WHITEPAPER

Private Credit: Strategies for Sustaining Success

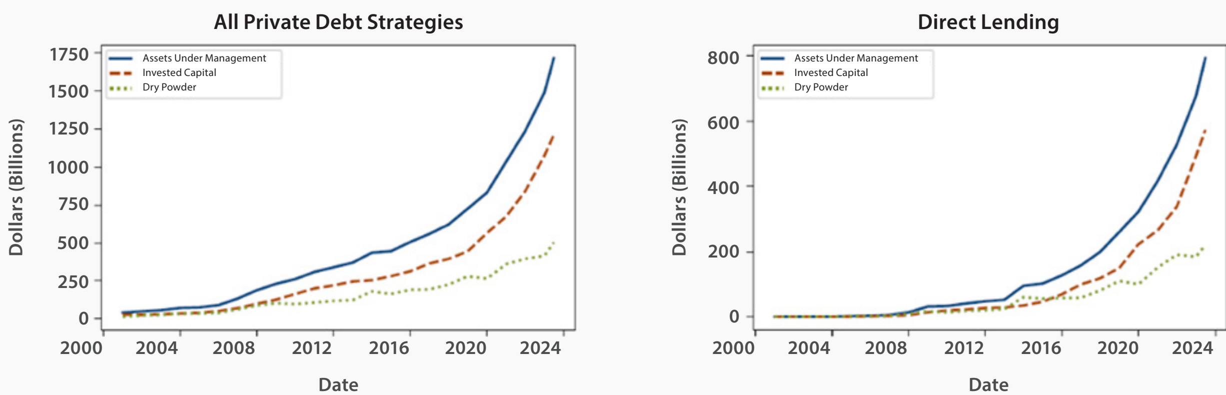
Scaling Your Business to Manage Growth

The rapid growth of private credit funds has led to a maturing, competitive market. For managers of private credit funds to continue to grow assets while managing operational and regulatory risk, it is important to achieve economies of scale and use technology to operationalize and automate critical functions in the loan origination and credit review processes. The ability of a fund manager to scale operations – without upping headcount – to meet investor service expectations can be an important differentiator for profitable lending and controlling management expenses.

This paper details certain key challenges private credit fund managers face in managing growing loan volumes and how intelligent technology can help managers mitigate operational risk while developing scalable processes that work across multiple loan types and varying market conditions.

The growing popularity of private credit as an alternative to traditional fixed income has attracted many new entrants into the private credit space, from newly-formed managers to established asset managers that have developed (or acquired) private credit expertise, to traditional banks that have begun offering private credit investments through an affiliated asset manager. The result is an increasingly crowded marketplace where multiple managers are competing for the same investor base and for the same universe of middle-market loans. In the face of increased demand, higher transaction volumes and strong competition, the challenge for fund managers is to scale their private credit business, increase processing capacity and optimize operational performance in order to compete effectively and grow profitably.

Growth in Private Debt Allocations



Note: 'Dry Powder' refers to committed, but not invested, capital. Invested capital is committed and invested capital (typically in the form of loans). Assets under management is the sum of invested capital and dry powder. Data as of June 2023. AUM data reported with a 6-month lag.

Source: www.federalreserve.gov/econres/notes/feds-notes/private-credit-characteristics-and-risks-20240223

How Do Fund Managers Keep Up?

Given the growing complexity that comes with increasing loan volume and heightened investor expectations around transparent reporting, private credit fund managers seek efficiencies where they can, including opportunities for technology to undergird automated, streamlined and scalable processes. Private credit managers are increasingly relying on technology to reengineer complex loan operational functions. For example:

- Optical character recognition (OCR) and natural language processing (NLP) technologies can digitize non-standard data, such as agent notices, loan documentation and borrower information, and convert them into standardized formats for more efficient, automated processing.
- Robotic process automation (RPA) and machine learning act as a sort of "digital worker." Software can be "trained" to take over a number of routine, labor-intensive processes. For private credit managers, RPA solutions can reconcile cash flows, analyze creditworthiness of prospective borrowers, and generate invoices or track payments.
- Digitizing the loan application process can allow single entry and efficient processing of loan, borrower and collateral data. Automating the application process can reduce the review and approval time-frame and better manage errors or other human-originated risks.
- Document management systems can help firms comply with regulatory requirements by managing the records and related data generated in the loan process.

