

the hedge fund journal

Prestige Funds

Private debt and the financing of the new economy

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The Prestige group of companies is a specialist private debt fund manager, established more than 14 years ago with the objective of providing investors with access to the growing market in SME financing in the UK. At the time of Prestige's foundation, not long before the Great Financial Crisis, the landscape of the UK's business banking landscape was beginning to be reshaped.

The 2008-09 financial crisis caused many banks to step away from or considerably downsize their small business lending operations, largely due to new regulatory demands and capital adequacy requirements. This also resulted in the closure of many UK high street bank branches. It created a situation where the UK small business economy became underbanked. We have also seen this happen in many other developed countries since. Yet in the UK alone, SMEs account for 99.9% of the business population¹. It is an important part of the overall economy that it can be hard to gain exposure to as an investor.

The number of private sector businesses in the UK has increased steadily since 2000, from 3.5m 20 years ago to approximately 6m today. Of these, over 40,000 employ more than 50 people. SMEs remain the critical part of the UK economy. Yet they are underserved by commercial banks.¹

The growth of the private debt market

Prestige group operates in the fast-growing private debt market, once considered a sub-set of either hedge funds or private equity, but now almost fully emerged as a separately recognised and vibrant asset class in its own right.

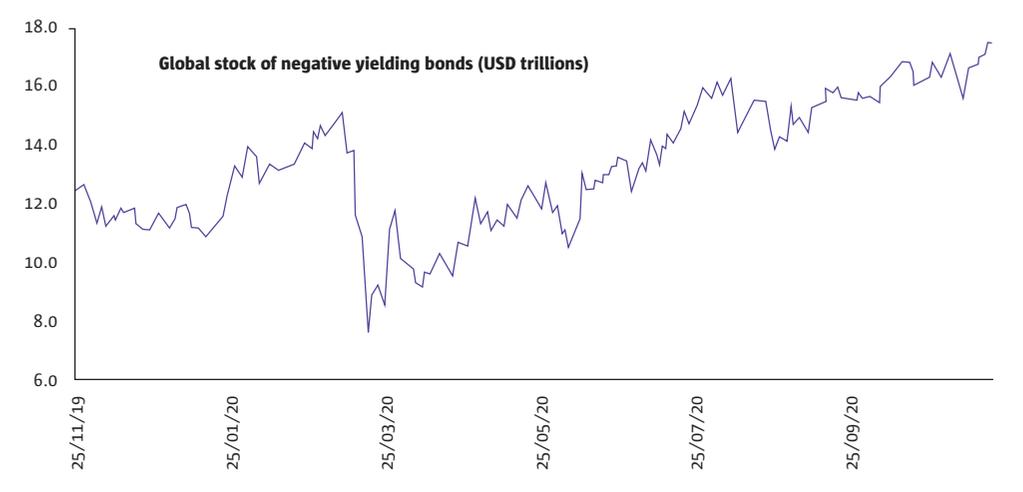
Latest numbers for the market's growth from Preqin² indicate an 11.4% annual growth rate, to USD 1.46 trillion by the end of 2025. Along with private equity, private debt is projected to be the most rapidly growing segment of the alternative investments market in the next five years.³

KPMG has estimated that the average annual AuM growth of the Luxembourg private debt funds sector alone is 36% per annum, pointing to considerable ongoing take up of a strategy that is not correlated to values in public markets. Revealingly, KPMG also notes that direct lending, an area in which Prestige specialises, is growing at a rate of around 38% a year (among Luxembourg funds)⁴.

The attractions of the private debt market for institutional investors are dual. Firstly, the sector is not correlated to public markets. This has been amply demonstrated by Prestige's own debt funds, which have provided consistent monthly returns throughout 2020, with some of the most extreme

Fig.1 Negative yielding bonds in developed markets hit an all-time high in November 2020

Source: Bloomberg



public market volatility we have seen in over a decade. Last year was a serious test for the relative correlation of private debt and the asset class came through with flying colours.

