Private Debt Investor: Investors' Council 2014

It was with great pleasure Private Debt Investor welcomed some of the leading decision-makers in this growing asset class to the inaugural PDI Investors' Council at the Trianon Palace Hotel, Versailles in December.

It's not often such an influential group of investors and managers connect to air their views on the opportunities and challenges facing the industry, and indeed help to define the very asset class itself.

Personally I would like to thank all Council members for your part in making the event a truly interactive experience and a pleasure to host. I hope you are able to join us for the 2015 Council meeting.

The following is an edited summary of the event in keeping with Chatham House Rule.

Best wishes,

James Clark

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Introduction

At the beginning of December Private Debt Investor (PDI) invited a group of managers and investors to network and discuss the issues that affect this new asset class against a backdrop of reduced bank lending, low interest rates and increased competition.

The following is an edited version of that closed forum, which was held in the historic Trianon Palace in Versailles, France.

SESSION 1: THE ASSET CLASS MATURES – MOVING TO A STABLE FUTURE

Session moderator James Newsome, managing partner of Arbour Partners, kicked off the day's proceedings by asking delegates how they see the private debt market evolve in 2015? Will it increasingly be seen as an asset class in its own right and will Europe ever achieve the depth and breadth of the non-bank lending market in the US? Has the market reached a 'new normal', asked Newsome, where low interest rates, reduced participation of bank lenders and low default rates are expected to endure?

Outlook and opportunities in private debt

The LP perspective:

The director of a large North American pension fund was confident that the number of new funds launching towards the end of 2013 and beginning of 2014 pointed to a healthy fund raising market. "There is a lot of dry powder interested in private debt. We are also hearing a lot of similar pitches from general partners," he said.

It will only become apparent in the next three to four years whether private debt will take its rightful place as an asset class, according to the representative of a sovereign wealth fund. Managers' portfolio skills will be tested over that period as the funding cycle evolves. This is already evident in real estate debt projects where returns are starting to come down amid claims – perhaps unfairly – that credit quality and underwriting are slipping, the SWF manager pointed out.

"Market acceptance and penetration is increasing dramatically in Europe."

The GP perspective:

When a US alternative asset manager set up in Europe in 2007, there were roughly 200 private debt deals in the market, said a partner in the firm's London office. In 2014, that figure had risen to 500 with "market acceptance and penetration increasing dramatically in Europe, according to a US asset manager. Research by his firm has shown that most funding deals involve both a bank and a non-bank alternative. He said: "We've done 20 deals in Europe in 2014 worth more than $1.5 billion - the selectivity rate has not gone up so credit quality is still high. We're still targeting the same returns as two or three years ago."

A real estate debt specialist, which focuses on English-speaking markets, believes a UK recovery is three years behind the US, which is "flush with cash". In America, a 4% return on a 10-year fixed loan on New York City office building may be good enough for a life insurer, but a pension fund or sovereign

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wealth fund will need to look elsewhere for superior returns. UK, Australia and Ireland offer opportunities for such groups, he suggested.

A European alternatives manager is confident that LPs' return expectations of 8% to 10% on infrastructure debt deals are still realistic.

What are the constraints to investing?

Convincing investors:
A director responsible for private debt at a large consultancy said that pension funds and insurers have relatively small allocations to private debt, although allocations have increased over the years. Many don't have any exposure to illiquid investments, while others have between 5% and 10%. However, the consultant said he would be "happy for our clients to have double that exposure". He fielded several questions from the floor:

Q: Will the consultant business model impact the way the private debt market evolves?

A: Solutions such as consultants' own fund of funds offer investors the opportunity to move into assets they would not normally access. In doing so, they have to decide whether the risk-return profile is appropriate and, crucially, whether they can live with the net impact of the fee structures in the alternatives space. Four of five years ago, when most investors first entered the space, there was a significantly higher risk-return profile, which is no longer the case.

