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Private Credit
What Is It Really?

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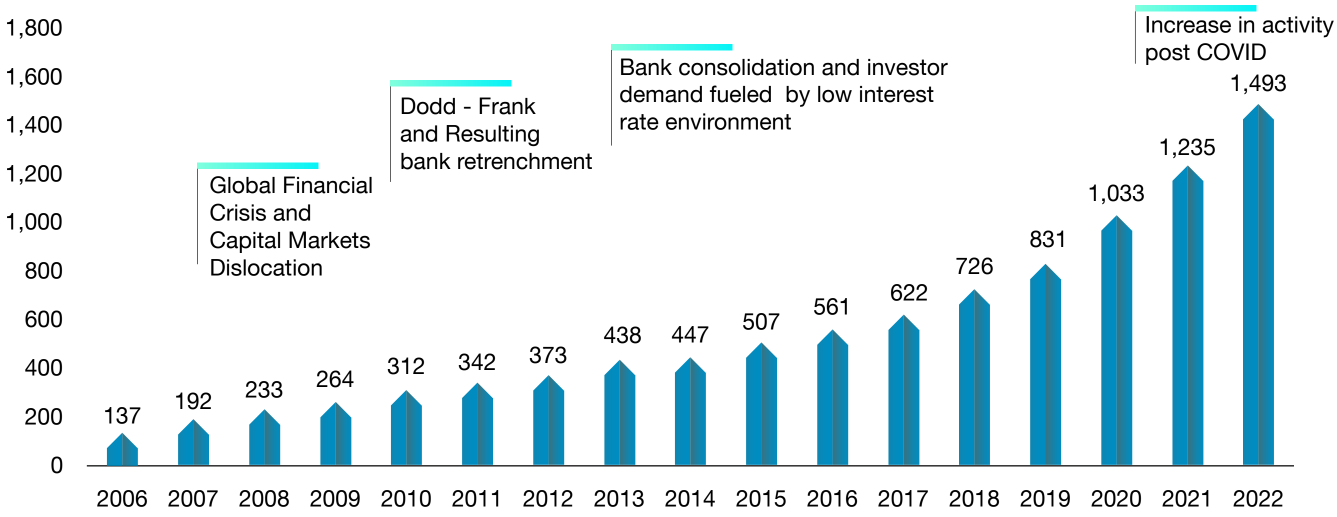
Private Credit – What Is It Really?

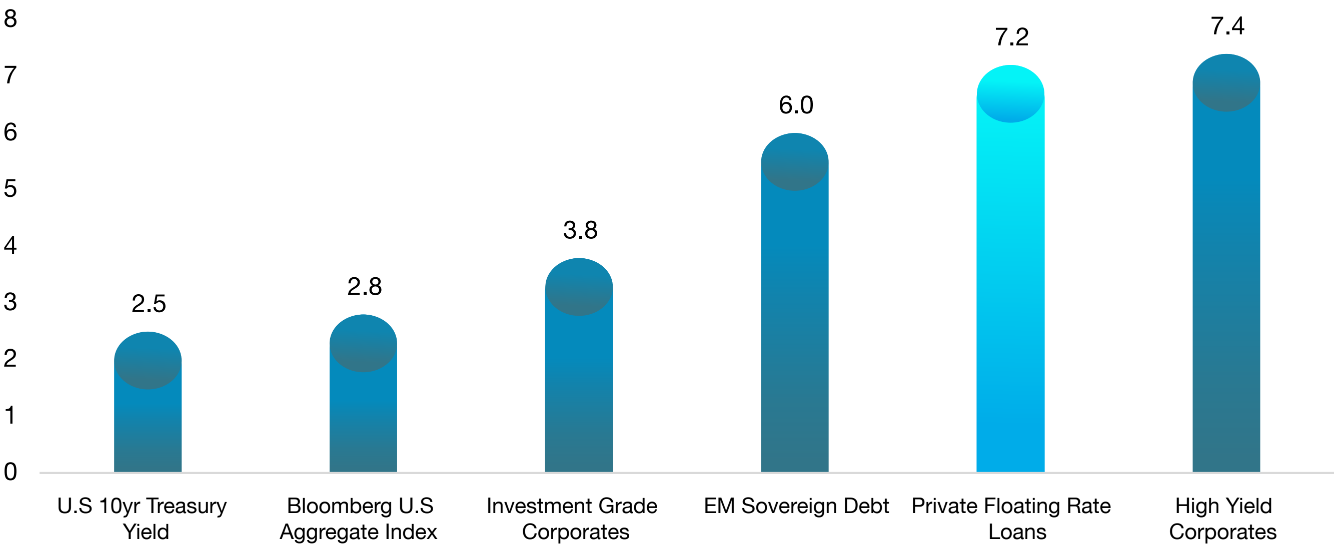
Private credit is one of the fast-growing investment segments with assets under management (AuM) of USD 1.6tn as of March 2023. It is expected to grow to USD 2.3tn by 2027, with more optimistic estimates placing it at USD 3.5tn by 2028.[1] The asset class has also outshone other debt instruments in terms of past performance and is expected to generate 11.3% annual return in the next 5 years.[2] As an alternative asset class, it also aids in portfolio diversification.

