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CREDIT COUNCIL



SS&C

Financing the Economy 2023

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Acknowledgements

Nicholas Smith,
Managing Director,
Private Credit
nsmith@aima.org

Guillermo Pérez Molina,
Associate, Private Credit
gperezmolina@aima.org

Samuel Koslover,
Analyst, Private Credit
skoslover@aima.org



Foreword



Jiří Król
Global Head of the
Alternative Credit Council



Bhagesh Malde
General Manager and Head
of SS&C GlobeOp

Welcome to the ninth edition of the Alternative Credit Council's Financing the Economy research series, produced in partnership with SS&C Technologies.

This research has become a key industry reference point, providing investors and policymakers with data and insight on the trends underpinning the growth of private credit into a globally recognised asset class.

The ninth edition comes at a time when a combination of rising interest rates, macroeconomic headwinds and political uncertainty are testing the industry in a way not seen during the past decade. In this context, it was an easy decision to focus this year's research on the performance of private credit strategies in this environment, and examine the resilience of risk management practices in the sector.

Flexibility, speed of execution and direct relationships with borrowers remain key features of private credit. During the past year, these attributes have come to the fore for borrowers in need of finance partners they can rely on, and ones who are able to adapt to their needs. For investors, these attributes also continue to be an important driver of returns, with private credit fund managers able to address stress more proactively and effectively than other lenders. While higher interest rates are placing more scrutiny on these attributes, they also create greater potential for higher returns for lenders who can stand up to this scrutiny.

Our research also shows several larger firms continue to play a significant role in the corporate lending markets. The scale of these strategies naturally draws significant attention – and rightly so – however, the story of private credit continues to move beyond corporate lending. We expect to see more interest in opportunities such as real estate debt, asset backed lending, infrastructure and trade finance in 2024, with these strategies acting as additional growth engines for the asset class.

Our research also addresses questions posed by policymakers and regulators on what the growth of private credit means for the resilience of the economy and stability of the financial system. The data gathered in this paper offers a window into credit risk management practices, how firms manage liquidity and the role of leverage in private credit investment strategies. If the debate on these issues is as important as many attest, it is vital that such a debate is evidence-based. We hope that our findings will be valued by policymakers and act as an important contribution to their ongoing discussions.

We would like to thank the firms and individuals who supported this research and contributed their time and expertise. We hope that investors, private credit managers and policymakers will find our data and insights useful.



Executive Summary

Significant growth in new lending led by larger firms

Private credit managers deployed an estimated \$333bn during 2022. This was a significant increase from the estimated \$200bn that was deployed globally in 2021. This growth has been spearheaded by larger lenders who deployed more than \$10bn each per year, accounting for 58% of total capital deployed globally. Deployment opportunities for corporate lending continue to be impacted by reduced M&A and private equity deal flow, however lenders are also more active in other markets such as large cap lending, non-sponsored debt, real estate and asset-backed lending.

Standing up to higher interest rates

Higher interest rates have shone a spotlight on fund manager risk management practices and the creditworthiness of portfolio companies. 35% of respondents identified interest rate risks as the biggest challenge affecting borrowers. The impact of interest rate rises remains localised to specific firms, fund and vintages. Where loan par value adjustments have been necessary, these are in a moderate range of 0-5% for the majority of loans. Private credit fund managers are also proactively amending loan terms where necessary, although 53% of respondents stated that such activity only applied to less than 5% of the loans in their portfolio. Initial credit selection, risk management practices and relationships with sponsors and lenders are expected to be key differentiators between firms and the returns on capital they can achieve.

Leverage plays a modest and well-managed role in private credit

36% of respondents report using no financial leverage in their private credit funds. For funds that do use financial leverage, the vast majority do so below 1.5 times of debt to equity. Subscription line financing is the most common forms of leverage used by 52% of respondents. This plays an important cashflow management role helping to smooth capital calls from investors. The main source of leverage continues to be banks who provide financing to 81% of respondents. Private credit funds and leverage providers maintain robust credit and counterparty risk management practices which are supported through detailed and frequent transparency and reporting requirements.

Liquidity risk management central to structuring

An estimated 58% of capital invested in private credit strategies is done so through closed-ended structures. 21% of capital is invested through managed accounts with 11% managed through open-ended funds, although demand for both may increase as investors explore alternative structures that can improve the efficiency of capital deployment or meet their liquidity needs. Our data also finds that private credit fund managers using open-ended structures make extensive use of liquidity management tools such as lock-ups, gates, redemption windows, notice periods and slow-pay structures, with such tools tailored to the investment strategy and needs of investors.



Research methodology

Financing the Economy 2023 is based on data from several sources. The Alternative Credit Council (ACC) and SS&C Technologies (SS&C) conducted a survey of private credit managers and received responses from 56 private credit managers and investors. The survey data was then explored by the ACC and SS&C in a series of one-on-one interviews.

Respondents collectively manage an estimated \$914bn in private credit investments (Figure 1) representing approximately 60% of the total private credit market (Figure 2). Respondents to this survey invested an estimated \$203bn in private credit assets in 2022 (Figure 12).

Respondents to this survey also provide finance to borrowers of various sizes (see Figure 3) and invest across a broad cross-section of jurisdictions and strategies.

Figure 1

Estimated private credit AuM of survey respondents

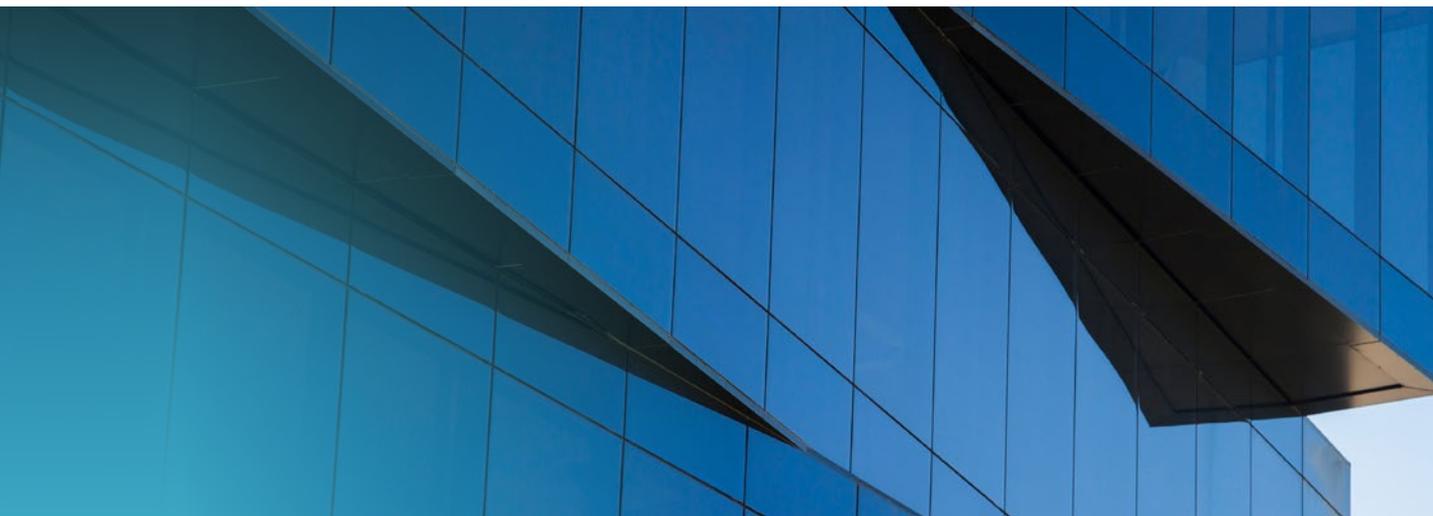


Figure 2

Global private credit AUM and breakdown of committed capital and dry powder (Source: Preqin Pro)¹

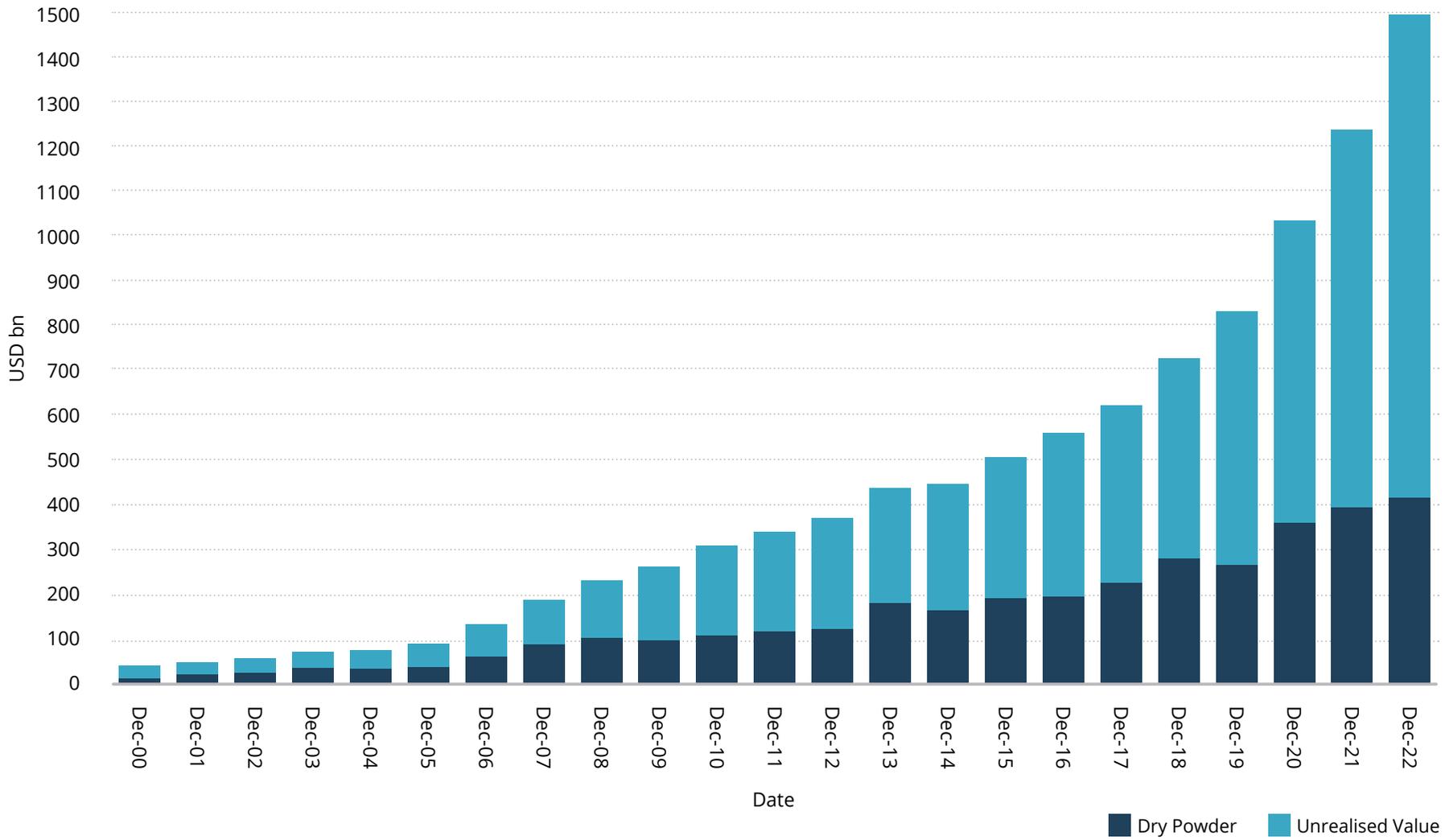
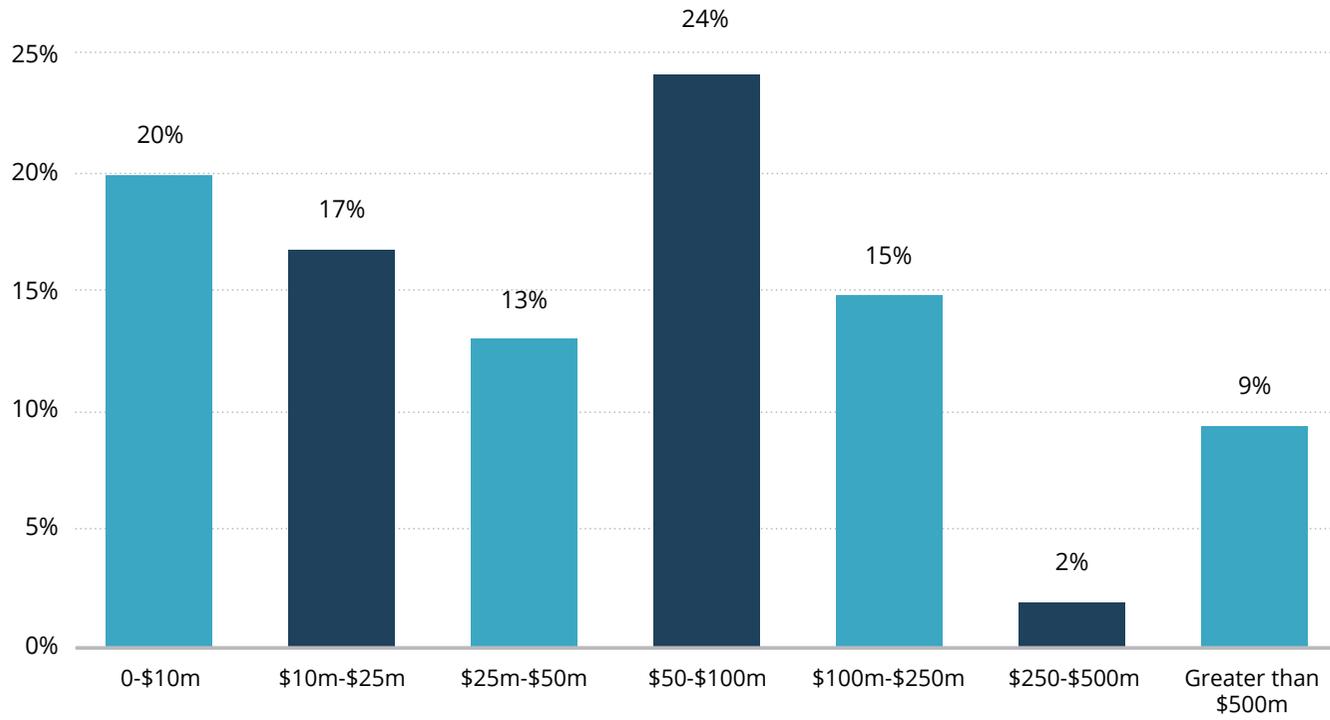


Figure 3

What is the typical target loan size that you make within your private credit strategy?





Chapter 1

Resilience in a higher interest rate environment

Chapter 1

Resilience in a higher interest rate environment

Key takeaways:

- Private credit funds have weathered the higher rate environment better than anticipated, with modest adjustments to loan values and relatively low instances of stress and default.
- Credit selection and risk management practices around portfolio company cashflows are seen as a key differentiator between firms.
- Many funds are showing extremely strong performance through a combination of higher coupons and effective management of downside risks.

The single biggest factor affecting private credit portfolios is the increase in central bank interest rates (see Figure 4). Interest rates have been at historically low levels for most of the past decade but have risen significantly during the past 18 months (see Figure 5). This has fuelled perceptions that there would be higher instances of stress or defaults in the private credit markets.

While our interviewees acknowledged this sentiment, there was also a consensus that higher rates have had less of an impact than expected across portfolios and the broader market. In instances when stress in portfolio companies has occurred, it has tended to relate more to the reverberation of issues from the Covid pandemic rather than as a direct impact of the higher rate environment. Another common position was that issues within individual businesses were often idiosyncratic to the company – for example, poor management execution of the business strategy – as opposed to broader sectoral or wider portfolio issues. This suggests the sector is more resilient than forecast and in a strong position to continue expanding its footprint in the corporate lending sector.

On an operating basis, we see that our companies are generally performing well and servicing their loans. At the same time, as sole lender, we're in a good position to collaborate with portfolio companies and sponsors to help manage through any issues as they arise.

Blair Jacobson, Partner and Co-Head of European Credit, Ares Management



While some ascribed this to a lag between rate rises and their impact on credit markets, risk management practices in the sector were seen by interviewees to have played a central role in the resilience of private credit portfolios to date. This section explores some of the key ways in which firms are managing those risks.

Only a very small number of portfolio companies are facing issues, some of which trace back to Covid when they were shut for a period of time. For the private equity side, the slowdown in growth is not great but from a credit perspective it is a minor factor. When I look at the portfolio, we are in sitting in a defensive position today.