Q: Traditionally, investors have seen private debt as a tactical exposure more than a permanent allocation. Are they starting to accept that the asset class is a permanent, strategic investment?

A: Yes, it used to be more of an opportunistic entry, but pension funds are looking at it much more strategically. Today it is more about moving allocations around, and we think this trend will continue and that the asset class will perform an important role in the industry.

Backing the right manager:
The head of private debt at a European alternatives specialist expressed concern about the number of new GPs that have emerged as a result of high demand for private debt. He said: "The biggest constraint is that there are so many teams out there raising funds without a track record; it is key to back the right team."

An asset manager encouraged LPs to dig deep into their GPs' ability to operate in different cycles, especially in how they work with portfolio companies. He pointed out that mid-market companies hit bumps, and it is important that a manager has significant resources and the time to deal with adverse conditions. "Credit, unlike private equity, is asymmetric. We're in a do-not-lose-money

"Credit, unlike private equity, is asymmetric. We're in a do-not-lose-money business, and we fight hard not to."

business, and we fight hard not to," he said.

LPs should also be made aware that niche businesses can deliver consistent returns, according to a small private debt manager with a $240 million fund. He said that his firm is today lending into a different landscape than before the credit crunch. "People have broadened their horizon about sourcing capital."

The asset management head of the alternatives arm of a large European bank also highlighted the importance of a GP's ability to manage through a down cycle. He said: "You have to scale up at that point to move from just origination and portfolio management to include restructuring." That involves hiring new people with the right experience, because restructuring requires different skills. The key thing for an LP is you need the GP to keep investing, and the best time to invest is often at the downturn of a cycle.

> "I'm very happy to pay for performance in the long term but paying large fees as a running cost is difficult to justify."

However, a partner in a US alternatives manager pointed out that the ability of a GP to buy in a downturn depends on the economics of the asset class. "We are not a 2-and-20 asset manager and we charge on deployed capital, not committed capital." This makes it difficult to bulk up, which is a real constraint on smaller managers that do not have multiple funds and large teams.

The thorny issue of fees:
The representative from a UK public pension fund pointed out that in the public sphere there is strong central government pressure on fees, which he feels is misguided because the focus should be on performance instead. "I'm very happy to pay for performance in the long term but paying large fees as a running cost is difficult to justify." He emphasised that while it is possible for an LP to pay the kind of fees charged by alternative managers, the question is whether it is possible to intellectually convince the LP that it is worth paying.

The head of alternative investing at a North American public pension fund brought a different perspective, when he stated while there is a room for niche strategies and managers, LPs should not be expected to "subsidise" a GP that needs more capital or fees to run a business. "We will pay as low fees as possible and almost always negotiate. The burden is on GPs to make sure the assets under management are sufficient to cover the cost of a business and to ensure they have the necessary expertise."

A 2% fee is simply not acceptable in private debt any more, a partner in a private equity and infrastructure firm added.

How is the investor base changing?

A regional manager at a European firm asked delegates whether the investors in private debt products have really changed over the time.

The head of direct lending a large mezzanine provider said that alternative managers are for the first time selling to traditional fixed income investors looking for yield in a low-interest environment. While bigger investors were the first movers, smaller pension funds – through consultants – are also showing interest in the space. They have missed some of the early returns but are still interested, he said. He pointed out that such LPs' fixed income buckets are so much larger that it is important for GPs to position their products correctly to benefit from that money. The direct lending head believes that over the next five to ten years it will be an established asset class with five to ten large managers focusing on the area. "Several small funds will no longer be around because of lack resources. Scale, reputation and brand will end up being the success factors," he added.

A specialist manager working with family offices pointed out that while his firm is always looking for niche players, data has shown that more than 90% of new managers disappear after raising their first fund.

