WHAT DEBT FUND MANAGERS NEED TO KNOW ABOUT BACK-OFFICE OPERATIONS TO MANAGE COMPLEXITY AND STRENGTHEN COMPLIANCE

Opportunities Abound for Private Debt

In the past decade, the opportunities for private debt have grown significantly. When banks changed their lending criteria after the 2008 financial crisis, it created a lending vacuum that the alternative asset market has been able to neatly fill. Today, the majority of the funding for SMEs (small and medium-sized enterprises) in the US originates with the capital markets through debt or equity issuance.

Alternative lending not only addresses the needs of today's businesses, it also aligns with the needs of today's investors. With trends such as low interest rates, low growth, and economic uncertainty affecting performance for traditional investments, institutional investors have turned to debt funds as a means of diversifying their investments and minimizing risk.

With strong interest from both the business and investment communities, private debt is trending up. Globally, aggregate capital secured annually for debt funds has risen year over year since 2014. In 2017, this asset class saw $115 billion raised-the largest influx of capital to date[1]- and more than one-third of institutional investors (37%) had investments allocated to private debt.[2]

The future looks even brighter for debt fund managers. More than two-thirds of investors (68%) have a positive perception of private debt,[3] and 98% of institutional investors plan to increase or maintain their private debt allocations in the long term.[4]

For General Partners, the situation presents attractive opportunities, but it's not without its challenges; debt funds add a layer of complexity to an asset class that is already burdened with growing administrative requirements. To ensure success, managers need to examine their back-office expertise and processes to ensure that they're capable of supporting this complex and administration-heavy strategy.

This white paper examines some of the trends and considerations that debt fund managers need to be aware of as they prepare for the future.

1 Preqin, Quarterly Update: Private Debt, 2018.
2 Preqin, Private Capital in 2017: Key Findings from the 2017 Preqin Global Alternatives Reports, 2017.
3 Preqin, Global Private Debt Report, 2017.
4 Preqin, Quarterly Update: Private Debt, 2018.

Managing Administrative Complexity is Key

The popularity of debt funds and the range of options available are attracting a growing number of General Partners. But while the debt market is forging ahead, the administrative expertise may be lagging behind.

While many firms are expanding into debt funds or adding to their existing debt portfolios, not all of them have the back-office expertise they need to administer this complex strategy. As a result, debt fund managers are more likely to run into problems associated with back-office operations. According to the Alternative Investment Management Association (AIMA), 90% of private credit managers report that they are experiencing issues with their loan administration.5

As the debt market matures and competition increases, it encourages greater diversity, flexibility, and specialization in debt funds. This, in turn, is increasing the level of expertise and effort required to administer this dynamic fund type.

General Partners who need to manage funds of increasing complexity have two options: they can augment their investment in in-house talent and technologies, or they can outsource administration to a professional third party.

Faced with the choice, many firms are opting to outsource. As of year-end 2017, USD$8.42 trillion in alternative assets were managed by outsourced fund administrators, an increase of more than 10% compared to 2016. The trend was even more pronounced among private equity and debt assets, which saw an increase of 18.2% from the previous year, making it the asset class with the fastest growing adoption of this outsourcing option. At the end of 2017, assets under administration (AUA) for private equity and debt totaled USD$2.49 trillion.6

“90% of private credit managers report that they are experiencing issues with their loan administration.”

5 AIMA, Enhancing the Loan Administration Function: Marrying Capacity and Customisation, 2018.
6 eVestment, Industry Survey: Alternative Fund Administration, May 2018.

The Back Office Advantage

The trend toward outsourcing fund administration is on the rise across all fund strategies, fueled in part by rising investor expectations and administrative requirements.

But for debt funds specifically, the advantages of outsourcing are even greater. The latest research suggests that outsourcing the administration of this complex strategy can help General Partners scale up swiftly to embrace the opportunities, access senior level expertise, and maintain a competitive edge in an asset class that is becoming increasingly crowded with investment options.

