PitchBook

Global Private Debt Report

H2 2019

PitchBook

Contents

As this is our inaugural private debt report, we welcome your feedback. Please send any comments or recommendations to reports@pitchbook.com. In addition, two previous analyst notes, which may be used as industry primers, can be found using the links here and here. We hope this report is useful in your practice.

Credits & contact

PitchBook Data, Inc.

John Gabbert Founder, CEO
Adley Bowden Vice President, Market Development & Analysis

Content

Dylan Cox Lead Analyst, PE
Van Le Senior Data Analyst

Contact PitchBook

Research
reports@pitchbook.com

Designed by Conor Hamill

Click here for PitchBook's report methodologies.

Introduction

Over the last decade, private debt has become a building block of institutional portfolios. Due largely to more stringent banking requirements following the global financial crisis, what was once a relatively small group of non-bank lenders has become a more diversified group of managers spanning strategies and geographies. **Global private debt fundraising totaled $125.9 billion across 89 vehicles in 2019, a 17.3% YoY climb in value** but an 11.0% drop in the number of vehicles, reflecting a broader trend of fewer but larger funds seen across alternative assets. Though worries persist around the proliferation of covenant-lite facilities and other borrower-friendly terms, LPs continue to increase allocations to the strategy and have been rewarded with record levels of distributions.

The largest substrategy within private debt is **direct lending, which accounted for $71.6 billion, or 56.9% of capital raised globally in 2019.** These funds, which make loans directly to middle-market companies, typically aim to provide returns in the high-single-digit to low-double-digit range, a return profile that has evaded investors in traditional fixed income and high-yield markets over the last decade. Public pensions were early allocators to this substrategy and show little sign of slowing commitments.

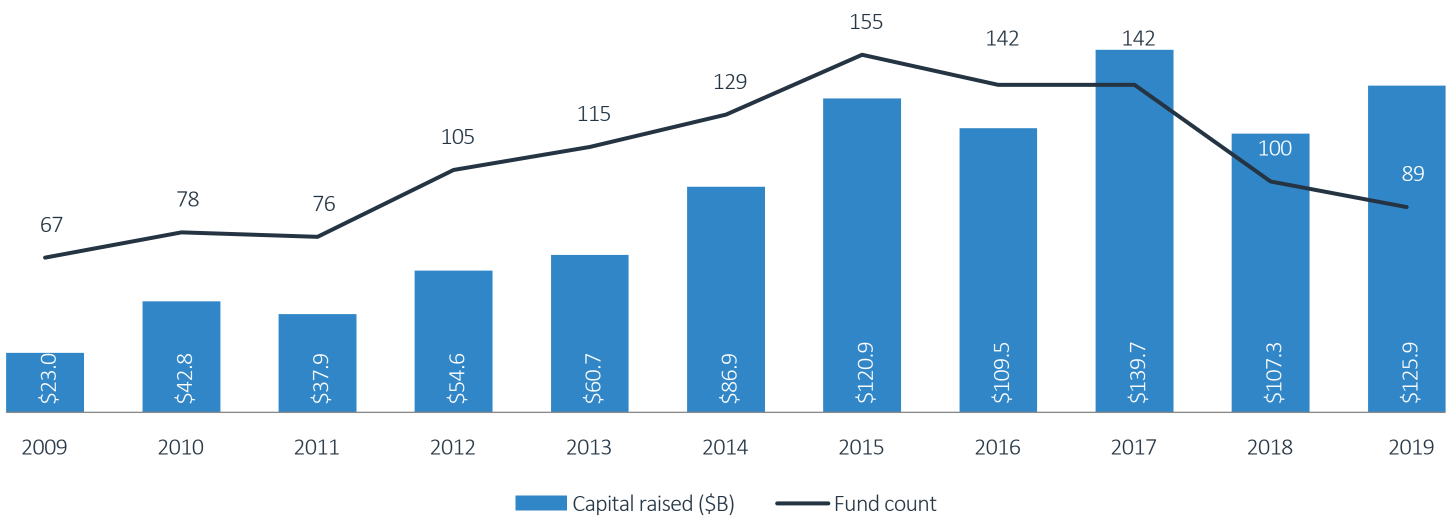
Due in part to the stellar growth in fundraising over the last few years, dry powder continues to accumulate in private debt funds, reaching $241.4 billion at the end of Q1 2019. The buildup has spurred worries about excesses in the market, but **relative to the pace of investment, dry powder has remained nearly unchanged over the last five years.**

