Wealth matters

Beyond traditional: Pulling back the curtain on Private Credit

When you pull back the curtain on Private Credit, it reveals new opportunities beyond those offered by traditional asset classes. Private Credit provides investors with another avenue to support growth and innovation across industries and economies. These investments typically provide recurring income, while reducing portfolio volatility through economic cycles. Our preference is to combine more defensive, senior secured lending exposures with select growth opportunities, including mezzanine or opportunistic debt as well as distressed debt.

> "This is a good climate ... you can get equity returns from debt now, and when you invest in debt you have a much higher level of certainty of return relative to equity ownership."
>
> HOWARD MARKS, OAKTREE CAPITAL, MAY 2023

Private Credit is not a new asset class. On the contrary, it has been around for decades. Rapid growth followed the Global Financial Crisis (GFC) as banks faced increased regulatory capital requirements, and thus more restrictive lending practices. Non-bank lenders benefitted from this structural change, stepping-up to bridge the gap in supply of capital for corporate loans. Given the relative strength of the Australian banking sector, this trend was less evident and a key reason for the domestic Private Credit market being relatively nascent.

The past few years have seen a rapid rise in Australian investment into the asset class. For example, AustralianSuper is in the process of tripling its exposure to global Private Credit by the end of 2024 to circa $15 billion. Investors continue to seek new ways to generate attractive income and total returns amid a challenging economic and investment backdrop.

The diverse nature of the asset class enables investors to gain exposure to a vast array of attractive industries and companies, without some of the complexities and risks associated with equity ownership. It also typically offers low correlation to other asset classes.

Although interest in Private Credit has been gaining momentum, it still retains a level of ambiguity. Importantly, while opportunity knocks, so too does risk. In this *Beyond traditional* article, we pull back the curtain and demystify Private Credit by outlining:

- ✓ The market dynamics supporting continued investment into the asset class.
- ✓ The benefits and risks of including exposure in portfolios.
- ✓ Our approach to building Private Credit into portfolios.

Demystifying Private Credit

Private Credit can be divided into four main subsegments – Corporate Loans, Asset Backed Financing, Property Debt and Infrastructure Debt. This article predominantly focuses on **Corporate Loans**.

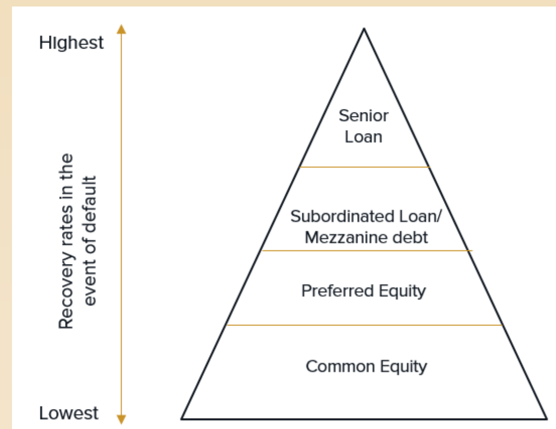
There are primarily three avenues for a company needing to borrow debt capital:

Loans from banks | Issue publicly-traded credit | Loans from non-banks

While larger companies typically rely on banks and publicly traded credit markets for financing, small to mid-sized borrowers have traditionally been limited to bank funding. Due to the shift in the regulatory environment post-GFC, these companies are increasingly reliant on non-bank lenders (Private Credit providers).

Private lenders can offer customised lending solutions tailored to the unique needs of borrowers. Loan sizes normally range from $10 million to $100 million, although some larger funds have much higher lending capacity.