Global Private Credit Market Size (USD bn)



Source: AllianceBernstein

Performance of Private Credit Over Public Debt - 15-year average yields (%)



Source: Moonfare, Trez Capital, Nuveen (2022)

[1] MorganStanley, Blackrock
[2] Blackrock

As an emerging asset class with immense growth prospects and attractive estimated returns, private credit has piqued the curiosity of many. According to a survey of family offices, lack of knowledge about specific asset classes has been cited as significant barrier to private markets investing.[3] In this context, we set out to explore the world of private credit.

Private Credit – A Primer

What is private credit?

Private credit refers to provision of loans by a non-bank lender to companies that are typically small-medium enterprises and are non-investment grade. These debt agreements are agreed privately between borrowers and lenders, and are not traded on public markets. Returns in this asset class are achieved by charging a floating rate spread above the reference rate.

> **"Customized funding solutions & speed of execution are factors likely to drive growth of private credits"**

What is spurring private credit?

Following the global financial crisis, banks have pulled back from lending amid regulatory oversight and market turbulence and private credit has been quick to fill in this void. In recent months, monetary tightening, macroeconomic uncertainty and banking crisis in the U.S have led to tightening of lending by the banks, spurring growth in private credit. Going forward, in addition to tightening lending standards by the banks amid less favourable economic outlook, factors such as borrowers preference for customized funding solutions and speed of execution offered by private credit, investors' desire for diversification, catering of public markets mainly to large borrowers are likely to drive growth of private credit.

What are the benefits of private credit?

Borrowers benefit from the speed, certainty of execution, customization offered by private lenders. For investors, the asset class offers the following benefits,

1. Income generation - As a credit investment, the asset class offers predictable stream of cashflows through interest payments by borrowers. In the decade to 2022, the asset class' returns were about 3-6% over public high yield and broadly syndicated loans.[4]

2. Resilience - As lenders have deeper access to company records, it offers scope for better due diligence and documentation. Nearly 80% of private direct loans recover from defaults, compared with 50% for unsecured public corporate bonds.[5] The lending agreements are also tighter than in public markets.

3. Diversification – The asset class has low correlation with stocks and bonds.[6] Additionally, the multiple strategies within private credit such as corporate credit which is cyclical and distressed debt which are countercyclical themselves offer diversification benefits.

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[3] Moonfare
[4] Goldman Sachs
[5] Moonfare
[6] Moonfare

How is it different from private equity?

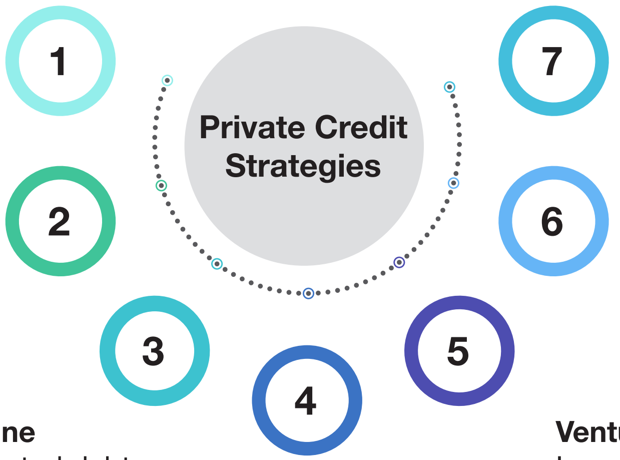
	Private Credit	Private Equity
Ownership	No stake ownership for the investor	Ownership stake acquired by the investor
Predictability	Predetermined interest rate and loan repayment plan	Returns dependent on the target company being listed or sold to another investor
Term	Short to medium term investment	Long-term investment
Liquidity	Interest payments eases liquidity constraints.	Low liquidity
Potential Returns	Likely lower than private equity but more certain	Higher but uncertain
Risk	Relatively lower-risk investment	Higher-risk investment

Source: OurCrowd

What is role of private credit in a portfolio?

