INSIGHTS

JULY 2023



SPREADING OUT

PRIVATE CREDIT'S NEXT GROWTH WAVE

EXECUTIVE SUMMARY

Putting a positive spin on the inevitable nod to economic uncertainty in financial commentary this year is private credit – an asset class for which AUM has breezed past the trillion-dollar mark on a decade-long, steeply upward climb.

Closed bank doors are open opportunity windows for private credit fund managers, who are finding the prospects available on the market to be more secure and profitable than ever.

No doubt, bigger players and those that got in early on the private credit pie have the chance to dominate this increasingly popular market, though – as we discover in the first section of this report – there are entry opportunities for those who play smart.

Growth brings enough dynamism and innovation to keep incumbents on their toes and, as our research finds, competition will play out in myriad arenas – bringing to the fore new lending terms, advanced tech, evergreen capital structures and new deployment niches, among other strategic considerations.

The speed and scale of private credit growth also raises questions about portfolio management, visibility, monitoring and, ultimately, default risk that could have spill-over effects on other financial markets. Funds have their mitigation strategies in place and though some expect regulators to eventually get involved, they're not springing to action just yet – as we learn in section two.

At any rate, we seem to be witnessing private credit's "golden moment", as described by Blackstone president Jonathan Gray following the firm's Q1 2023 earnings – which attributed 60% of its inflows for the quarter to credit, real estate credit and insurance per FT reports.

AFTAB BOSE
REPORT AUTHOR

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METHODOLOGY

This Private Equity Wire research is based on survey responses from nearly 50 GPs, spread mainly across North America (49%), Europe (27%) and Asia Pacific (20%). The survey was targeted at all managers that have private credit funds, either as their predominant strategy (61%) or in among private equity (12%), hedge funds (2%), traditional assets (8%) or a mixture of alternative strategies (10%). Responses are complemented with insights and quotes from senior leaders and experts from within the private credit market interviewed by the PEW team.

KEY FINDINGS

1

Credit earnings inching closer to equity returns

Interest rates increasing by hundreds of basis points, widening spreads and booming demand are pushing credit IRRs easily into the double digits for most funds – in many cases upwards of 15%. With no changes expected in contributing circumstances, most fund managers expect these numbers to equal, if not surpass, their returns on equity investments.

2

Evergreen capital structures offer a competitive edge

Nearly two-thirds of fund managers have either set up a permanent capital structure for liquidity or plan to do so in the next 12 months. These strategies pave the way for more flexibility with deposits and withdrawals and allow investors to see quicker value on their investments – all of which can give funds a crucial competitive advantage in an increasingly crowded market.

3

Low-risk lending is producing high-risk rewards

Higher-double-digit returns are conventionally associated with higher-risk strategies such as mezzanine lending, special situations or distressed opportunities. But PEW's survey finds that not only is (usually senior secured) direct lending the top deployment priority for most funds, but this strategy is also producing returns above 10% for most and higher than 15% for many.

4

Private credit regulations are a work in progress

Most fund managers report that recent regulatory changes have made no meaningful difference to their lending and expansion abilities, and some say it's gotten simpler – perhaps a deliberate move from regulators to preserve the economic momentum being generated by private credit. Still, bigger firms are experiencing more regulatory complexities than others, and there are regional varations too.



LAY OF THE LAND

Indicators for private credit – from investor demand to returns – remain highly positive, with variations in market trends by region and fund size

The global private credit pie is $1.4tn big per FT estimates, and it's getting bigger. Direct lending saw green when banking covenants were tightened in the wake of the financial crisis and recent interest rate hikes – with consequently widened spreads – have further boosted demand for the asset class.

Private Equity Wire (PEW) surveyed fund managers with a range of alternative investment strategies – from specialist private credit to private equity (PE), hedge funds and traditional assets, among others – to find 78% of managers have launched a new private credit fund in the last four years, and 68% plan to do so in the next 12 months (see fig 1.1). "Despite ongoing uncertainty, private credit is offering premium yields relative to most liquid debt alternatives, broadly syndicated loans and high-yield bonds at present, with the added benefit of floating rates to keep pace with interest rate fluctuations," says Bill Sacher, Partner & Head of Private Credit at Adams Street Partners.

