Spotlight:

Private Debt Funds – The New Alternative?

Emerged from the global financial crisis as opportunistic managers, private debt filled the vacuum left by the retreat of the traditional banks and has become one of the biggest success stories creating tremendous opportunities for the industry. Following the rise of private debt as an institutional asset class, investors are faced with a vast number of funds and strategies to choose from, catering to a wide range of risk/return profiles. However, debt and credit funds face several challenges, mostly regarding the ever changing regulatory framework. The following roundtable discussion was held at the LRI Investment Summit 2018 in Frankfurt and gives insights on private debt fund structuring and the role of Luxembourg as first choice for all lending market players.

Rolf Dreiseidler: Please briefly outline the role of your company in regard to private debt.

Adrian Aldinger: Arendt & Medernach is a full-service law firm that advises sponsors of private debt funds regarding both the set-up of the appropriate fund structures as well as the management companies thereof, i.e. alternative investment fund managers. In addition, we advise clients on their ongoing regulatory compliance obligations arising from the aforementioned activities.

Heike Schmitz: DLA Piper advises investors, funds and asset managers with regard to the set-up of private debt fund structures. The funding often comes from German institutional investors, particularly insurance companies and pension funds, the structures are usually set up in the main European fund hub, Luxembourg.

Valeria Merkel: As an Audit/Tax/Advisory firm we offer holistic support to our clients in different stages of their business. During the set-up, we help companies structure their business from a tax and regulatory perspective. On the investment side our M&A transaction team supports the buy & sell side. During the lifetime of the structure we offer audit, certification & assurance services, consulting & managed services i.e. tailored investor reportings, risk management, accounting and corporate services for corporate structures. In summary, we offer a whole range of services that our clients can choose from, depending on their preferences and their set-up.

Ulfar Mölk: LRI Group is a licensed UCITS management company and has an authorisation as an Alternative Investment Fund Manager (AIFM) in Luxembourg. As for private debt, we do offer the full range of the Luxembourg fund structuring toolbox ranging from investment vehicles like the SIF (Specialised Investment Fund), the SICAR (Investment Company in Risk Capital) to the Reserved Alternative Investment Fund (RAIF) as well as Securitisation solutions. We do not only consult our clients in setting up the fund in the right structure, but also offer the portfolio management and risk management function as well as depositary services.

Dreiseidler: Private debt is quite a buzz word these days, so before we continue into details could you please give us a quick definition of the asset class and the sub-segments related to it?

Schmitz: The private debt fund structures we advise usually invest either in corporate private debt or in real estate/infrastructure debt. Corporate private debt strategies include e.g. U.S. corporate lending or SME lending in the EU. Real estate and infrastructure debt strategies tend to concentrate on "classical" real estate financing as lender of record or secondary lender or participant in a bank financing arrangement, but increasingly also invest in debt relating to infrastructure projects – e.g. road infrastructure, network infrastructure, storing facilities, infrastructure for renewable energies.

Merkel: Private debt is probably the most diversified asset class across geographies, industries, equity sponsors and asset types: real estate, infrastructure, private equity sponsored via typical categories like direct lending, distressed debt, mezzanine, fund of funds, Special Situations and venture debt; mostly focusing on commercial loans, mid-market corporate loans, but also including niche markets such as trade finance, private loan platforms like fintechs and crowd lending.

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Valeria Merkel
Partner, Asset Management,
KPMG Luxembourg

Dreiseidler: Let's take a deeper look into corporate private debt. There appears to be quite a debate on the investor side about the pros & cons of U.S. vs European direct lending and also regarding Senior vs. Junior and Unitranche sitting somewhere in between. What do you see in your day-to-day practice?

Schmitz: Actually the first private lending structure which I advised was a Canada based limited partnership doing U.S. corporate lending for a big European insurance company. Since then we have seen many similar transactions, but it appears that U.S. lending has lost some of its attraction at least when it comes to German institutional investors. Clients tell us that their investments have not led to the expected returns, in particular since this is a mature market with many other players. Currently, from what we see the more sophisticated German institutional investors rather focus on Asia and emerging markets private debt.

Mölk: In general the Anglo-Saxon direct lending market is more mature than the European direct lending market wit. Investors seeking this exposure invested in those markets. Currently we see this topic becoming more en vogue in the European market with more managers offering those strategies. And here we can also distinguish between real estate and corporate lending with an advance in the real estate lending.

"We see the more sophisticated German institutional investors rather focus on Asia and emerging markets private debt."

