AUSTRALIAN INVESTMENT COUNCIL

PRIVATE CREDIT

The voice of private capital

PRIVATE CAPITAL SERIES

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THE AUSTRALIAN INVESTMENT COUNCIL IS COMMITTED TO CREATING A BROAD AWARENESS OF THE PRIVATE CAPITAL INDUSTRY AND THE CONTRIBUTION IT MAKES TO THE GROWTH OF BUSINESSES AND THE NATIONAL ECONOMY.

Alongside private equity and venture capital, private credit forms an important part of Australia's private capital sector and is a rapidly growing asset class. The information set out below provides an introduction to private credit for those who are new to the industry and demonstrates how private credit operates within the private capital ecosystem.

01

WHAT IS PRIVATE CREDIT?

Private credit – also referred to as private debt and private lending – is an important alternative form of finance for private capital investment and for small to medium-sized businesses. It is not publicly traded and includes any credit held by, or extended to, privately held companies taking the form of loans, bonds, notes or private securitisation issues.

Private credit mostly involves non-bank institutions such as specialised credit managers, insurance and asset managers, superannuation funds and Family Offices making loans to private companies or buying those loans on the secondary market.[1]

Private credit providers often work alongside traditional banks in situations where the loan is too large for one bank to underwrite. In addition, private lending is used where traditional bank lending may not be accessible such as where there are complex business structures in need of bridging finance, where start-up or fast growth companies have difficulty borrowing from established banks or where companies are restructuring.

It is also used to finance real estate and development activities, infrastructure projects, trade finance and other forms of credit that may require bespoke expertise and flexible capital.

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02

PRIVATE CREDIT RISK/RETURN SPECTRUM

There is a range of private credit providers willing to lend at different risk and return levels. Funding can be sourced through a variety of options such as senior direct lending and/or unitranche focused funds, mezzanine debt, real estate and infrastructure funds, distressed debt and special situations/opportunistic credit funds. In addition to paying back the full sum of the loan in the future, the company that borrows the funds must also pay interest during the term of the loan to the lending institution.

03

PRIVATE CREDIT INVESTMENTS

Investments by specialist private credit funds generally focus on small and medium-size businesses that are not large enough to access the public debt/credit markets. However, with the growth of private credit funding and continued pull-back in corporate lending by banks across the globe, large private equity-owned companies are increasingly funding their debt from private credit providers rather than the public markets. Alongside corporate private lending specialist funds, insurers and asset managers are also part of the private credit ecosystem. They provide additional private credit expertise in areas such as real estate development and infrastructure projects along with investment into distressed company debt, mortgage pools, and consumer finance.

[1] What is Private Debt, Pitchbook, February 2020.

SOURCES OF FUNDING

SENIOR DIRECT LENDING

Direct lending funds provide loans to mid-market companies. The lenders raise capital directly from investors to fund a portion of the loan in a syndication or to fund the entirety of the loan with little or no syndication to the institutional loan market. The loans are held in a General Partner/Limited Partner style investment fund by the lender. They are typically illiquid, senior secured loans with a range of maturities between 3-7 years and with floating coupon rates.

MEZZANINE FINANCING

Mezzanine financing bridges the gap between debt and equity that gives the lender the right to convert an equity interest in the company if there is a payment default. This form of financing is commonly used by larger, more established companies to fund growth projects and to expand their businesses.

DISTRESSED DEBT

Distressed debt refers to bonds bought from companies experiencing cash flow issues. These bonds are usually bought at a significantly discounted rate and investors in a company's distressed debt will often end up with some control of the business. Distressed debt investors aim to ensure the businesses they invest into remain viable and have the potential for future growth.

SPECIAL SITUATIONS

Special situations investors rely on a one-time, atypical event with the potential to materially impact a company's value either positively or negatively. This type of investing can stem from companies undergoing divestments, mergers and acquisitions, liquidations, restructures, share buy-backs, rights offerings and major legal cases.

