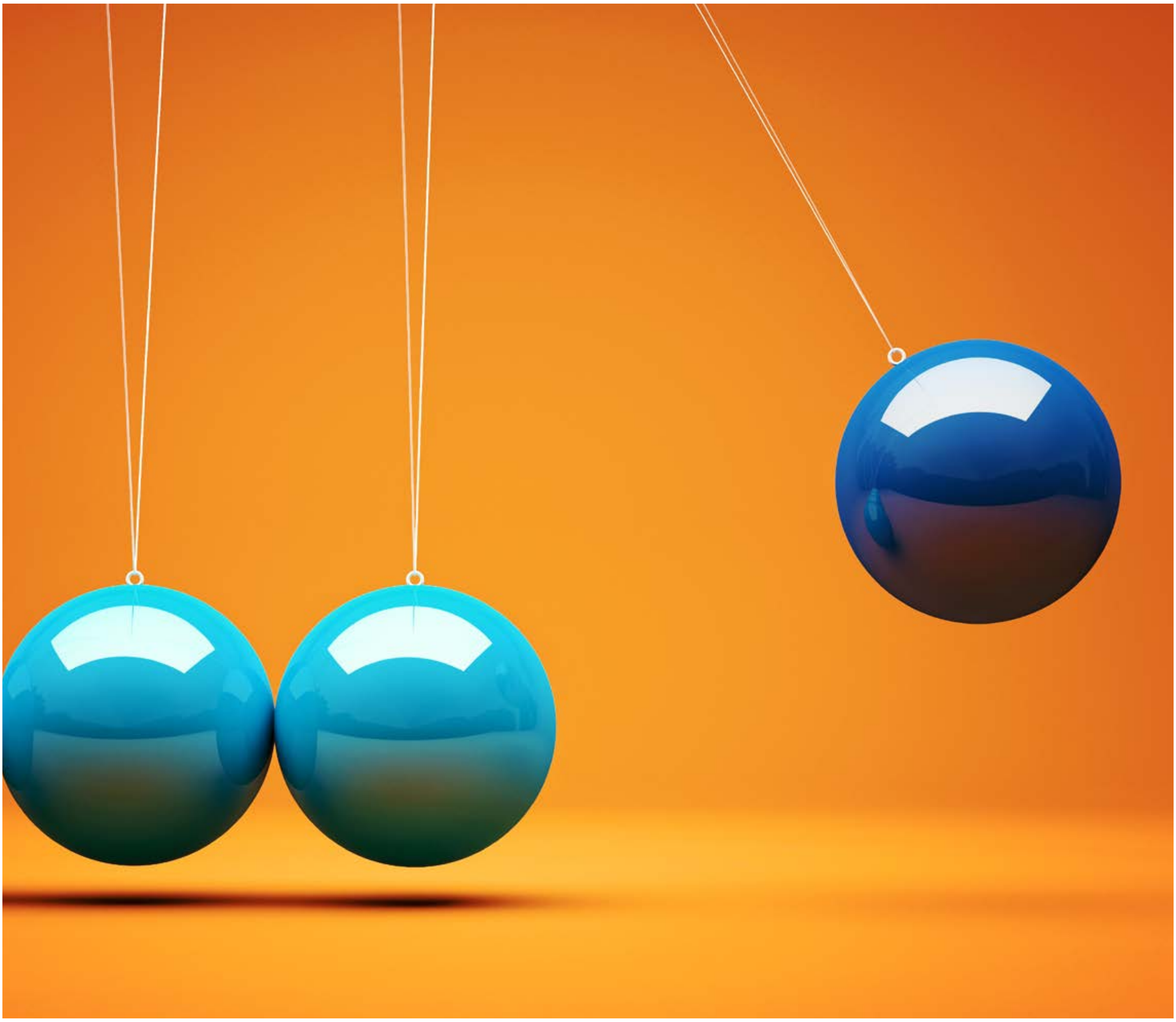
INVESTMENT MANAGER SERVICES

Can private credit maintain momentum?



