Private debt managers bullish despite uncertainty

- Banks keep retrenching from the lending market
- Asset owners are reassessing allocations in the face of uncertainty
- The asset class is now seen as core in institutional portfolios
- 2024 could be a 'golden age' for private credit

LAUREN MILLS

When the global financial crisis wreaked havoc across the banking sector, private credit emerged as a potential winner.

The introduction of regulation forcing banks to focus on balance sheet efficiency meant many retreated from their traditional lending activities, leaving a void in the market.

Alternative asset managers were all too happy to step in. Private credit as an institutional asset class was born and became increasingly popular over the ensuing years.

Global asset managers are still in the process of restructuring to adapt to meet the growing demand for private debt opportunities from institutional clients.

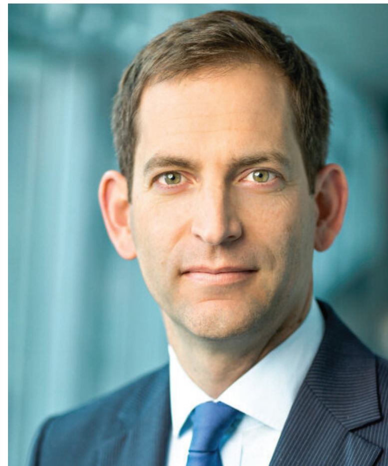
In October, Schroders Capital brought together its private debt and credit alternatives business in a new business unit, underlining the importance of the asset class to its own operations.

Schroders' newly formed Private Debt and Credit Alternatives (PDCA) business will comprise real asset debt, structured and corporate credit, speciality finance and impact lending.

The new unit will initially oversee $30bn (€28bn) in assets under management with more than 100 investment professionals, Schroders said.

Georg Wunderlin, global head of private assets at Schroders Capital, said at the launch that there was "clear appetite from investors" to capture the diversification and returns that private assets can offer.

"Global macroeconomics combined with the credit cycle are providing strong tailwinds particularly for debt and credit strategies," he said. "The private debt total market is estimated at around $23trn, but only some 6% is currently served by private credit managers, leaving plenty of room for growth."



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However, interest rate hikes, over-allocation to the asset class, fundraising challenges and higher default risks may bring about a re-evaluation of private credit.

Then there is the issue of whether performance can hold up in the event of an economic downturn, followed by questions about private debt's ability to generate a sufficient illiquidity premium over returns available on public securities.

Asset allocators have a lot to think about as they enter 2024, but despite the headwinds, there remains plenty of enthusiasm for private credit with some experts predicting 2024 could be a 'golden age' for the asset class.

Opportunities on the horizon

Christophe Fritsch, global head of alternative credit at Axa IM, believes that the coming months will bring several opportunities in the private credit space.

One of these is refinancing the upcoming maturity wall of corporate loans and bonds which are now approaching their repayment dates.

Fritsch says: "We expect to see issuers increasingly turning to the private credit market that can offer borrowers speed, certainty of execution, flexibility in refinancing solutions and confidentiality."

Banks continue to retreat from middle market lending due to increasing regulatory scrutiny. This will lead to opportunities to acquire discounted consumer and commercial loans, including the related origination platforms, from banks eager to reduce risk and raise liquidity.

Fritsch believes that for investors "this may present an opportunity to take over direct origination of a wide range of loans", adding that "this is particularly true for US banks that will be looking to sell some capital-intensive businesses".

Adam Wheeler, co-head of Barings' global private finance group, says demand for private credit has "materially grown due to the record levels of private equity dry powder in the market".

"Combined with the continued retrenchment of the banks, this has further created an opportunity for private debt firms to enter the market to help provide alternate financing solutions," he says.

Wheeler adds that the inflationary environment has led to higher interest costs for companies but also higher returns for investors.

He says: "When base rates are factored in, the absolute returns for the asset class are currently around 10% for first lien senior secured risk, which feels very compelling, due to the floating-rate nature of the underlying loans.

"For high-quality companies, like those we invest in, leverage levels for new investments have decreased and loan-to-value ratios have remained low."

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Terms and conditions are also moving in favour of lenders, he adds.

