Private credit market update

Patrick Suchy, Dave Lowery

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, who are continuing to increase allocations. A recent investor survey, *Preqin Investor Outlook: Alternative Assets, H2 2023* suggested that 51% of existing private credit investors expect to increase their allocations further over the long-term – more than any other asset class.

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). 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.

Some investors believe that the industry has not experienced a significant test since it was spurred into growth following the global financial crisis (GFC) as illustrated by Figure 1 on the next page. 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.

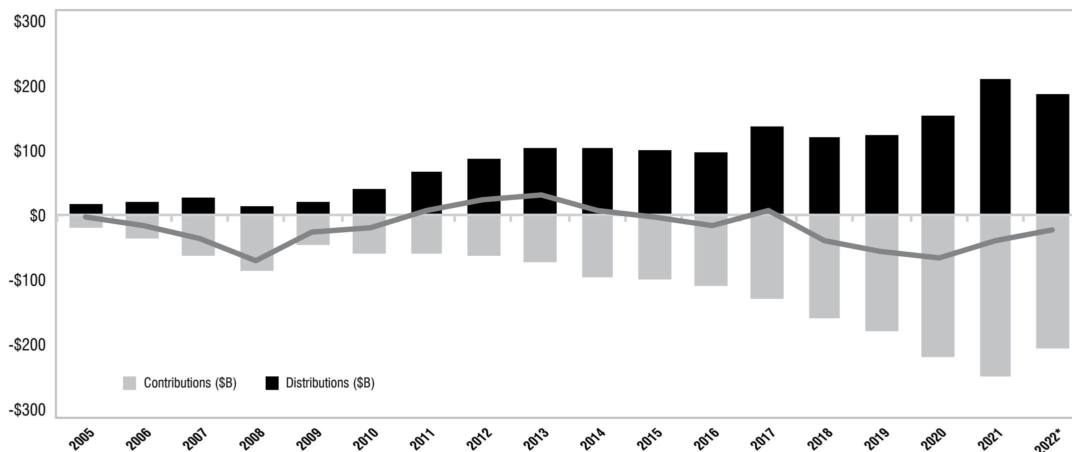
With increased allocations and rising rates providing a boost to performance, it is unsurprising that the private credit market is now far bigger than it was at the time of the GFC. In fact, as shown in Figure 2 on the next page private credit AUM was more than $1.5 trillion across institutional-focused 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 $862 billion ($bn).

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.

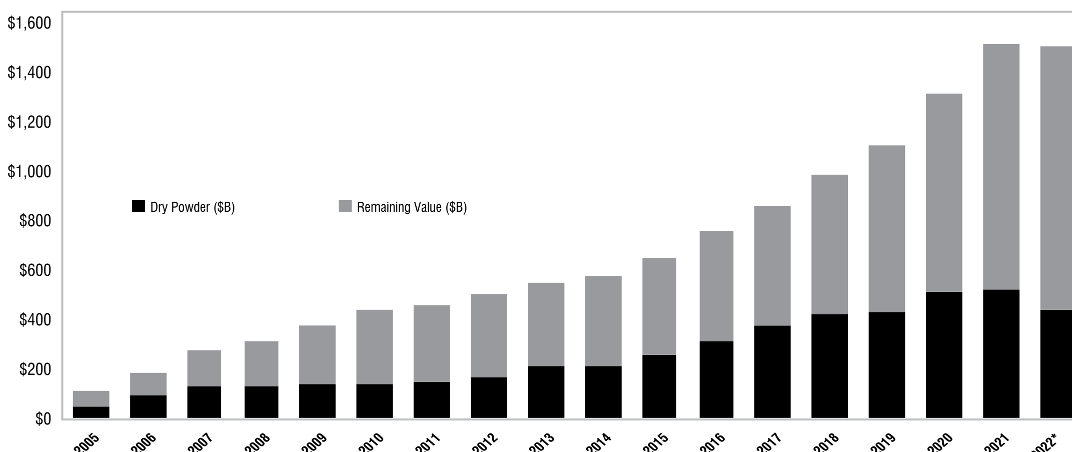
Currently, credit markets are experiencing a real supply/demand imbalance, with commercial banks actively retrenching further, because of balance sheet pressures. This has resulted in lower volumes of loan underwriting. This has been a key tailwind for the private credit industry, serving to increase its market share.

Figure 1. Private debt cash flows ($bn)



Source: Pitchbook, end 2022 data as of September 2023

Figure 2. Private credit AUM ($bn)



Source: Pitchbook, data 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 $103 trillion of global fixed income assets outstanding, and bank balance sheets are around $98 trillion in size.

Private credit, in contrast, boasts around $1.5 trillion in AUM—equal to around 1.5% of those far larger markets as shown in Figure 3 on the next page. While the overall private credit market is obviously large, it is small in a global multi-asset context. The fact 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.