Ability To Scale

Opportunities abound in debt, but to take advantage of them, General Partners must be able to keep pace. Fund managers have the expertise required to originate and allocate deals, but without the necessary expertise and capacity to service a labor-intensive debt fund, they can quickly run into difficulties.

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Outsourcing the administration of debt funds can take the pressure off the back office and enable firms to manage more loans without escalating costs or jeopardizing investor trust or lending agreements. The AIMA survey revealed that 75% of debt fund managers cite the “impact on the manager’s capacity to support new business” as the primary reason to outsource loan administration.

An outsourced solution can also be valuable in helping fund managers to branch into nontraditional loan types such as syndicated loans, convertible loans, revolvers/delayed draw instruments, and other complex debt structures. The ability to manage these types of loans was cited by 70% of private credit managers in the AIMA survey as the most valuable aspect of loan administration services.

Investor Trust

Debt is an alternative strategy that is both dynamic and fast-evolving, and fund managers must compete fiercely for capital and investment opportunities. While the manager's track record of delivering returns is the most important consideration for most investors, the ability to communicate fund information to investors clearly, promptly, and in detail is fast becoming a key factor in the decision to invest.

Between 2014 and 2015, there was a 400% increase in investors who ranked a firm's ability to handle reporting requirements as the most important selection criteria,7 and a 2017 EY survey found that 62% of private equity firms say that "improved investor reporting" has helped them increase their competitive edge in the market.8

The need for accurate, timely, and transparent reporting is especially acute among private debt investors, with a recent Preqin report revealing that more than one-third of debt-fund investors (37%) believe that their interests are not aligned with those of their fund managers. Transparency was also seen as an issue, with 45% of investors citing greater transparency at the fund level as a key area with the potential for improvement alignment.9

Partnering with a fund administrator enables General Partners to improve the reporting function significantly as well as to reassure investors by putting administrative oversight into the hands of an objective, professional third party.

"62% of private equity firms say that 'improved investor reporting' has helped them increase their competitive edge in the market."

7 EY & Private Equity International, Global Private Equity Fund and Investor Survey, 2016.
8 EY & Private Equity International: Global Private Equity Survey, 2017.
9 Preqin, Global Private Debt Report, 2016.

Leading Technology

The alternative asset class as a whole has begun focusing on technology as a means of automating transactional activities, using data more effectively, strengthening compliance, and providing more detailed, customized reporting.

For debt funds, the need for an investment in technology may be even more urgent because of their dynamic structure and additional complexity. Relying on legacy systems or manual processes can result in spiraling administrative costs for resource-intensive debt servicing.

Close to half of managers with debt funds (45%) cite the limitations of their existing technology to track loans as an operational challenge. In fact, technology is one of the top three most prevalent operational challenges for this fund type.10

However, the costs of implementing and maintaining market-leading technology can be unrealistic for a small firm or even a mid-sized firm. In these cases, partnering with the right outsourced fund administrator enables debt fund managers to benefit from an integrated system of accounting, administration, reporting, and debt management technologies without shouldering the costs and maintenance of an in-house solution.

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HAZIC FUND ADMINISTRATION

Do You Have the Right Technology?

While off-the-shelf technologies exist for standard debt instruments, they are usually not sufficient without extensive customization.

To support the administration of a debt fund adequately, look for:

- The ability to maintain loan amortization schedules and account for complex terms, including:
  – All interest day count conventions
  – Paid-in-kind (PIK) interest
  – Original issue discount (OID)
  – Term changes (including interest rates and PIK components)
  – Amortization of fee income
  – Variable interest rate loans with floating base rates
  – Revolvers/delayed draw instruments and unfunded commitments
  – Loan covenants and collateral requirements
- The ability to generate customized, comprehensive, and concise reporting
- An interactive dashboard
- Integration with an accounting system
- The ability to bulk-upload trades and other data
- Automated market data feed for floating base rate resets such as LIBOR rates
- The ability to prepare, customize, and distribute recurring portfolio company invoices (ideally, via a secure portal)

Access to Expertise

For experienced and new debt managers alike, access to high-quality fund administration expertise is often challenging. Assembling a back-office team with the right experience to service the complex and ever-changing needs of a debt fund is a tall order. That expertise should include accounting for nonstandard debt instruments, working with technology customized to meet the needs of debt funds, and understanding the unique reporting needs of debt funds.