Private lenders played a central role in fuelling growth and innovation in recent years. Can they successfully navigate a more challenging market environment?

Executive summary.

Once a relatively niche corner of the financial landscape, the private credit market blossomed into a dynamic and vital hub of activity in recent years.

Attracting diverse investors and new players, it morphed into a diverse ecosystem serving new borrowers in a dazzling array of sectors. Favourable regulation and a 'Goldilocks economy' propelled private credit forward to this point. Will it be able to sustain its momentum, or will growth be undermined by competition?

Our view is that these amount to light crosswinds, buffeting the industry but not hindering overall progress. Having established itself as an attractive alternative to both investors and borrowers, private credit will keep growing, albeit at a slower pace. Challenges remain. Facing a riskier environment, investors are demanding more transparency and flexibility from their managers. Customisation makes scaling operations difficult for managers. Competition may ultimately pressure spreads and margins. Complacency could spell trouble, and forward-thinking lenders are treating these challenges as opportunities to adapt.

> **'Everything old is new again'.**
>
> **— Jonathan Swift**

The big bang.

It could be argued that private loans are the oldest type of financial transaction on earth.

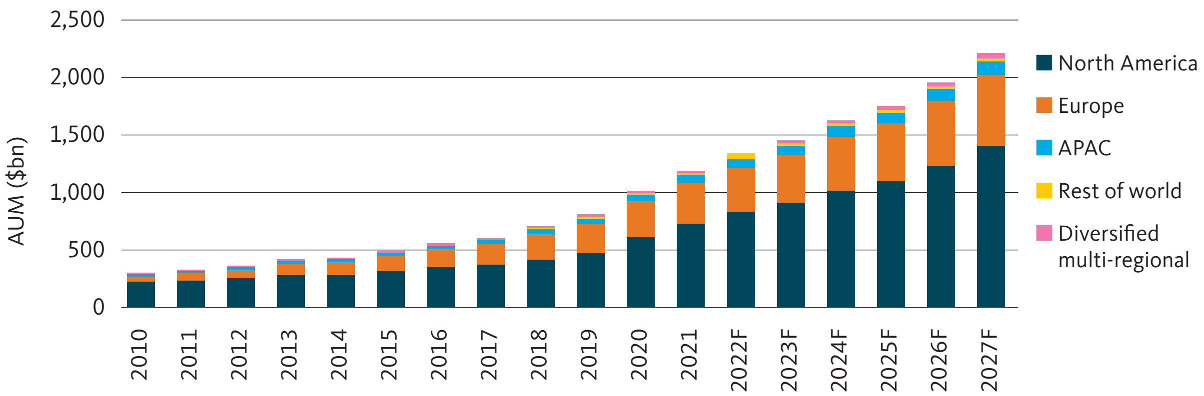
Despite that pedigree, private credit lived in the shadow of bank loans and publicly traded debt until very recently. A shock to the system was needed to upset the status quo, and the global financial crisis delivered in late 2007. Since that debacle, private credit has grown at an unprecedented pace and established itself as a prominent asset class serving a wide range of investors. Stepping in to replace banks as sources of funding for small and mid-sized enterprises, private lenders initially relied almost exclusively on institutional capital. Both borrowers and investors have multiplied and diversified since then.

The sudden retreat of risk-averse banks makes the growth trajectory of private credit no less remarkable. New regulatory guardrails meant banks could not lend as much and public debt was subject to new minimums. These developments created a vacuum around transactions involving smaller growth-oriented businesses—a vacuum that private credit firms were happy to fill.

The low-interest environment added fuel, causing institutional investors and wealthy individuals to intensify their search for higher yields away from traditional bond markets. Spreads have typically been attractive. Since its inception in September 2004, the Cliffwater Direct Lending Index has delivered annualised total returns of 9.37% through mid-2023.[1] With the recent memory of asset values collapsing in lockstep, many investors are also keen on more effective portfolio diversification. According to Preqin, diversification is the top reason for investing in private credit.

