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A Survey of Private Debt Funds

Based on BFI Working Paper 2023-10, "A Survey of Private Debt Funds," by by Joern Block, University of Trier; Young Soo Jang, Chicago Booth; Steven N. Kaplan, Chicago Booth; and Anna Schulze, University of Trier

KEY TAKEAWAYS

- Since the financial crisis, nonbank financial intermediaries have gained prominence, including private debt (PD) funds and collateralized loan obligation funds (CLOs); of these two, PD funds a mystery.
- PD funds consist of investors that raise capital commitments through closed-end funds (like private equity) and make senior loans (like banks) directly to middle-market firms (where most PD funds are lent).
- PD funds generally provide more leverage than banks, charge higher interest rates, use less leverage in their funds, appear to monitor more often, and tend not to make asset-based loans.
- Both US and European PD investors are very optimistic about the near-term and longer-term future of private debt investing.

Like water, financing tends toward the path of least resistance. Likewise, when regulations are erected to restrict or otherwise guide the flow of financing, money often finds its way through more amenable pathways. Case in point: When the Great Financial Crisis of 2007-09 triggered tightening banking regulation to buttress the financial system against future shocks, corporate lending looked to sources outside the banking sector.

Prominent among nonbank financial intermediaries since the Financial Crisis are private debt (PD) funds and collateralized loan obligation funds (CLOs), and of these two, PD funds remain something of a mystery. CLOs, on the other hand, which are syndicated loans typically arranged by a large commercial bank, are better understood, and the same holds for private equity (PE) funds, which are pooled investment vehicles. Many researchers have studied how banks, PE funds, and CLOs affect corporate finance, but less is known about the emerging role of PD funds.

To address this gap, this new research examines the role of PD funds, which is set to become the second-largest private capital asset class in 2023. What are PD funds and what do they do? What do they invest in? How do they compare with banks, CLOs, and PE funds? What are the implications of PD's rise for policymakers? These and other questions motivate this new research, which also raises important implications for policymakers and their understanding of how investors are raising finances in a post-Financial Crisis world.

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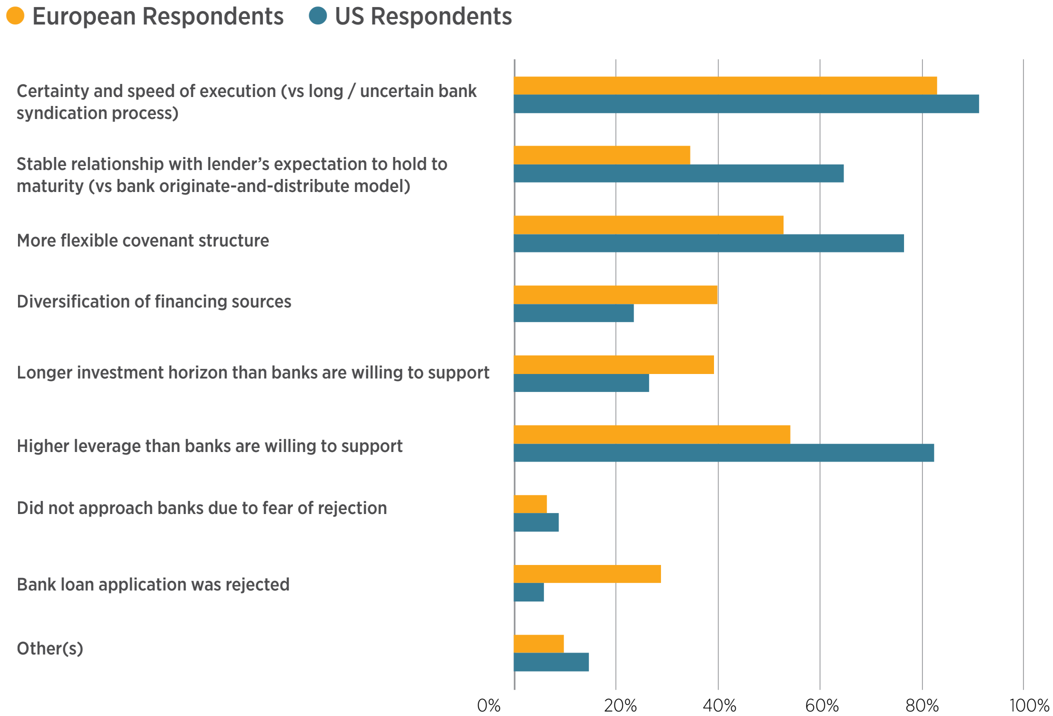
Figure 1 · Reasons Why Firms Can't Get Bank Financing



Note: This figure presents the reasons for why some firms which are reliant on private debt might not be able to secure money through a bank. The question asked is "Why do you think banks would not want to finance companies that are reliant on private debt?" The authors report the results separately for the European and US respondents. The respondents were allowed to make multiple choices; hence, the authors report the results separately as a fraction of the number of respondents and responses.

PD funds: traditionally untraditional

To begin, while there is no standard definition of private debt, the authors offer the following: PD funds consist of investors that raise capital commitments through closed-end funds (like private equity) and make senior loans (like banks) directly to middle-market firms (where most PD funds are lent). By way of example, a private debt fund may serve as a lending source for a commercial real estate developer who is looking for a bridge loan with a bank. In other cases, a PD fund loan may finance the entirety of a rehab project or some other funding proposal. One attractive feature of PD loans is that they do not require the often-lengthy approval process required from a bank.