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

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The quote

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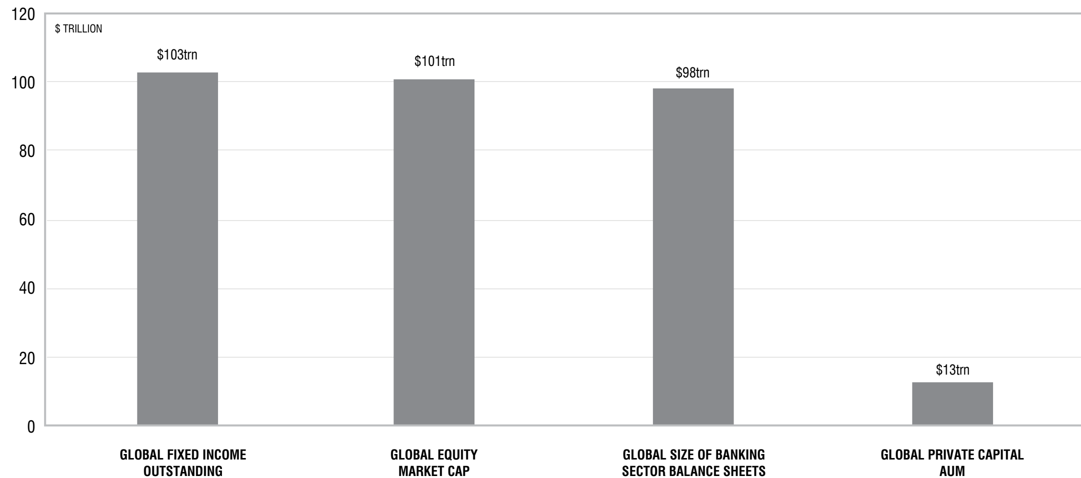
Figure 3. Size of public and private markets



Source: Apollo, SIFMA, BIS, Pitchbook, Apollo chief economist, data as of November 2023

Table 1. Better pricing and more lender-friendly terms compared to two years ago.

	Q4 2021	July 2023
Coupon	3mE/L + 5.50-5.75%	3mE/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
All-In Rate		
EUR	5.5-5.8%	10.0-10.5%
USD	6.5-6.8%	11.7-12.2%
Plus: Upfront Fees/OID (Annualised)		
EUR	0.8% (2-3% Total)	0.8% (2-3% Total)
USD	0.5% (1-2% Total)	0.8% (2-3% Total)
Unlevered Asset Yield		
EUR	6.5%	11.0%
USD	7.2%	12.7%
Leverage/LTV	↓	↓
Doc Protection/ Covenants	↑	↑

Source: HSBC Asset Management, data as of July 2023

general level of base interest rates. As shown in Table 1, this has boosted returns particularly since interest rates began to increase significantly during 2022.

As depicted in Figure 4 on the next page, 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.

The asset class has several other potentially positive traits in its favour. Unlike private equity, as private credit 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 is still, however, some credit risks within private credit markets that are actively managed.

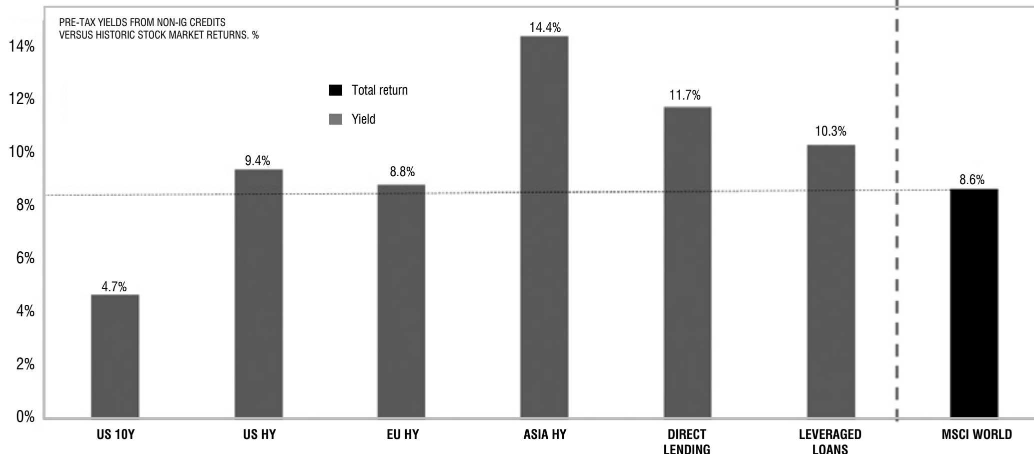
The structure of the market also provides protections for investors, often leading to higher recovery rates in the event of a default, according to Moody's data in *Examining Infrastructure as an Asset Class*, September 2021. The direct lending market is largely a covenanted market, offering investors better protections than many other asset classes.

According to Arcmont Asset Management Insights *Direct Lending vs Liquid Markets*, July 2022, around 96% of the European leveraged loan issuance was 'covenant-light' compared to around 5% for direct lending during 2021. 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.

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 chance, as they seek customised funding solutions, clear paths to-

Figure 4. Credit market yields



Source: HSBC Asset Management, end 2022 data as of September 2023

wards 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.

However, this success comes with 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 continue to receive increased coverage. **FS**

The quote

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