Secondly, investors are now on a hunt for yield. It is becoming clear to many investors that huge allocations to government debt markets which are nearing negative yield territory (and have actually arrived there in some cases), will not be viable if they are to continue to meet liabilities. In our discussions with institutional investors globally, we have become aware that private debt is regarded as an important yield bearing alternative to traditional fixed income securities.

Over 60% of respondents to last year's Preqin alternative investments survey intimated that they expected private debt would be playing a bigger role in the years to come. Nearly 60% of investors also told Preqin they expected to increase their allocations to private debt over the next five years.

How does Prestige Funds lend?

Prestige group consists of several different companies under common ownership and/or control. We now employ and retain over 100 finance professionals in the UK, with an additional established team based in Malta. Our lending teams operate out of Cambridge (rural economy / clean energy) and London (generic SME lending). We also have a strategic partnership in New York (cash flow finance / trade finance).

Prestige group uses private lending operations that act as its intermediary between the market and the fund management business: the three separate lending companies each focus on a different segment of the economy.

Privilege Finance is based in Cambridgeshire in the UK and has built up a considerable team of commercial finance specialists with experience and contacts in the rural SME lending business. Much of its activity has been within the farming sector and related small businesses and infrastructure projects in the UK rural economy. However, more recently its experience in funding on-farm clean energy - driven by the rise in electricity prices in the UK - has led to the creation of a specific green energy project finance arm.

Nucleus Commercial Finance (NCF) is based in London and provides highly flexible financing for small businesses across the UK. Nucleus has built up a sophisticated in-house risk analysis and credit monitoring process that allows it to evaluate credit-worthy situations. NCF operates across several different financing lines and has built up a team of personnel with experience from the commercial banking market, as well as rolling out proprietary technology to assist with loan approvals and risk oversight.

Capstone Capital Group is based in New York and provides financing to assist US corporate clients with their cash flow requirements. This includes client specific solutions such as factoring services, purchase order financing and trade finance. Capstone has been in business in the US SME market for more than three decades and has built up specialist expertise in working with companies in the construction industry.

These businesses play an important part in ensuring that the loan portfolios within the Prestige Funds range are properly sourced and managed and are diversified away from key strategic risks. For example, Prestige took a strategic view after the 2016 UK

Brexit vote to avoid lending to businesses which were heavily exposed to Brexit risks. We also exclude some sectors entirely due to the risks or ethical considerations inherent in those sectors.

Brexit and the pandemic

Private debt providers have played an important role supporting SMEs during the pandemic and in some respects this has made things quite binary since it is clearer to see which business and sectors are winners and losers. For example, Nucleus Commercial Finance, which manages part of the Prestige loan portfolio, was accredited by the British Business Bank for the UK's Coronavirus Business Interruption Loan Scheme (CBILS). Under CBILS, the first 12 months of interest on a facility and any arrangement fees are paid by the UK government as a Business Interruption Payment. The UK Government guarantees 80% of this finance to the lender, giving confidence to continue lending to UK businesses. So far Nucleus has lent approximately GBP 200m through UK government schemes, but has received more than GBP 2 billion in new loan applications, resulting in approximately 11,000 individual company enquiries. The UK government replaced CBILS with the Recovery Loan Scheme (RLS) in April 2021. This scheme ensures that businesses of any size can continue to access loans or finance up to GBP 10 million per business.

Nucleus' accreditation is important as it represents the high-level recognition of the expertise and technology already embedded in private lenders in the UK.

Private debt funds are well-positioned to benefit from the reconstruction of the economy in the post-COVID economy. The UK small business sector in particular has remained very resilient in the face of both the pandemic and the associated threat of Brexit. According to Goldman Sachs, for every two UK businesses that have cut jobs during the pandemic, another has increased its employee base. Although 44% of firms cut jobs last year, 62% have continued trading without interruption.

Financing of small businesses through government-backed schemes like that managed by Nucleus Commercial Finance has played a critical role in helping to support small businesses through these trying times - 98% of small businesses say government support has had a positive impact, with 80% telling Goldman Sachs that the current support on offer from the government is enough to ensure their business survives.