"It's also the safest part of the debt capital stack – it's generally dollar one first-lien term debt that's first in line for company cash flows, it has the benefit of security and collateral and has superior rights in bankruptcy and workout. So direct lending can deliver premium yields while also playing defence – a compelling proposition in this economy."

Sacher says this combination of factors is enough to push private credit higher than most other strategies on the priority list for institutional investors – an assessment backed up by Suhail Shaikh, who was appointed co-Head of Investcorp's private credit business in January.

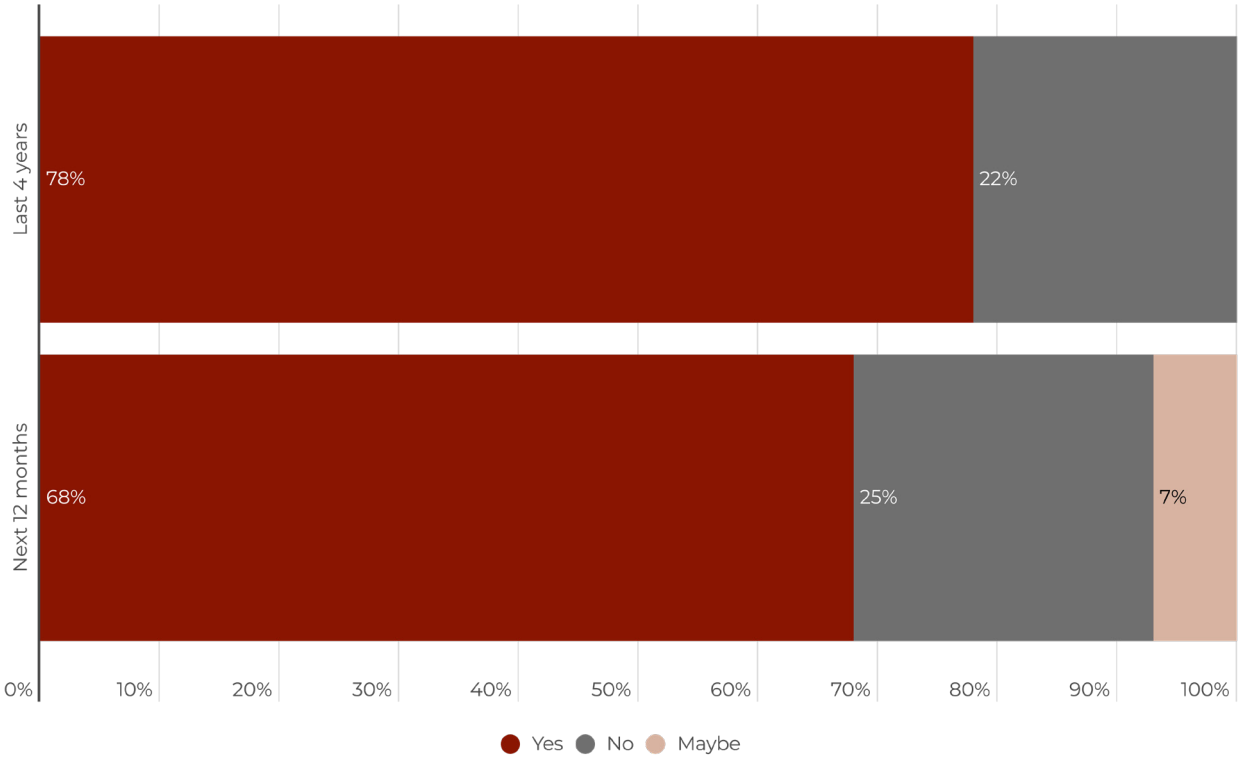
He says private credit has become the "product of choice" for investors, adding that "managers are shifting their focus and expanding private credit offerings to meet growing investor demands."

Yields alone are enough to entice investors. PEW's survey found an impressive 20% of fund managers are recording IRRs of more than 15% on their private credit portfolios, another 51% report IRRs in the early double digits, while nearly a quarter are clocking 5-10% (see fig 1.2).