Peter Lockhead, Managing Director and Portfolio Manager of the Senior Debt Partners strategy, ICG

Figure 4

What is the biggest challenge affecting borrowers in your private credit portfolio?

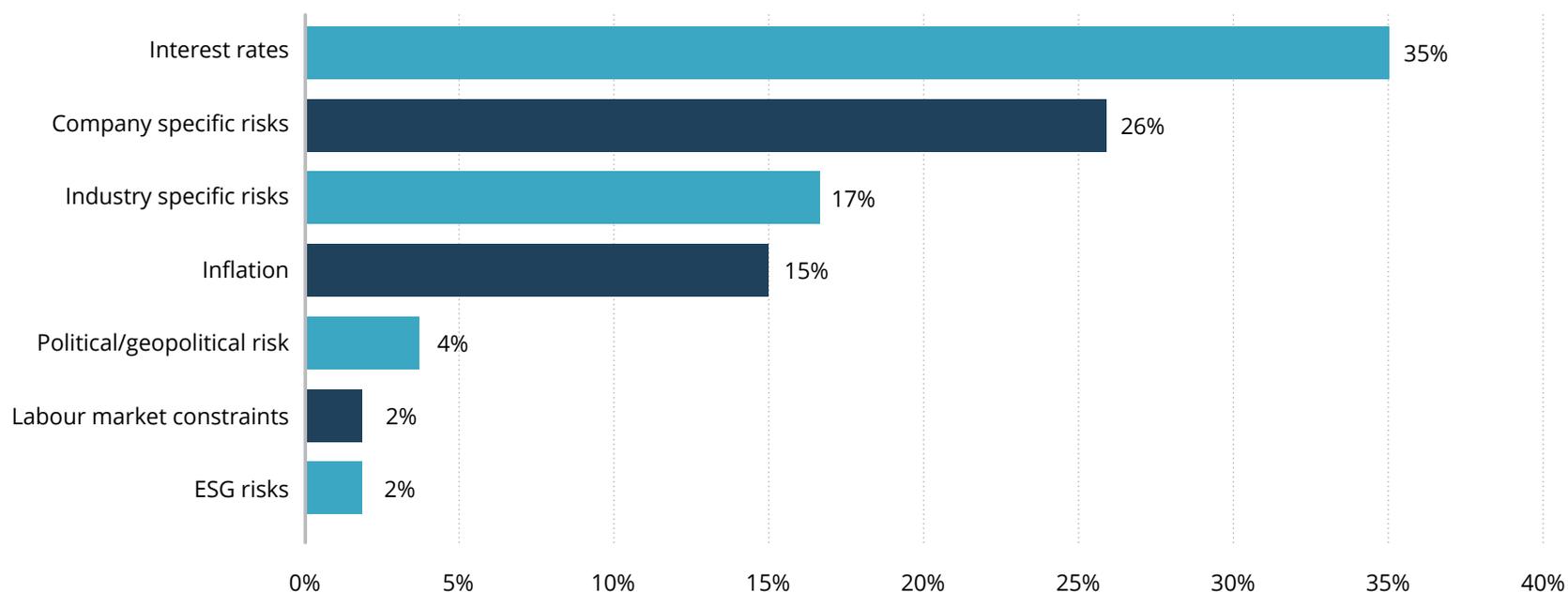
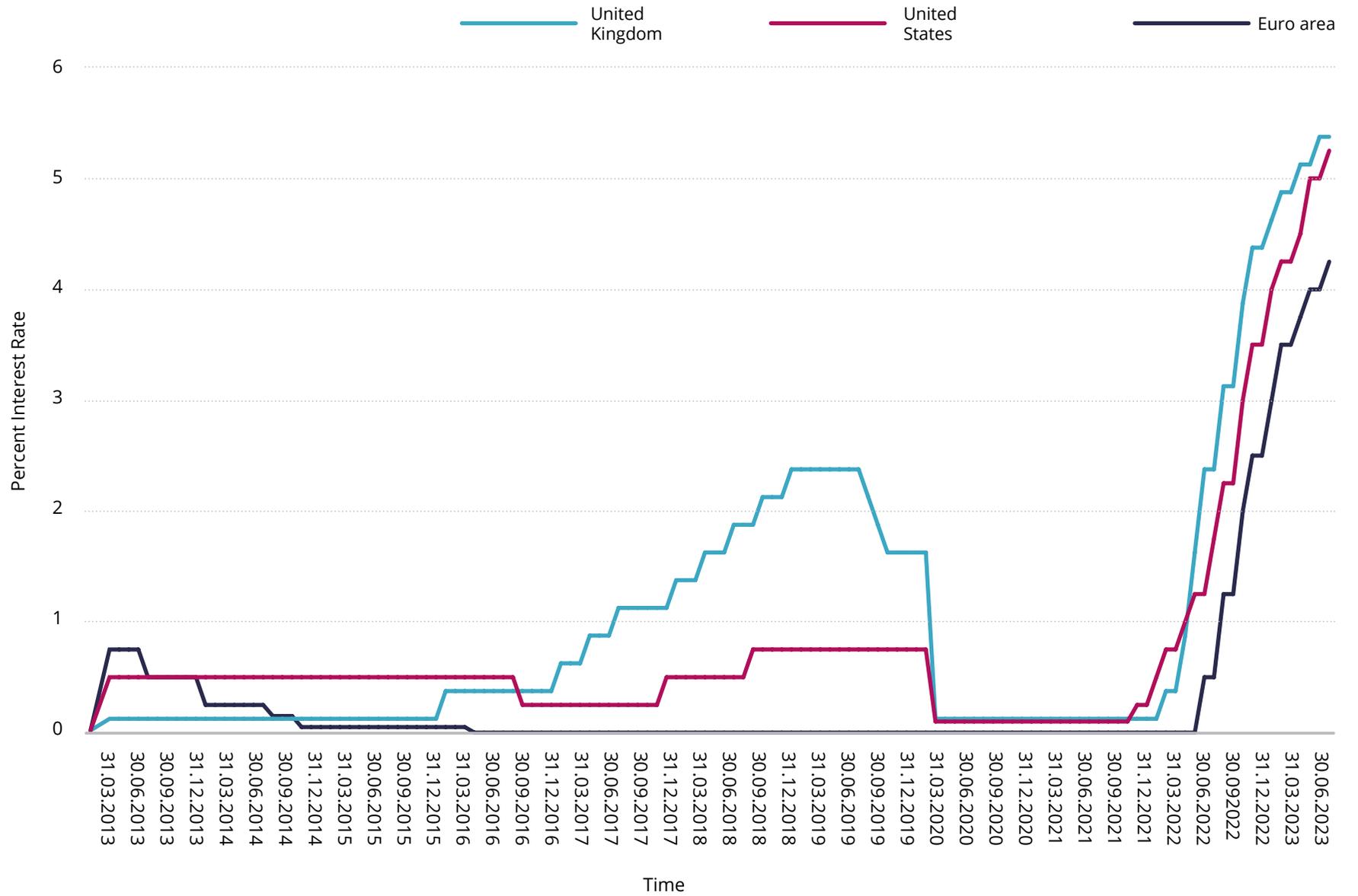


Figure 5

US, UK and Euro area interest rates between 2013-2023ⁱⁱ



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The only way that a direct lending firm can go backwards is if it cannot refinance its own portfolio. Fundraising plays a key role in this and, in the current environment, bigger funds have an advantage. Fundraising has definitely got more challenging, some firms will not have the capital to refinance their own back-book and that is a problem.

NATHAN BROWN, CHIEF OPERATING OFFICER, ARCMONT ASSET MANAGEMENT



Direct lending has so far not been very involved in cyclical sectors of the economy. Thus, if the economy was composed only of sectors where direct lending has been investing, there would be no recession. Provided that you are in the right sectors, the broader state of the economy and statistics like GDP growth are secondary considerations.

Peter Lockhead, Managing Director and Portfolio Manager of the Senior Debt Partners strategy, ICG



Focus on credit risk management

Our interviews confirmed that private credit managers continue to focus on sectors like business services, healthcare, software, climate and energy transition and financial services, as well as on those with less exposure to cyclical pressures and those which are capable of producing significant growth. Other niche sectors like industrial maintenance and repair companies, which have low capital expenditures and are resilient to macroeconomic conditions, have also been attractive for managers. While such sectors are not immune to broader economic pressures, any impact will be lower than in other sectors.

Another area supporting the resilience highlighted by interviewees was the practice of proactively mapping how many portfolio companies are hedged when rates began to increase in order to understand and manage their rate exposure. These exercises provided visibility on how many businesses within the portfolio had hedges in place to mitigate the impact of interest rate risk, with this typically ranging from between 40-60% of the portfolio. While this means that a substantial proportion of borrowers within private credit portfolios were unhedged, having visibility on this permitted private credit funds to prioritise unhedged companies from a risk management perspective.



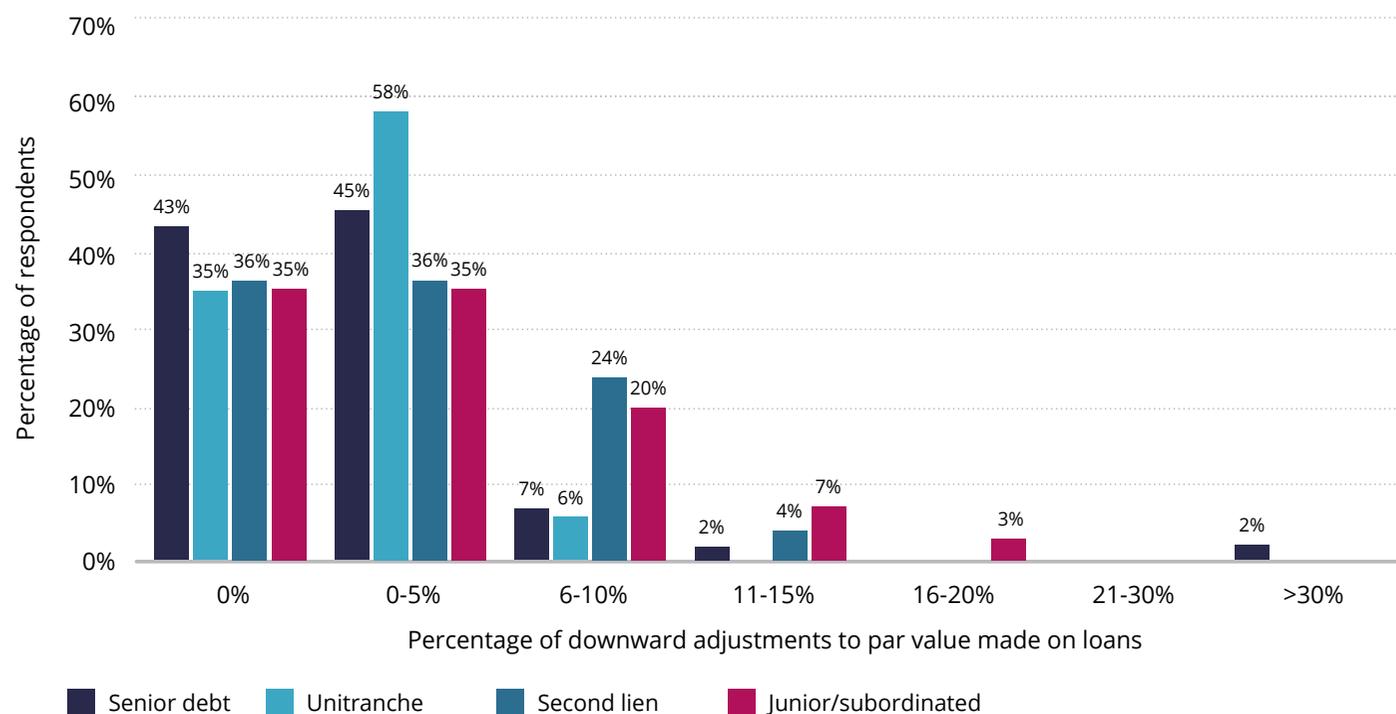
One way of assessing the impact of a higher rate environment is to look at adjustments to loan par values made by managers on loans within their portfolios. Our data indicated (see Figure 6) that these have been moderate and manageable, with most adjustments being between 0% and 5% of par value. These adjustments were attributed to specific issues with individual companies, albeit some reported that adjustments were sometimes correlated with specific vintages. It was also noted that transparency to investors on the adjustments and reasons for the adjustment continues to improve. While such valuations will continue to be assessed, the data offers further support to the view that private credit funds have remained resilient through 2023.

The high inflation and high interest rate environment have demonstrated the importance of backing market leaders and companies that have the ability to pass-through cost increases. Part of ensuring portfolio companies have appropriate capital structures and a resilient business model is regular stress testing, ongoing engagement, and anticipating issues well in advance.

Sonia Rocher, Managing Director, Portfolio Manager, European Private Debt, BlackRock

Figure 6

What, if any, downward adjustments or estimated downward adjustments to par value have you made on loans within your portfolio during the last two valuation periods?





We are vigilant because macroeconomic and geopolitical conditions are still volatile and there remains uncertainty around how the elevated rate environment will play through for some of these borrowers. We are cautious but positive particularly with the repeat borrowers who are seeking financing support again.

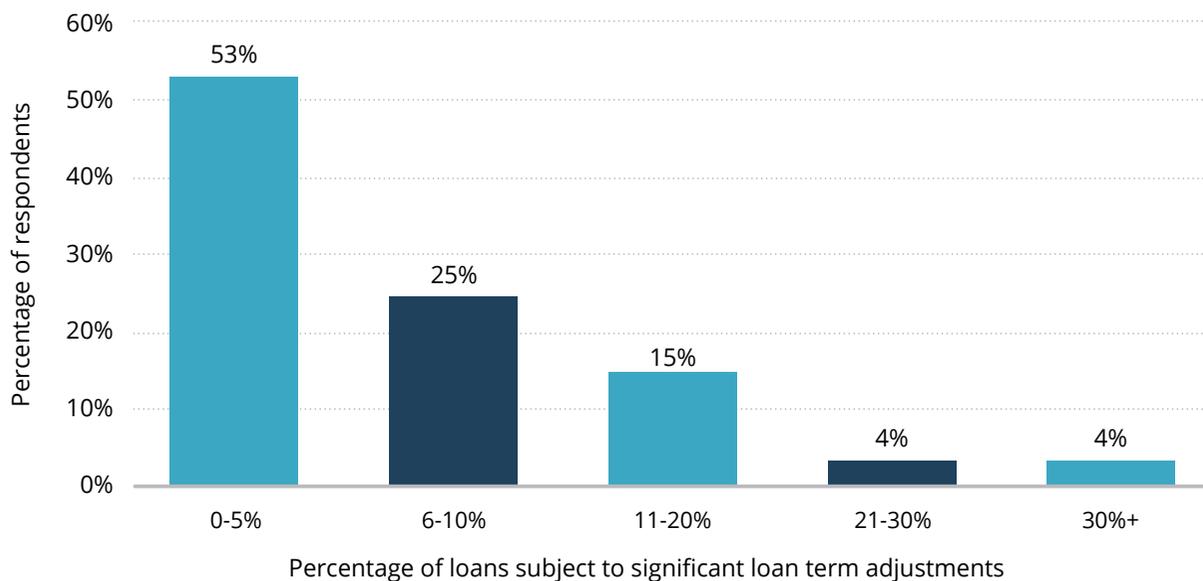
**MARC CHOWRIMOOTOO, MANAGING DIRECTOR AND PORTFOLIO
MANAGER FOR PRIVATE CREDIT, HAYFIN CAPITAL MANAGEMENT**



Figure 7 also shows that small parts of private credit portfolios have already begun to undergo adjustments in order to manage stress in portfolio companies. Interviewees emphasised that these adjustments are not occurring at significant levels and that, so far, situations have been handled well. They added that adding more portfolio companies to the watchlist is not necessarily negative, as it is part of sound and responsible risk management practices and allows managers to better monitor the difficulties and anticipate any real problems. In fact, placing a portfolio company on the watchlist early is a way to prevent dealing with worse situations later.

Figure 7

What proportion of loans in your portfolio have been subject to significant loan term adjustments (e.g. covenant waivers, payment holidays, cash to PIK or other restructuring) in the past year?



It's important for us to be engaged financing partners and keep a close dialogue with the companies we invest in when the company performs, this helps us to better understand and assess the situation in case a company underperforms.