As they are structured as floating rate loans, the returns improve with increase in interest rates. In addition to improving fixed income returns, private credit aids in modulating risk in private markets. As they are senior to private equity, including them could reduce total risk while maintaining return expectations. Over the period 2015-2023, a portfolio with 20% allocation to private credit had lower volatility, higher annualized returns, and added 140 bps of income.[7]

What are the different private credit strategies?



Direct Lending
Non-bank lending, directly to small and medium enterprises

Distressed
Debt of companies that are in bankruptcy, or likely to enter bankruptcy

Mezzanine
Subordinated debt that is senior to equity position

Special Situations
Funding an event like merger or spin off

Venture
Loans to start-up or early stage companies

Fund of Funds
Fund investing in many third party debt funds

Unitranche
Combines senior and subordinated debt into one tranche

Source: Blackrock

[7] Blackstone

Of the strategies, direct lending-senior debt constitutes a major portion of private debt at about 30%, with AuM close to USD 500bn. This is followed by distressed debt and special situations with AuM of each being close to USD 300bn.[8]

Major Players and Performance of Funds

Globally, many major fund managers have exposure to private credit. For example, Goldman Sachs AuM in private credit is over USD 170bn while Ares Management has about USD 160bn investment in direct lending strategies.

Top 10 Companies By Amount of Capital Raised For Past 5 Years (January 2018-June 2023)

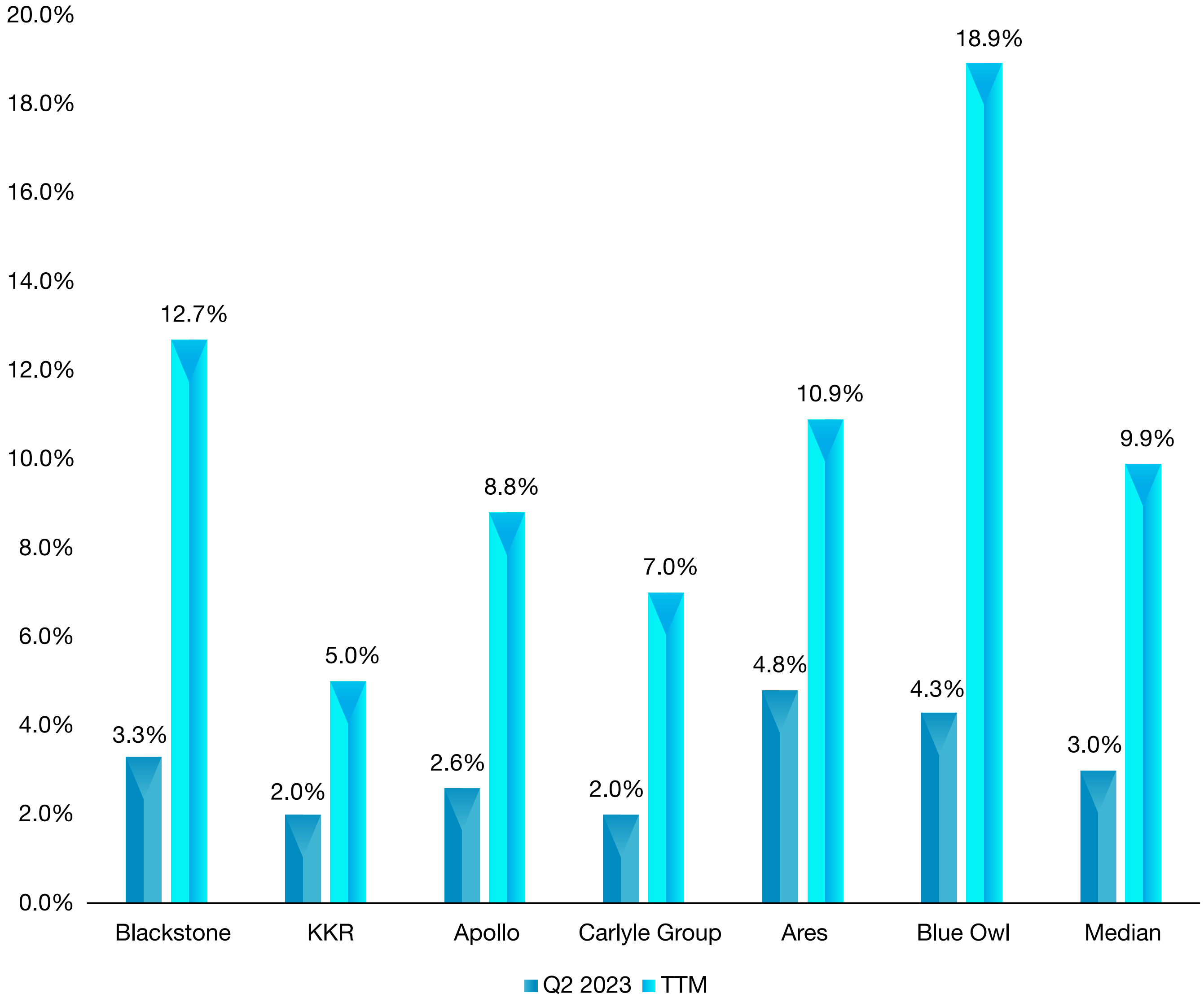
Rank	Company	Headquarters	Amount Invested USD mn
1	Ares Management	Los Angeles	117,171
2	Goldman Sachs Asset Man-agement	New York	83,421
3	HPS Investment Partners	New York	66,742
4	Blackstone	New York	58,389
5	Apollo Global Management	New York	49,612
6	Intermediate Capital Group	London	49,482
7	Oaktree Capital Manage-ment	Los Angeles	46,317
8	BlackRock	New York	45,727
9	AXA IM ALTS	Paris	43,769
10	M&G Investments	London	38,005

