INSIGHTS

Emerging themes in the post-pandemic private credit space

A compelling growth story

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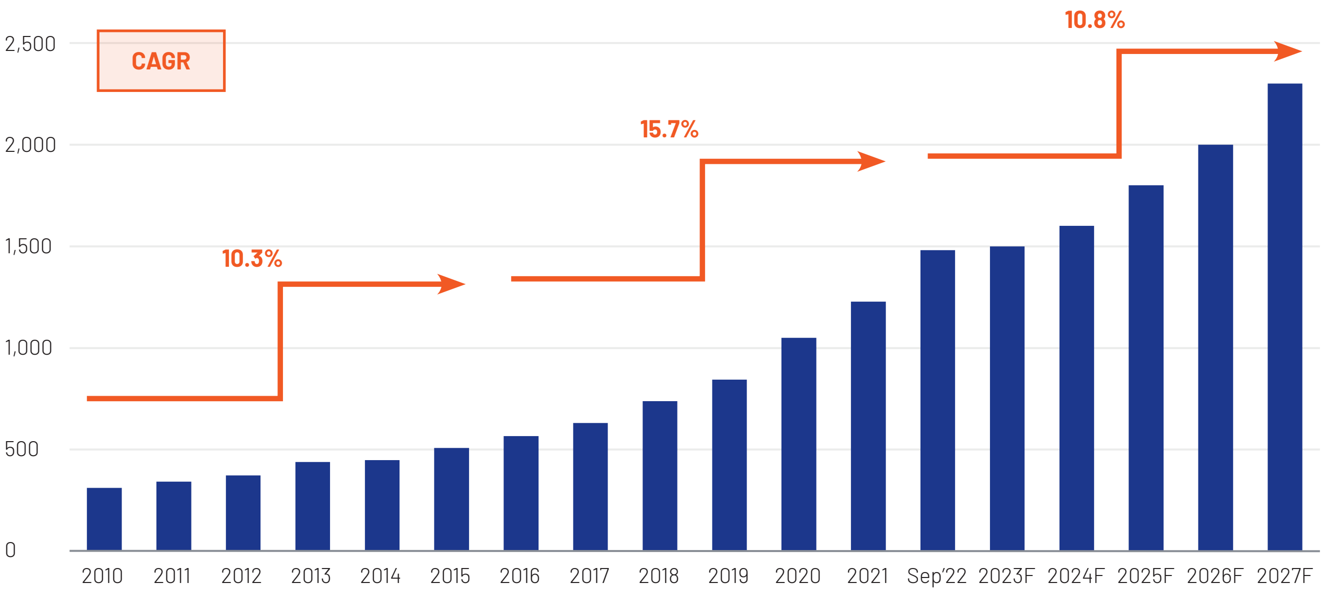
The global financial crisis (GFC) in 2007/08 paved the way for and initiated the rapid evolution of the private debt sector as banks retrenched from mid-market lending due to regulatory changes. Total AuM has grown swiftly, reaching USD1.4tn globally at the end of 2022, up from about USD500m in 2015, and is expected to reach USD2.3tn by 2027[1]. Overall fundraising in 2021 reached a record USD227bn across private debt strategies[1], +26% vs 2020 and almost 5x the amount raised a decade ago.

