CION INVESTMENTS

What is Private Credit?

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Private credit has experienced rapid growth over the last few years. We look at the history of this asset class and the current state, as well as its utility in investor portfolios.

I GET PRIVATE EQUITY – BUT WHAT'S PRIVATE CREDIT?

Private credit is a way for businesses to raise capital (money). In private equity, an investor owns all or part of the company. In private credit, the investor lends money to the company in exchange for interest payments and can impose covenants and/or collateralization that secures the loan. They are called private because unlike publicly offered company stocks and bonds, the shares (equity) or loans (credit) are not available to the general public.

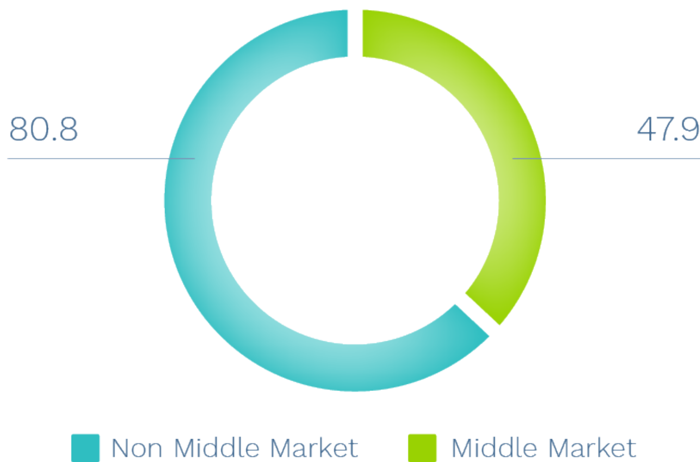
HOW DID THIS GET TO BE AN ASSET CLASS?

Growth in this asset class, like private equity in the 1980s, is being driven by institutional investors. A change to ERISA laws allowed institutional pension funds to invest in private equity. With private credit, institutional investors looking for income in a low-yield post-Global Financial Crisis (GFC) environment suddenly realized that the vast landscape of middle market businesses were actively seeking sources of non-bank funding. Bank consolidation and lending pull-back left them underserviced, and to gain access to funding they would pay higher interest rates.

The middle market comprises nearly 200,000 businesses and represents one-third of private-sector GDP. These companies are defined as having $10 million to $1 billion in annual revenue and they employ approximately 47.9 million people[1].

Middle market businesses are considered by investors because they can offer diversity across both geographies and industry sectors. They have also shown resilience, and outperformed during 2007–2010, the depth of the GFC, by adding 2.2 million jobs[2].

Total Middle Market Employment as of June 2019

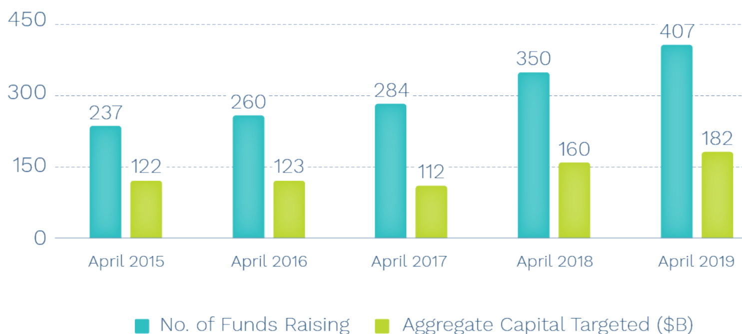


Source: National Center for the Middle Market, 2Q 2019 Middle Market Indicator; Federal Reserve Bank of St Louis Research Division, Federal Reserve Economic Data (FRED)

WHAT'S HAPPENING NOW?

Private credit (sometimes it's called private debt) has quadrupled in size over the last 10 years and is projected to reach $1 trillion in assets under management by 2020[3]. The number of managers entering the space has grown, and managers with a history of investing have increased their assets under management. The chart below shows the growth in both the number of funds raising capital and the aggregate capital targeted.

Growth of Private Debt Funds 2015-2019



Source: Prequin Pro, Quarterly Update: Private Debt, Q1 2019

ALL THAT GROWTH CAN'T JUST BE THE HIGHER INTEREST PAYMENTS?

This asset class is considered to be illiquid, and so can accrue an illiquidity premium relative to other more liquid asset classes. Private credits are usually held for long periods or even to maturity – the expectation is that they will pay interest throughout the course of the loan and return the principal to the lender at the end.

Private credit funds may also offer portfolio utility, meaning that these funds may contribute to the portfolio beyond adding return from the underlying investments. Private lenders can focus on senior secured loans, giving the lenders payment priority in the event of a default. They may also deliver additional value by directly influencing pricing and structuring covenants into the terms of their loans.

This can result in more attractive risk-reward characteristics, as they can incorporate enhanced downside mitigants over public debt markets.

WHAT HAPPENS IF THERE'S ANOTHER DOWNTURN?

This is the good part where we quote prestigious industry journals and academic studies. *Institutional Investor* has examined recent research on non-bank credit that finds that "private credit funds can lend capital when it's otherwise unavailable, which can smooth the credit cycle and, as a result, stabilize the market.[4]. That just means that if we have another downturn and banks decrease lending, private debt funds are already well-positioned to offer credit that banks are unable to. This can keep businesses going, which can then mitigate the severity of a downturn and help things get back to normal.

HOW CAN INDIVIDUAL RETAIL MANAGERS ACCESS THESE FUNDS?

A growing number of leaders in credit management are beginning to recognize the demand for the asset class and bring their expertise to retail investors for the first time in the form of closed-end funds, making private credit available to all modern portfolios.

RISKS

As with any asset class, there are certain risks associated with private credit. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. Because private credit can be debt investments in non-investment-grade borrowers, the risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, private credit investments are generally illiquid which require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.

To learn more about Private Credit, please contact your financial advisor.

[1] National Center for the Middle Market, 2Q 2019 Middle Market Indicator.

[2] National Center for the Middle Market, 2Q 2019 Middle Market Indicator.

[3] McElhaney, Alicia, Private Credit Funds Stabilize Markets, Research Shows, Institutional Investor, February 15, 2019; Parajon Skinner, Christina "Nonbank Credit", Wharton School at the University of Pennsylvania, February 13, 2019

[4] McElhaney, Alicia, Private Credit Funds Stabilize Markets, Research Shows, Institutional Investor, February 15, 2019; Parajon Skinner, Christina "Nonbank Credit", Wharton School at the University of Pennsylvania, February 13, 2019

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