SESSION 2: COMPARING AND CONTRASTING DEBT STRATEGIES

Risk-return expectations

Hans-Peter Dohr, managing partner at DC Placement Advisors, hosted the second session of the day. He started by asking an investment consultant how he would explain the return expectations of a private debt investment to an asset allocation trustee. The answer was complex: most portfolios have guidelines on risk-adjusted returns, and institutional investors do not have the ability to simply accept and absorb ever decreasing returns – there are too many other options out there, said the consultant.

He added that the starting point in the conversation with an investor is not around just one aspect of private debt, such as just infrastructure or just real estate debt, but rather what returns the investor wants to capture and the best ways of doing so. Every investor looks for something different: an insurer, for example, may not want anything beyond investment grade-like investments and will not accept the risk that comes with a 4% or 5% return. At the higher risk end, others will not consider any opportunity that yields less than double-digit returns. "We look to GPs to put solutions in place, whether it is through funds or separate accounts," he noted.

Dohr asked the head of private investments at a global asset manager what advice he would give a typical large German insurer interested in private debt. Such clients want long-duration, stable yield, was the simple

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answer. The manager therefore looks for strategies to deliver it, such as infrastructure debt on the one hand for long duration, combined that with other strategies such as real estate and corporate debt for the yield. He said: "In private debt, more than any other asset class, you have to offer a tailored solution because clients have varying needs, and therefore you have to be flexible." He added that the expected returns of the sub-asset classes change from year-to-year, and clients need to be made aware of that. Default, maturity and duration expectations also need to be taken into account when putting together a portfolio.

Mezzanine expectations:
The investment consultant pointed out that it is no longer possible to achieve 8% to 12% returns on mezzanine loans. He said that in the past it was possible to take advantage of dislocations but that the market is now more structured and supported. Property funds are undershooting their expected returns by 200 to 300 basis points, while infrastructure debt funds are down by 2% to 3%. "The returns are there as a guide to give an indication of risk profile, but you have to be aware of what's happening in the world."

Drivers for returns in real estate:
There are great differences in real estate debt returns depending on geographic location, according to the head of a US real estate adviser. At the moment the US is at the top of the cycle with good fundamentals and a tremendous amount of capital from around the world coming into the loan market. He also believes that the UK has plenty of capital but it is inefficient and structured poorly as it is dominated by short-term floating rate bank lenders. His firms sees a big opportunity in offering longer fixed-term loans, which avoids maturity defaults. The UK has plenty of borrowers, and whereas in the US a 75% loan is a loan, in the UK it is considered a stretch loan so there is less competition. "The relative value is certainly in the UK," he said.

Corporate debt opportunities:
The head of direct lending at a specialist mezzanine manager said his firm has a range of different risk-return profiles ranging from more liquid loan portfolios through to higher risk mezzanine strategies yielding returns of 18% to 19%. "We like to stick to our speciality of sub-investment grade credit, and within that have created a portfolio of products that can be sold to different investors with different risk appetites." Geographically, he sees opportunities in established markets in Asia, such as Singapore, Hong Kong and Australia, which does not bring with it the expected premium associated with emerging markets. He believes the US to still offer opportunities because it is more efficient, but with tighter spreads. He added that there is a trend developing among his firm's larger clients for segregated mandates with multi-strategy limbs, which allows for a mix-and-match approach to their risk-return needs. He said: "It is a sticky model based on a partnership."

Specialist strategies:
A partner at a European specialist debt provider pointed out that his firm lends to companies that are reliant on private equity sponsors, which is reflected in the prices. It derives its revenues in the first

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instance from the debt contract (around 15% to 16%) with enhancement from the equity taking the total return to 20% plus. The firms also targeting a net internal rate of return of 14%, backed up by diversification across geographies and sectors, but, said the partner, "we are most interested in the quality of deals and sponsorship".

