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Insight: The challenges for PD arms of PE firms

As private equity shops continue to broaden their businesses, many are making a credit play. But what does it take to turn an idea into a success?

Since the global financial crisis, limited partners have created or increased their portfolio allocations to credit across numerous strategies, creating an opening for financial firms to broaden their investment products.

Private equity houses have been among those taking action, either through larger funds, wider geographic footprint or additional investment platforms. Frequently, though, the answer is via debt arms.

"In today's market, private credit is still a very desirable asset class," says Stuart Wood, a managing director at fund administrator Cortland. "There are a lot of opportunities for private equity managers to leverage their existing relationships and start a credit fund."

Adams Street Partners saw such an opportunity when it brought in head of private credit Bill Sacher and co-founder of private credit Shahab Rashid, both formerly of Oaktree Capital Management, to launch its debt arm in January 2016.

The credit group was designed to offer yet another service to private equity shops. Through its fund of funds and co-investment practices, Chicago-based Adams Street has invested in and alongside private equity sponsors' funds.

"The missing piece, the only form of capital we had yet to provide to the private equity sponsors, was credit. This was part of a strategic plan to fill that last missing piece," Sacher says.

Larger firms like Capital Dynamics, which manages more than $27 billion in assets, as well as smaller shops such as The Sterling Group, which oversees $2.2 billion, have jumped into the credit pool this year.

"We have seen a number of private equity firms look at private debt as a way to diversify their business. Many have seen other private debt managers and platforms scale enormously in recent years," says Haroon Chishti, a director in placement agent First Avenue Partners' private credit team, adding that private equity firms are keen to "launch products while the fundraising window is still open".

Private equity and private credit have existed under the same roof for years – Apollo Global Management has been active in both asset classes since soon after its founding in 1990, while Ares Management raised its first equity fund in 2003 and entered direct lending a year later. The Carlyle Group and KKR launched portions of their credit businesses in 2003 and 2004, respectively, and Blackstone had a mezzanine debt business years before it bought GSO Capital Partners in 2008.

The private equity firms that launch credit arms today, however, are doing so amid a marketplace that is increasingly saturated. In total, 528 funds were in the market in the first half of the year, the most ever according to PDI data. This hardly leaves LPs with a lack of choice, but first-timers keep popping up as the credit cycle lengthens.

LOCKING DOWN CAPITAL

As of late August, PDI data show there are currently 139 first-time funds in the market targeting a combined $42.8 billion, with 30 debut credit vehicles launched this year alone seeking more than $7 billion in total.

So far this year, seven first-time funds have closed, locking down nearly $4 billion. That number is on track to surpass the $5.5 billion raised last year by debut managers.

"The challenge is always raising the money. That said, I think we're in an environment where the demand for private credit is higher than I've ever seen before in my career," says Sacher. "But the challenge is that it's also a very crowded market," where many managers are "all vying for these same dollars".

However, GPs have reason to hope that money will continue flowing into the asset class, as the summer 2017 edition of Coller Capital's Global Private Equity Barometer shows that 40 percent of surveyed LPs plan to increase their private debt allocation, while only 8 percent plan to reduce that figure.

Just because investors plan to step up their commitments to private debt doesn't necessarily mean the due diligence standards are lower, however. Wood says private equity funds are often successful in hitting their fundraising target, but that reaching the goal can take longerthan firms expect, in part because of that extra due diligence.

"LPs are getting more sophisticated and are aware of what managers need to run a successful credit fund," he says. "We've seen a lot of private equity funds that are being faced with additional due diligence and extra scrutiny on their debut credit fund, because LPs know it's a different product with different challenges."

Ted Goldthorpe, the former president of business development company Apollo Investment Corporation and the managing partner of BC Partners Credit, pays heed to the credit behemoths that have evolved since the 1990s and 2000s. London-based BC Partners hired him in February 2017 to run its credit arm.

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"The Blackstones and Apollos of the world have paved the way for us, which is they've educated the entire private equity investor base on credit," he says. "People understand it. They are very well versed in it given the success of Apollo's and Blackstone's credit businesses."

IT'S PERSONNEL

If finance is a relationship business, a good team is indispensable, particularly when launching a new platform or strategy where the firm may not have deep expertise. A high-quality investment team is something that shops can't skimp on, as it can determine everything from the credit group's culture to its deal pipeline.

Establishing a private debt arm "requires a multi-year commitment. Investors want to see that a manager is thoughtful about building a long-term credit business. Attracting a high-quality team with discernable edge and track record is the first step to success", Chishti says.

Standard practice seems to be private equity shops hiring credit veterans away from alternative lenders. To name a couple, Francisco Partners lured Scott Eisenberg from GSO Capital Partners and Northleaf Capital Partners brought in David Ross, formerly of Bain Capital Credit.

"I think private firms all come at this from different ways. A lot [of firms] have moved people over from private equity into credit or hired junior people," Goldthorpe says. "At BC Partners, we are not repurposing a team of internal people and putting them in front of debt investors."

Sacher and Rashid say they were able to put their Adams Street team together soon after launching the strategy. They added four members in September 2016 and two others since then. Rashid also says private equity sponsors have responded favourably from a dealflow perspective.

Jess Larsen, the Americas head at First Avenue, says: "On-boarding a credit team with a track record to execute the strategy will most often unlock a positive dynamic for the vital first fundraise."

BABY GOT BACK

A good credit investment team can only go so far. It needs strong back office support, something private equity firms may not be equipped to handle, as debt products are not only fundamentally different from equity investments but also far more diverse.

"There is certainly a challenging back office component with accounting and reporting, because there are some distinct nuances between equity investments and various credit products that can be unique to the debt type," Wood says.

These include delayed draw portions of term loans, payment-in-kind interest and unitranche debt. Firms also need a deeper bench of analysts to monitor the credit and underlying borrowers, something that isn't necessarily the case with private equity. Sacher sought help from an outside advisory firm to assist with this aspect of Adams Street's credit business.

"There are some aspects of administering the loan flows that we have outsourced to a firm that does this for a lot of different debt managers," he says. "But the vast amount of accounting and finance, legal and compliance, and HR, IT and all the support you need to operate on a day-to-day basis was already in place."

Cortland's Wood says firms must adjust their paradigms in subtle ways, including how some investments are measured. For example, cash-on-cash return may be a better way to measure some debt investments' performance as opposed to net internal rates of return, as is the standard for private equity vehicles.

In his experience, Sacher says, investors care about both cash-on-cash return as well as net IRRs. One area that differs notably in the metrics from equity are senior loans where, particularly with the application of leverage, firms can produce "attractive IRRs" but the cash-on-cash metric won't necessarily be as high as equity.

A recurring theme comes through in all the conversations: private equity firms may be well-positioned to set up credit vehicles, but that doesn't mean success will come easy.

"I think there's a level of underestimating regarding what it takes to set up a durable credit practice," Wood says. "After lining up the front office team responsible for sourcing the deals, many private equity firms think, 'That's great, we've got what we need now, let's get out and start marketing."

"Launching new private credit strategies can be challenging even for the most reputable private equity firms," Larsen says. "Showing that the private credit strategy builds upon the expertise gained from years of private equity investing is most helpful. The loyal private equity LPs will be the first point of contact in building the foundation and momentum of the fundraise."

Larsen's colleague Chishti adds that the reputation of the private equity firm matters as well. "Better branded firms will likely have a stronger market reception and the support of existing investors, while mid-tier firms may have trouble attracting high quality talent and difficulty justifying why they are entering the business." -

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