White paper

# Bridging the gap

Private credit's path to becoming a portfolio cornerstone

Moonfare

Contents

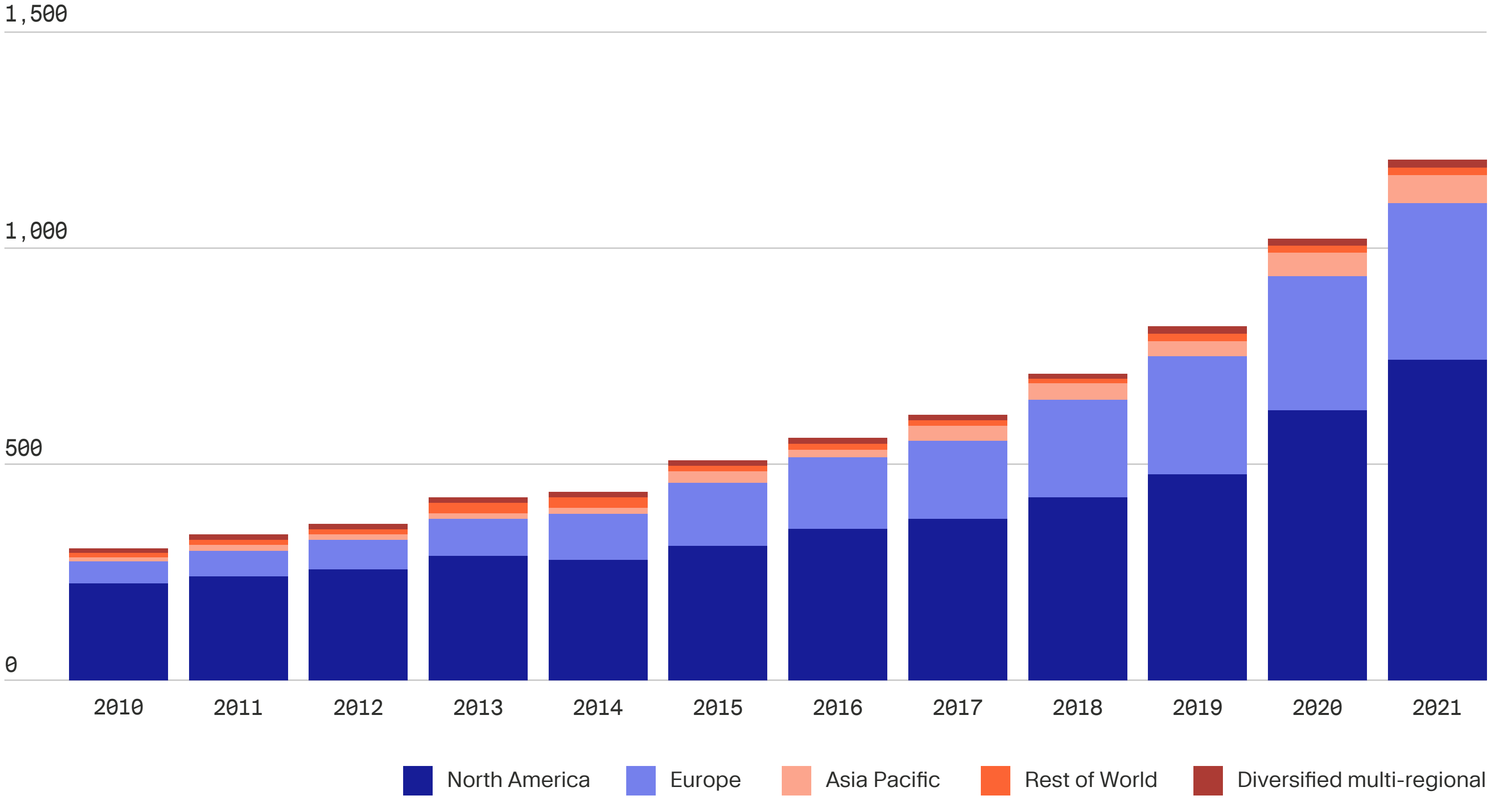
# Mapping out private credit's *enduring qualities*

## Diversification and income generation are among the key features behind credit's consistency

The story of private credit's growth is one of finding opportunity amid adversity. Following the global financial crisis, established lenders pulled back owing to increasing turbulence and regulatory oversight, leaving a gap in the market that private credit providers were all too happy to fill. According to Rice University research, banks in the US 'permanently decreased' lending relative to their other activities from 2008 to 2017.[1] Meanwhile, according to Preqin, private credit assets under management roughly doubled from 2010 to 2015, to $500 billion. Over the following five years, it doubled once again to over $1 trillion.[2] The growth is not expected to slow down either; Apollo Global Management, for example, believes the industry could grow to replace as much as $40 trillion-worth of fixed income markets.[3] What are the fundamental characteristics of debt that have fuelled this growth?

**Private credit's rapid expansion to a trillion-dollar asset class**

Private debt assets under management ($bn)




Source: Preqin, 2022

## Downside protection and diversification focus

Private credit typically sits higher in the capital structure compared with equity. As such, it can better shield investors' interest if the underlying assets are at risk of default. For example, fund managers can place more stringent monitoring requirements to detect early signs of financial distress. They can also work closely with portfolio companies to renegotiate lending agreements, help secure equity recapitalisation or provide other forms of guidance. This form of oversight and flexibility is unlikely in public markets, by contrast, where an agreement could require alignment across hundreds of investors as opposed to one.