Limited prior experience is one of the top operational challenges for the loan administration function, with 42% of debt fund managers reporting that they are impacted by this issue. Outsourcing fund administration enables General Partners to access the expertise they need to service debt funds, even those that are more complex. According to AIMA, "access to expertise" is the top reason private credit managers outsource loan administration; more than three-quarters (78%) choose to partner with a third-party administrator for this reason.

WHAT DO PRIVATE CREDIT MANAGERS OUTSOURCE?

70% outsource fund administration and accounting
48% outsource loan administration
30% outsource regulatory reporting 11

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SERVICE CONTINUITY

For investment firms in every strategy, back-office turnover can be one of the greatest threats to productivity and reputation - and a significant point of vulnerability. When someone leaves the firm, it can create chaos, especially because the most seasoned employees are the most likely to be lured away.

The issue is especially problematic for debt funds because loans must be continually monitored and serviced. Any break in continuity can have serious consequences. Loan terms need to be kept current so that calculations are correct, and covenants need to be monitored to ensure that the outsourcing fund administration eliminates the cost and disruption caused by internal turnover. By documenting key processes, sharing knowledge across a multi-person team, and using a central repository for current and historical fund administration data, a fund administrator retains institutional knowledge and ensures continuity throughout the lifespan of the fund.

LOAN ADMINISTRATION

Top 3 Operational Challenges for Managers with Debt Funds:

45% cite investor or regulator reporting

45% cite limitations of existing technology to track loans

42% cite limited prior experience in loan administration12

12 AIMA, Enhancing the Loan Administration Function: Marrying Capacity and Customisation, 2018.

DEBT FUND ADMINISTRATION ESSENTIALS

Every fund requires significant back-office servicing, including fund accounting, administration and compliance, capital management, financial reporting, and investor services.

Because of the ongoing monitoring required, the administration of debt funds comes with an extra layer of complexity and higher maintenance requirements.

Whether you choose to administer your debt fund in house or outsource the work to a third party, the monitoring process needs to include:

- Documenting loan covenants and monitoring them on a real-time basis
- Reviewing loan notices and organizing them for future reference
- Updating terms and calculations of debt instruments in the loan servicing application, including:
  – Changes in variable interest rates
  – Changes in terms (such as PIK/cash toggle)
  – Restructuring debt instruments
  – Converting debt instruments
- Reviewing loan amortization schedules monthly, including all calculations
- Preparing and distributing portfolio company invoices, as well as reconciling to cash received, and following up on outstanding amounts

HAZIC FUND ADMINISTRATION

Finding the Right Debt Fund Administrator

When choosing a fund administrator for your debt fund, look for a service partner that offers the certifications, processes, and core capabilities that will support your firm now and into the future. Remember, even if your current fund has a simpler structure, choosing a fund administrator with experience in more complex debt ensures that you have the ability to pursue any opportunity that presents itself in the future without having to switch service providers.

Look for these indicators of an experienced, well-resourced fund administrator:

- System and Organization Controls (SOC) 1, Type 2 certification
- A documented service-level agreement (SLA)
- Documented onboarding processes
- An integrated accounting, analytics, reporting, and loan servicing platform that can be customized to the needs of your debt fund
- Experience in debt funds and administering nonstandard debt instruments
- Experience processing a high volume of debt instruments
- Investor reporting processes that follow the Institutional Limited Partners Association (ILPA) guidelines
- An investor portal that provides 24/7 digital access to reports
- A CFO portal that provides access to fund data and analytics
- A documented disaster recovery and business continuity process

Questions to ask prospective partners:

For how many years have you administered debt funds?

How many debt fund clients has your firm serviced over the years?

Are any of those clients managing complex debt types?

Can I speak to two of your debt clients about their experience with your firm?

What types of technologies do you use to support the administration of debt instruments?

Are you able to provide customized financial reporting?
