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PRIVATE MARKET ASSETS: THE NEW FUNDING STREAM THAT'S HERE TO STAY

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

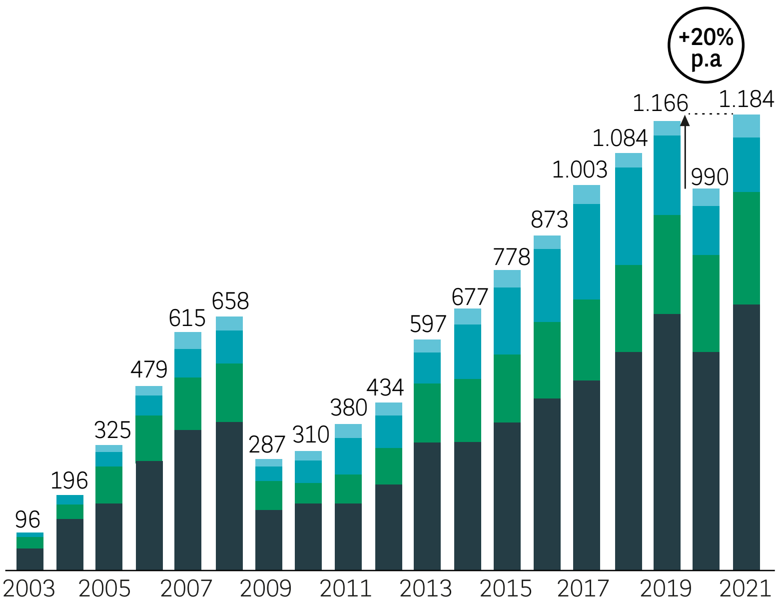
PRIVATE MARKET ASSETS: THE NEW FUNDING STREAM THAT'S HERE TO STAY

Private market assets have transformed the investment landscape in the 14 years since the global financial crisis.

Latest figures show that there is now almost $10tn[1] invested in private markets, in what is becoming a global and ever more diverse asset class.

This is a market that has grown steadily for more than a decade. And after a brief, pandemic-induced lull in 2020, that momentum looks set to continue. The latest market data suggests that investor demand for private market investments accelerated again in 2021, with fundraising up nearly 20% year on year and more than $3.5tn deployed across the full spectrum of private market asset classes[2].

Private markets rally to new heights
Chart A: Private markets fundraising by region, $billion



	2016-21 CAGR,%	2020-21 growth,%
Total	6.3	19.7
Rest of world	10.7	29.7
Asia	-5.6	13.1
Europe	8.1	16.9
North America	9.2	21.6

Source: McKinsey private markets annual review 2022 (Prequin data).
Excludes secondaries, fund of funds and co-investment vehicles to avoid double counting of capital fundraised.

Within this broader asset class, private debt has proved to be particularly resilient, regardless of the underlying economic circumstances. It is the only private markets asset class to have increased fundraising every year since 2011, including during the pandemic. The size of the private debt market has now topped $1tn, with fundraising across different strategies totalling $192bn in 2021 – a 10.4% increase on the previous year, and almost five times the amount raised a decade ago.

1 Source: McKinsey & Co - total AUM across private markets reached an all-time high of $9.8tn as of June 30 2021 – up from $7.4tn the year before

2 Source: McKinsey & Co. Chart A ; McKinsey private markets annual review 2022

Part of the reason for this resilience is that private debt covers a diverse and varied range of different investment strategies. This includes loans to corporates, SMEs and other organisations as well as infrastructure and corporate real estate debt. This diversity has enabled different private debt strategies to deliver across varying economic conditions, for example infrastructure and corporate real estate debt have historically performed well in rising inflationary environments. Recent studies show that it is this dramatic expansion in direct lending strategies which has accounted for 73% of fundraising growth over the past decade.

These figures suggest that the growth seen over the past year is not simply a case of these markets playing catch-up after lockdowns and a Covid-affected slowdown in economic activity. There are clear indications that demand for private market investments, and private debt in particular, is growing in response to changing economic circumstances. Increased inflation, higher interest rates, and the need to deliver on more sustainable investment requirements that meet more strenuous environmental, social and governance (ESG) or net-zero targets all play to private debt's strengths.

So it's no surprise the pool of potential investors is both broadening and deepening. McKinsey figures show that the threefold growth in fundraising over the past decade has been powered by more institutional investors participating in this market, with many existing investors also increasing their target allocations.

