
PERMANENT
CAPITAL SUMMIT
2018
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Contents

Foreword

The 4th Annual Permanent Capital Summit, sponsored by Dechert, ING, RSM and KBW/Stifel, brought fund sponsors and asset managers together in New York to consider the impact of a shifting financial and regulatory environment on the formation and investment of permanent capital.

Alternative asset advisers and the funds they advise have enjoyed a positive year, said Thomas J. Friedmann, co-chair of Dechert's Permanent Capital practice. The permanent capital market has matured rapidly – so rapidly, indeed, that asset management firms now view the asset class as a core element in a diversified product line.

Over the past year, a number of large alternative-asset management platforms entered the market for the first time, some by starting new funds, others by acquiring existing funds. Globally, private credit assets are already well beyond the US$600 billion mark, well on their way to reach a forecast US$1 trillion by 2020.

Yet while many signs point to continued growth in the broader non-bank lending community of public funds, private funds and CLO platforms, a number of questions remain. Could the flood of capital into direct lending funds create an asset bubble? Could permanent capital products become less competitive over time, either due to a heavy compliance burden or through the commercial banks' re-entry into the loans market?

These questions – and others – are what the Permanent Capital Summit was designed to address.

"The permanent capital market has matured rapidly."

Private Credit Market: 2018 & Beyond

Three industry leaders opened the Summit's first panel discussion with a dynamic examination of the private credit market's evolution. Growth in the sophistication of transactions and the number of new entrants pointed to the asset class's increased acceptance. Opportunities abound, suggested panelists, but challenges and risks continue to be prevalent. The outlook in Europe in particular appears uncertain.

Panelists warned that managers must be mindful of the regulatory environment that shapes each transaction. With investors deploying capital ever more quickly, a disciplined approach is vital in order to avoid suffering the kind of credit loss that could harm a business or brand. Understanding differences between investors, creating attainable goals for each client and choosing structures or products that deliver consistent returns in the long term are fundamental to success. It's important to remember, too, that people are at the core of every investment decision – culture always trumps strategy.

Now, as the end of a cycle approaches, the industry is bracing itself for consolidation. New winners are likely to emerge, while others may not survive. In an uncertain environment, agreed the panelists, it is even more important that managers keep their investment principles at front of mind. Ensuring that each and every transaction conforms to principle is the surest way of balancing risk and reward and helping drive long-term value for clients.

Michael Arougheti, Director, Co-Founder, CEO & President, Ares Management, L.P.
David Brackett, Managing Partner & Co-CEO, Antares Capital
David Golub, President, Golub Capital
John Timperio, Partner, Dechert LLP (moderator)

Financing Private Debt Strategies

Trevor Clark, Partner, Twin Brook Capital Partners
Patrick Frisch, CFA, Managing Director, ING Capital LLC
Manuel Henriquez, Founder, Chairman & CEO, Hercules Capital, Inc.
Arthur Penn, Founder, Chairman of the Board of Directors & CEO, PennantPark
Jay Alicandri, Partner, Dechert LLP (moderator)

Broadly, BDCs and other private debt vehicles continue to enjoy great variety in the types of capital available to them and, in many cases, increased flexibility in arranging terms.

Lenders continue to focus on the quality of a management team's experience and its track record in surviving long-term business cycles.

Much attention has been given to the effect of the recent change in law permitting a reduction in required minimum asset coverage. Panelists pointed out that many BDCs will still be subject to the more stringent standards under their credit facilities and bonds. Even qualifying BDCs will still need to win significant buy-in from financial institutions, bondholders, shareholders and rating agencies in order to take full advantage. Nevertheless, the reduced requirement will be helpful not only in the case of intentional leverage, but might also serve as a buffer for forced leverage in the event of a downturn.

Efficient leverage that provides flexibility and capacity to grow is critical to every BDC. Every layer of capital serves a specific purpose, so each must be chosen carefully in order to optimize the conversion of different asset types to leverage. And while investment decisions still focus primarily on asset quality, the issue of whether leverage can be obtained on an asset is also paramount.

Panelists warned of limitations in the use of sidecars and joint ventures – structures that have historically proven helpful as a way to boost investor returns rapidly, but whose usefulness may diminish in view of the reduced asset-coverage requirement.

