DECALIA PRIVATE MARKETS

PRIVATE MARKETS **FOCUS**

Please see appendix at the end of this document for information on sources, important disclosures and disclaimers

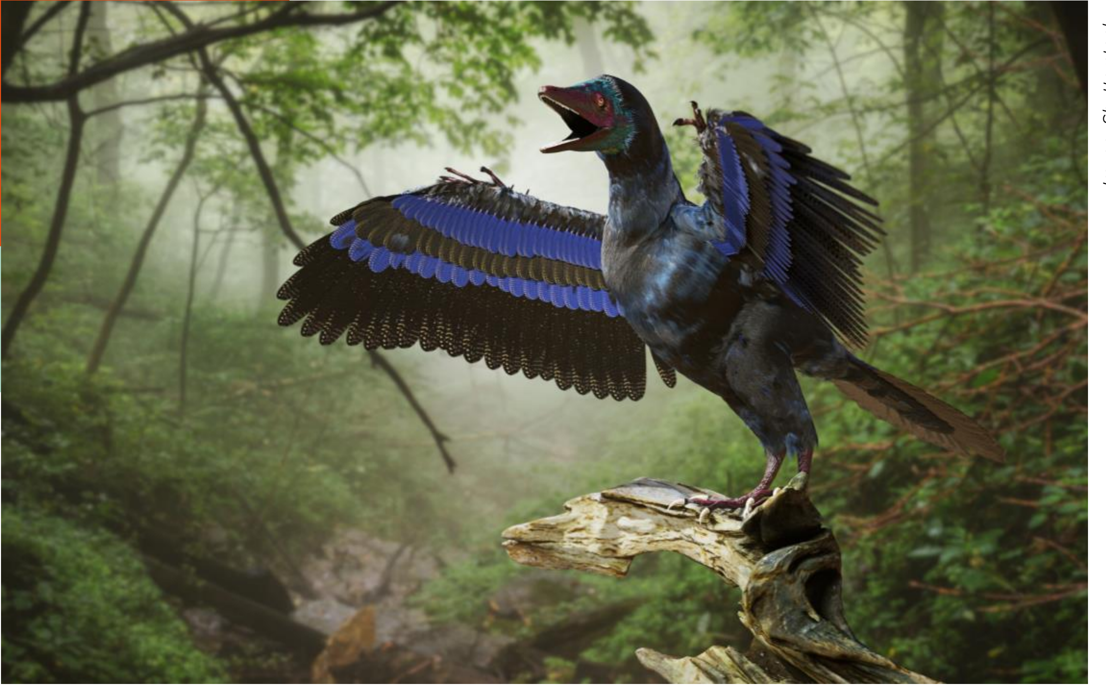


Image: Shutterstock

OCTOBER 2024

EVOLUTION IN PRIVATE CREDIT'S GOLDEN AGE

Reji Vettasseri. Lead Portfolio Manager of DECALIA Private Credit Strategies

GOLDEN MOMENTS, AGES AND ERAS

- High rates and the retreat of the banks → a private credit golden age
- As monetary policy shifts, selectivity is needed to capture all benefits

THE "DINOSAURS" VS. THE "BIRDS"

- The golden age allowed the rapid growth of giant private credit "dinosaurs"
- Specialised credit "birds" are better evolved for current conditions

SWIFTER, NIMBLER AND ABLE TO FLY

- Strategies with strong deal flow can deploy fast while base rates are high
- Smaller, nimbler approaches target dislocated and less competitive niches
- Specialist structuring can give upside exposure to the benefits of falling rates

EVOLUTION IN THE GOLDEN AGE

IN THE AGE OF THE "DINOSAURS", LOOK OUT FOR THE "BIRDS"

Golden Moments, Ages and Eras

In early 2023, Blackstone's Jon Grey claimed private credit was in a "**golden moment**". Others soon started talking of a **"golden age"**. And, not to be outdone, by year end, Blackstone execs were back in a viral Christmas video, bopping to the song "It's the **Alternatives Era**".

The golden age thesis is simple. **High interest rates and reduced competition from traditional lenders** have enabled a jump in private debt returns. Indeed, Preqin data shows private credit has been the **best performing private markets asset class this decade**, with a 15.8% IRR (vs. 12.8% for PE).

But, as monetary policy shifts again, is this a "moment", an "age" or an "era"? The answer varies by specific strategy.

The maturing phase of a golden age can be the most exciting of all. **Better credit vintages often originate when rates are high and exit as they fall.** If contractual returns are locked in at inception, falling rates only support early refinancing (with pre-payment penalties) and boost upside from features such as warrants.

There is still time to take advantage. Rates are set to fall only gradually. Moreover, while bond traders at their Bloomberg terminals react with electric speed to ECB decisions, private credit deals gestate slowly. Terms can take **as much as six months to fully react to central bank moves**.