Its figures also show that while private market deal activity surged in 2021, the average deal multiples did not. This is supported by PWC research, showing a 34% uplift in deal activity across Europe and EMEA regions.

Smaller deal multiples indicate that a wider pool of institutional investors are now also looking to access some of the benefits and illiquidity premia that these private market investments offer – be it the enhanced yields, stable income or reduced volatility across market cycles.

To date much of the demand for private market solutions, particularly in the private debt space, has come from larger institutional investors and big defined benefit pension schemes. But a wider range of more specialist investment solutions has led to increased demand from smaller institutional investors and other segments of the market. Defined contributions pension schemes, wholesale wealth aggregators and more specialist distributors now have private markets on their radars.

These factors all indicate that this relatively new asset class – which only really started to gain ground in the wake of one particular financial crisis – is in a strong position to continue to provide effective solutions for a wider range of institutional investors under very different economic conditions.

The Great Financial Crisis highlighted the limits of valuing long-term holdings every day and brought awareness about the 'price of liquidity' concept. It also demonstrated to borrowers that being subject to a refinancing risk could jeopardise their existence.

Private debt helps provide an answer to both sides of the equation. On the one hand, it helps borrowers secure funding on different terms, and on the other it enables investors to monetise a premium, in particular for giving up liquidity. It consequently opens the door to product innovation, increased portfolio diversification for investors, while providing an additional source of funding for borrowers.

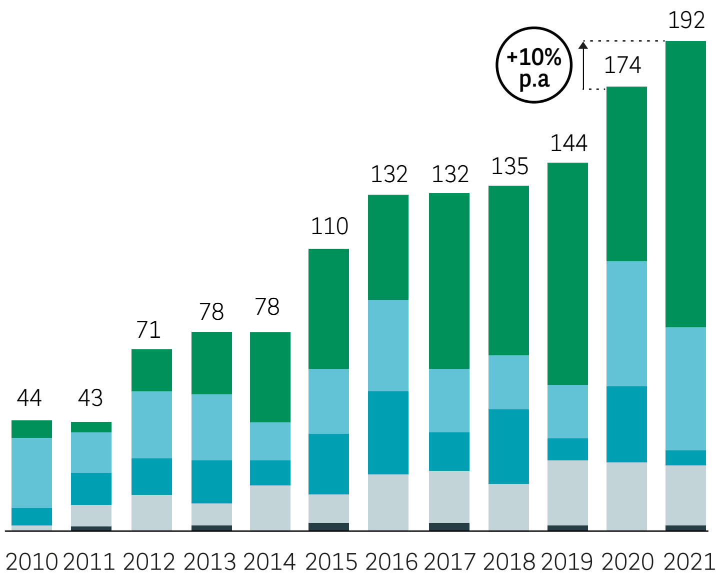
In this paper, we take a more in-depth look at the drivers behind this extraordinary growth. We'll also examine the range of investments available, with a particular focus on how the private debt sector is enabling a broader base of institutional clients to meet the investment challenges of a new decade.

PRIVATE DEBT: A DIVERSE ASSET CLASS

Private markets cover a broad spectrum of investment options, including private equity, private debt, infrastructure and real estate, as well as new additions, such as forestry and timber that have particularly attractive ESG credentials.

Of these, private debt has been the most consistent performer over the past decade, increasing fundraising every year since 2011. This is partly due to the diversity of investment strategies and sub-strategies that can be deployed across the economic cycle.

Private debt fundraising continues to climb
Chart B: Global private debt fundraising by sub-strategy, $billion



	2016-21 CAGR,%	2020-21 growth,%
Total	20	10.5
Direct lending	22.6	-16.6
Distressed debt	2.2	-16.6
Mezzanine	-16.8	-56.4
Special situations	3.0	-7.3
Venture debt	4.1	40.3

Source: McKinsey private markets annual review 2022 (Prequin data).
Excludes secondaries, fund of funds and co-investment vehicles to avoid double counting of capital fundraised.

Diversity benefits begin with the range of underlying asset classes within private debt, which includes lending to corporates, SMEs and other organisations, infrastructure and commercial real estate debt and structured finance. Within each of these asset classes, further diversification comes in the form of geographical and currency exposures, alongside options on the capital spectrum, be that regarding duration, fixed- or floating-rate options, or debt seniority.