Energy debt sector:

An EMEA head of direct lending for a global energy fund stressed that now is a good time to be in the energy market, with especially the oil industry offering some distressed opportunities. The firm has a 30-year track record, and provide investors with substantial education about the energy sector. "One of the figures that attracts people is that if you only invest in our default portfolio you will get a positive return." He also pointed to the firm's ability to get out of difficult deals, and said: "We're selling a yield story, targeting returns in the mid to high teens, and have turned away deals that offer a 12% return."

The LP perspective: does reality live up to the promises?

The head of private equity at a big US family office aims to achieve low to mid-teen returns in its private debt investments, and does so through a variety of strategies. It also co-invests with several debt fund managers. He said: "At this point the cycle is challenging in the US, and the biggest challenge is how to put your money to work." Through a combination of senior debt, leveraged funds, middle market debt etc, the family office has created a mini credit fund-of-funds to help it through the cycle.

Attempting to exploit dislocations in the funding market, the sovereign wealth fund entered the private

debt market in 2010, initially investing in US credit hedge funds and real estate debt and as the market recovered moving into European middle market direct lending. A portfolio manager at the SWF said its investing was conceived as an opportunistic strategy, and remains so, apart from middle market direct lending, which is regarded as more permanent, targeting returns of 7% to 9% net. He highlighted losses on a rescue financing strategy in the US as one of the SWF's main disappointments.

The representative of the North American public pension fund, which has been in private debt since 2006, sees private debt as a core investment. Given the illiquid nature of such investment, it does not invest in or commit capital to an external manager if it can do so internally or get the same exposure through liquid investments. It targets a weighted average net return of 8% to 10%, ranging from the lower end of the return spectrum to distressed funds with much higher target returns. He said: "The private debt market is cyclical, and we believe it is best practice to be invested all the time across different mandates and change as needed."

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Caveat emptor:
However, the London partner in a US alternatives investment manager warned investors to take into account the lineage of an investment team. He said: "It's all about the people and how they are wired. Credit is risk asymmetric so it tends to attract people who see the glass as half empty." He said the quality talent pool is very small.

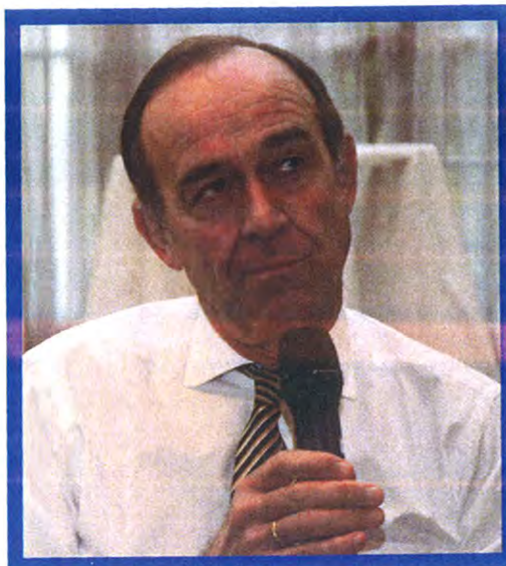
How do GPs price losses into each asset?
The head of funds for a large bank pointed out that before the financial crisis many banks committed the "fundamental error" of not pricing in any losses. Today, he said, it is on average 150 basis point per loan, depending on the hold level.

The London partner of a US alternative investment manager said said that with mid-market senior direct lending, investors expect 60bps per year. His firm tends to write loans where it is the only lender, which leads to higher recovery rates.
He said: "Part of our pitch is that we control our destiny. When things go wrong, the buck stops with us."

In a similar vein, the chief executive of a European mid-market investment specialist said his clients expected "zero losses, even in the mezzanine market", and therefore it only invests in private equity backed companies.

An MD at an emerging market private debt manager spoke of his experience with large pension funds and insurers. A direct lender with a 12 year track record, the firm's cumulative default rate is 1.5% per year and its expected loss rates 60 to 70bps. Most of recent losses have come from China and it no longer operates in the country, and it has also been hit by the currency crisis in the Ukraine.