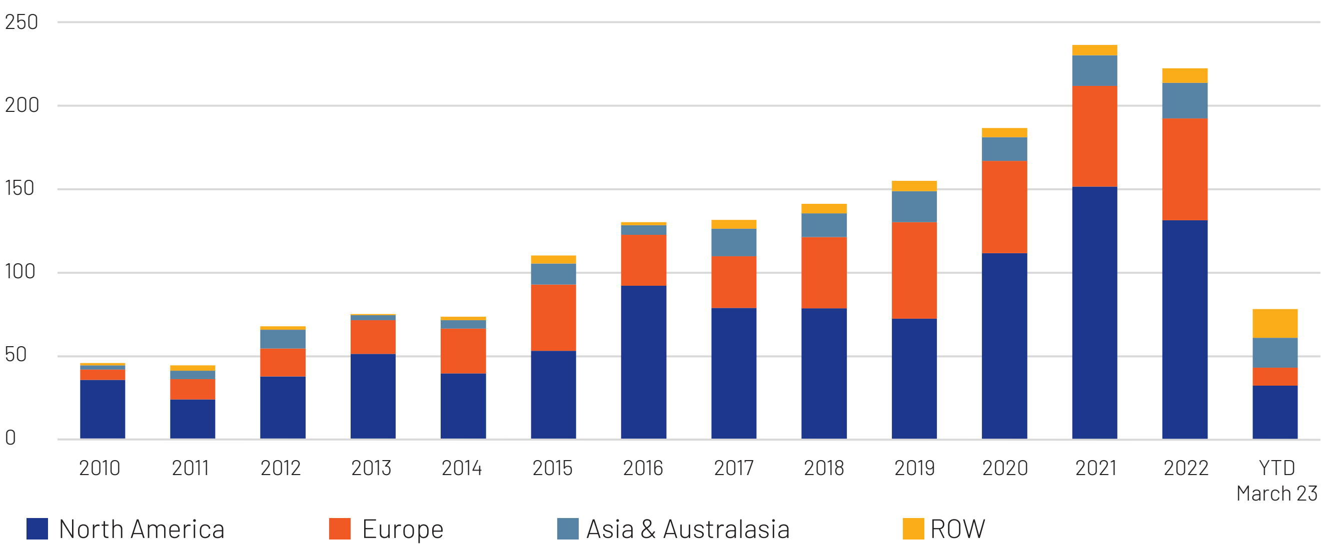
More than a decade later, another global event in the form of the pandemic boosted the alternatives sectors. Managers have been resilient and are coming up with varied product offerings to meet increased investor demand while trying to gain an edge in the private credit ecosystem.

Global private debt AUM (in USDbn)[1]



Source: Preqin

Regional fundraising (in USDbn)[1]



Source: Preqin

Key themes that have emerged since these events

After the GFC	After the pandemic
Market drivers	
Need for restructuring and the financing void created by regulatory challenges in the banking system augmented growth in private credit	Challenging market conditions and the need for refinancing further strengthened the private credit market. As a result, the asset class remains resilient, with positive AuM and fundraising growth
Strategies in focus	
Strategies such as mezzanine, special situations and distressed debt took center stage in the financing regime and have now become an established platform within private debt; these strategies previously just had a minimal share	Managers are now moving away from the crowded market and shifting their focus from diversification to differentiation » Technology/growth, healthcare/life sciences, asset-backed lending, sustainable/impact/ESG and NAV financing have become key "growth engines" for private credit managers
Typical financing	
Traditional financing structures of first- and second-lien debt shifted to tailor-made solutions such as unitranche loans	Unitranche facilities have become more compelling due to their multiple advantages over traditional financing structures, more specifically for the middle market
Containers	
Funds were mostly raised through commingled/pooled or separate account structures	Apart from commingled and SMAs, managers are raising money through new vehicles such as non-traded BDCs, interval funds and tender offers, as these are more flexible ("open-ended") instruments and offer more liquidity to investors » Interval and tender offer funds, BDCs and REITs posted record sales of USD80.5bn on a combined basis in 2022 (+19% y/y)[5] » Managers are also building their wealth channels by joining hands with insurance companies
Geographical focus	
North America and Europe emerged as bigger markets for private lending opportunities » North America's private debt AuM increased more than 2x, from USD210bn in 2009 to USD438bn in 2018, while European counterparts witnessed almost 3x growth, from USD263bn in 2009 to USD732bn in 2018	Private credit managers' compass is shifting from developed markets such as North America and Europe to Asia Pacific and other developing regions such as the Middle East and South America » Asia Pacific's private debt AuM grew from USD48bn in 2018 to USD93bn as of September 2022

In this insight paper, we discuss the two key themes that have emerged in the private credit space since the pandemic, strictly from an offering point of view:

1. **Specialised financing:** in pursuit of a "differentiated offering", seasoned managers (such as Blackstone, Ares, Blue Owl, HPS, Apollo, KKR and Sixth Street) have moved "up-market" to focus on larger (USD1bn+) credit opportunities through specialised/niche offerings

2. **Expansion in regions outside developed markets** has become a regular channel for raising commitments, and managers are increasing their exposure to Asia, South America and other lucrative markets. Managers (such as Cerberus, Goldman Sachs, HPS, Ares, Bain Capital, Barings and KKR) have successfully scaled up by tapping markets outside North America and Europe

Section 1

What is specialised financing?