Howard Sharp, Managing Director of Alcentra's European private credit team, suggests the delta between credit and equity returns is shrinking. "Private credit's growth in the last decade has largely coincided with a time of 0% interest rates which, speaking from experience, is decidedly abnormal. Spreads were small which kept returns on credit in single digits."

"Current base rates are 3-5% across euros, sterling and dollars, which is already a 500-basis-point boost to returns at the upper end. Topping this off, spreads are widening by 100 basis points which, combined with fees, can easily push returns into double digits for senior secured debt. PE returns, meanwhile,

Figure 1.1 Share of managers raising private credit funds



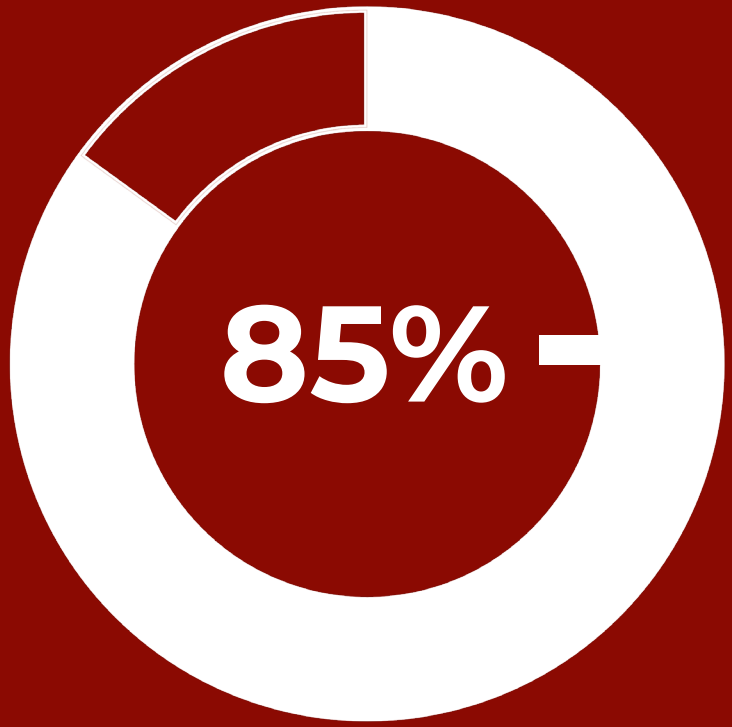
Analyst note: *Respondents were asked, "Has your firm launched a new private credit fund in the last four years?" and "Does your firm plan to launch a new private credit fund in the next 12 months?"*

Source: Private Equity Wire readers survey

KEY FINDINGS

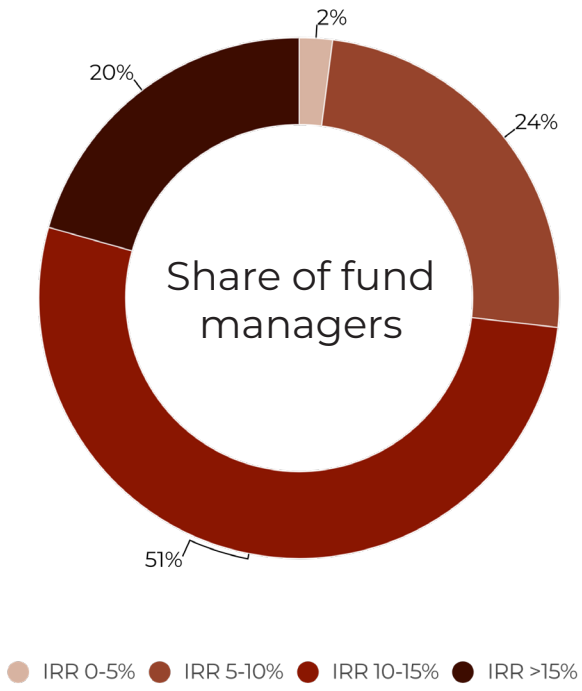
Managers are demonstrably bullish about credit earnings

Share of managers who agree credit earnings could equal/surpass equity earnings in the next 12/24 months



INSIGHTS

Figure 1.2 IRR distribution across private credit portfolios



Analyst note: *Respondents were asked, 'What bracket of IRR is your firm recording on its private credit portfolio?'*

Source: Private Equity Wire readers survey

have come under pressure now due to valuation resets – down by 30% in some cases – allowing private credit to close the gap."

