

# Private Credit Market Update

January 2024

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Private credit as an asset class is in demand from a range of investors. The asset class has become a direct substitute for traditional fixed income assets for many investors, which are continuing to increase allocations.<sup>1</sup> A recent investor survey suggested that 51% of existing private credit investors expect to increase their allocations further over the long-term – more than any other asset class.<sup>1</sup>

This increased interest is not limited to investors. Private credit has generated significant headlines in the global press in recent months. Journalists have commented on the growth the asset class has experienced, as well as risks. Some central banks have also flagged the asset class as of increased importance, given the strong growth in assets under management (AUM).<sup>2</sup> This means private credit markets could come under increased scrutiny in future.

Regardless of the future path towards increased scrutiny, and potentially regulation, the core long-term drivers of activity are both powerful and long-term. For investors, we believe the underlying investments' exposure to floating rates at a time when interest rates have risen at their fastest pace in decades is key to their relative attractiveness. This rising interest is combined with a focus on credit quality and underwriting, is increasingly at the forefront of investors' minds when undertaking due diligence on potential managers. While some investors believe that the industry has not experienced a significant test since it was spurred into growth following the global financial crisis (GFC).<sup>3</sup> In our view, this may be true in some respects, but managers are likely to have been robust in their own underwriting.

Investment activity has increased significantly in recent years, as can be seen in the cash flows across the asset class. After an extended period of capital calls, they could begin to turn positive, as previous investments mature.

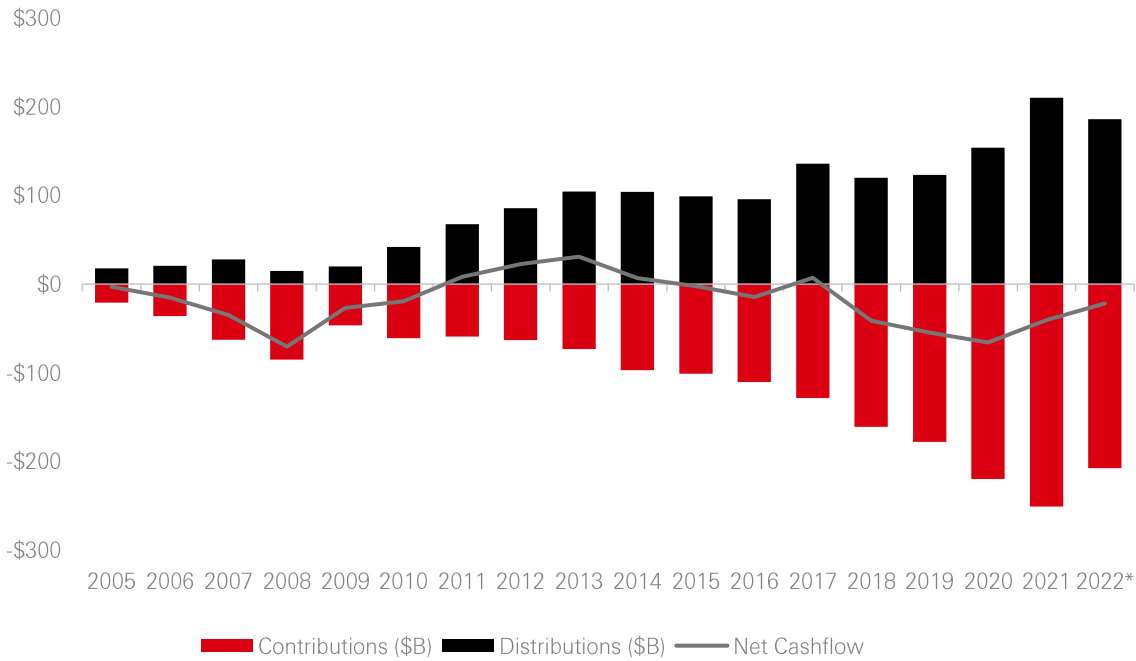
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1. Preqin Investor Outlook: Alternative Assets, H2 2023

