CIO Office Outlook

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Roadmap for Private Credit: 2024

February 2024

Overview on the Key Opportunities & Challenges

In this note we highlight the key drivers that are expected to have an impact on Private Credit in the year ahead:

Key Private Credit Market Drivers

Weaker **GDP** trend may adversely affect, but severe recession risk is low.

Low | **Medium** | High

Buoyant **Capital Demand** remains a growth driver and is expected to create favorable conditions.

Low | **Medium** | High

Moderating **Inflation** will not adversely impact companies' margins.

Low | Medium | High

Resilient **Fundraising/Dry Powder** driven by high demand from institutional investors.

Low | **Medium** | High

The **Interest Rate** cycle is expected to sustain returns.

Low | **Medium** | High

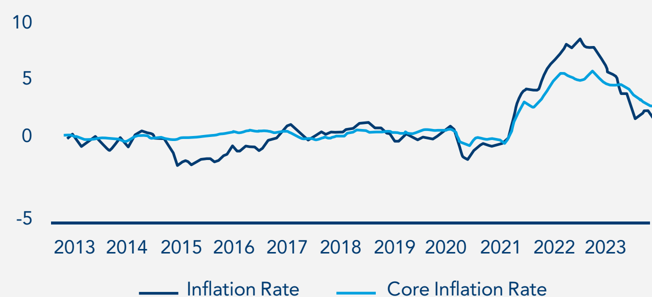
The **Default Rates** may increase, but marginally.

Low | **Medium** | High

Private Credit continues to grow and validate its status as a critical and scalable asset class. A pullback in traditional bank lending, coupled with higher interest rates and spreads have pushed private credit into 'mainstream' rather than being an alternative source of capital. In 2023, private credit totaled more than ~US$1.6 trillion globally and represents ~12% of the US$13 trillion alternative investment universe.[1]

Inflation

US Inflation



Inflation Rate — Core Inflation Rate

Source: FRED Economic Data

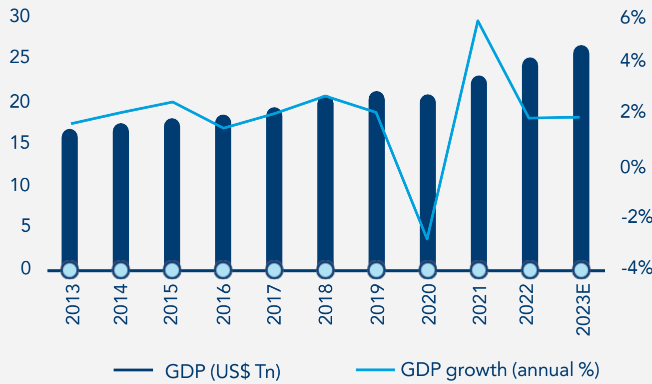
- Two years since pandemic, the global economy struggled with supply chain disruption, leading to an inflation spike. The annual inflation rate for the US peaked in June 2022 at 9.1%, since then have cooled down to 3.1% in November 2023.[2] The core inflation has been relatively sticky with only a drop of 2.6% to 4%.[3]
- The demand has stayed buoyant, with a low unemployment rate and an increase in real wages. We see the sharp downward move in inflation largely been contributed by the rapid supply-side recovery.

We anticipate a sustainable drop near the Fed's inflation goal range of 2%–2.5% by the end of 2024.

Source 1: Bloomberg
Source 2: Forbes – Inflation
Source 3: FRED Economic Data

GDP

US GDP



Source: IMF

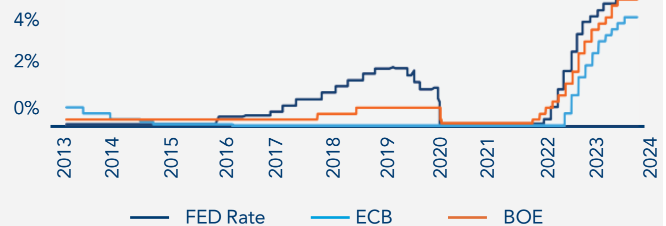
- Global GDP has shown strength in time of heightened uncertainty but is now moderating as the impact of tighter financial conditions, weak trade growth, and lower business and consumer confidence are increasingly felt.
- The lagged impact of previous monetary tightening will continue to feed through for the next few quarters, pushing GDP growth lower. As per IMF, U.S.'s real GDP is projected to grow by 2.1% in 2023, 1.5% in 2024, and 1.8% in 2025.[1]
- Geopolitical risk pose as a wild card; the ongoing conflicts in the Middle East and Ukraine, US-China tensions and global national elections in over 40 countries around the corner can quickly alter this outlook.