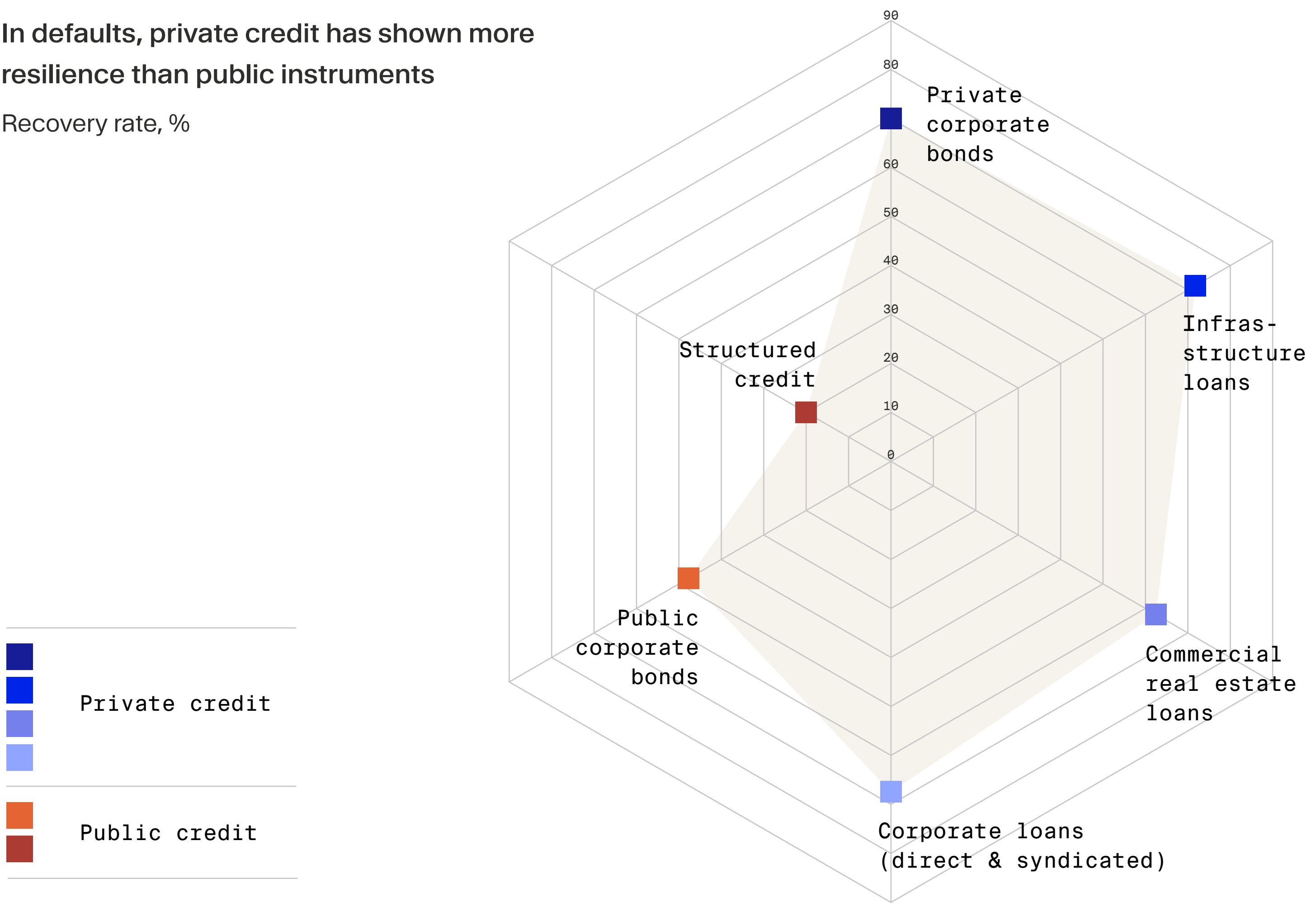
This heightened degree of active involvement could be part of the reason why private debt alternatives have demonstrated more resiliency compared with public markets. The historic default rate of private credit is around 2%, while the same rates in the high yield markets are at 3.6%.[4] Based on past data, private creditors also have had better chances to recover their money in defaults. According to research from Abrdn, recovery values for private direct loans are close to 80%, while unsecured public corporate bonds recovered 50% of par given a default. [5]

Private debt can also be a natural diversifier given its low correlation with stocks and public bonds.[6] As such, the asset class can be potentially a neat addition to a traditional 60/40 portfolio, where 60% is allocated to public equities and 40% to fixed income. Past data substantiates claims of outperformance; both private credit and private equity have outperformed global public equity and credit markets in 19 of the 20 years until 2021, according to Hamilton Lane.[7]

## Nearly 80% of private direct loans recover from defaults, compared with 50% for unsecured public corporate bonds, according to Abrdn.

**In defaults, private credit has shown more resilience than public instruments**

Recovery rate, %




Source: Abrdn, 2019

## A higher ceiling

In addition to downside protection, private credit's historical performance relative to most public debt instruments also provides a further case for the asset class. Over the last 15 years, the yield on floating-rate private loans — meaning the interest attached to a debt instrument is variable — averaged 7.2%. This contrasts favourably with the returns put up by traditional fixed income markets and only slightly below more risky high-yield corporate bonds, according to data from Trez Capital and Nuveen.[8] Similar outperformance is observed in the Cliffwater Direct Lending Index, which tracks more than 12,000 directly originated middle market loans.[9]

Meanwhile, the short to mid-term future seems equally optimistic for private credit performance. Blackrock's predicted annual return on direct lending investments currently amounts to an attractive 11.3%, ahead of all other asset classes in the ranking.[10]

Investors need to keep in mind, however, that fund manager selection has been critical in achieving above average returns in the past. A study of 448 private credit funds with vintage years between 1986 and 2018, for instance, found there was a large dispersion between top quartile funds, with an IRR of 23.3%, as compared to the bottom-quartile funds, with an IRR of −3.6%.[11]

## A key source of income generation

In most cases, credit investments can offer a predictable stream of cashflows through regular, scheduled and contracted repayments. Compared to equity, income-oriented private credit does not have to rely on earnings or growth to drive returns.

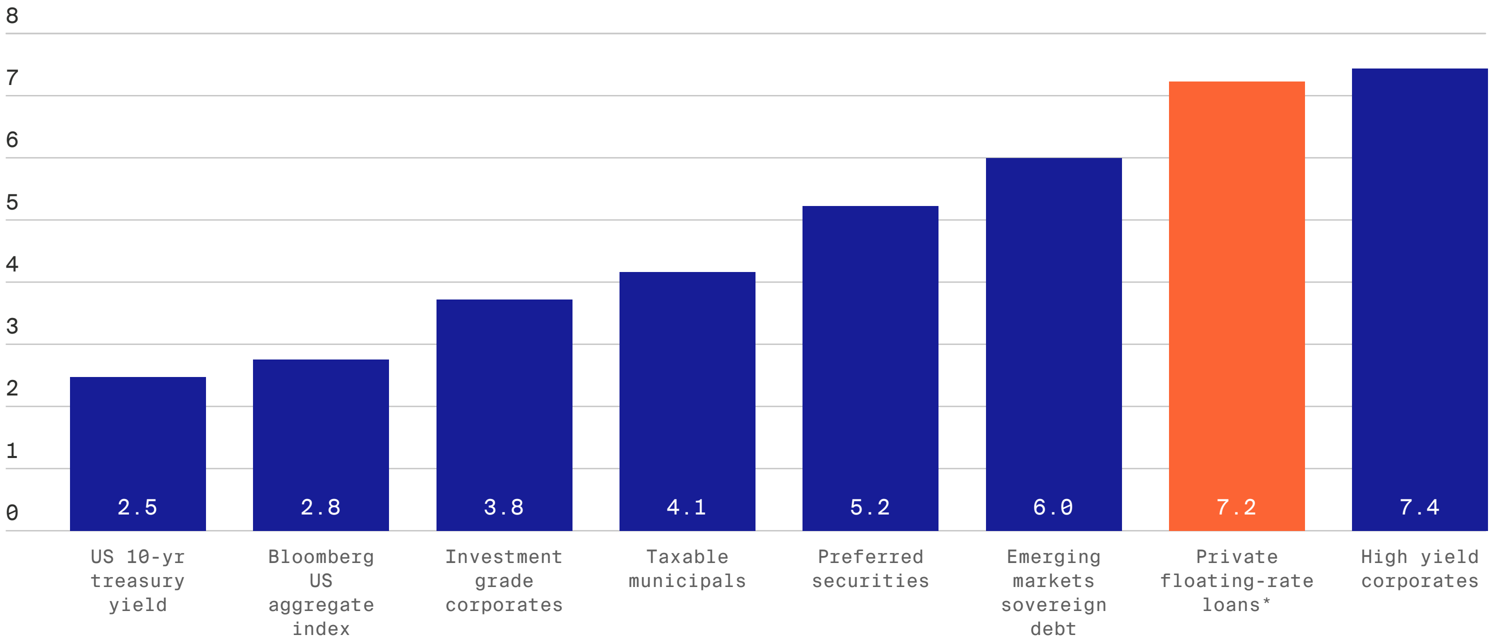
Adding these payments up annually — usually encompassing interest earned — would give us the annual net profit, known as the yield. Yield is a measurement used across fixed income assets by investors to determine what return an investor can expect each year.