Source: Private Debt Investor

[8] Blackrock; As of March 2023

With most private debt being floating rate loans, the funds have delivered positive performance amid rising interest rate environment. According to Pitchbook, private debt funds have returned 4.2% in 2022. Over the long term, 2009–19 vintage funds have generated a median net IRR of 9.3%.[9]

Gross Private Debt Returns Reported By Major Firms

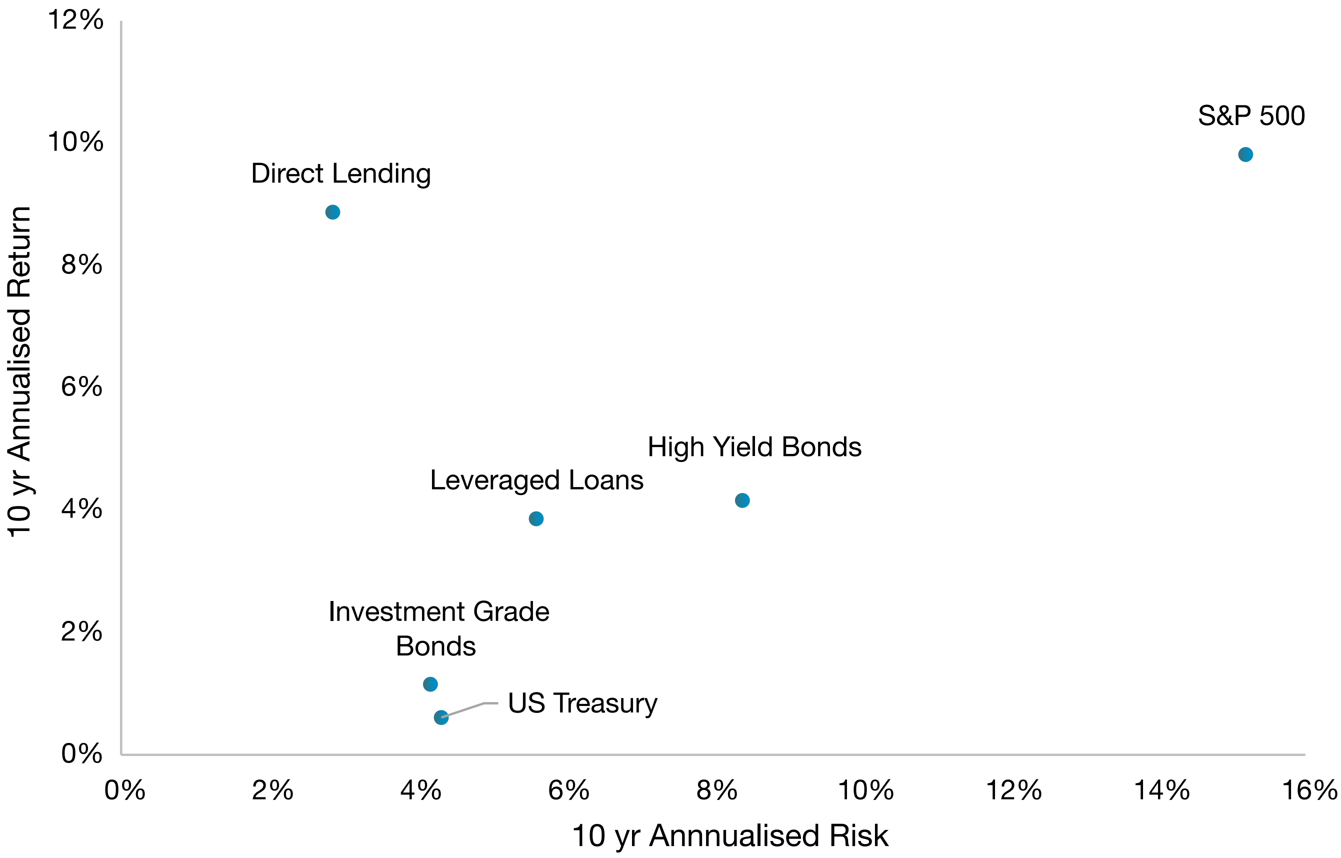


Source: Pitchbook

A comparison of risk-return profiles of asset classes shows direct lending, a segment of private credit, has lower risk and higher return than its more liquid public market peers.