Heike Andrea Schmitz
Counsel, Fund Structuring/Insurance Asset Management DLA Piper UK LLP, Cologne

Dreiseidler: Since we are supposed to talk about debt funds as such it would be interesting to gain greater insight on how the European market in general and Luxembourg as a major hub for private debt specifically has evolved over time – where do we stand today?

Merkel: Our latest loan fund survey illustrates the Luxembourg local market. There is much market data on the well-developed U.S. market, some on the EU, but we were missing the data on Luxembourg that became the motivation of the survey. So what does it say? Luxembourg isn't isolated from the rest of the world and there is no big difference in terms of trends in investment strategy clearly led by senior loans, followed by high yield bonds, then direct lending. This is however not surprising as, according to the Association of the Luxembourg Fund Industry (ALFI), over 70% of the top 30 loan fund managers worldwide are present in Luxembourg. The biggest part of the market is still unregulated.

The unregulated market in the form of limited partnerships (*société en commandite simple* or SCS), Luxembourg special limited partnership (*société en commandite spéciale* or SCSp) and especially Securitisation Vehicles and Soparfis (*Société de Participations Financières*) has historically driven growth in holding and financing vehicles).

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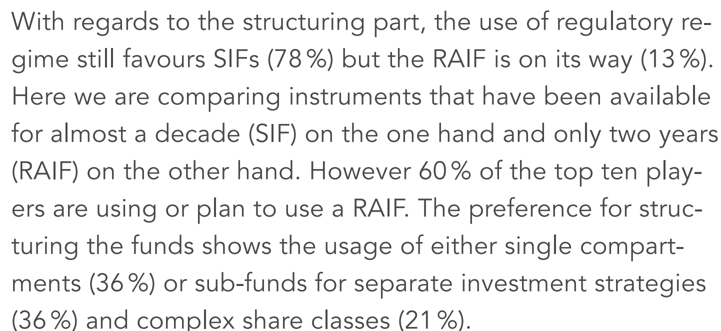
Ulfar Mölk, CAIA, FRM
Head of Portfolio Management
Real Assets, LRI Group

However, the trend goes towards regulated vehicles especially when it comes to loan origination, as in some countries borrowers cannot receive loans from an unregulated entity. With regards to investor preferences in general, the acceptance of and need for regulated entities is paramount.



With regards to the structuring part, the use of regulatory regime still favours SIFs (78 %) but the RAIF is on its way (13 %). Here we are comparing instruments that have been available for almost a decade (SIF) on the one hand and only two years (RAIF) on the other hand. However 60 % of the top ten players are using or plan to use a RAIF. The preference for structuring the funds shows the usage of either single compartments (36 %) or sub-funds for separate investment strategies (36 %) and complex share classes (21 %).

The growth in demand for Luxembourg debt funds is still very healthy with 23.5 % even though in the last two years we saw record growths at 160 % (FY 2017/16) and 280 % (FY 2015/16) respectively.

Aldinger: Other surveys commissioned by the Alternative Investment Management Association (AIMA) and European Association for Investors in Non-Listed Real Estate Vehicles (INREV), respectively, provide a more global view of the Luxembourg debt fund market. The surveys show that for both European and non-European sponsors, Luxembourg has become the jurisdiction of choice for the setting up of debt funds. This holds true for both diversified credit strategies as well as specialised like real estate debt funds. Regarding the preferred choice of vehicle for the implementation of such strategies, limited partnerships are at the top of the list with securitisation vehicles also ranking highly for certain strategies.

Dreiseidler: We all know that there is not a one-size-fits-all solution when it comes to finding the right legal structure for a fund. What needs to be considered to identify the right fund structure and are there any trends that you see in the market?

Mölk: Since the introduction of the RAIF structure in 2016, we have seen increased popularity due to its shorter time frame for time-to-market. The most common reason to choose a SIF or SICAR over a RAIF despite the time-consuming regulatory burden is dictated by the type of investors targeted and the size of the fund. Fully regulated and supervised investment structures may still be required by certain institutional investors such as pension funds and insurance companies. Furthermore, as a RAIF must be managed by an authorised AIFM, investors may opt for a SIF or SICAR structure if the size of the fund does not require an authorised AIFM. Having existed for more than 10 years, the SIF and SICAR are established regimes that have contributed strongly to Luxembourg's position as a top international fund domicile; however, the RAIF aims to replace these prior regimes in the short run.