For the chief executive of a US real estate investment manager, "conviction-based lending is all about making good loans to good borrowers" and his firm factors in a 30bps hit to yield on long-term fixed rate loans.



Which regions offer sweet spots?

Emerging markets:
The emerging market specialist avoids China, rogue states and large Asian countries, because they are aggressively banked. South America, apart from Argentina and overbanked Chile, offer many opportunities, as do countries like Kazakhstan in Central Asia, and smaller countries in Asia, including Cambodia.

Energy:
The US will continue to be interesting in the energy sector, according to the head of direct lending at a specialist energy manager, while power in Europe and distressed opportunities in the oil and gas sector offer opportunities. He is also excited by a large gas discovery in Brazil the size of the North Sea.
In Mexico the introduction of competition in the energy sector is offering some low-hanging fruit, he added.

> "(Clients expect) zero losses, even in the mezzanine market."

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SESSION 3: PUTTING CAPITAL TO WORK – HOW ARE FUNDS ENSURING THEIR RETURNS MATCH EXPECTATIONS?

David Waxman, managing director at Azla Advisors, hosted the session and he addressed his first question to general partners, asking them about the health and vibrancy of the market.

The GP perspective: what types of deals are hot – and what is the flow?

A European investment manager focusing on unitranche and mezzanine financing to sponsored buyouts is currently most interested in lower mid-market deals between €70 million and €150 million, according to its regional MD. She said dealflow has improved significantly and has been particularly good in 2014 in France and Germany, but the UK has become fairly competitive.

The head of direct lending at a specialist energy manager said his firm has had "a tricky time" in the past 18 months: it raised a large fund in 2013 but has held back investing because pricing has been too competitive. He hopes that his firm's discipline will be rewarded in the long run.

It was the reverse for the emerging market manager, whose MD pointed out that a lack of competition in the sector has led to good dealflow.

The COO of a European growth debt provider, too, has been pleased with the strong dealflow it has seen, predominantly from private equity sponsors. Historically, the manager has been involved in deals in the early-stage $20 million to $30 million range, but lately it has seen some creative solutions coming from much later-stage companies.

> "It is still quite easy to get those returns with reasonable risk, ranging from unitranche to special opportunities."

Are returns improving for GPs?

The real estate investment manager has seen an interesting arbitrage in that there are unlimited buyers for high-grade new issue commercial mortgage-backed securities, even though the underlying individual loans are fairly unattractive.

The head of direct lending for a European debt manager does not compete in a volume market. The manager looks to provide solutions for which borrowers are prepared to pay, normally connected to M&A deals where convenience, speed of execution, size of ticket and relationships are important. Crucially, he said, he has not seen any price compression over the past few years: "If you are diligent and you're plugged into a market, you can create well-rewarded solutions for which you don't compete on price but on less tangible factors."

Looking after about 28 debt funds across Europe, the head of funds for a large bank said since the bank lenders have withdrawn there has been a higher risk approach. He pointed out that about 70% of funds have seen an increase in yield over the past few years, although there has been some compression – about 25bps – on senior debt. But, he added, fees have not been under pressure.

The reason for this lack of compression, according to the head of direct lending at a European debt manager, is down to that fact that money is raised from investors on the basis of certain return requirement and

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therefore managers are not incentivised to reduce fees. Bank lenders' return requirements, driven by capital regulations, too has introduced a flaw in the market. This has led to an oversupply of capital in certain situations

The representative from the bank responded that while there are now fewer deals than before the financial crisis, the quality of the capital has improved tremendously, providing better risk-return profiles.

Stepping in where banks fear to tread:
As banks increasingly retreat from the lending market, opportunities are opening to non-bank lenders. The head of funds at the large bank pointed out that while there is a floor at which the banks can lend there is an opportunity for debt funds to partner with the banks in effort to increase yield for investors.