[9] McKinsey; 1IRR spreads were calculated for funds within vintage years separately and then averaged out. Median IRR was calculated by taking the average of the median IRR for funds within each vintage year.

Comparing Risk & Return for Select Asset Classes (Q3 2013-Q3 2023)



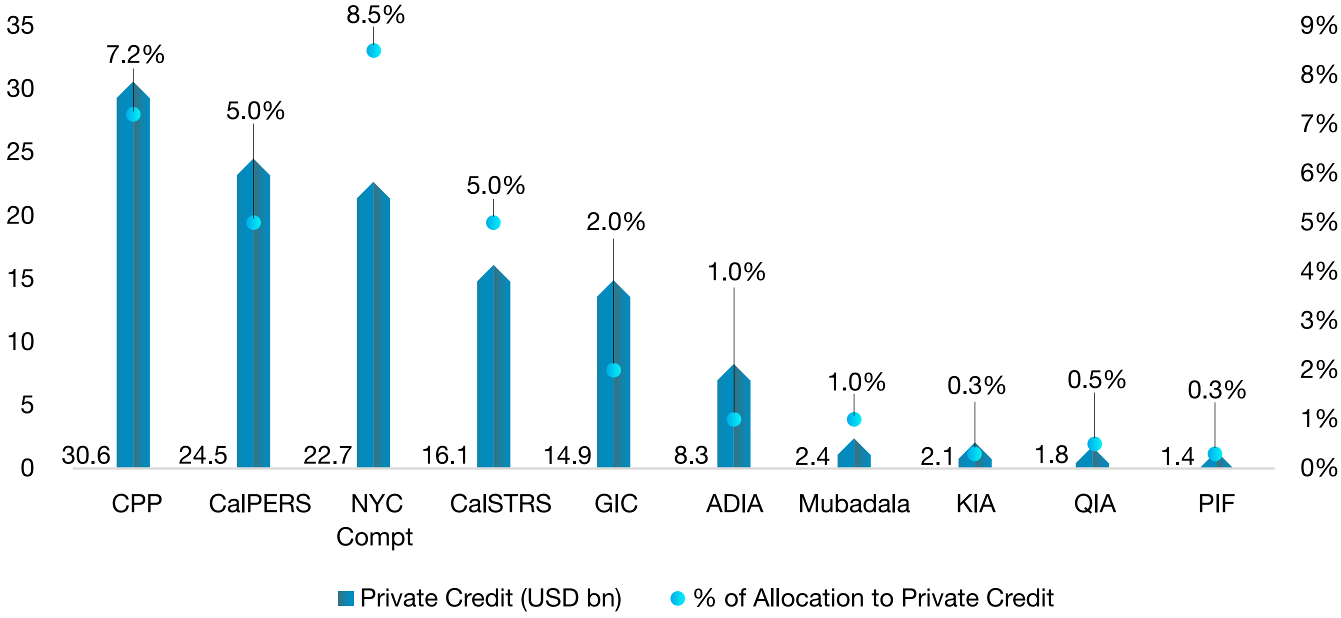
Source: Refinitiv; Note: Indices considered - Direct Lending- CliffWater Direct Lending Index; The index tracks private middle market loans, the largest segment of private credit market.[10] Investment Grade Bonds – S&P US Aggregate Bond Index. US Treasury – S&P US Treasury Bond Index. Leveraged Loans -Morningstar LSTA US Leverage Loan 100 Index. High Yield Bonds – ICE BoFA High Yield Index.