Dylan Cox
Lead Analyst, PE

PitchBook

Fundraising

Private debt fundraising activity



Source: PitchBook | **Geography:** Global

The private debt market has swelled substantially over the last decade, driven largely by post-crisis banking regulations and institutional investors' search for yield in a low interest rate environment. Global private debt fundraising totaled $125.9 billion across 89 vehicles in 2019, a 17.3% YoY climb in value but an 11.0% drop in the number of vehicles, reflecting the trend of fewer but larger funds seen across alternative assets. AUM has also ballooned, topping $660 billion in Q1 2019, nearly triple the figure from 2009. The continued growth in private debt has meant more competition among lenders, giving more bargaining power to issuers. This, in turn, has spurred concerns around the proliferation of covenant-lite facilities and generally borrower-friendly terms. According to one recent survey, 54% of private credit managers were willing to underwrite total debt/EBITDA above 6.5x,[1] compared to bank loans, which are typically limited to a maximum of 6.0x. In this period marked by a surfeit of capital in nearly every corner of the financial markets, only time will tell if managers have extended themselves too far in an effort to put capital to work.

Private debt is not a monolithic strategy, but is instead made up of a variety of approaches. The most noteworthy substrategy within private debt, in terms of dollar value, is direct lending, which accounted for $71.6 billion, or 56.9% of private debt raised globally in 2019. These funds, which make loans directly to middle-market companies, typically aim to provide IRRs in the high-single-digit to low-double-digit range, a return profile that has evaded investors in traditional fixed income and high-yield markets over the last decade. The proliferation of direct lending funds, many of which lend solely to sponsor-backed[2] companies, coincides directly with the growth of PE over the last decade. Following the global financial crisis, traditional lines of credit (mostly from banks) for LBOs dried up, and direct lending funds—which, due to a lack of regulatory requirements, can be more nimble in terms of speed and certainty of close than banks today—stepped in to fill the void. Some direct lenders depend entirely on PE sponsors for their deal flow, and this has given rise to worries that they will be unable to turn away bad deals, especially if they want to continue receiving calls from PE sponsors regarding future opportunities. For their part, fund managers maintain they can keep deal terms from eroding, but the potential conflicts of interest are clear.

Direct lending funds have especially benefited from public pensions, such as Arizona's State Retirement System and the Teacher's Retirement System of the State of Illinois, making private debt a meaningful portion of their portfolios. In fact, the former plans to increase its allocation to direct lending from 13% of its portfolio to roughly 17%.[3] Following the lead of these early adopters, much larger allocators have begun to take note. For example, Ben Meng, the newly appointed CIO of CalPERS, announced in December 2019 that the plan would terminate the bulk of its outside public equity managers and earmark at least $5 billion of the

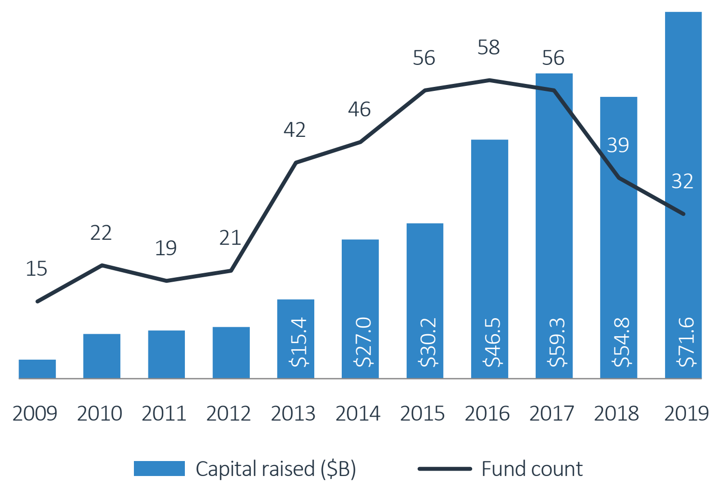
1: "Trends in Private Credit," Proskauer, April 5, 2019.
2: In this case, we use "sponsor-backed" to mean owned by a PE firm.
3: "Public Pensions Throw Their Weight Around in Private Debt," Bloomberg, Brian Chappatta, January 6, 2020.

proceeds for allocations to direct lending. "I think [direct lending is] something we overlooked in the past, particularly given the changes in regulation after the global financial crisis," Meng told the CalPERS investment committee.[4] Though relatively small compared to the total size of its plan ($372.6 billion)[5] the shift in CalPERS' portfolio, which is often seen as a bellwether for public pensions nationwide, suggests that allocations to direct lending are only beginning to gain steam.

While corporate credit exposure (via direct lending) may dominate the private debt landscape in terms of fundraising and AUM, real estate, infrastructure and more niche strategies are also important to consider. Global commitments to infrastructure debt and special situation vehicles neared all-time highs in 2019, at $8.8 billion and $10.3 billion, respectively. Real estate debt funds saw a disappointing $7.9 billion raised last year, less than half of 2018's total. With that said, the substrategy came off its strongest three-year period in terms of fundraising and has largely benefited from the higher risk weighting that post-crisis banking regulations assigned to "High Volatility Commercial Real Estate Loans," limiting banks' ability to lend to such deals.[6] Meanwhile, fundraising for distressed debt funds—which can involve both corporate and asset-backed credits—fell to $15.8 billion, well below the five-year average of $27.4 billion. New commitments to distressed debt hit a post-crisis peak in 2016 but have since waned due to limited instances of distress in an extended bull market.

