ALTERNATIVE CREDIT COUNCIL

lendingforgrowth.org

FINANCING THE ECONOMY 2022

in partnership with

ALLEN & OVERY

AIMA

ALTERNATIVE CREDIT COUNCIL

Contents

Foreword	04
Executive summary	05
Research methodology	06
Chapter 1 – The investment case for private credit	10
Chapter 2 – Focus on the borrower	34
Chapter 3 – Investment due diligence and risk management	46
Chapter 4 – What to expect in 2023	64
Summary of key findings	70
End notes	71

Acknowledgements

Alternative Credit Council

Nicholas Smith, Managing Director, Private Credit

Samuel Koslover, Analyst, Private Credit

Allen & Overy

Hannah Gates, Partner

Denise Gibson, Partner

Stanimir Kostov, Partner

Annette Kurdian, Partner

Jake Mincemoyer, Partner

This PDF contains elements that are interactive.

Foreword

Jiří Król
Global Head of the ACC

Hannah Gates
Partner, Allen & Overy

Welcome to Financing the Economy 2022, the eighth edition in a series of papers analysing the global private credit industry produced by the Alternative Credit Council (ACC) in partnership with Allen & Overy LLP.

The *Financing the Economy* research series has charted the story of private credit from niche investment strategy to a trillion-dollar asset class. The 2022 edition confirms that this story remains a global one, with the sector continuing to expand its footprint across Europe and Asia. In both these and more developed markets, the growth of the sector means that SMEs through to large corporates all have access to deeper and more diverse sources of liquidity.

The publication of this research comes at a time when many features of the economy that we have become accustomed to are changing. Previously, dormant factors like rising interest rates and inflationary pressures, alongside regionalisation and re-shoring of supply chains, have returned to the fore. These are having a profound effect on the economy, with the impact of their return likely to be felt for several years to come.

In the context of a more challenging outlook for the economy, we have focused this year's research on the current business environment and real-world impact of the financing provided by our members.

By analysing how private credit managers assess and manage their investment opportunities we hope to provide a valuable window into the role our sector will likely play in supporting businesses of all shapes and sizes through the current uncertainty.

The findings of this research offer reasons for optimism. Lenders have invested in their risk management practices and are demonstrating selectivity and discipline when granting loans. They continue to provide finance as traditional lenders retrench their activity, which validates our view that the sector does not encourage pro-cyclicality, and that diversifying sources of finance improves economic resilience.

Being a good lender is as much about due diligence and risk management as it is about deployment rates and returns. It is welcome to see that investors in private credit are firmly attuned to this notion and are placing this at the core of their manager selection, due diligence and capital allocation processes.

Prudent lending and investment discipline have been at the heart of the sector since its inception, driving its growth and expansion more than any other factor. This paper highlights the centrality of this factor once more as the sector navigates economic headwinds and continues to be a key partner for borrowers and investors looking to do the same.

Executive summary

Supporting borrowers through uncertainty

Private credit fund managers have continued to expand their lending activity, providing finance to a greater spread of businesses. Private credit funds reported a 20% increase in their lending volumes in 2021 and the sector retains a positive outlook towards deployment opportunities in 2022 and 2023. Firms reported increased deal flow, despite the slowdown in M&A activity, as other liquidity providers retrench. While there has been a notable trend towards loans granted to larger corporates, often in excess of $1bn, our data indicates that businesses in the lower, mid and upper mid-market now have access to deeper pools of private credit capital. The certainty of execution and flexibility of terms offered by private credit fund managers is attractive to borrowers of all types in a challenging market.

Emphasis on prudent lending by lenders and investors

Private credit fund managers have invested in their risk management functions during periods of growth. This is manifesting in tighter lending terms across deal pricing, lower levels of leverage and enhanced covenant protections. There is a greater emphasis on data analytics and risk indicators to assess and monitor the financial health of existing portfolio companies. Where potential challenges are identified or stress occurs, the direct relationship between lenders and their portfolio companies and private equity sponsors incentivises all parties to address these challenges and make adjustments to return the business to a healthy position. Investors are increasingly sophisticated in how they review investment due diligence, documentation and workout capacity across private credit managers. Investors are increasingly using these factors to differentiate between private credit managers and allocate capital.

Choosing the right opportunities in a challenging market

Inflation, rising interest rates and economic volatility are creating multiple challenges for investors and private credit managers. Inflation and macroeconomic risk were identified by 55% of respondents as the biggest challenge for their portfolios and future lending activity. Private credit funds are responding to this by being more selective when deploying capital, focusing on businesses in non-cyclical sectors, those with strong cashflows and the ability to retain pricing power. Floating rate products are proving attractive to investors as a protection against the impact of rising rates. Seniority in the capital structure is seen as important in the current environment, although many lenders and investors are preparing to invest more flexibly across the capital structure in coming years.

Expansion across developed and emerging markets

Our data indicates that private credit managers expect growth to take place across both developed and emerging markets. While the UK and US were cited as the national markets with the greatest growth potential, the aggregate preferences of our respondents reveal that most private credit managers expect Europe and Asia to see significant growth. The research also suggests that this growth will take place across a range of markets in those regions rather than being confined to specific jurisdictions. Much of this growth is being led by the private equity market which continues to spearhead private credit's expansion into new markets. This development is likely to prove valuable for the European and Asian economies as they seek to diversify the sources of finance available to borrowers.

The investment case for private credit remains compelling

Market volatility and the denominator effect have affected capital raising during 2022 but private credit managers expect this trend to be temporary. Our research finds that investors continue to develop dedicated private credit allocations, with the track record and strength of investor relationships continuing to drive strong capital raising across the industry. While there are differences of opinion about the extent to which private credit will become a mainstay of retail portfolios, UK and EU efforts to support retail investment in private credit through the LTAF and ELTIF are expected to provide new sources of capital for the sector. Industry initiatives supporting harmonisation of ESG risk disclosure through the ESG Integrated Disclosure Project suggests that ESG and stewardship remain a core part of lenders' activities and this will not diminish despite more challenging markets.

Research methodology

Financing the Economy 2022 is based on data from several sources. The Alternative Credit Council (ACC) and Allen & Overy LLP (A&O) conducted a survey of private credit managers and received responses from 54 private credit managers and investors. The survey data was then explored by the ACC and A&O in a series of one-on-one interviews.

Respondents collectively manage an estimated $805bn in private credit investments. The managers estimate they deployed around $127bn in 2021 (see Figures 1, and 2). Respondents invest across a broad cross-section of jurisdictions and strategies (see Figures 3, and 4).

Respondents to this survey also provide finance to borrowers of various sizes (see Figure 5). While most respondents typically lend to borrowers with average EBITDA between $25-100m, there were notable cohorts of respondents that typically lend to businesses with lower or higher EBITDAs.

Figure 1: Estimated private credit AuM of survey respondents –

$805bn

Figure 2: Total estimated capital deployed by respondents in 2021 –

$127bn

Figure 3: Which regions does your firm invest in? (Select all that apply)

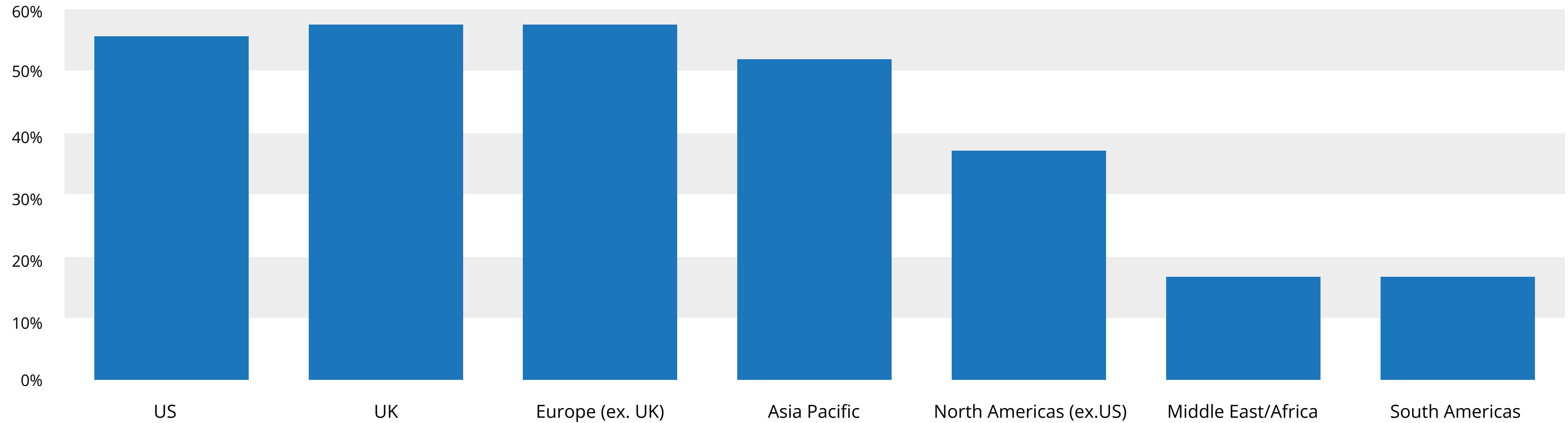


Figure 4: To which of the following private credit strategies (broadly defined as investments in loans, private bank debt, private debt securities and similar instruments, but excluding publicly traded bonds or more liquid fixed income strategies) are you currently deploying capital?

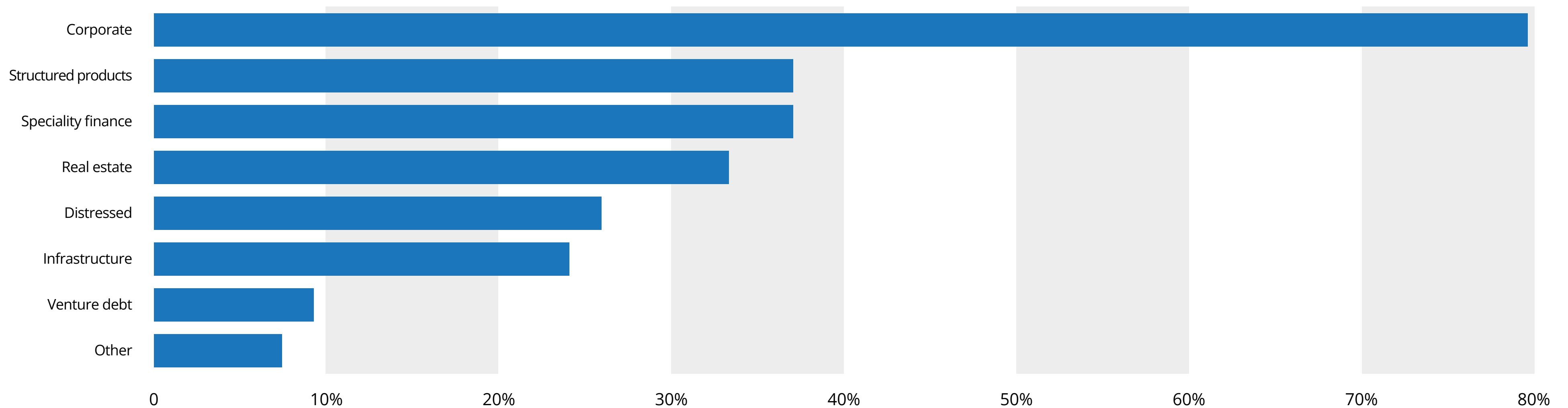
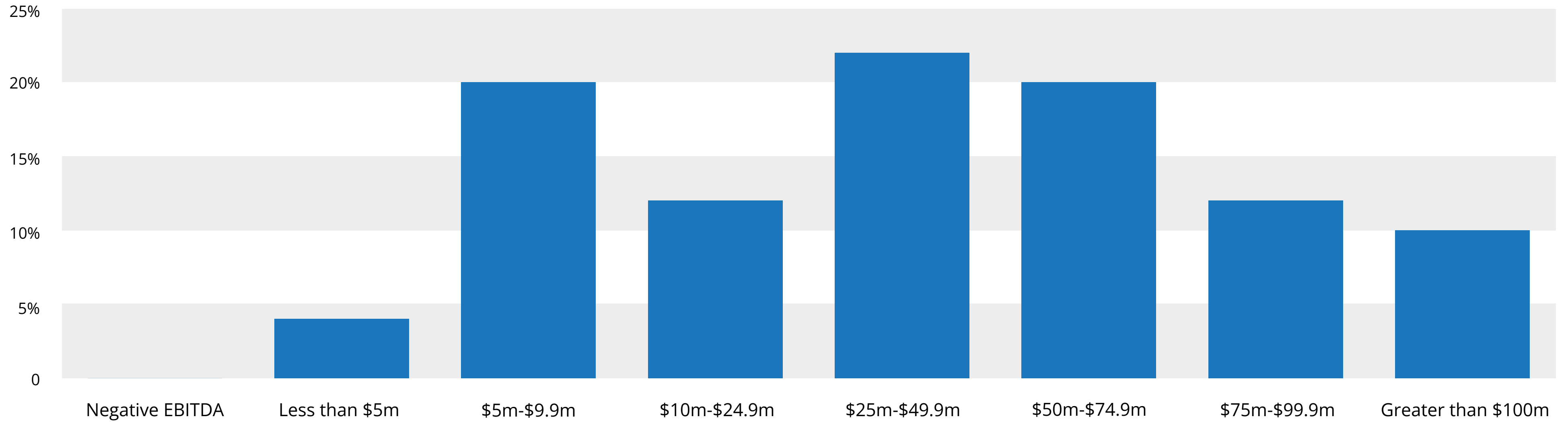


Figure 5: What is the average EBITDA* (in USD millions) of your firm's borrowers?



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

Chapter 1 – The investment case for private credit

Key findings:

- Global private credit managers deployed an estimated $127bn during 2021, growing their lending activity approximately 20%
- Private credit managers continue to expand into new markets and strategies
- Though having paused mid-year (2022) due to rapid changes in the macro environment, managers are recalibrating and remain optimistic about deployment opportunities in the next twelve months
- The investment case for private credit is still compelling in a rising rate environment as long as macrostresses remain manageable for borrowers

This research series has provided an annual assessment of the global private credit market since 2015, highlighting the trends supporting its growth as well as potential headwinds facing the asset class. Throughout that period, our research indicated a strong confidence amongst private credit managers about the growth prospects for the asset class. This view has been broadly vindicated by the stability of the returns generated by private credit managers during this period, and the broader growth of the asset class (see Figures 6 and 7).

Figure 6: Global private credit AUM and breakdown of committed capital and dry powder (source: Preqin)[1]

