



# Opportunities abound for private debt

Over the past 15 years, the opportunities for private debt have grown significantly. When banks changed their lending criteria after the 2008 financial crisis, it created a vacuum that the alternative asset market has been able to neatly fill. Today, the majority of funding for small and medium-sized enterprises (SMEs) in the U.S. originates with capital markets through debt or equity issuance.

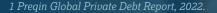
Alternative lending not only addresses the needs of today's businesses, it also aligns with the needs of today's investors. With trends such as rising interest rates, low growth, and economic uncertainty affecting performance for traditional investments, institutional investors have turned to debt funds to diversify their investments and minimize risk.

Driven by a growing business need for debt capital and continued investor interest in diversification, private debt has trended steadily upward. According to Preqin data, private debt grew by 13.5% annually over the past decade compared to 11.5% for both private equity and venture capital. It has also proven itself capable of returning a solid performance. The outsized shockwaves sent through the financial and business communities by the pandemic prevented private debt from flourishing, but this asset class held its own and proved its resilience, a fact that investors have noted.

Throughout 2021, private debt funds continued to attract considerable capital, with 202 private debt funds closing a total of \$193 billion during this time. Looking ahead, private debt will continue to attract sizable capital: 91% of investors say they intend to maintain or increase allocations to private debt over the long term. Pregin predicts that private debt assets under management (AUM) will reach \$2.69 trillion by 2026.

For general partners (GPs), the situation presents an attractive opportunity, but it's one that comes with a unique set of challenges. Alternative assets are already burdened with growing administrative requirements, and debt funds add yet another layer of complexity.

This insight report examines some of the trends and considerations that debt fund managers need to be aware of as they prepare for the future.









The popularity of debt funds and the range of available options are attracting a growing number of GPs. But while the debt market is forging ahead, the administrative expertise may be lagging behind.

While many firms are expanding into debt funds or

adding to their existing debt portfolios, not all have the back-office expertise they need to administer this complex strategy. As a result, debt fund managers are more likely to run into problems associated with back-office operations. A survey conducted in 2018 by the Alternative Investment Management Association (AIMA) found that 90% of private credit managers

experienced issues with their loan administration, and the task has become no easier as investor demands for greater transparency have only added to the burden.<sup>2</sup>

As the debt market matures and competition increases. it encourages greater diversity, flexibility, and

specialization in debt funds. This, in turn, increases the level of expertise and effort required to administer this dynamic fund type.

GPs who need to manage funds of increasing complexity have two options: they can augment their

> in-house talent investment and technologies, or outsource administration to a professional third party.

Faced with the choice, many firms are outsourcing, a trend that has gathered speed over the past five years. In 2016, Pregin estimated that 30% of all AUM were administered by a third party.3 In 2018, an Ernst & Young (EY) survey

indicated that the proportion of private equity managers that outsourced the fund-accounting function had leapt to 55%.4 And a 2021 survey indicates that the shift continues, with nearly 45% of private fund chief financial officers (CFOs) intending to increase the level of outsourcing for the fund accounting function.<sup>5</sup>

Nearly 45% of private fund CFOs intend to increase outsourcing for fund accounting

2 AIMA, Enhancing the Loan Administration Function: Marrying Capacity and Customisation, 2018.

3 Pregin, 2016 Pregin Global Private Equity & Venture Capital Report, 2016.

4 EY, At the Tipping Point: Disruption and the Pace of Change in the Alternative Asset Management Industry, 2018.

5 Private Funds CFO, Private Funds CFO Insights Survey, 2022.



# The back-office advantage

The trend toward outsourcing fund administration is on the rise across all fund strategies, fueled in part by rising investor expectations and administrative requirements.

But for debt funds specifically, the outsourcing advantages are even greater. The latest research suggests that outsourcing the administration of this complex strategy can help GPs scale up swiftly to embrace the opportunities, access senior-level expertise, and maintain a competitive edge in an asset class that is becoming increasingly crowded with investment options.