VENTURE DEBT

This type of financing is generally used by start-up companies. Investors are compensated with the company's warrants on common equity as start-ups generally do not own enough assets to provide collateral. Venture debt is usually provided to start-ups that have already successfully completed several fundraising rounds but do not have sufficient cash flows to obtain conventional loans.

PRIVATE CAPITAL INVESTMENT CAN INVOLVE A BROAD RANGE OF DIFFERENT ACTIVE MANAGEMENT STRATEGIES, ENCOMPASSING EQUITY AND DEBT INVESTMENT INTO SMALL, NEW AND INNOVATIVE BUSINESSES, THROUGH TO UNLISTED FAMILY BUSINESSES AND BUYOUTS OF LARGE LISTED CORPORATIONS.

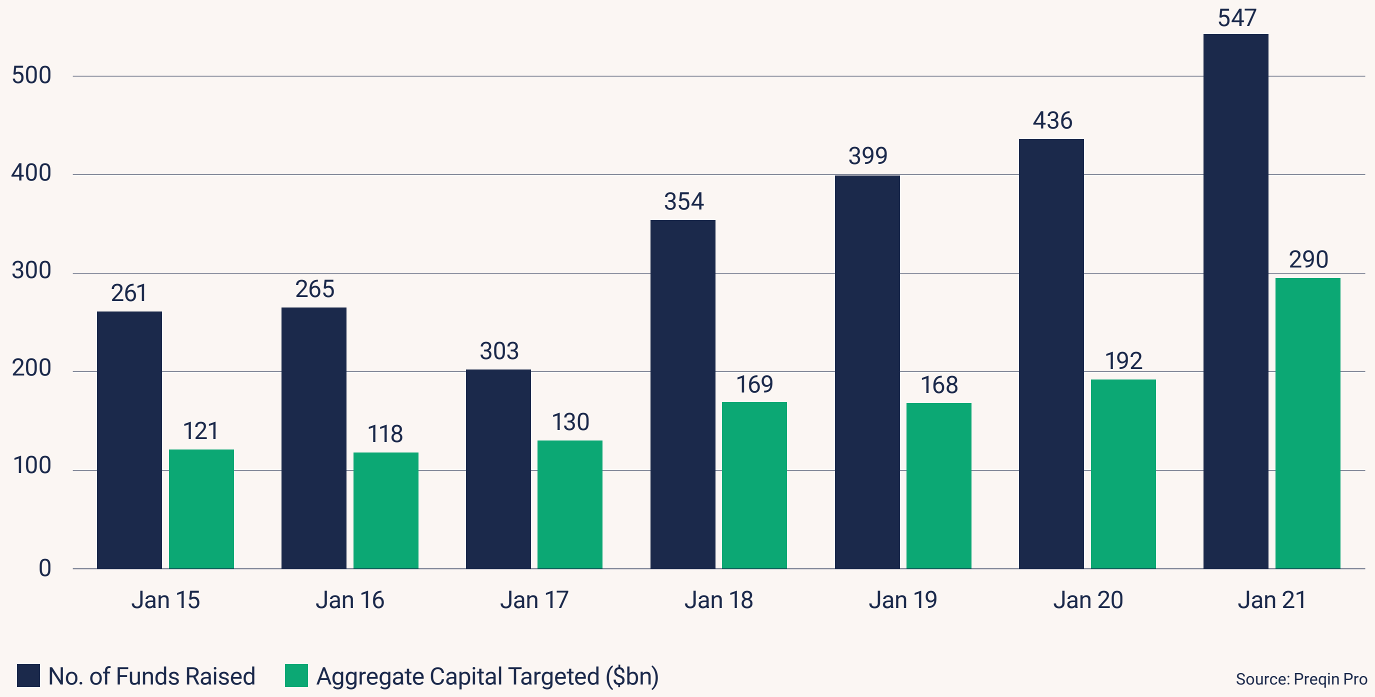
THE GROWTH OF PRIVATE CREDIT

The increased demand for alternative lending structures was catalysed by the global financial crisis. Tighter regulations on banks created demand for private credit as an alternative source of finance from sectors of the market seeking more flexible capital.