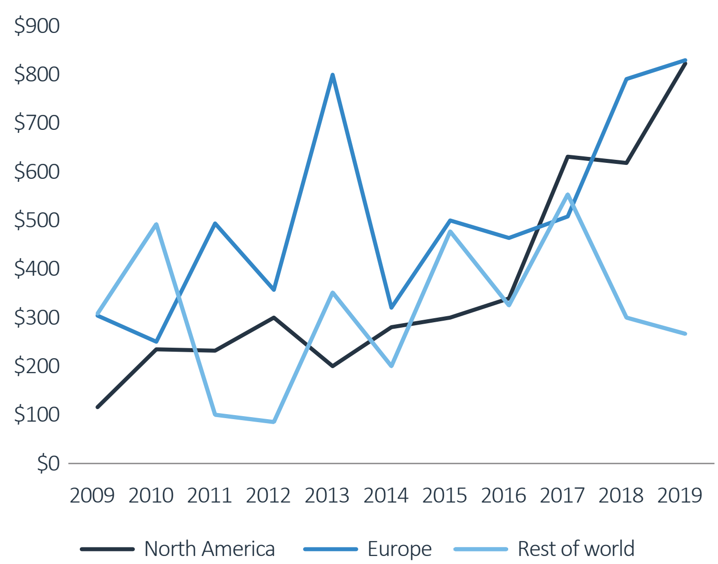
While the private debt market has traditionally been more developed in the US than in Europe, the latter is beginning to catch up. European fundraising approached 40% of global fundraising value in each of the last two years, substantially above the longer-term average. One of the largest funds raised this year was London-based BlueBay Direct Lending fund III, which closed on $7.7 billion (about €6 billion), more than three times larger than its predecessor vehicle. Further afield, three of the six largest funds currently in the market are based outside of the US—including India, the UK and Canada—signaling that private debt is poised to grow further outside of its more traditional market.

Direct lending fundraising activity



Source: PitchBook | **Geography:** Global

Median fund size by region ($M)



Source: PitchBook | **Geography:** Global

4: "Money from Fired CalPERS Equity Managers May End Up in Direct Lending," Chief Investment Officer, January 8, 2020.
5: Investment & Pension Funding 2018-2019, CalPERS
6: "What is a 'High Volatility Commercial Real Estate' Loan, and How Does it Affect Your Ability to Lend?" The Bankers' Statement, Vorys, Robin K. Capozzi, Shane D. Schlichter and David M. Aldous, 2017.

Notable mandates and fundraising by size

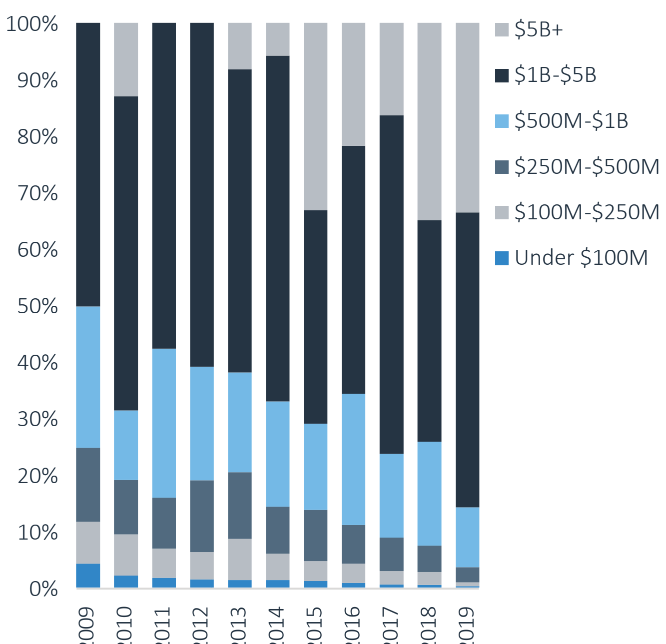
Notable recent mandates to private debt funds

LP name	LP type	Mandate amount ($M)	Announced date	Fund types included
Strathclyde Pension Fund	Public pension fund	$633.1	January 3, 2019	Real estate debt
Los Angeles County Employees Retirement Association	Public pension fund	$500.0	May 3, 2019	Real estate debt, direct lending, special situations
Cuna Mutual Group	Insurance company	$350.0	February 4, 2019	Private equity and private debt
Employees Retirement System of Texas	Public pension fund	$270.0	March 6, 2019	Direct lending, mezzanine, distressed debt, real estate debt, and special situations
Nationwide Pension Fund - Nationwide Section	Corporate pension	$259.4	February 4, 2019	Real estate debt, real estate equity, direct lending, infrastructure, growth equity
CenturyLink Defined Benefit Master Trust	Corporate pension	$60.0	July 29, 2019	Real estate, private debt, growth equity
Cambridge Retirement System	Public pension fund	$30.0	January 8, 2019	Direct lending