Mikkel Sckerl, portfolio manager and senior partner at Capital Four, is also confident about the prospects for private credit, despite stubborn uncertainty in the markets.

He says: "When there's still uncertainty in the world investors try to work out how they want to allocate going forward. I think the robustness of the return profile of private credit is quite attractive at the moment.

"When you do a senior corporate direct lending loan now it's at a 12% yield. So you're starting to see yields and expected returns that are quite attractive in their own right."

Institutions are still attracted

Preqin recently forecast that private

debt assets under management will grow at nearly 11% annually to $2.3trn in 2027, meaning the asset class is showing no signs of slowing in the immediate future.

Wheeler argues that institutions will continue to increase their allocations to private credit for a number of reasons.

He says: "Private debt can deliver regular distributions back to investors which can be considered as a valuable benefit for institutional investors' private markets portfolios.

"Deal flow volumes are anticipated to increase in Q4 2023/Q1 2024 as the quantum of dry powder is put to work, thus providing financing opportunities – at elevated return levels compared to around 12-18 months ago, due to the base rate increases – for the private debt asset class.

"Also, due to the underlying loans being 'private' in nature, there is no mark-to-market volatility that is experienced in comparable public debt securities. Assets are usually held to maturity, or when loans are repaid via a refinancing, for example, which further reduces the pricing volatility of these assets as there is a lack of an active secondary market."

Private debt capital is further receiving investor appetite due to the floating rate nature of the loans, which inevitably will increase the returns that institutional investors can expect from their investment.

Private debt has increasingly become a 'core' allocation within asset allocators' private markets portfolios. The asset class has also built a reputation and strong track record in the market for delivering regular distributions to investors while exhibiting very low loss levels so far, Wheeler notes.

He adds: "The asset class also offers a range of return options, depending on the risk appetite of the investor, via the ability to invest in various positions in the capital structure, or if an investor desires to employ fund level leverage to enhance their anticipated return outlook."

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Jonathan Stevens

Slowdown increases default risk

In the current market environment, borrowers are facing headwinds such as rising rates, wage inflation, cost inflation, and supply chain disruption that could lead to underperformance.

Wheeler says: "Although a recession or economic slowdown could lead to an increase in defaults, we believe that a strong focus on credit discipline at the underwriting stage – for example, stress-testing a borrower's ability to finance their interest payments in a rising rate and inflationary environment, and the implementation of tight lending documentation – can strongly mitigate the impact that these events can have on a portfolio and the asset class as a whole.

"Additionally, lenders have now experienced the unprecedented circumstances that COVID for example would have had on borrowers, and thus can deploy capital when many risks are known and can be underwritten. A focus on building a diversified portfolio of borrowers situated in defensive sectors should mitigate the impact of adverse market shocks on a portfolio, and further emphasise the resilience of the private credit market."

Jonathan Stevens, head of private debt at AEW, which recently created a private debt platform, says: "Default rates across the broad market will increase during periods of economic stress. Private debt risk, however, is highly idiosyncratic and we are confident that our current portfolio will continue to perform.

"As defaults manifest in the broader market, the capital available from banks and the CLO [collateralised loan obligations] market will reduce, bringing more balance in negotiation, leading to more conservative transaction structures and better pricing than have been available in the recent past."

The golden age of private credit

In the private markets space there is a bifurcation between an increased need for capital on the one side and decreasing availability of capital on the other side.

This adds up to opportunity on a potentially unprecedented scale, according to managers.

Wunderlin says: "Fundraising is hard even for private credit strategies – however, deployment is fairly easy because there's a lot of opportunity and on a relative value basis, and a lot of highly attractive opportunities."

Fritsch believes the coming year represents one of the best yet for private credit.

He says: "Both institutional and retail investors are actively looking for less correlated assets, higher yields, lower volatility, downside risk management and floating-rate exposure to be defensively positioned and earn compelling risk-reward returns which alternative credit provides.

"This unique configuration in terms of demand and supply for private debt is making us think this is the 'golden age' of private debt/credit with significant AUM raised over the last months and several platforms launched on both sides of the Atlantic."