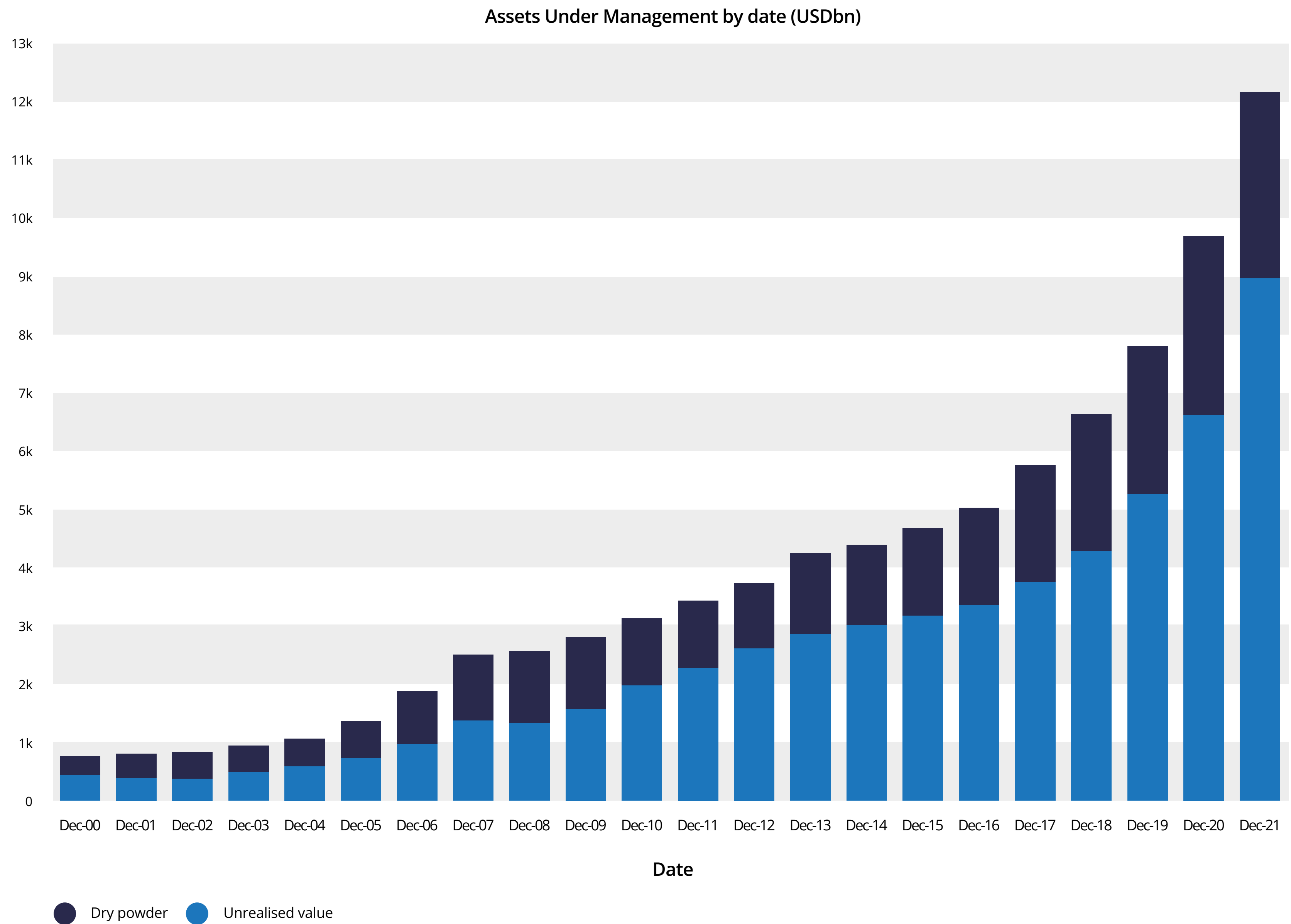
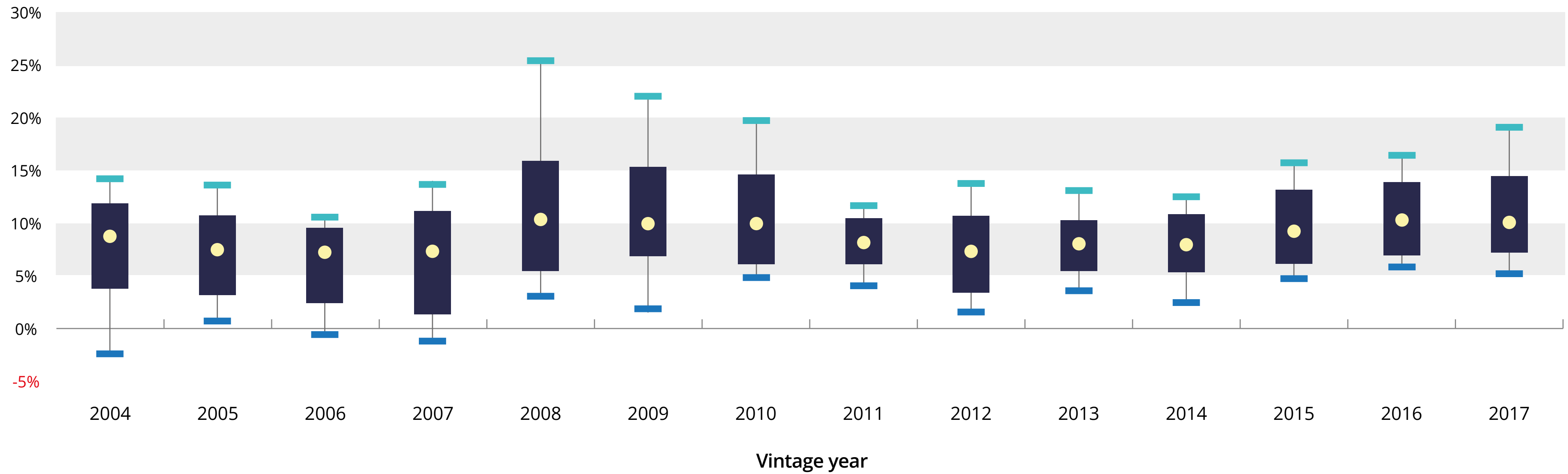
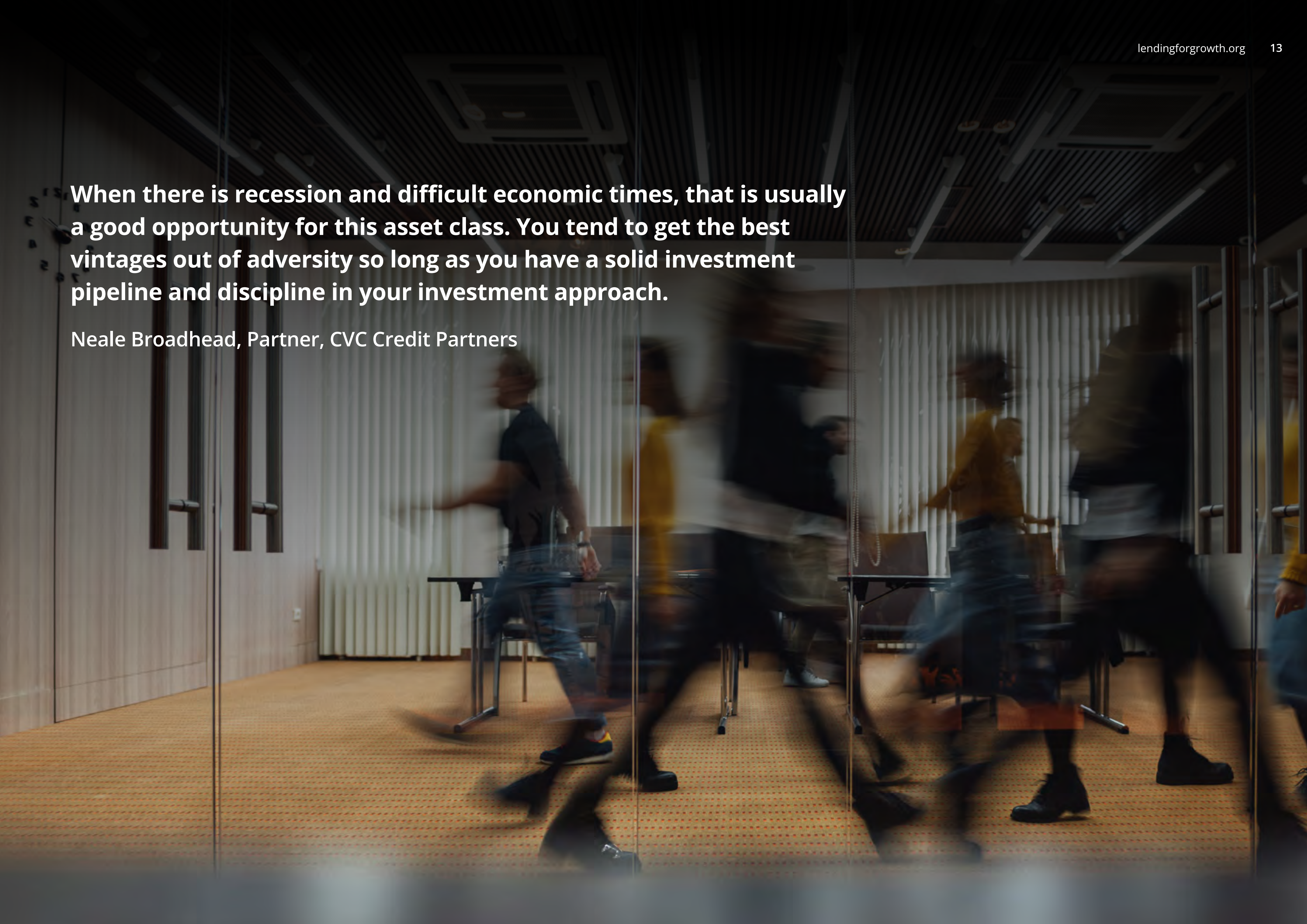


Figure 7: Private debt dispersion by vintage year (source: PitchBook)[2]



Data from our survey (see Figure 8) indicates that confidence levels amongst private credit managers remain broadly positive about the outlook for the next twelve months. As we will see in later chapters, private credit managers remain under no illusions about the challenges posed by inflation risks and a potential downturn in the economy, however they do not believe that such factors have substantially diminished the appeal of private credit to investors and borrowers.

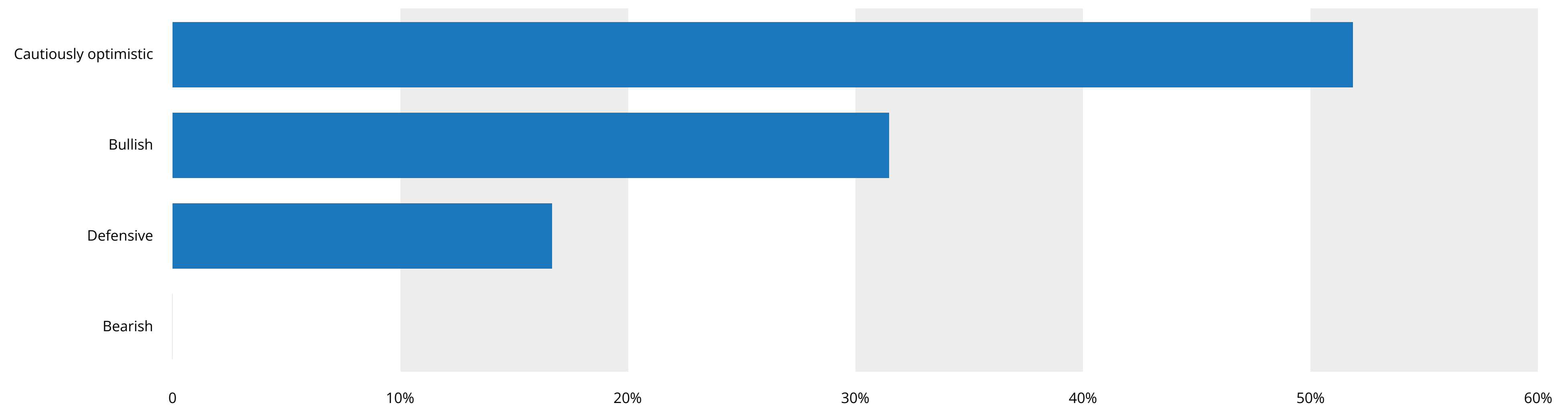
If history is a guide, macroeconomic and financial stress has the potential to further expand private credit's role in the economy. As traditional sources of finance tend to retrench during times of stress, private credit remains 'open' as illustrated by the recent dramatic drop in volumes in the broadly syndicated market (see Figure 9).



When there is recession and difficult economic times, that is usually a good opportunity for this asset class. You tend to get the best vintages out of adversity so long as you have a solid investment pipeline and discipline in your investment approach.

Neale Broadhead, Partner, CVC Credit Partners

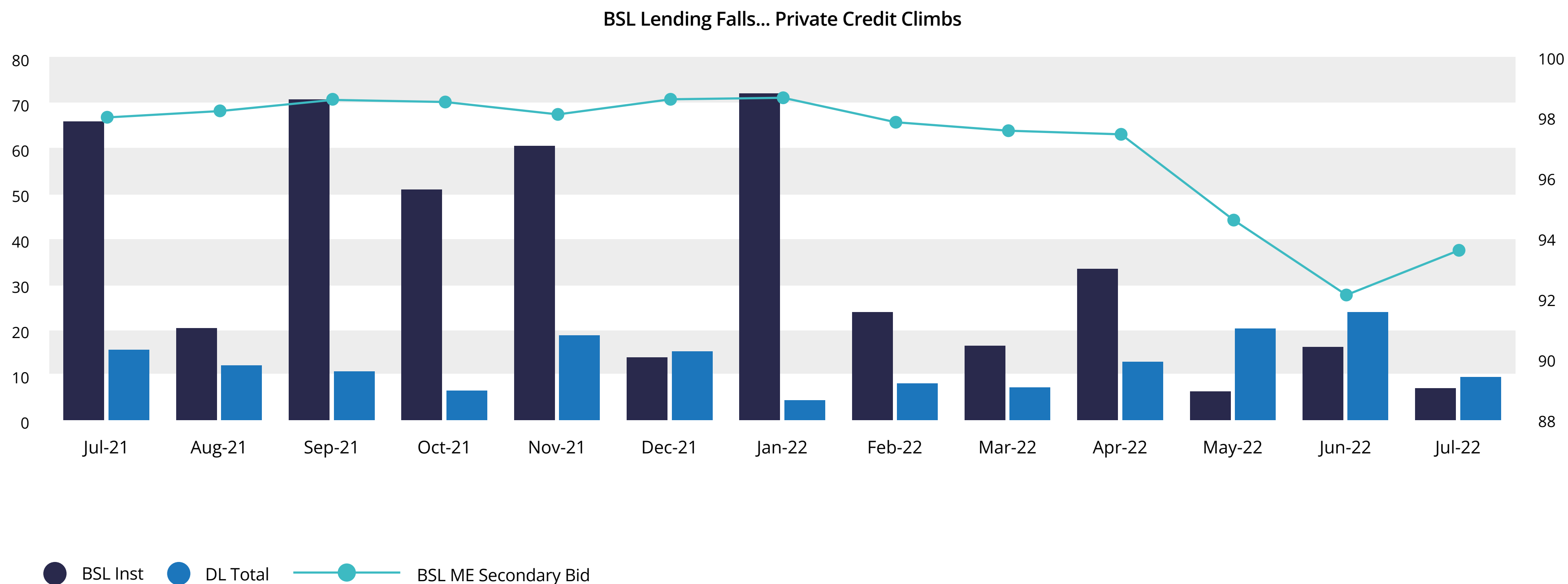
Figure 8: How do you assess your overall market sentiment regarding private credit over the next 12 months?



Capital availability in the public market has become constrained as often occurs during volatile environments like today's. New financing opportunities have shifted largely to the private markets. As a result, we are seeing many attractive entry points: the terms are better, spreads have widened out, fees have increased, and the underlying documentation has been more lender friendly. It is a really attractive environment for private credit.

Eric Muller, Portfolio Manager & Partner, Chief Executive Officer – BDCs, Oak Hill Advisors

Figure 9: US Broadly Syndicated Loan and Private Credit activity during past 12 months (source: LSTA)[3]



The strong secular growth we have seen in private credit has been further accelerated by the recent volatility in the public credit markets. The result is an even greater opportunity set for private lenders to provide scale financing solutions at attractive terms.

Michael Zawadzki, Global Chief Investment Officer, Blackstone Credit

Capital deployment – bumper 2021 followed by recalibration in 2022

In aggregate, respondents to the survey state they deployed approximately $127bn of capital in 2021 (see Figure 2) suggesting that around $200bn was deployed by the industry overall. This represents an approximate 20% increase in the lending activity of private credit managers on the previous year.[4] This increase is supported by similar observations for 2021 when it comes to global Merger and Acquisition (M&A) activity post- Covid-19.

Managers interviewed for this research offered a range of views when discussing capital deployment by private credit managers in 2022. While some firms reported record levels of capital deployment and a significant growth in origination opportunities, others highlighted a degree of restraint and repositioning compared to the high levels of deployment they undertook during 2021.

Common factors cited across our interviews when discussing capital deployment trends included:

- Continued expansion of the business into new markets;
- Strong demand from existing borrowers;
- Increased demand for private credit amongst corporates especially, but not exclusively, from larger businesses due to reduced liquidity in the public and broadly syndicated markets;
- Overall increase in bargaining power towards lenders manifesting itself in better financial and non-financial terms;
- Smaller transaction sizes and more 'club' deals between many mid-market lenders; and
- Heightened focus on core due diligence and credit underwriting processes with selectivity increasing.

The indication from the banks is that they expect to hold large volumes of financing due to changes in the CLO and institutional market. The implication therefore is for private debt funds to step in, however, even at the present size of around $1.2 trillion the private credit market is simply not large enough to absorb all the opportunities available.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau Capital

Taken in aggregate, these trends corroborate the view that structural tailwinds supporting the sector's growth remain in place but with some significant nuance in comparison to 2021.

Given the strong focus on financing M&A deals and PE sponsored activity, it is not surprising that private credit deal volume is being affected by the global M&A pullback. This is most pronounced in the US, private credit's most significant market, with volumes down 40% year on year, but also in Europe and Asia with volumes down 24% and 30% respectively (see Figure 10).

However, that is often outweighed by managers continuing to either structurally or opportunistically step into the large corporates funding space as other sources of finance dry up. Furthermore, in the non-sponsored space, some managers report the best opportunities they have seen since 2009 but, given the difficulty in successfully scaling non-sponsored lending, this sector is unlikely to be the main driver of overall private credit growth going forward.

To sum up, 2022 is likely to see slower growth in deployment than in 2021, but will still be a year of further growth nonetheless. On a relative basis, the overall mix of financing volume is likely to be tilted more towards larger corporates and non-sponsored lending. From a macroprudential perspective, the flexibility of private credit to adapt while continuing to deploy capital when other parts of the markets retrench is a significant and positive feature of the sector.