Source: PitchBook | **Geography:** Global

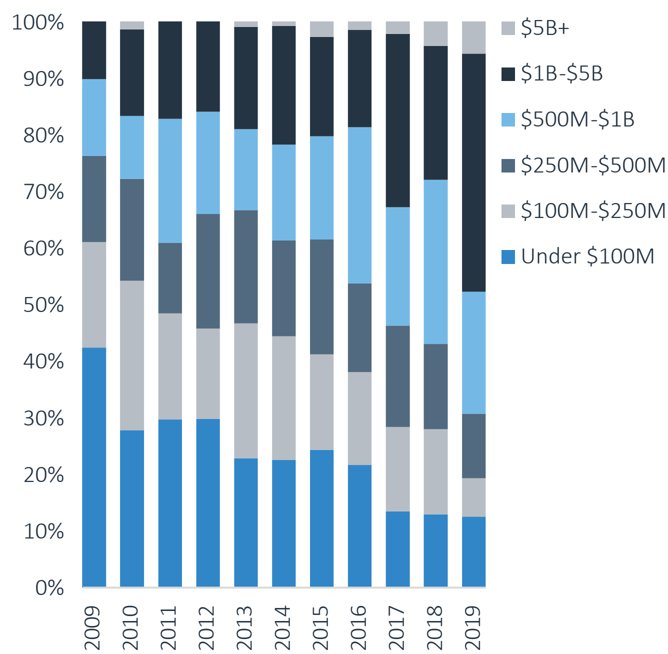
Note: Fund types listed may differ from exact language used in mandates and have been adapted to fit PItchBook reporting style.