Share in Asset Allocation of Institutional Investors

A recent survey of institutional investors managing USD 3tn in assets has found that their portfolio allocation to private credit averages at 5.7%.[11] According to another survey of asset managers across Europe, the Middle East and the US in November 2023, nearly 75% of respondents plan to increase investments in private credit over next 12 months.[12] The asset class is also seeing favour among sovereign investors, given their lower liability constraints compared to banks and higher risk appetite on the back of longer time horizon available for investment. Among top 10 global State-Owned Investors (SOIs) by AuM, average allocation to private credit has grown from 2% in 2015 to 3.2% in 2020.[13]

[10] CliffWater
[11] Goldman Sachs
[12] Funds Europe/Aeon Investments
[13] Global SWF

Private Credit Allocation by Some SOIs (2022)



Source: Global SWF

Risks and Regulatory Environment

Credit risk is heightened as the borrowers may have weaker debt profile as they are likely to have been denied funding by banks. As private credit funds are typically closed ended, investors might not be able to take their money out during downturn. Additionally, illiquidity and lower underwriting standards than banks are also risks associated with private credit. About 33% of the private debt deals in 2021 were covenant-lite, compared with 15% in 2020, showing growing acceptance for lower downside protection.[14]

With most private credit loans being floating rate loans, while higher interest rate environment offers improved returns, it also brings in the element of higher default risk.

"Private credit is largely unregulated. Given the growth of the industry and involvement of retail investors, there is growing concern amongst regulators about the systemic risk"

However, estimating the default rate in private credit is difficult given the opacity. Hence privately-owned single-B/CCC rated issuers U.S high yield market could be considered as proxy, given their leverage at 5.8x is comparable to that of implied leverage of U.S private credit which is estimated at 6x. Based on this, the default rate in private credit space for 2023 is estimated at 4.5%. This compares with the default rate for overall HY market at 1.4%.[15]

Private credit is largely unregulated. Given the growth of the industry and involvement

[14] Crisil
[15] Financial Times/Bank of America

of retail investors, there is growing concern amongst regulators about the systemic risk posed by the segment. In case of deterioration in credit quality in the backdrop of high interest rate and slowing growth, given the opaque nature of private credit, it might not be noticed until it is spilling over to the broader economy. Other concerns include mass withdrawals from open-ended funds, lending by banks to private credit funds. In this backdrop, regulatory landscape is getting more stringent in the opaque private markets. Some recent regulatory developments are,

- **U.S –** In August 2023, the Securities and Exchange Commission passed rules that amongst other stipulations would require private fund advisers to provide investors with periodic statements on fund fees, expenses, and performance etc. However, stakeholders in the private fund industry have sued the regulator stating that such rules are beyond the bounds of its authority. In December 2023, US federal banking regulators proposed a new set of reporting requirements for bank loans and commitments to private credit lenders and intermediaries.

- **European Union -** In July 2023, a draft regulation was proposed by the member states and European parliament's negotiators. This would restrict the amount of borrowed money that private debt funds could invest.

- **U.K –** Private credit market is broadly unregulated.[16] In September 2023, Financial Conduct Authority was reported to have been preparing to review private market valuations. In recent months, Bank of England had asked banks to report of their exposure to private credit. It has also highlighted that with the end of period of cheap money, its impact on private markets has to be focused upon.

Some GCC countries have also passed regulations related to private credit.

- **UAE -** The Financial Services Regulatory Authority of the Abu Dhabi Global Market (ADGM) has issued its Private Credit Fund Rules in May 2023. These rules would enable ADGM based funds and their fund managers to originate and invest in private credit. In June 2022, Dubai Financial Services Authority implemented a new regime for private credit funds operating in the Dubai Financial Centre.

- **Saudi Arabia –** Saudi Capital Markets Authority had introduced regulations for credit funds in early 2022. This was the first credit fund regime adopted in the region.[17]

> **“UAE and Saudi Arabia capital markets authorities name passed regulations for private credit”**

[16] ReedSmith
[17] Lexology

Costs of Funds

According to a study on fees for private credit funds in the market from 2016-Q3 2022, management fees and carry have evolved from 2% and 20% in 2009 to a median of 1.5% and 15% as of Q3 2022.[17] Management fee had ranged between 0.4% to 1.75% as of Q3 2022. Recently some players such as KKR and Carlyle have announced that they would not be taking any carry on their new European private credit funds. Typically, private credit funds charge a management fee and an incentive fee. While they do not seem to levy upfront placement fee and distribution fee for institutional investors, the same is levied for Class D shares which are available only to certain distributors.