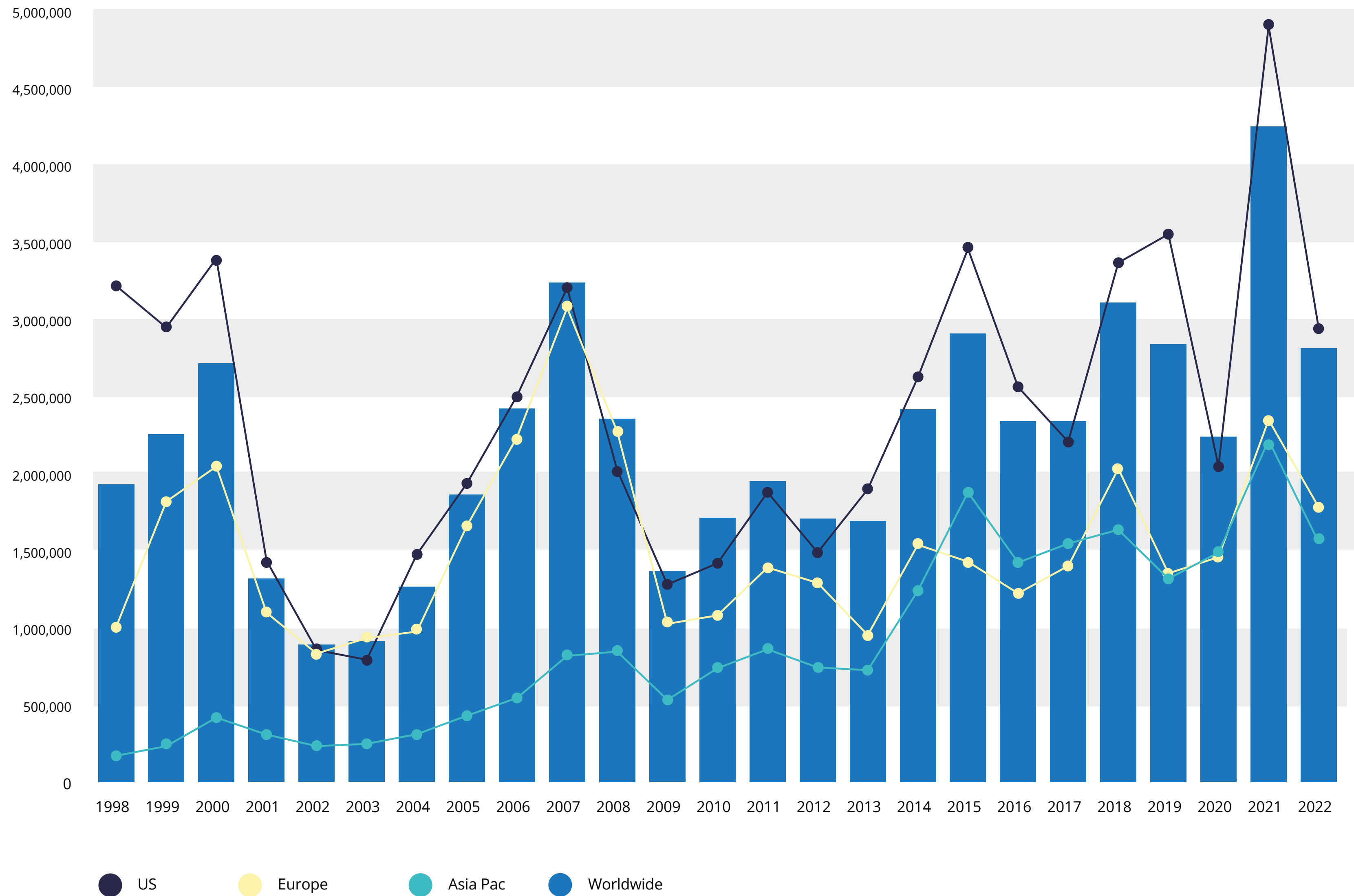
Overall, deployment across the industry has been strong since the beginning of the year. The current market volatility and macro uncertainty has affected the pipeline to some extent as price expectations on the equity side have not fully readjusted and some firms have put M&A and acquisitions plans on hold as a result.

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

If M&A activity picks up - which is our base case - we could see a really interesting vintage for private lenders as there will be less heat in the syndicated debt markets. New deals will have lower leverage, higher coverage ratios, and improved pricing and documentation. We believe this will be the case for both senior, and particularly, junior private debt.

Michael Small, Partner, KKR

Figure 10: Global year to date M&A values – US$ Millions (source: Refinitiv)[5]



We are looking for less cyclical companies that have greater predictability and visibility into their future earnings as we expect economic headwinds to accelerate. We are also identifying parts of our market where there is extreme dislocation and friction within specific sectors, such as consumer products, building products, and industrials.

Allan Schweitzer, Portfolio Manager, Beach Point Capital

The market is good for direct lenders for two main reasons – firstly, banks retrenchment, and secondly because new-issue CLOs are generally finding it more difficult, therefore liquidity is out of the market. Thus, we have been able to step up to the plate and do deals with some fantastic sponsors and low LTV.

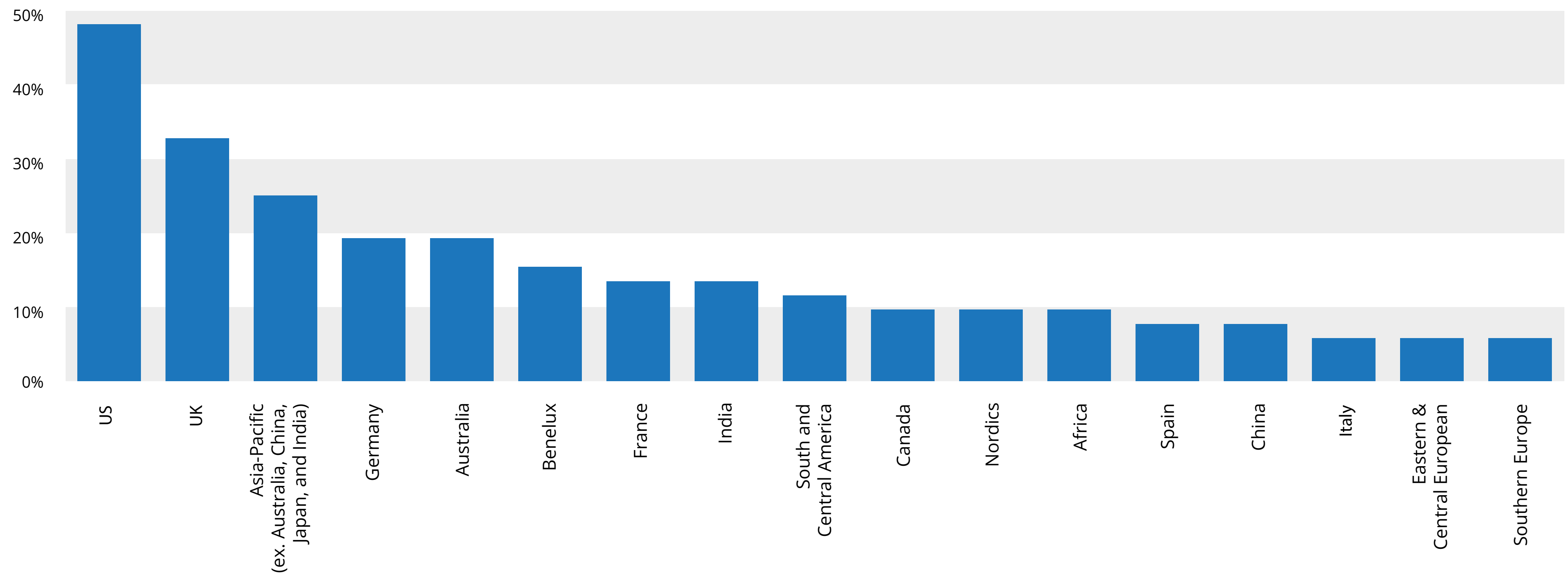
Neale Broadhead, Partner, CVC Credit Partners

Growth prospects across all markets

The private credit market continues to expand into new regions and jurisdictions. Our data shows a dispersion across respondents when asked which three regions they expect to have the highest growth potential over the next three years (see Figure 11).

Taking their answers in aggregate shows that the US (47%) and UK (31%) were the markets most cited by respondents. This likely reflects the existing depth of these markets as a strong platform for further growth.

Figure 11: Which three private credit markets do you foresee as having the highest relative growth potential over the next 1-3 years?



If we aggregate this data into higher-level geographical regions (see Figure 12), Europe (ex. UK) emerges as the top region slated for growth with more than 80% of respondents citing an EU market as one of their top three choices. While the EU has been a strong growth market for private credit throughout the past decade, much of the growth witnessed has clustered in markets such as France and Germany.

Our data (see Figure 13) shows that respondents expect other EU markets beyond France and Germany to also have significant growth potential. This suggests that private credit will play a larger role in the financing of companies based in these markets, and the asset class will broaden its footprint in the EU over the coming years.

From an economic perspective, this is an important development for the EU as it represents a material enhancement to the financing options available to EU corporates at a time when it seeks to provide a new regulatory framework for loan origination (see Box: European Private Credit and the Capital Markets Union).

European Private Credit and the Capital Markets Union

A core objective of the Capital Markets Union (CMU) project is to diversify the sources of finance available to European businesses. The growth of European private credit during the past decade indicates that significant progress has already been made in this regard, and our latest data highlights how the market is poised to both deepen and broaden over the next three years.

Recent proposals to amend the AIFMD and ELTIF regulatory frameworks include proposals that may significantly affect the ability of private credit managers to support European businesses.

While negotiations between co-legislators are ongoing, several reforms have been proposed to the AIFMD framework that would place additional requirements on loan origination funds relating to their use of financing, liquidity risk management and risk management processes in order to manage perceived macro-prudential risks. On a more positive note, reforms could result in a decrease in barriers to cross-border lending, allowing funds in one jurisdiction to finance companies in all other EU jurisdictions with greater ease. It is expected that the new framework should put to bed the longstanding concerns related to loan funds and financial stability and create a more stable and harmonised regulatory framework going forward.

The recently agreed reforms to the ELTIF Regulation have been broadly welcomed by private credit managers as a significant upgrade to the ELTIF[6]. As well as allowing the ELTIF to be a more competitive product compared to its international peers – Business Development Companies and the UK Long-Term Asset Fund – these reforms will help to unlock retail investment capital as a new source of finance for European businesses.

ELTIF funds will now benefit from:

- A broader range of eligible assets
- Use of leverage for both retail and professional funds
- Flexible rules related to co-investment
- The ability to structure fund-of-funds and master-feeder structures
- Greater flexibility in relation to investor liquidity
- Streamlined distribution to retail investors

The ELTIF reforms have demonstrated that it is possible for policymakers to balance multiple considerations and combine resilient supervisory frameworks with features that attract international capital into the EU. The ability of policymakers to do the same with respect to the AIFMD will have a material impact on whether the potential identified by this research for private credit in Europe is realised.

Figure 12: Which three private credit markets do you foresee as having the highest relative growth potential over the next 1-3 years? (Regional breakdown)

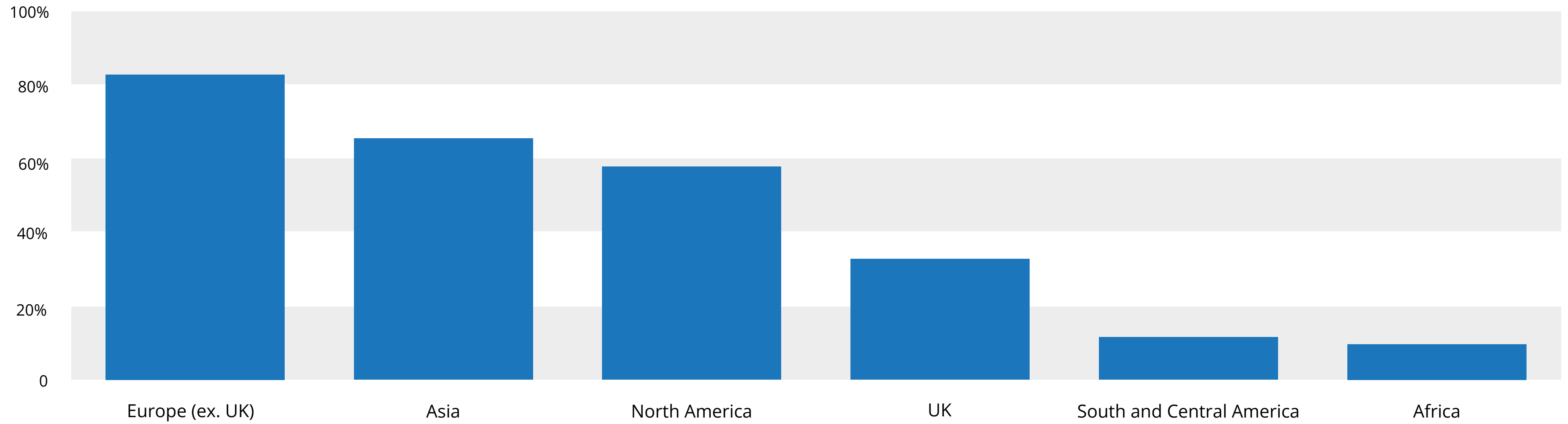
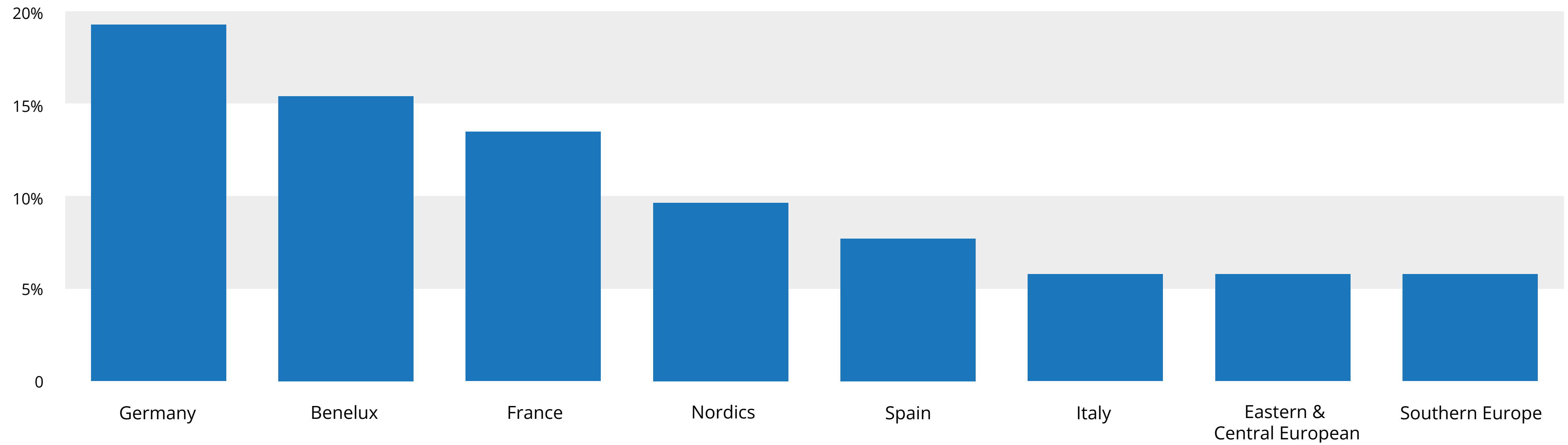


Figure 13: Which three private credit markets do you foresee as having the highest relative growth potential over the next 1-3 years? (Europe ex. UK jurisdictions only)



Our data also highlights strong levels of confidence in the growth potential for private credit in Asia, with 65% of respondents citing a jurisdiction in the region as having the highest growth potential. This year has already seen the launch of multiple $1bn+ private credit funds targeting the region.[7]

Our data offers further evidence that the well documented promise of Asian markets is beginning to be realised, and there will be increased investment by private credit managers in the region over the coming years.

If you believe in Europe converging with North America in terms of the contribution of institutions to financing corporates, the current market backdrop could be another accelerator to such trend. But, from our perspective higher growth is much easier when you start from an even lower base and that's really Asia where we expect significant growth of our credit activities.

Emmanuel Deblanc, Global Head of Private Markets, Allianz Global Investors

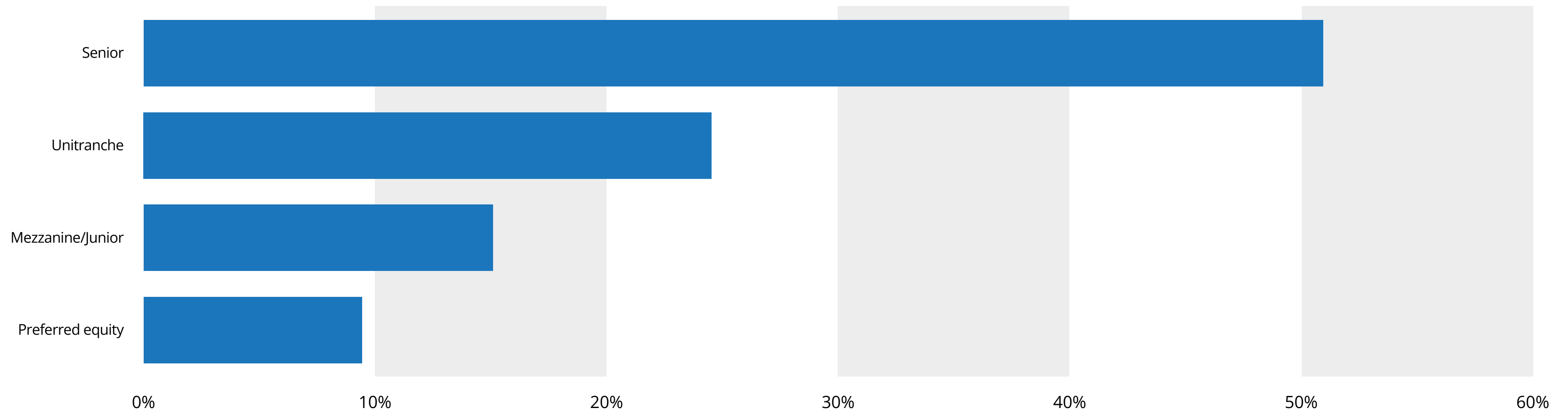
I think it is only a matter of time until more people are talking about Asian private credit because it is a massive opportunity. If we consider the likely level of M&A in the region supported by private equity activity, combined with the limited depth of the local bank and bond markets, there should be strong demand for private credit. Many aspects of the market dynamic remind me of Europe prior to the institutionalisation of the loan market and the advent of direct lending.

