THE BIRTH OF PRIVATE CREDIT INTO MAINSTREAM FINANCING

- Stuart Fiertz, **Alternative Credit Council**

Whether it is supporting manufacturing or healthcare, or providing funding to companies that can revolutionize renewable energy, the private credit industry is now truly instilled in supporting companies to grow and achieve their goals. The industry is lending to businesses at record levels and having witnessed a 20% compound annual growth rate since 2000, it is now expected to hit $1tn by 2020, according to recent research by the Alternative Credit Council (ACC).

Borne out of the financial crisis of 2008 and banks' constrained ability to lend, private credit is now seen as an accepted and credible source of finance and a standalone asset class. The current run of low interest rates has fuelled the hunt for yield, with attractive, decorrelated returns drawing the attention of investors, while the flexibility to structure loans that suit specific needs and offer financing at speed have appealed to borrowers. That has already led to increased levels of repeat business, in particular from those that were already provided funding to grow and are now looking to expand further through bolt-on acquisitions. Interest rate increases could attract more capital into the industry, as investors look to diversify their portfolio and secure uncorrelated sources of income.

The ACC research, titled 'Financing the Economy', highlighted numerous positive signals around the sector. Managers are increasingly willing to invest for the long term; in fact, 63% said they preferred terms of between two and six years. Almost a quarter stated they favoured terms of six years or more, compared with only 8% in 2015. Such appetite for longer investment horizons will appeal to pension funds and insurance companies as they seek profiles that can match their own liabilities and could attract further capital into the industry. The size of deals also underlines the commitment of managers to see borrowers succeed with their businesses, with some 45% of managers saying they target loans of between $25mn and $100mn, while one-fifth eyed deals in excess of $100mn.

Research showed SMEs remain important recipients of private credit, with one-third of committed capital lent to SMEs and mid-market businesses. Lending to larger businesses is on the rise, receiving around one-fifth of all lending, which highlights that private credit managers are utilizing their expertise and experience to offer specialized finance solutions beyond their traditional mid-market base.

Headline dry powder figures – also known as available capital – may attract publicity but are only about one-third of the industry's total assets. It is common for managers to adopt a one-third investment strategy over a three-year period and as the industry continues to grows, absolute levels will naturally rise. Still, dry powder is at its lowest level in several years and is dramatically lower than the 45% levels seen leading up to the financial crisis (2000-2008).

Growth of the industry is now also spilling into new markets to create a truly global industry, as the appeal of private credit is recognized and we do not see this waning as we head into 2018. ACC research found that outside the established areas such as the UK and the US, managers saw Germany, France and Canada as offering the most growth potential. Growth across Europe and Asia-Pacific had been particularly helped by regulatory reform and the ACC will continue its work to encourage positive reform that will support the sustainable development of private credit.

As new players enter, the industry has become increasingly competitive. It should not come as a surprise that the private corporate loan market has shifted noticeably in favour of borrowers in terms of coupons and covenants over the past three years. Nearly half of private credit managers stated that covenants had become less demanding over the past three years, with only 14% saying loan terms had become more demanding. This flexibility is one of the many factors the industry excels at when compared with banks. Increased competition has not compromised several pillars that characterize the industry. Private credit managers continue to primarily use closed-end fund structures, leverage across the market remains modest and lending standards and due diligence continue to be robust. The industry's mantra is now implanted: 'cautious and rigorous' in its approach to lending. As the sector matures, this will be an essential requisite to sustainable growth of private credit.

Going forward, we expect a greater appreciation of the breadth of the private credit industry. Moreover, we expect to see stressed and distressed private credit managers play a key role in the restructuring and recapitalizing of the €1.1tn of NPLs on European bank balance sheets. Commensurate with that opportunity will be an increase in the capital committed to that role. The underlying companies will be injected with new dynamism which will contribute to the healthy growth of the real economy.

ALTERNATIVE CREDIT COUNCIL

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that manage $350bn of private credit assets.

The ACC is an affiliate of the Alternative Investment Management Association.

Stuart Fiertz is also co-founder and President of Cheyne Capital.

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