Institutional investors increasingly have the option of investing in cross-asset products that cover a broad spectrum of the private debt universe.

A DECADE OF GROWTH

What's behind private debt's sustained growth over the past decade? It all started with regulatory changes introduced after the global financial crisis that imposed new capital requirements on banks. This led to a withdrawal of funding, which particularly affected smaller- and medium-sized businesses and sub-investment grade credit opportunities. Direct lenders and private debt managers, which are not subject to these capital requirements, then moved into this void to service these funding requirements.

For investors who can afford to lock their money away for longer periods of time, private debt has been trumping traditional fixed-rate income and government bond yields ever since. To date, this higher yield has not come with any significantly higher corresponding losses in terms of default. When interest rates fell to historical lows, this attractive risk-return profile became even more so. For institutional pension schemes in particular, looking to match long-term liabilities with secure income streams, it has become a key building block in an allocation strategy that rotates private debt with other fixed income assets.

This is a situation that hasn't merely benefited investors and lenders. Many businesses looking to access this funding have shown a preference for the speed and convenience – and sometimes preferential terms – that direct lending can provide, compared with traditional bank finance. Figures indicate that growth has been particularly strong among middle-market companies, held by private equity sponsors.

These factors have led to a seismic shift in structural lending over the past decade. Whereas banks accounted for almost 70% of sponsored middle-market financing in 2013[3], they accounted for just 11% in 2021; direct lending made up the shortfall.

3 McKinsey & Co. Chart B McKinsey private markets annual review 2022

PRIVATE DEBT MARKETS: EVER MORE SOPHISTICATED

As the market has grown and developed, more private debt managers have become involved, often seeking to differentiate themselves through increased scale and capital flexibility. Many 'mega-funds' have hit the market as a result. At the other end of the spectrum, some private debt managers have sought to offer more bespoke investment solutions, tailored to the individual needs of clients.

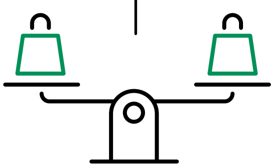
This diversity of strategies has underpinned broader private debt growth and enabled the asset class to offer a variety of solutions for clients as underlying economic conditions shift.

Although private debt investors rotated to more growth-oriented strategies in 2021, there was also strong support for distressed fundraising, which maintained near-historic highs. These figures demonstrate how the diversity of strategies available within private debt can meet the needs of a broadening investor base with very different investment needs and targets.

In 2022, economic conditions appear to be shifting again. Sustained inflationary pressures have stoked uncertainty – and therefore volatility – in listed equities and fixed income markets.

But the range of sub-strategies within the private credit universe can help support institutional investors during a period of economic uncertainty. The threat of higher and more prolonged inflation will likely lead to increasing demand for floating note options, as opposed to fixed-rate strategies. However, the appetite for higher-risk mezzanine debt may decline if recessionary fears start to materialise in some regions.

With such a breadth of private debt investments available, however, institutional investors will always be able to find a bespoke solution that suits their risk-return profile and the economic conditions.



Finding the right balance between what is sustainable for a borrower and what is acceptable for investors becomes a central point for asset managers.

Innovation is at work here, as private debt contracts can be adapted to mitigate risks to the ultimate benefit of investors (adding tailor-made covenants) or even to support impact financing (linking interest levels to ESG targets)

BUILDING MORE SUSTAINABLE PORTFOLIOS

The other fundamental change that will inevitably support the future growth of private debt markets is the global shift towards a low-carbon economy.

Three key factors underpin this.

First, there is a clear need to build infrastructure to support a greener economy, be it offshore wind, tidal wave or other renewable energy generation, higher-speed rail links or faster broadband solutions. Building this infrastructure will require private finance, alongside public subsidy, much of which is likely to be supplied by direct lending, rather than traditional bank finance.

Second, there has been a raft of new regulations introduced across many developed markets. These require pension companies, insurers, asset managers and institutional investors to identify key ESG risks and support and promote more sustainable investment themes, be they energy transition, impact investing or net-zero goals. These institutional investors need to find sustainable investment opportunities that continue to hit their financial targets. Private debt funding in the low-carbon economy could deliver on both sides of this equation. Many industry experts predict that there will be more regulation on these issues in the near future, potentially extending to cover issues such as biodiversity and social impact, alongside climate change.