Not only that, but 59% say that current support levels are equipping them to grow their business in the future. Four out of five UK SMEs now feel they no longer require further government support to prevent further redundancies.⁵

Indeed, according to research published by the *Times* Newspaper (12/2020), in the three months to September 2020, gross trading profits of the UK corporate sector jumped by 23% to a record GBP 126 Billion.

As for Brexit, while Prestige and its lending firms have carefully managed Brexit exposure risk, so far the impact of Brexit on the SME sector has been less acute than previously expected.

Despite fears of a 'no deal' with the EU throughout the course of 2020, less than 25% of SMEs were concerned about the negative impact of Brexit⁶. According to a survey from accounting software provider FreeAgent, almost 60% of SME owners are not worried about their future, and the number that thought Brexit would have a negative impact on the economy fell steadily in the course of 2020.

SME owners are refocusing their efforts on either trading within the UK, or trading with countries outside the EU itself. This positive narrative for SMEs is now being described as 'surthriving' - describing those firms that have embraced the changes forced upon them and have become more dynamic - according to data from FreeAgent only 21% of UK SMEs are now worried about the impact of Brexit, and 10% say *the pandemic has actually opened up new opportunities*.

Re-greening the economy

There is increasing investor pressure on fund managers to demonstrate how they are reducing their exposure to fossil fuels and implementing ESG criteria within their portfolios. We are also seeing the emergence of many new funds that have some form of green or environmental agenda.

Prestige has been active in this space for more than a decade. Our credentials stem from our activity within the rural / agricultural SME lending market via our Privilege Finance arm. This has focused on helping to finance on-farm clean energy solutions, including bio-gas plants.

Part of the momentum for these projects has been the soaring price of electricity in the UK, and secondly the need to process farm and community waste more cost-effectively. These demands have met in the form of bio-gas installations which can process farm waste while producing clean power for farms and the wider rural communities.

Privilege Finance has become one of the largest providers of project finance for bio-gas plants in the UK. Additional technical and management support for these installations is also provided along with the finance, to make sure the project remains viable, profitable and loans are repaid. Since 2012 Privilege Finance has invested over GBP 600 million in both new

builds and acquisition projects in renewable energy. Our activity in this space is supported by the UK government, which realises that much still remains to be done to assist the country to meet its 2030 clean energy goals. The projects we back now generate approximately 1.3 TerraWatts of energy per year, meaning that each day they generate approximately 3.5 GW, which translates to approximately 1 million homes powered, based on average household energy usage in the UK. These plants are collectively saving the equivalent of 1.48m metric tonnes of CO2 each year. This is achieved by diverting 503,345 metric tonnes of waste, the equivalent of over 70,000 lorry loads, away from landfill each year.

We currently manage two dedicated impact investing private debt funds in this space. Our oldest vehicle has now been in operation for 12 years and we are on the point of launching a third fund to also target this ethically important area.

The future

Prestige group has been operating for over 14 years now. In that period we have raised over USD 2 billion for our range of alternative credit funds. In 2020 our wider group of companies raised a further USD 300 million of non-fund debt from several large financial institutions which provide alternative funding to established alternative lenders.

This non-fund interest is a testament to the expertise and technology we have now accumulated in-house: it is a lending operation and network that other financial institutions wish to deploy capital into.

Investor appetite for private debt remains high. The additional demand for strategies that can focus lending into infrastructure that will assist the world in its carbon neutrality goals is only going to increase. Our latest fund launch is tailored to the demands of the Islamic finance market, and as its underlying tenets, covers financing specifically within the ESG project mix of our activity. We anticipate there will be further demand for specific ESG-driven strategies of this nature within private debt in the future. **THFJ**

FOOTNOTES

1. UK Government – 2019 statistical release
2. Preqin – The Future of Alternatives 2025
3. Past performance is not a reliable guide to future performance, investments can go down as well as up
4. KPMG / ALFI - Private Debt Fund survey 2020
5. Small Business Britain – The Impact of Covid 19 to Date (Goldman Sachs)
6. Survey data based on 500 SME interviews by FreeAgent, October 2020