Sonia Rocher, Managing Director, Portfolio Manager, European Private Debt, BlackRock





The active management element of the sector matters. You are not just sitting on your hands waiting for the covenant alarm to go off every quarter. You have got that ongoing dialogue and, while you don't see a huge amount of defaults in the sector, you do see a lot of adjustments to get ahead of problems.

Craig Packer, Co-President and Head of Credit,
Blue Owl Capital

When discussing this data, interviewees highlighted that managers currently have options and flexibility to deal with repayment risk in their portfolios compared to previous periods of stress, like the exogenous shock of Covid.

Our interviewees emphasised the importance of the direct relationships between private credit managers and sponsors or management teams in allowing parties to agree a quick and effective adjustment. Across the interview base, lenders noted their willingness to support companies facing stress if the business case remains compelling and sponsor commitment remains strong. This might include, for example, a request for private equity sponsors to commit more equity in order for lenders to offer the borrower payment holidays or other solutions. For managers focused on larger companies with lower LTV and larger volumes of equity capital within the business, there were strong incentives for lenders and equity owners to come to an agreement.

It was also noted that the use of Payment in Kind (PIK) instruments was seen as a valuable option for lenders and equity investors to provide time for businesses to adjust while retaining value for credit investors. Managers are aware that PIK is not

a permanent solution for companies undergoing structural problems, and their role is better suited to companies with viable economic prospects and where the sponsor or management team remains fully committed.

In this regard, PIK-toggles have become common among the terms being offered recently, with the caveat that managers generally only offer them to companies that demonstrate the continuing value of their business performance and where the sponsor remains fully committed. Managers were keen to emphasise that the use of PIK-toggles in private credit is different from the common perception of it in liquid markets, thanks to the existence of personalised relationships, sponsors and covenants.

Some managers emphasised their privileged position as the sole lender in most of their deals – 95% of them in some cases – which made the use of such adjustments more appropriate than if they were dealing with a business in a similar position but as part of a lending syndicate. The contrast with syndicated deals is useful, as it is generally more difficult to coordinate multiple lenders in order to find solutions which can delay any necessary remedial action.





Moreover, the close connection between private credit and private equity, with some private credit portfolios being 80%-90% private equity-owned, means that lenders can rely on private equity sponsors to assist during stress and workout situations. This was already the case during the Covid period, when private equity sponsors were very supportive in providing liquidity. Interviewees reported that sponsors have continued to be transparent and proactive regarding problems within their portfolio companies. In some situations, private equity sponsors are willing to commit more equity, particularly so in instances where private equity stakes in these portfolio firms are already high and greater value is at stake.

In workout situations where there is a divergence with a private equity sponsor, debt-to-equity arrangements are a common option. If the private equity firm no longer sees value in that portfolio company and does not want to undertake a costly and time-consuming workout, it often chooses to hand over the keys to the private credit lender.

Unlike during Covid, which had maximum uncertainty in the beginning, we believe that we have a lot more control of the situation now. If things go wrong, we see owners adding equity, raising cash through divestitures of divisions, trimming costs, and streamlining working capital. Part of our model is being the sole lender as much as possible, so if there are any issues, we can work with companies to determine the best path forward.

Blair Jacobson, Partner and Co-Head of European Credit, Ares Management

Interviewees emphasised that investors expect private credit managers to be prepared and ready to take ownership of distressed portfolio companies and manage them in order to maximise their returns where necessary. Among the outliers, some managers do not consider taking the keys as an ordinary part of their strategy while others

do include it as a more common and opportunistic option. Moreover, interviewees highlighted that the compelling threat of a lender taking the keys from a portfolio company can be used effectively to pressure a sponsor when there are disagreements on how to deal with a workout situation.



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In difficult situations we work closely with management team and private equity sponsor to actively manage the situation on a case by case basis. In most cases, this involves equity sponsors injecting additional equity, which is important to demonstrate alignment and their ongoing support for the company.

**SONIA ROCHER, MANAGING DIRECTOR, PORTFOLIO MANAGER,
EUROPEAN PRIVATE DEBT, BLACKROCK**



Focus on cashflows

The most immediate pressure of higher rates on corporate businesses is that it increases demand on cashflows. The sentiment when this research was carried out was that the higher interest rate environment is likely to persist for the foreseeable future and managers were keen to stress the importance of cashflow modelling within their risk management frameworks.

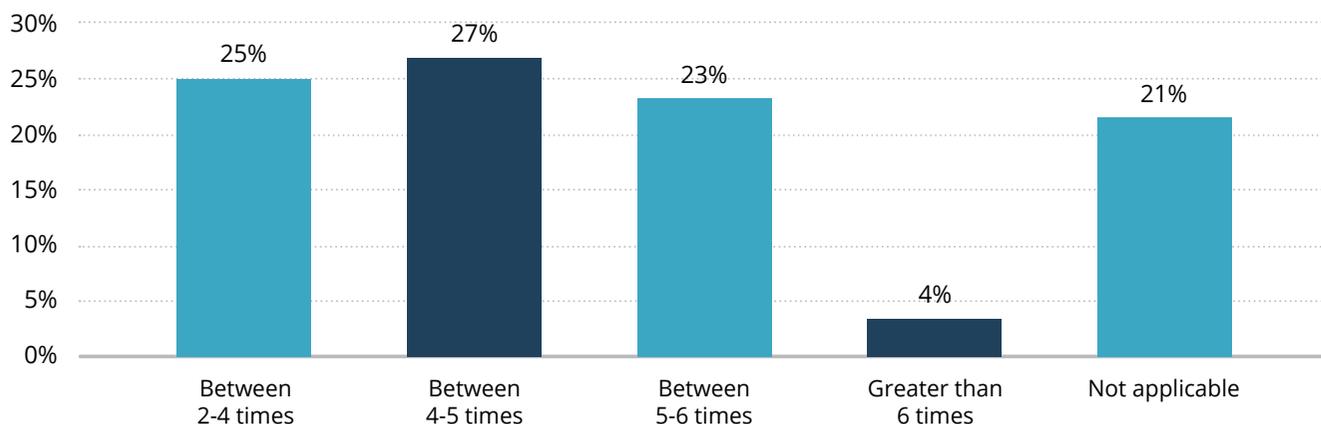
Cashflow problems are already appearing in portfolio companies as they adapt to the new rate environment. However, interviewees mentioned that a lag effect may lead to more issues surfacing in 2024. They highlighted that debt coverage ratios are already coming down from their typical 2.5x-3x levels, although these are still far away from levels which would present real challenges for portfolio companies.

One factor supporting the ability of portfolio companies to meet higher debt costs is the growth of their underlying earnings. As shown in Figure 8, the typical debt-to-EBITDA ratios of borrowers reported by survey respondents is also comparable to levels reported in previous editions of this research. This suggests that earnings growth has been sufficient amongst portfolio companies to maintain this ratio.

Figure 8

What is the most common ratio of debt-to-EBITDA* of the borrowers (at the time the loan was provided) for your direct lending to corporates?

*EBITDA based on either GAAP or IFRS accounting standards and excluding any addbacks



Compared to pre-GFC deals, there is generally more equity in these capital structures. In the mid-2000s, equity was usually less than 20-30% of total capital. More recently, equity checks in the market average up to 60%, resulting in LTVs well below 50%. These companies are typically well-capitalised to help manage through volatile market conditions.

Blair Jacobson, Partner and Co-Head of European Credit, Ares Management

Our view is that this is a sea change and that rates are not going down any time soon. This 'higher for longer' environment represents a new market that investors must learn to navigate.

Nicole Adrien, Managing Director, Chief Product Officer and Global Head of Client Relations, Oaktree





The key for debt manageability is not the market valuation and the equity, but the liquidity. Portfolio companies can have big debt-to-equity cushions and still not be able to afford interest payments.

Nathan Brown, Chief Operating Officer,
Arcmont Asset Management

While earnings growth has remained strong in many businesses, lenders are also taking steps such as requesting minimum cash balances be retained or seeking greater information on cashflows to support their understanding of whether this growth will persist. In this regard, the extent to which managers have selected companies capable of producing stable growth and meeting higher debt costs may become a more important factor in distinguishing performance. Some interviewees highlighted that their deals had been structured and underwritten independently of the wider growth prospects of the portfolio company, and with other elements of protection (e.g. collateral) to manage potential downside risks. This means that growth is not the only factor to consider.

Interviewees also noted the wider economy had performed better than expected in 2023, with the resilience of the US economy in particular standing out. The US has so far succeeded in avoiding a recession, reporting an unrevised 2.1% annualised GDP growth rate in Q2 2023.ⁱⁱⁱ It is therefore unsurprising that cashflows are still relatively strong with an increased proportion of cashflow going to credit investors as opposed to equity investors when compared to recent years.

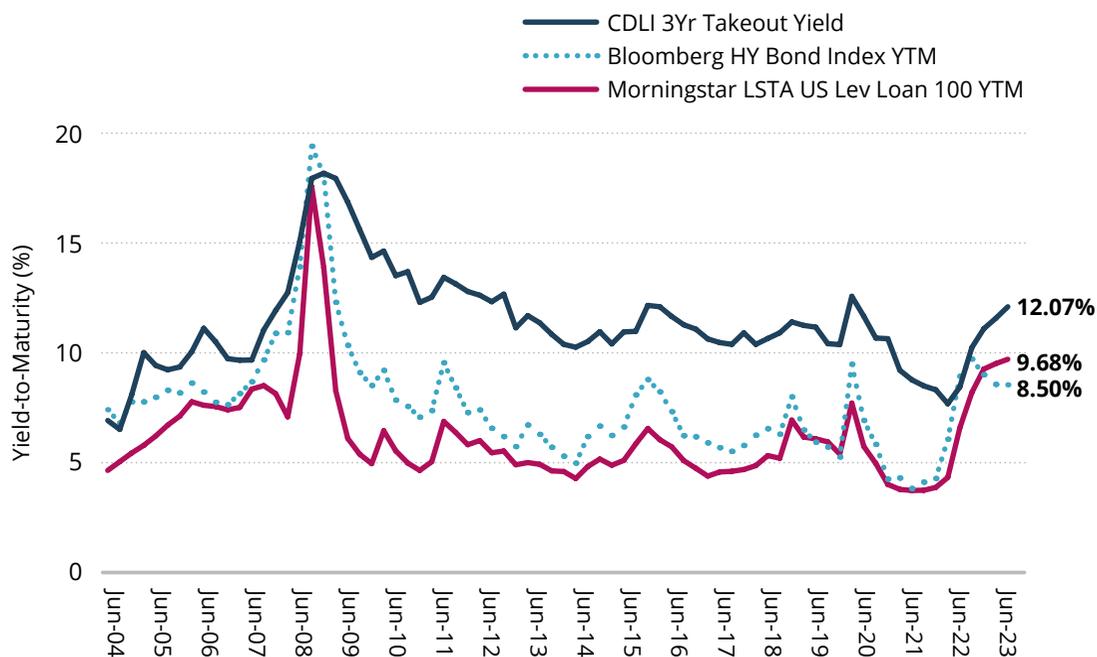


Thriving, not just surviving

Rising interest rates have also been a significant performance tailwind to private credit during the past twelve months. The majority of corporate loans made by private credit are a floating rate product, meaning that the rise in interest rates has increased the level of return they are receiving on their investment. The relative return on private credit has also remained competitive to other credit markets. Following a short period of unusual spread compression, private credit unlevered yield has increased to 200-300 bps over the more liquid non-investment grade markets. Figure 9 shows that while we are not back to the average levels of spreads seen in the decade prior to 2021, we have seen a return of the illiquidity and/or complexity premium associated with direct lending.

Our interviews revealed that many unlevered senior secured corporate loans are now achieving returns of 12-14% making this extremely attractive on a risk return basis. Similarly, lending strategies targeting non-senior positions in the capital stack or employing modest leverage reported returns in the high teens, which makes them competitive with other alternative investment strategies that have traditionally offered investors a higher rate of return.

Figure 9
High Yield Bond and Leveraged Loan Yield-to-Maturity Comparison, Sep 2004 to Jun 2023^v



We are seeing that borrowers no longer require an education on private credit. The asset class has become mainstream, and we believe it will command an even greater share of overall lending activity going forward.

Viral Patel, Global Head of Technology Investing, Blackstone Credit

Maybe ten years ago, going through private debt funds was really something alternative for borrowers, particularly if the usual standard bank financing was not available, but now this has become much more mainstream.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau



It's great when the thing that you think has the best relative value in the market happens to be the thing that you are most expert and best positioned in and we are in one of those moments right now.

Greg Leveto, Portfolio Manager & Partner, Oak Hill Advisors



Defaults and subsequent rates of recovery are one of the biggest factors impacting the returns provided by private credit funds. Two thirds of respondents to our survey indicated that they expect recovery rates to be in line with historical averages (see Figure 10), while of those who expressed a different view there was a slight majority towards recoveries being lower. Figure 10 also contrasts this data with previous research to show how sentiment on this question has changed since 2019.

While the sentiment of our respondents is therefore mildly towards recovery rates being lower than expected, industry data indicates that current credit loss rates on middle market debt remain well below historical market trends – 0.09%^v in 2022 against a 10-year average of 0.90% (see Figure 11). This data also indicates that credit losses in private credit remain lower than other credit markets at present.

Figure 10

What are your expectations around recovery rates on defaulted loans during the next three years?

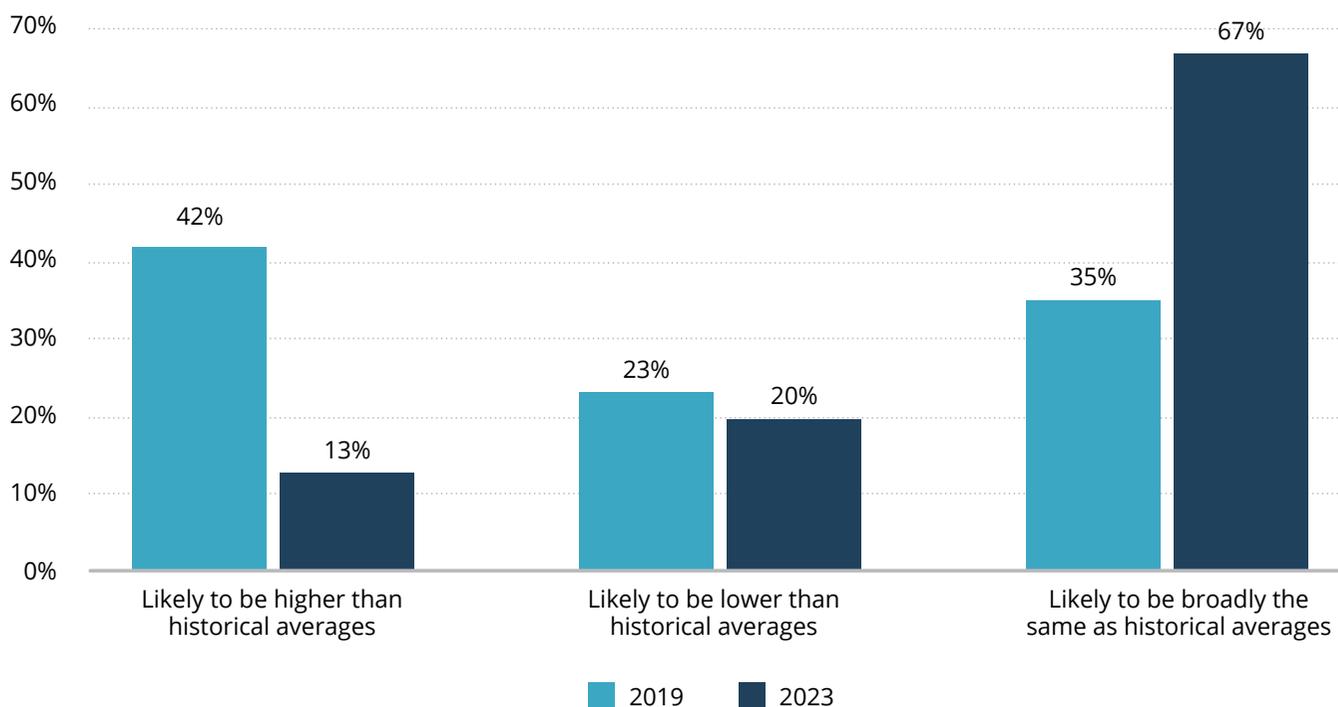


Figure 11

18-year comparative credit loss rates (2005-2022)⁽ⁱ⁾

	High Yield Bonds			Leveraged Loans ^a			CDLI Middle Market	US Bank Commercial & Industrial Business
	Default Ratio	Recov Rate	Credit Loss	Default Ratio	Recov Rate	Credit Loss	Debt ^b	Loans ^c
							Credit Loss	Charge-Off Rate
2005	2.80%	56.00%	1.23%	3.00%	84.00%	0.48%	-0.89%	1.01%
2006	0.90%	55.00%	0.41%	0.50%	84.00%	0.08%	-0.06%	1.27%
2007	0.40%	55.00%	0.18%	0.20%	69.00%	0.06%	-1.74%	2.25%
2008	2.30%	27.00%	1.68%	3.70%	58.00%	1.55%	0.59%	5.03%
2009	10.30%	36.00%	6.59%	12.80%	61.00%	4.99%	6.91%	9.37%
2010	0.80%	41.00%	0.47%	1.80%	71.00%	0.52%	2.96%	6.01%
2011	1.70%	49.00%	0.87%	0.40%	67.00%	0.13%	1.78%	2.85%
2012	1.30%	53.00%	0.61%	1.40%	55.00%	0.63%	0.60%	1.73%
2013	0.70%	52.00%	0.33%	1.70%	69.00%	0.53%	0.19%	1.06%
2014	2.90%	48.00%	1.51%	4.30%	73.00%	1.16%	-0.01%	0.81%
2015	1.80%	25.00%	1.35%	1.70%	48.00%	0.88%	0.70%	1.20%
2016	3.60%	31.00%	2.48%	1.50%	63.00%	0.56%	1.41%	1.65%
2017	1.30%	53.00%	0.60%	1.80%	57.00%	0.79%	1.75%	1.38%
2018	1.80%	40.00%	1.08%	1.70%	63.00%	0.64%	0.93%	1.11%
2019	2.60%	23.00%	2.02%	1.60%	49.00%	0.84%	0.87%	1.65%
2020	6.20%	22.00%	4.84%	4.00%	48.00%	2.08%	3.30%	1.82%
2021	0.30%	50.00%	0.15%	0.50%	56.00%	0.22%	-0.27%	0.60%
2022	0.80%	55.00%	0.38%	1.00%	60.00%	0.39%	0.09%	0.66%
Inception	2.36%	43.00%	1.49%	2.43%	63.00%	0.92%	1.03%	2.30%
Last 10 Yrs	2.20%	40.00%	1.47%	1.99%	59.00%	0.81%	0.90%	1.19%