#### Ability to scale

Opportunities abound in debt, but to take advantage of them, GPs must be able to keep pace.

Fund managers have the expertise required to originate and allocate deals, but without the necessary expertise and capacity to manage a labor-intensive debt fund, they can quickly run into difficulties.

Outsourcing the administration of debt funds can take the pressure off the back office and enable firms to manage more loans without escalating costs or jeopardizing investor trust or lending agreements. The AIMA survey conducted in 2018 found that 75% sought to outsource loan administration to increase their capacity to support new business.

An outsourced solution can also be valuable in helping fund managers branch into nontraditional loan types such as syndicated loans, convertible loans, revolvers or delayed draw instruments, and other complex debt structures. According to AIMA, 70% of debt fund managers saw the ability to manage these types of loans as the most valuable aspect of administration services.





## **Building trust**

Debt is an alternative strategy that is both dynamic and fast-evolving, and fund managers must compete fiercely for capital and investment opportunities. While the manager's track record of delivering returns is the most important consideration for most investors, the ability to communicate fund information to investors clearly, promptly, and in detail is fast becoming a key factor in the decision to invest.

As a result, enhanced investor reporting has rapidly become a priority. In 2020, 43% of private equity firms had made an investment in investor servicing technology.6 Today, 75% have an investor portal in place, with another 19% planning to introduce one within a year.7

Partnering with a fund administrator enables GPs to improve the reporting function significantly as well as to reassure investors by putting administrative oversight into the hands of an objective, professional third party.

6 EY 2020 Global Private Equity Survey. 7 Private Funds CFO, Private Funds CFO Insights Survey, 2022.

## Leading with technology

The alternative asset class as a whole has begun focusing on technology as a means of automating transactions, using data more effectively, strengthening compliance, and providing more detailed, customized reporting.

For debt funds, the need for an investment in technology may be even more urgent because of their dynamic structure and additional complexity. Relying on legacy systems or manual processes can result in spiraling administrative costs for resource-intensive debt servicing.

However, the costs of implementing and maintaining market-leading technology can be unrealistic for a small or even a mid-sized firm. In these cases, partnering with the right outsourced fund administrator enables debt fund managers to benefit from an integrated system of accounting, administration, reporting, and debt management technologies without shouldering the costs and maintenance of an in-house solution.







#### To adequately support the administration of a debt fund, look for the following:

- The ability to maintain loan amortization schedules and account for complex terms, including:
  - All interest day count conventions
  - o Paid-in-kind (PIK) interest
  - Original issue discount (OID)
  - Term changes (including interest rates and PIK components)
  - o Amortization of fee income
  - Variable interest rate loans with floating base rates
  - o Revolvers or delayed draw instruments and unfunded commitments
  - Loan covenants and collateral requirements
- The ability to generate customized, comprehensive, and concise reporting
- · An interactive dashboard
- Integration with an accounting system
- The ability to bulk-upload trades and other data
- · Automated market data feed for floating base rate resets such as LIBOR rates
- The ability to prepare, customize, and distribute recurring portfolio company invoices (ideally, via a secure portal)





## Access to expertise

For experienced and new debt managers alike, access to high-quality fund administration expertise is often challenging. Assembling a back-office team with the right experience to manage the complex and everchanging needs of a debt fund is a tall order. That expertise should include accounting for nonstandard debt instruments, working with technology customized to meet the needs of debt funds, and understanding the unique reporting needs of debt funds.

Outsourcing fund administration enables GPs to access the expertise they need to manage debt funds, even those that are more complex. The AIMA survey of private credit managers found that 78% identified "access to expertise" as the top reason they outsourced loan administration.