The head of direct lending at a European debt manager highlighted opportunities in Europe where the market has historically been inefficient because of an overreliance on banks, especially in the mid-market. Combined with a lack of capital market solutions, borrowers don't have a lot of options, which presents private debt managers with opportunities without price compression.

The London partner of a US alternatives manager said the Europe debt market will never be as institutional as the US. The US market was bank dominated in the 1980s and 1990s, but then a large-scale consolidation took place and the banks lost interest in the mid-market. The void was filled by institutional investors. In Europe, while banks are also overleveraged and subject to regulation, they have not consolidated to the same extent.

The LP perspective: what are your return targets?
The head of public markets at a UK public pension fund, which recently switched its entire fixed income strategy to private illiquid credit, said the fund moved out of traditional fixed income because of the poor risk-reward ratio. He said: "We have a long-term target to beat our actuarial assumption of gilts plus 2.5%, so across the portfolio we need returns of 6.5% to 7%." In reality it aims to do better and look for opportunities that have intellectual reasons for delivering a superior risk-return. He added: "We're not just taking advantage of the fact that banks can't lend anymore and therefore we can step in; we look for something more imaginative than that."

A large US pension fund has a target return of 7.5%, in line with its peers, while its Canadian counterpart pointed out that if institutions are having to settle for lower returns, it has to come with lower risk.

A manager that provides segregated mandates to clients, look for returns of 9% to 11% net in private debt. Its head of private investments said: "It means searching for higher risk strategies. It is still quite easy to get those return with reasonable risk, ranging from unitranche to special opportunities."

The representative from a family office said his firm targets returns in the low teens across credit portfolios. The firm is particularly interested in structured finance side such as collateralised loan obligations. However, it has not found many such opportunities in Europe, in contrast to the US.

Is the competitive landscape shifting?
The investment consultant said the number of private debt managers have increased significantly in recent years. A European investor said he looks for continuity in his portfolios, supporting the same managers through different funds as long they continue to perform. He said his firm has had to rebalance its portfolios to reduce exposure to mezzanine and focus more on distressed opportunities and standalone funds. He added: "The biggest change has been the emergence of private debt as an asset class, although it remains unproven there are many new teams in the market, but we prefer to stick with known managers."

The investment consultant also noted the increasing participation in private debt markets of traditional fixed income houses moving into the private debt space, such as large hedge funds that have the resources and the platforms to compete.

SESSION 4: INVESTMENT STRATEGIES AND THE LP/GP RELATIONSHIP

Moderator Jean-Philippe Keravec, partner at Campbell Lutyens said while banks have retreated they have not completely disappeared from the lending market. However, it is becoming apparent that banks are coming back to infrastructure finance, and within months took control of up to 80% of the market, according to a recent survey. In project finance, too, they have returned from no involvement to taking on some big deals again.

Are the banks coming back – and are they increasing their market share?

The head of direct lending at a European alternative manager agreed that the banks never really left – they just adjusted their risk appetite. There was supply-side dislocation in the market a few years ago, which created the opportunity for private debt providers. He said: "Today it is demand driven just as it is supply-side driven. Our clients come to us because they choose not to take a bank solution, not because they cannot get a bank loan."

"We call banks our 'frenemies'," said the European partner in a US manager. "We have deep and multi-faceted relationships with them. Sometimes we compete but often we share deals with them. We can peacefully co-exist."The big issue facing banks is regulation and the partner can only foresee more regulation coming in. This bodes well for the private debt market as competition is reduced.

The head of funds for a large bank, however, is convinced that banks will never return to the funding levels they commanded before the financial crisis. "The market has changed for good. The banks have learnt a lesson." He believes the institutional sector, such as insurers, will eventually take the place of banks as lenders.

The head of alternative investment for a North American pension fund believes that the outlook for the private debt market will be better in a few years' time. He said the ramp-up in the European middle market has been accelerating, and has been pitched by 24 GPs in recent months, and that in the short term there will be more competition from banks. He added: "I hope in time there will be less competition and better pricing and terms. Pricing right now can't get much worse."