Private debt funds ($) by size



Source: PitchBook | **Geography:** Global

Private debt funds (#) by size

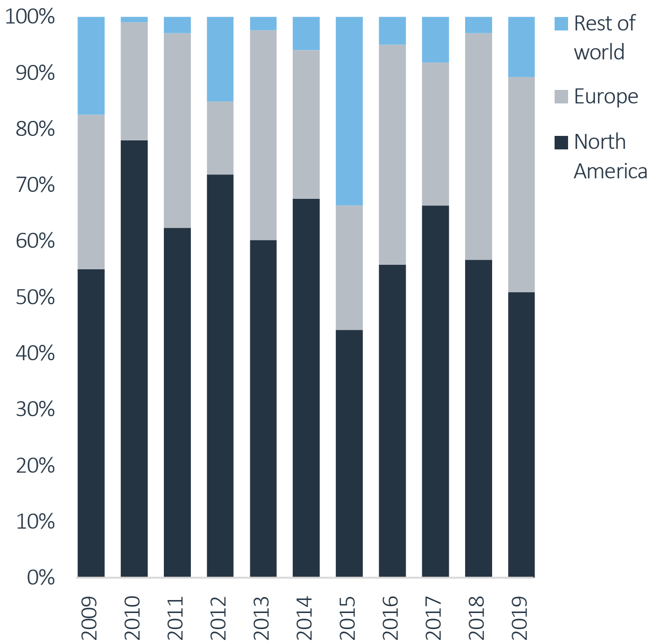


Source: PitchBook | **Geography:** Global

PitchBook

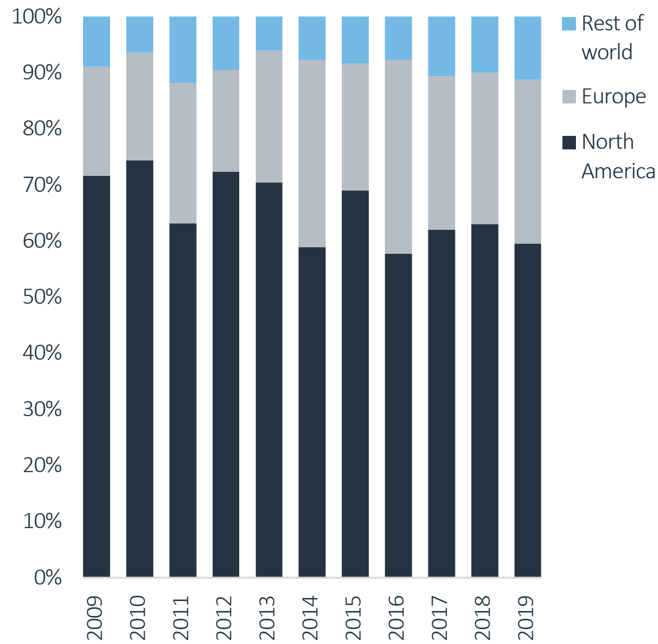
Fundraising by region and type

Private debt funds ($) by region



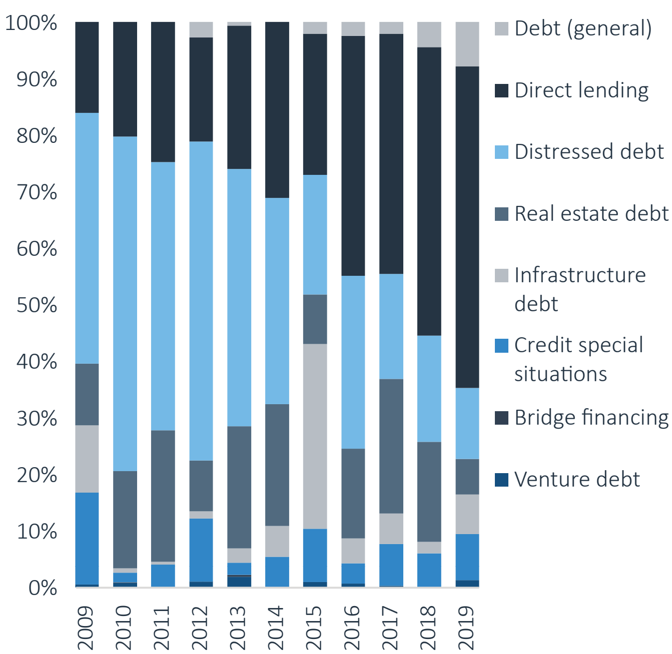
Source: PitchBook | **Geography:** Global

Private debt funds (#) by region



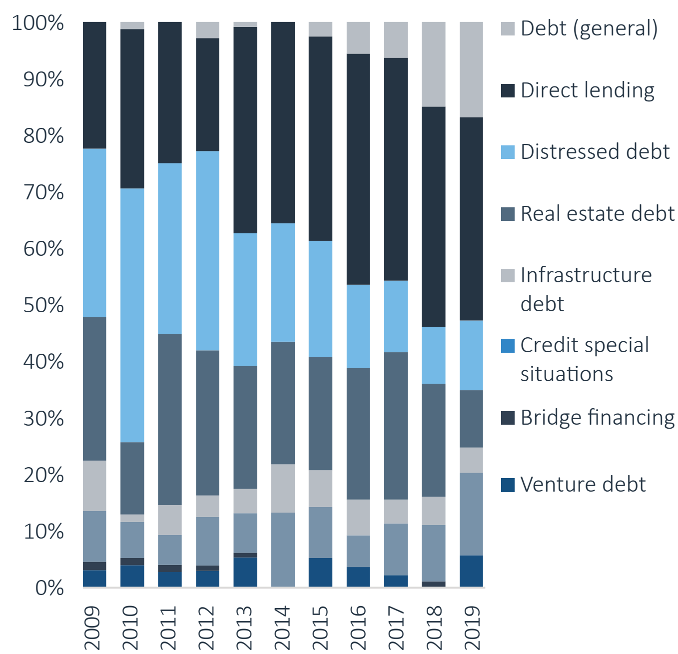
Source: PitchBook | **Geography:** Global

Private debt funds ($) by type



Source: PitchBook | **Geography:** Global

Private debt funds (#) by type



Source: PitchBook | **Geography:** Global

PitchBook

Dry powder and AUM

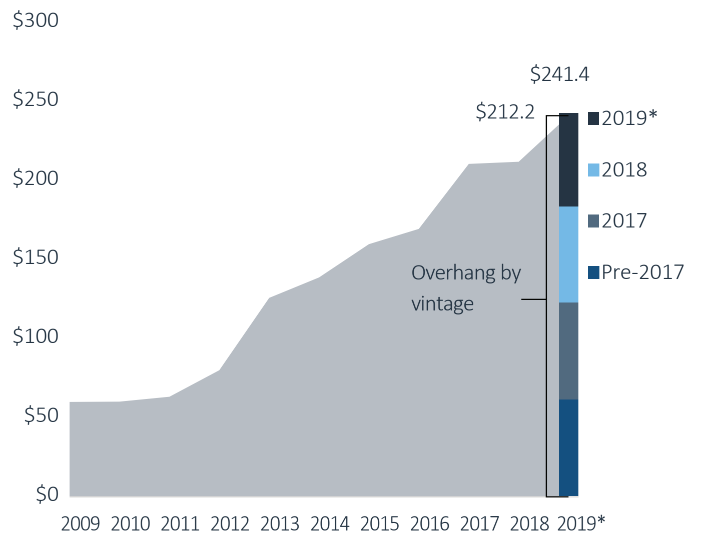
Due in part to the stellar growth in private debt fundraising over the last few years, dry powder for the strategy has continued to accumulate, notching $241.4 billion in value by the end of Q1 2019. The buildup has spurred worries about excesses in the market, but relative to the pace of investment, dry powder has been nearly unchanged over the last five years. Dividing today's dry powder sum by the three-year rolling average of LP contributions to (i.e. capital calls from) private debt funds, we see a relatively modest 2.4 years of dry powder on hand,[7] signaling that managers as a whole aren't struggling to deploy capital and may not be as desperate for deal flow as some suspect.