For private credit, yield rates are usually higher than the income coming from traditional fixed income assets. According to Goldman Sachs, for instance, private credit generated income at a rate some 3–6% higher than public high yield and broadly syndicated loans.[12]

Private direct lending is currently expected to generate 11.3% annual return in the next five years, per BlackRock.

### The performance edge of private credit over public debt

15-year average yields (%) by selected debt instrument classes




Source: Trez Capital, Nuveen, 2022

*Floating-rate loans are represented by the S&P/LTSA Leveraged Loan Index

# How to *mitigate* five key private credit risks

Prudent investors have several tools at their disposal to overcome the asset class' hurdles.

I

## More companies are likely to default on their debts during downturns.

Fund managers can negotiate better protections and structure stronger covenants into the terms of their loans, compared to public credit, This is particularly true now given the growing demand for private solutions with public credit markets closed to many businesses.

In addition, closer relationships with portfolio companies allow private credit managers to uncover financial risks earlier, which they can further mitigate by restructuring loans anytime in their lifecycle.

II

## Interest rates are cyclical; what if they revert back down?

Mitigants include interest rate floors, hedging and debt refinancing. In addition, private credit funds typically only hold debt instruments for around two to three years before refinancing or selling them on, in comparison to private equity funds which can have holding periods of more than 10 years. This limits how sensitive the price of the debt is to spread changes. It's also important to note that, regardless of interest rate environment, the vast majority of the spread for many private credit managers is driven by company performance, not interest rates.

III

## Private credit remains an illiquid asset class.

Contractual debt repayments, typically paid every quarter, can partially ease liquidity constraints. In addition, the fund's life is usually shorter than in private equity, while a growing secondary market may offer a recourse for investors to offload investments prematurely. In 2022, the value of secondhand stakes of private debt funds hit $17 billion. At the current rate, these deals could reach $50 billion by 2026.[13]

IV

## What if a fund offers loans in multiple currencies, creating foreign exchange risk?

Many credit funds offer loans in currencies other than the one in which they are denominated. Currency risks can be mitigated with hedging programmes, restricting the fund's risk profile entirely to the ability of the borrower to repay the loan. The predictability of cash flows in a credit fund relative to private equity funds also makes hedging much easier to implement.

V

## With parameters different to PE, how are funds selected?

The success of private credit managers largely hinges on origination capacity, resources, industry expertise and the ability to source through networks. These elements can add value and are what differentiates top-tier fund managers from below-average ones.

# Credit check-in: *demystifying* the world of private credit

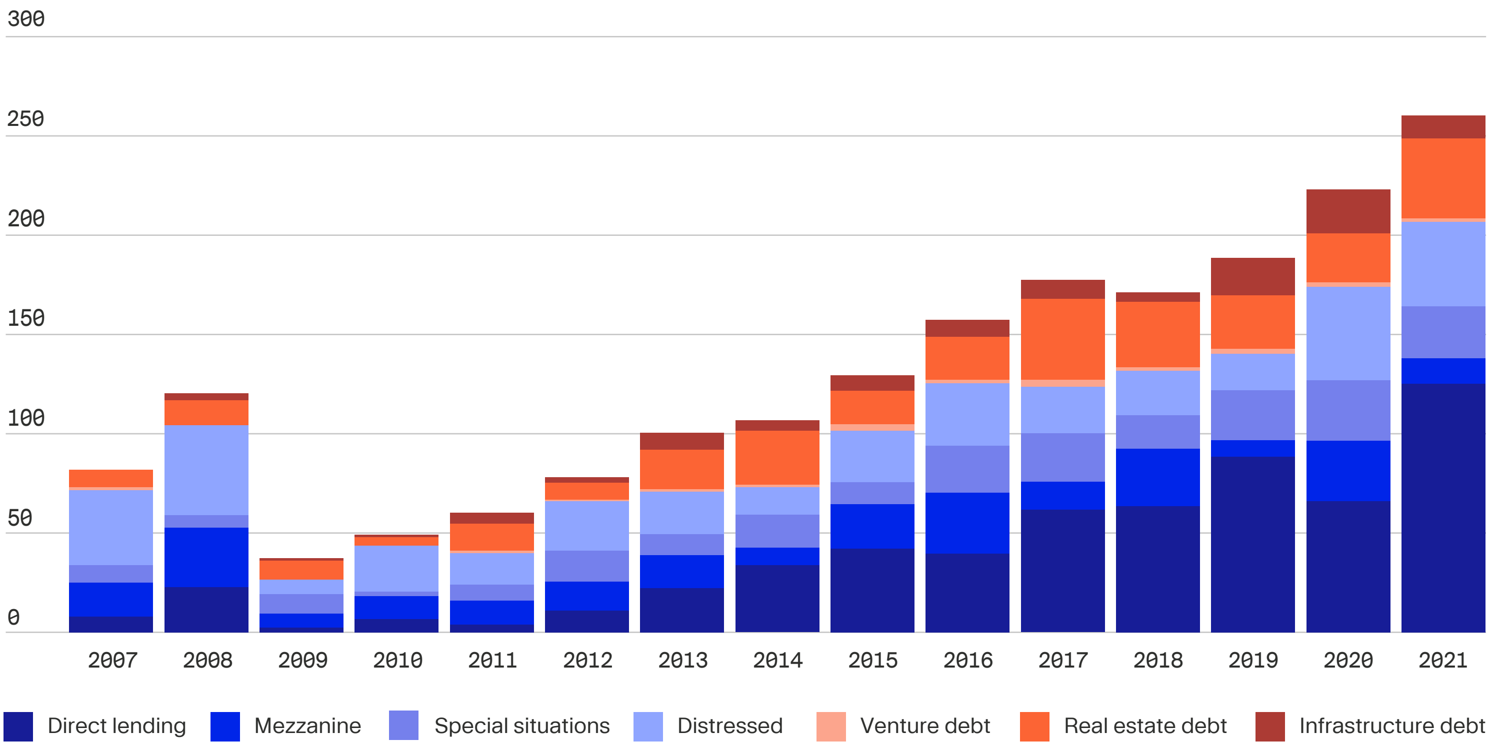
## From senior secured to preferred equity, each private credit category offers unique features in terms of seniority, risk and return

For many investors — institutional or not — coming to the private credit anew can be an uphill task in terms of understanding. While private markets in general have a learning curve, credit specifically can come across as notoriously esoteric, with terms such as 'mezzanine' and 'lien' muddying the waters. It is understandable in this context therefore that, according to our survey of family offices in 2022, nearly two thirds of respondents cited a lack of knowledge about specific asset classes as a significant barrier to private markets investing.[14]

With this in mind, we've broken down the often opaque credit world into easy to understand, bite-sized chunks, so you can approach it with confidence.