Compounding this growth was the role of private credit in financing mergers and acquisitions, particularly as private equity firms put unprecedented sums to work. After growing at more than 10% a year, private credit is now a US$1.5 trillion global market.[2] While the United States accounts for two-thirds of assets under management, the European market is also growing steadily. Asia represents significant untapped potential.

Figure 1. Strong and steady asset growth



Source: Preqin Pro. Data as at May 2023.

[1] Nesbitt, Stephen, et al., '2023 Q2 Report on U.S. Direct Lending', Cliffwater, 2023.
[2] 'Five Key Trends in the Current Private Credit Market', Dechert LLP, 3 June 2023.

Moving beyond institutional

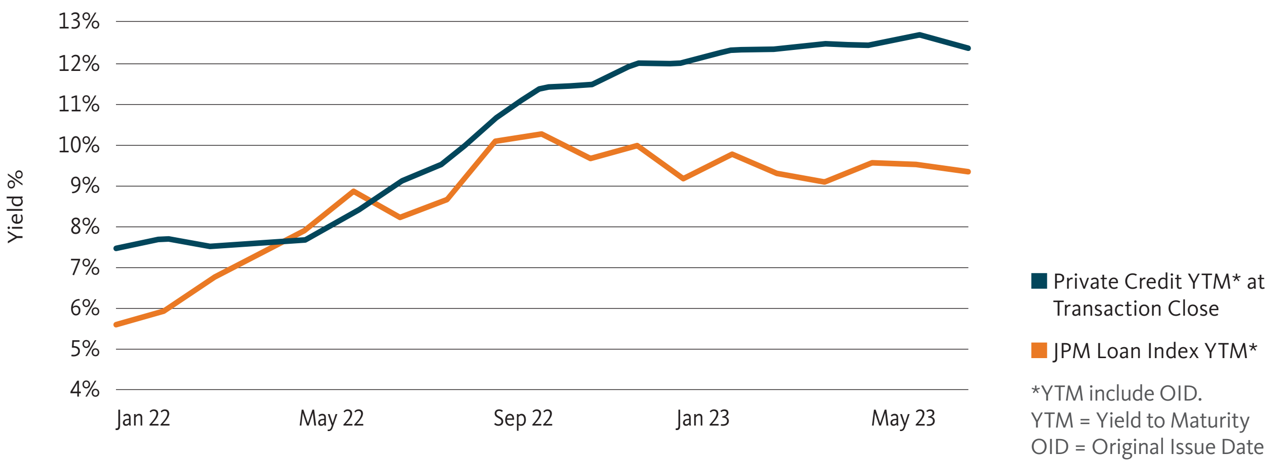
One noteworthy aspect of private credit's growth trajectory is the fact that dry powder is being deployed far more rapidly than other alternative asset classes. According to Preqin, the industry's collective cash reserves were reduced by 32.1% of total AUM at the start of 2021 to 30.3% by the third quarter of 2022, even as total assets grew by US$194.8 billion.[3] This trend underscores the breadth and depth of enthusiasm for private credit.

Contributing to this demand is the growing diversity of investors. While institutional investors remain the dominant force, individual investors and their advisers have joined the fray. This diversification of capital sources is reshaping the business, impacting deal origination, underwriting practices, and risk management strategies. The attraction is obvious: direct loans have been yielding 300 basis points more than publicly traded instruments in recent months (Figure 2).

Traditionally, institutional investors such as retirement plans allocated capital to partnership vehicles managed by specialist lenders. High minimum commitments were accompanied by management and incentive fees. Business development companies (BDCs) now offer access to smaller investors. SEC oversight and attractive dividend yields attract retail investors and their advisers, but price volatility can be high for exchange-traded BDCs, and average fees can total 4.75% of net assets.[4] Interval funds are an even more recent innovation, further expanding access to private credit by increasing liquidity on a contractual basis.