2. Reuters, Bank of England asks banks to report private credit exposure, as of December 2023.

3. Moody's, Private credit faces stress test: Moody's as of June 2023.

## Private debt cash flows (\$bn)

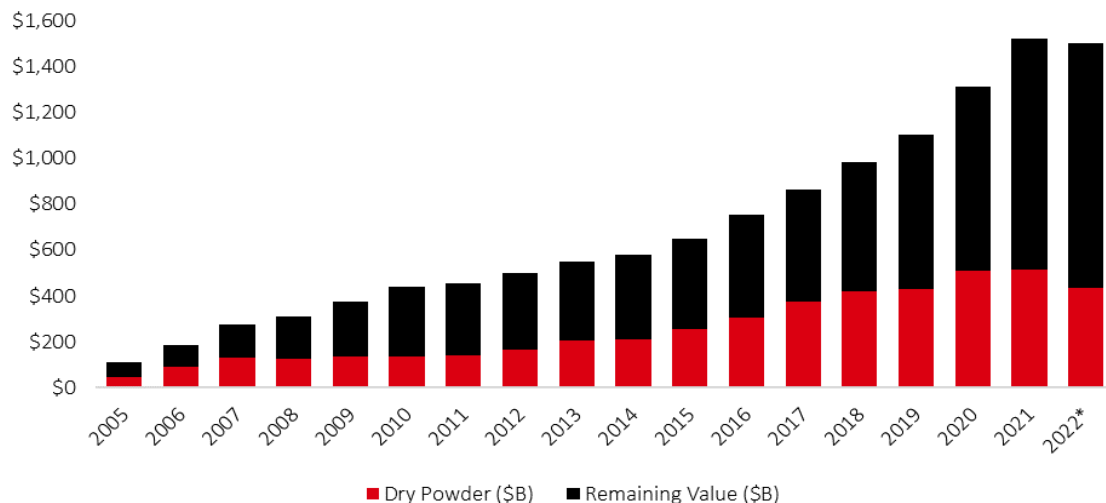


Source: Pitchbook, end 2022 data as of September 2023

With increased allocations and rising rates providing a boost to performance, it's unsurprising that the private credit market is now far bigger than it was at the time of the GFC. In fact, private credit AUM was more than \$1.5tn (across institutional-focused funds) at the end of 2022, having grown at a compound annual growth rate of 11.7% since the end of 2017, when AUM stood at \$862bn.<sup>1</sup> Increasingly, traditional buyout managers are seeking to expand into private credit investments, as they look to take a slice of the growth currently underway. This is also partly because buyout returns may be more difficult to deliver in a higher rate environment – particularly one which could result in an eventual recession.

One of the long-term drivers of activity in private credit markets is the continued retrenchment of banks from many areas in which they were historically dominant. Private credit has been one of the major beneficiaries, taking market share from the banks. Currently, credit markets are experiencing a real supply / demand imbalance, with commercial banks actively retrenching further, as a result of balance sheet pressures. This has resulted in lower volumes of loan underwriting. This has been a key tailwind for the private credit industry, serving to increase its market share.

