CIO Office Insights

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Simplifying Private Credit

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Article Key Takeways

Private credit is an income generating alternative asset.

Private credit comprises of secured lending to private businesses on a bespoke basis.

An alternative source of capital to traditional banks mainly provided through a fund structure, which is managed by a specialist fund manager.

Private credit total AUM of the asset class has grown by 14% from $513m in 2015 to $1.3 trillion in 2022 and is expected to reach to $2.3 trillion by 2027.

Attractive risk-reward, diversifier, Inflation hedge, Income yielding and resilient asset class are often used as synonyms in defining private credit.

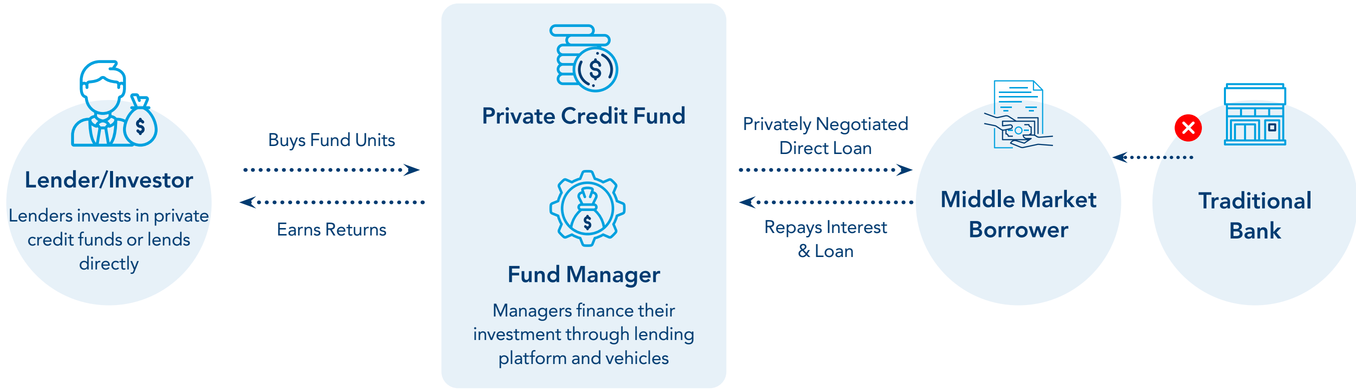
Attractive risk-return profile compared to traditional public market debt, with median net IRR of 9.5% and a standard deviation of 3.4%.

What is Private Credit

Private credit, is a secured lending method that allows businesses to raise capital. It is an alternative asset class that connects the demand and supply of lending and borrowing money through a privately managed fund. On the supply side it provides the investors with the opportunity to lend money to companies through private credit instruments such as loans and bonds. While on the demand side, for businesses, this form of credit is a more attractive alternative to the traditional lenders due to their faster transaction execution capabilities and availability of flexible terms. This opportunity to bridge the two sides have expanded dramatically over the last decade as traditional bank lending were constrained in the post credit crisis world due to regulatory pressures and eyeing this the alternative sources of risk capital stepped in to fill this void.

These borrowing businesses are often middle-market private equity-backed companies, which simply means that both lenders and equity providers can work together on the operational and capital structure to improve the chances of success. These businesses represent an essential cross-section of the economy and are a critical driving force in creating a sustainable source of jobs and revenues. As per National center for the middle market[1], the U.S. middle market is commonly defined as companies with annual revenues ranging from $10 million to $1 billion, depending on the industry. These companies although may not be the largest in the sector but are still an economic powerhouse contributing about 48 million jobs and about one-third of the $30 trillion in annual revenue generated by the private sector in the U.S.

Source 1. National center of the middle market FY2022 MMI Report.

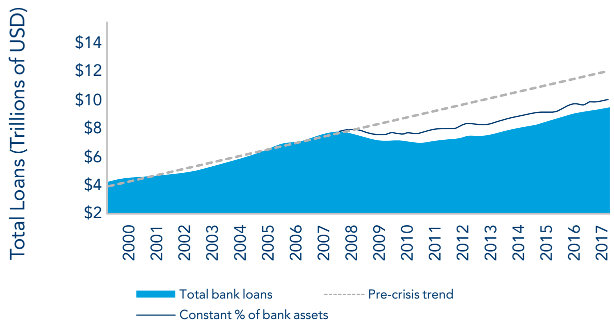


Private Credit: A Rising Star

Private credit has been in existence since the initiation of the lending industry. During the 90's, the financing landscape was simpler with banks being the primary financers in the economy, holding over 70% of the market share in leveraged buyout debt. Post 2008, this scenery quickly evolved as the world recovered from the global financial crisis and sweeping regulatory changes were brought to curb the traditional financial institutions. During this time, institutional investors, in search for income generating opportunities, stumbled upon the oasis of the private credit market with its vast landscape of middle market companies actively seeking sources of non-banking funding.

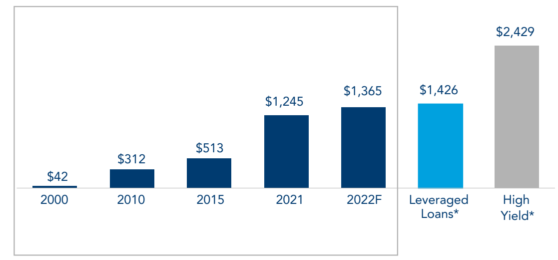
Since then, the private credit sector in the United States has experienced significant growth, with assets under management surpassing $1.3 trillion in 2022. This growth is expected to continue as investors seek the comfort in its appealing features during times of market volatility, including low correlation, current yields, floating rates, and insulation from declining valuations. Moreover, the variety of strategies available in this asset class contributes to its consistent growth. According to Moody's recent estimate, total assets under management are expected to reach at least $2.3 trillion by 2027.