## Service continuity

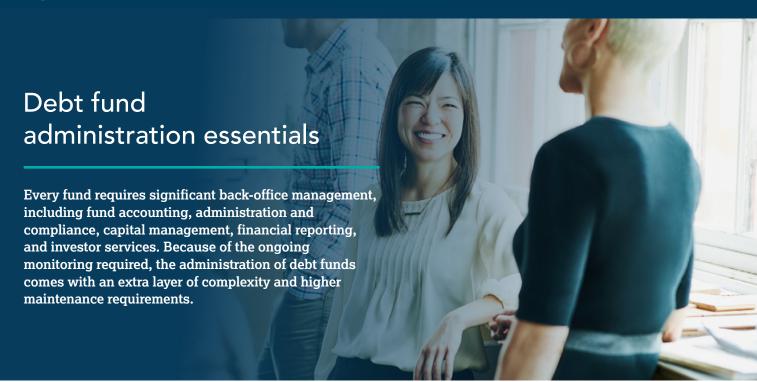
For investment firms in every strategy, turnover can be one of the greatest threats to productivity and reputation—and a significant point of vulnerability. When someone leaves the firm, it can create chaos, especially because the most seasoned employees are the most likely to be lured away.

The issue is especially problematic for debt funds because loans must be continually monitored and managed. Any break in continuity can have serious consequences. Loan terms need to be kept current so calculations are correct, and covenants need to be monitored to ensure the portfolio company is compliant.

Outsourcing fund administration eliminates the cost and disruption caused by internal turnover. By documenting key processes, sharing knowledge across a multiperson team, and using a central repository for current and historical fund administration data, a fund administrator retains institutional knowledge and ensures continuity throughout the lifespan of the fund.







Whether you choose to administer your debt fund in-house or outsource the work to a third party, the monitoring process needs to include:

- · Documenting loan covenants and monitoring them in real time
- Reviewing loan notices and organizing them for future reference
- Updating terms and calculations of debt instruments in the loan management application, including:
  - o Changes in variable interest rates
  - o Changes in terms (such as PIK or cash toggle)
  - Restructuring debt instruments
  - Converting debt instruments
- Reviewing loan amortization schedules monthly, including all calculations
- · Preparing and distributing portfolio company invoices, as well as reconciling cash received, and following up on outstanding amounts





# Finding the right debt fund administrator

When choosing an administrator for your debt fund, look for a partner that offers the certifications, processes, and core capabilities that will support your firm now and into the future. Remember, even if your current fund has a simpler structure, choosing a fund administrator with experience in more complex debt ensures you have the ability to pursue any opportunity that presents itself without having to switch providers.

### Look for these indicators of an experienced, well-resourced fund administrator:

 System and Organization Controls (SOC) 1, Type 2 certification

A documented service-level agreement (SLA)

Documented onboarding processes

An integrated accounting, analytics, reporting, and loan servicing platform that can be customized to the needs of your debt fund

Experience in debt funds and administering nonstandard debt instruments

Experience processing a high volume of debt instruments

Investor reporting processes that follow the Institutional Limited Partners Association (ILPA) guidelines

An investor portal that provides 24x7 digital access to reports

A CFO portal that provides access to fund data and analytics

A documented disaster recovery and business continuity process

### Questions to ask prospective partners:

How many years have you administered debt funds?

How many debt fund clients has your firm managed over the years?

Are any of those clients managing complex debt types?

Can I speak to two of your debt clients about their experience with your firm?

Yes No

What technologies do you use to support the administration of debt instruments?

Can you provide customized financial reporting? Yes

For more information on selecting a fund administration partner, read CSC's insight report on "Fund Administration Outsourcing."





#### **About CSC**

CSC provides tailored administration and strategic outsourcing solutions to support the complex operations of alternative asset managers across jurisdictions and asset types while adhering to global regulations and compliance. A market leader, we work with funds of all sizes, from start-ups to the largest and most experienced fund managers in the world. Founded in 1899, CSC prides itself on being privately held and professionally managed for more than 120 years. We are the trusted partner of choice for more than 90% of the Fortune 500® and more than 70% of the PEI 300. CSC has office locations and capabilities in more than 140 jurisdictions across Europe, the Americas, Asia Pacific, and the Middle East. We are a global company capable of doing business wherever our clients are—and we accomplish that by employing experts in every business we serve. We are the business behind business®. Learn more at cscgfm.com.