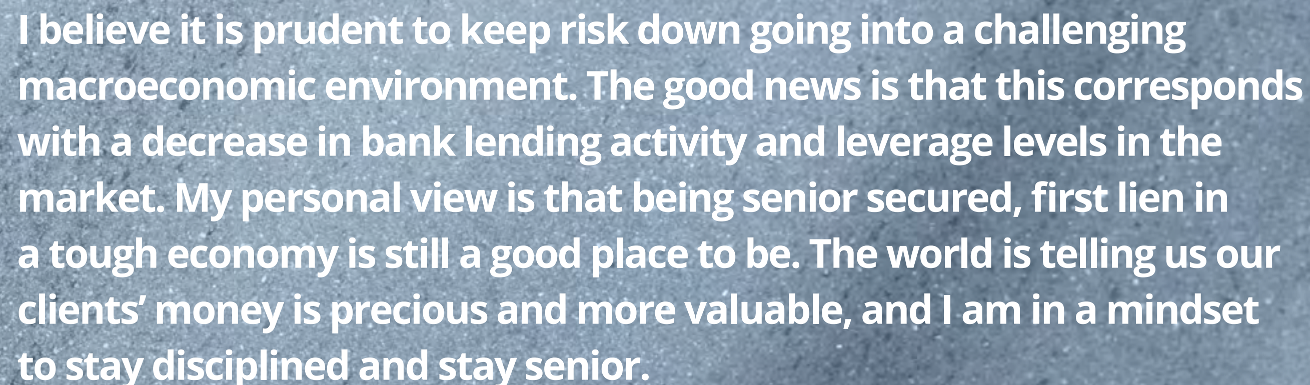
Michael Small, Partner, KKR

Seniority seen as a key driver of future returns

While it is difficult to forecast the likely risk-adjusted return potential of different segments of the capital structure with certainty, interviewees consistently highlighted seniority as a key driver of returns over the coming years. This sentiment is also reflected in our data (see Figure 14) with most respondents expecting senior positions to offer the highest risk-adjusted return potential. When questioned on this, interviewees consistently commented that the biggest driver of returns in private credit was preventing and minimising potential losses rather than finding incremental means to increase returns. This is consistent with the asymmetric nature of credit investing, where loss potential will always significantly outweigh return potential. While some interviewees separately highlighted how significant equity cushions in many portfolio companies made other sections of the capital structure attractive on a risk-adjusted basis, this cohort noted that this would always be a subordinate consideration of the broader fundamentals of the business such as cashflow and market position as a driver of return.

Figure 14: Which sections of the capital structure do you foresee as offering the highest risk-adjusted return potential for lenders over the next 1-3 years?





I believe it is prudent to keep risk down going into a challenging macroeconomic environment. The good news is that this corresponds with a decrease in bank lending activity and leverage levels in the market. My personal view is that being senior secured, first lien in a tough economy is still a good place to be. The world is telling us our clients' money is precious and more valuable, and I am in a mindset to stay disciplined and stay senior.

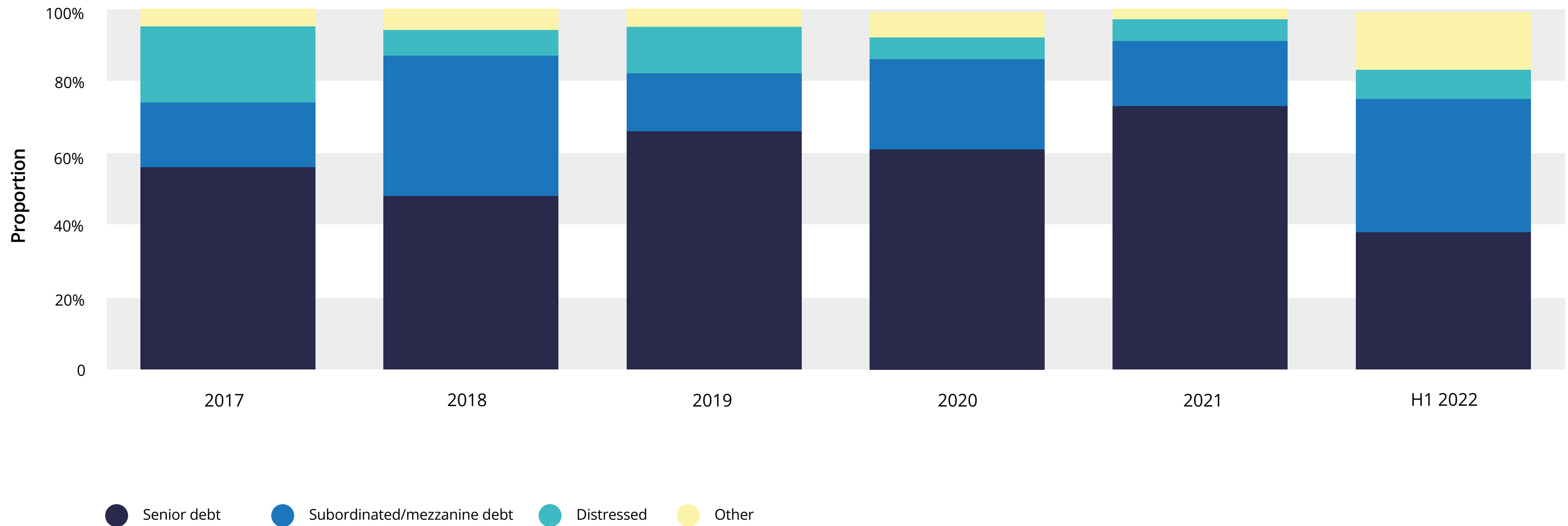
Blair Jacobson, Partner and Co-Head of European Credit, Ares Credit Group

The current preference and optimism for senior positions identified by our research is, however, not necessarily reflected in the data available for private credit funds currently raising capital.

As shown in Figure 15, there was a marked reduction between 2021 and H1 2022 in the proportion of funds raising capital for senior debt, with funds raising capital for subordinated or distressed credit strategies making up a greater proportion of the market.

This may indicate that while investors and private credit managers currently have a strong proclivity for senior positions, they may be preparing to move further down the capital structure in the future.

Figure 15: Private credit capital raising across different investment strategies (source: Private Debt Investor)



How will private credit fare in a rising rate environment?

The growth of private credit during the past 15 years has coincided with an extended period of low interest rates globally. While there have been multiple instances of stress in the economy during this period, these have not been accompanied by higher interest rates which are an important determinant of how loans are priced by banks and other lenders. Central banks have implemented interest rate rises during 2022 and signalled that they expect to continue on this path until inflation is brought in line with their mandates. While forecasting inflation and central bank rate activity is beyond the scope of this paper, these factors support the view that a higher rate environment is likely to persist in the near to medium term.

I am bullish on the ongoing growth of direct lending. I am bullish in terms of it being seen by investors as a good quality, defensive, low volatility asset class which gives decent returns in difficult times.

Andrew McCullagh, Managing Director and Portfolio Manager for Private Credit, Hayfin

We have been talking about the dislocation of the banking market for a decade and it has got more and more profound. You do not really see the banks being that relevant in deployment, especially when they turn away due to technical or perceived risk. They are just not as consistent as a fund which has raised lots of capital for a specific strategy.

Neale Broadhead, Partner, CVC Credit Partners

**The banks have, for the first time, properly retrenched from our market.
We have seen it most strongly since the Ukraine crisis.**

Rafael Calvo, Managing Partner, Head of Senior Debt Funds and Co-Head of Origination, MV Credit

Private credit managers typically grant loans on a floating rate basis whereby the coupon on the loan increases in line with any interest rate rises. Floating rate loans therefore provide some inbuilt protection for investors against the value of their capital and absolute returns being eroded by higher interest rates and inflation. The protection provided by floating rate loans should however only be considered in conjunction with the impact of higher rates on the borrower's ability to repay the loan. The important consideration is the point at which the higher interest rate substantially weakens or overwhelms the ability of the borrower to manage and repay their debt while also operating as a successful business. While current levels of inflation are perhaps higher than some expected, many interviewees indicated that they have been modelling this for some time and factored this into their initial lending decisions. Such considerations are also front of mind for new loans.

Another area to consider when assessing the impact of higher rates is how they will affect the cost and availability of financing. Fund-level leverage is not used by all private credit fund managers as part of their investment strategy, but using finance in some capacity is relatively common in today's market. Finance is typically provided to private credit funds by banks, pension funds or, in some instances, other asset managers. While many managers are able to benefit from fixed rate financing, this is not universal and we could see a differentiation of manager returns depending on how they have been able to structure their fund's liabilities going forward.

Industry data modelling (see Figure 16) on the impact of higher interest rates on the Business Development Company (BDC) market provides support for the view that some parts of the industry and its investors should be net beneficiaries from moderate rate increases.

Some interviewees highlighted the need to be diligent when understanding the impact of higher financing costs, but such risks were not seen to be significant or beyond the ability of prudent managers. Large-scale defaults across the corporate sector (i.e. significantly in excess of historical trends for both private credit and traditional lenders) was the only instance cited by our interviewees as having the potential to make higher interest rates a net negative for the sector overall.

The markets for capital raising to LBOs is relatively shut and one reason for this is that valuations are down. Anything that is up for sale is generally of higher quality and has been able to maintain valuation and those are the deals that can get financed.

Mark Jenkins, Managing Director and Head of Global Credit, Carlyle

Figure 16: Example: annual impact on net income of base rate changes in interest rates[8]

(in millions) Basis Point Change	Interest and Dividend Income	Interest Expense	Net Income
Up 300 basis points	$513	$100	$413
Up 200 basis points	$358	$66	$292
Up 100 basis points	$206	$33	$173
Down 100 basis points	$(154)	$(34)	$(120)
Down 200 basis points	$(295)	$(67)	$(228)
Down 300 basis points	$(359)	$(98)	$(261)

The cost of leverage has been going up, but mostly from rising interest rates. Both credit facility costs and interest income from assets are typically floating rate with a base rate and spread. Since the base rate movements are largely offsetting, our objective is to secure attractive asset spreads compared to financing spreads. We have, therefore, been focused on locking in financing spreads while they have remained low.

Eric Muller, Portfolio Manager & Partner, Chief Executive Officer – BDCs, Oak Hill Advisors

Is there still an illiquidity premium?

Another notable feature of the current environment has been the narrowing of spreads between private credit and public or more liquid parts of the non-investment grade credit markets. Figure 17 provides examples of how the yield on publicly traded leveraged debt, in this case investments in single B rated high yield instruments, has been rising steadily since the beginning of 2022 and now exceeds 9.5%. Figure 18 looks at the comparison between the different markets more directly, showing that the spreads between high yield bonds and private debt are at historic lows.

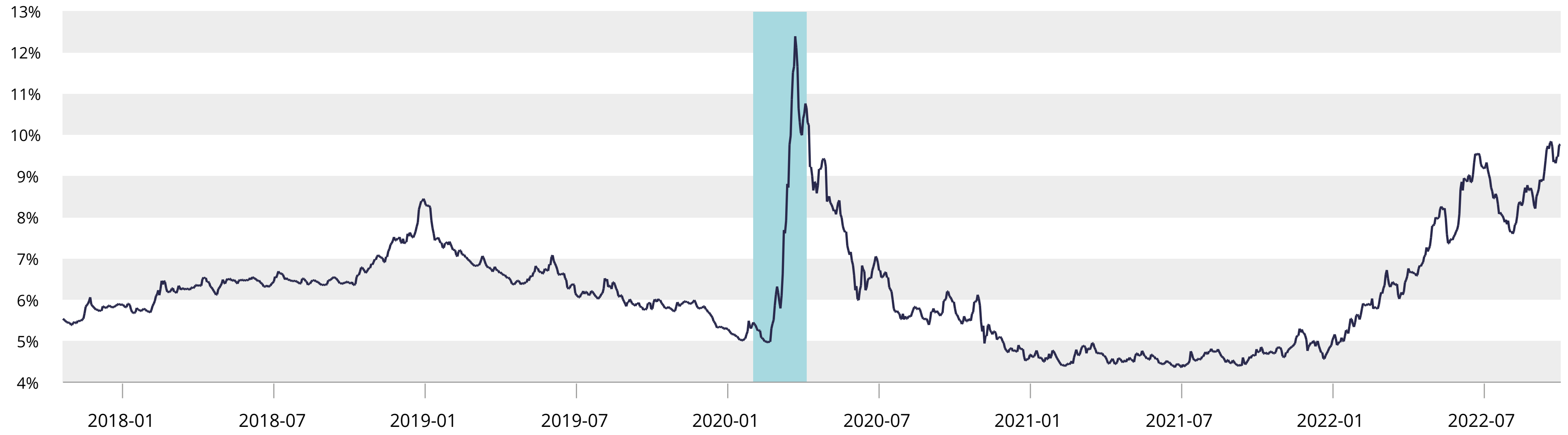
Our research indicates that while movements in the price of some publicly traded instruments has become more comparable with private credit in some markets, we are also seeing repricing in the private credit markets that is likely to show up in next year's numbers. Spread differentials in the primary market continue to hold, while significant differences remain between the two investment types when it comes to risk return characteristics.

The ability of credit investors to protect their interests is likely to be a differentiating factor in protecting against downside risk. As we will see in later chapters, a focus on documentation and risk management practices continues to be a core discipline for private credit funds, particularly when compared to public credit markets. Finally, the volatility of liquid debt markets during 2022 contrasts with the steady returns private credit managers are seeking to provide their investors. While pricing of more liquid instruments may be attractive today, there is less certainty that such pricing will remain available for a consistent period. Taken together, these factors suggest that the illiquidity premium remains intact despite changes seen in other credit markets during 2022.

The illiquidity premium can come in different formats, including actual yield, a reduction in risk or an overall lower volatility, all of which make the asset class relatively attractive.

Andrew McCullagh, Managing Director and Portfolio Manager for Private Credit, Hayfin

Figure 17: ICE BofA Single-B US High Yield Index Effective Yield (14 Oct 22)[9]



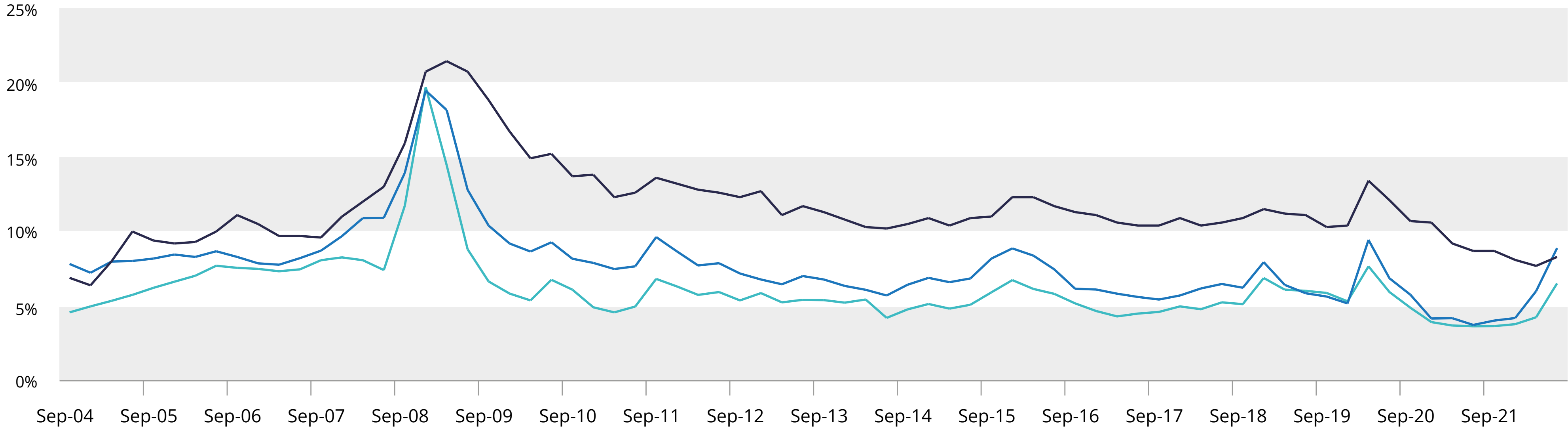
Shaded areas indicate U.S. recessions

Source: Ice Data Indices, LLC

fred.stiouisfed.org

U.S. recession

Figure 18: HY Bond and Leveraged Loan Yield-to-Maturity Comparison, Sep 2004 to Jun 2022 (source: Cliffwater Direct Lending Index)[10]



Cliffwater Direct Lending Index (3Yr Takeout Yield)

Bloomberg High Yield Index (YTW)

Morningstar LSTA US Leveraged Loan 100 Index YTM

Chapter 2 – Focus on the borrower

Key findings:

- Borrowers of all shapes and sizes now have access to deeper pools of private credit capital
- Private credit is primarily a source of growth capital for the economy
- Lenders tend to focus on non-cyclical businesses with leadership positions in their sectors
- Flexible credit solutions and certainty of execution continue to be prized by borrowers
- Private equity continues to spearhead private credit's expansion into new markets

This chapter focuses on the real-world impact of the financing provided by private credit managers, the borrowers who benefit from these investments and the purpose of the financing being provided. Data from our survey and interviews with leading private credit fund managers indicates that borrowers expect more significant headwinds in both the short and medium term. Common factors cited include inflation and rising interest rates, the broader realignment of global supply chains, changes in customer behaviour and how products and services are delivered to end consumers.

While these headwinds affect all businesses to some extent, our research reveals patterns in the types of businesses that private credit fund managers are typically lending to and the rationale for their investment in such firms.

They [borrowers] want a bit more certainty with their financing, certainty of pricing, certainty of terms, which is what direct lenders are offering in this period.

Nicole Downer, Managing Partner, MV Credit

A number of borrowers, who traditionally raise financing in the liquid markets, are increasingly looking at private credit as an alternative solution. This trend has accelerated with the recent market volatility now that liquid markets have essentially shut down and cost of capital currently prohibitive. Yet, we do not see this as a structural shift as the market will eventually bounce back – the question is when and how?

