ESG and secondaries to drive the next phase of growth

New opportunities are emerging as private debt embraces innovative financing solutions, says Cécile Mayer-Lévi, Head of Private Debt at Tikehau Capital.

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Looking back over the past decade in private debt, how would you describe the evolution of the asset class?

'Over the last ten years, private debt has gone from what was once called shadow banking to becoming a mainstream alternatives asset class that is very much in the spotlight. It was originally mainly targeting companies that had difficulties in accessing bank credit and is now providing innovative financing solutions far more broadly to a wide range of high-performing borrowers. With this transition has come much more competition, but it is better to be part of a fast-growing strong market than to be alone in a non-existent market. Private credit has become increasingly standardised, so we are principally backing private equity sponsors who will now always have us as part of their decision-making process when they look at deals. And it has become global – what started out as a US solution is now standard practice worldwide.

Another significant evolution is the way in which we fundraise, which remains highly focused on large institutions like pension funds and insurance companies. Now, private debt globally has started to be extremely successful in reaching out directly to retail investors, where one of our key merits is our ability to offer regular cash yield. That has proved very attractive to private investors and is in contrast to pure private equity, where the expected return could be much higher, but that regular yield is not there.'

How has your organisation's business changed over the last ten years as a result?

'The size and scale of our business has certainly grown alongside the market, allowing us to do a wide range of financing all over Europe. Our business was focused on France originally, but now it is in Benelux, Italy, Spain, the UK, Germany and, to an extent, the Nordic region. What has been really key for us has been growing up with the markets and remaining very local country-by-country, with expert local people on the ground in each of those jurisdictions.

In the past decade we have been through many situations, working with nearly 80 different private equity sponsors, and those relationships have built up nicely over time. Some of those relationships are like old couples now: when they work well, private equity and private credit like to stick together and we are therefore doing a lot of repeat business with many sponsors. We also do more and more deals as the incumbent lender, working with portfolio companies on a long-term basis and staying with them as they move from one sponsor's ownership to another. Our business has certainly changed in terms of the strategies we have

'ESG has also proved to be a great way to engage with companies.'

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been growing over the past decade. We are doing far more bespoke transactions where there might be an element of equity co-investment, payment-in-kind and preferred equity, along with unitranche lending. More people now come to us earlier in their processes and there is a willingness to engage and create solutions that meet individual requirements.

Finally, in 2020 we introduced ESG ratchets into the transactions we structure, thus encouraging borrowers to improve their ESG performance. This has been a big change to how we do business.'

What differences are there between the European and US private debt secondaries markets?
'Actually, the secondaries market is a truly global market. The US is always more advanced in terms of the number of opportunities though, in part because of the number of intermediaries that are there. We have chosen to base our secondaries team out of New York because the market is a bit broader, but it is a very global market such that if you are operating in the US that does not mean you can't take care of European or Asian investors.

Usually the portfolios are very international because the investors have been looking for diversification themselves and tend to have a mix of geographies in there. So we have done deals for Italian investors because we know them, and we can help them lower their exposures whether the content of their portfolio is predominantly US or European.'

ESG has moved much higher up the agenda for private debt funds. What have been the key drivers of that shift, and what do you consider to be the most significant market developments there?
'Clearly the global market environment was a key driver, fuelled by LP demands and the regulatory focus, where the SFDR framework has been a real accelerator. ESG has also proved to be a great way to engage with companies, initially as a means to differentiate ourselves and be innovative, and now as part of a systematic engagement with all stakeholders on the topic. This is something that matters to employees, management teams, investors, the regulators and our team members, so it is really important for us to be involved.'

How is Tikehau Capital now incorporating ESG into its private debt funds?
'The ESG ratchets that we helped pioneer in Europe are now really systemic, to the point where globally we now have half of our transactions featuring sustainability-linked loans and they are incorporated into 100% of our new loans. The key change is that those have now become market practice, and our organisation has been at the heart of driving that. We had a lot of interactions with trade organisations to make sure those became market standard, because to make those happen there needed to be a degree of market standardisation.

Sustainability-linked loans really move all of this forward, because it is about a lot more than companies just reporting on their ESG criteria. With ESG ratchets, there are agreed KPIs that companies really need to measure, track and improve on, which has driven a major change in the way in which we engage with companies.

More recently, we moved one step ahead and we committed to setting a net zero pathway for all new private debt funds. Each fund's decarbonisation objectives have been designed to meet the annual reduction required to reduce greenhouse gas emissions by 50% by 2030. This is consistent with the net zero pathway, and with a 1.5°C aligned carbon budget. The key to success in this implementation will be the quality of our engagement approach through ESG ratchets.'

What do you think we will see private credit managers focusing on over the next decade to push forward on ESG?
'Looking forward we expect esg ratchets to become more routine, so that perhaps in five years' time we won't need to ask questions about the potential for an ESG ratchet and will instead be able to really engage having already identified the key KPIs and criteria. There will inevitably be more stranded assets as a result, because those borrowers that are second class from an ESG perspective will increasingly struggle to find finance.' ■

> 'The ESG ratchets that we helped pioneer in Europe are now really systemic.'

Want to know more?
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SUMMARY

Over the last 10 years, private debt has gone from what was once called shadow banking to becoming a mainstream alternatives asset class that is very much in the spotlight.

It was originally mainly targeting companies that had difficulties in accessing bank credit and is now providing innovative financing solutions far more broadly to a wide range of high-performing borrowers.

With this transition has come much more competition, but it is better to be part of a fast-growing strong market than to be alone in a non-existent market.

With ESG ratchets, there are agreed KPIs that companies really need to measure, track and improve on.

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