The Evolution of Private Credit

Institutional investors faced with the growing challenges in Private Credit are turning more and more to investment solutions businesses to construct portfolios with favourable forward looking risk-adjusted returns.

Investors in traditional types of liquid income strategies are increasingly concerned about expensive valuations, low income, rising interest rates and signs that the credit cycle has entered its late stages. Many institutional investors have taken the view that private credit offers some degree of insulation against these dynamics. To date, institutional investors have typically implemented this view by allocating to "middle market" lending strategies within growth or liability matching portfolios.

In the benign default environment since the global financial crisis, these strategies have seen strong returns and low default rates. Looking ahead, we can see two important dynamics playing out which imply that investors may have to use more creative solutions to generate attractive risk adjusted returns from private credit.

1) A trend towards increasing risks and diminishing returns

Banks have undoubtedly retrenched from "middle market" lending. Most private credit managers sell their strategy based on this story. What they don't mention is that so much money has flooded into the private space that access to capital from a borrower's perspective is just as easy today as it was before the global financial crisis. In fact, there is so much money being put to work by private investors that pricing is coming under pressure and expected returns are being maintained by stepping down the capital structure, reducing credit quality, relaxing lending terms and/or using more fund level leverage.

2) Beta-like returns

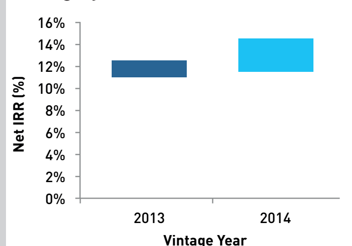
Credit investors are not rock stars. The upside is known at the start of any investment (par + coupon) and so is the downside (zero in the event of default and no recovery). It is therefore unsurprising that managers who follow the same vanilla "middle market" lending strategies and have good credit underwriting have a low dispersion of outcomes, even across a full cycle. This minimises the value added by manager research in what has become a commoditised space.

As a result of both of these dynamics, institutional investors are increasingly looking to investment solutions providers to build private credit portfolios which spend illiquidity budgets in more thoughtful ways to generate income from more attractive areas of the market. Below are some of the solutions the Portfolio Solutions Group at Morgan Stanley Investment Management has been discussing with their clients.

Accessing liquid core "middle market" lending

Business Development Companies ("BDCs") offer investors a liquid proxy for core "middle market" lending. At their most basic, BDCs are private credit funds with their equity listed on an exchange. Their underlying asset allocation closely mirrors the structure of the "middle market" and a diversified portfolio of BDCs would represent a way for investors to capture the beta of "middle market" lending and achieve a current yield of approximately 9%. However, because BDCs are listed equities, they show relatively high volatilities so are most relevant for investors who cannot accept illiquidity, which makes the volatility a more acceptable trade-off.

Figure 1: IRR ranges for US Middle market Direct Lending funds by vintage year



Source: Preqin, Data has been controlled for vintage year, strategy and geography. Vintage year peer groups before 2013 are so small that sample sizes are not meaningful. Vintage years after 2014 do not have IRRs available on Preqin as of the date of analysis. Data as at 31 December 2016.

Figure 2: Market Structure of "middle market" lending and BDCs

	Core "middle market" lending strategies[1]	BDCs[2]
Direct Lending	40-60%	55%
Mezzanine Debt	20-30%	30%
Equity and Other	10-20%	15%

Sources:
1. MSIM market survey of Direct Lending managers. Data as at end May 2017
2. Cliffwater Direct Lending Index for underlying Securities. Data as at end March 2017

Figure 3: The Evolution of Private Credit Since the Global Financial Crisis (GFC)

Desirable Attributes	Post – GFC Core "middle market" Lending	Today Core "middle market" Lending	Specialist Private Credit
Senior secured	✔	X	✔
Floating rate income	✔	✔	✔
Lender friendly terms	✔	X	✔
Default remote structures	X	X	✔
Prudent use of fund leverage	✔	X	✔
Low correlation with traditional assets	X	X	✔

Source: MSIM market survey of Private Credit managers. Data as at end May 2017.

Lending into capital constrained markets to increase risk-adjusted return expectations

Explaining why capital-constrained credit markets are attractive is a simple matter of supply and demand. If demand for credit is high and supply is low, suppliers can command higher prices and earn higher returns. According to recent press reports *(e.g. "Debt funds seeing pricing pressure on excess capital", Private Debt Investor, 13 March 2017)*, supply and demand is almost evenly matched in "middle market" lending, as described above. At the extreme ends of the market (large and small cap), there is less money put to work (i.e. the supply / demand gap is wider). Lenders, therefore, can charge premium pricing which allows them to generate higher returns without using as much subordination or leverage whilst also using tighter terms.

Specialist types of private credit markets are even more capital constrained. This is due typically to their complexity and the required underwriting skill set. Exploiting the supply and demand imbalances of these markets may offer higher returns without necessarily higher risks when compared to core "middle market" lending strategies. Investors can potentially achieve up to an additional 500bps of total return by moving from "core" to "specialist" strategies which generally have a low cross correlation with one another and with traditional asset classes.

However, there is no such thing as a free lunch. These favourable attributes are achieved via alternative risk premiums. Due dilligencing these strategies is more intensive and it is becoming increasingly more complex to capture the desireable characteristics of a private credit portfolio.

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