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Opinion

Private Credit: Opportunities Abound but Diligence Necessary

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Institutional investor interest in private credit has grown rapidly in recent years, but institutional investors would benefit from heeding extra caution when entering into this complex asset class.

Bond yields haven't seen pre-2008 levels, and as central bank balance sheets become more bloated, long-term investors such as insurance companies, pension plans and endowment funds have pursued other ways of obtaining much-needed yield and long-term returns to match their liabilities. Interest in private credit strategies stems from investors seeking diversified return streams from the many variations of these strategies, including mid-market direct lending, real estate and infrastructure debt, asset-backed structured products and distressed debt.

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This has led private credit to grow at a rate not seen since the hedge fund expansion of the 1990s. By providing mid-market loans that were traditionally made by banks, private credit funds have amassed roughly $605 billion globally in both unrealized value of invested assets and dry powder as of January 1st 2017 according to Preqin. The global private credit market is set to hit $1 trillion by 2020 according to research conducted by the Alternative Credit Council.

A Unique Market

The private credit market has its own unique way of functioning. The nature of the market enables negotiation to achieve favorable terms for lenders. For example,private debt lenders can allow borrowers to manage their interest expense and/or balance sheet more optimally by customizing cashflows or sizing the debt to the cashflows of a bankruptcy remote entity.

In return for this customization and structuring, the lender often gets physical security, interest coverage and leverage covenants and first priority of cashflows to mitigate risk and protect the downside under stress scenarios. These protections minimize the loss given default of a particular investment when the entity does not perform as planned. Including private credit in a broader portfolio also provides exposure to sectors and credits not otherwise investible with lower correlation. It is also a relationship-based market, where investors are focused on long-term strategy with limited liquidity options.

The details of private investments are not widely accessible nor are they usually externally rated and the form and structures can be very unique. Thus, the higher cost of entry (qualified team, additional administration, systems support) deters many investors from entering this market, which provides exclusivity for those that can invest.

Proceed with Caution

Though there are clear opportunities in private fixed income, institutional investors need to be cautious. Investors must consider the illiquid nature of this asset class and allocate appropriately. Investing in an open pooled fund can provide some liquidity under normal market conditions, whereas investing in a segregated or closed end fund can be less liquid. Therefore, investors must be prepared to wait until the private assets mature or pre-pay to get their money back.

Additionally, investors must be prepared for the fact that most private credit instruments are not rated, which may have capital implications. Moreover, investors must understand that some of the information provided by the borrower is protected under non-disclosure agreements which limit the details that can be shared. Finally, as most private credit instruments are not traded, investors must get comfortable with the valuation methodology of the private credit manager.

Asset managers should be prepared to provide institutional investors with a range of short, medium and long durations to meet a variety of strategic investing needs. Asset managers who have a specialist expertise in credit research, credit analysis, credit structuring and legal and operational due diligence, are in an ideal position to source private debt investments in the U.S. and globally.