In light of the recent expansion of total dollars flowing into private debt, many industry participants are voicing concerns that the surplus of capital has given additional leverage to borrowers. In particular, covenant-lite terms become concerning in the case of an economic slowdown, since the lender's recourse can be limited when it's needed most. Another common practice that tends to give investors pause is EBITDA adjustments, in which future earnings growth and/or cost-saving measures are factored in before they occur. By some estimates, these adjustments—which rarely pan out as planned—can account for as much as 25% of EBITDA in leveraged loans.[8] Some of these worries have contributed to volatility in the broadly syndicated leveraged loan market—which is dominated by banks rather than private funds—in recent years.

Given concerns around overly competitive deal terms and pricing, as well as the presumption that the current economic cycle is long in the tooth, we expect the market to move toward shorter-duration assets that are more senior in the capital stack to mitigate exposure to potential default risk stemming from an economic downturn. Self-amortizing facilities are also likely to be used in cases where the creditor wants to minimize duration. However, because this is the obvious theme in this environment, these deals are likely to be priced more competitively and investors are likely to sacrifice yield.

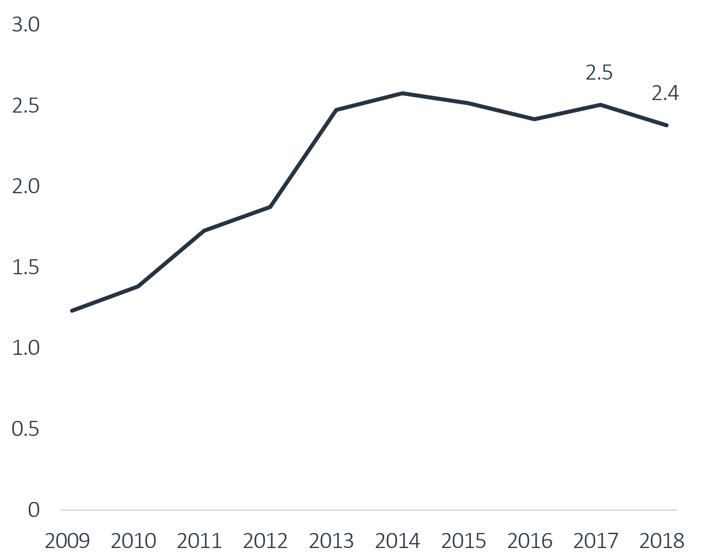
Considering the growth in fundraising and subsequent dry powder over the last decade, it comes as no surprise that AUM for private debt fund managers has grown in tandem. AUM surpassed $660.0 billion by the end of Q1 2019. Between 2009 and year-end 2018, AUM grew at a CAGR of 11.4%. Much of this growth has come from multi-strategy, alternative asset managers that may offer private equity, private debt, real estate, infrastructure and hedge funds, rather than only private debt strategies. Well-known GPs such as Cerberus, Apollo, Carlyle, BlackRock and Neuberger Berman all raised private debt funds in 2019.