Specialised lending is a tailored capital solution that predominantly targets a set of asset classes or sectors. Continued growth in the private credit space and the changing socio-economic landscape have prompted managers to shift their focus from the traditional "business as usual" to something that initially was nuanced but is now becoming the next big thing. Specialty lending, sustainable impact-/ESG-focused opportunities and NAV financing are some of the offerings that have gained relevance recently. Managers have amassed larger commitments, as these offerings are stable and have forecastable income flows with relatively lower risk. These new niche areas are set to become well-established platforms within the private credit space.

1. Specialty financing – the next generation of private credit lending

What is specialty financing?

Simply put, specialty finance is a financing activity that is largely asset- or revenue-backed and can be broadly bucketed into three categories:

Emergence of specialty finance

The post-pandemic world has proven to be a fertile ground for specialty finance, highlighting the importance of addressing the specific financing needs of businesses. Specialty lending – which largely finances technology/growth, healthcare/life sciences and asset-backed securities (ABS) opportunities – is currently one of asset managers' key growth drivers, as this type of lending

» Is sector-/industry-specific; this ultimately narrows the investment mandate, limiting risk

» Reduces the correlation of the underlying investments with the broader economic environment

For instance, litigation finance is affected only by the outcome of a specific legal proceeding and not by the broader macro environment or default rates in the corporate credit world. Moreover, the loans are typically secured by underlying pools of thousands of individual financial assets, which helps further diversify risk and ensure the overall risk is not tied to a single event.

Market size of specialty financing and active players within this space

Specialty finance lending currently accounts for less than 10% of total private debt AuM, providing an excellent opportunity for specialist lenders to identify and fund interesting niche markets. Big players have geared up and have already raised larger commitments – Blackstone closed USD4.6bn for its latest life sciences fund, Ares raised USD3.7bn for its sports and media fund against a target of USD1.5bn and Owl Rock is targeting USD5bn for a second series of its technology finance corp. Prominent managers within this space include Apollo, KKR, HPS and Sixth Street, which have raised larger commitments through BDCs and other structures.

These robust fundraising figures and investors' inclination clearly indicate that specialty lending is the pillar of next-generation private credit.

2. Sustainable/impact/ESG – offerings for a changing world

With the world's largest institutions (both public and private) pledging to back the energy transition, another noticeable trend within private markets is the launch of new funds and strategies that are ESG- or impact-focused. Many private equity (PE), infrastructure, private credit, venture capital and even hedge fund managers are actively seeking capital for these dedicated strategies.

What are ESG-/impact-focused funds?

An "environmental, social and governance (ESG) fund" is any investment vehicle for which the fund manager uses ESG criteria to inform its composition and asset-allocation strategy.

Why ESG?

Over the past decade, strong growth in private markets was mainly driven by asset prices and flows. However, these traditional growth engines are now being threatened by growing economic headwinds. Furthermore, investors strongly believe that companies that perform well on ESG criteria are less risky and better prepared for uncertainty. Thus, ESG is poised to become a key differentiator in driving market growth, and asset managers need to focus on differentiating their products to drive demand and inflows.