Aldinger: When structuring a product, one always needs to take into consideration three key requirements: investor expectations, fund level considerations and asset-linked constraints. Depending on the clients' needs, these three components may be awarded different degrees of importance. In terms of choice of fund vehicles, Luxembourg has a vast array of available options, both regulated and unregulated. The

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Adrian Aldinger
Partner Private Equity & Real Estate,
Arendt & Medernach

most frequently retained company/partnership form for debt funds are, as already mentioned, tax transparent limited partnerships, either in the form of a common limited partnership with legal personality or special limited partnership without legal personality.

Furthermore, the RAIF has proven very popular with investors since its inception in 2016. This is due to the fact, that it enables sponsors to incorporate various structuring features such as variable share capital or compartments into a quasi-regulated vehicle, as regulatory oversight is ensured at the level of the AIFM, which the RAIF needs to mandatorily appoint. As the case may be, the structure can be further expanded to accommodate tax-exempt investors by adding a feeder fund above the master-RAIF – often structured as a limited partnership – either in the form of another RAIF structured as a corporate entity or a securitisation vehicle. For institutional investors that are used to working with SIFs, the above structuring solutions can be applied in a similar fashion. That being said, whilst such investors did prefer SIFs in the past when the RAIF was newly introduced due to a lack of “track record”, we now see more and more of such investors investing in RAIFs, which will further contribute to its overall market acceptance and likely result in the RAIF becoming the predominant fund structuring option for certain products in the near future.

Schmitz: As a German fund and regulatory lawyer I am always amazed at the multitude of options for fund structuring proposed by our Luxembourg colleagues. Currently we are setting up a number of RAIF structures for German institutional investors, but we also advise with regard to a number of "historical" SIFs that have been set up in the past. While more sophisticated German investors easily go for RAIF structures we have seen some initial concerns from German pension funds and smaller insurance companies due to their unregulated nature. However, since the RAIF's AIFM is fully regulated and supervised most of them where easily convinced.

Since we often advise both Solvency I and Solvency II investors with regard to fund structures I can confirm that both regimes lead to substantial differences with regard to private debt fund structuring. We therefore strongly recommend to consider them from the outset. The formal and "schematic" approach of Solvency I has a tendency to lead to more complex structures e.g. via securitisations whereas under Solvency II many internal aspects of the investor such as internal investment guidelines, operational requirements and risk assessment have to be taken into account.

Dreiseidler: From your experience, what are the key aspects to seriously think about when setting up a private debt fund regarding operational aspects? Or put it another way: what can go wrong on the operational side after having ticked the boxes on the fund structuring side?

Schmitz: In my view there is a lot that can go wrong if the operational side is not considered from the outset. It does not help if we provide the client with a "perfect" structuring solution which is not feasible from an operational perspective. We therefore strongly recommend to our clients to involve operational entities such as the AIFM and the depositary already in the structuring phase and to pay a lot of attention to their qualification. According to my opinion private debt definitely requires skilled and experienced operational entities and is – aside from the big players – nothing that can be handled internally by an investor.

Mölk: You need a holistic view on the product and all the necessary steps to service it properly. Does the fund plan to acquire loans or does is plan to perform loan origination? If we look at direct loan origination you need to consider many aspects. Who will be the legal counsel on the loan documentation, do you want to perform loan servicing in-house or delegate it to a third party, how do you want to value those loans for example at cost or fair value and finally does the AIFM provide sufficient knowledge expertise to handle all mentioned issues?

Merkel: Communication, planning and understanding the underlying is key. Processes like risk management, valuation, accounting and NAV calculation are interdependent; require a holistic approach and a deep dive already in the set-up phase. Most of the times we see these left aside until it's too late to change or renegotiate. Many topics like the right understanding of internal risk systems and abilities, valuation methodology, liability, information rights and flows should not be taken for granted for a simple reason: this asset class is not standardised and historically has not been the core competence of asset management, but rather of banking teams.

Dreiseidler: How do you think direct lending will develop further? What might private debt 2.0 look like?

Aldinger: Private debt will continue its growth as an attractive asset class for institutional investors. Even if the current low-yield environment will slowly come to an end at differing speeds depending on the geographic markets, private debt will continue to have its place as a non-correlated asset class in a diversified portfolio. With such increased market exposure and acceptance of the asset class, regulatory scrutiny may be expected to increase which will, at least at European

level, most likely result in some degree of regulatory convergence to limit the risk of regulatory arbitrage. Consequently, the structuring options and products will continue to evolve to reflect market demand and regulatory requirements.