PEW's survey backs up this observation – 84% of managers agree private credit earnings could equal/surpass equity earnings in the next 12-24 months (see fig 1.3).

For Sharp, the gap might shrink, but it's unlikely to close. "PE investors who are in a position to hold on will likely wait out the valuation dip till performance improves. This varies, but equity returns have the potential to reach multiples of 3x and higher, whereas credit averages out at around 1.3x – so a crossover is improbable."

INCUMBENT DOMINANCE

Booming demand for credit raises questions about who will service this appetite. Shaikh, who noted that managers are adjusting their strategies in response, was himself appointed early this year as part of an expansion drive for Investcorp's private credit business. Other big names are also in action – KKR appointed Dan Pietrzak as its new Global Head of Private Credit in May, around the same time that Apollo announced plans to up its European private credit headcount, citing growing demand and higher returns as contributing factors.

The market is hot, though the expectation is that big names and established players will continue to hog the lion's share. Bill Sacher of Adams Street Partners says: "The private credit market has grown quite crowded and competitive in the last 10-15 years. And while

APAC spotlight

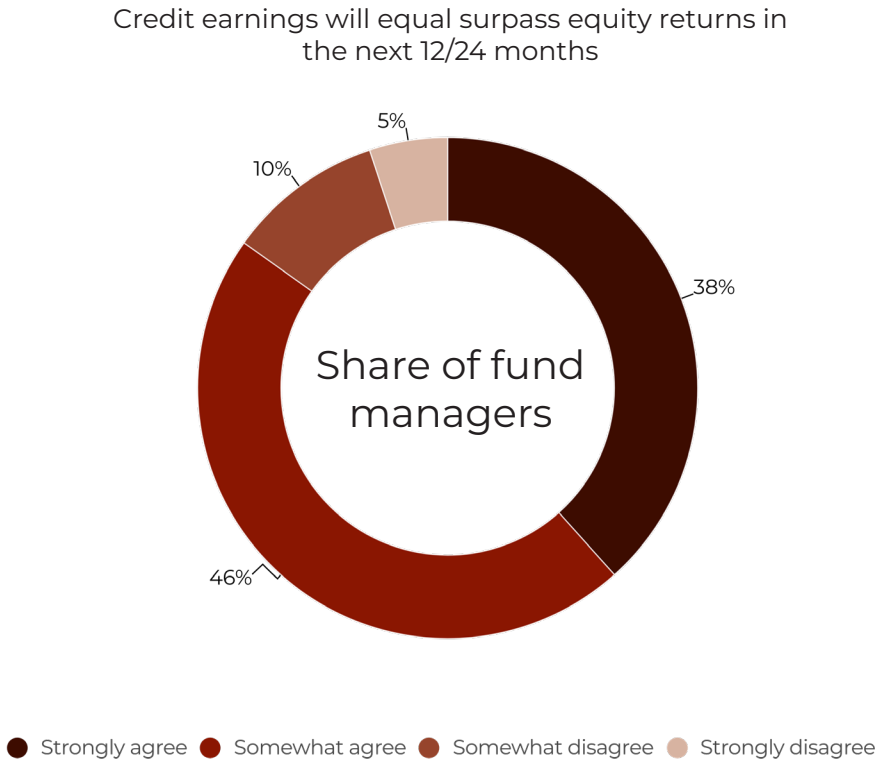
North America and Europe have long been the epicentres of the global private credit market, though a multitude of positive indicators in Asia-Pacific (APAC) are catching the eye.

PEW's survey paints a rosy picture: 89% of APAC fund managers raised a new private credit fund in the last four years and 78% plan to do so in the next 12 months; 78% of managers in APAC are recording double-digit IRRs– a higher share than any other region; and 38% note the regulatory landscape has simplified in the last 12 months – more than twice the share of European managers (18%) and over six times the share of North American managers (6%) who said the same.