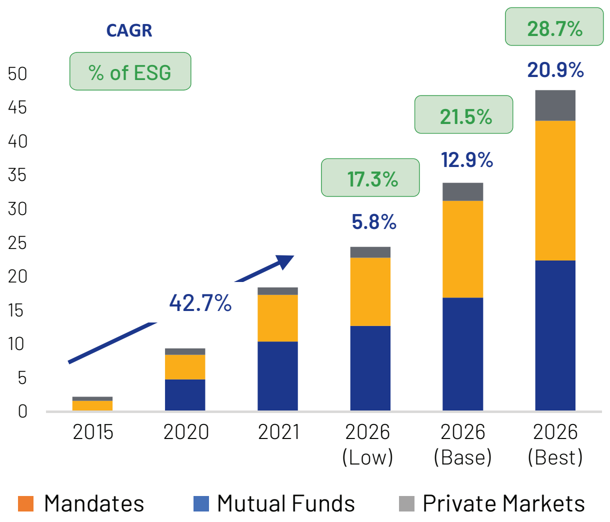
ESG-oriented funds are expected to grow much faster than the asset and wealth management market (at a base CAGR of 12.9%) and are rapidly becoming one of the go-to assets for differentiation, according to PwC's Asset and Wealth Management Revolution Report 2022. The report further notes that ESG AuM is expected to reach USD33.9tn by 2026 and the ESG share of overall AuM will likely rise to 21.5% by 2026 from 14.4% in 2021. In addition, 81% of institutional investors in the US plan to increase their allocations to ESG products over the next two years.

Of the USD10.3tn invested in private capital, c.USD4.37tn is managed by firms committed to ESG, according to Preqin's ESG Report 2022. Private debt has some of the highest amounts of ESG commitment (39% of its AuM).

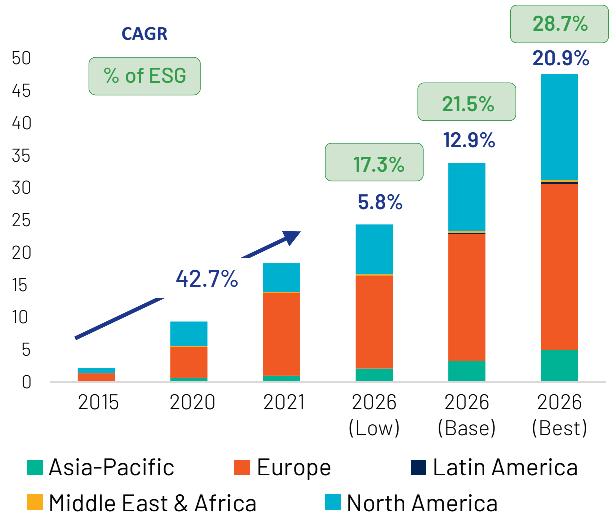
Furthermore, reaching the goal of net zero emissions by 2050 would require an average annual global capex of over USD6tn; therefore, managers believe that energy-transition strategies present a significant opportunity[2].

Growth in ESG investments may outpace the market as a whole

Global ESG AuM (USDtn)



Global ESG AuM by region (USDtn)



Global ESG AuM (USDtn)	2015	2020	2021	2026 (low)	2026 (base)	2026 (best)
Mandates (note 6)	0.0	4.8	10.4	12.7	16.9	22.4
Mutual funds	1.6	3.6	6.9	10.1	14.3	20.7
Private markets	0.6	1.0	1.1	1.6	2.7	4.5
Total	2.2	9.4	18.4	24.4	33.9	47.6

Global ESG AuM by region (USDtn)	2015	2020	2021	2026 (low)	2026 (base)	2026 (best)
Asia Pacific	0.2	0.7	1.0	2.1	3.3	5.0
Europe	1.2	4.8	12.8	14.3	19.6	25.6
Latin America	0.0	0.0	0.0	0.1	0.2	0.3
Middle East and Africa	0.0	0.1	0.1	0.2	0.3	0.4
North America	0.8	3.8	4.5	7.7	10.5	16.3
Total	2.2	9.4	18.4	24.4	33.9	47.6

Source: PwC (Asset and Wealth Management Revolution Report 2022)

Active players in the space

Notable activity in the space includes Brookfield's USD15bn closed in 2022, one of the largest energy-transition funds; it targets USD20bn for its next iteration. Apollo has committed and deployed about USD6bn in sustainable investing via its clean-transition platform and plans to raise more through its infrastructure and credit strategies platform. Ares is currently raising its second climate infrastructure fund; its first fund racked up USD2.2bn. Blackstone launched a sustainable resources platform aiming to deploy USD100bn in climate and energy-transition solutions over the next decade and is currently raising its third green private credit fund with a target of USD6-7bn and a fourth energy-transition fund targeting USD6bn.