Sample Fee Structure – Blackstone Private Credit Fund (BCRED)

Fee Type	Fee
Management Fee	1.25% per annum on NAV
Incentive Fee	12.5% of net investment income (subject to 5% hurdle rate and catch-up) paid quarterly 12.5% of realized gains net of realized and unrealized losses
Upfront Placement Fee (Not applicable for institutional investors)	Up to 1.5% (Class D shares) Up to 3.5% (Class S shares)
Distribution / Servicing Fee (per annum, payable monthly – not applicable for institutional investors)	0.25% (Class D shares) 0.85% (Class S shares)

Source: Blackstone

Suitability for Investors

While funds are being offered to retail investors, given the emerging nature of this asset class, lack of transparency and evolving regulatory space, the segment is more suitable for institutional investors and high net worth individuals.

[18] Callan

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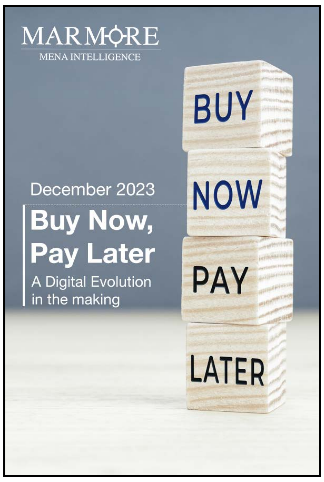
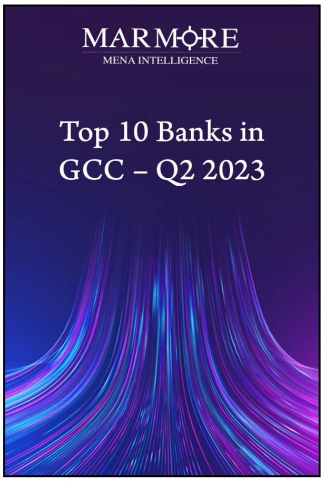
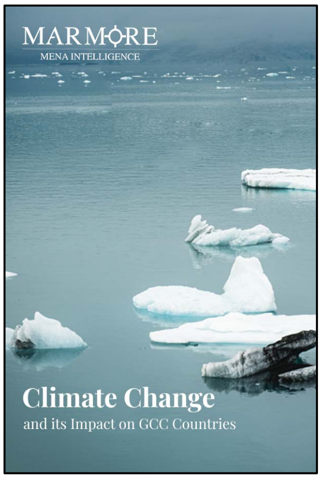


Buy Now, Pay Later - A Digital Evolution in the making

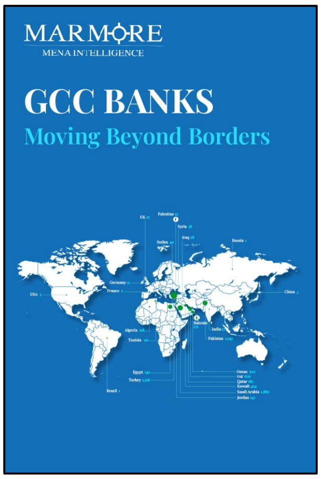


Top 10 Banks in GCC - Q2 2023

Global Minimum Effective Tax Rate - How GCC countries will be impacted?