This has been particularly relevant to private equity and corporate markets which have increasingly turned to private credit financing for mergers and acquisitions, leveraged buyouts, recapitalisations and corporate restructurings that underpin many private equity and corporate strategies.

In these types of deals, the ability of a lender to manage complex credit structures, while also providing flexible solutions and acting with speed is in line with the needs of private equity firms. Given these factors, private credit managers are well-placed to continue to grow alongside the private equity industry as the lenders of choice. This has also extended to the non-private equity sponsored corporate deals as business lending from traditional sources has declined due to increased capital requirements placed on banks by the regulators.

FIG. 01 PRIVATE CREDIT FUNDS IN THE GLOBAL MARKET, 2015 — 2021[2]



Source: Preqin Pro

THE ABILITY OF A LENDER TO MANAGE COMPLEX CREDIT STRUCTURES, WHILE ALSO PROVIDING FLEXIBLE SOLUTIONS AND ACTING WITH SPEED IS IN LINE WITH THE NEEDS OF PRIVATE EQUITY FIRMS.

The data in Fig 1[2] shows that globally, the number of private funds has continued to grow in recent years, reflecting increasing demand for the flexibility that this form of finance offers to private markets.

[2] *Preqin Global Private Debt Report*, February 2021

PRIVATE CREDIT INVESTMENT STRATEGIES[3]

The main private credit investment strategies are capital preservation and return maximisation.

01 INCOME AND CAPITAL PRESERVATION

This strategy includes sponsor-focused senior debt and mezzanine funds as well as real estate or infrastructure focused debt funds, which seek to deliver predictable returns while protecting against losses.