## Private credit AUM (\$bn)



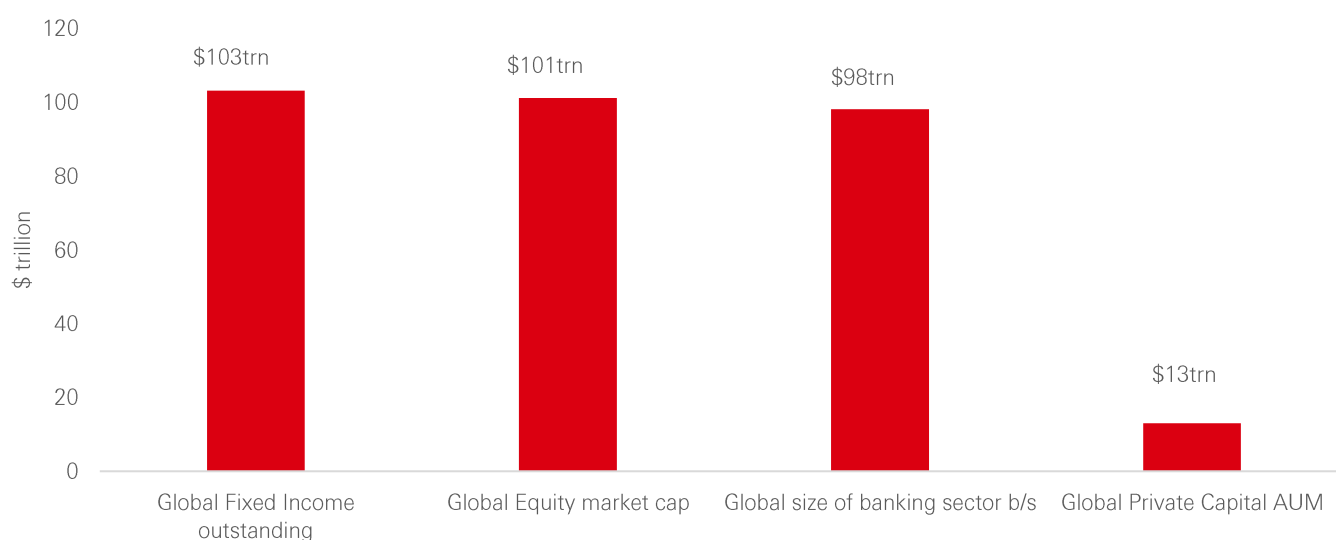
Source: Pitchbook, data as of August 2023

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1. Pitchbook, as of August 2023.

Despite the strong growth of the private credit asset class, it still represents a small part of the overall credit market. To put the size of the private credit market into context, there is around \$103tn of global fixed income assets outstanding, and bank balance sheets are around \$98tn in size. Private credit, in contrast, boasts around \$1.5tn in AUM – equal to around 1.5% of those far larger markets (please refer to the source below). While the overall private credit market is obviously large, it is small in a global multi-asset context. That private credit is now an established alternative to public debt and leveraged loan markets is almost self-fulfilling, as borrowers themselves now often see private lenders as an increasingly attractive option.

## Size of public and private credit markets



Source: Apollo, SIFMA, BIS, Pitchbook, Apollo Chief Economist, data as of November 2023

## Risk-adjusted performance drives interest

We believe investors currently favour private credit investments for several reasons. The short-duration nature of private credit investments positions funds at the 'right' end of the yield curve – for now at least. Important and potentially attractive features for investors include the floating rate nature of the investments, which provides a hedge against inflation.

Unlike fixed-rate debt instruments, such as bonds, the value of which will be negatively impacted by rising interest rates, private credit loans have a floating-rate coupon. As such, these are reset periodically and linked to a benchmark rate, which translates into yield increases (or falls, depending upon loan terms), along with the general level of base interest rates. This has boosted returns – particularly since interest rates began to increase significantly during 2022. Data shows that direct lending investments are now delivering higher yields than many other investments and are at a level where they are outperforming the historic returns for global equities over the last decade.<sup>1</sup>

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1. Source: HSBC AM, data as of November 2023

## Better pricing and more lender-friendly terms compared to two years ago

	Q4 2021	July 2023
<b>Coupon</b>	3mE/L + 5.50-5.75%	3m E/L + 6.25-6.75%
Memo: Base Rate		
EUR	-0.6%	3.7%
USD	0.2%	5.4%
Floor (EUR/USD)	0.0% / 1.0%	n/m
<b>All-In Rate</b>		
EUR	5.5-5.8%	10.0-10.5%
USD	6.5-6.8%	11.7-12.2%
<b>Plus: Upfront Fees/ OID (Annualised)</b>		
EUR	0.8% (2-3% Total)	0.8% (2-3% Total)
USD	0.5% (1-2% Total)	0.8% (2-3% Total)
<b>Unlevered Asset Yield</b>		
EUR	6.5%	11.0%
USD	7.2%	12.7%
Leverage/LTV	↑	↓
Doc Protection/Covenants	↓	↑

