

White Oak
Global Advisors, LLC

White Oak Global Advisors, LLC

Incorporates SASB’s standards into its ESG research and underwriting processes for prospective credit issuance, dedicated Head of ESG & Impact.

Applying responsible investing to private debt

Factors	Challenge	Opportunity
Data availability	Lack of consistent and public data	Investors can rely on proprietary models and in-house experts to utilise different techniques to analyse and integrate ESG information. Those who can prove superiority in modelling ESG risks will excel
Liquidity	Lack of liquidity relative to public markets	Account for ESG issues which may arise over time, active engagement with lenders to influence
Flexibility of terms	Bargaining power	Ability to negotiate better terms will allow lenders to push for higher ESG standards, leading to improved outcomes and lower risks
Stakeholders	Multiple stakeholders, leading to compromised standards	Direct lenders are in a better position to obtain information and argue for higher standards. But one can also seek ESG info from third parties to improve awareness of a borrower's credit position
Leverage for engagement	Senior management access	Direct or loans with a smaller number of lenders will tend to be able to engage more effectively on ESG issues
Return profile	Focus on default risk	Better understanding of ESG-related risks will help improve comprehensiveness of risk framework and reduce the LT default risk
Credit risk profile	Firms with weak credit records	Be aware of firms with limited ability to absorb the impact of ESG issues

Key ESG considerations at different stages of a private debt investment

Applying ESG to direct lending strategies is trickier compared to that of their peers in private equity, which use their majority stakes to determine company behaviour. Direct lenders have to introduce ESG at multiple entry points, from:

- **Pre-deal cycle,** to
- **Pre-transactions:** origination and pre-assessment, due diligence and investment approval, to
- **Post transactions:** investment holding period and exits.

They can include applying negative ESG screens to turning away weak borrowers, considering ESG risks in loan underwriting, active engagement and ESG monitoring through the life of an investment. Other emerging trends include adding of covenants into loans that flag breaches to sustainable practices. Another tool is offering rebates on loan payments as an incentive to achieve specific ESG goals.

Source: UNPRI Spotlight on Responsible Investing in Private Debt

Highlights from Prism Private Markets and powered by Global Market Intelligence

Find out more:

https://distributioninsight.broadridge.com

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