The Private Credit market is highly diverse across industries, capital structure and credit quality – each opportunity carries individual benefits, returns and a level of risk for investors. Some important considerations include:



- **Seniority:** **Senior secured** debt ranks highest in the capital structure and, as such, has the highest recovery rate in the event of a default. This means senior secured loans typically carry lower risk and are therefore priced at lower interest rates. **Mezzanine debt** is subordinate to senior debt of the same issuer, and consequently carries higher risk and offers higher returns (in the form of higher interest rates).
- **Covenants:** Lenders may impose certain conditions, restrictions or requirements on the borrower. These are designed to protect the interests of the lender e.g. maintaining certain financial ratios (leverage and interest cover) or restricting asset sales.
- **Security:** It's critical to evaluate the collateral or assets pledged to the lender. This legal claim over the borrower's assets serves as a form of capital protection against default for the lender.
- **Credit quality**: The quality and creditworthiness of companies vary considerably. Some loans are known as **special situation or opportunistic**, which are provided to borrowers with unique needs or in specific situations, typically at higher levels of risk. Loans can also be made to non-performing companies – those facing financial difficulties, perhaps in need of a restructure. These are known as **distressed debt**.
- **Pricing:** Private Credit loans are generally floating rate and priced at a margin over a variable **base rate**, such as the bank bill swap rate. This margin should be commensurate with the level of risk taken by the lender, including illiquidity premium.
- **Potential equity upside**: Loan structures may include equity-like instruments such as **warrants** (option to purchase certain number of shares at a future date at a fixed price) which provide additional upside potential.

The stage is set – market dynamics driving Private Credit growth

> "The new reality is that some things — for example, holding certain types of credit — are more efficiently done by a non-bank."
>
> JAMIE DIMON, CHAIRMAN & CEO JP MORGAN CHASE

Companies have long relied on Private Credit to finance acquisitions and growth. Recent market dynamics continue to drive significant opportunities for investors in the asset class.

Supply dynamics – regulation limiting supply from traditional funding sources, such as banks

On the supply side, regulatory requirements to hold higher levels of capital have seen mainstream banks generally become more conservative in their lending practices. Increased regulations have resulted in banks having less appetite for smaller, more risky and less liquid credit issuance. This has had a range of implications:

1. Restricted business credit availability - as banks prioritise funding loans with lower capital charges, such as mortgages;
2. Inability to provide innovative solutions or loan structuring – internal risk frameworks within banks encouraged the underwriting of 'vanilla' loan products with standard terms, which may not necessarily cater to the unique needs of borrowers and their complexity;
3. Bureaucracy and rigidity of processes at traditional banks - leading to delays and uncertainty of funding for borrowers.

Private Credit in Australia has more than tripled in size since 2016, as small to mid-sized corporate borrowers are increasingly becoming reliant on non-bank lenders for debt capital. Looking ahead, we expect Private Credit to continue to grow and win market share in the Australian corporate loan market.

Demand dynamics – the need for funding as more growing companies stay private for longer

There are thousands of mid-sized private companies in Australia – approximately 35,000 – with innovative ideas and growth ambitions. These companies are typically limited to accessing capital from private lenders, given the scarcity in bank funding and desire of owners to retain control (rather than issue equity). Increasingly, these companies are staying private for longer (see: Private Market Equity: Exploring Aladdin's Cave), driving their need for private capital to fund growth.

Further, the demand for Private Credit is underpinned by record amounts of Australian Private Equity capital looking to be deployed – with Private Equity funds turning to Private Credit to support merger, acquisition and investment activity.

Investor dynamics – allocations to Private Credit are growing

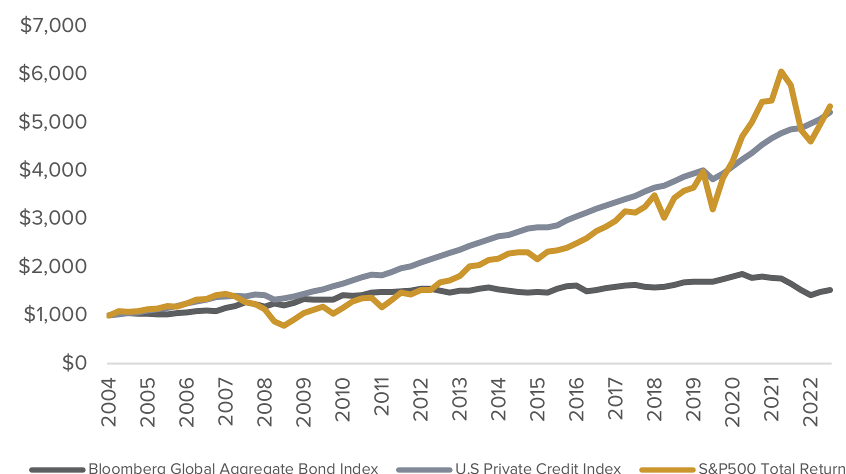
In Australia, portfolio allocations to Private Credit have been underrepresented. However, this is changing and now growing rapidly, with superannuation funds and private investors allocating more to the asset class – AustralianSuper, UniSuper, Aware Super and Mercer Super Trust have all noted their desire to deploy further capital into Private Credit.