**Private credit markets have increased in complexity as well as size**

Raised funds ($bn)




Source: Goldman Sachs, Understanding Private Credit, 2022

## Public credit vs private credit

Simply put, private credit encompasses debt agreements that are originated and agreed privately between borrowers and lenders, and not subsequently traded on public markets. These loans are illiquid, but can potentially be higher yielding. Public credit, by contrast, is simply debt issued or traded on the public markets.

Banks are often associated with public lending. However, the identity of the lender doesn't define whether a credit is public or private. Banks, asset managers and even credit funds often participate in a mixture of both public and private credit arrangements. Indeed, some fund managers may use short-term public lending instruments, such as U.S. Treasury bills, as cash equivalents in the makeup of their overall fund.[15]

## How credit stacks up

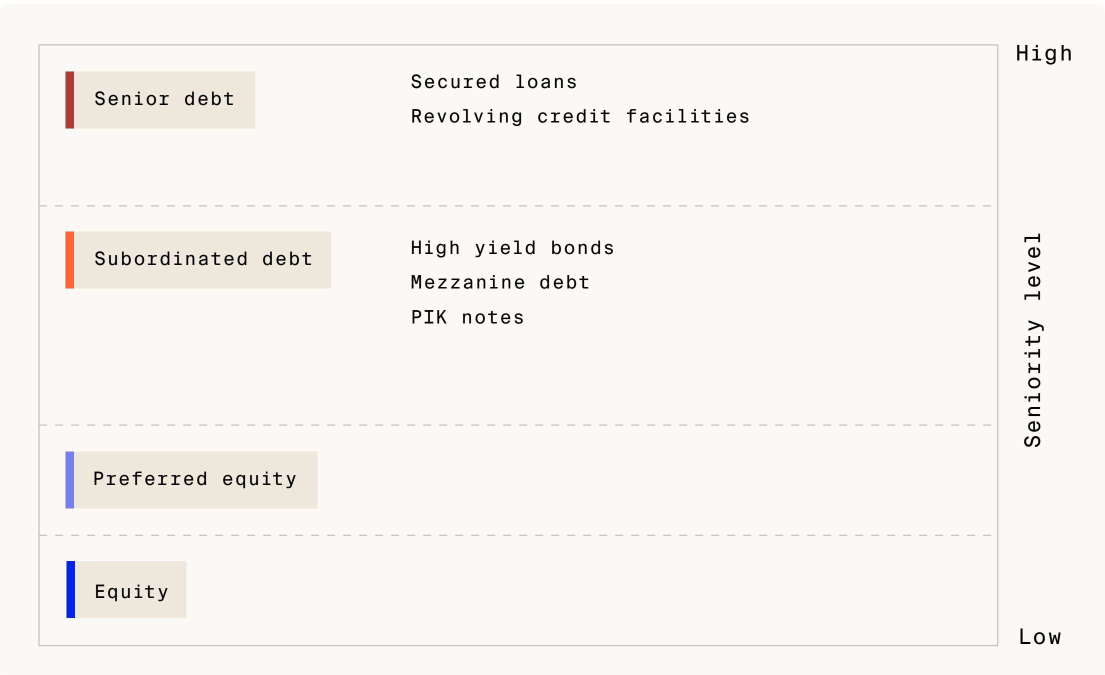
Credit can also be broken down into several more subcategories. These subcategories can determine elements such as:

- The level of protection a lender receives;
- How much influence the lender has on the borrower regarding the terms of the agreement;
- Whether the borrower has influence in the shape of board seats;
- The length of the agreement itself.

Different managers often use different terminology for what are essentially the same or similar instruments. For the sake of simplicity, we will look to get under the hood of credit by using the following overarching terms: senior, subordinated and preferred equity.

> Private credit investments are comparatively illiquid, but they can potentially be higher yielding for the investor than public assets.

### How different layers of credit fit into a typical company capital structure




Source: Moonfare, 2022

## Senior debt

Senior debt is money owed by the borrowing company that has the first claim over other types of assets when it comes to repayment. For investors, this type of debt offers less potential in terms of returns — target returns can typically range from 4%-7% per year for senior lenders, compared with up to 20% for some other credit types.[16]

However, this is to a degree offset by the greater amount of protection provided. For issuers, senior debt costs less to service than other types of credit. However, in return, the lender can pull a number of levers to make the deal more attractive for them. As well as having seniority in the capital structure — putting the lender at the front of the queue when it comes to repayments — the lender can institute a number of conditions on the borrower in return for the funding. These restrictions, known as covenants, can include borrower obligations such as maintaining a certain credit rating as well as forbidding the borrower from issuing other forms of debt. In some cases, the lender can even set limits on how much the issuer can spend outside of its core operations.

Senior lending instruments can come in several forms, including privately arranged investment-grade bonds and more general direct lending facilities. These can take the shape of direct agreements with businesses, or even deals with private equity firms and their portfolio companies to fund acquisitions or undertake refinancings. Ares Management, for example, closed approximately $2.1 billion in direct lending commitments in the first quarter of 2023, including deals with leading sponsors such as Bain Capital, New Mountain Partners and Thoma Bravo to support buyouts and existing portfolio company initiatives.[17]

Senior debt, which is at the front of the line when it comes to repayments, typically yields a 4%-7% return per year, per Connection Capital.

## Subordinated debt

Subordinated debt — also known as junior debt — covers an array of agreements that, while above equity in the pecking order of repayments, sit below senior debt in terms of repayment priority. These instruments are likely to have less restrictive covenants than senior notes. Yet by taking on this extra risk, lenders can expect to receive a higher rate of return. PitchBook, for example, notes that a typical mezzanine loan — a type of subordinated debt — issued earlier this year could yield in the range of 12.5% to 14%.[18]

These outsized returns are part of the reason why we are now seeing more institutional investors raising funds targeting the subordinated debt space. Goldman Sachs Asset Management, for example, closed its eighth mezzanine-focused fund on $15.2 billion earlier this year,[19] while Morgan Stanley is reportedly looking to collect $2 billion for its fourth dedicated junior debt fund, a size that would make it 25% larger than its predecessor vehicle.[20]

## Preferred equity

The next in line after subordinated debt is preferred equity. While not technically a form of debt, it carries several characteristics that make it a hybrid-like instrument occupying the space between debt and equity. Preferred equity holders for example, receive priority over common stock when it comes to repayments much like debt holders, and typically have limited influence over a company's governance.