Finally, we have clients' increased demand for better oversight of ESG risks across their portfolios, plus a clear demand from end investors for more sustainable investment options. The so-called 'Greta Thunberg effect', bolstered by increased scrutiny from a number of pressure groups, has led to many institutional investors wanting to offer greener options. To win new mandates, institutional investors need to demonstrate they are actively tackling climate change, and taking their stewardship and corporate and social responsibility requirements seriously.

Currently, there is far more scrutiny of ESG risks within the listed equities and fixed income markets. The progress made within private markets, including private debt, has not been as widespread as across the broader industry – but as this starts to change, private debt investments will become a more attractive option within asset allocation strategies.

Part of the challenge of monitoring ESG within private debt derives from what is appealing about the underlying assets themselves – their idiosyncrasy. This makes it difficult to apply a standardised process across different strategies and products. Assessing the ESG risks inherent in infrastructure assets or commercial real estate assets, for example, will be a very different process to assessing the potential ESG factors from lending to smaller or medium-sized tech businesses.

There is, therefore, a need for customised ESG processes to accommodate the spectrum of private credit and real assets.

At BNP Paribas Asset Management (BNPP AM), we have always had a strong sustainability focus. We've built effective and comprehensive ESG frameworks and continue to develop and improve proprietary tools to assure investors that all relevant ESG risks are being properly assessed and managed.

We believe the move towards more sustainable investment and greater oversight on a range of ESG factors is likely to be one of the driving forces that will shape investment markets in the decades ahead. This will apply not only to listed investments but to a whole range of private market investments.

Providers that lead the way on developing effective frameworks to monitor and manage these risks are likely to win business from competitors and deliver better long-term performance for clients and investors alike. This is a dynamic and developing area. As new risks are identified, requiring more in-depth analysis of many material ESG factors, the frameworks for monitoring them must evolve.

PUTTING SUSTAINABILITY INTO PRACTICE

Identifying and managing ESG risks has become an increasingly important part of the wider investment process.

At BNPP AM we have developed a framework to help identify the key risks associated with the different private debt sub-strategies, and promote more transparent ESG practices across this industry. This helps clients build more sustainable portfolios that can deliver on both their financial targets and ESG goals.

Our clients can have complete confidence that all potential risks to the value of a project are being assessed and that more sustainable growth opportunities are prioritised.
Our objective is to assess the ESG performance and climate impact of the range of investments available to us and to select only the best-performing projects.

Chart C: Framework for ESG Analysis

ESG CRITERIA TAILORED TO THE NEEDS OF EACH STRATEGY

CORPORATE LOANS

- ESG process combining quantitative and qualitative assessment
- Questionnaire and issuer level analysis

REAL ASSETS

- Full ESG integration
- Third Party validation (Iceberg Data Lab)
- NEC[1] Reporting

STRUCTURED FINANCE

- Flagging, identifying and promoting ESG transparency security level
- Issuer level analysis
- Sustainability Transparency Report

Source: BNP Paribas AM, April 2022.

1 Net Environmental Contribution.

SUMMARY

Private markets and private debt investments look set to play an increasingly important role within institutional investors' asset allocation strategies over the coming years. This is supported by a push/pull dynamic. On the one side, businesses are ever keener to rely on more flexible and innovative lending streams; on the other, a wider range of investors are looking for more diverse investment options, especially those featuring attractive risk-return profiles.

The market has matured to a point where the range of investment solutions cater for every investor's individual requirements, regardless of target yield, to make portfolios more resilient through different economic cycles.

These fundamental market shifts are overlaid with an increasing awareness of the vital role asset management can play in the transition towards a lower-carbon economy. Limiting the extent of climate change is an imperative for the financial services sector as a whole, if it is to keep the financial risks that come with it to a minimum. Growing awareness of this stark fact is sure to make private markets ever more attractive to investors in the coming years.

Although private debt is a relatively new asset class, it is one that is likely to be an increasingly significant part of institutional portfolios over the next few years.

Investors are becoming more and more sophisticated and want strategies that help them meet a range of different financial and ESG goals. The challenge going forward will be for investors to source the optimal opportunities that satisfy these investment and ESG objectives. This will require effective partnerships with asset managers with deep networks and a strong understanding of their local environments and regions.

This is not just an asset class that is here to stay; it is an asset class that is continuing to adapt, develop and thrive in order to meet the full range of complex investment demands of today's market.

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INVESTORS' corner

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