Other macro trends continue to affect debt vehicles' leverage facilities. More assets are pressing up against existing covenants, and more private debt vehicles are making LTV investments and seeking to receive credit in their borrowing bases for such investments. And while excess capital has driven aggressive terms and created a borrower-friendly market, panelists underscored the need to take great care when reviewing asset quality.

"Show Me the Money" – Capital Raising Around the World

Opportunities to raise capital abound in the private credit market, despite increased competition. Globally, while European markets can appear worthwhile for investors, the panelists warned that Europe's comparatively lower exposure to leverage can see investors turn shy of unitranche products. And with a leveraged loan market just a quarter of the size of its U.S. equivalent, limited European capital can also present challenges.

In terms of credit strategy, demand remains strong across the entire yield spectrum. Institutional investors appear to be increasingly drawn to the senior part in capital structures, however, which is skewing demand towards first lien over mezzanine products. High investment in senior direct lending strategies has also been evident, compelling managers to be prudent in deploying capital and managing their dry powder.

The range of fund types on offer remains varied, although the growth of funds-of-one has sparked a shift in the market towards separately managed accounts over pooled investment vehicles. The growing popularity of private BDCs has also played a significant role.

Direct lenders are increasingly favoring blocker or treaty structures for their private funds in order to avoid ECI and UBTI, with less interest in "season and sell" structures. Panelists pointed out that BDCs/RICs have the "cleanest" of structures from a tax perspective, although the need to explain the structure's mechanics to non-U.S. investors remains a major hurdle. Closed-end funds can provide an effective substitute, the panel noted, particularly when the lower amount of permitted leverage is not an issue.

As for the future, a trend to watch is the influence of scale. While larger players can clearly exert more influence and source a wider range of opportunities for clients, scale can also help ensure survival in a downturn. In uncertain times, stability, rather than growth, may be the best pointer to long-term success.

"We can structure anything," said one panelist. "The question is: should we?"

Matthew Bloom, Senior Managing Director, Guggenheim Partners, LLC
Michael Boyle, Director & Portfolio Manager, Bain Capital Credit
Thomas Raterman, CFO, Runway Growth Credit Fund Inc.
Jon Waterman, National Asset Management Practice Leader, RSM US LLP
Richard Horowitz, Partner, Dechert LLP (moderator)

Seeking Alpha through Consolidation and Other Strategic Transactions

Among the many factors motivating consolidation and other strategic transactions, the desire to increase assets under management is a primary driver. In private credit, as in so many other business sectors, scale matters. Increased scale can give business development companies greater access to portfolio companies, facilitate diversification and smaller hold positions, and reduce expenses as a percentage of AUM. Capital, after all, is precious, and scale is important when it reduces relative costs. Scale may also enable BDCs to compete effectively in an increasingly challenging market.

Panelists expressed misgivings about the public nature of the auction process, a context far from ideal in terms of rewarding bidders. Indeed, a growing body of opinion calls into question the efficacy of a public auction process, which has driven an increase in transaction proposals communicated through unsolicited principal-to-principal calls and passive market checks.

Panelists agreed that ensuring a cultural fit between the entities to be combined in a strategic transaction is among the most important considerations — at least as important as making sure that the deal makes good commercial sense.

As to the future, the overall market cycle and relative pricing of credit assets remain important indicators for consolidation transactions. Any dislocation in the credit markets undoubtedly will create opportunities for more M&A activity. Recent legislation permitting BDCs to incur additional leverage upon receipt of certain approvals is likely to drive additional growth, helping to create wider opportunities for strategic transactions.

Richard Byrne, Chairman, CEO & President, BDCA and President, Benefit Street Partners
Michael Forman, Chairman & CEO, FS Investments
Vince Foster, Chairman & CEO, Main Street Capital Corporation
Al Laufenberg, Managing Director, KBW/Stifel
Thomas Friedmann, Partner, Dechert LLP (moderator)

The Sponsors

Dechert's multidisciplinary permanent capital team is actively engaged in advising asset managers in all aspects of their capital strategies. We act for 41 of the top 50 global private debt firms as identified by *Private Debt Investor* in 2017. Our lawyers possess a detailed understanding of the most current trends and developments, the latest regulatory hurdles, up-to-the-minute market terms and an insider's perspective when it comes to regulatory compliance. We are committed to turning our experience and expertise into value for our clients.

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Dechert LLP

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