And, the **secular case for private debt is as strong as ever**. Rates are not headed back to zero any time soon. Private credit is structurally well-positioned to take share over the long term.

Yet, selectivity is becoming key. We see an **evolving divergence between the large cap private credit "dinosaurs"**, forced into commodity business in order to grow, **and smaller**, **specialised firms (the "birds")**, who are adapted to thrive in changing conditions.

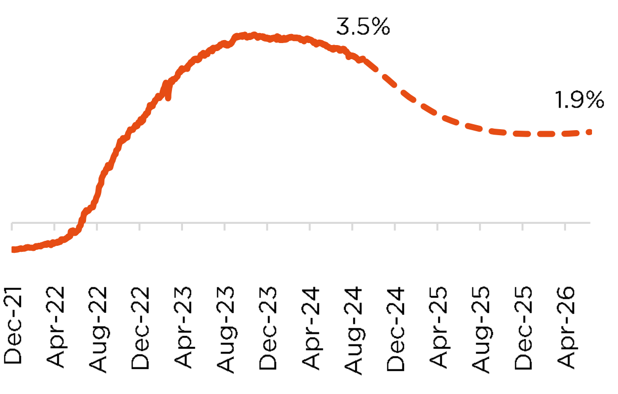
Specifically, we believe the key features of those still basking in a golden age are: the "**swiftness**" to deploy quickly and effectively while base rates remain high; the "**nimbleness**" to swoop on pockets of dislocation; and the **"ability to fly"** by structuring upside exposure that benefits from monetary easing.

3 Yr Horizon IRR for Private Markets Asset Classes (2020-23)

Private Debt	15.8%
Infrastructure	13.0%
Private Equity	12.8%
Real Estate	10.5%
Venture	5.0%

Source: Preqin

3m Euribor (Historic and Forward Curve)

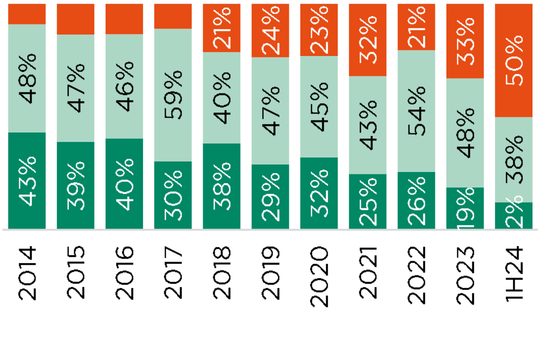


Source: Bloomberg

EVOLUTION IN THE GOLDEN AGE

IN THE AGE OF THE "DINOSAURS", LOOK OUT FOR THE "BIRDS"

Private Debt Fundrasising by Fund Size



Source: Pitchbook

In the Age of the Dinosaurs...

If the genesis of private credit was in the pullback of the banks during the GFC, the late 2010s was its "Cambrian explosion," when a multitude of new managers sprang to life. Now we are in the age of the dinosaurs, where **big funds reach unprecedented size.**

According to Pitchbook, in H1 24, 88% of private credit fundraising was for >$1bn funds. **Over the five years to 2023, the top 50 firms alone raised a colossal $1.3tn** *(PDI).* The very largest publicly state goals to grow much further. Ares seeks to boost its AUM by 75% by 2028. Apollo aims to double in size by 2029.

In the golden age, everyone was a winner. But **can the giants beat the market as they start to become most of "the market"**? Is that even their aim?

The challenge for all private credit firms used to be raising capital: they had to price at a premium to convince LPs to back them. For the "dinosaurs", the issue is becoming finding enough food to eat: to win more deals they will need to price tighter and convince LPs that that is good enough.

...Look Out For the Birds

Large cap players primarily focus on direct lending, financing PE buyouts. Private credit can do more, but **other segments from asset-backed lending to growth financing and the smaller end of the market remain underpenetrated**.

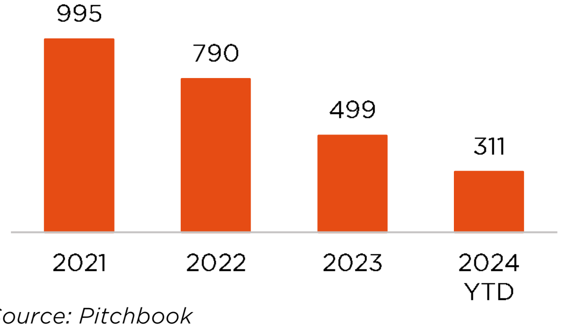
Such strategies, providing value-added solutions in less competitive situations, are not subject to commoditisation and can **command a sustainable premium.** They are also particularly suited to current market conditions.