Further retail participation is inevitable. Direct lending platforms and peer-to-peer models have already emerged, offering alternative channels for both borrowers and investors. While still a relatively small niche, these mirror similar developments in the private equity market and can be viewed as a sign of things to come.

Figure 2. Direct loans yielding 300 basis points more than public markets



Source: J.P. Morgan; data as at 31 July 2023. *YTM includes original issue discount (OID). At issuance, private credit deals are issued at a discount to par value, which represents a fee paid from the lender to the issuer.

[3] McGrath, Charles et al., 'Alternatives in North America 2023', Preqin, May 2023.
[4] Swedroe, Larry, 'Private Direct Lending Offers Attractive Yields', VettaFi Advisor Perspectives, 2 May 2022.

Wider scope and deeper relationships.

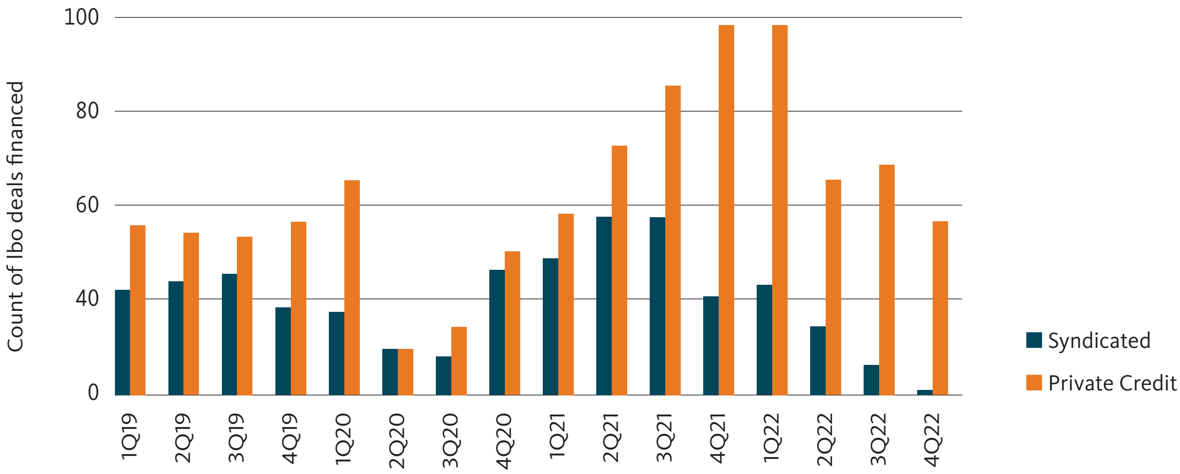
Finding that banks cannot readily provide credit solutions tailored to their needs, a growing assortment of borrowers is also turning to private lenders.

Corporations and management teams account for a growing slice of the market. Technology startups seeking expansion capital, real estate developers requiring project financing, and healthcare companies looking for specialised loans are all examples of the industry's expanding reach. The rise of niche borrowers has expanded the array of lending opportunities and added a layer of complexity to investment decisions.

De-risking by banks also means private credit now serves large corporate borrowers in addition to the small and medium-sized businesses that were the core client base after the global financial crisis. Larger borrowers also appreciate the flexibility of private credit transactions that are also less subject to the whims of public market investors. Some borrowers are even willing to pay a premium for the certainty, simplicity, and discretion that can be expected from private transactions, especially when 'the timeline for issuance is cut from months to weeks'.[5]

All these factors help facilitate long-term relationships, streamlining loan administration in a way that is attractive to all parties. This is particularly true in the case of acquisitions led by private equity investors, which are increasingly dependent on private credit as a source of funding (Figure 3).

Figure 3. Private credit funding most deals



Source: Data as at 31 December 2022. Morningstar, Pitchbook - Leveraged Commentary & Data (LCD). Private Credit count is based on deals tracked by LCD News.