a Source: JP Morgan Markets, Bloomberg US High Yield Bond Index, Morningstar LSTA US Leveraged Loan 100 Index

b Source: Cliffwater Direct Lending Index (Realised Credit Losses)

c Source: Federal Reserve (Fred: CORBLACBS)





With the balance of power having shifted from borrowers to lenders, we are now leaning in heavily to the opportunities in the market, stepping in to fill the void left by banks that have retreated.

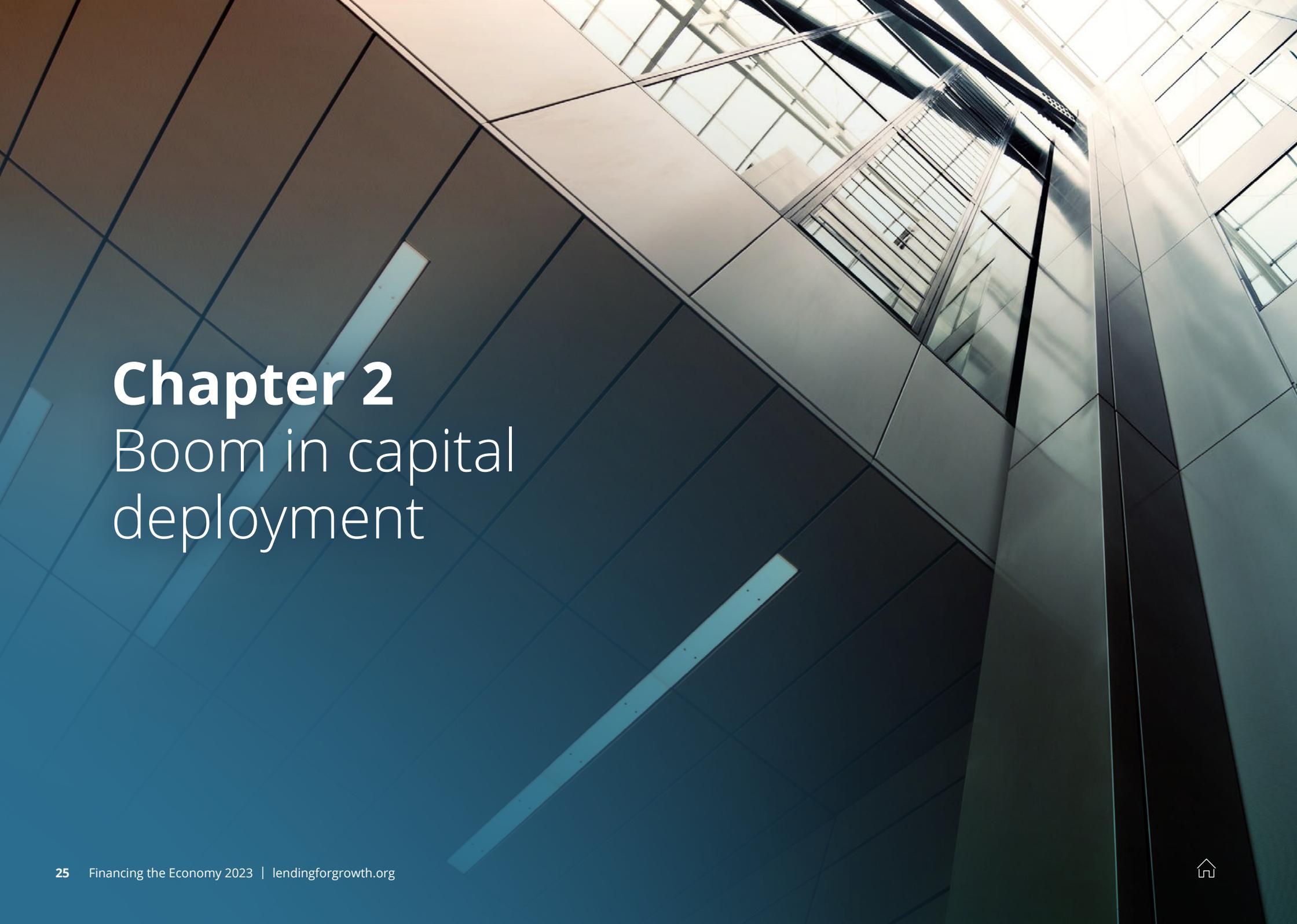
Nicole Adrien, Managing Director, Chief Product Officer and Global Head of Client Relations, Oaktree

Furthermore, data from KBRA notes that further interest rate rises are unlikely to significantly increase the default risk of middle-market portfolio companies compared to the current rate. They estimate that with interest costs of 12.5%-13%, circa 16% of middle-market portfolio companies would be unable to meet interest payments from current cashflow. When modelling increases in the US base rates to 5.5%, 6.5% or 7%, they find that this is unlikely to materially increase the stress beyond that which has already occurred following the initial rate rise.^{vii} The KBRA forecast also notes that private credit managers are likely to recover their principal, even assuming a conservative recovery rate of 40% which is far below what firms report they would expect to achieve in such situations.

If we're starting out at a 40%-45% loan to value, the company can lose 50% of its value and the lenders will still get a par recovery. I know it might not be intuitive that the company can lose half its value and we still get our money back, but that is by design. It is a very important aspect of direct lending that these companies can have a significant deterioration of value and we are going to get all or most of our money back.

CRAIG PACKER, CO-PRESIDENT AND HEAD OF CREDIT, BLUE OWL CAPITAL





Chapter 2

Boom in capital deployment



Chapter 2

Boom in capital deployment

Key takeaways:

- In 2022 private credit fund managers invested an estimated \$332.6bn capital, up 60% on the previous year.
- 58% of the total capital deployed by private credit managers globally is estimated to come from firms deploying more than \$10bn per year.
- Better lender terms, further retrenchment of banks and the need for flexible capital solutions is fuelling cautious optimism amongst private credit managers about current deployment opportunities.

In total, we estimate that private credit managers invested \$332.6bn in 2022^{viii}, which is a 60% increase on the \$200bn that we estimated private credit managers invested in 2021. Respondents to this survey who reported deploying more than \$10bn in 2022 account for only 7% of the sample size (see Figure 12), but we estimate these firms account for approximately 58% of the total capital deployment by private credit managers globally. This means that the 60% increase from 2021 to 2022 in capital invested has been spearheaded by larger lenders. The evident consequence of this trend is that the market is becoming increasingly concentrated in the larger lenders.

Private credit has set itself apart in past months and years by consistently ensuring availability of capital, which wider capital markets have not managed to provide.

Marc Chowrimootoo, Managing Director and Portfolio Manager for Private Credit, Hayfin

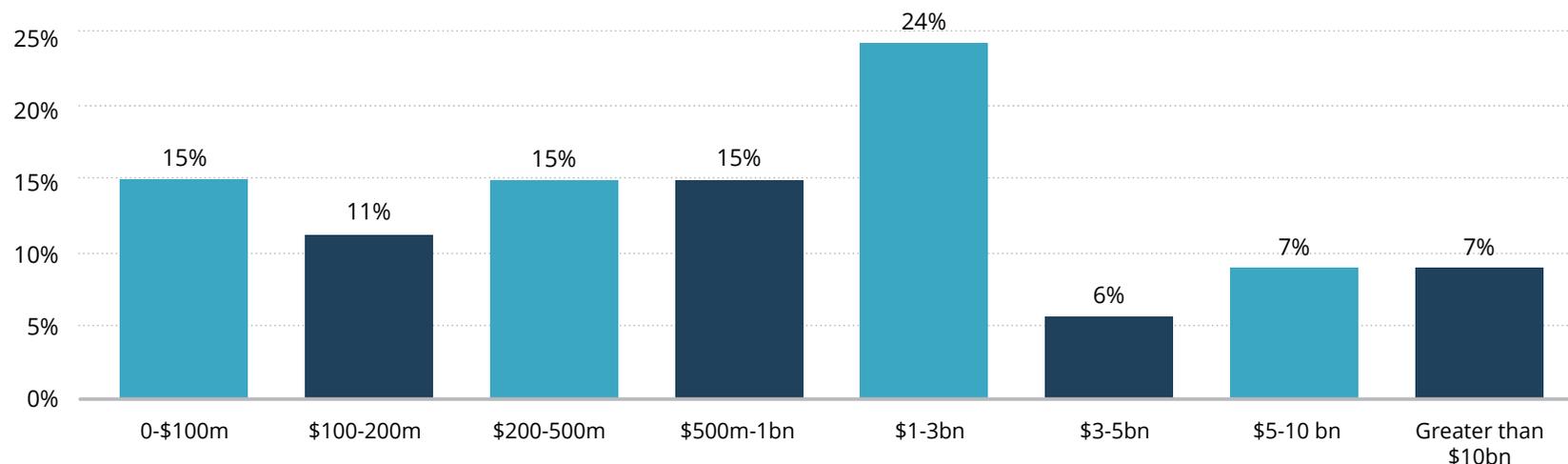
2023 has been a very interesting and overall attractive environment to invest in high-quality credit. We still believe there is a robust opportunity to invest in high-quality businesses with fresh equity dollars from best in class sponsors and owners.

Greg Leveto, Portfolio Manager & Partner, Oak Hill Advisors



Figure 12

What was your approximate annual business volume in 2022 (sum of loans originated/ invested in)?



Direct lenders are in a good position to take advantage of any incoming M&A as the banking and the syndicated markets are still illiquid and not a 100% there. This also means a slight increase in competition on the direct lending side.

Malek Ghali, Managing Director, Head of Deal Team, MV Credit

The deployment opportunities for private credit funds in this period have been affected by several factors. Refinitiv data suggests that worldwide figures for M&A are down 29% compared to the same period in 2022 and the lowest January to August total since 2013.^{ix} This has reduced deal flow for private credit firms targeting M&A activity in both the US and Europe. In Europe Q2 2023 has seen a 47.9% drop in dealmaking compared to Q2 2022, although our interviewees indicated that deal flow started to recover in Q3 2023.

While deal flow linked to M&A and leveraged buyouts has fallen, interviewees emphasised that direct lending has continued its growth by accessing increasingly larger deals and expanding into new markets over the past two years, providing borrowers who may turn to high yield debt or syndicated lending debt with a compelling alternative. In this regard, the downturn in leveraged loans and high-yield markets has played a role in the resilience of private credit deal flow in 2022-2023 by compensating for the slowdown in M&A and private equity deals, allowing private credit lenders to take refinancing opportunities away from banks. It has also helped private credit lenders to achieve better terms by placing managers in a privileged position vis à vis borrowers and sponsors.





In Europe, club deals are also becoming more and more common for larger deals. Such deals differ from traditional syndicate lending activity as each manager will typically do their own underwriting rather than rely on a lead arranger. The increasing popularity of co-investment amongst sovereign wealth funds and large institutional investors is another factor supporting private credit lenders in financing larger loans.

Because public markets have been closed for the first part of this year, there are large sponsors that are taking a private debt solution for the first time. They are doing it because they see the advantages of dealing directly with a partner, the inherent flexibility, and better maintenance arrangements.

Nathan Brown, Chief Operating Officer, Arcmont Asset Management

What we have found is that even in the low M&A environment there are still transactions happening. Over half of our deployment this year has been in new M&A with the rest being add-on facilities for our existing portfolio companies and new borrowers.

Marc Chowrimootoo, Managing Director and Portfolio Manager for Private Credit, Hayfin Capital Management

The drop in M&A volumes has been offset by the fact that private credit managers currently are the only solution for many borrowers.

Peter Lockhead, Managing Director and Portfolio Manager of the Senior Debt Partners strategy, ICG

Market data points to an obvious drop in M&A activity in the first quarter of 2023, but there has also been a change of the dynamics within the broader European market. While deal flow and volumes have decreased in markets such as Germany, others such as the Netherlands have seen an increase in deal activity. There have been compensatory geographic effects which is good for the market overall since it is broadening as well as maintaining a relatively high level of activity.

Joss Trout, Head of Investment Specialists Group, Tikehau





There is no doubt that the upper-middle market direct lending space is merging with the leveraged loans market. I think that over time you will see an equilibrium between the high yield bond market, leveraged loan market and direct lending. Borrowers will choose one or the other or a combination of the three. It's not about direct lending taking over leveraged loans but about the natural interplay between direct lending, leveraged loans and high yield bonds.

**JUSTIN PLOUFFE, DEPUTY CHIEF INVESTMENT OFFICER
FOR GLOBAL CREDIT, CARLYLE**



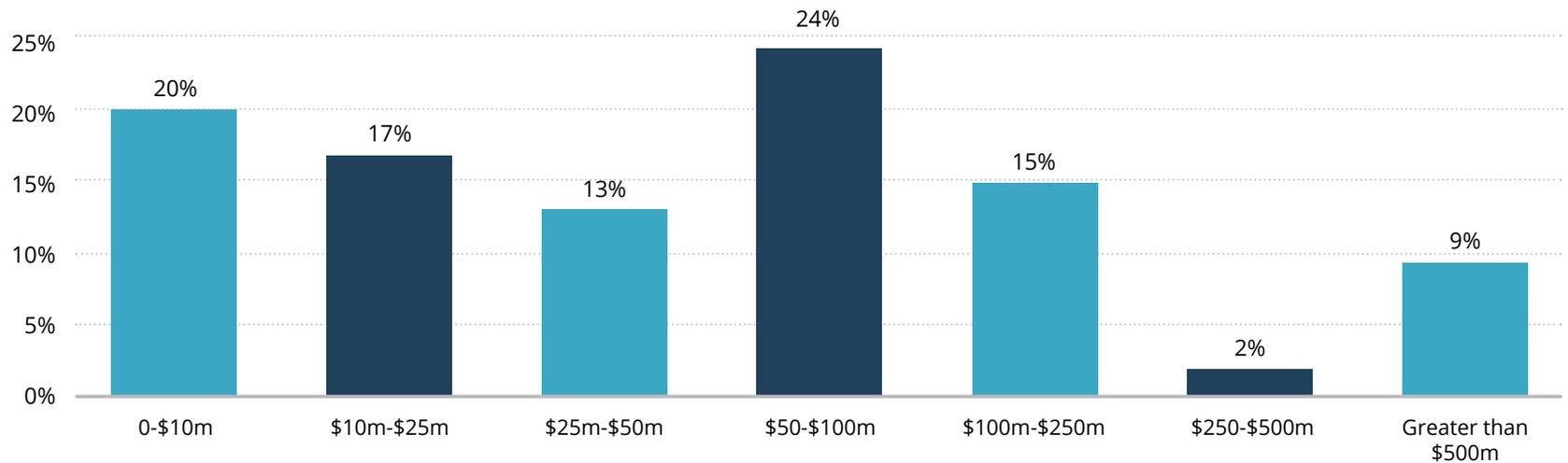
We are seeing larger companies seeking private financing solutions, and any impression that there is a return give-up at the upper end is a misconception. Few managers can lend at that scale, which can be an opportunity to develop unique relationships and truly drive terms. Meanwhile, these borrowers tend to be more resilient with typically greater pricing power, operating flexibility, and business line diversity.