Preqin reports the two dominant lending strategies in APAC are special situations and mezzanine lending, and growth is very much on the cards. Per the report, six new private debt funds of this type were launched in 2022, each closing above the $1bn mark. Private credit AUM in the region has already beaten forecasts, and fundraising is expected to win over other regions.

Big managers are responding – Blackstone is betting big on the region, with plans to implement a 10x increase from $500m deployed to APAC private credit assets in Q4 2022 to $5bn in the "near term" according to a Bloomberg report from May.

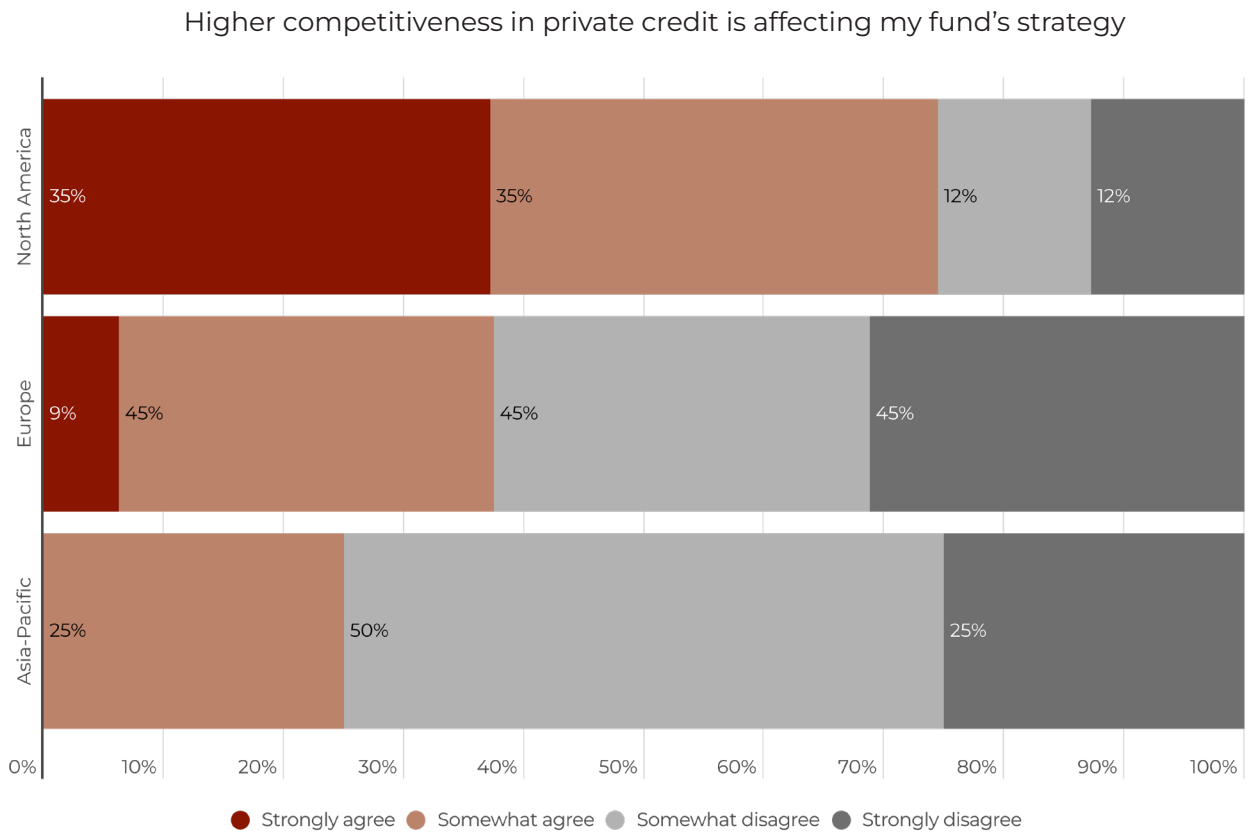
Figure 1.3 Credit vs equity earnings forecast



Analyst note: *Respondents were asked, 'To what extent do you agree private credit earnings could equal/surpass equity earnings in the next 12/24months?'*

Source: Private Equity Wire readers survey

Figure 1.4 Regional variations in private credit competitiveness



Analyst note: *Respondents were asked, 'To what extent do you agree that growing competitiveness in the private credit space is directly affecting your fund's investment strategy?'*

Source: Private Equity Wire readers survey

widespread fundraising challenges that have come with public market volatility have been offset by investor demand for private credit, new entrants will struggle. The fundraising stats reflect this – the average size of funds is on the up but the list of first-time funds is shrinking."