> We expect US real GDP growth to slow to ~1.5% - 1.8% in 2024, where severe recessionary conditions are unlikely.

Interest Rates and Yields

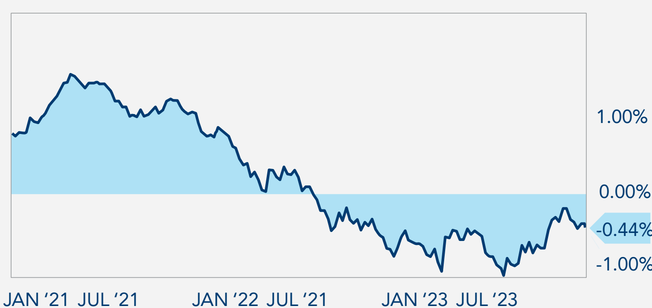
- In reaction to rapid inflation rise, central banks around the world took an aggressive stance with rapid interest rates hike. US Fed's reactive 2022 rate hike cycle is the fastest in the history with rates currently at 5.25%-5.5%. [2]
- Subsequently, a collapse of Silicon Valley Bank (SVB), Credit Suisse, and other smaller banks in Q1 2023 signaled a major shift in the bank credit availability in the US.

Interest Rates



Source: Bloomberg

2/10 Yield Spread



Source: YCharts

- Representing this fear, the 2/10-year treasury yield curve remained deeply inverted in 2023. An inverted yield curve is an classic indicator of a probably impending recession.
- However, more recently as we approach the peak of the interest rate cycle, the 10-year Treasury yield has cooled down from its peak of 5.02% to 4.10% in December, 2023.[3] Optimism reverting with a drop in inflation and dovish statements coming in from Fed's December meeting.

> In anticipation of US Fed reaching its target inflation rate, we are expecting a rate cut of 75-100 bps starting as early as Q2 2024.

Source 1: International Monetary Fund

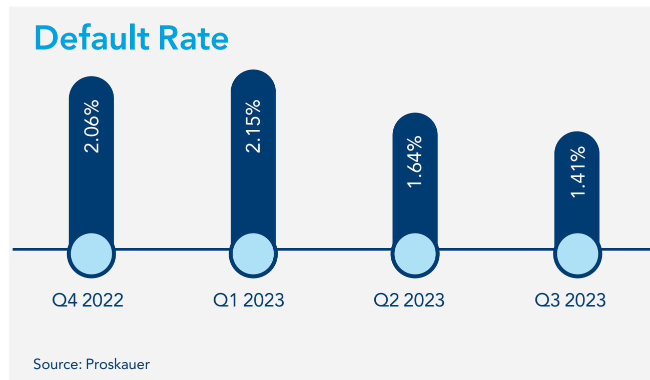
Source 2: Forbes - Inflation

Source 3: Reuters - U.S. bond yields

Default Rates

- The corporate sector proved to be resilient in 2023, with sustained consumer spending, notably in the US, and supportive tailwinds from capital investments.
- Proskauer's Private Credit Default Index, which tracks senior-secured and unitranche loans in US, saw an overall default rate of 1.41% in Q3 2023, down from Q1 2023 peak of 2.5%.[1]
- Although we have started to see the pressure build up in the annual revenue and EBITDA with economy slowdown. As per Lincoln International Private Market Database, the interest coverage ratio of US private credit borrowers have contracted from 1.7x in Q1 2023 to 1.5x as of Q3 2023.