Private debt capital overhang ($B) by vintage



Source: PitchBook | **Geography:** Global
*As of March 31, 2019

Private debt years of dry powder on hand

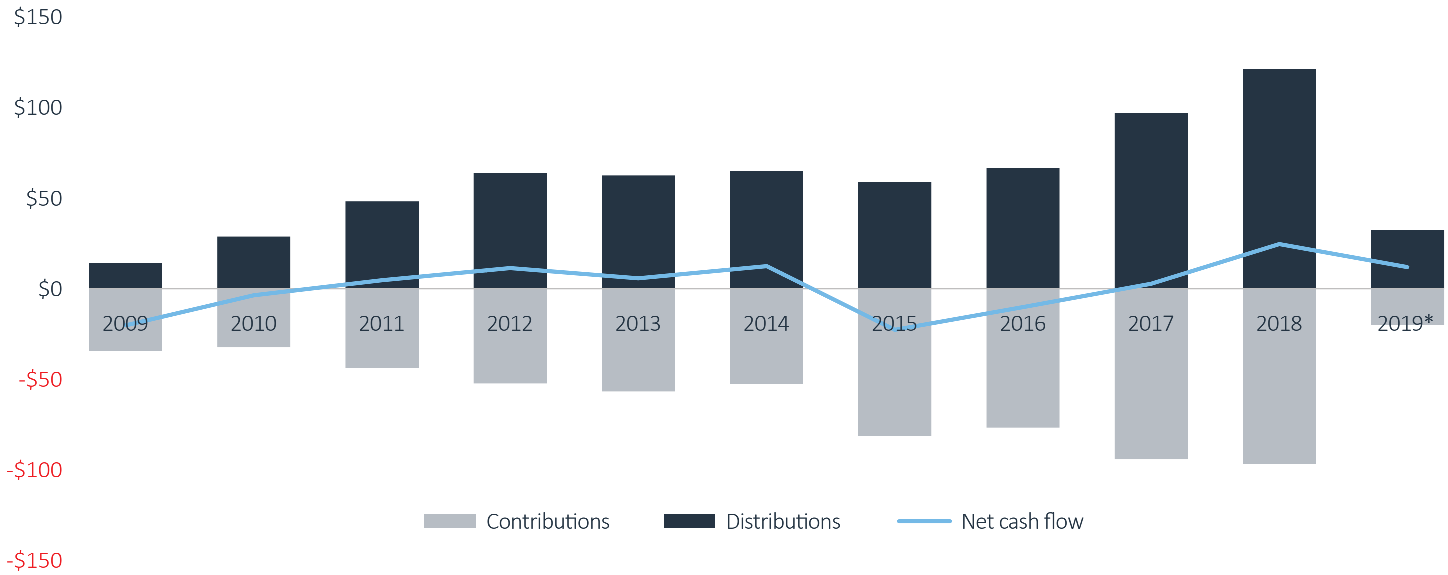


Source: PitchBook | **Geography:** Global
Note: Cash on hand is equal to dry powder divided by the three-year rolling average of contributions.

7: As of year-end 2018.
8: "Tense Time for Buyers of Riskier Corporate Loans," The Wall Street Journal, Paul J. Davies, January 6, 2020.

Performance and cash flows

Private debt cash flows ($B)



Source: PitchBook | **Geography:** Global
*As of March 31, 2019

Distributions to LPs from private debt funds started strong in Q1 2019 following 2018's record $24.6 billion in net cash flows to LPs. These positive cash flows will likely drive future fundraising for the asset class, as distributions—at least those made toward the end of the investment period—must be recommitted to maintain target allocations. Cash flows in private debt tend to result from interest payments, rather than from the one-time sale of a company, so the net figures have not trended as positively as for other private market strategies (e.g. PE, VC), despite there being similar market dynamics in place. In addition to the positive skew of these cash flows lately (i.e. LPs are receiving more in distributions than is being called down), the magnitude of these flows has changed, as well. Both contributions and distributions topped $90 billion for each of the last two years; distributions exceeded $100 billion for the first time in 2018. We expect these cash flows to balloon further as a result of the larger funds raised in recent years.

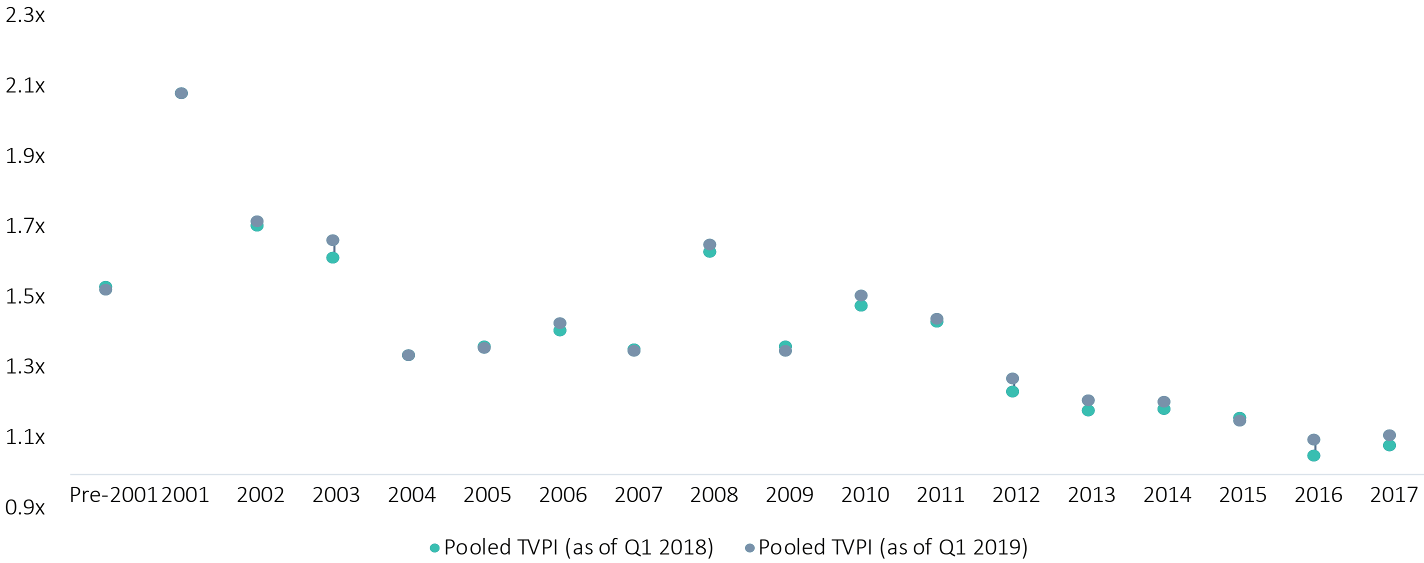
Due to the lower risk profile of debt compared to equity, private debt tends to have a more stable return profile than other private market strategies. We see this not only in cash flow data, where the net figure has been less positive in private debt, but also in fund performance data. The one-year rolling horizon IRR—which measures the change in both realized and unrealized returns in private debt portfolios—has hovered between 6.0% and 11.0% for each of the last 11 quarters. Similarly, no vintage (aside from 2003) in our dataset saw TVPI change by more than 5.0% of paid-in capital in the four quarters ending Q1 2019. However, private debt does not come without risk. The strategy saw one-year returns as low as -30.6% in the depths of the financial crisis, a reminder to investors that serious losses can and do occur.