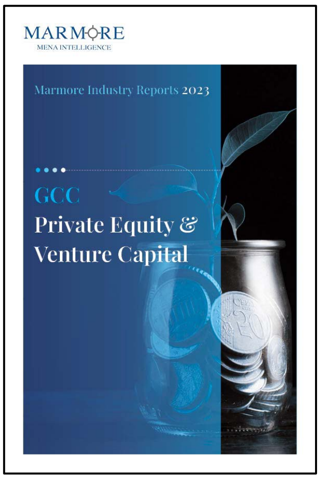


Climate Change and Its Impact on GCC Countries

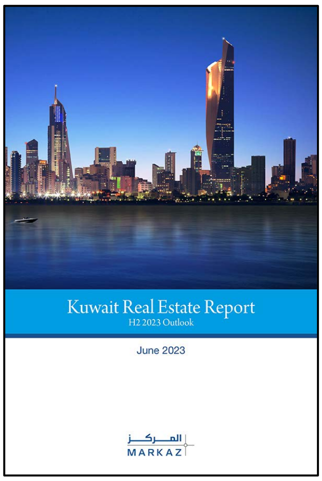


GCC Banks - Moving Beyond Borders

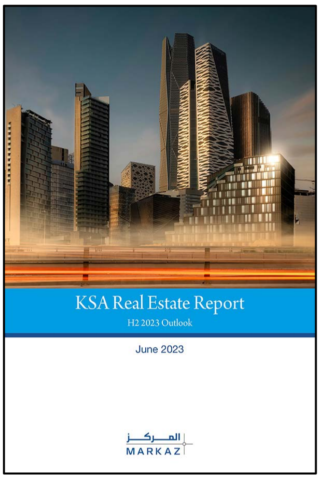
China Slowdown: GCC and Global Impact



GCC Private Equity and Venture Capital



Kuwait Real Estate Out-look H2 2023

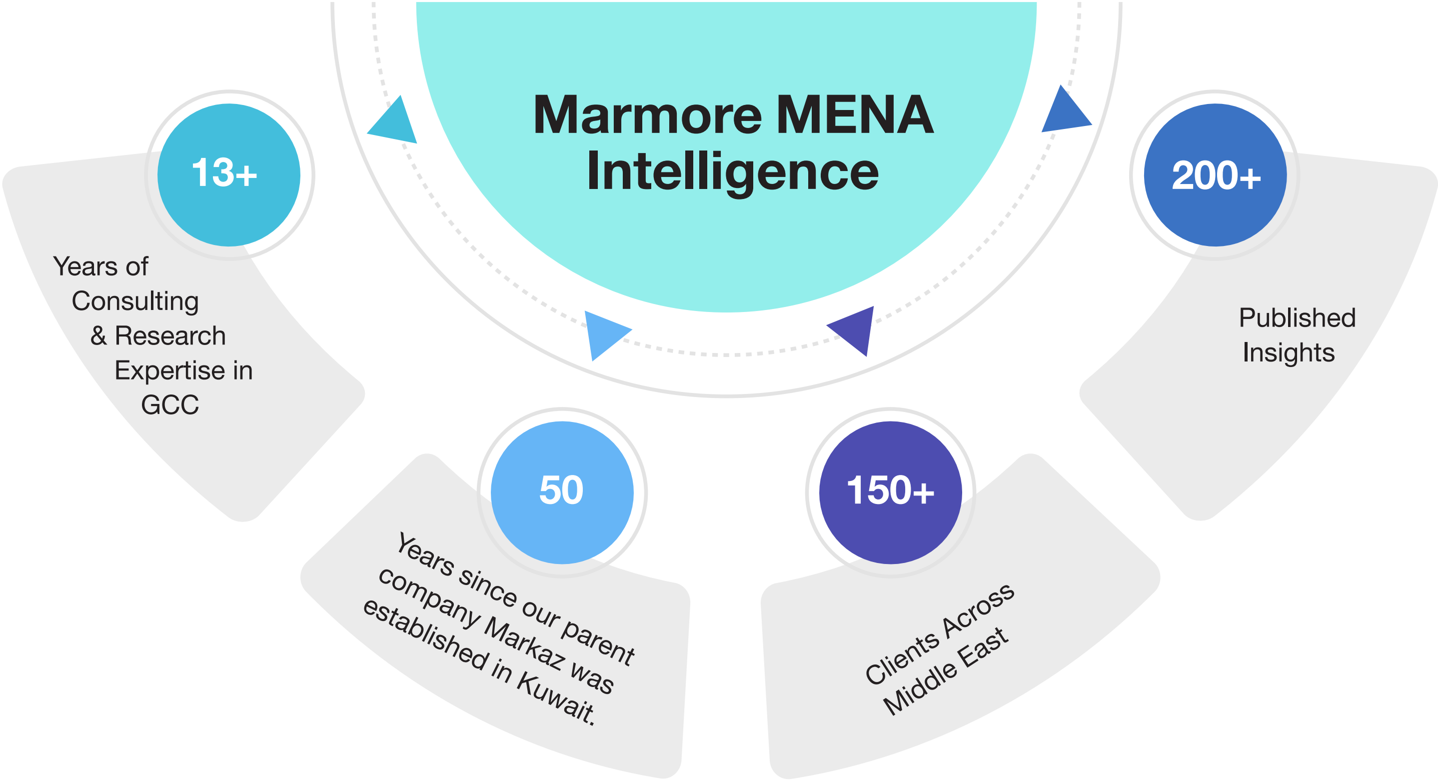


KSA Real Estate Outlook H2 2023

UAE Real Estate Outlook H2 2023

GCC - An Attractive Emerging Market Allocation Play

Fed Interest Rate impact on GCC banks



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