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

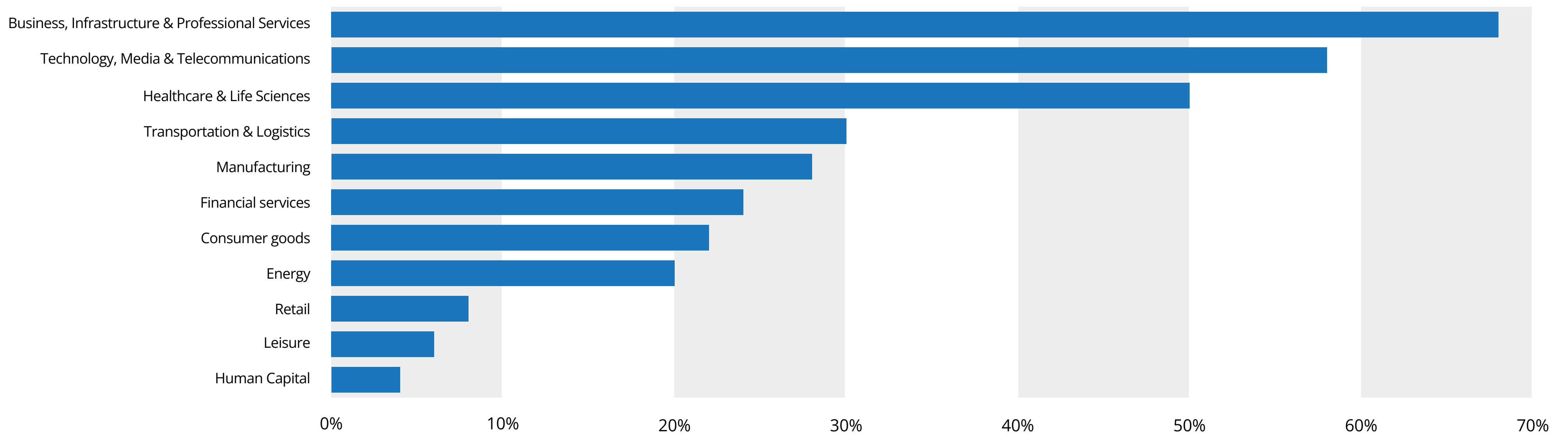
Investing in the future

Our research indicates that the top three industries invested in by private credit fund managers are Business, Infrastructure and Professional Services, Technology, Media and Telecommunications and Healthcare & Life Sciences (see Figure 19). While each sector of the economy will include businesses with different levels of financial health, these sectors were described by our interviewees as more likely to be resilient to the headwinds facing the economy, as well as having stronger long-term growth prospects than other sectors.

These sectors have typically contributed more to overall job growth in developed economies where tertiary sector businesses account for a greater proportion of corporates.

This macroeconomic aspect was described as a key consideration by all lenders interviewed for this research and a key element of their investment due diligence and credit underwriting process.

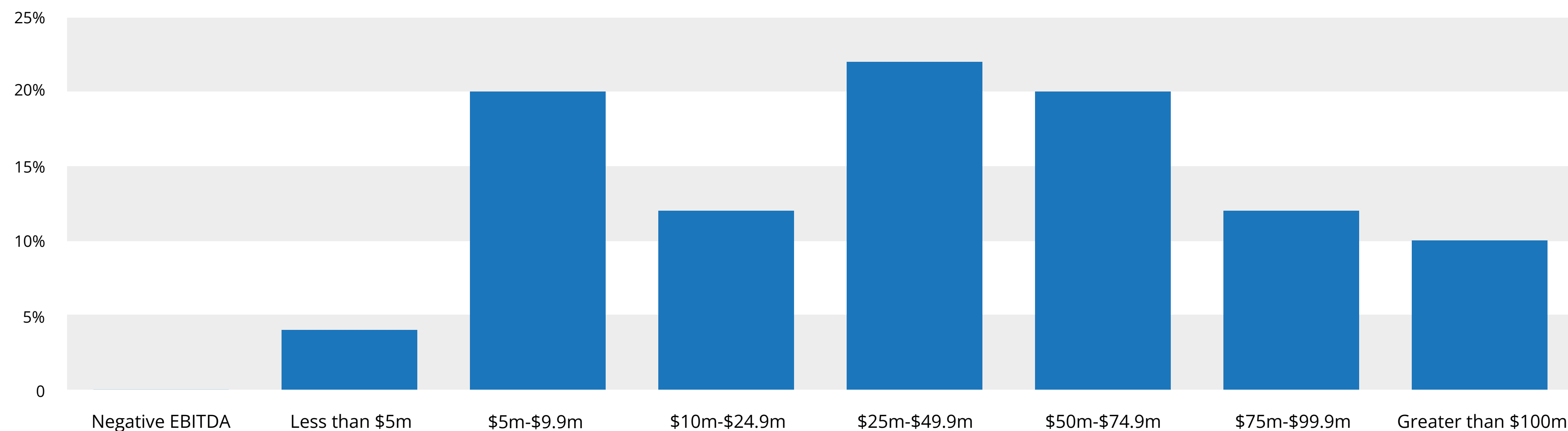
Figure 19: Please indicate the top three industries that you invest in through your main or flagship fund



Given the impact of Covid-19 and inflationary pressures in the economy, the retail and leisure industries were cited by the fewest number of respondents as sectors they invest in. Several interviewees also highlighted that there will always be durable companies in these sectors that are well placed to capitalise on customer demand and benefit from declining competition from their peers.

We also see greater divergence between respondents in the size of business they are now looking to finance (see Figure 20). Whereas previous editions of this research indicated a focus on mid-market businesses (in 2017, 57% of private credit managers were lending to borrowers with EBITA of between $10-50m[11]), our data shows greater dispersion in the average EBITDA of the firms that respondents are lending to within and beyond this bracket.

Figure 20: What is the average EBITDA* (in USD millions) of your firm's borrowers?



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

We have seen larger companies be more resilient in the current environment as they tend to have greater pricing power, operating flexibility, and business line diversity.

Michael Zawadzki, Global Chief Investment Officer, Blackstone Credit

Several interviewees expressed the view that market dynamics had become more favourable when lending to larger companies. The reasons for this were reduced liquidity in the broadly syndicated markets, volatility in the corporate bond market and a general appetite amongst some businesses for lenders to provide large sums of debt finance, either solely or as part of a club. These factors had seen some firms deploy much greater sums of capital to these types of borrowers than in previous years. While only a minority of respondents selected larger EBITDA categories when responding to our survey, it is likely that such firms (and borrowers) represent a disproportionate amount of the capital deployed due to the sums involved.

Elsewhere in the market, the dispersion of private credit managers across the EBITDA bands used in Figure 19 suggests that borrowers of all shapes and sizes now have access to deeper pools of private credit capital than in previous years. While lending to larger companies (and commensurate larger loan sizes) tended to attract more attention, our research highlighted that lending to lower-middle market companies also remain attractive to lenders. Such firms were seen to have several compelling advantages from a lender perspective, including potentially better yield, lower leverage and stronger documentation, as well as easier access to management. In times of stress or market turbulence, these firms were also seen as nimbler than their larger peers, with greater ability to update their business strategy in response to challenging market conditions. These features were seen by many interviewees as compelling reasons to focus on smaller businesses ahead of the economic tests expected in 2023.

Focus on growing businesses

Irrespective of which sectors respondents reported investing in, our data demonstrates that most of their current portfolio companies are displaying growing EBITDA. As demonstrated in Figure 21, 63% of firms described their portfolio companies as growing their EBITDA, with 10% electing to describe them as high growth (i.e. greater than 10% growth year on year). A plurality of respondents (40%) stated that M&A activity was the main purpose of the finance they provide (see Figure 22). Taken with the proportion of respondents who selected either operational expenditure (16%) or company expansion (14%), this finding provides strong support for the view that private credit is primarily a source of growth capital for the economy.

We take the approach of partnering with people or organizations to help them achieve their growth objectives, whether that's acquisitions, capital expansions, or other means. A partnership approach means you deliver what you say you're going to deliver, and if you need help, let's have a discussion.

Mark Jenkins, Managing Director and Head of Global Credit, Carlyle

A private debt solution is often better than a liquid solution, largely due to the follow-ons and acquisition facilities after the initial loan. We offer flexibility for borrowers to keep growing which makes private credit a really attractive option when compared to the liquid market.

Nathan Brown, Chief Operating Officer, Arcmont Asset Management

Figure 21: Which of these statements best describes EBITDA growth at your current portfolio companies:

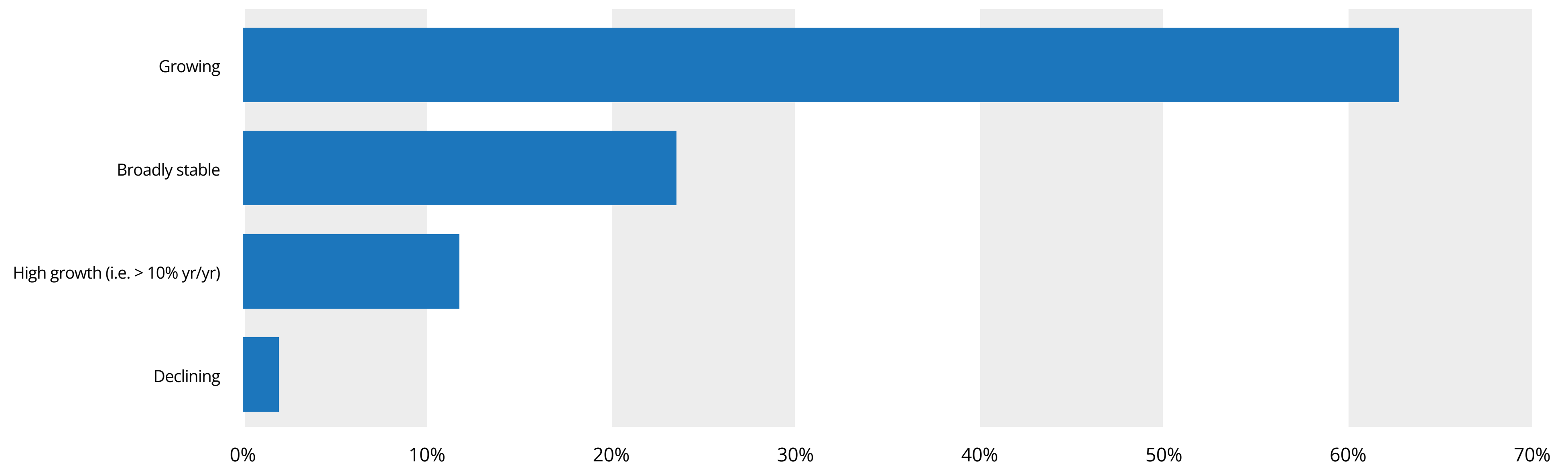
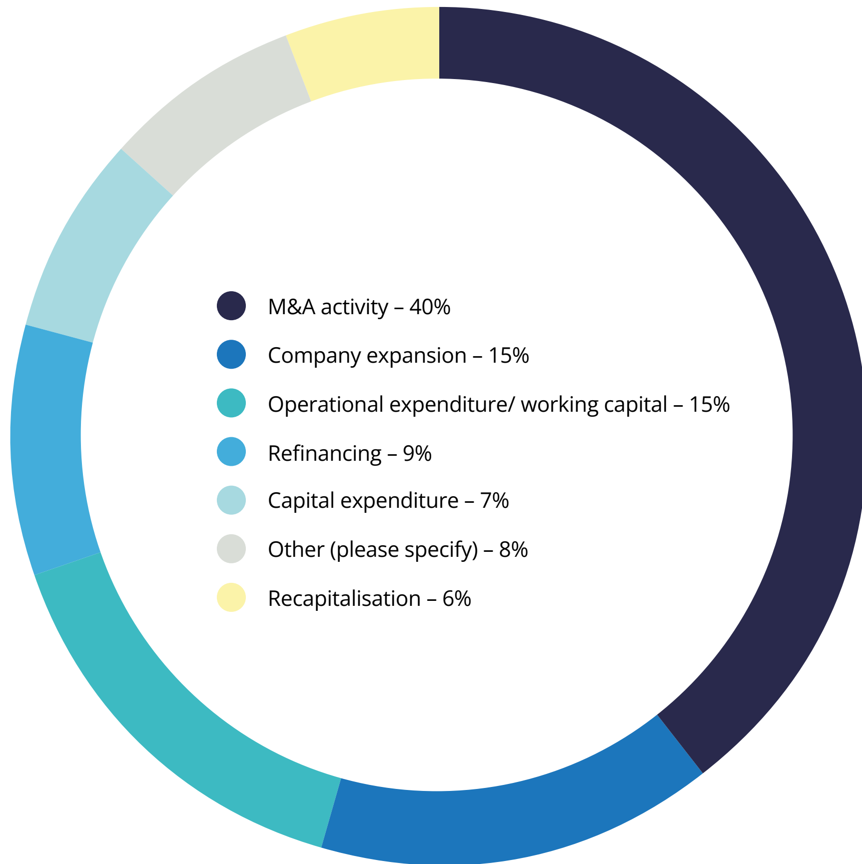


Figure 22: What is the typical purpose of the financing provided to your borrowers?



M&A activity for our portfolio companies has been extremely important during 2022, requiring the provision of add-on capex and acquisition facilities. Companies with investment from private equity and private credit funds are being very proactive in response to the macroeconomic challenges posed by inflation and higher energy costs.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau Capital

Our survey also asked respondents to state which percentage of their existing borrowers are companies to whom they have previously lent. Figure 23 shows that this represents a significant proportion of almost all origination activity, with less than 30% saying that this represented between 0-20% of their existing portfolio. When describing this activity, lenders highlighted how their own growth (measured by the size of their latest vintage funds) had allowed them to provide further finance to prior portfolio companies looking to continue their own growth and expansion. While such deals would be treated as 'new' for the purposes of due diligence, having existing relationships and knowledge of business practices were seen as important advantages for both parties.

Another example of this is the growing trend for 'follow on' facilities when providing acquisition finance. These facilities provide borrowers with the guarantee of additional capital beyond the initial loan amount, for example, when they have identified further acquisition opportunities within pre-agreed parameters . While such arrangements are unlikely to be included as standard in all deals, they are an example of how private credit managers continue to provide businesses with the flexible finance solutions they need to support their investment.

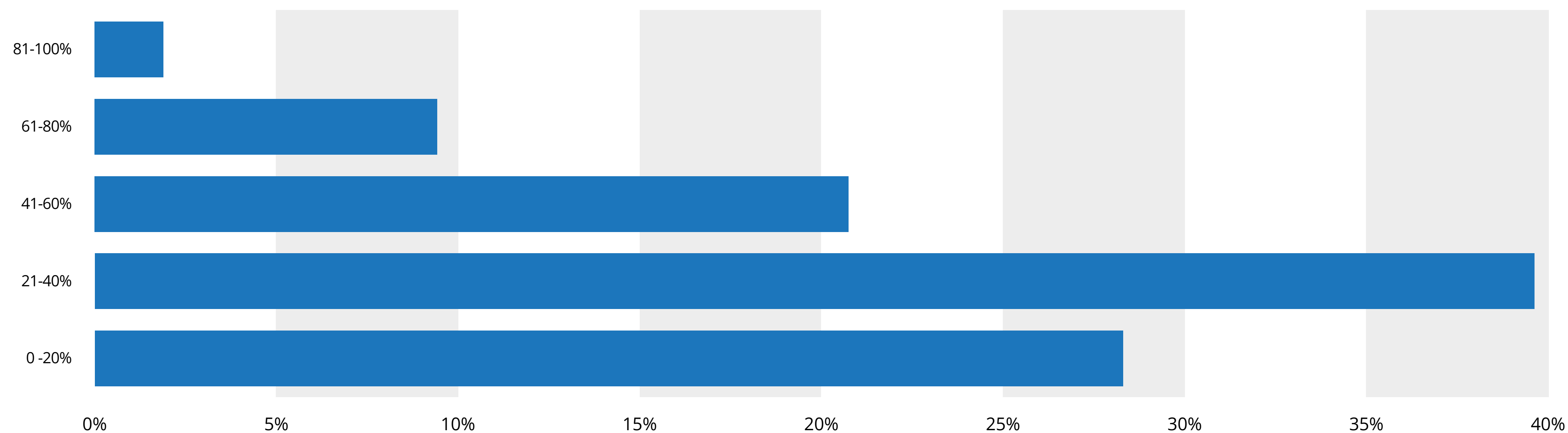
The second phase of the direct lending universe is the back-book. A large percentage of the deals we made this year are with existing borrowers. As companies grow, they have add-on acquisitions or they want to re-lever because their EBITDA has grown. Your number one source of deployment is your historic borrowing base.

Nathan Brown, Chief Operating Officer, Arcmont Asset Management

We see a tremendous investment opportunity in the more complex, dislocated parts of the leveraged finance market. There are many companies with looming maturities that we think may have a more difficult time refinancing than they would have a few years ago as funding costs rise and capital markets activity slows. Accordingly, we have focused on situations where we may be able to provide rescue financing or capital opportunistically, having developed deep expertise partnering with borrowers across multiple cycles.

Allan Schweitzer, Portfolio Manager, Beach Point Capital

Figure 23: What percentage of your existing borrowers are companies which you have previously lent to?



Which sectors are harder to reach?

