How Private Credit's golden era continues to shine

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1. Why borrowers and investors are turning to private credit.

2. What are the key drivers behind private credit's golden era.

3. How technology is driving the growing appeal.

The current economic climate is creating opportunities for private credit fund managers and their investors, as Aztec Group Head of Private Credit, Kevin Hogan, and Luxembourg Head of Private Credit, Francesca Raffa, now explore.

Money is tight, spending is low, and businesses of all kinds are looking at creative ways to be successful.

The current economic climate is tough. Global central banks have raised interest rates to their highest levels for 15 years to control soaring inflation, with experts predicting that rates may remain high for a while to come. This makes lending from conventional banks more expensive and more difficult, leading borrowers to source capital from elsewhere.

Enter private credit as an alternative source of funding for borrowers who may not be able to access traditional bank loans or public markets, while also offering investors a number of benefits including the potential for higher returns, diversification, reduced exposure to market volatility and income generation.

All of which is contributing towards the rise and rise of private credit. According to Preqin's Global Report in January 2024, private credit funds now account for more than $1.6 trillion assets under administration (AUA). With an annual growth rate of 10.8%, it is forecast that by 2028, private credit's global AUA will have grown further, to around $2.7 trillion.

Why private credit is an attractive alternative

As well as conducive macro-economic conditions, private credit funds have a number of advantages that borrowers can benefit from in an increasingly competitive lending market, including:

1. Customised financing solutions – private credit funds offer the flexibility to structure financing solutions that meet the specific needs of borrowers, including loan terms, repayment schedules and other financing aspects specifically aligned to the borrowers' unique circumstances.

2. Speed and efficiency – private credit funds can often provide faster, and more streamlined financing solutions compared to traditional lenders.

3. Less stringent requirements – private credit funds often have less stringent requirements than traditional lenders, and may be willing to lend to borrowers with lower credit scores or less established businesses.

4. Industry expertise – many private credit funds specialise in the private markets, allowing them to have a deep understanding of the borrower's business and industry.

5. Avoid forced liquidations – private credit funds are closed-ended structures which provide funding certainty and avoid forced liquidations.

For investors, private credit funds also offer the opportunity for higher rates of returns as interest rates rise, since they use a variable market rate plus a spread.

Technology is enabling private credit's golden era

Market conditions may have assisted in making private credit more appealing to investors and borrowers, but technology is enabling the success and growth of the asset class, too.

Technology has allowed private credit fund managers to gather and analyse vast amounts of data quickly and efficiently, allowing them to make more informed lending decisions and assess credit risk more accurately. Meanwhile, the rise of online platforms and marketplaces has made it easier for private credit funds to connect with borrowers. Technology is facilitating the matchmaking process between lender and borrower, making this a more efficient process.

Private credit has grown and diversified significantly over the last 15 years, and this expansion requires increasingly complex and timely back-office management, to ensure fund data is processed and analysed accurately and quickly. The best technology can simplify and automate tasks, such as modelling loans through the life cycle to predict cash flows and returns, generating cash projection and reconciliation reports to ensure timely follow up of expected and missing proceeds, collecting and processing loan information, and providing timely and accurate automated data extracts to investment managers to further facilitate portfolio monitoring.

Technology of course has improved communication and collaboration between managers and borrowers. Digital communication channels like video conferencing and online document sharing have made it easier for lenders to interact and share information, streamlining the loan origination, servicing and monitoring process and allowing for faster decision-making.

Any cause for concern?

This may be a golden era for private credit, as some industry commentators have called it, but it’s not without risk or concerns ahead. There are challenges for businesses that rely on debt to fund their activities which they must be aware of to avoid default risk.

Interest rates have gone up, making it harder for businesses to service their debt and stay solvent. They need to have enough cash on hand to cope with the changing market conditions meaning new deals will have to be less leveraged to attract investors. We will likely see companies restructuring and lowering their debt-to-equity ratio to show they can manage these cashflow demands.

While heavily leveraged businesses can benefit from substantial capital and the benefits that brings, this can result in an increased risk of default, particularly when the market is unpredictable, and rates are higher. Companies can still mitigate against these risks by focusing on disciplined investment structuring. Paying attention to covenants and liability caps in private loans, agreed between the borrower and lender, will largely influence both the risk appetite and exposure to losses in the event the borrower defaults.

The difficulty for these companies is that such an approach is inherently dictated by the market conditions and outlook at the time deals are entered into. This may result in portfolios that are unsustainable and no longer fit their target investment strategy. We have seen some managers investing in payment in kind (PIK) options, which may historically have been considered a red flag, but in the current high interest rate environment is considered an acceptable tool to restructure certain investments.

Ultimately, to deliver on the promise of private credit, investment managers must take precautions in a macro-economic environment that is grappling with inflation and recessionary pressures. However, if they mitigate the risks, with the help of rapidly evolving technology, then investors, managers and borrowers can all continue to benefit from private credit's golden era.

To discuss any of the talking points raised in this article further, please contact Kevin or Francesca.

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