Most German banks are still in the business as originators, according to the head of private investments at a European manager, but the banks

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are no longer buy and hold investors but are instead transferring those loans to asset managers, which means they are still seen as competitors to other investors.

The chief executive of a mid-market private equity manager pointed out that many of the sellers in secondary deals are banks. "They are still decreasing their balance sheet in private debt."

The evolution of private debt: a place in fixed income

Moderator Jean-Philippe Keravec suggested that private debt as an asset class could in future be split into two, with mezzanine on the one hand and direct lending becoming a new asset class under fixed income. He asked delegates for their views.

The head of public market investments at the UK public pension fund believes there are long-term strategic positions that are a natural fit for non-bank institutions with long-term money, but the question remains whether those areas will become part of the ongoing financing to businesses.

Keravec asked him whether the people in charge of mezzanine investing at pension funds are the same ones responsible for direct lending. The response was clear: the majority of pension funds will never have the origination network to exploit the best opportunities and invest via specialist funds instead. When pension funds consolidate there may be an internal direct lending function.

The alternatives specialist at the Canadian public pension fund said that his organisation's fixed income bucket includes any credit investment that pays a coupon, including private debt. He said: "Where it gets trickier is where you go outside the curve, when it starts to look like private equity on the distressed side."

His counterpart at a US pension fund also pointed out that most plans do not all place private debt under the same heading. Some, he said, put it under alternatives, while other lump it with fixed income, private equity or some other bucket.

For the head of direct lending at a European asset manager, private debt is unequivocally a fixed income product. The only question for him is whether it belongs in the defensive or the growth bucket.

How do LPs invest: through funds only or directly?

The investment consultant said investors were initially only interested in accessing private debt through funds, but are becoming more comfortable with direct lending through, for example, segregated accounts.

The head of public market investment at the UK pension fund suggested that in the current low interest-rate environment, an investment that offers Euribor or Libor plus 500 bps it has become a fixed income investment because the margin is bigger than the floating rate.

Is there a trend for large investors to build internal private debt teams?

The representative of the sovereign wealth fund believes this will probably not be widespread, unless the organisation is very large due to the huge barriers to entry.

The London partner of a US asset manager believes that while LPs can become more like GPs by investing directly in private equity, it is less likely in the immature private debt market. He did however, cite the case of Canadian pension plan that does its own principal debt investing while some SWFs are

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co-investors. He said: "Will they compete with the GPs? Probably not – they will probably partner on more deals with us."

What type of funds should LPs consider?
A partner in a private equity firm with a family office focus said that his preference is for shorter duration funds. The chief executive of a mid-market investment manager pointed out that such niche funds involve a lot of work but they do exist.

There isn't a right answer between niche and large funds, according to the head of investments at another large private equity family office. However, the problem is that a lot of managers have similar funds doing slightly different things, which can cause a conflict of interests, he said. "For that reason we'd prefer a multi-strategy approach in one bigger fund."

The investment consultant agrees that larger funds give more flexibility. It is not a good idea to have a small fund with short investment period because it takes away flexibility, he added.

What are the criteria for first-time funds?
The managing partner of a London-based adviser believes that a first-time fund with one stand-out selling point, which the opposition doesn't have, will get a deal done, even if it is weak in other areas. He cited the example of one pan-European fund that managed to attract very senior sponsorship allowing it to complete a deal despite not having any presence in Europe.

The head of private debt investments at a private equity investor was clear that most smaller LPs are risk averse when it comes to investing in first-timers.

The UK pension scheme, which is publicly accountable, is very risk-averse because it doesn't want to be publicly humiliated over bad decisions. The fund's head of public market investment said: "We have to do due diligence, but a spin-off from an existing team trying to do something new would be much more interesting than a complete new start-up."