We also find evidence that the volume of lending by private credit managers to non-sponsored businesses (i.e. those that are not owned in whole or in part by private equity businesses) remains below their levels of lending to sponsored businesses. Our survey data (see Figure 24) presents a mixed picture on the rationale for this, with the largest cohort of respondents submitting 'other' as their answer, stating the following reasons:

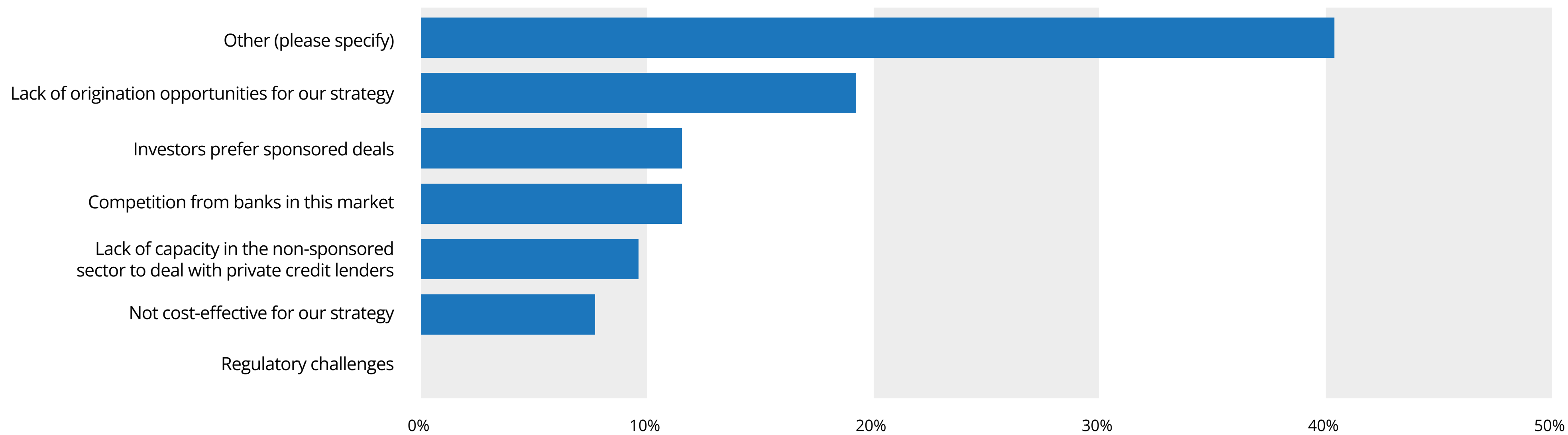
- We typically see a higher quality of diligence, governance and access to equity in case of underperformance within sponsored transactions
- Our investment process is oriented primarily to sponsored borrowers
- Lack of access to equity capital and sophistication
- Limited high quality non-sponsored deal flow

While these comments are consistent with our findings, a minority of respondents highlighted that they are 'focused on the non-sponsored space' and that 'all or the majority of their borrowers are non-sponsored businesses'.This suggests that as private credit expands into new markets, it is likely that growth will remain spearheaded by private equity investments. This scenario was described as key by several interviewees, with the Asian market offered as an example of how a greater private equity footprint was an incentive for private credit funds looking to invest in the region.

Sponsored deals are far more prominent in the corporate space than in real-estate because investors move more easily between private equity and private credit than from bricks and mortar equity up into real estate private debt. There isn't the depth of market in real-estate, and there isn't the spectrum of loans found in private credit.

Stuart Fiertz, Co-Founder & President, Cheyne Capital

Figure 24: What is the biggest barrier to your firm increasing its lending to non-sponsored borrowers?



Chapter 3 – Investment due diligence and risk management

Summary of key findings:

- Private credit managers place a premium on due diligence and risk management
- The impact of inflation and macroeconomic risk are the key challenges facing lenders
- Private credit firms will typically invest in fewer than 10% of the total deals they assess
- Firms have invested heavily in their risk management functions during periods of growth
- Firms use a range of indicators to assess and monitor the financial health of their portfolio companies

As noted in Chapter 1, eliminating and minimising potential losses from investments is the primary driver of returns for private credit managers.

The sector, by definition, has a different appetite for risk than traditional lenders or investors in public credit and typically invests on the basis that any loans originated will be held to maturity. To ensure they can meet the expectations of their investors, private credit managers place a premium on their approach to due diligence and risk management. This is described by almost all firms as the most important differentiator between private credit managers, and the one which investors should place the most emphasis on when assessing individual lenders.

As shown in Figure 25, inflation and macroeconomic risks are the main issues facing businesses across the market. This is consistent with the views expressed by interviewees that credit markets are showing other signs of later cycle behaviour. While similar sentiments have been expressed regarding credit markets for more than five years, the levels of inflation seen in 2022 far exceed those previously experienced. This is likely to place greater stress on the corporate sector, testing both its resilience in the face of likely reduced consumer spending, as well as its ability to continue servicing debt obligations in the face of higher interest rates as central banks act to reduce inflation.

This chapter summarises the findings of our survey on key risk management metrics and the approaches taken by private credit managers to maintain discipline in this environment, and what lenders see as key differentiators between firms.

The popular (marketing) argument which circulates in the market is that private equity sponsored transactions are safer per se. This "argument" will be tested in particular in the first real challenge for the direct lending market. No, COVID was not a challenge, but it can become an issue in the long run. A private equity sponsor will never put money back into a bad investment in our view.

Sven Gralla, Fund Manager Private Debt, Hauck Aufhäuser Lampe Privatbank AG/ Kapital 1852

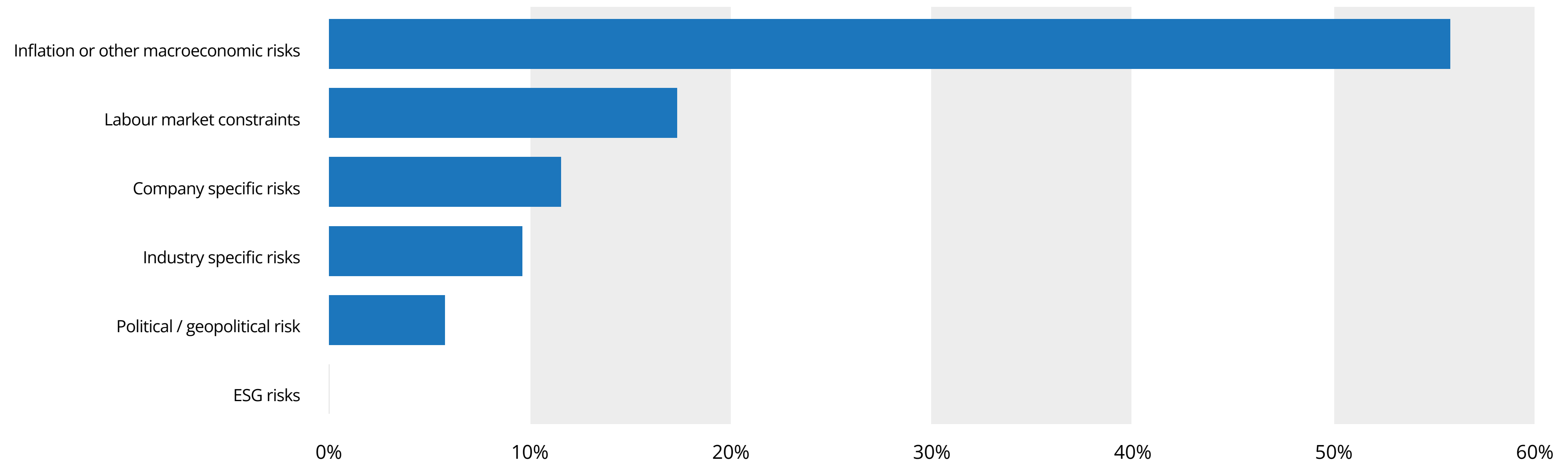
During periods of markets volatility, the overall level of risk is higher but there remain opportunities to invest in resilient credits with strong fundamentals and robust financial structures. However, disciplined underwriting is important to make sure the increased yield reflects market repricing and not increased risk appetite.

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

The private credit market is taking too much comfort in the fact that their instrument is floating rate, and not considering enough the impact of the battle to contain the inflationary beast that has been awoken.

Stuart Fiertz, Co-Founder & President, Cheyne Capital

Figure 25: What is the biggest challenge affecting borrowers in your private credit portfolio?



We think businesses are still very much challenged by a variety of inflationary pressures. Wage-related costs have increased materially as the labour market remains tight across all industries and a wide range of geographic locations. Wage inflation is much stickier and more entrenched within the cost structures of a lot of companies, and we do not see that going away any time soon.

Allan Schweitzer, Portfolio Manager, Beach Point Capital

Selectivity, due diligence, and discipline

Every private credit manager will have a system in place to filter the deals they invest in from the total number of investments they consider. Firms will typically receive information on investment opportunities through several sources including debt advisors, banks, private equity firms and their own networks.

As shown in Figure 26, most private credit firms will invest in fewer than 10%, and the majority of them in fewer than 5%, of the total deals they receive information on. While the rate of deal realisation will naturally vary between firms, this data point highlights the importance attached to selectivity within the market. When questioned on the key factors behind their selectivity, interviewees highlighted the role of their investment mandates and the role of their own due diligence standards in differentiating between firms which they felt were more likely to succeed.

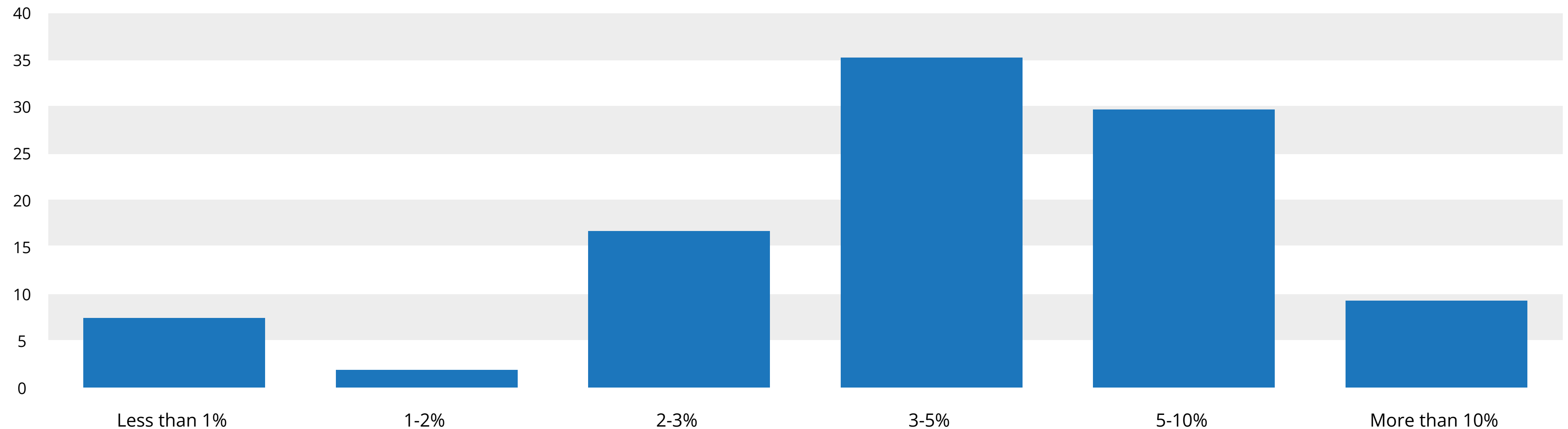
We will look at what we believe are the key potential drivers of profitability over the next four to five years and run various scenarios. There are some businesses where wage inflation is more relevant and others where energy inflation is more relevant. We will run those scenarios and test the resilience of the business's cash flows and ability to service its debts on what we see is a reasonable, worst-case picture.

Andrew McCullagh, Managing Director and Portfolio Manager for Private Credit, Hayfin

We have constant deal flow but we are declining a lot of opportunities and taking our time and capacity to make sure we focus on the right opportunities for our investors. This usually means ensuring we can appropriately manage the pricing discrepancy between the liquid broadly syndicated loan market with the pure private credit segment.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau Capital

Figure 26: What is your rate of deal realisation in relation to the number of deals you examine?



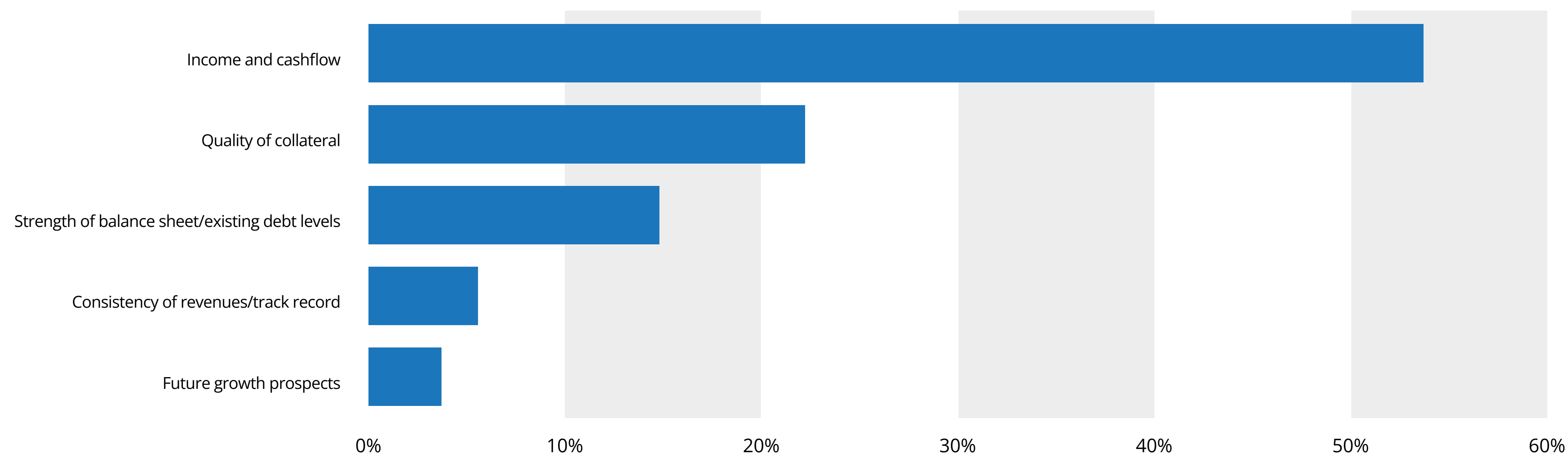
While investment mandates can often provide a much clearer way to filter deal opportunities (for example, explicitly excluding or limiting investment in certain sectors or jurisdictions), due diligence typically requires the balancing of multiple factors including, but not limited to, cashflow, balance sheet strength, market positioning, growth prospects and the maturity of the business model. When asked to prioritise their most important financial consideration, 51% of respondents chose to emphasise income and cashflow (see Figure 27).

'Cashflow is king' is a common sentiment amongst business owners when considering the health of their firms and it is no surprise that lenders would also place similar emphasis on this when determining where to invest.

The single biggest leading indicator of success in private credit is the quality of the businesses you are investing in. We focus on scale, market-leading companies with strong growth tailwinds, limited cyclicality, and high free cash flow conversion.

Michael Zawadzki, Global Chief Investment Officer, Blackstone Credit

Figure 27: What is the most important financial consideration when granting a loan?

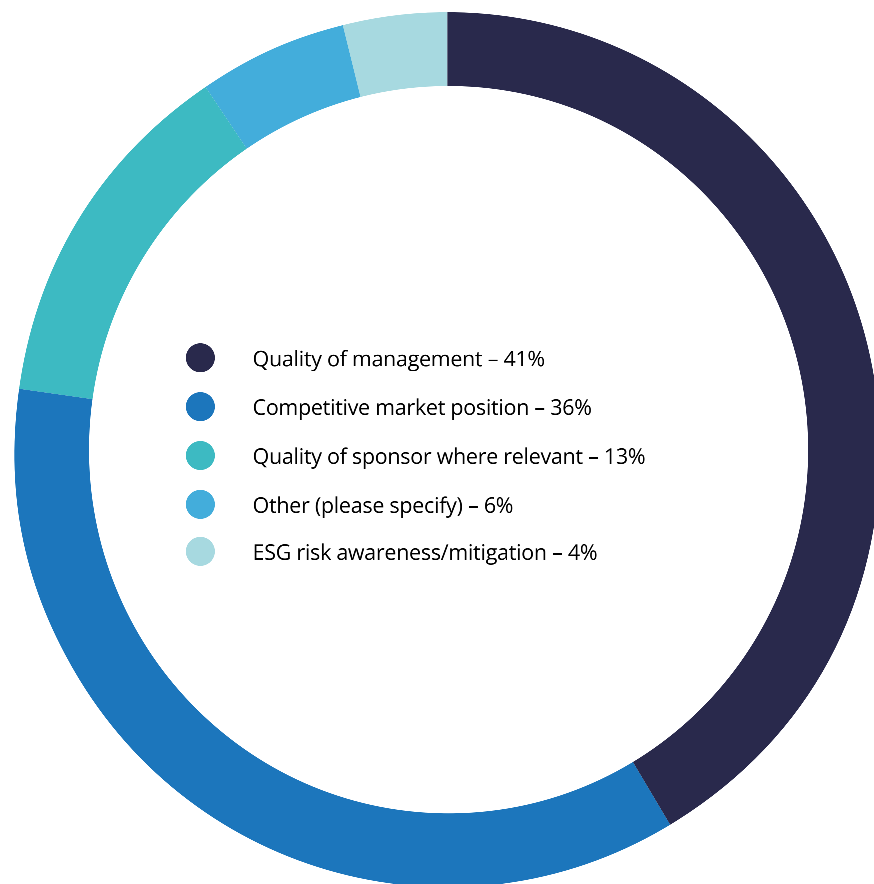


In terms of the most important non-financial considerations when granting a loan (see Figure 27), nearly 80% of respondents chose either quality of management (42%) or competitive market position (36%). Our interviewees viewed these elements as generally intertwined and consistent with their sentiment that their main job as a lender is to find good quality businesses and lend to them on competitive terms. Several interviewees commented that this question forced a relatively unnatural choice upon them, as due diligence would consider all of these issues with any final determination based on weighing these factors as well as others not included in our survey to achieve a balanced view.

We are going to see higher interest rates. This is what we have been assuming for the last three or four years in our modelling. We didn't know when, but it was going to happen someday. From that perspective, we were always looking for companies that were going to be more resilient through the cycles and able to withstand our modelling.

Rafael Calvo, Managing Partner, Head of Senior Debt Funds and Co-Head of Origination, MV Credit

Figure 28: What is the most important non-financial consideration when granting a loan?