Default Rate



Source: Proskauer

> We are witnessing a moderate increase in rating downgrades YoY. We anticipate that the default rate will rise above the historical average rate of 2% in accordance with this and the anticipated decline in the economy, however will stay below the GFC recessionary peak of 12%.[1]

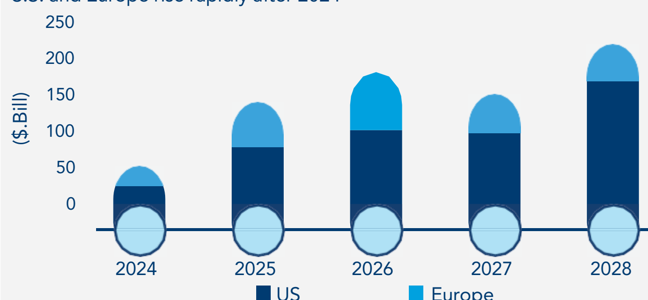
Capital Demand

- Market demand for fresh capital remains healthy, however the difficult fund sourcing environment is creating challenges for borrowers. Broadly syndicated loan (BSL) issuance in the U.S. and Europe is down nearly 30%, to its lowest level since 2010 (at $318 billion).[2]
- As per S&P Global, 82% of $790 billion debt of 'B- and below' have maturity dates lined up between 2024-2028. This demand is mainly concentrated in Health Care, Technology, Media, and Entertainment and Consumer products.

> We are anticipating a healthy pipeline of opportunities for lending, as the liquidity needs are effectively catered by private debt.

Debt maturities will pressure funding demands

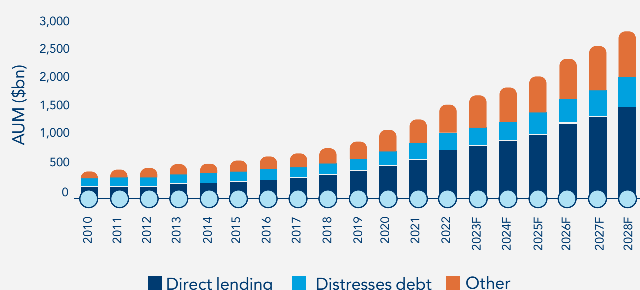
Annual maturities of nonfinancial corporate debt rated "B-" and lower in the U.S. and Europe rise rapidly after 2024



Includes nonfinancial corporate issues" bonds, loans, and revolving credit facilities that are rated "B-" and lower by S&P Global Ratings. Data as of July 1, 2023. Source: S&P Global Ratings Credit Research & Insights.

Fundraising and Performance

Global private debt AUM* by strategy



*AUM figures exclude funds denominated in Yuan Renminbi

Source: Preqin

Preqin estimates that private lending firms presently hold more than $400 billion in dry powder. Of this, $150 billion is set aside for special situations and distressed investments.

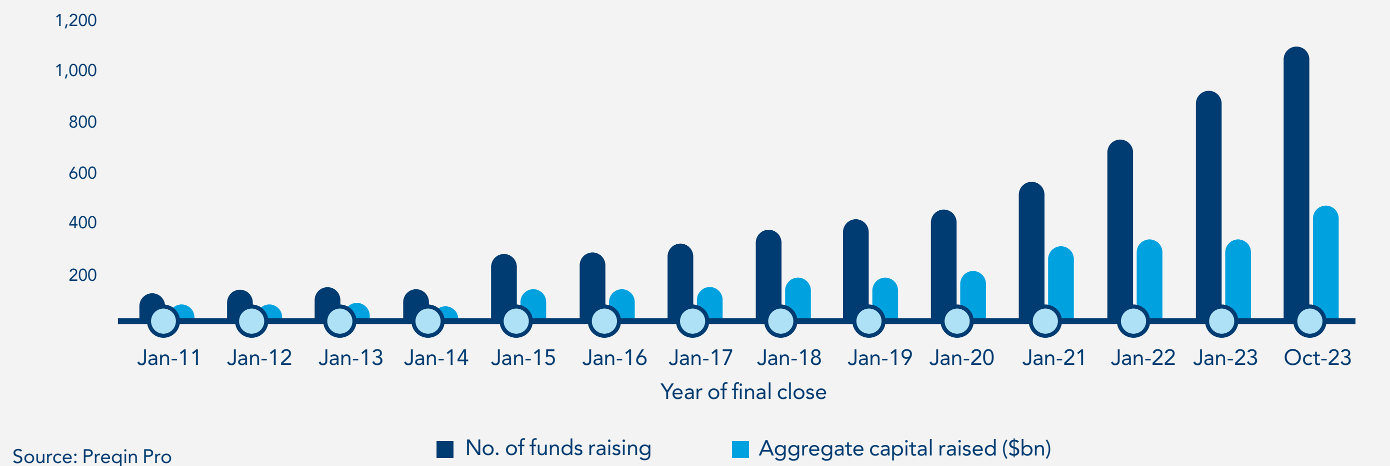
- Private debt AUM would increase at a CAGR of 11.1% from 2022 to 2028F, reaching an all-time high of $2.8tn, nearly double the $1.5tn figure from 2022.
- It is expected that direct lending will be the strategy with the strongest AUM growth - growing at 7.3%.
- As per the Preqin Investor Survey, ~55% respondents expect an increase in portfolio allocations to Private Debt, which exceeds the past 5 year average.