Preferred equity is becoming an increasingly popular method of financing, particularly among private equity managers. On one level, issuing preferred shares in a portfolio company can provide sponsors and underlying investors access to liquidity, something particularly salient in the current depressed exit environment. In addition, these shares can allow investors and others to retain or get access to potential future upside, without the manager losing tangible control over the underlying business.

# Quickfire credit: outlining some of the more *esoteric terms* in the debt landscape

## High yield bonds

Debt instruments issued by borrowers that are deemed below a certain ratings threshold by credit rating agencies. Also known as 'junk' bonds, they carry increased risk but offer higher yields than investment grade bonds to compensate.

## Mezzanine debt

Credit issued to a borrower which comes attached with warrants or options that allow the lender the right to convert its loan into an equity stake should the borrower default.

## Unitranche

A hybrid type of loan structure that combines senior and subordinated instruments into a single obligation. The rate paid on the loan is a blend of the ones attached to the preexisting senior and subordinated loans.

## Secured notes

A form of credit that uses the borrower's assets as a form of collateral. This can include assets from property to invoices and even existing cash. The loan is therefore 'secured' against these resources.

## Payment-in-kind (PIK) notes

A bond that allows the borrower to pay interest by issuing additional debt or preferred stock. Typically used by companies looking to ease cash flow problems by reducing the need to pay interest in cash. PIK notes do not provide consistent cash income for investors as opposed to other fixed income instruments.

## Distressed debt

Debt issued by a company that is in financial distress, meaning it has an unstable capital structure. This could include companies in the middle of a bankruptcy, or companies showing signs of approaching one such as breaching covenants.

## How credit fits in for investors and borrowers

Private credit encompasses a wide array of investments, each with its own unique features in terms of seniority, risk and return. But what role does credit play in reality for businesses? And how can investors compare private credit with the wider investment universe?

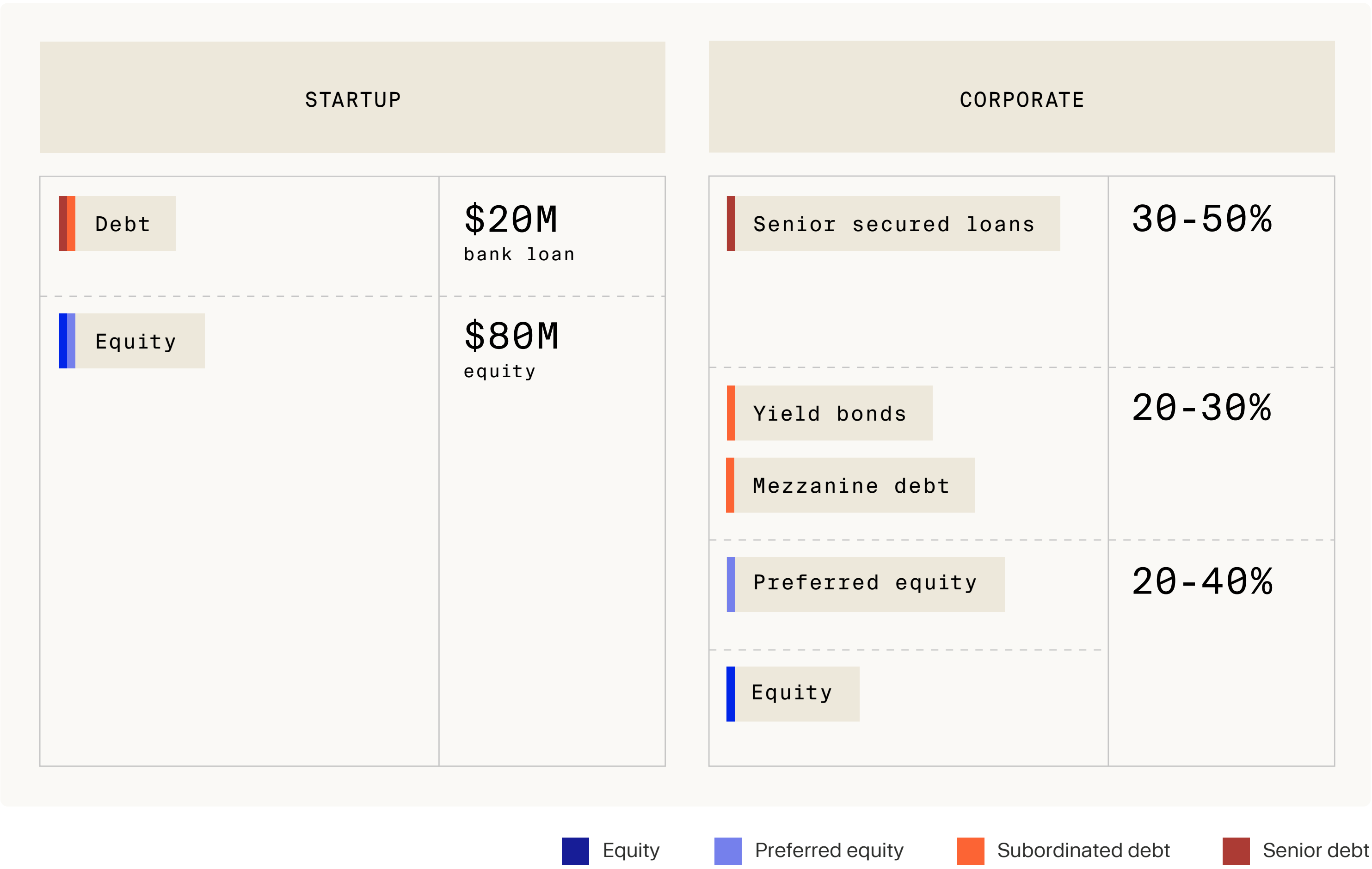
In general, credit's role increases as companies age and become more mature. If we take the overall debt and equity mix of a startup, for example — known as the startup's capital structure — it is likely that its makeup will be largely equity-based. And while credit options do exist even at the earliest stage of a company's life, these are less common, and likely very costly to service for borrowers.[21]

The lack of credit in this context is understandable given what investors typically want from debt; a steady income stream with downside protection. Early-stage startups often don't have much in the way of collateral, are often in the proof-of-concept phase, and are trying to demonstrate the viability of a product as opposed to generating revenue. The aims of the company and the needs of the investors in this case are not the best fit.The fit becomes more harmonious, however, if we look at a possible capital structure of a company at a more mature stage of development.