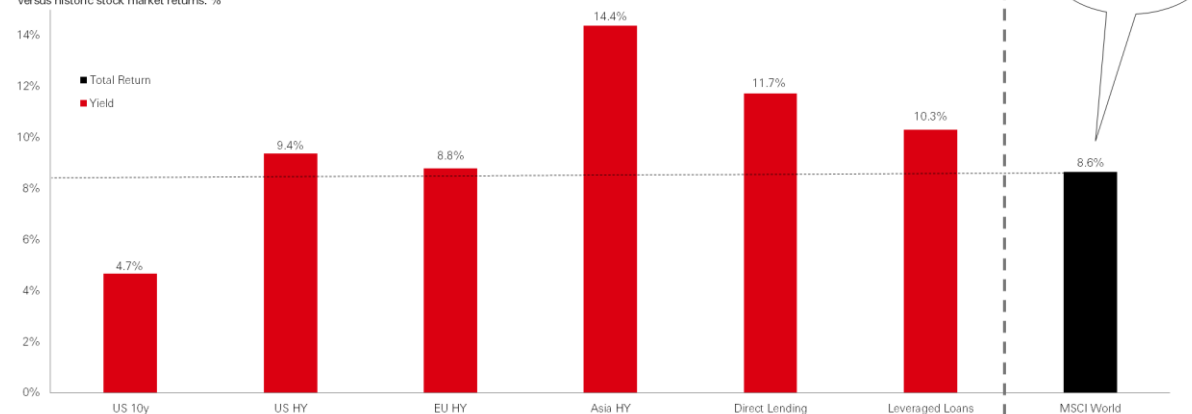
Source: HSBC Asset Management, data as of July 2023

The asset class has several other potentially positive traits in its favour. Unlike private equity, as the investments have a fixed life, there is no reliance on an exit strategy, with capital returns to investors at the end of the term. Other asset classes, such as private equity, are reliant on the exit market as a route to delivering returns to fund investors. This is particularly relevant now, given the significant slowdown in private equity exits, which have reduced distributions back to investors. There are still, however, some credit risks within private credit markets that are actively managed.

The structure of the market also provides protections for investors, often leading to higher recovery rates in the event of a default, according to Moody's data.<sup>1</sup> The direct lending market is largely a covenanted market, offering investors better protections than many other asset classes. In 2021, around 96% of the European Leveraged Loan issuance was cov-lite, compared to around 5% for direct lending.<sup>2</sup> These covenants provide the lender an ability to step in and renegotiate terms of the lending agreement, force changes in the company, and, if necessary, take enforcement action. Without this ability, the lender is left relying on a payment default; at this point, the condition of the company will likely have deteriorated significantly, resulting in a lower recovery.

### Credit market yields

Pre-tax yields from non-IG credits versus historic stock market returns. %



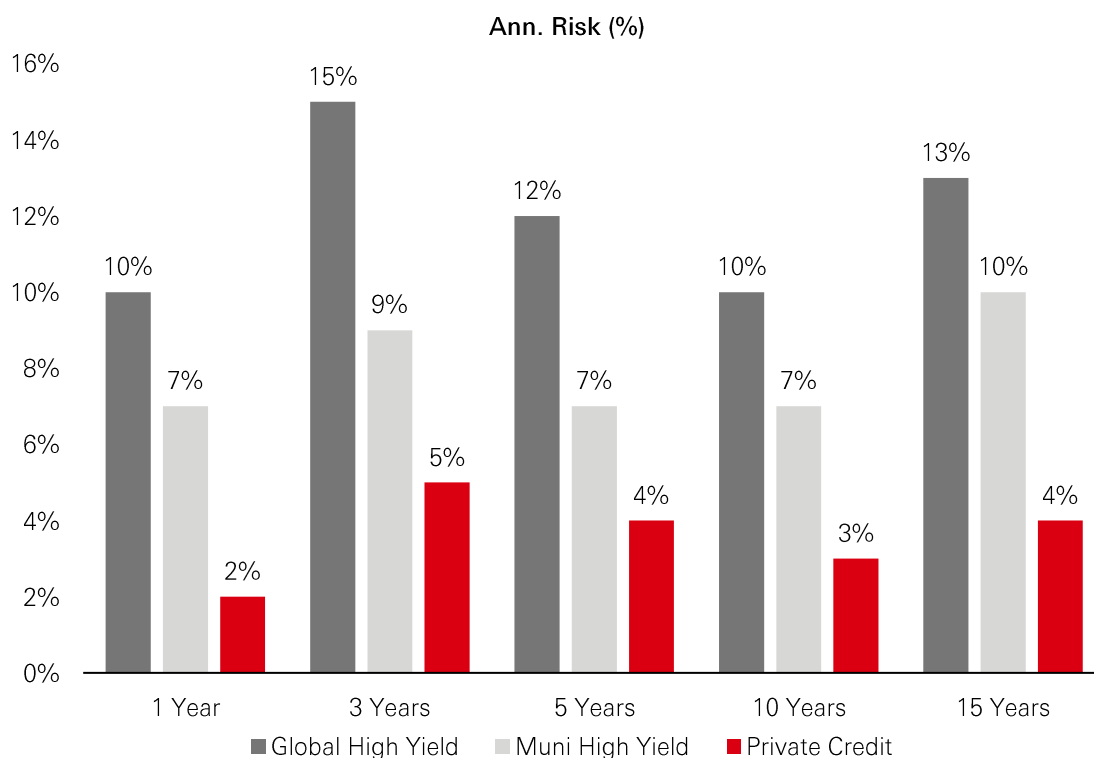
Source: HSBC AM, end 2022 data as of September 2023

