Unlocking Opportunities with Private Credit Funds

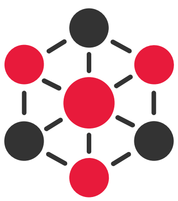
The Rise of Private Credit

Private credit funds have exploded recently, with billions of dollars raised for private credit from U.S. investors in 2023 alone, following a decade of strong growth. According to PitchBook, the market grew from roughly $500 billion in 2012 to $1.75 trillion in 2022. The rise in popularity of these funds can be attributed to a surge in businesses seeking new and alternative avenues to capital in a high interest rate environment. Their popularity is also due to the advantages they offer investors, especially at a time when markets are uncertain and overall dealmaking has slowed to the point where many private equity firms are struggling to get funding for leveraged buyouts. While traditional banks are required to hold comparatively higher levels of capital to what they lend and are subject to rigorous regulatory scrutiny, private credit has greater flexibility in these areas. Private credit funds have also been **outperforming traditional private equity ventures**. In 2023, the private credit portfolios of seven listed private equity managers achieved a median gross return of 16.4%, compared to 9.8% for their private equity strategies, making private credit an attractive investment opportunity.

Advantages of Private Credit Funds

Private credit funds offer investors access to non-public markets and present a range of benefits not offered by traditional and public market investments, and through strong recent fundraising, have been able to enter the lending market with a focus on high-yield deals.

DIVERSIFICATION



Spreading exposure across multiple sectors and credit profiles is key to mitigating portfolio risk. Private credit funds work across a diverse range of credit instruments, including senior secured loans, mezzanine, and distressed debt, to offer higher yields than other types of investments. Private credit investments typically have low correlation with public market assets like stocks or bonds, so even when public markets are down, private credit can perform well. Insulating against market volatility in this way makes private credit funds an attractive investment vehicle.

RISK MITIGATION

Private credit funds can take advantage of the risk mitigation strategies many companies have in place when they assess the viability of an investment. Asset managers can consider a company's reputation, position in the market, longevity, risk mitigation and response strategies, and past financial performance when considering offering private credit. However, it is essential that asset managers do not rely completely on a borrower's own assessments of its qualifications for private credit. To take on the appropriate amount of risk and capture returns, long-term, fund managers must put each investment prospect through rigorous due diligence and risk management testing before committing.

CUSTOM STRUCTURES

Private credit funds can be highly flexible, creating customized investment structures to generate alpha for investors. Often, private credit funds can offer value-added features that traditional banks cannot, including warrant coverage, equity kickers, revenue or profit-sharing agreements, and performance-based incentives. By tailoring bespoke covenants and maturity profiles, private credit funds can capitalize on shifting market conditions to offer a broad range of investment options and risk parameters. Investors concerned with preserving capital can opt for senior secured loans, for example, while those seeking higher returns may opt for higher risk alternatives like distressed debt.

CONVERSION TO EQUITY

Credit facilities and loans provided to companies by private credit funds often come with covenants setting out terms for the lender in case of a breach. In certain circumstances within a private credit fund, when a borrower defaults on a loan or breaches a covenant, the credit facilities can be turned into equity. Certain privileges may be built into the covenant, such as inclusion on a company board for the private credit fund, or even a takeover, should the covenant be tripped by the borrower.

Opportunities for Fund Managers

Financial firms considering private credit funds as part of their overall investment strategy should take the following steps:

ESTABLISH AN INVESTMENT STRATEGY

First, determine the investment focus of the fund — senior secured loans, for example, or distressed credit — by conducting thorough research and analyzing the current economic climate. In times of economic uncertainty, sitting higher up in the stack can help foster investor confidence because it can lower the risks associated with the investment. For example, a focus on first-lien lending allows private credit fund investors to recoup their investments before others draw their equity in a liquidation scenario, which can serve as a balance against market volatility. Loans of this nature — sometimes described as "Tier 1" capital — have higher transaction speed and certainty than distressed debt, making them attractive, especially to more conservative investors.

Second, develop a sound strategic approach to the size of companies the fund will target, and the industries in which they are active, to build a portfolio that can meet the fund's investment goals. Investing in larger companies can strengthen a portfolio, as they tend to prove more resilient in the face of economic headwinds, with lower rates of default than smaller companies.

Private credit funds can also target a broad range of industries where traditional banks have historically been less active. For example, **infrastructure investments**, where private credit funds lend to governments around the world, have expanded rapidly in the last few years, and Bloomberg estimates that this market could grow to $1.5 trillion by 2027. Asset managers should conduct thorough industry research to determine which industries their private credit fund will target.

ENACT RISK MANAGEMENT PROTOCOLS

Asset managers should approach illiquidity risks common in private credit deals by aligning overall investment goals with short-, middle-, and long-term liquidity needs. To maintain appropriate levels of liquidity and mitigate risk, diversifying private credit portfolios is critical. A diverse portfolio will help drive stronger returns by offsetting the negative impact of individual defaults or downturns, which helps firms maintain consistent cash flow and the flexibility required to take advantage of future investment opportunities.

Due diligence is key to successful deal-making, and the high levels of demand and competition for private credit fund investment mean that in the rush to secure investors quickly, some firms may risk deploying less robust due diligence processes. Private companies that seek loans from private credit funds may have their own due diligence protocols in place, but asset managers should ensure that thorough care is taken when examining fund structures, borrowers' credit history, and any conflicts of interest that may affect the value of the investment and increase the level of risk.

ENSURE PROPER COMPLIANCE PROTOCOLS

As private credit funds become increasingly active in the lending space, there has been a commensurate increase in scrutiny from institutions including the Federal Reserve on how they operate. Asset managers must monitor for — and stay ahead of — potential regulatory changes and compliance requirements.

As with other types of deal-making, private credit funds must maintain and update their accounting, compliance, and reporting procedures to offer transparency to investors. Funds should also be vigilant about assessing internal conflicts of interest, especially if they are investing in both the credit and the equity of a company. In April 2024, the International Monetary Fund (IMF) published the second chapter of its Global Financial Stability Report, which called for greater regulation and oversight of the private credit market. Consulting regularly with legal and tax advisors can help asset managers head off risk from potential regulatory overhaul while maintaining the flexibility that makes private credit attractive. Sound management remains the key to driving return on investment by addressing potential tax implications and avoiding the fines, litigation, and reputational harm that may arise from non-compliance.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