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[5] Global Investment Strategy Team, 'Can private credit continue to outperform'? J.P. Morgan Private Bank, 1 September 2023.

Economic crosswinds

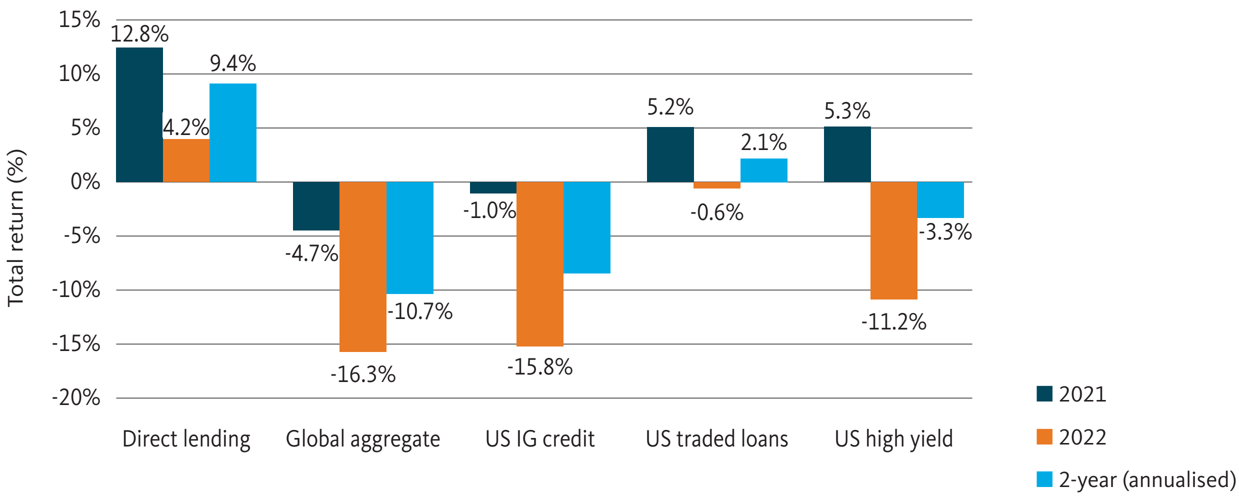
Private credit's surge in popularity came about when interest rates hovered at or near zero. With no immediate prospects for a return to that era, what happens now? Most private loans use floating rates, meaning that a rising rate environment generally benefits lenders. As Preqin points out, 'The current macroeconomic environment has favoured private debt. While economic growth has slowed, rising interest rates are supportive of floating rate-focused assets ... as higher base rates should translate into better returns'.[6] Superior returns during volatile markets highlight the resilience of private credit as an asset class (Figure 4).

Borrowers are less sanguine about higher interest rates. Those in cyclical sectors can find themselves under tremendous stress, and the risk of default goes up amongst businesses forced to absorb higher costs due to inflation.[7] Default risk is higher for older loans dating back to the ultralow-rate environment, but newer loans are less likely to be subject to sudden shifts in the rate environment.

Interest rate hikes also mean less appetite for highly leveraged deals, but private lenders are adapting, even as capital structures shift in response to interest rate risk. The private credit market features a diverse set of participants, each with unique roles and strategies. Traditional asset managers, private equity firms, and specialised lenders all play pivotal roles. This has been increasingly important as market conditions cause some lenders to reduce their exposure to individual deals.

According to Macquarie, 'Due to building economic headwinds and general uncertainty in the markets, some private credit funds have reduced their position size in debt facilities to account for the riskier climate, but the sector has shown adaptability in assembling larger direct lender groups to sustain heftier unitranche financing'.[8]

Figure 4. Enviable performance in very different market environments



Source: Data as at 31 December 2022, unless otherwise noted. Morningstar, PitchBook for US Traded Loans represented by the Morningstar LSTA Leveraged Loan Index. Bloomberg Barclays Indices for the Global Aggregate, US High Yield, and US IG Credit. Cliffwater for Direct Lending represented by the Cliffwater Direct Lending Index (CDLI) through 30 September 2022; assumes 3Q22 total return of 1.82% repeats in 4Q22.