Brian Towers, Managing Director, Blackstone Credit

Private credit managers also remain active across a range of credit markets and serve borrowers of all sizes (see Figure 13). This means that deployment opportunities for the sector overall remain positive even if some market segments see fewer deals or face increased competition. Views amongst interviewees naturally varied on where the greatest opportunities are, but all recognised that the diversification of the sector beyond the mid-market was an important factor in private credit continuing to deploy greater sums of capital.

Figure 13

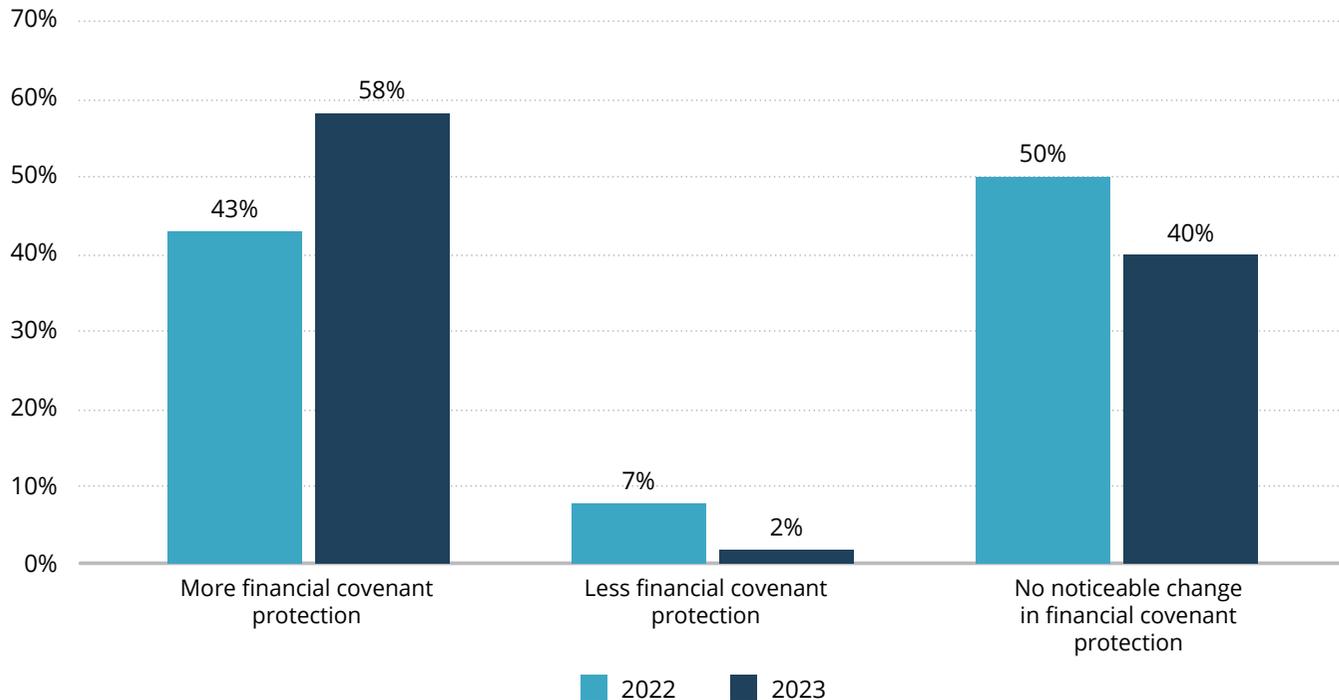
What is the typical target loan size that you make within your private credit strategy?



Another factor supporting deployment is the ability of lenders to secure the terms they want when underwriting the loan. As shown in Figure 14, 58% of respondents reported that financial covenant protection had improved over the past year. When considered alongside 2022 data, we also see a longer-term trend of firms reporting increased covenant protection in the market. Data from *Financing the Economy 2022*^x also shows that prior to the improvement in covenant protection experienced over the past year, 67% of respondents reported using an average of two or more financial covenants, with 45% reporting more than two. This means that the continued increase in covenant protection is even more significant, particularly when compared to other markets like leveraged loans, where covenants are rarer.

Figure 14

How has financial covenant protection changed over the past year?



Covenant breaches allow the manager to go on the offense when workout situations arise.

Daniel Leger, Managing Director,
MGG Investment Group

We are seeing some margin compression coming in, in certain cases; however, I still think that direct lenders are able to offer favourable terms to investors.

Malek Ghali, Managing Director, Head of Deal
Team, MV Credit



There is a huge financing gap for European SMEs, presenting significant opportunities. We lean towards non-sponsored lending, which is typically growth-oriented, as opposed to lending in a leveraged buyout scenario. In the case of non-sponsored lending, the intention is often to support a strategically important project or initiative like the construction of facilities, capital expenditure to support business expansion or other growth-related activities. This approach should ideally result in an improvement in credit quality, and when it's time to refinance, the company should have significantly reduced its leverage, making it a stronger credit with greater resilience to market fluctuations.

Stuart Fiertz, Co-Founder, President and Head of Responsible Investment, Cheyne Capital

Interviewees emphasised how covenants and documentation remain a key tool for managers to protect the value of investor capital, particularly in relation to interest rate coverage ratios, minimum EBITDA, minimum liquidity and maximum leverage levels. They added that, in the current environment, a company breaching covenant terms is not necessarily a bad thing, as this situation generally transfers power from the borrower to the lender, which allows lenders to manage risk more carefully and closely. Another benefit of the more lender-friendly environment towards documentation is that it gives them greater agency when considering refinancing opportunities and potentially revising the terms.

This favourable environment remains subject to competitive pressures between private credit managers as well as other lenders but, for the time being, the tightening of lender terms is likely to support returns for current vintages and improve the lender's position on deals originated in recent years that have been refinanced during 2023.

2023 has also seen further examples of bank retrenchment in the corporate finance markets. The collapse of Silicon Valley Bank and regulator-sanctioned sale of Credit Suisse to UBS created significant uncertainty in the first half of the year.





One impact of this has been for banks to reassess their risk appetite for lending in certain markets and private credit funds have been a beneficiary of this. While it does not appear there will be further disruption in the banking sector on a par with that seen in 2023, the upcoming implementation of the Basel reforms in the US is likely to create further opportunities for private credit funds to expand their origination footprint.

In this respect private credit funds are likely to become more important partners to banks. Many already have close relationships and some have entered into formal lending partnerships^{xi} which permit banks and private credit fund managers to support the corporate sector across their entire financing needs. For example, private credit lenders often cooperate with a pool of banks in refinancing deals, as well as launching joint private credit funds. In other instances, private credit lenders have worked with banks to manage situations where the private credit lender no longer wished to continue investing in a successful company and has transferred the relationship to a single bank or group of or banks. In these cases, private credit lenders usually maintained a minor stake as 'skin-in-the-game' alignment of interest with the banks. The financing provided by banks to private credit funds is also a vital part of many private credit strategies. This will be explored later in this paper.

One of the features of the current high-rate environment is that direct lending now has competition, as investors can park their money at 4%-5% in money markets or investment grade corporate credit, giving optionality. This, however, is likely to be a short-term tactical trend, and direct lending still provides the opportunity to compound returns over the long-term at very attractive levels.

Joss Trout, Head of Investment Specialists Group, Tikehau

The collapse of SVB, the ongoing banking crisis and upcoming regulation means that at the macro level there is even less capital from banks coming into SME lending.

Daniel Leger, Managing Director, MGG Investment Group

Private credit has a long runway ahead – of the \$80 trillion total addressable corporate credit market, only \$1 trillion is private. With continued pressure on the banking system, private credit managers will also have an ability to diversify their offerings into other credit asset classes, from asset based finance to real asset debt, where yields are similarly attractive.

Viral Patel, Global Head of Technology Investing, Blackstone Credit



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Banks still have an important role in the private credit ecosystem as they tend to be the most senior lenders. Therefore, less bank capital still translates to less credit lending. In our workstream, we generally do not compete against banks as they have been out of the direct lending space for some time.

**JUSTIN PLOUFFE, DEPUTY CHIEF INVESTMENT OFFICER
FOR GLOBAL CREDIT, CARLYLE**



Additional insights

The asset-based lending market is evolving in a way that is similar to what we have already seen happen in non-investment grade corporate markets. Banks are reducing their presence as direct capital providers and instead becoming financiers of alternative managers' portfolios, which as we continue to see in broader corporate private credit markets is a tremendous opportunity for alternative investors.

Greg Leveto, Portfolio Manager & Partner, Oak Hill Advisors

The major difference between us and corporate lenders is that the people we are facing are Chinese SMEs and these companies don't have access to financing. Banks in China only finance big corporates.

Silver Kung, Founder, Chairman and CIO, Siegfried AM

Add-on financing is very attractive. Private equity sponsors see commercial opportunities that exist with some dislocated multiples.

Malek Ghali, Managing Director, Head of Deal Team, MV Credit

We need to do a better job of convincing investors that we, as non-sponsored lending managers, are effectively taking on the role of the private equity sponsor.

Stuart Fiertz, Co-Founder, President and Head of Responsible Investment, Cheyne Capital

If we increase ticket size, we are facing two consequences: One, you will risk being more concentrated on some companies; And two, we have this yield close to 9% because we are dealing with the small \$1 mn ticket companies that cannot go to the bank for financing so they can only turn to us. But if you are sourcing from a larger ticket, for example a \$50m receivable, that means you are dealing with larger sellers that can always get financing in China at rates close to 3-5%. So how do we maintain the same small-ticket strategy, we invest in technology.

Silver Kung, Founder, Chairman and CIO, Siegfried AM

The current financial challenges with some of the Chinese banking institutions means you've also just got more caution from the global banks as well, which usually plays in our favour. Additionally, we see private equity getting a bigger footprint in the region, and that tends to be first through the door, and then the private credit funds follow.

Silver Kung, Founder, Chairman and CIO, Siegfried AM



Chapter 3

Leverage in private credit
is low and well-managed



Chapter 3

Leverage in private credit is low and well-managed

Key takeaways:

- 36% of respondents report using no financial leverage. A further 51% report using financial leverage at levels below 1.5 times of debt to equity.
- Banks are the primary providers of leverage with 81% of respondents using them. Other providers include insurance companies and other asset managers.
- Private credit fund managers have robust risk management frameworks in place when using leverage as part of their investment strategy and report data periodically to support the risk management practices of leverage providers.

The use of leverage by private credit funds is now subject to increased scrutiny from policymakers and regulators. In this section we explore the data from our survey on the role of leverage in private credit investment strategies, the typical providers of leverage, the terms on which leverage is provided and risk management practices by fund managers and leverage providers.

The most common forms of leverage used by private credit fund managers are subscription line financing, borrowing against portfolio assets, which is mainly used as investment leverage aimed at increasing the funds' exposure, and cashflow management facilities (Figure 15). The latter two forms of leverage are secured against fund assets, while subscription line financing borrows against capital commitments from investors. Subscription line financing, which is sometimes structured as a revolving credit facility, is primarily used to smooth capital calls from investors. As the primary source of credit risk is default by the investor on their contractual commitment, subscription line finance is seen by finance providers as relatively low risk given such instances almost never materialise. It was noted by interviewees that this form of financing had become more expensive recently in response to interest rates rises.

We use a comfortable amount of leverage but, beyond just focusing on that headline number, we want to reduce and minimise our exposure to mark-to-market risk. We want to have as much control as possible and make sure that lenders cannot mark down the value of our assets. We are constantly running sensitivity analyses to make sure we have the liquidity and, if marks come down, we have the assets or capital to put into the vehicles. This is a heavy lift, but it is a big part of what we do and how we do it.

Craig Packer, Co-President and Head of Credit,
Blue Owl Capital



As Figure 16 shows, 36% of respondents do not employ any investment leverage, while 51% of firms employ between 0.1 and-1.5x leverage. These levels are consistent with previous ACC research indicating that there has not been a significant change in the use of leverage by private credit funds. On a relative basis the levels of leverage in the market are also modest compared to other finance providers and asset managers.

Leverage has become more expensive and difficult to access. Following the SVB crisis we've seen banks become a lot more selective about who they provide financing to. Pricing has widened considerably, although it's somewhat rebounded recently for top-tier managers. Banks are clearly laser-focused on risk management.

Nicole Adrien, Managing Director, Chief Product Officer and Global Head of Client Relations, Oaktree

Figure 15

Which of the following types of financing/leverage does your firm use with respect to your private credit strategies? (Select all that apply)

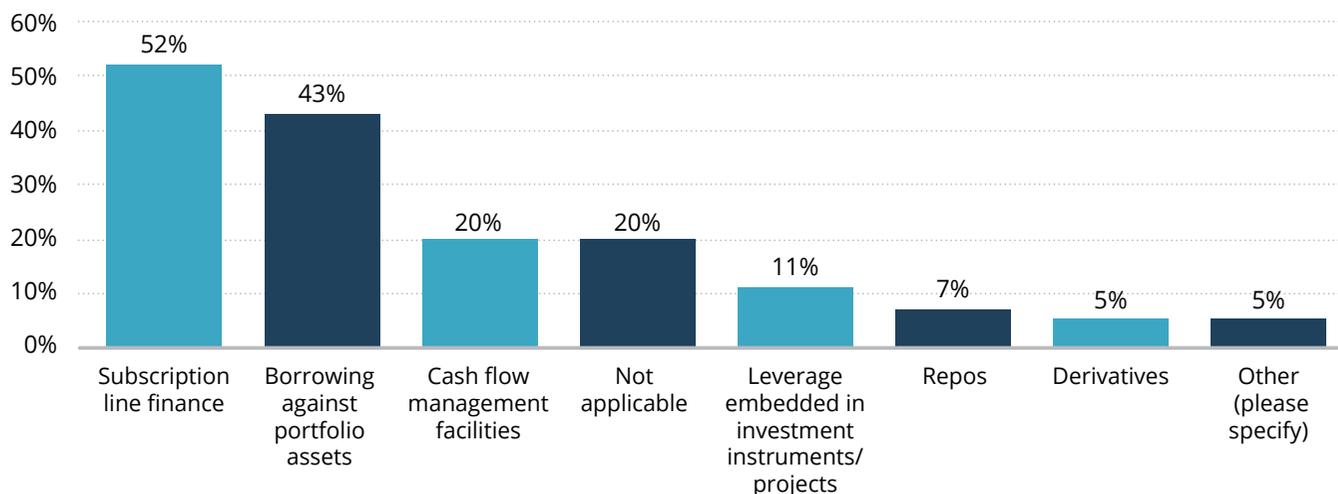
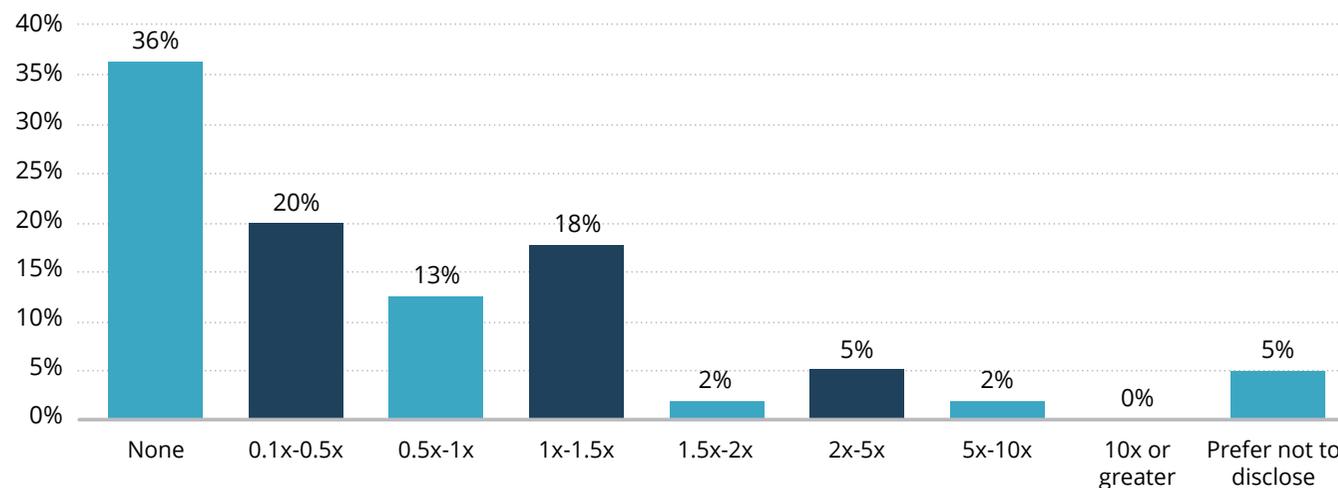


Figure 16

How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (unit of debt per unit of equity)?