Alcentra's Howard Sharp says proven track records are crucial for investors as things stand.

Sharp says: "The direct lending market for corporate M&A in Europe is just over a decade old – a product of the financial crisis when banks were discouraged from lending in the leveraged space. A handful of players established themselves at the time and have continued to dominate the market – to the point where the top 10 direct lenders today control 60-65% of the European private credit market in terms of deal activity."

Distinctions between the markets in the US and Europe show the latter has strong indicators for a more diversified private credit landscape in the future. "The reason being a large share of direct lending in Europe is bilateral, where the winner takes all in a deal. The three-decade-old US direct lending market, on the other hand, sees many deals clubbed between 5-7 lenders working collaboratively. And in contrast, the top 10 direct lenders in the US control only 15% of the market," Sharp says.

PEW's survey reveals a distinction between the two markets – 70% of PEW's survey respondents in North America agree that higher competitiveness in the private credit

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Direct lending can deliver premium yields while also playing defence – a compelling proposition in this economy

Bill Sacher
Head of Private Credit, Adams Street Partners

market is directly affecting their fund's strategy, compared to 54% in Europe (see fig 1.4). Asia-Pacific fund managers appear less phased by competition – only 25% agreed it's affecting their strategy.

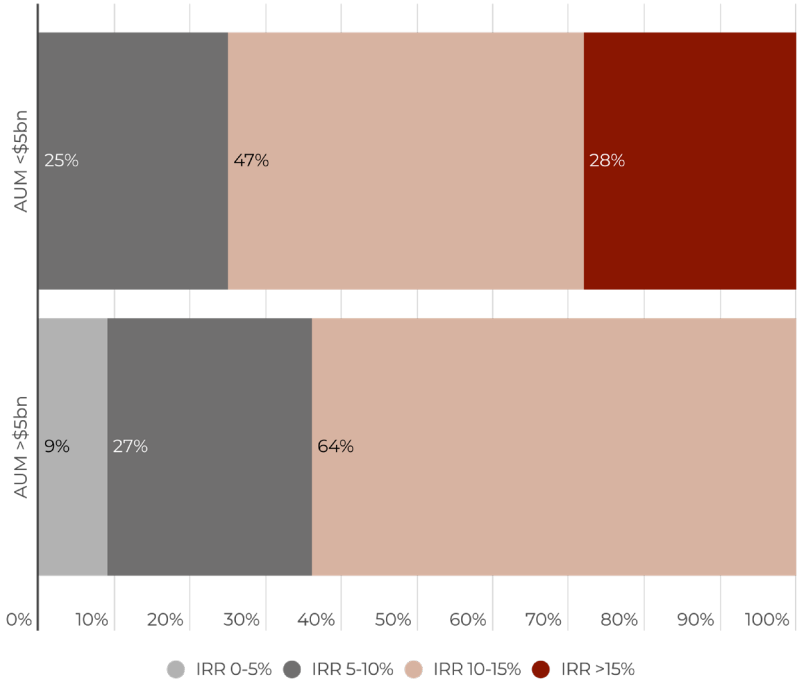
The direction of travel in Europe, Sharp notes, is towards the US model – as established funds reach saturation in terms of exposure, borrowers will look to bring in third-party lenders to collaborate on transactions. New entrants could get a foot in the door if they can club themselves with incumbent funds to help mutualise risk on deals. Not everything favours the big players – per PEW's survey not a single fund with AUM above $5bn reported IRRs in excess of 15% on the private credit portfolios, compared to 28% of those with sub-$5bn AUM (see fig.1.5).