3. NAV financing – a new niche

Apart from the sector-oriented mandates, asset managers are benefiting increasingly from NAV financing to improve fund returns or achieve other objectives.

What is NAV financing?

Simply put, NAV financing/lending refers to capital provided by a lender to an alternative manager against the NAV of its fund portfolio. The manager uses the capital proceeds to benefit a particular fund and uses the same fund's assets as deal collateral.

What triggered its growth?

NAV finance has gained significant momentum over the past two to three years, driven largely by the challenges of uncertainty and stressed valuations after the pandemic and tightened liquidity. Moreover, NAV financing is garnering interest because asset managers and investors are recognising it as a valuable, flexible tool to enhance growth across multiple levels of their businesses.

Different uses of NAV financing for different stakeholders

Asset managers

PE managers use NAV financing to create value in their funds through add-on acquisitions at existing portfolio companies ***as an alternative to mezzanine financing or additional equity investment***

Management companies

Management companies use NAV finance to support larger GP commitments, strengthening alignment with their LPs*. It is also used to drive platform expansion into new geographies and asset classes, by retaining equity ownership*

Investors

LPs use NAV financing as an alternative to a secondary sale. Typically, they raise capital to generate early liquidity, ***to fund future commitments or to rebalance their portfolios.*** *The investor receives capital upfront, avoids a discount to NAV and retains access to portfolio upside*

Recent activity in the space and potential

Crestline and 17Capital, among others, recently closed USD1bn+ funds as investor interest surges and more managers borrow against their funds to obtain capital for strategic moves.

The year 2022 marked another all-time high in NAV financing activity across the PE sector, with 50% growth in deal volume (over USD30bn) and a 40% increase in the average transaction size. Based on the size of the addressable market (USD1.6tn of NAV that exists across European and North American buyout houses), 17Capital expects NAV financing to grow 7x, to USD700bn by 2030 from USD100bn in 2022.

Funds have a combined USD9tn in unrealised value, according to Preqin, and it expects NAV financing to be universal among PE funds within the next five years. This would be fuelled by growing demand for NAV credit that is increasingly being met by specialised NAV lenders. The report further notes that recent NAV lending M&A activity, NAV lending-specific fund launches and the emergence of NAV lending as a sub-strategy for LP private credit allocations highlight this market's potential and continued growth.

In a nutshell, NAV-based credit financing has proved to be a versatile solution for a broad range of fund-level financing requirements, and has significant potential. NAV financing is, therefore, expected to emerge as a standalone asset class within the broader private debt space.