When discussing the role of finance supporting the return profile of private credit, investors noted two important impacts of the higher rate environment. The first was that, by increasing the returns from their lending activity, higher rates were reducing the need for private credit funds to use leverage to meet their return targets. The second was that higher rates were also translating into higher costs of finance and lower risk appetite to lend from some finance providers. Another relevant factor in the market is how investors who may have previously preferred unlevered strategies were now more willing to consider levered strategies. As demonstrated in Figure 16, the net impact of these trends on absolute levels of leverage appears to be neutral to date.

With yields across the credit markets being structurally higher – at the highest point in recent history – private credit managers can generally generate attractive returns for investors without applying significant levels of leverage.

Viral Patel, Global Head of Technology Investing, Blackstone Credit

We make sure our assets and liabilities are matched as much as possible and we do not use short term mark-to-market trigger lending or borrowing. We use long term locked up leverage lines because we never want to be a forced seller in the event a market movement devalues a perfectly performing loan.

Justin Plouffe, Deputy Chief Investment Officer for Global Credit, Carlyle



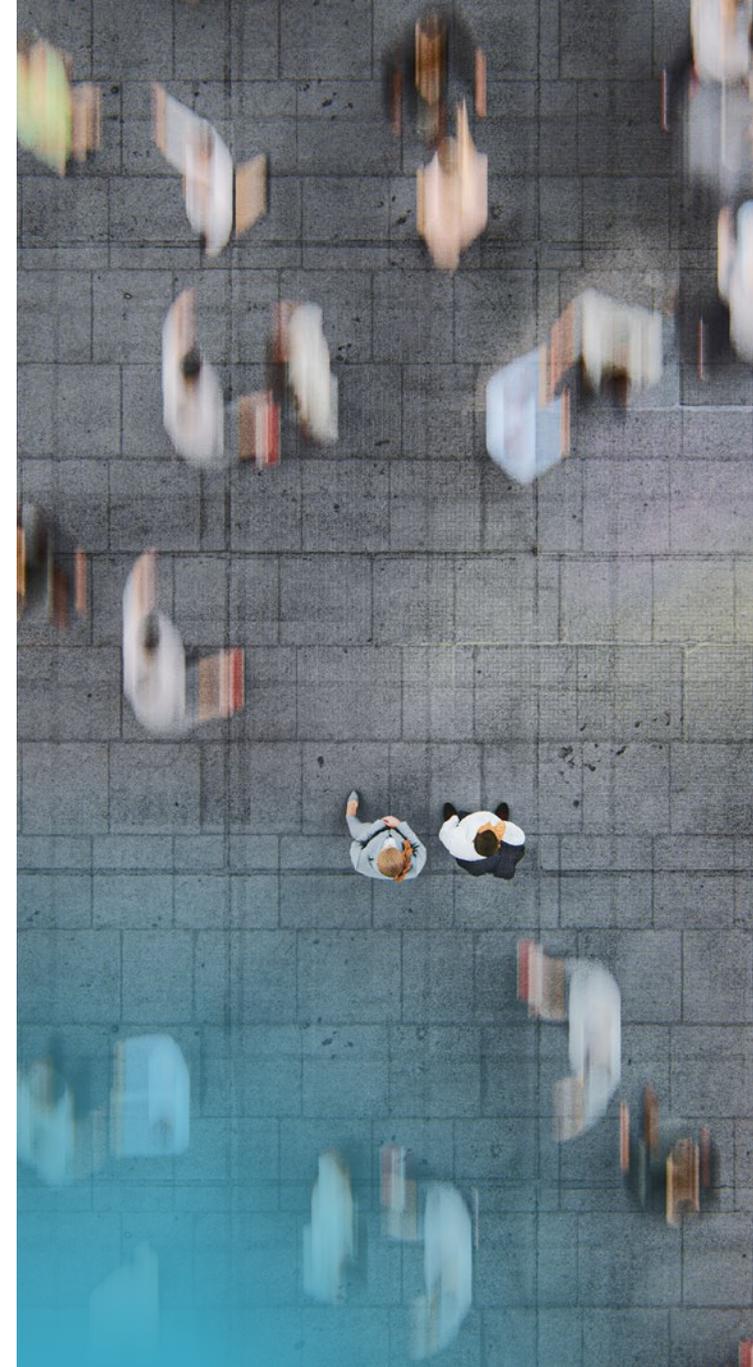
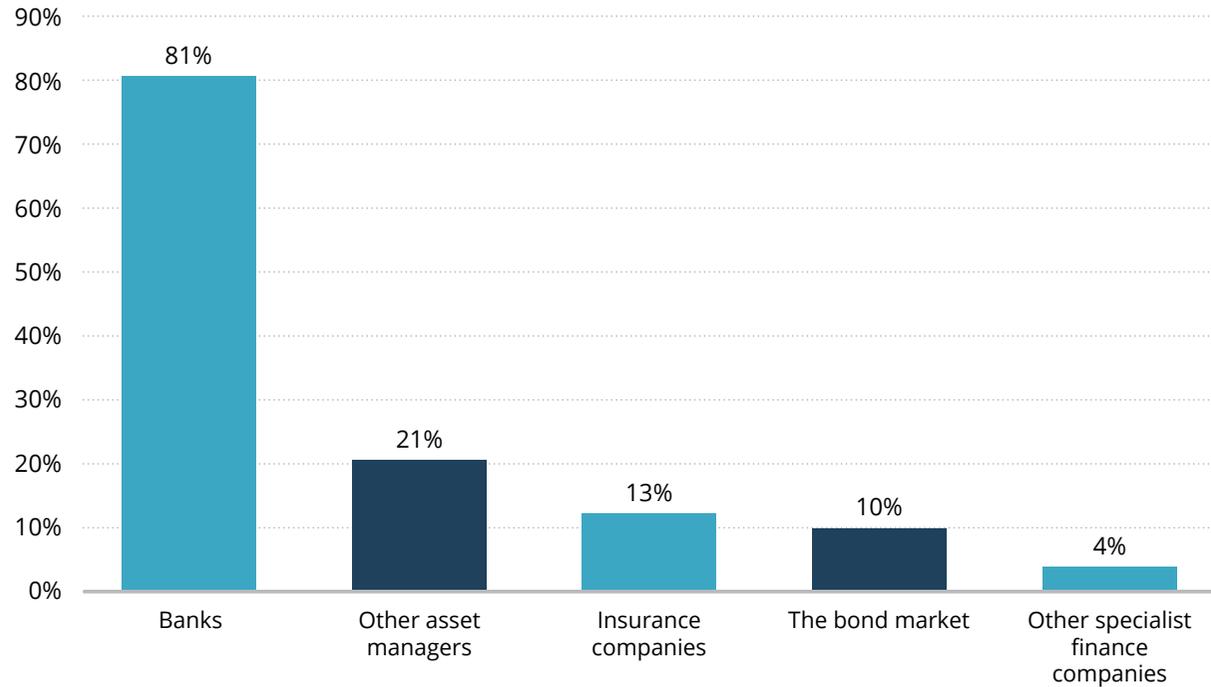
Who provides leverage and on what terms?

The main providers of leverage for private credit funds continue to be banks (see Figure 17). While there was some initial impact on the willingness of banks to finance private credit funds following the collapse of Silicon Valley Bank earlier this year, this was only a temporary change. Our data also shows that other lenders are entering this market and beginning to diversify the sources of financing for private credit funds.

Figure 17

Who do you use as providers of leverage/financing to your funds? (tick all that apply)

*Excluding survey respondents who responded that this question was not applicable



Our research also highlighted consistent practices when it comes to establishing the terms of finance, for example, in relation to the maturity profile, collateral, lender recourse and risk management. As shown in Figure 18, most financing facilities have maturities of greater than one year. Financing facilities shorter than one year typically relate to cashflow management facilities rather than investment leverage. Interviewees emphasised that the potential for liquidity mismatches was always a central consideration when structuring any lines of credit. As well as matching any borrowing to the maturities of the underlying assets, firms also establish a diverse range of financing facilities to further mitigate potential risks.

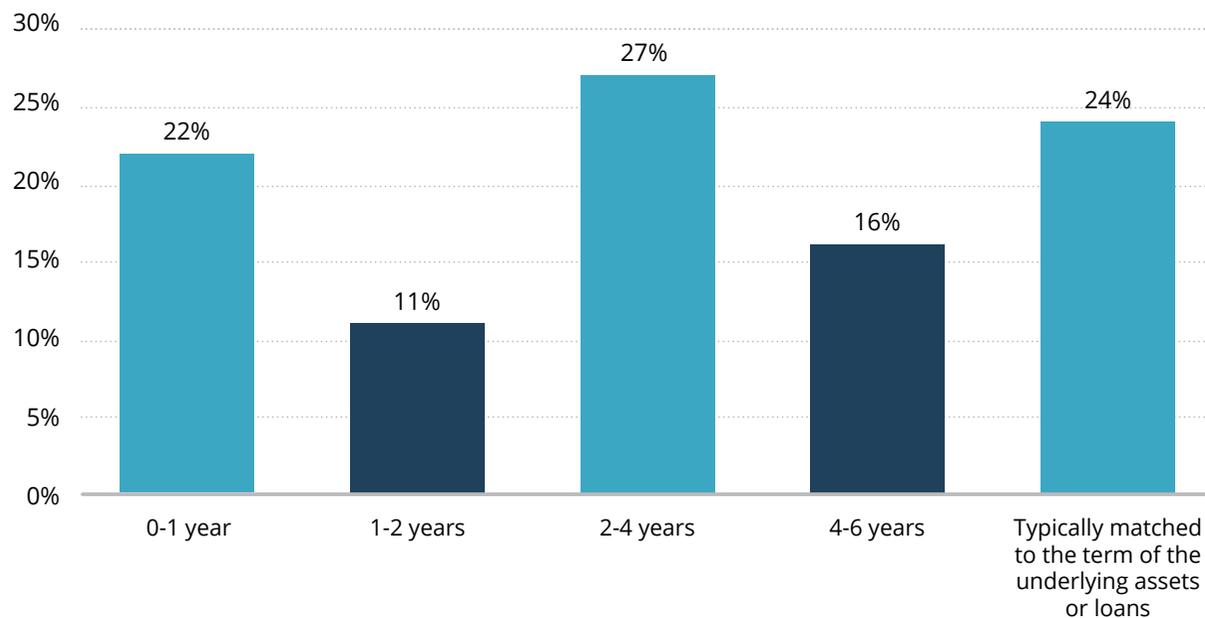
Where private credit funds borrow against portfolio assets, managers generally arrange the borrowing facilities in a way that matches the profile of the assets and minimises potential liquidity mismatches. For example, some interviewees arrange two credit facilities for each commingled fund, with the first facility in place three to six months after closing the fund and the second one a year later. These have a typical timeframe of six years, usually covering three years of investment period and three years of harvesting, with the option to extend the facility another year.

After a facility is activated, finance providers will also receive regular reporting and updates on the portfolio of assets. This can include information on the latest valuation of the assets by external providers, as well as an update on relevant credit metrics and performance of the assets. This ensures the finance provider has good visibility on their investment and there is data to underpin any dialogue between the private credit fund manager and leverage provider on whether and how it is necessary to adjust the asset pool. Leverage providers therefore have good visibility on asset performance and periodic opportunities to refresh or repair any issues with the collateral.

Figure 18

What is the typical term of the financing used when borrowing against portfolio assets in relation to your private credit investments?

*Excluding survey respondents who responded that this question was not applicable

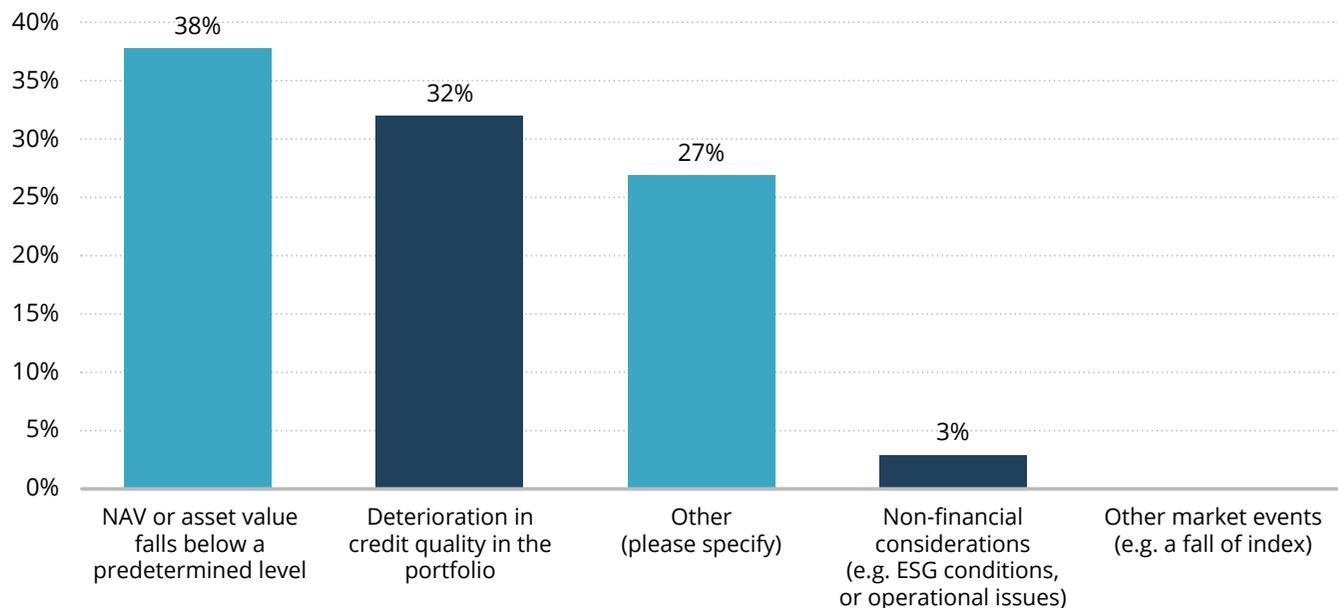


From the perspective of leverage providers, private credit funds are attractive borrowers. Lending against a diversified pool of assets provides more downside protection than lending against each individual asset. Recent research from KBRA has found that investment-grade rated private credit fund financing facilities, which can represent up to 3x of fund equity, can withstand cumulative defaults of the underlying collateral at an average of 62%, assuming an average recovery rate of 58%^{xii}. Non-investment-grade exposures can withstand defaults at an average of 37%, assuming an average recovery rate of 57%. In both scenarios there is significant headroom before lenders to such funds would be exposed to any risk of losses on their principal. Indeed, these extreme scenarios far exceed the typical loss and default rates witnessed in private credit and other credit markets, meaning there would have to be either historically unprecedented macroeconomic challenges or a severe underwriting failure at an individual firm for such a scenario to occur.

Private credit fund managers also reported that finance providers undertake a high level of due diligence, as well as a high level of credit analysis on the underlying businesses that make up the loan portfolio. This applies both to fund investors when lending for subscription facilities and to individual investments when lending for leverage and against

Figure 19

Under which conditions can the financing party withdraw financing/demand repayment of the facility?



a pool of assets. Bank lenders also require regular reporting on the status and leverage levels of the underlying pool of assets, and that data on every investment used as collateral is provided to them. These disclosures are similar to those made by private credit funds to their investors. While no two

credit facilities are exactly alike, it was reported that it was relatively common for negotiations between managers and finance providers to take between three and six months, depending on the prior relationship and nature of the finance request.