As for incumbents, Sharp notes a series of large-scale acquisitions – such as his own Alcentra's induction into the Franklin Templeton Umbrella and Nuveen's March acquisition of Arcmont – that signal the emergence of large, transatlantic players in the specialist private credit space. The main competitive threat to these specialists is the rising number of large PE houses, cited above, that are heavily focused on capitalising on credit, completing multiple billion-dollar raises in quick succession. ■

KEY TAKEAWAY

The private credit landscape in the US is more mature and diversified than in Europe – new entrants in the latter market could capitalise on the need for incumbents to mutualise risk on transactions.

Figure 1.5 IRR distribution by funds with AUM less or more than $5bn



Analyst note: *Only firms with AUM <$5bn are recording IRRs in excess of 15%*

Source: Private Equity Wire readers survey

GOING WITH THE FLOW

An increasingly competitive market is pushing funds to adjust their deal terms, approach to technology, capital structures and deployment priorities

Competitiveness in private credit differs not only by region but also by size – larger firms are far more concerned with competition than relatively smaller ones. Still, on average 59% of all funds are adapting to an evolving market, and competition will likely play out in a variety of arenas (see fig 2.1).

One is deal structure. Howard Sharp of Alcentra says: “There are three main axes that firms in our business use to differentiate themselves: the amount of leverage we will offer, pricing levels and the documentation with which we’re prepared to sign a deal. These all differ from one negotiation to the next.”

Though useful for competition, dynamism in deal structure does add a great degree of complexity to portfolio management, especially as the number of transactions managed by individual funds is booming. Sharp says there can be certain boilerplate features to every