Horizon IRRs for debt funds compared to public indices*

Strategy	1-year	3-year	5-year	10-year
Private debt	6.5%	8.1%	7.0%	11.6%
S&P 500	9.5%	13.5%	10.9%	15.9%
Russell 3000	8.8%	13.5%	10.4%	16.0%
Russell 200 Growth	3.9%	14.9%	8.4%	16.5%
Morningstar US Real Assets	5.1%	3.2%	2.0%	5.4%
Bloomberg Barclays US Corporate High Yield	5.9%	8.6%	4.7%	11.3%

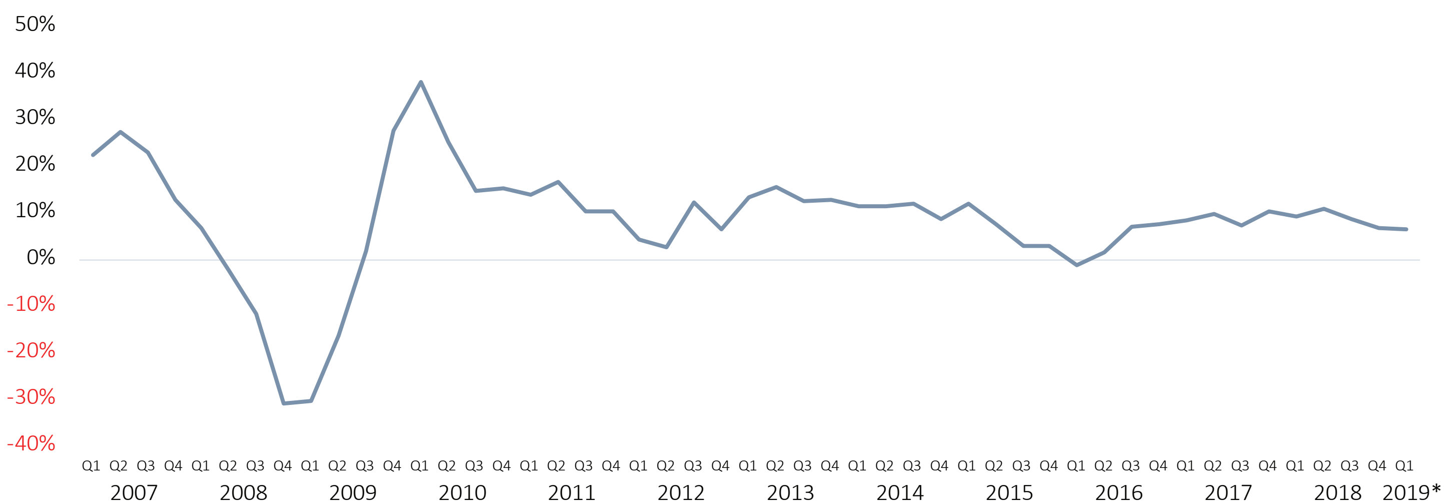
Source: PitchBook | **Geography:** Global
*As of March 31, 2019
Note: All public index values are CAGRs.

Private debt one-year change in pooled TVPI by vintage*



Source: PitchBook | **Geography:** Global
*As of March 31, 2019

Private debt rolling one-year horizon IRR



Source: PitchBook | **Geography:** Global
*As of March 31, 2019