Once a business has scaled, started to break even and is looking ahead to milestones such as an IPO, the makeup of the capital structure will likely be more complex. As well as existing equity investors in the shape of employees, VCs and PE firms, for example, credit providers are increasingly likely to play a role in a company's story. Mexico-based unicorn Clara, for example, agreed to a $150 million credit facility with Goldman Sachs in 2022, in order to expand its infrastructure and the size of its credit lines.[22]

### Credit's role increases as companies begin to generate revenue

Capital structure of a hypothetical tech startup (left) and an illustrative corporate capital structure (right)




Source: Andreessen Horowitz, Oxford Square Capital

## The capital structure and credit in a risk-return context

We've outlined how credit fits in with other asset classes at various stages of a company lifecycle, and — in isolation — their risk in terms of repayment and seniority. However, for investors, stacking asset classes on top of each other is not a viable way of prioritising investment decisions. While risk is certainly an issue to consider, these must be counterbalanced with the potential risk-adjusted returns that could be on offer.

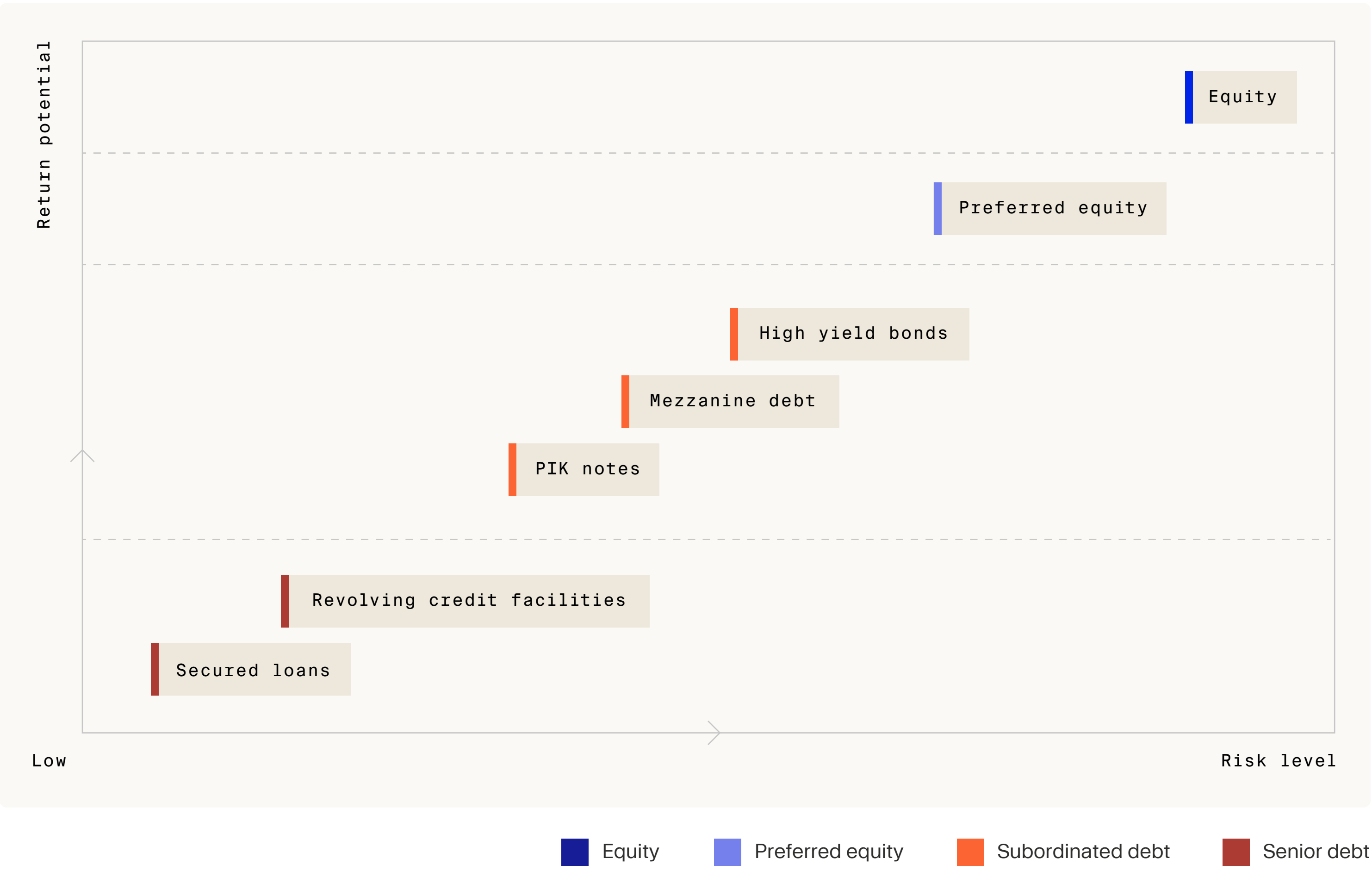
To do this, we can take the example of the more mature company's capital structure and plot this in two dimensions instead of one. While senior credit provides ample protection, this is offset by expected lower returns than other asset classes with lower repayment priority. Investors looking to explore adding credit to their portfolio therefore need to weigh up these factors in advance.

The growth in private credit has brought immense opportunity. However, understanding its complexities — from protection mechanisms, risk-return trade-offs and where it fits into a company's capital structure and strategy — is vital in order to accurately gauge how the asset class can suit them as part of a well-diversified private markets portfolio.

Investors looking to allocate to private credit need to weigh up their return appetite against their tolerance for risk.

### How credit compares across the cap structure in a risk-return context

Risk-return measure of different asset classes split across capital structure strata




Source: Moonfare, 2023

# The keys to today's *credit opportunity*

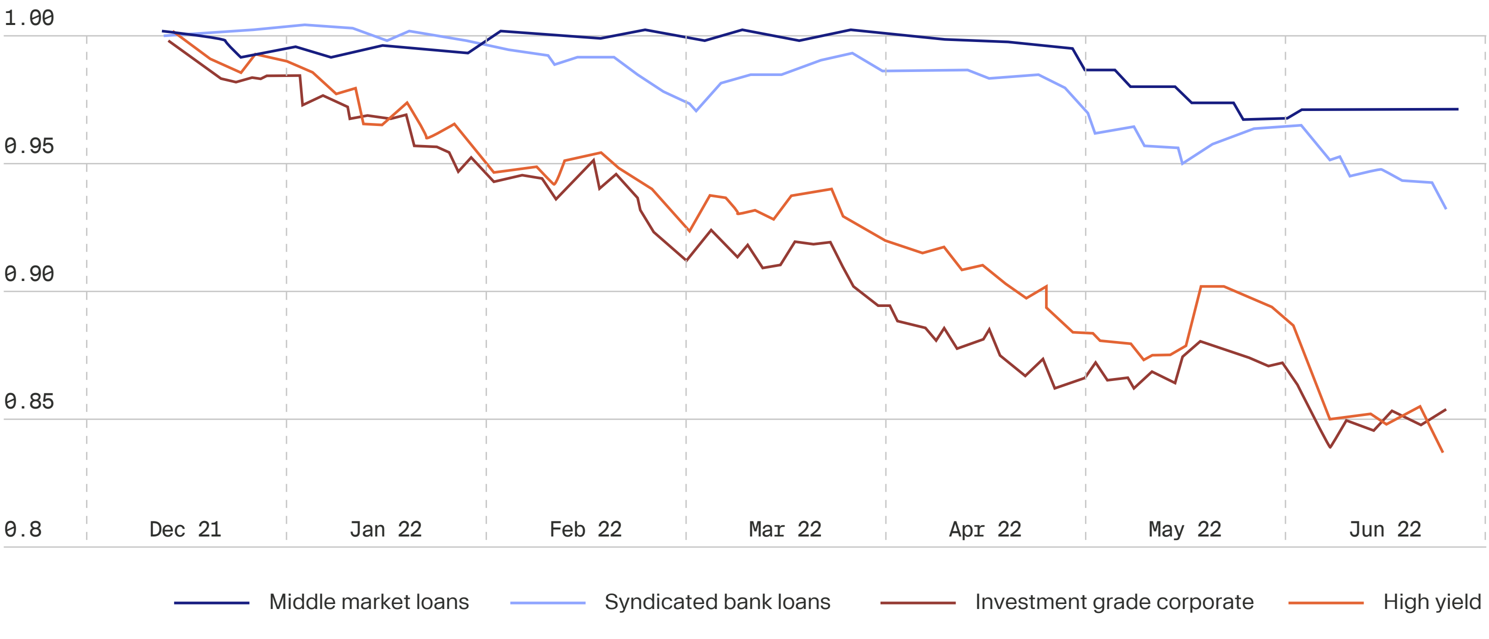
## Rising interest rates, growing demand for refinancing and bank retrenchment have provided tailwinds for private credit in 2023