The private lending lifecycle has various stages that can benefit from the use of technology to help manage increasing operational complexity.

Origination: A principal function of a private credit manager is to identify and pursue lending opportunities that are aligned with the investment philosophy of a given fund. Once an appropriate lending candidate has been identified, the private credit manager then must work closely with the borrower from due diligence and credit review processes through closing. Using manual-intensive processes such as spreadsheets to track and advance in-process loans will become unsustainable as the private credit manager increases the number of loans it is simultaneously working towards closing. Software solutions are available to help manage deal pipelines, show managers at a glance where deals stand in the pre-closing stage, and package origination data for review and approval within a manager's corporate governance and management infrastructures.

Private credit managers often have separate, single-purpose systems that support the different loan management workflows – origination, loan accounting, investor servicing and collateral monitoring. This reduces efficiency and impedes the ability to scale, as data must be transposed from one system to another, either manually or through complex integrations. The optimal scenario is a centralized solution that consolidates all these functions in a single platform, which accelerates loan processing and ensures data consistency across all workflows.

Loan applications: Competition among private credit managers has increased, resulting in multiple managers pursuing the same limited universe of quality lending targets. One way managers can differentiate themselves is the efficiency with which they process loan applications. Paper-based processes are slow and inefficient, and can result in human-based errors and inaccuracies. Automating the loan application process can result in faster, more seamless processes that reduce the risks of errors and delays. An intelligent loan application platform can perform "completeness checks" to confirm that all required documents and information have been provided, and can prompt lenders and borrowers when additional information or documents are needed. This is not to say that paper will be eliminated completely, but technology such as optical character recognition (OCR) can transform unstructured data in loan applications into digital formats to allow for automated processing. When combined with machine learning powered by a large language model, an OCR-based solution will learn to recognize formats over time and further speed up application processing.

Loan Administration Overview

Single integrated platform that supports the entire loan lifecycle

Origination

- a. Application
- b. Credit Review
- c. Credit Committee Memo
- d. Commitment
- e. Broker Performance
- f. Pipeline Tracking

Primary or Master Servicing

- a. Closing
- b. Loan Notices
- c. Tax & Insurance Escrows
- d. Payment Processing
- e. Remittances
- f. Payoff Statements

Asset Management RE Focused

- a. Appraisals
- b. Operating Statements
- c. Rent Rolls
- d. Covenant Tracking
- e. Construction Budgets
- f. Google Mapping

Accounting

- a. Chart of Accounts
- b. Policy
- c. Valuations
- d. Free Amortizations
- e. Multi-Currency
- f. Multi-Basis

Credit review: The credit review process is another area that would benefit from automated processes to ensure that the data analyzed by the manager is current, accurate, and complete. In private credit loans, the borrower collateral used to secure the loan is critical, and the ability to accurately identify and value the collateral is a key component of the credit review process. A centralized loan management platform should have the ability to incorporate external information, such as borrower operating statements or collateral appraisal values, in order to calculate debt service coverage and loan-to-value (LTV) ratios, the key metrics that indicate there is sufficient cash flow to make payments and that the collateral exceeds the loan value.

RPA can be used to perform key functions in the review process, such as data collection and analysis, reducing the amount of "human time" devoted to data collection efforts so that managers' investment staff can devote more time to consideration of credit risks generally.