Schmitz: Being a lawyer I am of course not at the forefront of new trends. From what I see I would assume that private debt will definitely get increasing attention from German institutional investors in the current low interest rate environment. While the big players are already moving on to new occasions many of the medium-sized insurance companies and pension funds will follow. One of the main challenges will therefore be to find sufficient opportunities for the new money flowing in. Moreover, the European Commission has a very close look at private lending outside the banking sector since in its view this "shadow banking" leads to significant risk potential for the financial markets. I would therefore expect that the level of regulation will continue to increase and create an environment in which only specialised players can survive.

Merkel: Firstly, Debt 2.0 will become more mature and robust in terms of loan administration and internal risk modelling – more standardized – however with a strong focus on specialisation and niche markets as debt plays a significant role in the diversification of existing portfolios. We see positive support through the capital markets union initiative in the EU, but the shadow banking connotation still exists. Therefore the pertinent focus of European Securities and Markets Authority (ESMA) in 2019 and beyond remains to strengthen liquidity stress testing. Secondly, automation and digitalisation is also reaching this asset class for more efficiency, robustness and transparence. And third point: I would put a question mark on pricing and expected return, given the current market heat and increasing interest rates that we expect in the future.

Mölk: I fully agree that the private debt market will become more mature and specialised. But from my point of view the regulator will not put any hurdles in front of the market participants concerning unleveraged loan funds. As the contingency is not as severe as there is only equity involved in those investments. Therefore I am also convinced that the volumes will go up in the European market; not only on the investor side, but also on the asset side.

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Adrian Aldinger is a Partner in the Private Equity & Real Estate practice of Arendt & Medernach where he advises fund sponsors on all legal and regulatory aspects related to the structuring, formation, marketing and ongoing operation of alternative investment funds with a particular focus on real estate, private equity, debt and venture capital funds. He studied law in Erlangen and Berlin and holds the German first (2007) and second (2009) state exam in law. He is admitted to the bars of Berlin (Germany) and Luxembourg. He is founding member and vice chairman of the German-Luxembourg Lawyers' Association.

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Rolf Dreiseidler is Managing Partner at POLARIS, which he joined in 2017. Prior, he was Managing Director and Head of Institutional Clients Germany at Man Group Plc. Before joining Man Investments in July 2007, he acted as Head of Funds of Hedge Funds with Deka Investment GmbH. Previously, he was appointed head of agency office at Bundesverband Alternative Investments e.V. (BAI). Rolf started his career as a capital markets consultant with Accenture GmbH, Duesseldorf. He holds a master degree in economics from the University of Bonn. He is a CFA and CAIA charterholder and lecturer at EBS Executive Education of the EBS University for economy and law since 2004. He has also been serving as Co-Chairman of the German Alternative Investments Association (BAI) since 2010.

Valeria Merkel
Partner, Asset Management, KPMG Luxembourg
Valeria Merkel is an audit partner with more than 14 years' experience in the fund industry. As a *Réviseur d'Entreprises* agréé and a Certified Chartered Accountant (ACCA), Valeria brings highly regarded expertise in serving clients in the cross-border fund sector including both regulated and unregulated alternative investment vehicles. In addition to UCITS, her focus lies in private equity, real estate, infrastructure, and debt. Valeria is an active member of several ALFI working groups, as well as the Promotion Committee of the Luxembourg Private Equity & Venture Capital Association (LPEA). She furthermore leads KPMG Luxembourg's Alternative Investment Visibility Team.

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Being responsible for Portfolio Management Real Assets at LRI Group, Ulfar Mölk oversees all delegated mandates and real asset transactions having extensive knowledge in fund structuring. He previously worked in Risk Management for Deutsche Asset Management as well as Fund Analyst for Nordea Asset Management. He holds a degree in Economics from the University of Mannheim and is a Chartered Alternative Investment Analyst (CAIA) and certified Financial Risk Manager (FRM).

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Heike Andrea Schmitz focuses on advising companies of the insurance and finance sector on all corporate matters as well as the investment of assets of insurance companies and on fund law. She advises national and international institutional clients on investments under Solvency I and Solvency II, fund structuring and fund law as well as on M&A transactions, run-off/legacy business and group restructuring. Based on her long-standing experience in the group legal department of a large European insurance group she provides an inside perspective on topics relevant for the insurance sector and is very experienced in working with experts from other disciplines like asset management, accounting and tax.