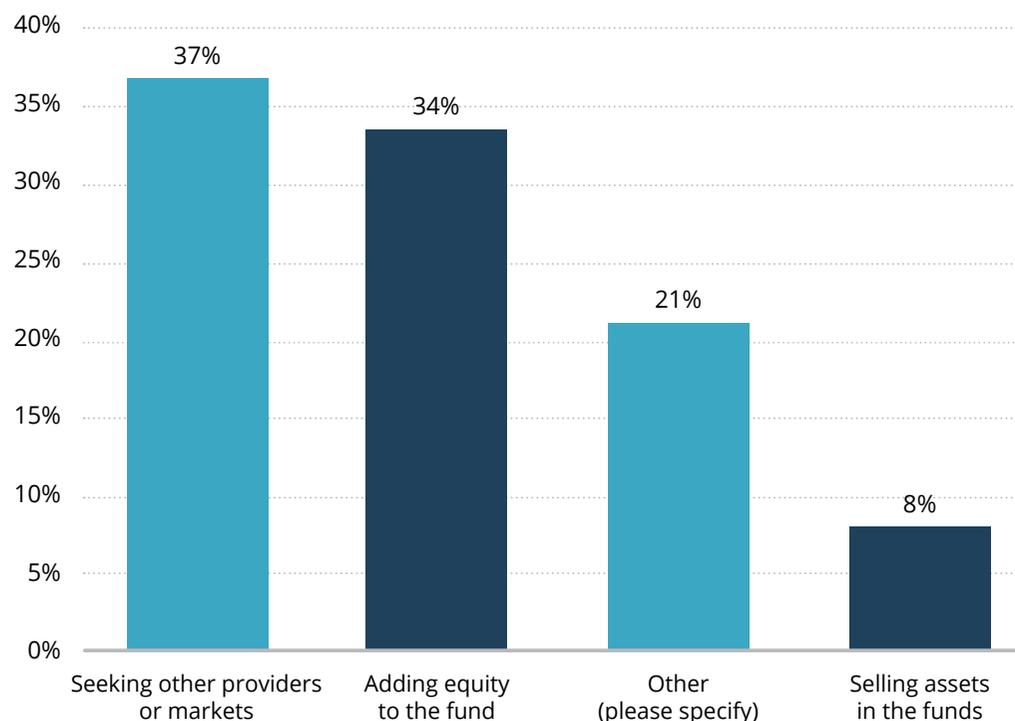
Our research also revealed some of the common reasons finance providers withdraw the financing. In addition to those listed in Figure 19, respondents to our survey also highlighted more specific considerations such as breaches of debt service coverage ratios (DSCR) or loan covenants by borrowers, changes of control or losing an investment grade rating. It was also noted that some credit facilities are structured to be paid down on the maturity of the loan assets under a cash sweep mechanism. In any case, interviewees highlighted that the withdrawal of financing is not a common occurrence, and in past periods of stress like Covid banks have been supportive and open to finding solutions to repair stressed facilities instead of simply calling defaults.

Interviewees for this research highlighted that their firm's approach to risk management would include a considerable buffer against such conditions ever being met. The regular monitoring and reporting to finance providers was an important mitigant against such conditions being triggered unexpectedly, while also giving fund managers and lenders more opportunities to address potential issues proactively. Figure 20 highlights some of the tools available to private credit fund managers in this respect.

Figure 20

What tools are at your disposal to manage situations where financing/leverage provision is at risk of being lost/not renewed?

*Excluding survey respondents who responded that this question was not applicable



Chapter 4

Liquidity risk management practices mitigate mismatches



Chapter 4

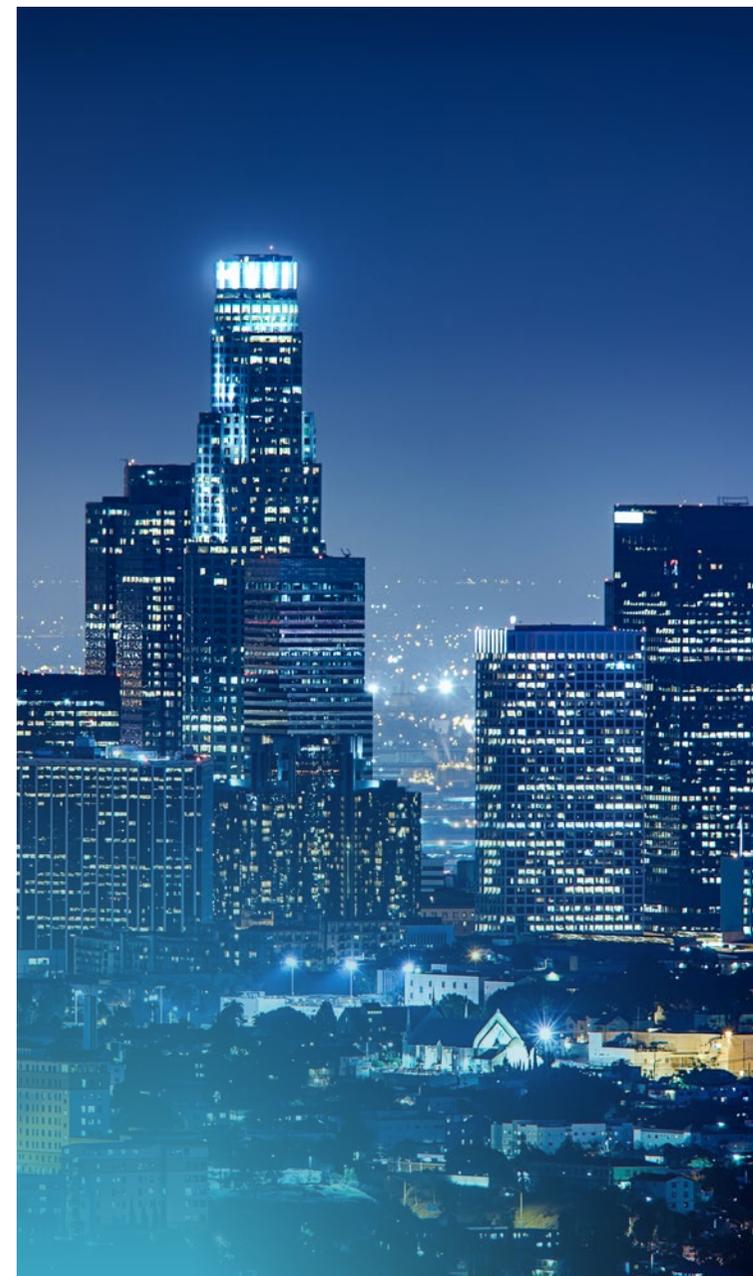
Liquidity risk management practices mitigate mismatches

Key takeaways:

- An estimated 58% of capital invested in private credit strategies is done so through closed-ended structures.
- Investors are exploring alternative structures that can improve the efficiency of capital deployment or meet their liquidity needs.
- Private credit fund managers are already making extensive use of liquidity management tools to align the liquidity profile of open-ended funds with the needs of investors and underlying assets.

Our *Financing the Economy* research has previously highlighted how closed-ended commingled funds are the predominant way investors in private credit strategies access the asset class. As shown in Figure 21, there are signs the market is gradually changing with investors now using a broader range of structures. Our recently published white paper *In Partnership: trends in private credit fund structuring*^{xiii} documented how investors were increasingly seeking structures that provide ongoing exposure to private credit strategies, as well as products that maximise their investment returns. One impact of this trend is for greater volumes of capital to be invested via various forms of open-ended funds, hybrid funds, managed account structures and co-investment vehicles.

Using data from our survey, the ACC estimated the volume of capital invested into private credit strategies through different investment structures (see Figure 22). This suggests that 58% of private credit capital is currently invested through closed-ended structures. The ACC also calculated the proportion of assets invested through commingled structures from our sample size. As shown in Figure 23, our estimate indicates that 84% of capital managed within commingled structures sits within closed-end fund structures.



Interviewees for this research expect demand for alternative structures to increase as investors become more familiar with the asset class and the general trend for customised investment mandates amongst institutional investors. However, our data currently indicates that the bulk of assets within private credit are managed in closed-ended fixed maturity structures.

Figure 21
What structures do you use to invest in private credit assets? (select all that apply)

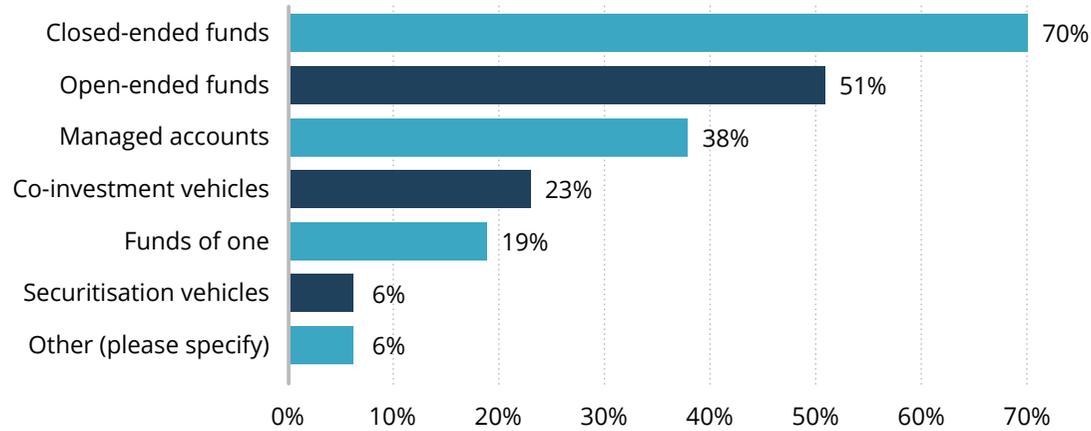


Figure 22
Estimated percentage of private credit assets managed within different investment structures

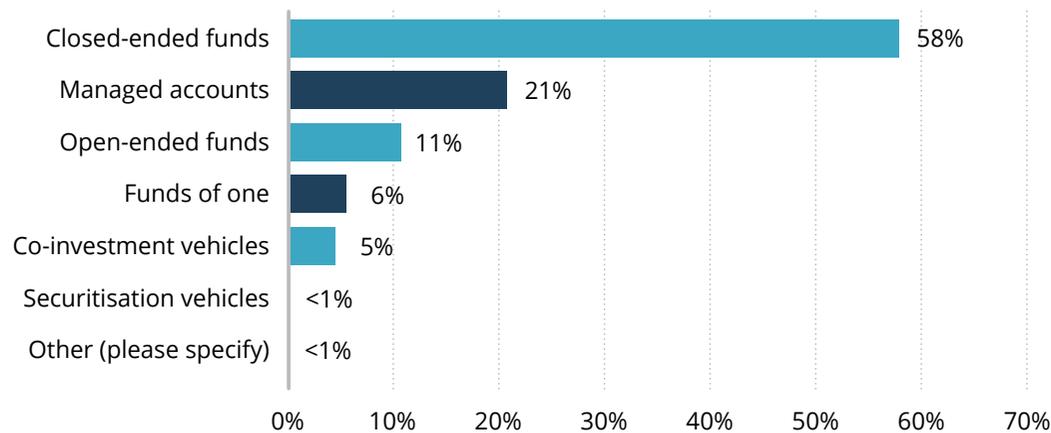
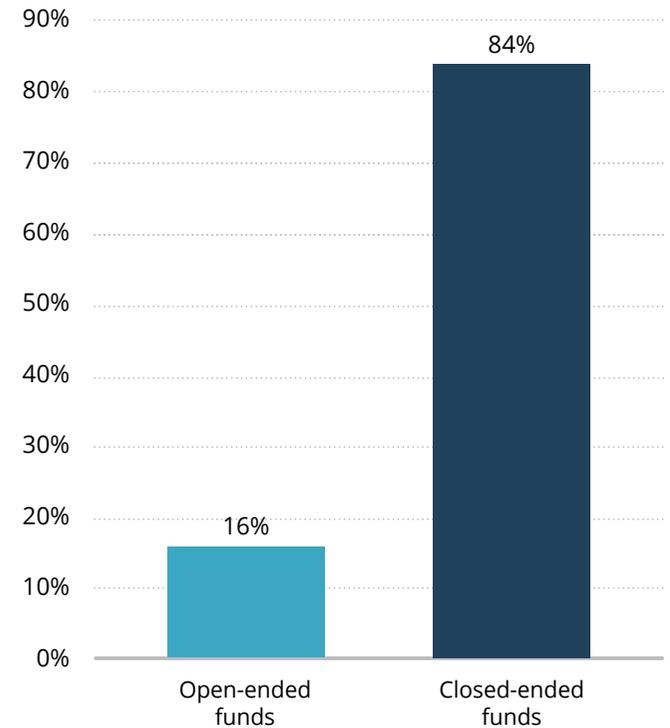


Figure 23
Private credit assets managed within commingled structures – estimated percentage of assets managed within open and closed-ended fund structures





Focus on liquidity terms in open-ended structures

As noted above, a relatively small proportion of investors now access private credit through open-ended structures, but many investors are exploring more liquid alternatives. While such structures are generally defined as ones which provide investors with a right to redeem their capital prior to liquidation, there are multiple ways in which funds can be structured to meet this right. In this section we provide a closer examination of how private credit fund managers are structuring their open-ended funds, the current application of liquidity management tools (LMT) in the sector and the underlying drivers amongst investors for more liquid investment structures.

While there has been growth in more liquid private credit strategies, such as trade finance or asset backed lending, corporate lending strategies continue to make up the bulk of the asset class. The underlying assets of these strategies (corporate loans) typically have multi-year maturity profiles (e.g. three to seven years) and there is almost no trading of these loans. Private credit fund managers using open-ended funds to invest in these assets therefore need to employ multiple liquidity risk management tools to align the fund structure with the liquidity profile of the assets and the needs of their investors. As shown in Figure 24, there are multiple tools available to investors.

Liquidity is a natural evolution of a market that is coming of age. There are always good reasons for people to exit before the end of the fund life, including regulatory reasons and the denominator effect.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau

The concept of evergreen in practice can take on many forms, but the clearest trend may be solving investor demand for greater exposure to private credit, and more consistent deployment.

Brian Towers, Managing Director, Blackstone Credit



Figure 24

Typical liquidity risk management tools employed in open-ended or hybrid funds

Lock-up periods	Preventing redemptions for a pre-determined period.
Ex-ante investor gates	Pre-determined limitation on the amount of invested capital a given investor can redeem at one time.
Ex-ante fund level gates	Pre-determined limitation on the aggregate amount that all investors in a given fund can redeem at once.
Prescribed redemption windows	Investors may only redeem at pre-determined intervals
Notice period	Investors must provide minimum notice for redemption requests.
Slow pay provisions	Segregating an investor's share of the assets and returning it in line with maturity of the asset, e.g. run-off basis.



It is common for multiple LMT to be employed within a single fund structure and managers can additionally tailor the tools to meet investor needs, e.g. adjusting the length of the lock-up period or size of the gate. Our survey explored market practices across key LMT for private credit fund managers.

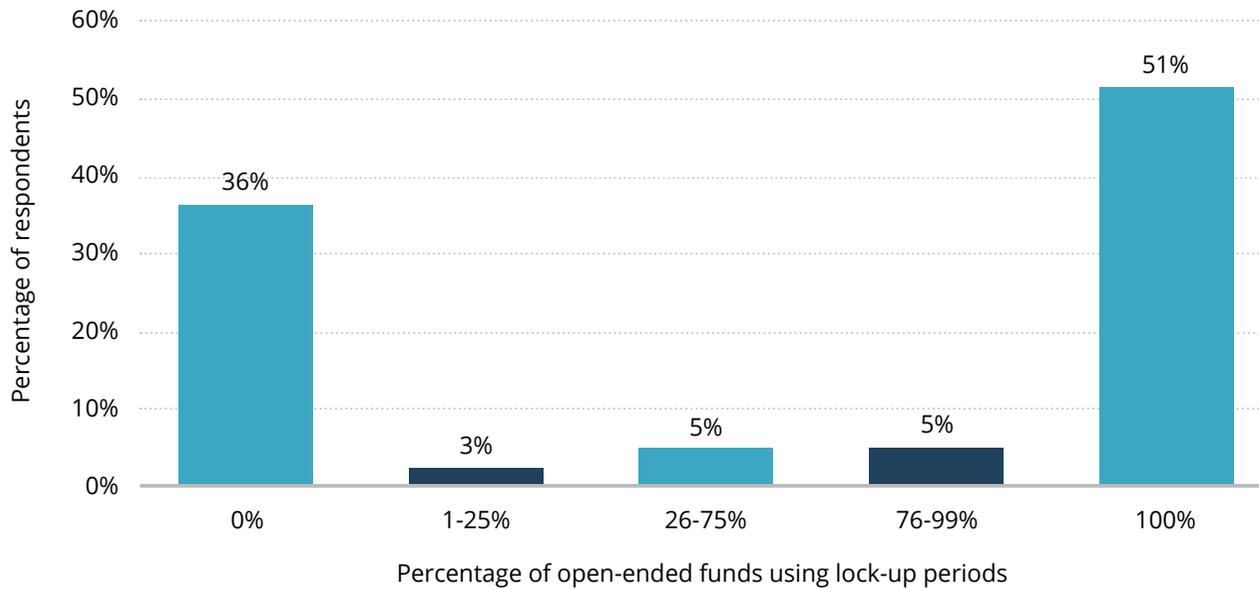
64% of our respondents reported using a lock-up period for some of their open-ended funds, with 51% stating that they do so for all their open-ended funds (see Figure 25).