Documentation of terms and conditions: Technology is often used to help manage the sheer volume of documentation that accompanies higher-volume private credit lending operations where conventional systems are unable to do so. With intelligent automation, digital workers can review and check documentation for accuracy and compliance with disclosure and regulatory requirements, while ensuring that borrowers are complying with principal and interest payment terms and uses of loan proceeds. RPA software can also validate property insurance by reading emails and attachments from insurers and comparing their information against the loan agreements to make sure the borrower is complying with insurance requirements.

Loan servicing: This is another area where an intelligent automation solution can automatically invoice borrowers, collect payments and allocate them accurately to the private credit fund. A centralized loan management system should have the ability to track loan drawdowns as well as changes in interest rates (for variable rate loans) over the life of each credit agreement. The latter calls for an interface with market data sources to update the index rate on which the loan is based – typically the secured overnight financing rate or SOFR – and automatically calculate the new interest rate.

Valuations: Fund managers are obligated to value loans that are held as investments, and private credit loans are typically illiquid and do not trade, which means that the manager is responsible for fair valuing the assets and revising those valuations as credit quality changes with the borrower. A central loan management system should be able to import

borrower income statements and use them to test scenarios that show managers when contractual covenants are at risk of being breached, payments may be missed, or the borrower will likely seek to restructure the loan. These "early warning" signals can and do affect the valuation that is ascribed to a particular loan. In addition, for loans that are collateralized, the value of the underlying collateral also changes, and managers need to monitor the value of the collateral and consider whether additional collateral is needed to the terms of the loan need to be adjusted. A core loan management system with integrated collateral monitoring functionality can help managers track appraisals over time.

Renegotiations and workouts: When borrowers fall into distress or special situations, fund managers need a pre-determined workout strategy for renegotiating loan terms. Predictive analytics can leverage cash flow projections, combined with marketplace trends, to flag loans that may face future distress, and present various workout solutions that reflect both the loan terms and borrower circumstances. A loan management system can simplify and automate the packaging of loans for sale to funds specializing in distressed debt.

Fund accounting and administration: When loans are pooled into investment funds, particular attention is required in the areas of fund accounting and administration. Compared to other private asset classes, private credit poses unique accounting challenges. For example, each loan in a fund may have its own, individually negotiated terms and conditions, leading to a high degree of complexity. Cash flows over the life of a loan can be unpredictable, with late payments and delinquencies. Funds investing in multiple jurisdictions, or that have taxable and non-taxable investors, face added complexity in complying with the tax and accounting standards of each jurisdiction. Fee structures tend to be non-standardized. Fund managers need a fund accounting platform with the flexibility to address such nuances and deliver accurate reporting to investors. That is why many managers choose to outsource the fund administration and accounting function to a third-party administrator.

When to Consider Outsourcing

The question of whether and when to outsource is often "buy vs. build". Outsourcing technology and some or all middle- and back-office activity can allow fund managers to gain greater agility and efficiency while reducing their operational overhead and risks.

Managers can choose which services make sense to outsource and which ones the manager may wish to keep in-house. This decision will depend on the manager's staff capabilities, expertise and bandwidth, as well as the firm's existing technological infrastructure and lending activities.

To determine whether and what to outsource, start by examining your current operations. Identify routine but necessary tasks that are taking an inordinate amount of staff time. Those are candidates for outsourcing. Think too about the types of skills and expertise you need on staff versus those best left to external specialists. Outsourcing operations allows you to focus your internal resources on fundraising, deal sourcing, credit analysis and other activities that truly drive revenue and value. Your in-house operations team can then assume a more supervisory role, reviewing and approving work rather than performing it.

On the technology front, does it make sense to invest in a modern, scalable infrastructure and the IT expertise necessary to maintain it and keep it up to date? Do you have floor space for the hardware required? Do you have people who are working remotely most or much of the time? It may make more sense to house your core origination, accounting and servicing platform in the cloud, serviced and supported by a technology provider.

The goal is to scale your operations to accommodate growing loan volume and complexity while delivering on investor demands and expectations, not only for performance, but also for operational integrity, transparency and service quality. That may be easier to achieve through a strategic partnership that complements your strengths as a fund manager.

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