How will the private debt market develop in three years' time?

The head of funds at the alternatives business of a large bank predicted a 5% to 10% increase in fund-raising in the next two to three years, but the real question for him is where the money should be deployed, because both through funds and direct lending there are not a lot of options. He sees the highest growth in venture debt in the UK, where

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his bank is looking for partnership agreements with debt managers. While senior and unitranche debt will remain the flavour of the year, infrastructure is suffering from a lack of liquidity, which banks are unlikely to provide, he added.

The head of investments at a large manager focusing on institutions and family offices is confident that his firm will invest more in private debt in the coming year. He said: "Combined with the assumption that banks will remain less active, the market should grow."

The investment consultant expects to see less investment in real estate debt and infrastructure and more into corporate debt, but believes that the overall allocation to debt will go down somewhat in 2014.

Will rising interest rates have a significant impact?

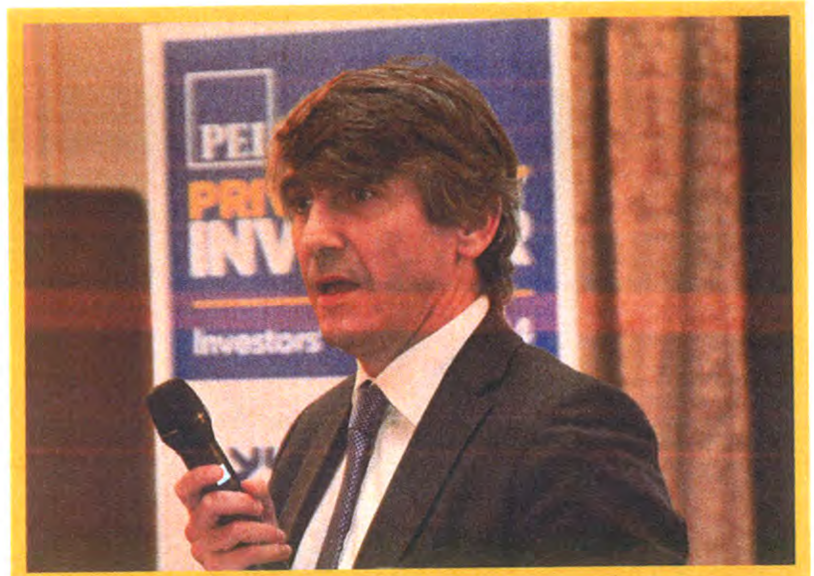
The head of public market investment at the UK pension fund feels strongly that interest rates will not rise significantly in the short term. If they do, he said, GPs will get a "free ride" on their performance fees.

What happens to portfolio companies' ability to service their debt asked the London partner of a US investment manager? He doesn't believe rising rates will impact them too much – interest rates will have to move a lot before they have a negative effect. The investment consultant agreed that rising rates are not a main concern for LPs.

What are the prospects for growth private debt?

Private debt as a growth investment conceptually has a huge tailwind, according to the head of investments at a European asset manager. He believes LPs want to be in that area, but GPs are naturally cautious to step into the void left by private equity sponsors. "A dam could burst," he warned.

The managing director of an advisory firm believes that the most effective way for a GP to do growth



debt is not to replace the equity sponsor but to work alongside it. For example, on a $15 million growth deal, typically the equity sponsor will put in $10 million and the debt sponsor $5 million, he said.

What are the risks for private debt in the next two years?

The biggest risk is that senior lenders or funds stretch themselves too much, said the head of European investment manager. They may end up selling a senior product but taking on junior risk, which is something that has not been tested in the market yet, he added.

The chief executive of a mid-market investment manager, said the demand for returns in a market that still has limited opportunities is a huge risk. Several other delegates agreed the fact that too much money is chasing too few deals is possibly the biggest risk for the asset class.

"Combined with the assumption that banks will remain less active, the market should grow."