The longer maturity profile of many private credit strategies (e.g. corporate loans or real estate debt) means that it is important for investors to commit their capital for an initial period. Of those respondents who do not use lock-ups, many reported being invested in trade finance or more liquid strategies where such LMT were less relevant.

Figure 25

What percentage of your open-ended funds use lock-up periods?

*Excluding survey respondents who do not manage open-ended funds





Our survey also shows that a large majority of respondents that offer redemptions do so at quarterly or greater intervals (see Figure 26). This is unsurprising given that valuations on private credit funds are typically undertaken quarterly. As well as redemptions typically being staged at quarterly or longer intervals, our data also indicates that a majority of respondents also have notice periods of one month or longer (see Figure 27). Respondents offering more frequent redemptions or shorter notice periods were typically focused on more liquid private credit strategies or assets with shorter maturity profiles.

The pattern of these data points is further reinforced when considering Figure 28 and the percentage of respondents who employ gates in their open-ended funds. Once again, the third of respondents who stated they do not use gates broadly conformed to those invested in more liquid private credit strategies.

Figure 26

When can investor redemptions typically occur for your open-ended funds investing in private credit assets?

*Excluding survey respondents who do not manage open-ended funds

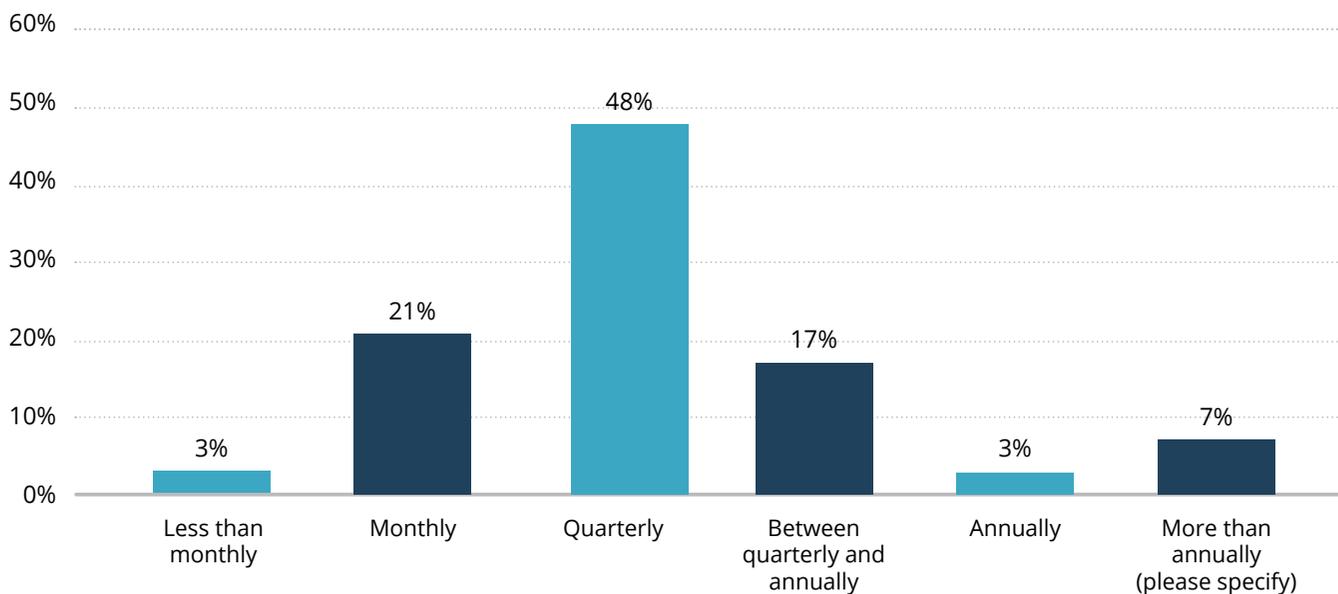


Figure 27

What is a typical notice period for your open-ended funds investing in private credit assets?

*Excluding survey respondents who do not manage open-ended funds

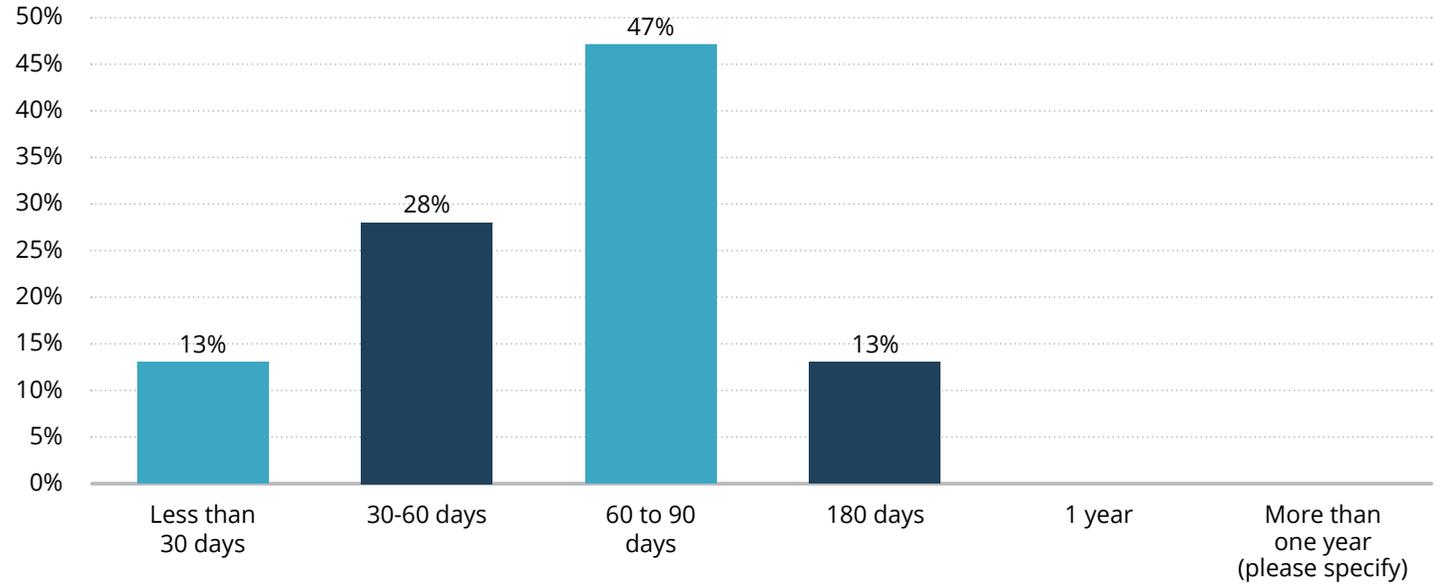
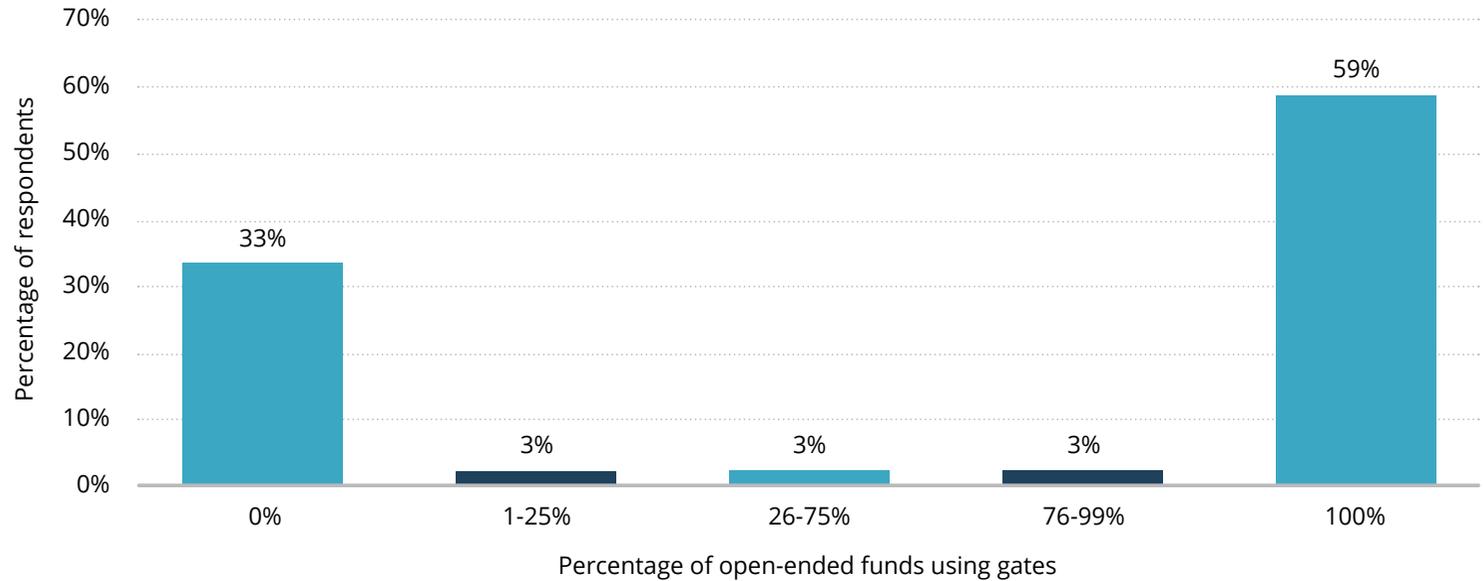


Figure 28

What percentage of your open-ended funds use gates?

*Excluding survey respondents who do not manage open-ended funds



Looking at these data points in aggregate, it is reasonable to conclude that private credit fund managers are using LMT ubiquitously in open-ended funds that they manage to provide investors with some form of redemption, even if there is no single standard for liquidity risk management that holds across all strategies.

Managers interviewed for this research highlighted that flexibility to structure the most appropriate LMT for each fund is vital to ensuring that these align the maturity of the assets with the needs and expectations of the investors. This is particularly important given the range of maturity profiles of private credit assets that now exists and the broadening investor base for private credit. Interviewees also highlighted how such structures have held up well in the face of both short-term market stress (e.g. arising from challenges in the banking sector during Q1 2023) as well as longer periods of uncertainty (e.g. during the Covid pandemic).



Lessons for policymakers and investors

Liquidity risk management by non-bank financial institutions has been identified by capital market regulators and central banks as a priority area for review. Policymakers in Europe have introduced specific rules relating to liquidity risk management for the UK Long-Term Asset Fund and the European Long-Term Investment Fund, as well as within the revisions to the Alternative Investment Fund Managers Directive framework. Our data indicates that market practices are already addressing many of the primary concerns expressed by policymakers – for example the potential for liquidity mismatches – and firms are proactively considering liquidity risk management when setting up these funds.

One tool discussed less frequently is the use of slow pay provisions, whereby a redemption request leads to the investor's share of the assets being segregated from those of other investors and returned in line with maturity of the asset, e.g. on a run-off basis, as opposed to being returned as their share of the fund NAV at that time. Such structures are relatively common amongst private credit funds offering structures that permit some right to redemption as a means to prevent liquidity mismatches.



Another key element identified by our research is the way in which LMT are typically designed and agreed ex-ante i.e. prior to the investor committing their capital. This supports the investor's understanding of how their redemption would be processed across a range of scenarios. For example, how redemptions are prioritised in instances where they exceed a pre-agreed maximum threshold, as well as where there is ample liquidity to meet the redemption. The likelihood of such scenarios emerging is also considered ex-ante through consideration of historical data on the return profile of the asset, stress testing against economic headwinds, as well as an increase in investor redemption requests due to unrelated liquidity challenges. Our research indicates that as well as feeding into the design of LMT to address different scenarios, it also reduces the likelihood that a private credit fund manager would need to limit redemptions in a disruptive manner.

One additional factor highlighted in our interviews was the importance of flexibility when designing structures which provide investors with the most efficient means to access private credit strategies. A proportion of respondents to this survey stated that they do not use LMT to the same extent as corporate lenders, because they are inappropriate or unnecessary for their strategy. At the same time, investors are becoming more familiar with the benefits of more liquid structures to increase the efficiency of their investments. By reducing reinvestment risk and permitting greater compounding of the investment returns, more open-ended structures can have a substantial impact on the returns on capital invested. For investors with investment horizons spanning decades, even small efficiency gains can produce a significant improvement in their returns.



Summary of key takeaways

Chapter 1

Resilience in a higher interest rate environment

- Private credit funds have weathered the higher rate environment better than anticipated, with modest adjustments to loan values and relatively low instances of stress and default.
- Credit selection and risk management practices around portfolio company cashflows are seen as a key differentiator between firms.
- Many funds are showing extremely strong performance through a combination of higher coupons and effective management of downside risks.

Chapter 2

Boom in capital deployment

- In 2022 private credit fund managers invested an estimated \$332.6bn capital, up 60% on the previous year.
- 58% of the total capital deployed by private credit managers globally is estimated to come from firms deploying more than \$10bn per year.
- Better lender terms, further retrenchment of banks and the need for flexible capital solutions is fuelling cautious optimism amongst private credit managers about current deployment opportunities.

Chapter 3

Leverage in private credit is low and well-managed

- 36% of respondents report using no financial leverage. A further 51% report using financial leverage at levels below 1.5 times of debt to equity.
- Banks are the primary providers of leverage with 81% of respondents using them. Other providers include insurance companies and other asset managers.
- Private credit fund managers have robust risk management frameworks in place when using leverage as part of their investment strategy and report data periodically to support the risk management practices of leverage providers.

Chapter 4

Liquidity risk management practices mitigate mismatches

- An estimated 58% of capital invested in private credit strategies is done so through closed-ended structures.
- Investors are exploring alternative structures that can improve the efficiency of capital deployment or meet their liquidity needs.
- Private credit fund managers are already making extensive use of liquidity management tools to align the liquidity profile of open-ended funds with the needs of investors and underlying assets.



Endnotes

- i Source: Preqin Pro
- ii Source: BIS
- iii Source: Reuters <https://www.reuters.com/markets/us/us-q2-gdp-growth-unrevised-21-weekly-jobless-claims-edge-higher-2023-09-28/>
- iv Source: Cliffwater https://cliffwater.com/files/cdli/docs/Cliffwater_Report_on_US_DirectLending.pdf
- v Source Cliffwater https://cliffwater.com/files/cdli/docs/Cliffwater_Report_on_US_DirectLending.pdf
- vi a Source: JP Morgan Markets, Bloomberg US High Yield Bond Index, Morningstar LSTA US Leveraged Loan 100 Index
b Source: Cliffwater Direct Lending Index (Realised Credit Losses)
c Source: Federal Reserve (Fred: CORBLACBS)
- vii Source: KBRA Insights <https://www.kbra.com/publications/dBPqqPhn/kbra-insight-on-private-credit-middle-market-rate-stress-another-50-basis-points>
- viii Estimated using the reported capital deployment of our respondents and scaling this up based on the private credit assets under management of the respondents relative to the global private credit market (Preqin estimate)
- ix Source: Refinitiv <https://solutions.refinitiv.com/MAReport2023-DealsIntelligence>
- x Source: Financing the Economy 2022 <https://acc.aima.org/compass/insights/private-credit/financing-the-economy-2022.html>
- xi Source: Financial Times <https://www.ft.com/content/1d3cdb11-97e9-41fb-866b-97a3d8c1b8b3?shareType=nongift>
- xii Source: KBRA Insights <https://www.kbra.com/publications/HszPknkq/private-credit-funds-in-pictures-safety-in-numbers>
- xiii Source: ACC 'In Partnership' <https://www.aima.org/compass/insights/private-credit/trends-in-private-credit-fund-structuring.html>