Why include Private Credit?

The Private Credit asset class provides a series of benefits for portfolios, including:

1. Recurring income and strong risk-adjusted returns versus other asset classes

Target returns on Private Credit investments vary considerably, depending on the risk of the underlying loan and whether equity upside potential is available. Income is typically the primary source of return – borrowers make periodic interest payments, providing Private Credit investors with a recurring source of income (although this isn't necessarily the case for distressed or opportunistic loans).



Source: Bloomberg, Cliffwater Direct Lending Index

Over the past decade, Private Credit has generated annualised income returns of circa 10% – a higher yield than most other asset classes[1].

Relative to Equities, Private Credit has delivered comparable compounded returns but with lower volatility and drawdowns in periods of market stress.

In Australia, the more limited number of Private Credit providers and the strong demand for capital enables lenders to negotiate favourable terms on loans with borrowers, potentially generating higher returns.

A recent example was a loan funded by a domestic Private Credit fund provided to a fast-growing technology company founded in Australia, SafetyCulture (a global leader in mobile first, health, safety and compliance applications). The fund provided a A$20 million senior secured loan facility, with a maturity of three years, an 11% interest rate on drawn down capital, plus fees and other potential sources of upside.

2. Lower volatility

Given its illiquid nature, valuations of Private Credit investments typically exhibit lower volatility than asset classes which are traded and priced daily. Investments are not subject to the intraday fluctuations faced by publicly traded credit (which are dependent on, amongst many factors, investor appetite, interest rates and market conditions). Therefore, Private Credit has the potential to generate relatively higher returns per unit of risk than listed asset classes.

Importantly, returns have historically been resilient in periods of market volatility and shown consistent performance through both up and down markets.

[1] based on data from the Cliffwater Direct Lending Index as of end March 2023

3. Vast, diverse opportunity

> "(Energy transition is driving a) huge capital need, it's growth oriented, it's impacting hard assets and established businesses, and this is the type of environment that creates a favourable investment opportunity for us in the Private Credit business".
>
> ROBERT HORN, BLACKSTONE CREDIT, GLOBAL HEAD SUSTAINABLE RESOURCES GROUP

Increasingly, much of the world's growth, innovation and returns are occurring in private markets. When exploring Private Credit opportunities, there is significantly more diversity among types of borrowers – spread across industry, geography and size. Private Credit provides investors with exposure to less traditional sectors, including those leveraged to long-term growth trends, such as the energy transition – without some of the complexities and risks associated with equity ownership. This creates a prolific set of opportunities for Private Credit investors.

4. Low correlation versus other asset classes

Private Credit has historically exhibited relatively low correlation with both traditional asset classes (Equities, Fixed Income) and alternative asset classes, including Private Equity and Infrastructure. By combining strategies with lower correlations to other assets in a portfolio, investors can reduce overall portfolio volatility.

CORRELATIONS	U.S. Equities	Non-U.S. Equities	Emerging Markets	Global High Yield	Aggregate Fixed Income	Private Equity	Private Infrastructure	Private Debt	Private U.S. Real Estate
U.S. Equities	1.00								
Non-U.S. Equities	0.89	1.00							
Emerging Market Equities	0.80	0.85	1.00						
Global High Yield	0.41	0.44	0.39	1.00					
Aggregate Fixed Income	0.26	0.27	0.25	0.65	1.00				
Private Equity	0.41	0.42	0.40	0.04	0.00	1.00			
Private Infrastructure	0.46	0.52	0.50	0.14	0.11	0.66	1.00		
Private Credit	0.33	0.36	0.31	0.78	0.20	0.06	0.14	1.00	
Private US Real Estate	0.37	0.33	0.28	0.07	0.08	0.53	0.60	0.03	1.00

Source: Russell Investments

Uncovering the risks

The broad spectrum of Private Credit opportunities leads to very different risk and performance drivers. As with any investment, risks accompany returns.