A further consideration expressed by interviewees concerned overall levels of discipline in the market. The different investment mandates of each firm and their own weighting of factors when considering investment opportunities provides ample scope for firms to come to different conclusions when deciding whether to invest in a company. However, many firms highlighted that even accounting for these differences, deals were either coming to market or being done in instances where they felt there were insufficient protections or risk-adjusted returns available to lenders. While this sentiment was expressed by almost all firms, it was also acknowledged that this hypothesis will only be tested over time with discipline determined on an ex-post rather than an *ex-ante* basis.

This sentiment should however be contrasted with our survey, which found that fewer than 8% of respondents stated that they felt covenant protection had diminished in the past twelve months, compared to 39% citing an improvement in terms (see Figure 29). The erosion of covenant protection and emergence of cov-lite loans has been a clear trend in the public and broadly syndicated credit markets for several years.

While it is unlikely that private credit markets are immune from this trend, our data suggests that, given the increased overlap between the lenders and borrowers that make up these markets, terms have become somewhat more favourable overall.

This is also likely to be welcomed by investors who see covenants as a key means to monitor risk and step in where required. As well as providing a way to monitor the financial health of a business, several of our respondents also highlighted the importance of documentation when it comes to aligning the interests of borrowers and lenders. This is especially the case when it comes to the use of collateral and retaining security. Such covenants remain a vital tool by which lenders protect their interests. This was cited as one area where the strength of documentation typically matters more in situations of stress and greater economic volatility, and one which may come to the fore over the coming years.

Deal flow has been very strong, and we have had the luxury of being able to pick and choose the best transactions. I also think there's been a better balance between borrowers and lenders in terms of documentation.

Mathieu Vigier, Co-Head of Senior Debt Partners, ICG

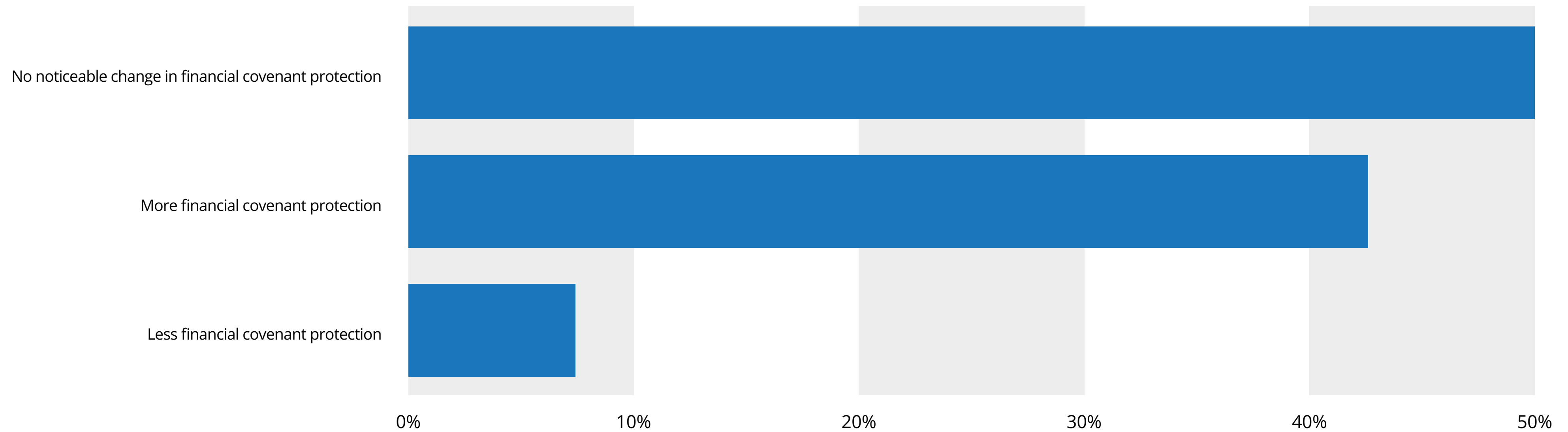
A few key things to look for in a potential investment is correlation to the economic cycle, operational leverage and the ability to access liquidity in tough economic conditions.

Emmanuel Deblanc, Global Head of Private Credit Markets, Allianz Global Investors

What has clearly changed is the basket and leverage capacity, which was always where the main discussions and compromise on synergies and the way we were incorporating those took place.

Cécile Mayer-Lévi, Head of Private Debt, Tikehau Capital

Figure 29: How has financial covenant protection across your private credit investments changed over the past year?



Knowing your portfolio and identifying potential stress before it becomes a problem

Our conversations with private credit managers indicate that there has been significant investment in portfolio monitoring processes and workout capacity over recent years. While investment managers in other alternative investment strategies may opt for leaner operating models, we do not see similar models being developed by private credit managers. The nature of credit investing has acted as a significant incentive for firms to invest in their risk management functions as they have grown their AuM and expanded into newer markets.

We think earnings will eventually decline and that means cashflow will come down. That means some firms are going to have more issues, and we are trying to be proactive in dealing with those.

Mark Jenkins, Managing Director and Head of Global Credit, Carlyle

We all need to be highly mindful of the macroeconomic headwinds. You need to keep macro in mind and ask yourself if those dynamics change how you diligence companies, the questions you ask, analysis you do, and how you manage documentation and covenants in this market.

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

Our survey provides some examples of what this entails in practice and how firms assess the health of their investment portfolio. Figure 30 shows that almost half of our respondents stated that the loans in their portfolio contain more than two financial covenants, with nearly a quarter stating ‘around two’. It is not just the existence of financial covenants that matters as one needs to deeply analyse their detailed terms in order to understand whether they provide meaningful protection to the lender. At the same time, it is reassuring that, after years of many predicting the slow disappearance of covenants from the private debt market, we are seeing signs of the opposite trend.

Figure 30 provides a snapshot of the most common debt to EBITDA ratios for borrowers at the time a loan was provided. Only a fraction of respondents stated that this ratio was higher than six times, with around half of private credit managers submitting between four and six times. These and many other indicators are used by firms to assess and monitor the financial health of their portfolio companies on a regular basis. Interviewees consistently emphasised portfolio monitoring as a key differentiator for investors when assessing individual credit fund managers. This was seen to be particularly important in the current climate with even the healthiest businesses or those with strong growth prospects facing a challenging environment.

We are carefully monitoring the liquidity position of our existing or potential counterparties - especially where they may have collateral posting obligations under some energy contracts for instance. That is not necessarily a question of solvency in the long term, but more of a squeeze on liquidity in the short term.

Emmanuel Deblanc, Global Head of Private Markets, Allianz Global Investors

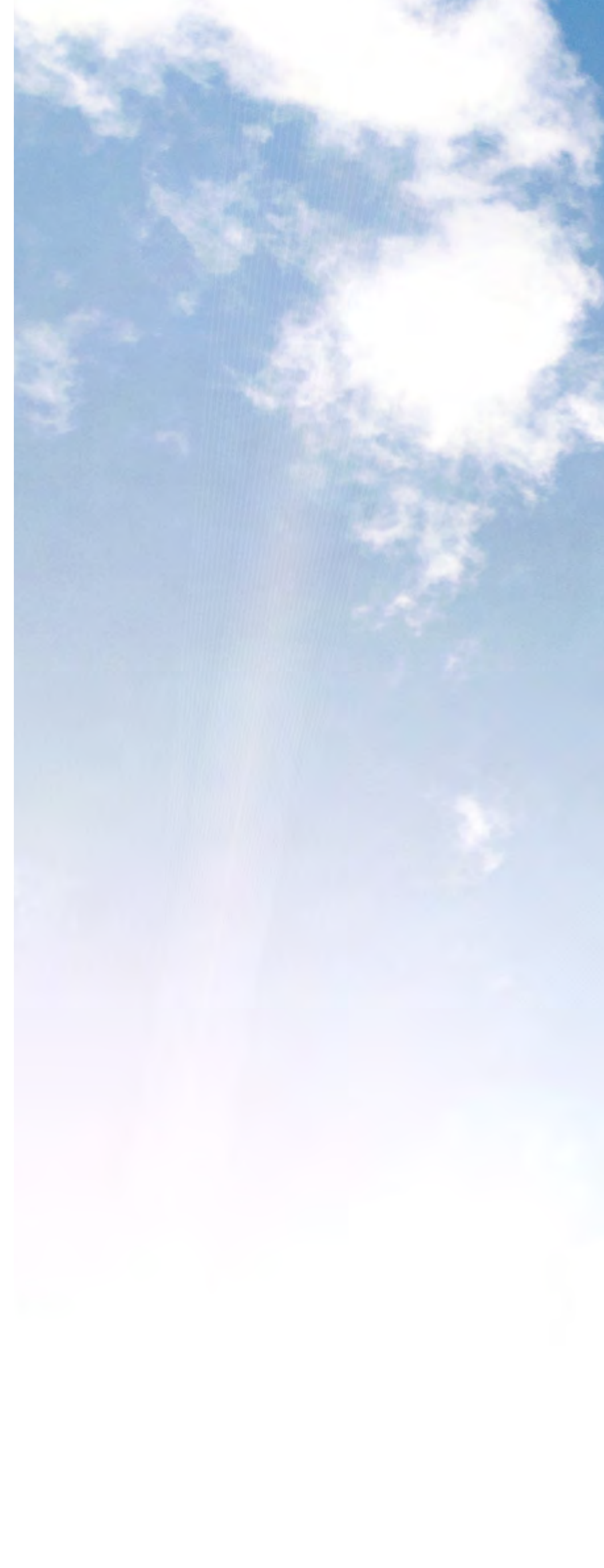


Figure 30: How many financial covenants do the loans in your portfolio contain on average?

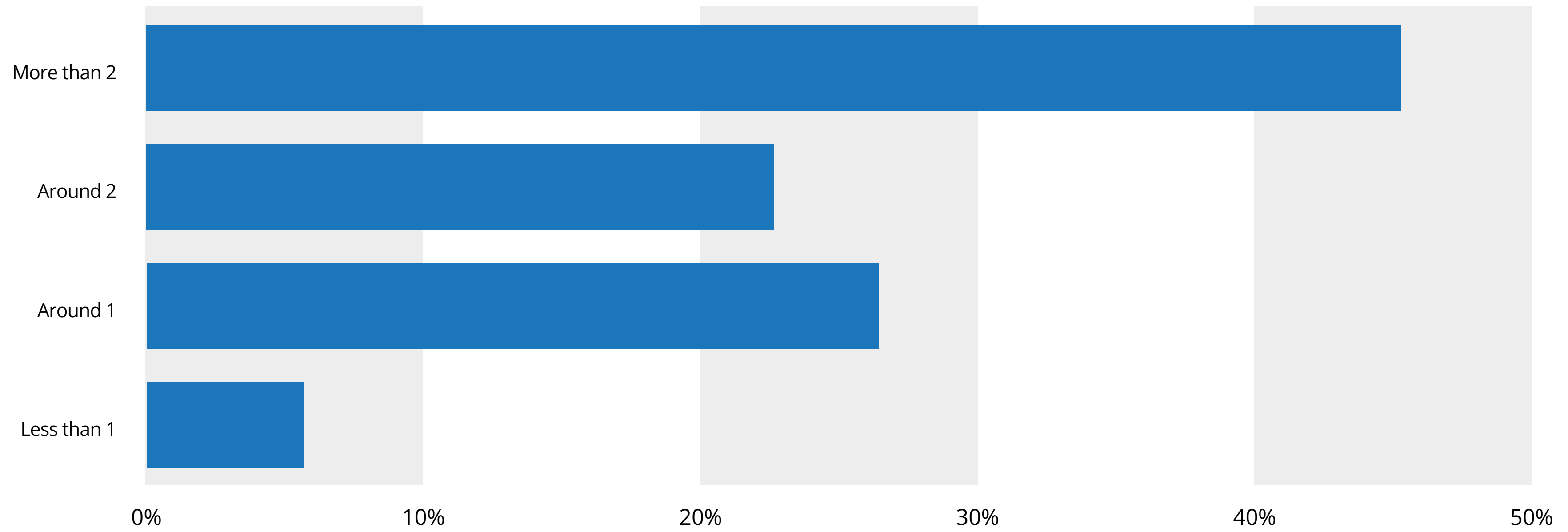
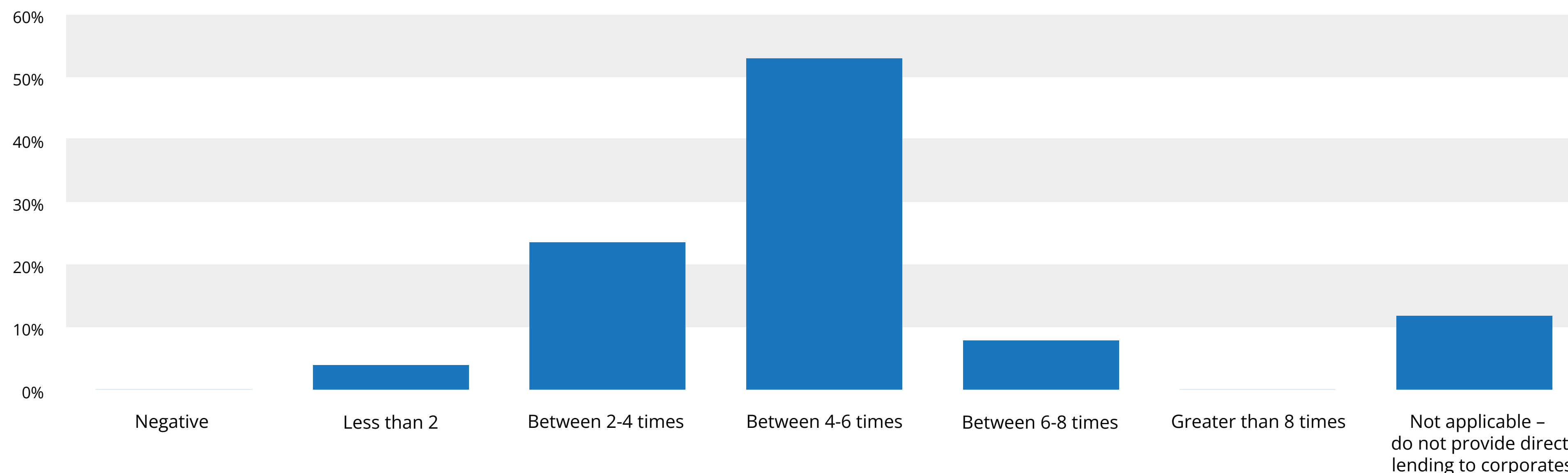


Figure 31: What is the most common ratio of debt-to-EBITDA* of the borrowers (at the time the loan was provided) for your direct lending to corporates?



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

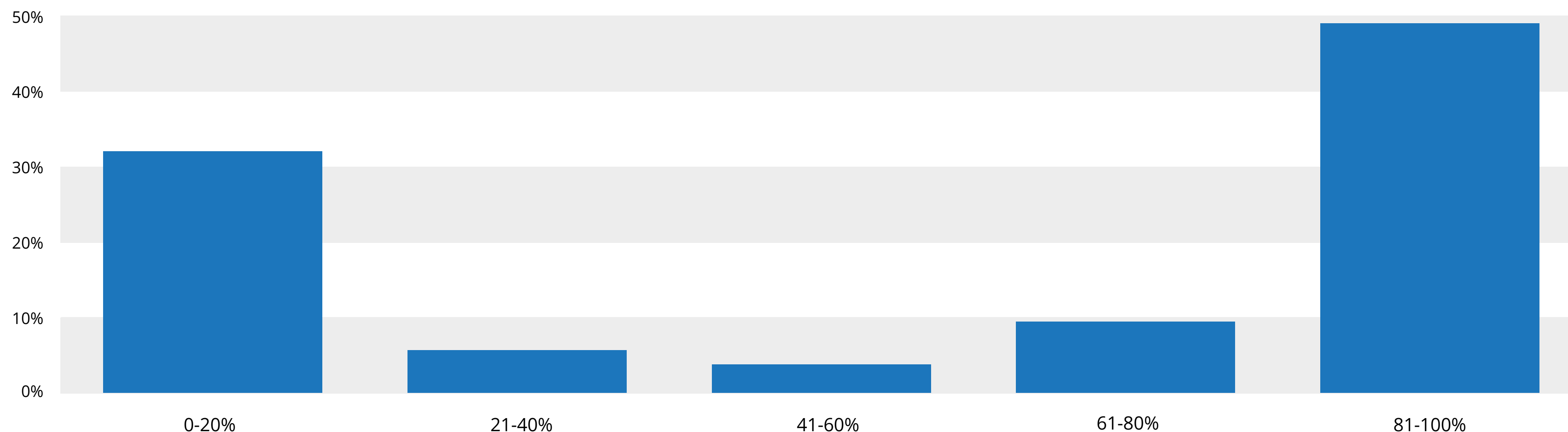
Valuation of portfolio assets was described by interviewees as another area where private credit fund managers can distinguish themselves. While it is well known that the valuation of private assets differs significantly from the public markets, we see evidence of different practices being employed within private credit markets.

As shown in Figure 32, 48% of respondents state that between 80-100% of their assets are valued using an external valuation agent. A significant minority (32%) reported that they use external valuation for less than 20% of their portfolio. When this point was discussed with our interviewees, it was noted that the use of external valuation services continues to be an area of interest to investors. While investors value the independence and specialist industry insight that external valuation agents can provide, they need to consider this alongside cost and value for money.

We have been consistent not only in our approach to risk but also on deal structuring, remaining focused on keeping to the basics of proper documentation given the economic uncertainties.

Matthieu Vigier, Co-Head of Senior Debt Partners, ICG

Figure 32: What percentage of assets within your private credit strategies are valued using the services of an external valuation agent?