6 McGrath, Charles, et al., 'Alternatives in North America 2023', Preqin, May 2023.
7 Keenan, James, 'Private Credit: Evolution and Opportunity in Direct Lending', BlackRock Alternatives, November 2022.
8 Eckermann, Bill, Ottersbach, Patrick, '2023 trends in private credit and direct lending', Macquarie, 10 March 2023.

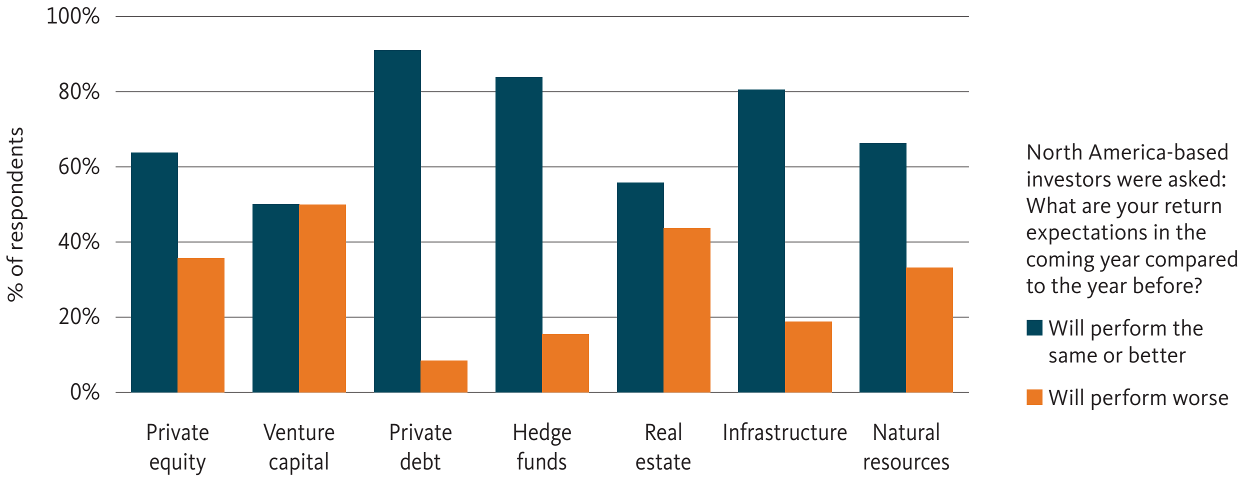
More, please

Some industry observers paint a picture of an overly exuberant market, but these claims ring hollow. In many cases, it is simply the source of funding that has changed. Borrowers are not significantly more leveraged.

Secular factors mean the long-term outlook for private credit is bright. Businesses need capital. Bank lending is inadequate. It is a vital source of funding for private equity managers sitting on large amounts of dry powder that they would like to put to work. Investors who can tolerate the lack of liquidity continue to be attracted to portfolio diversification, potential income streams, and outsize returns. Investors are so optimistic that they think private credit is more likely than any other alternative asset class to generate higher returns in the coming year (Figure 5).