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1. Moody's data: Examining Infrastructure as an Asset Class, 2021

2. Direct Lending vs Liquid Markets - Arcmont Asset Management, 2022

## Private Credit has experienced 4x less volatility than public credit, on average



Source: Goldman Sachs Asset Management/SAS, as of September 2022.

Global High Yield is represented by the Bloomberg Global High Yield Index. Muni High Yield is represented by the Bloomberg Muni HY Total Return Index. Private Credit is represented by the Cliffwater Direct Lending Index.

Muni High Yield yields are represented as the tax-equivalent yield, calculated by deducting a federal income tax rate of 40.8%.

## Conclusion

There are some major shifts underway in global lending markets. As banks reduce activity in areas they were once dominant, other options have emerged. Private credit markets are a beneficiary of this structural shift. Borrowers are also seeing the benefits of this change, as they seek customised funding solutions, clear paths towards execution, and the benefits a long-term and close relationships can bring.

Similarly, investors looking for diversification in their traditional fixed income investments, exposure to floating rates and an inflation hedge also benefit. Add in the structural protections that these types of investments typically bring to investors, and it is easy to see why interest and allocations have grown.<sup>1</sup> But with this success comes additional scrutiny. With central banks watching the market more closely and rising numbers of journalists dedicated to following the asset class, private credit is expected to receive increased coverage in the near future.

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1. Preqin Investor Outlook: Alternative Assets, H2 2023

## Key Risks

**Risk Considerations.** There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- ◆ **Illiquidity:** An investment in the Fund is a long term illiquid investment. By their nature, the Fund's investments will not generally be exchange traded. These investments will be illiquid.
- ◆ **Long term horizon:** Investors should expect to be locked-in for the full term of the investment
- ◆ **Economic conditions:** The economic cycle and prevailing interest rates will impact the attractiveness of the underlying investments. Economic activity and sentiment also impacts the performance of underlying companies and will have a direct bearing on the ability of companies to keep up with interest and principal repayments.
- ◆ **Loans to private companies:** The Fund will invest in loans to medium sized privately owned companies. There are specific risks associated with lending to such companies, including that they may have limited financial resources, access to capital and higher funding costs. They may also be more vulnerable to market, key-man and other risks and their accounts are not typically published.
- ◆ **Valuation:** These investments may have no or a limited liquid market, and other investments including those in respect of loans and securities of private companies, may be based on estimates which cannot be marked to market until sale. The valuation of the underlying investments is therefore inherently opaque.
- ◆ **Fund Risk:** Investments into this Fund may, among other risks, be negatively affected by adverse regulatory developments or reform, credit risk and counterparty risk. The credit market bears idiosyncratic risks such as borrower fraud, borrower bankruptcy, prepayment risk, security enforceability risk, subordination risk and lender liability risk.
- ◆ **Investor's Capital At Risk:** Investors may lose the entirety of invested capital

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