Section 2

Expansion into other regions

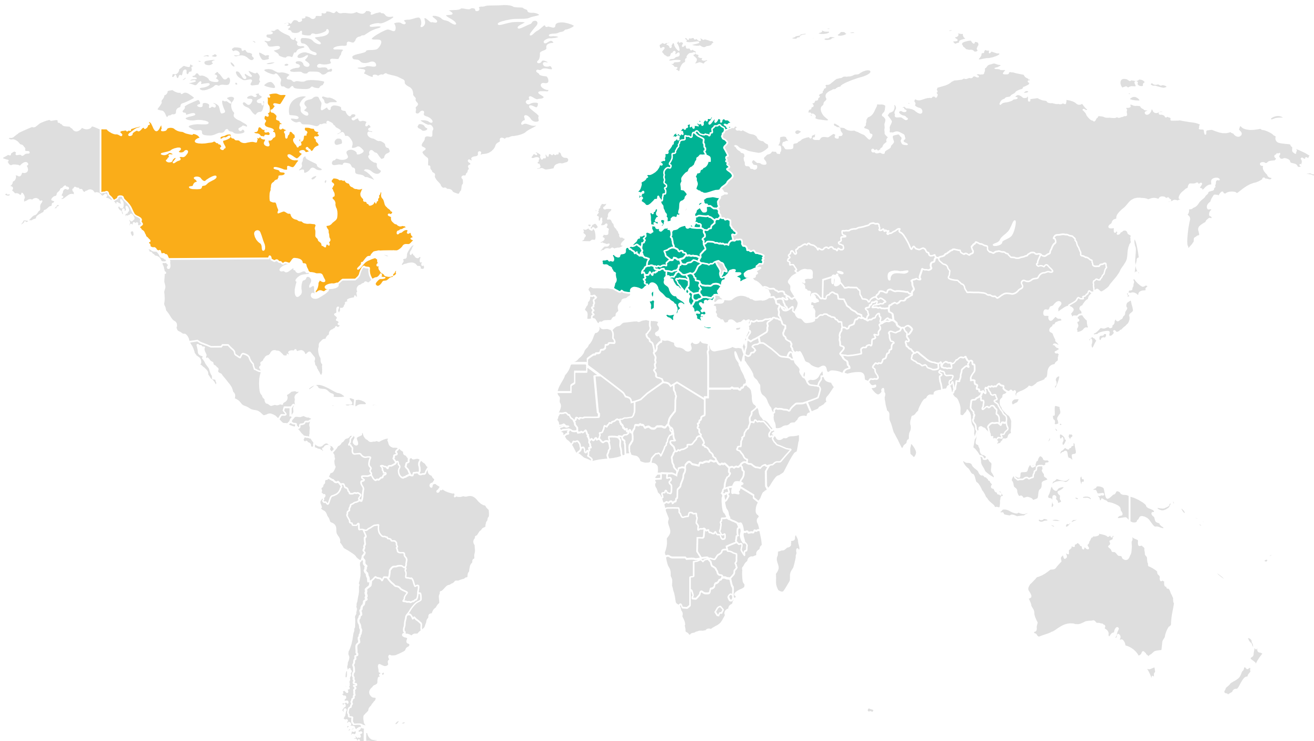
Private debt markets have witnessed rapid growth over the past decade, and North America has by far emerged as the dominant region within this space. Preqin expects AuM in this region to reach USD1.4tn by 2027, growing at 21.7% from 2021 to 2027. North America is projected to outpace the rest of the world, with stronger AuM growth than the global average of 10.8%. This would be driven mainly by the region's strong economy and asset allocators' preference for the US over other geographies. Despite the fear of recession, factors such as market depth, liquidity and maturity in an uncertain macro environment are expected to drive strong AuM growth in this region. The region is home to the bulk of fundraising activity, and Preqin forecasts fundraising for North America-focused direct lending funds to grow at a CAGR of 6.8% – to USD110bn by 2027 from USD74bn in 2021.

That said, the asset class (private credit) is gaining momentum in other parts of the world as well. Another major geography for private markets is Europe, where AuM is estimated to grow 10% annually, to USD636bn in 2027 from USD359 in 2021. As in North America, direct lending is expected to dominate in Europe as well, growing to USD415bn in 2027 from USD209bn in 2021 and accounting for 65% of assets in the region. However, the challenging economic conditions and the Russia-Ukraine war are expected to affect investor appetite, and fundraising in Europe is forecast to grow at just 2.6% annualised from 2021 to 2027.

Among other regions, Asia Pacific is gaining traction in terms of investment mandates and fundraising within private credit assets. Fundraising in Asia overtook that in Europe in 1H 2022, according to Private Debt Investor. Preqin forecasts AuM in Asia Pacific to reach an all-time high of USD116bn by 2027, growing at a CAGR of 8% from 2021 to 2027. Multiple asset managers have recently announced plans to expand into Asia: Blackstone plans a 10-fold increase in its private credit assets in the region to at least USD5bn "in the near term"; KKR raised USD1.1bn for its inaugural Asian credit fund; and Apollo launched a USD1.25bn Asia credit strategy last year.