Alternative lenders fill the funding gap left by banks post 2008



Source: World Economic Forum, Rice University's Baker Institute, FDIC

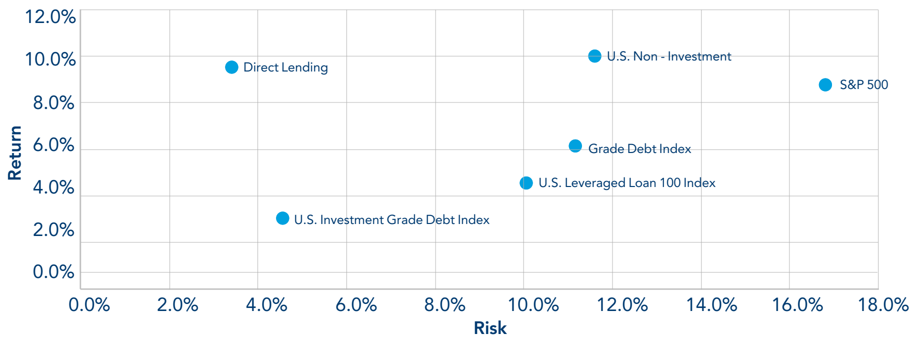
Private credit market growth



1Source: Bloomberg Finance L.P. & Preqin. Size of 'Assets Outstanding' represents current invested assets at NAV, including dry powder as of September 2021. * Source: J.P. Morgan. Size of the Global USD markets represents current market value of Global Leveraged Loans & High Yields Markets respectively as of May 31, 2022.

As a result, investors can be confident in the asset class,s ability to achieve projected growth due to its strong performance track record. Noting here that direct lending is the most prominent strategy within private credit and it has a resiliently provided a 9.5% median net IRR with volatility of 3.4% for 2004-2022 period.

Private credit outperformed other public asset classes since 2004



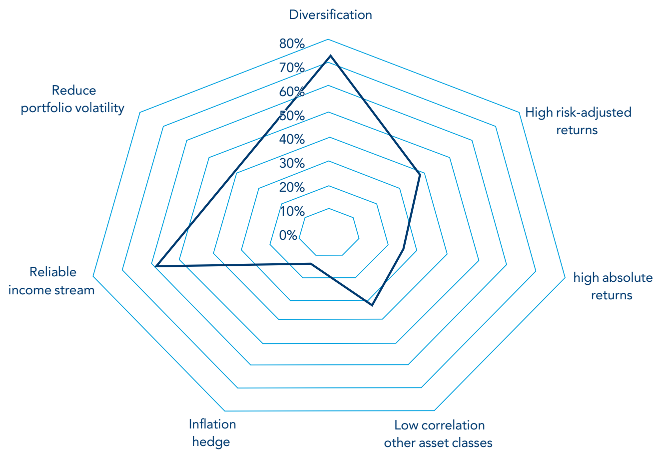
Source 2: Cliffwater Direct Lending Index, Q4 04 – 22 Q3. U.S. Investment grade debt index is represented by Bloomberg US Aggregate Index. U.S. Non-Investment grade debt index is represented by Bloomberg US Corporate High Yield. U.S. Leveraged Loan 100 Index is represented by Morningstar LSTA US Leveraged Loan 100 Index.

Why Invest in Private Credit

Investors commonly invest in private credit through commitments to unlisted private debt funds which are managed by fund managers specializing in this asset class. These funds are typically structured as limited partnerships where investors are able to combine a pool of capital which the fund manager can efficiently invest to generate returns.

The Preqin's web-chart displays the outcomes of a recent survey that outlines the motives of institutional investors to invest in private credit.

Investors reason for investing in private credit



Source : Preqin Pro 2022

Portfolio Diversification

Private credit investments offer a distinctive touch to a portfolio as compared to traditional public credit markets. With a range of strategies employed within this asset class, its performance base can be diversified based on the economic health of the borrower, industry and covenants. Moreover, some strategies can function in sync with the economic cycle or counter-cyclically.

Stable Current Income

The inherent nature of credit with fixed yield linked to investments makes it more resistant to an economic downturns relative to equity. This provides an additional smoothing effect on the overall portfolio performance over economic cycles.

Inflation Hedge

Rising Interest rates and inflation, a common site in today's world, are generally bad news for traditional debt instruments. However as private debt typically consists of floating rate loans it allows to hedge against risk and be resilient to inflationary pressure.

Attractive Risk Adjusted Return

Private credit has performed better than public loans in the last ten years, thanks to its yield premium and resilience. As per Preqin, this asset class has also provided an attractive risk return profile relative to other alternative asset class with a median net IRR of 10% and a standard deviation of 11.6%. [1]

Investment Flexibility

Private credit investors have an structural advantage over public market instruments as they have the freedom to choose the companies they invest in and negotiate the terms of the loans. This level of control allows for better management of risk and higher potential returns.

Secured Lending

Private credit investors benefit from deal structure which are more secured and robust than public market credit transactions. This protection is derived from better collaterals and financial covenants securing the loan as well as investors having direct access to management.

Seniority in capital structure

When a company becomes insolvent or fails to make debt payments, a senior direct lender has the advantage of claiming their payments ahead of any other financial responsibilities.

Source 1 : Preqin Private Debt 2023 report – For vintages 2009 to 2019.

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