Investment in restructuring and workout capacity

Our data shows that private credit managers continue to make interventions and adjust their loan terms where necessary (see Figure 33). Two thirds of respondents stated that they had made no significant adjustments which suggests that, in most cases, existing loans are generally performing well. While this paints a positive picture of private credit portfolios overall, many of the risks facing the corporate sector such as higher inflation or energy costs are yet to fully crystalise or be passed through to end customers. It would be premature to say that the sector has already managed these risks, or that there will not be higher volumes of adjustments made or outright defaults in coming years.

Our research also highlighted that firms have, for several years, been investing in their restructuring and workout capacity, both in terms of human capital and institutional structures. An example of this is the involvement of restructuring and workout professionals during the origination and investment phase of a transaction, capital investment in monitoring and risk management processes within firms, as well as a greater emphasis on restructuring and workout skills and experience across the entire firm. As shown in Figure 34, nearly 30% of private credit managers reported that restructurings are now led by dedicated workout teams or resources. While this data might suggest a shift away from the 'cradle to grave model' (i.e. where the deal team responsible for originating a loan is also responsible for any restructuring), our research indicates a more nuanced situation whereby dedicated monitoring and workout capacity is primarily a source of early warning and support for the deal teams who continue to hold primary responsibility for the loans. Several of our interviewees felt that this was necessary due to the increased scale of their lending activity, as well as the need to remain diligent given the risks in the current market.

Given the unfolding macroeconomic environment I do not think portfolio management is going to be just about covenant relief. There will be fundamental liquidity issues where the debt may need to be restructured, as average coverage ratios are rapidly compressing at the same time as certain sectors are facing pronounced, and likely prolonged, supply and demand pressure for the first time in many years.

Michael Small, Partner, KKR

With borrower and investor demand remaining strong, we believe the successful credit managers of the next few years will be those who take wider operational challenges into account and apply a prudent and diligent approach to investing and loan structuring.

Stuart Fiertz, Co-Founder & President, Cheyne Capital

Figure 33: What form/type of significant loan term adjustments to the loans in your portfolio have you taken in the past year? Select the top three

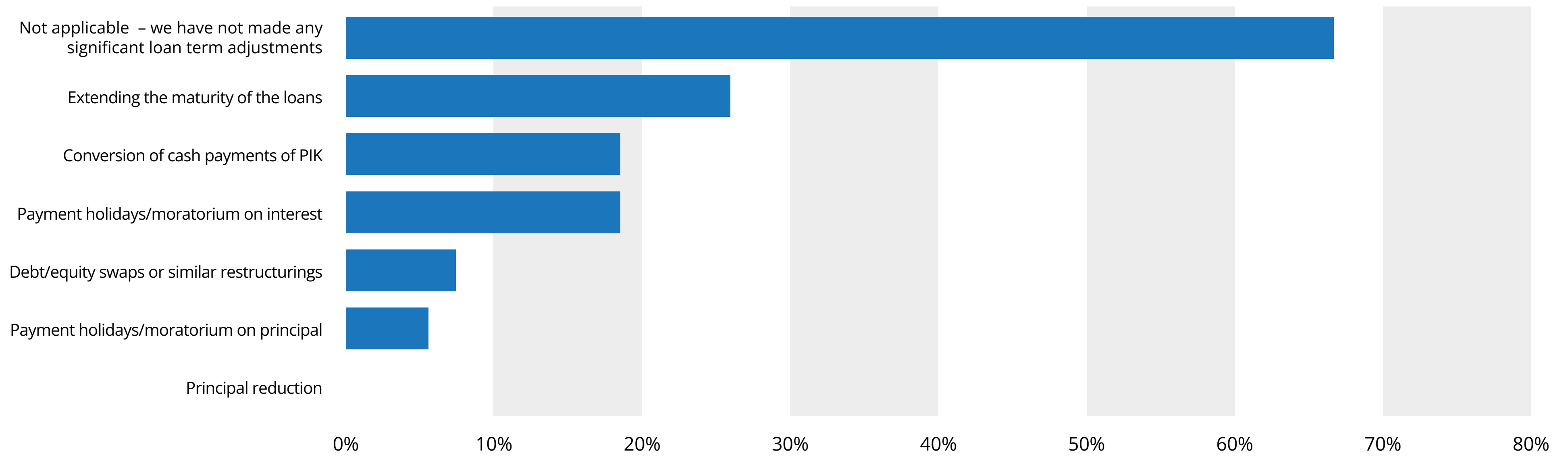
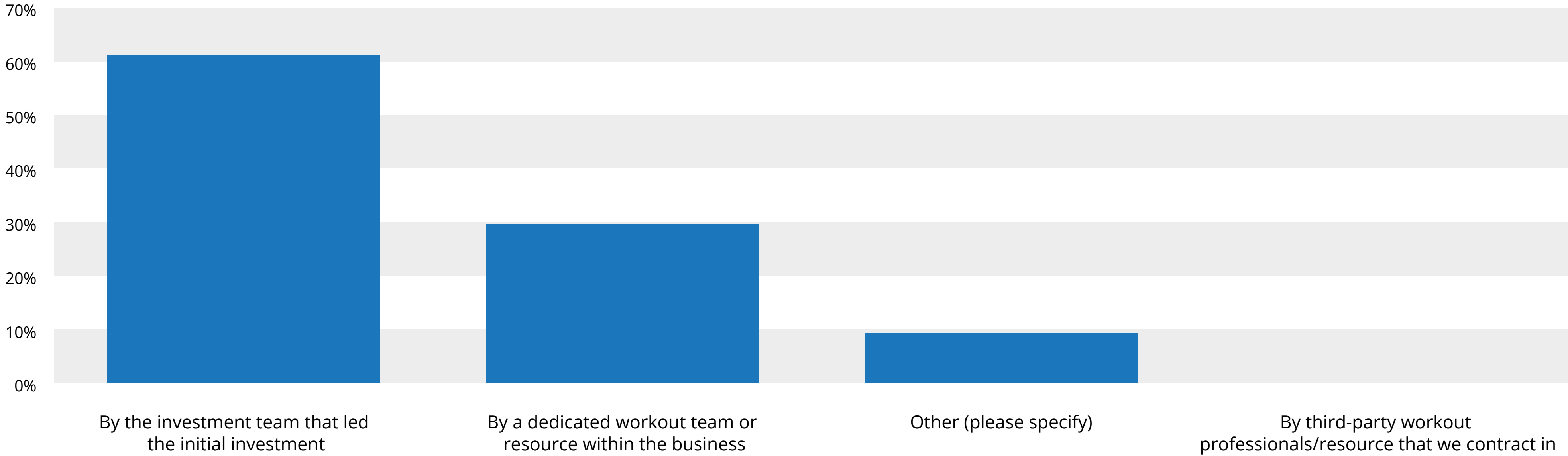


Figure 34: How are loan restructuring / workout situations typically handled within your business?



Chapter 4 – What to expect in 2023

Summary of key findings:

- Track record and strength of investor relationships continues to drive strong capital raising across the industry, despite the impact of the denominator effect
- Retail investor base will continue to grow due to the development of new fund vehicles in the EU and UK
- Industry initiatives supporting harmonisation of ESG risk disclosure to investors
- Investors are increasingly sophisticated in their approach to due diligence and manager selection

Our research also highlighted several trends that we expect to influence the market during 2023 and beyond. This section highlights our findings with respect to capital raising, ESG and investor due diligence.

I am starting to gain conviction that we will be entering into a bit of a golden age for private credit. I believe that the vintage of funds that we are all talking about now, late 2022 and 2023, could be very good performers in hindsight.

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

Investors are attracted to the defensive characteristics of this asset class and the prospect of strong risk-adjusted returns, especially in a rising rate environment.

Mathieu Vigier, Co-Head of Senior Debt Partners, ICG

Our research revealed a lot of confidence about the potential for private credit managers to continue raising capital and the ongoing growth of the asset class. The primary reason cited for this was the track record private credit has developed during the past decade. Being able to meet (or exceed) investors' return targets over this period, with relatively low volatility of returns, was a compelling argument for investors either looking to allocate or increase their allocation to private credit. This track record also supports the case for allocators to make the necessary adjustments to their portfolio management processes and invest in the right teams and structure to manage the allocation.

Fundraising data for Q2 2021 to Q2 2022[12] puts this broadly on par with the preceding twelve months. While some of our interviewees highlighted the impact of the denominator effect (where the reduction in the value of an investor's public markets portfolio reduces the amount of capital they can invest in other asset classes due to their investment limit being set as a fixed percentage of their overall portfolio) on an investor's ability to allocate capital, this was seen as a temporary phenomenon. Several interviewees also remarked that the increased return potential for credit funds in a rising rate environment was also bringing in new investors.

In addition to new investors partially compensating for the denominator effect, there is an optimism that relationships with existing investors would endure.

We have got a more mature market now. Investors have a dedicated private debt pocket of capital to allocate every year or two years. That allocation amount may go up or down, but it's not going to zero. Private debt is here to stay because for all of these big asset allocators, private debt is now an allocable strategy in its own right.

Nathan Brown, Chief Operating Officer, Arcmont Asset Management

One of the most talked about aspects of capital raising within private credit is the development of retail products. BDCs have gone from strength to strength during the past twelve months, with the fair value of the sector rising from $153bn to $240bn between Q2 2021 and Q2 2022[13]. At the same time, firms around the world are also developing new products for this target market while regulators in the UK and EU are introducing reforms to the Long-Term Asset Fund (LTAF) and European Long-Term Investment Fund (ELTIF), that will support the ability of retail investors to access private credit.

Interviewees noted that these vehicles will play an important role in bringing new types of capital to the sector. The regulated nature of BDCs, LTAFs and ELTIFs also provides an important safeguard for retail investors who lack the same capacity as their institutional counterparts to oversee asset managers. Our research also revealed differences of opinion about the extent to which private credit can become a mainstay of retail portfolios in the same way as it has become a mainstay of institutional investors' allocations.

We think that BDCs have evolved as a compelling product for retail investors to gain access to private credit, especially if they're starting to dip their toes into alternative credit. BDCs can be managed as an all-weather investment solution seeking to generate premium yields and protect against the downside through different market environments, including periods of market volatility and rising interest rates.

Eric Muller, Portfolio Manager & Partner, Chief Executive Officer – BDCs, Oak Hill Advisors

ESG is now BAU

ESG and stewardship were comprehensively discussed in last year's edition of this paper[14] and this topic was not the theme of this year's research. However, ESG and stewardship were mentioned unprompted during several of our interviews in relation to capital raising, investment due diligence and as part of loan adjustments and restructuring. This suggests that ESG and stewardship remain a core part of lenders' activities and this will not diminish in the face of more challenging markets.

The ACC has also been working with our members, the Loan Syndications and Trading Association and the UN Principles for Responsible Investment to form the ESG Integrated Disclosure Project[15]. This project has recently published a harmonised ESG disclosure template that will enable private credit managers to collect data on ESG-related investment risks in a consistent format. By reducing the burdens on borrowers and creating a consistent form of disclosure in the private and broadly syndicated credit markets, this template addresses the well-known coordination challenges around data disclosure and engagement with borrowers. The development of this template illustrates how lenders continue to respond to investors' needs and support better ESG and stewardship-related risk disclosure.

There is almost no conversation I have that does not include ESG or sustainability. This kind of behaviour is something that investors are expecting as standard. What is interesting is that allowing a poorly performing company to fail is no longer acceptable. There has been an interesting change of behaviour where everyone is now engaging.

Nicole Downer, Managing Partner, MV Credit

Investor due diligence

A common challenge to private credit fund managers is that it is impossible to distinguish between different lenders in the market. Typically, the quality of any credit market (and its lenders) is revealed over the course of a full economic cycle. This test has not yet been applied to private credit, but there was a strong consensus that 2023 would be a more challenging period for lenders. As noted above, the greater familiarity of investors with the asset class and the different operating models of GPs is also driving up expectations with respect to due diligence, infrastructure and risk management.

The ACC is currently working with its members and institutional investors to develop a standardised due diligence questionnaire (DDQ) to support an investor's ability to assess and differentiate between different credit fund managers. We expect to release this soon and believe this will be a useful resource for investors and private credit managers alike. Prior to the publication of this DDQ we asked interviewees to share their views on the more important aspects of the due diligence process that investors should consider. An overview of the responses provided by interviewees on this topic can be viewed on page 68.

What are the more important aspects of the due diligence process that investors should consider?

How many businesses have they taken over in the last 10 years and how did they manage those?

You should expect all your GPs to provide actual data, show the loss rates on every single deal they have ever done or where the can has been kicked down the road.

Focus on the legal process and recognise that you are constructing a diversified portfolio of legal contracts. Not just what the documents of what you're investing in say, but also an understanding and experience of what going through the workout process will entail.

Ask for the investment committee papers on the existing portfolio, go through them in detail and look at how much credence they place on through the cycle cashflow.

Look at the summation of the work we do when we underwrite a borrower.

Focus on how the lender will preserve capital and prevent losses rather than how they will enhance returns.

How big an origination footprint do they have, how much capital can they map into that origination footprint and how good they are at looking after their portfolio?

Look at staff retention as well as the depth of expertise of lending across cycles within the team.

Spend the time and effort looking at the risk that you are putting into your portfolio now.

Determine whether the investment committee paper is a form filling exercise or whether the investment committee actually reached for the substance and the real issues are being dealt with.

Consider the volume of repeat business with sponsors and whether that reflects a positive relationship.

Be granular in looking into how adjustments and compromises are made, as well as looking at default rates and the protocol in distressed situations.

Look at the personalities, the type of individuals and whether they're comfortable being in disagreement with each other, with the dynamics of actually being able to have a diverging view within the investment committee.

Summary of key findings

Chapter 1 – The investment case for private credit

- Global private credit managers deployed an estimated $127bn during 2021, growing their lending activity approximately 20%
- Private credit managers continue to expand into new markets and strategies
- Though having paused mid-year (2022) due to rapid changes in the macro environment, managers are recalibrating and remain optimistic about deployment opportunities in the next twelve months
- Investment case for private credit is still compelling in rising rate environment as long as macro-stresses remain manageable for borrowers

Chapter 2 – Focus on the borrower

- Borrowers of all shapes and sizes now have access to deeper pools of private credit capital
- Private credit is primarily a source of growth capital for the economy
- Lenders tend to focus on non-cyclical businesses with leadership positions in their sectors
- Flexible credit solutions and certainty of execution continue to be prized by borrowers
- Private equity continues to spearhead private credit's expansion into new markets

Chapter 3 – Investment due diligence and risk management

- Private credit managers place a premium on due diligence and risk management
- The impact of inflation and macroeconomic risk is the key challenge facing lenders
- Private credit firms will typically invest in fewer than 10% of the total deals they assess
- Firms have invested heavily in their risk management functions during periods of growth
- Firms use a range of indicators to assess and monitor the financial health of their portfolio companies

Chapter 4 – What to expect in 2023

- Track record and strength of investor relationships continues to drive strong capital raising across the industry, despite the impact of the denominator effect
- Retail investor base will continue to grow due to the development of new fund vehicles in the EU and UK
- Industry initiatives supporting harmonisation of ESG risk disclosure to investors
- Investors are increasingly sophisticated in their approach to due diligence and manager selection

End notes

1_Source: Preqin Pro

2_Source PitchBook

3_Source: https://www.lsta.org/news-resources/bsl-private-credit-friend-or-foe/

4_Estimates for deployed capital in the 2021 edition of this research were revised down from ~ $200bn to ~ $170bn following discussions with respondents about the data submitted.

5_Source https://www.refinitiv.com/perspectives/market-insights/two-year-ma-boom-runs-out-of-steam/#:~:text=By%20the%20end%20of%20Q3,percent%20so%20far%20this%20year

6_See https://acc.aima.org/article/press-release-aima-and-the-acc-applaud-positive-progress-on-eltif-regulation-reforms.html

7_See https://www.blackstone.com/news/press/blackstone-credit-expands-presence-in-asia-to-support-growing-demand-for-private-credit-financing/ and https://www.bloomberg.com/news/articles/2022-05-25/kkr-raises-1-1-billion-for-first-asia-pacific-credit-fund

8_Source: Ares Capital Corporation Form 10-q filing for the quarterly period ended September 30, 2022 - https://sec.report/Document/0001287750-22-000052/arcc-20220930.htm

9_See https://fred.stlouisfed.org/series/BAMLH0A2HYBEY#

10_See https://cliffwater.com/files/cdli/docs/Cliffwater_Report_on_US_DirectLending.pdf

11_See Financing the Economy 2017

12_See Pitchbook Global Private Debt Report H1 2022

13_See http://cdn.hl.com/pdf/2022/direct-lending-update-summer-2022.pdf

14_See Financing the Economy 2021

15_www.esgidp.org

About ACC

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 250 members that manage over US$600bn of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$600 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

ALLEN & OVERY

About Allen & Overy

At a time of significant market change in the legal industry, Allen & Overy is determined to continue leading the market as we have done throughout our 86-year history. The firm will do this by ensuring we always challenge ourselves to bring new and original ways of thinking to the complex legal challenges our clients face.

We cover the full spectrum of alternative investment, upstream and downstream and across all asset classes, from the structuring and establishment of managers and their funds, to the investments that they carry out. We have over 40 offices around the world with dedicated teams, providing almost complete geographic coverage for our Alternative Investment Manager clients. We act for all types of funds, managers and investors, including global, industry leading managers, younger managers and start-ups/spin-offs, sovereign wealth funds, pension funds and insurance companies, and have deep sector expertise in each of the key asset classes: private equity, real estate, infrastructure, distressed and credit.

We help design and implement some of the most complex and innovative cross-border alternative investment structures, and the deals (domestic and international) that are done via those structures, whether leveraged finance, fund finance, CLOs, structured finance and securitisation, and corporate transactions. In addition our regulatory, compliance, employment and tax teams support our clients' transactional and operational requirements.

CS2210_CDD-70811_ADD-104062