Illiquidity risk

Private Credit is not liquid like traditional Equities or publicly traded credit. Private Credit loans tend to be held to maturity, which typically range from three years to seven years. As such, investment vehicles tend to have longer lock-up periods and fewer redemption options.

Credit / Default risk

The non-investment grade nature of Private Credit investments implies they typically carry higher credit and default risk versus publicly rated and traded credit investments.

This reinforces the need for detailed due diligence, negotiation of terms and protective covenants by lenders. Importantly, the bilateral and customised nature of Private Credit loans allow lenders to work directly with borrowers to restructure loans under periods of stress, taking a proactive stance in supporting borrowers when risks arise.

If default does occur, loans provided on a senior secured basis (taking the highest position in the capital structure) with full covenant package typically provides lenders with capital protection, as loans are secured against assets in the event of a borrower default.

Building Private Credit exposure into portfolios

> "The anticipated returns, risks associated with the business cycle, and the altered financing landscape all contribute to a favourable range of opportunities for direct lenders."
>
> BCA RESEARCH, PRIVATE CREDIT SPECIAL REPORT, JUNE 14, 2023

Mutual Trust focuses on protecting and growing capital over the long-term under various economic and investment cycles. We believe it's essential to look beyond traditional asset classes by incorporating exposure to private markets – enhancing potential returns and reducing portfolio volatility – including Private Credit.

Our preferred portfolio approach is to combine exposure to publicly traded credit with Australian and international Private Credit opportunities. The optimal allocation is driven by factors such as risk tolerance, liquidity requirements and performance expectations.

In the second quarter of 2023, more than US$71.2 billion in capital was raised for new Private Credit funds, more than double the previous quarter, according to Preqin Research.

Mutual Trust partners with active Private Credit fund managers to gain diversified portfolio exposure. With the growth in the asset class, the number of Private Credit funds has risen rapidly. There are concerns around how hastily some fund managers may deploy capital in a competitive landscape, potentially rushing their due diligence process. Dispersion of returns among managers can be wide.

We reinforce the need for experienced managers to mitigate potential default and maximise capital preservation. We seek fund managers with a depth of experience in financial structuring through various market cycles, negotiation of terms and protective covenants, due diligence in assessing creditworthiness and disciplined deployment of capital. Our preference is to combine more defensive, senior secured lending exposures with select growth opportunities, including mezzanine or opportunistic debt, as well as distressed debt.

Examples of companies funded by Private Credit investments include Splend, EdventureCo and Altus Power. Please see following page for details.

Splend is a subscription-based, rent-to-own, business providing cars to rideshare and delivery drivers, along with affordable financing solutions tailored to the sector.

Splend currently leases cars in 10 cities across Australia and the UK, and has a strategic partnership with Uber. Recently Uber and Splend announced a program to provide drivers access to electric vehicles. Through the joint investment between Uber and Splend, drivers may switch to an electric vehicle and Splend will provide access to special pricing as well as offer subsided weekly pricing to driver partners on Splend's flexi-own plan.

Splend used private funding for growth and acquisition purposes including the acquisition of electric vehicles.

EdventureCo is a leading vocational and professional education and training group with operations across Australia, New Zealand and Southeast Asia. It is a premium provider of digital, soft and future skills training that prepares students of today for the roles of the future. EdventureCo businesses train over 20,000 students each year across more than 700 instructor lead courses via online and face-to-face delivery from 13 campuses.

Edventure Co used private debt funding to support the acquisition of Auldhouse Computer Training, the dominant provider of IT training in New Zealand.

Altus Power is a full-service solar company offering unique commercial, industrial and community solar solutions in the United States. Their services range from on-site solar generation to Community Solar, energy storage and Electric Vehicle charging solutions, all of which are tailored to each client's needs and energy usage profile. Altus Power completes projects with a local impact lens with an emphasis on benefitting the local communities.

Altus Power sourced private debt funding to expand it porfolio of solar assets.

Please call or email your Advisor to learn more about Private Credit opportunities, or if you have any questions.

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