Source 1: LCD; Default rate by year of origination period 2007-2009.

Source 2: S&P Global - Middle-Market CLO And Private Credit Quarterly

- Fundraising remains resilient, as of Q3 2023, the number of private debt funds available in the market increased by 19%, from 906 to 1,080. Over the same period, the amount of capital these funds targeted rose by 42%.[1] This rise in capital targeted shows the optimism of GP's in the prospect of private credit.

Private debt funds in market 2011 – 2023

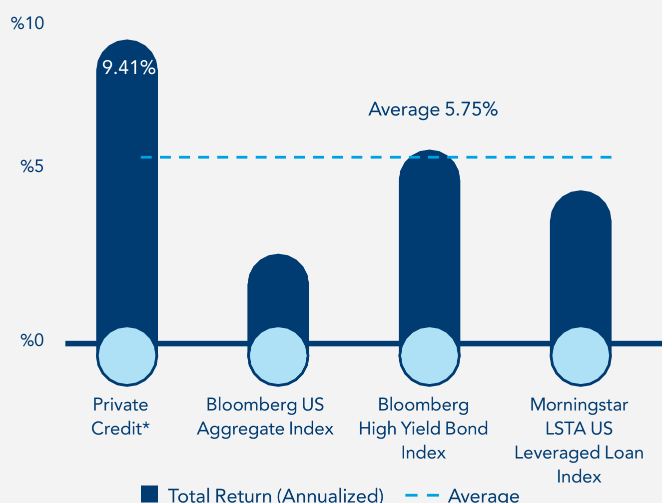


Source: Preqin Pro

- Private credit has consistently outperformed traditional fixed income asset classes, offering a defense against market fluctuations and losses during periods of market stress.
- Private credit has generated high returns with low volatility relative to other asset classes.

Asset Class Return

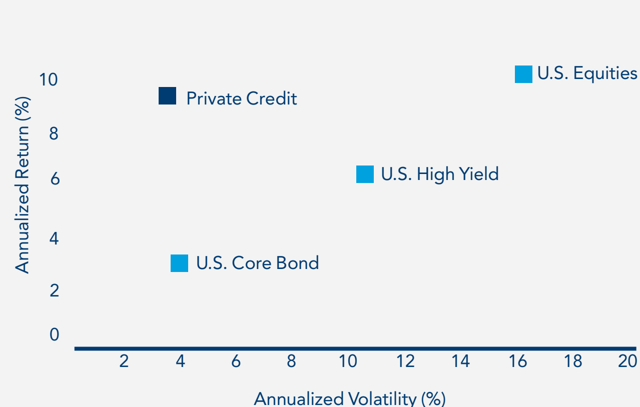
2005 – Sept 2023



Source: CDLI Q3 2023 Report

Asset Class Risk-Adjusted Return

September 2004-June 2023



Source: CDLI Q3 2023 Report

Period	YTD 2023	Q3 2023	1 Year	5 Years	Sept 2004 through Q3 2023
CDLI Total Return[2]	8.92%	3.17%	11.15%	8.64%	9.42%

Private Credit remains an attractive investment due to its ability to provide a reliable income stream, diversification, reduced portfolio volatility, and low correlation to other asset classes.

The macro conditions in 2024 are set in favor of private credit; inflation trickling down, gradual decline in interest rates, resilient GDP and corporate earnings, healthy capital demand and a mature supply of funds. Consequently, we believe it is well placed to continue to deliver an attractive risk adjusted return.

*Represented by Cliffwater Direct Lending Index (CDLI).

Source 1: Preqin

Source 2: CDLI Q3 2023 Report on US Direct Lending

CIO Office

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