The environment we find ourselves in today is markedly different to the one we found ourselves in just 18 months ago — in terms of outlook, monetary policy and inflation, among other factors. While private credit has grown significantly over the past decade, it is this change in wider macroeconomic sentiment that could propel the asset class to become a cornerstone of investor portfolios. In our view, this is down to three key drivers:

**Market volatility, bank retrenchment have shrunk traditional capital market access.** The increased uncertainty in the last 18 months has significantly impacted traditional lenders. Leveraged loan issuance in Western and Southern Europe, for example, fell by almost 40% in 2022 year on year to €183.4 billion, while high-yield bond activity was down by two thirds over the same period.[23] In what seems an echo of the aftermath of the global financial crisis, this has created an opportunity for private credit investors to fill this financing gap. However, given the turbulent economy, they can now do this on more favourable terms with tighter covenants and other borrower restrictions. (For more on the impact of covenants, see page 18). The turbulence may also boost the asset class in another way — with uncertainty leading to lower valuations and more businesses unwilling to sell for less, private credit could become one of the few options left for firms looking for capital.

**The stability of middle market loans during market volatility**

Average loan/bond price index to 100




Source: Bloomberg, ICE BofA HY Master II Index, LCD, 2022

**Rising rates grant credit investors more attractive yield prospects.** Many private credit deals are typically structured on a floating rate basis, meaning that the interest rate attached to the financing adjusts relative to a set benchmark rate. These benchmark rates, such as EURIBOR, are reference rates neither party can influence. For example, a floating rate note with a margin of 5%, and tied to EURIBOR which is trading at 3%, can be said to have a floating rate of 8%.

These rates have increased markedly in the last year as central banks tighten monetary policy. According to PitchBook, floating rates for loans on leveraged buyouts in the US almost doubled from February to September last year, from 4.8% to 9.8%. While this makes financing for the borrower more expensive, for the investor, this becomes an attractive opportunity to generate income at a higher yield. For example, income based returns across private credit reached 6.2% in 3Q 2022, higher than high yield bonds which recorded 4.2%.[24]
As a result of these forces, income generation has become the key consideration driving private markets investments in 2023, according to the BlackRock survey.[25]

This contrasts the problem public fixed income faces in this rising rate environment, with their value typically sliding as interest rates rise. Indeed, according to Blackstone, private credit significantly outperformed the Bloomberg US Aggregate Bond Index in periods when the 10-year US Treasury rate increased by 0.75%.[26]

**Growing demand for refinancing means more opportunities.** Private credit is also well positioned to offer both private equity investors and companies an avenue to refinance existing obligations.

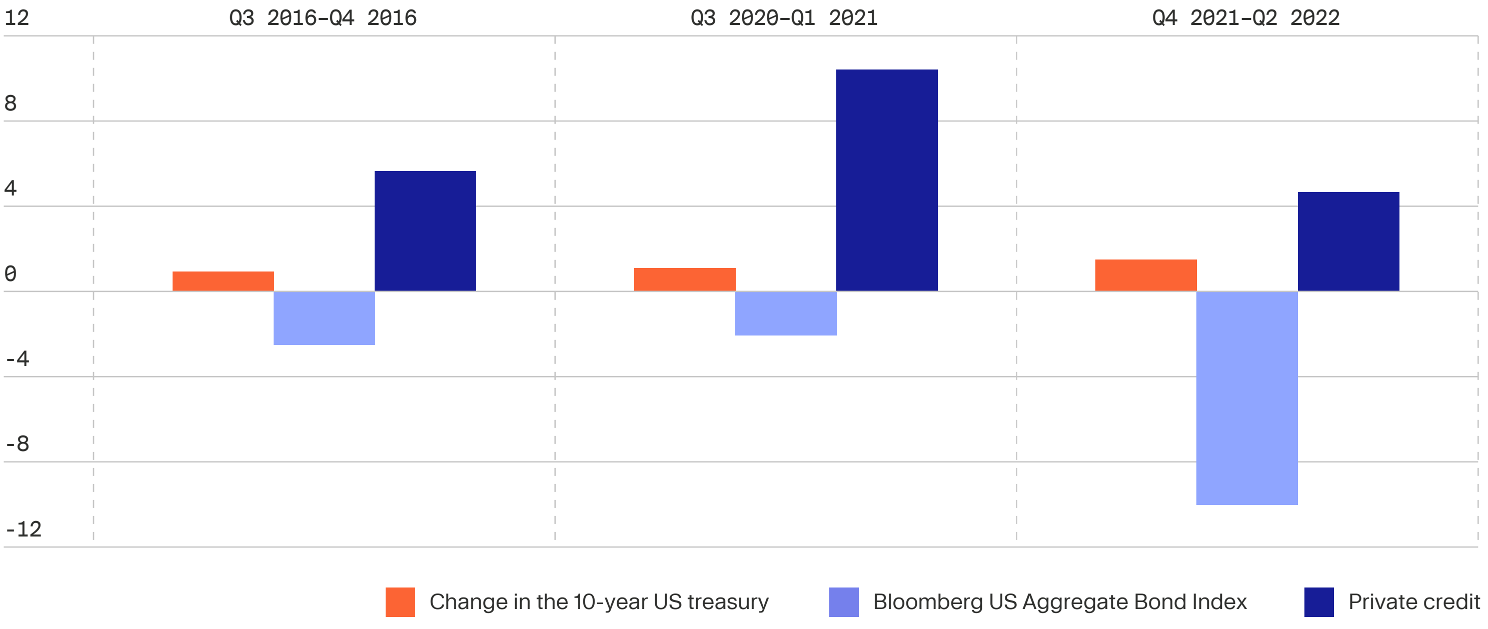
For sponsors, higher rates and lower growth is delaying potential exit paths, meaning that some private equity investors may prefer to refinance existing portfolio companies rather than sell them into a down market. For example, CVC Credit announced in May that it had supported the refinancing of KKR-backed cybersecurity company Optiv.[27] This came more than a year after KKR was reportedly exploring a sale or IPO of the business at a valuation of more than $3 billion.[28]

