Finding your niche – Prestige Funds on Direct Lending

Stockholm (HedgeNordic) – Prestige is a group of businesses founded in 2007 that operates a number of alternative credit funds focusing on direct lending, some of which are regulated in the European Union. Through its dedicated lending businesses in London and Cambridge the asset manager originates loans to small and mid-sized companies (SMEs) in the UK.

Prestige offers two funds for European investors – the Prestige Alternative Finance Fund, which was launched in 2009 and focuses on senior secured lending in ’asset finance’ and ’project finance’ with a focus on the UK agricultural sector, and the Commercial Finance Opportunities Fund which is a strategy that operates within senior secured asset based direct lending servicing financing needs of UK-based small and medium-sized enterprises.

Prestige runs about USD 1 billion in AuM from 300 professional investors ranging from pension funds, family offices, sovereign wealth funds and independent asset managers.

”We are in an interesting position when it comes to understanding the underlying dynamics of corporate activity and investor sentiment. As we speak to small companies and asset managers every day, we can often feel there is a great disconnect between the two. Small companies tend to sense changes in corporate activity more quickly than the equity market, which is more reactive in nature”, says Craig Reeves, founder of Prestige.

”This is an edge for us when operating pools of debt, as we are not only investing in talented people but also in systems that allow us to get an in-depth picture of sectors, customers, competition, threats and opportunities.”

”When lending money, we probably reject more than 90% of the loan applications we receive. We only lend in areas that we like, that we know and that we understand. What we tend to like are sectors linked to the old economy such as farming, food, construction, manufacturing, fabrication and engineering, as well as some limited service based businesses such as payroll and recruitment.”

”The companies we like often have one thing in common, they either have a productivity crisis and are looking for ways of financing in efficiency and financing out some of their fixed costs. Or they have a relatively good business but they can’t borrow money from the bank, or enough money or money quickly enough as many banks tend to focus on larger companies, real estate or the consumer.”

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”Lending to SMEs is usually expensive lending by traditional banks, regulators do not allow using leverage to the same extent and it requires greater monitoring and ’in life management’ which requires more resources compared to lending to large companies. Increasingly we also provide more than just money, in that both our dedicated lending businesses conduct an element of consulting which generates additional revenue and also considerably more market sector and customer intelligence. It also often leeds to a stronger overall relationship. This is where I believe we have an edge.”

”There are many different ways of securing financing for a promising business these days, the difference with us compared to angel investors or crowd funders is that we do not typically require a stake in the company, you don’t have to give away 50% of your business to get short term funding to accelerate the business. I realise we may seem more expensive, but we are likely to be a cheaper option for the longer term.”

Reeves says that they can feel the interest for private debt / direct lending based strategies is growing among investors and that they have an ongoing stream of investors making on-site visits.

”We raised about a quarter of a billion US Dollars last year and had around 50 on-site visits from institutional investors, and we are continuing to see great interest for private debt based strategies and for Prestige Funds. This is a very good position to be in because it allows us to grow the team and source more deals and analyse more complex transactions, which may eventually translate into better returns for our investors.”

Regarding interest from Nordic investors, Reeves says that it is increasing on the back of the continuous hunt for yield and concerns around rising interest rates and how this will affect bond portfolio returns in the coming years.

”We see good interest from the Nordics and from Sweden in particular, we have even created several Swedish Krona hedged share-classes to cater for that market. Over the summer we had a signficant allocation from a Finnish group, which is now our largest investor from Scandinavia.”

Can performance be sustained, what are the risks?

The inflows to Prestige from the insitutional investor community comes on the back of strong and consistent risk adjusted returns, in line with the industry as a whole during the last ten years. But can these performance numbers be sustained and what are the potential risks underlying the investment?

With over 1000 bank branches closed over the past 3 years in the UK, and the share prices of many traditional bank lenders still way below their 2007 highs, as well as a wave of new rules and regulations including significantly higher tier one capital adequacy required, it is far harder today for banks to lend money compared to 10 years ago. According to the Economist magazine just 10% of lending in the UK last year was to SMEs, despite the fact that there is a record 5.7 million of them and unemployment hovers around 45 year lows – suggesting there is strong demand.

Reeves mentions the operational risk, i.e. people, processes and systems, as being the most crucial part to their long term growth strategy and expanded capacity.

”There are a lot of Johnny Come Latelies, as I call them, everyone is in the lending business all of a sudden and not all lending funds are the same. Structurally many of them are set up like hedge funds – the ’get rich quick’ schemes. They charge the 2/20 from the 80s and 90s. Most of these funds will not make it in an environment of increased cost pressure from institutions, especially post Mifid II and Solvency II, and as the sector matures.”

”On our side, we run our credit funds with zero performance fees and low annual management fees in the range of 1.25% to 1.50% whilst using zero leverage. Over the last ten years we have consistently generated returns of around 5-7% with annualised volatility of around 1% with low correlation to traditional equities and bonds.”

This may help to explain why many industry commentators are now suggesting that private debt will reach US 1 trillion dollars within the next 2 years. However Reeves suggests that allocators and investors should continue to look carefully at individual managers and strategies.

”From a risk perspective you need to look closely at the team – who are they, how many of them there are, what their backgrounds are, how much is outsourced and how they mitigate and fix non-performing loans. Not all lending funds are the same in terms of size, scale and infrastructure and there will be a consolidation in the industry at some point.”

”At Prestige we have constantly invested in our busineses by hiring more people, smarter people, and we have brought in more systems and technology to have a more streamlined process supporting the team to make better judgements.”

”We are in the business of lending money to companies that often can´t borrow money from a bank. This requires considerable infrastructure to maintain a relationship with these businesses, especially within more complex and larger lending.”

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Reeves highlights the importance of having a reserve plan if things are not going in the right direction, meaning you as a lender don’t get your money back.

”You have to have a plan, at the beginning, of how to recover the assets and a strong process supporting that plan. If you don’t get the money back, how are you going to locate the asset, recover the asset, dispose of the asset and if you can´t dispose of it, how you will sweat it to get some of your money back?”

The second risk that Reeves mentions is liquidity risk.

”Our credit funds are not UCITS 4 daily dealing funds, you can´t have your money back tomorrow if you invest today. You are in for a period of time and the larger the amount you subscribe, the longer it is going to take you to redeem. There is a risk that a fund could get gated and restrict redemptions if there is a short term run on it in the event of another Lehman crisis, although we have worked hard to manage larger investors’ ability to submit short term outflows as well as maintaining a very diverse international investor base.”

Reeves says that there are clearly short and long term capacity constraints to what they do but that the business has grown steadily and organically over the last ten years.

”We cannot lend a billion dollars a year. We are lending anything between GBP 10-30 million pounds a month but the pipeline is considerable beyond situations that we reject. We are always looking for the right ideas, meaning projects where we can lend and get money back relatively easily. The underlying economic activity in the UK remains positive with some growth and the lowest unemployment in almost 45 years. There is a need for many companies to grow and scale up, in that context our financing is still a very attractive option for many.”