NORTH AMERICA (USDbn)[1]	
Total AuM (Sep'22)	USD925
% growth from Dec'20	45.8%
Capital raised[3]	USD955
Est. dry powder (Sep'22)	USD276

EUROPE (USDbn)[1]	
Total AuM (Sep'22)	USD403
% growth from Dec'20	28.4%
Capital raised[3]	USD460
Est. dry powder (Sep'22)	USD132



Source: Preqin

Asia Pacific and ROW (USDbn)[1]	
Total AuM (Sep'22)	USD153
% growth from Dec'20	59.5%
Capital raised[3]	USD162
Est. dry powder (Sep'22)	USD48

Conclusion

Despite the macroeconomic challenges, investor demand remains strong across private debt strategies. Preqin's November 2022 survey results indicate that private debt investors are satisfied with their investments, with 28% claiming the asset class exceeded return expectations and 60% saying it met expectations.

In a recent webinar hosted by Acuity Knowledge Partners[4], "Unlocking value in private markets", Venu Rathi from Morgan Stanley, one of the panellists, explained why they see tremendous growth in investors' asset allocation to private credit. This growth is largely attributed to the following:

» The rise in PE valuations of underlying assets in the past 5-10 years and institutional investors' preference for diversification

» Active M&A in recent years and support from private credit for buyout deals

» All-time-high levels of dry powder and a corresponding rise in private credit deployment

» Rising inflows from retail investors through non-traded BDCs and other retail vehicles

On the impact of the recession, Venu mentioned that robust deal flow requires market stability and is, therefore, likely to remain sluggish in the near term. However, the outlook for private credit is positive and it should continue to grow, albeit at a slower pace, given active M&A and rising LIBOR rates; 2023 vintage funds are projected to achieve higher returns.

In a nutshell, private credit managers are benefiting from market tailwinds and remain bullish on business prospects in 2023.

How Acuity Knowledge Partners can help

Our private debt/credit support vertical offers a number of services to private debt/credit middle and back offices; these range from deal origination and target screening to portfolio-monitoring services. We also provide private credit managers with live deal support including due diligence, relative valuation, and scenario and bond yield analysis.

Author

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Aditi has over 7 years of experience in research with hands-on experience in benchmarking exercises, trading & transaction comparable analysis, discounted cash flows analysis, report writing, company profiling, and fund benchmarking & competitive analysis.

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Footnotes:

1. Includes direct lending, distressed debt, special situations, mezzanine and venture debt
2. According to a report from Partners Capital
3. Period: 2011 to September 2022
4. Webinar – "Unlocking Value in Private Markets", hosted by Acuity Knowledge Partners
5. According to Robert A. Stanger & Co. data
6. "Mandate" refers to the allocation of funds to an investment manager to be managed for a specific purpose or style. It also refers to a formal appointment to advise on or arrange project financing

Sources:

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Acuity Knowledge Partners (Acuity) is a leading provider of bespoke research, analytics and technology solutions to the financial services sector, including asset managers, corporate and investment banks, private equity and venture capital firms, hedge funds and consulting firms. Its global network of over 6,000 analysts and industry experts, combined with proprietary technology, supports more than 500 financial institutions and consulting companies to operate more efficiently and unlock their human capital, driving revenue higher and transforming operations. Acuity is headquartered in London and operates from 10 locations worldwide.

Acuity was established as a separate business from Moody's Corporation in 2019, following its acquisition by Equistone Partners Europe (Equistone). In January 2023, funds advised by global private equity firm Permira acquired a majority stake in the business from Equistone, which remains invested as a minority shareholder.

Our expertise includes the following:

» Investment Banking: origination and trading support
» Investment Research support: covering all asset classes in terms of ideation, data science, and research support across the buy side and sell side
» Commercial Lending support: across origination, credit assessment, underwriting, and covenant and portfolio risk for all lending types
» Private Equity: origination, valuation and portfolio monitoring support
» Asset Management services support: across marketing, investment research, portfolio management/ optimisation, risk and compliance
» Corporate and Consulting services: market and strategic research; survey work; treasury and counterparty risk support; and CEO office support, including M&A, FP&A and investor relations support
» Compliance support: AML analytics, KYC, counterparty credit risk modelling and servicing across banks, asset managers and corporates
» Data Science: web scraping, data structuring, analytics and visualisation These services are supported by our proprietary suite of Business Excellence and Automation Tools (BEAT) that offer domain-specific contextual technology.

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