1 *Swifter*

In private markets, faster deployment generally helps. It allows fund structures to be more efficient. It means LPs have less undrawn commitment hanging over them. And now, with a time-limited opportunity to benefit from elevated base rates, **deployment pace is a key differentiator, favouring the specialists.**

Direct lending relies on M&A, which is in the doldrums. PE-backed activity in 2023 was at half of its 2021 peak, and most buyouts used less debt. Direct lenders stayed active by taking share from banks; but the banks are now back for the big deals. In H1 24, PE activity was up 9% y-o-y, but bank syndications more than doubled *(Pitchbook).*

Global LBO Deal Value ($bn)



Source: Pitchbook

EVOLUTION IN THE GOLDEN AGE

IN THE AGE OF THE "DINOSAURS", LOOK OUT FOR THE "BIRDS"

However, other segments are behaving completely differently. For instance, if PE is less active, companies are actually more likely to look for debt to finance growth, boosting demand for growth lending from non-sponsored companies that are ignored by most direct lenders.

To be sure of not missing out, **there is also another trick to play: investing in already well-deployed funds.** Private credit funds typically fundraise for a year. Some that are mid-way through this period may already be full of deals originated in ideal conditions.

2 *Nimbler*

In the golden age, private credit has been benefitting from subdued activity in the banking and bond markets. When the cycle turns it is important to be aware of what was a permanent retreat and where they were just on a pause.

As we saw in the previous section, there are signs traditional lenders are getting more active again in LBO financing, especially for larger deals. Instead, we prefer **segments which traditional lenders have never served well and where deep dislocations have now emerged.** For instance:

- ***Asset-backed lending:*** A few years ago we warned that asset-backed lending (including RE lending) was frothy. After asset valuations did in fact correct, many lenders were burned and pulled back sharply. Deals can now be originated at higher coupons and lower LTV, based on valuations that actually make sense.

- ***Credit secondaries:*** Demand from LPs for secondary liquidity solutions has soared as private credit AUM has grown and reduced M&A has led to a reduction in natural exits. However, the private credit secondary market is still in its infancy. Highly opportunistic deal making is possible, especially for small, specialised credit positions

- ***Tech lending:*** The collapse of Silicon Valley Bank in 2023 left a gap in the market that has not yet been filled. Meanwhile, demand for tech lending has increased as companies seek to limit dilution in bottom of the cycle equity rounds. And to make sure they can get it, borrowers have become much more cash flow conscious.

All dislocations come and go. The ideal strategy is of course to dynamically adjust opportunities open and close.

"Bird" Spotting: Differentiators In Current Private Credit Market Conditions

1 Swiftness	2 Nimbleness	3 Ability to Fly
Capture high base rates while they last	Swoop in and out of pockets of dislocation	Structure to gain upside from falling rates
Avoid dependency on the M&A cycle; choose well deployed funds	Look at e.g. asset-backed, secondaries and tech lending	Look for fixed coupons, pre-payment penalties and warrant features

3 *Able to Fly*

Private credit is often assumed to be a capped return strategy. But with the bespoke structuring seen in specialised credit, it is **possible to gain upside exposure above contractual minimums**. Terms can even be tailored to benefit from a falling rate environment.

One option is to **shift from floating to fixed coupons**. In an economist's dream world, this adds no value, as borrowers should fully factor expected rate movements into negotiations. In reality, especially in small deals, they look first at their initial quarterly payments, and arbitrage is often possible.

Pre-payment penalties also help. Borrowers are more likely to refinance early (especially in fixed rate deals) if rates and spreads fall. In loans with strong pre-payment penalties or make-wholes this can meaningfully boost IRR.

A further tool is **equity warrants** on top of contractual interest. If loans are refinanced early these are crystallised faster. If rates go down, their value also has a greater chance of going up. This is especially the case in rate sensitive segments, giving **another reason to overweight asset-backed exposure**.

From the Golden to the Heroic Age

What follows a “golden age”? The term is originally from Greek mythology, where the progression is to a “silver age” and a “bronze age”. Maybe this is where undifferentiated players will head.

But those who know their Hesiod from their Ovid, will remember that all these stages led up to **the “heroic age”**, where the famous stuff of legend happened. Perhaps this is the better analogy. Life will not be uniformly easy for everyone, but the greatest is yet to come. Just make sure to pick your hero strategies.

Reji Vettasseri is Lead Portfolio Manager for alternative funds and mandates in private markets. Reji was previously a portfolio manager at Morgan Stanley Alternative Investment Partners, an executive director at Goldman Sachs Investment Banking and a consultant at Bain & Company. Reji received a B.A. (Hons) in Law and a Master of Laws from the University of Cambridge, and an M.B.A. with Distinction from Harvard Business School.

CONTACT

DECALIA SA
Rue du Rhône 31
CH-1204 Genève

Tél. +41 (0)22 989 89 89
Fax +41 (0)22 310 44 27

info@decalia.com
www.decalia.com

External sources include:
- Preqin
- Bloomberg
- PDI, “The PDI 200”
- Pitchbook, “H1 2024, Global Private Debt Report”

All analysis based on latest available data as of 7 Oct 2024

Front page image from Shutterstock