As recessionary forces strengthen and companies face potential defaults, there can also be growing opportunities in the distressed debt space. Managers who focus on these types of deals typically get involved in restructuring situations, rescue finance or by purchasing discounted loans. Crescent Capital and Atalaya, for example, both closed their eighth flagship special situation funds at $8 billion and $1.8 billion, respectively.[29,30]

6.2% was the income based return across private credit in 3Q 2022, while high yield bonds recorded 4.2%, according to MV Credit.

### When interest rates rise, private credit returns move in lockstep

Returns when 10-Year US Treasury increase by 0.75%+




Source: Blackstone, 2022

# The mark of the covenant: why *the balance of power* has shifted to lenders

The free lunch that borrowers have enjoyed for the last 15 years is over.

Companies issuing loans and bonds during that time frame were able to enjoy historically cheap financing conditions, thanks to interest rates remaining rooted to the floor—and in some cases, below zero—since the global financial crisis. The intention, as what came to pass, was to stimulate more borrowing in order to facilitate recovery and eventual growth.

However, among corporate borrowers and lenders, this created a mismatch between the demand for loans and their supply. This imbalance meant that many lenders were forced to cede ground on their covenants, or other protections, in order to get any deals done. Indeed, according to Bank of England data, loans with watered-down investor protections—known as 'covenant lite' loans—made up more than 60% of global dealflow a full decade after the crisis.[31]

The negotiating power has shifted into the hands of lenders, as many borrowers have lost flexibility when trying to refinance existing debt.

Now however, the tables have turned. Rising interest rates are putting increasing pressure on borrowers' ability to honour existing commitments. According to the Lincoln Senior Debt Index, for instance, covenant defaults on private loans ticked up to 4.5% in the first three months of 2023, compared with 4.2% in the previous quarter. Ratings agency Moody's, meanwhile, expects the global corporate default rate to peak at 4.6% in 2024.[32]

Facing this pressure, many borrowers are realising that they do not have time to sit and wait for a better environment to refinance in, given the risk of defaulting and what that could do to their future borrowing costs.
Instead, many are opting to refinance existing obligations, placing the negotiating power firmly in the lender's hands given the lack of flexibility many borrowers now have. In turn, this is leading to many new deals being struck with increasingly lender-friendly terms. Investment manager Federated Hermes, for example, has noted a recent uptick in overall high-yield bond covenant quality, and highlighted a recent refinancing transaction that the lender was able to successfully negotiate 11 covenant changes in its favour.[33]

Senior debt managers are becoming increasingly active in this environment, looking to lock in lender-friendly terms after more than a decade of having to acquiesce to fewer protections than usual. In this context, the asset class could become a significant opportunity for investors looking for steady returns with significant downside protection.

# Why credit could be due for *sustained appeal*

## Navigating the risks will be tricky for investors, but the factors are in place that could set up private credit for success in the long term

*By Victoria James, Investment Manager, Moonfare*

With traditional stock and bond portfolios no longer naturally self diversifying in the current economy, investors and fund managers alike have been keen to find alternative assets that can act as a bulwark in an environment with stubbornly high inflation and interest rates. This journey has led many to explore the role private markets can play in this context — and in particular private credit.

This interest has shone a welcome light on an often overlooked asset class and its benefits across different market environments. Yet while these plusses are currently amplified, it's crucial to be aware of the potential headwinds that could emerge as we navigate this turbulence. Once these headwinds are mitigated, investors could be on the path to benefit from an asset class underpinned by promising fundamentals.

# Private credit investors are likely to remain well rewarded in the medium term for the risk they are taking on, in addition to the illiquidity premium they can expect to receive relative to public market debt.

## Recognise the risks

Credit's sensitivity to interest rate changes and the risk of the debt defaults are well-known headwinds that come with the territory for the asset class. However, the rapid growth in private credit markets also presents another, more holistic challenge — who do you allocate capital to in a market that, relative to private equity, does not have as many well-known or publicised managers at a global level? According to Preqin, there are around 4,000 managers actively investing in private debt.[34] By contrast, by mid 2021, the combined number of private equity and venture capital funds stood at almost 20,000.[35]

Accepting, assessing and understanding these risks is crucial to make most of private credit. Regarding interest rate risk, investors should be aware of the different levers they may be able to pull in order to mitigate them. These can include, as we have explored, gaining seniority in the capital structure through the debt, employing agreed upon interest rate floors to limit borrowing cost changes, and adding protections such as covenants into loan agreements to make them more investor friendly.

Transaction underwriting and structuring are also a key consideration, given the returns generated by credit funds tend not to vary as much as private equity funds. Identifying the right credit manager, meanwhile, requires further nuance. Considerations will mirror many of those that go into choosing any private fund, such as track record, expertise, strong governance and market reputation. However, given credit markets are less congested than private equity markets, it's also important to think about a manager's ability to position itself in a less-crowded area, while retaining a focus on deal quality.

At Moonfare, our dedicated investment team leverages technical expertise and long-standing GP relationships to ensure that the private market opportunities available to our community come from fully vetted, top-tier managers.

## What's behind credit's long-term potential

Navigating these possible headwinds could be key to making the most of the private credit opportunity, one which could be here to stay for the foreseeable future. Here's why:

***Private credit could benefit from banks' continued de-risking.*** The retrenchment of banks is creating a gap in the lending market that is likely to stay — and potentially grow further — as these institutions prioritise deleveraging and risk mitigation. This has created an opportunity for private credit funds to step in and provide borrowers with bespoke and more flexible solutions than can be provided by banking institutions, which need to adhere to stricter regulatory requirements as to how much risk they are allowed to take on. As this type of financing becomes embedded in the system, we could see the asset class evolve from initially being seen as a homogeneous source of capital, to a way for businesses and lenders to build long-term financing partnerships.

***Lingering uncertainty could drive ongoing asset class demand.*** The continued market volatility and search for yield is likely to drive investors toward private credit. Investors are likely to remain well rewarded for the risk they are taking on, in addition to the illiquidity premium they can expect to receive relative to public market debt.

***Opportunities for investors across the risk/return spectrum.*** The highly varied credit landscape provides a vast range of opportunities to suit many different risk appetites and return profiles. These can provide investors with different priorities with a means to add diversification, downside protection and in some cases non-cyclical additions to their portfolios.

## Endnotes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