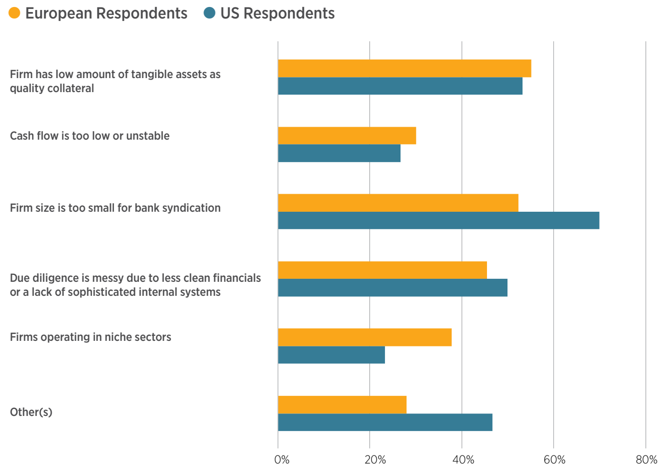
To examine the role of PD funds, the authors survey 38 US and 153 European private debt investors with combined assets under management (AuM) of at least $136 billion and €180 billion, respectively, which together represent a meaningful percentage of the private debt universe. The predominant strategy of the funds in the authors' sample is direct lending where the loan is bilaterally negotiated between a borrower and a single lender (or a small group of lenders) with the expectation that the lender holds the loan to maturity. Roughly 25% of the US respondents and 40% of the European respondents are affiliated with a PE firm; 45% of the US respondents have a Business Development Company (BDC), although they usually also have other funds. Finally, given that this survey was conducted in August and September 2021, before the volatility and economic headwinds of 2022, it allows the authors to gauge the extent to which private debt investors were prepared for, or concerned about, economic instability.

Please see the working paper for more results, but key responses include the following:

How do general partners (GPs) source, select, and evaluate deals?

- US investors source largely from sponsored deals while European investors source both from sponsors and independently.
- In selecting deals, US debt investors prioritize stable cash flows while European debt investors consider management and cash flows more equally, akin to PE investors.

Figure 2 · Reasons Why Firms Chose Private Debt Over Bank Debt



Note: This figure presents the reasons for firms choose private debt over bank debt as reported by the authors' respondents. Question is: "Why do you think firms choose private debt over bank debt?" The authors report the results separately for the European and US respondents. The respondents were allowed to make multiple choices; hence, the authors report the results separately as a fraction of the number of respondents and responses.

How do GPs compare PD relative to bank financing?

- PD investors believe that they provide financing to companies that banks would not otherwise provide, as well as more leverage.
- GPs attribute banks' reluctance to firms' small size, lack of accounting standardization/ transparency, lack of commitment, and lack of tangible assets.

How do GPs monitor their portfolio companies?

- PD loans appear to incorporate a mix of traditional bank loans and covenant-lite leveraged loans by both ex-ante restricting borrowers' actions through negative covenants, and still influencing borrowers' behaviors ex-post through renegotiation of financial covenant violations.
- GPs also use other methods employed by banks to monitor their investments, including periodic meetings and updates of financial statements, but GPs appear to monitor them more frequently than banks do.

Given the importance of PE sponsors to the private debt market, how do GPs characterize their relationships with those sponsors?

- European and, particularly, US debt investors find these advantageous, as PE sponsors help with deal quality, with deal sourcing, and in reducing information costs (through repeated interactions).
- These benefits allow the PD lenders to lend more (at higher multiples) and to craft more effective covenants.

What is the outlook on the current and future environment of the PD market?

- At the time of the survey (Aug.-Sept. 2021), both US and European PD investors were very optimistic about the near-term and longer-term future of private debt investing, with US investors also concerned about the influx of money from existing and new funds, and European investors relatively more concerned with competition from banks.

Conclusion

This research provides a novel view of an emerging and growing source of funding for US and European businesses. In doing so, it offers useful insights for policymakers who must consider the consequences—intended or not—of lending regulations. Particularly useful are the revealed distinctions and similarities between PD fund loans vs those of banks and more traditional loan markets. Those distinctions include that PD funds make cash flow-based loans to smaller companies, are willing to provide more leverage than banks to those companies, charge higher interest rates, use less leverage in their funds, appear to monitor more

> By way of example, a private debt fund may serve as a lending source for a commercial real estate developer who is looking for a bridge loan with a bank. In other cases, a PD fund loan may finance the entirety of a rehab project or some other funding proposal. One attractive feature of PD loans is that they do not require the often-lengthy approval process required from a bank.

often, and tend not to make asset-based loans. Similarities include that both types of funders use covenants when making loans.

Questions remain. For example, while PD investors were optimistic (circa fall 2021) about the prospects for future growth and success in the private debt market, we still do not have a complete understanding of why the PD markets have grown so much, and why PD investors believe that growth will continue. Further, what is it about PD funds that allows them to operate successfully in a bank-like fashion without the "traditional" (and theoretically sound) debt and deposit strategies employed by banks? Have PD firms discovered new methods, such as the reliance on PE sponsors, that allows them to lend and monitor loans more effectively? Further, what is the impact of regulatory changes, especially post-Financial Crisis?

Finally, and especially important for policymakers and regulators, is the degree to which PD funds are taking risk out of the traditional lending sectors, and what are the implications of this phenomenon on, for example, systemic risk? Are PD funds more efficient at managing risk? If so, do they create value that would otherwise not exist? These and related questions await further research.

CLOSING TAKEAWAY

This research provides a novel view of an emerging and growing source of funding for US and European businesses. In doing so, it offers useful insights for policymakers who must consider the consequences—intended or not—of lending regulations.

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