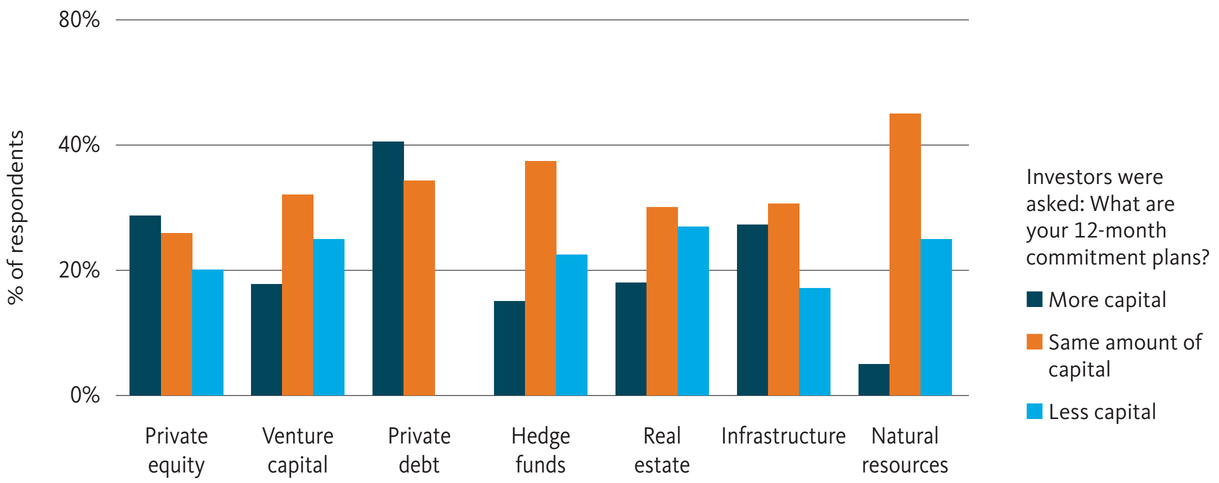
This bullish sentiment translates to growing allocations. According to a Preqin survey, more than half of all institutional investors plan to increase their allocation to private credit over the next 12 months (Figure 5). Unlike other alternative assets, there were no plans to cut investments in private credit.[9]

Figure 5. Investors are bullish on private credit ...



Source: Preqin Investor Outlook Survey, June 2023

Figure 6. ... and targeting higher allocations



Source: Preqin Investor Outlook Survey, June 2023

[9] McGrath, Charles et al., 'Alternatives in North America 2023', Preqin, May 2023.

The future is now.

Further growth is welcome news to managers, but it also obscures the challenges they face.

Their operating environment is changing at an accelerated rate, forcing lenders to evolve. Investors want increased transparency and may request more frequent valuations, preferably from independent third parties. Their tolerance of illiquidity may also diminish, fueling more trading of private credit secondaries. Compounding the difficulty of meeting these needs are the regulatory burdens that come with varying transaction structures and jurisdictions.

Adapting to these new realities while simultaneously fending off new competition from diversifying asset managers means private lenders cannot afford to be complacent. Private credit was already more complex than many other asset classes. A dizzying array of terms, covenants, and cash flows means a lot of bespoke arrangements and manual processing that are ripe for streamlining and automation. New niches such as sports, aviation, supply chain, and litigation finance all bring their own idiosyncrasies and nuances, meaning effective administration requires specialised expertise and tools. A less predictable economy amplifies the risks associated with this complexity.

As private credit managers and their expanding network of investors navigate a less benign economic landscape, thoughtfully designed processes and data flows become essential to effectively raising capital, sourcing deals, and structuring transactions. Managers are increasingly being asked to provide a level of service that was not traditionally offered. Investors are looking for more detailed data as part of a more comprehensive due diligence process. Greater transparency around risk exposures and ESG factors is becoming the norm. Scenario analysis might be requested.

Overwhelming at first glance, this shift presents an opportunity for managers who prefer to treat it as an opportunity. Competitive pressure comes at a time when the prospects and economics of the business are still very attractive. It also comes against a backdrop of rapid advances in data science and artificial intelligence. Private debt managers choosing to optimise their own teams, infrastructure, and operational processes could not have chosen a better time.

Having successfully built independent businesses, some will strike out on their own. Others will tap into a network of firms providing resources, expertise, and infrastructure to other private credit firms as well as the asset management industry at large. Forming partnerships with external organisations specialising in operational support and technology integration can have myriad benefits. Looking beyond potential cost savings, GPs that opt for a networked approach to growth are likely to find that it is more stable, compliant, and scalable, lowering distractions and allowing them to focus on generating superior returns for their investors as they navigate a more challenging market environment.

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