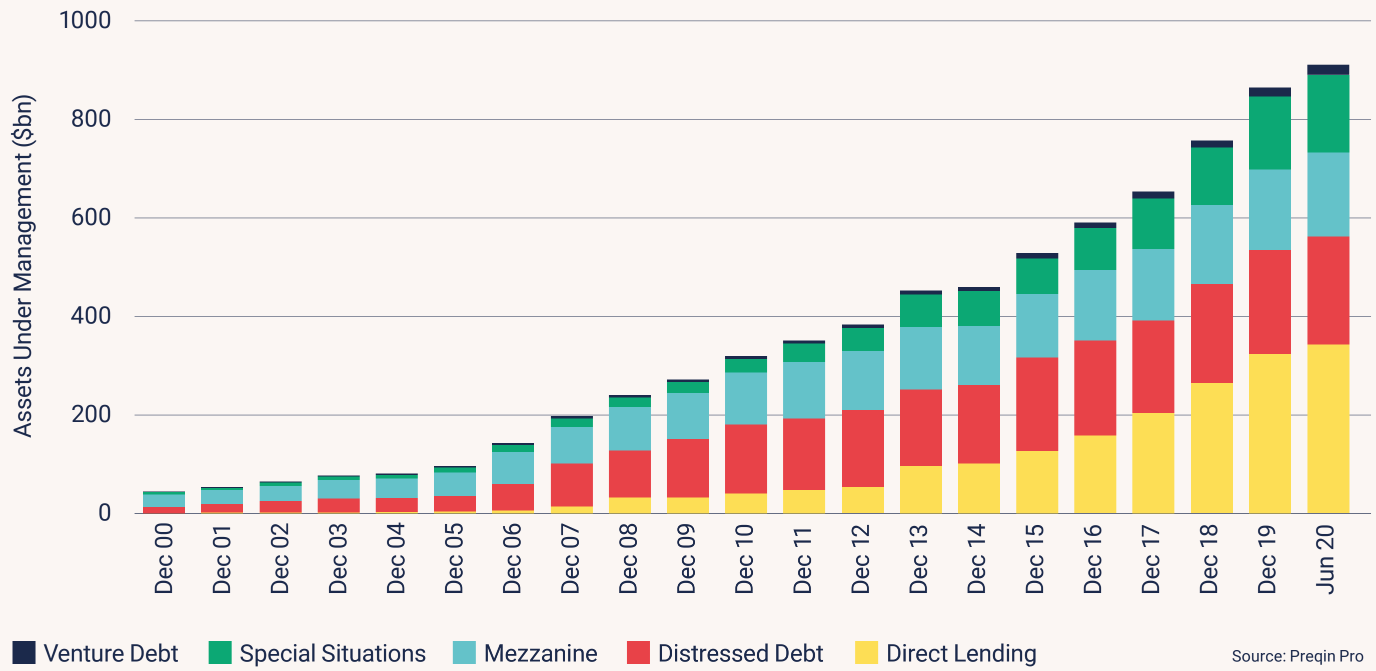
02 RETURN MAXIMISATION

This includes distressed corporate credit funds and opportunistic credit funds that focus on capital appreciation.

Strategies that don't easily fall into one of these categories are more niche/specialty strategies, such as aviation finance, health care royalties and peer to peer consumer lending.

Private credit has experienced continued growth over the past 20 years. In 2020, there were US $887 billion in Assets Under Management (AUM) for private credit on a global basis. Direct lending was the most prevalent asset in this class accounting for US $333 billion. Private credit continues to grow year-on-year and now comprises 12% of private capital AUM across the globe.[4]

FIG. 02 GLOBAL PRIVATE CREDIT ASSETS UNDER MANAGEMENT BY FUND TYPE, 2000 — 2020



Source: Preqin Pro

[3] Private Credit Strategies: An Introduction, Cambridge Associates September 2017
[4] Preqin Global Private Debt Report, February 2021

PRIVATE CREDIT IN AUSTRALIA

Private credit has been fast gathering momentum in Australia. Alternative lenders, drawn to the potential for attractive risk-adjusted returns and a reliable income stream, are expanding into segments of the private credit that was once the territory of banks.

Since the global financial crisis, a range of measures implemented by the Australian Prudential Regulation Authority have changed the playing field for private credit. Previously, the 'Major Banks' dominated the Australian credit space, accompanied by several foreign banks, institutions and accredited investors.

This has been further exacerbated in recent years where market conditions have been more favourable to equity investment over corporate bonds. As a result, traditional bank lending to small and medium-sized businesses has contracted, opening up opportunities for private lending.

The Reserve Bank of Australia has estimated the private credit market is worth $2.8 trillion.[5]

A further analysis estimates that 15% of loans to SME and middle-market businesses are provided by non-banks.[5]

This shift to non-bank lenders is expected to continue in the short to medium-term. While private credit transactions are predominantly through senior loans, Australia is experiencing a growth in the secondary market which provides another avenue of investment opportunity to build diversification, manage portfolio allocations and enhance returns.

PRIVATE CREDIT PROVIDES

15%

OF SME AND MIDDLE-MARKET LOANS

THIS SHIFT TO NON-BANK LENDERS IS EXPECTED TO CONTINUE IN THE SHORT TO MEDIUM-TERM. WHILE PRIVATE CREDIT TRANSACTIONS ARE PREDOMINANTLY THROUGH SENIOR LOANS, AUSTRALIA IS EXPERIENCING A GROWTH IN THE SECONDARY MARKET.

[5] *Private Debt Overview, Causeway Partners,* May 2019

ABOUT THE AUSTRALIAN INVESTMENT COUNCIL

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The Australian Investment Council is the voice of private capital in Australia.

Private capital investment has played a central role in the growth and expansion of thousands of businesses, which when combined represents a multi-billion-dollar contribution to the Australian economy.

Our members are the standard-bearers of professional investment and include: private equity, venture capital and private credit funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers.

FOR FURTHER INFORMATION

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