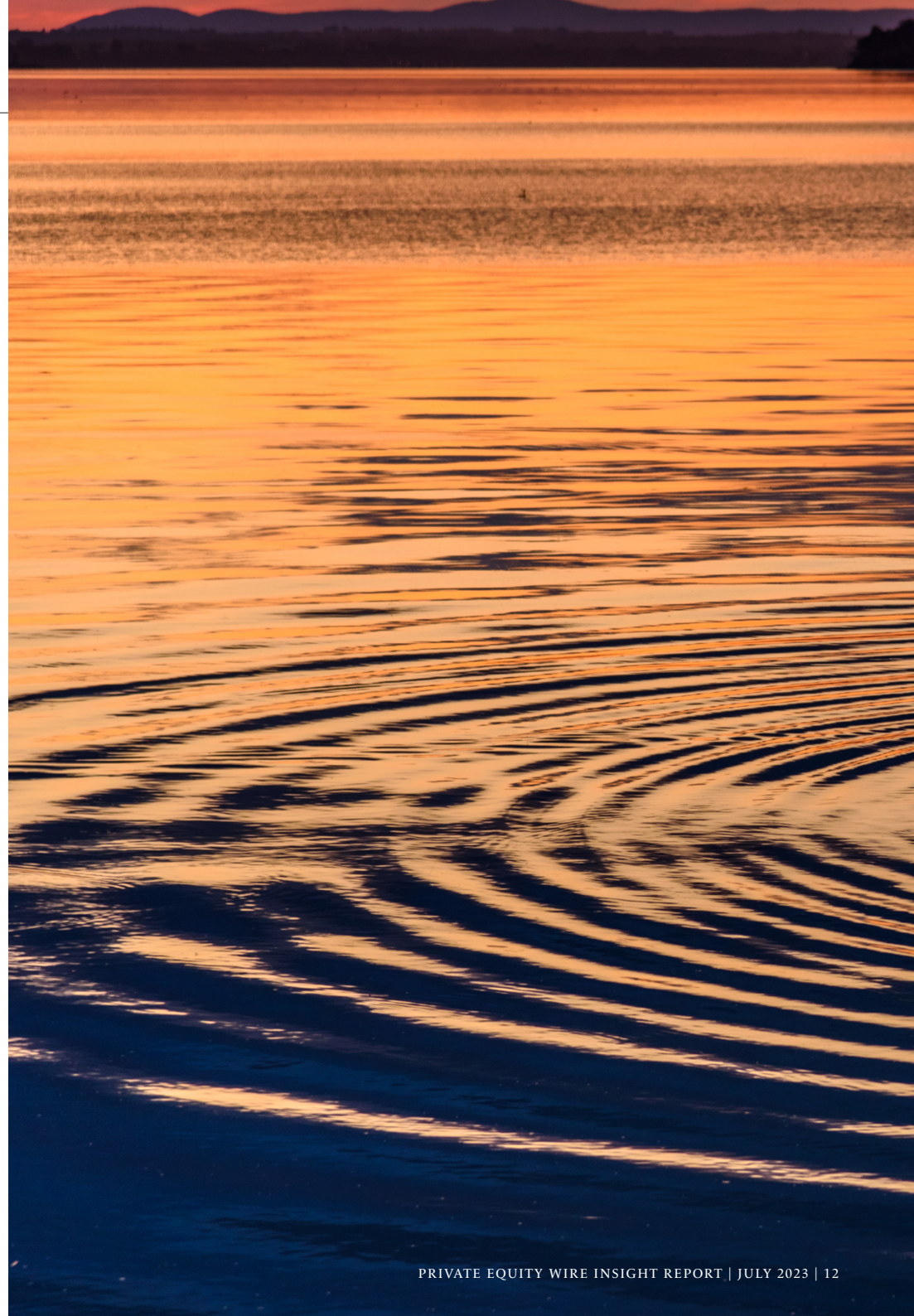
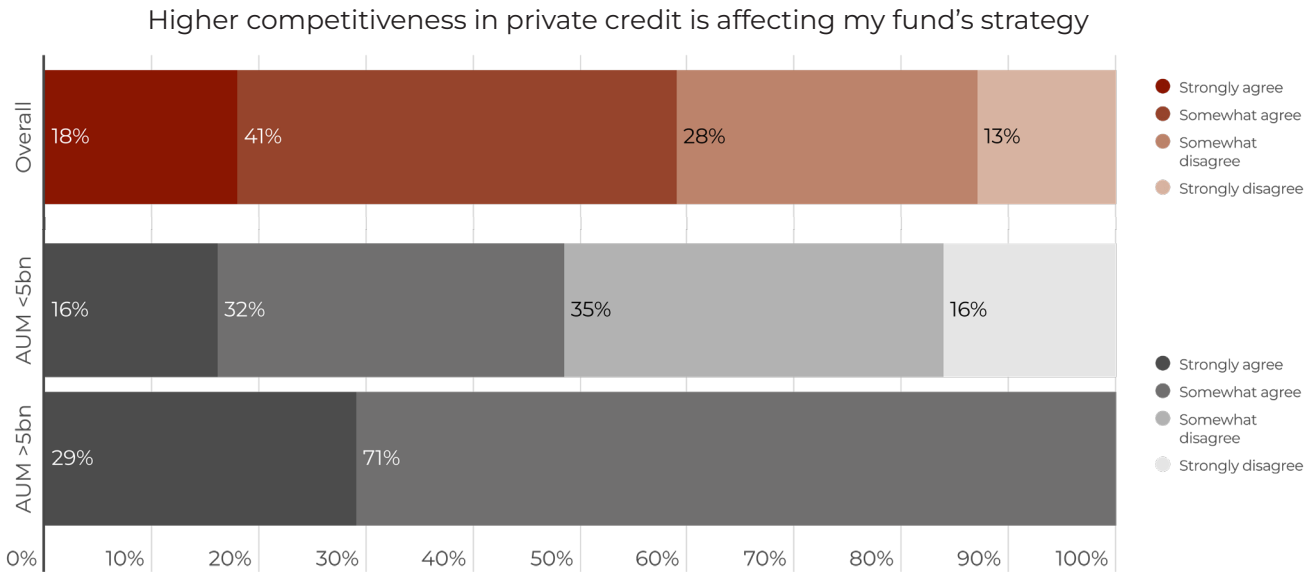


Figure 2.1 Private credit competitiveness by fund size



Analyst note: *Larger firms are feeling more effects of competition in private credit*

Source: Private Equity Wire readers survey

deal, but too much uniformity would nullify funds' unique selling points from an investor perspective. "In my experience, most industry-wide standardisation attempts have been deviated from quite aggressively," he says.

DIGI MANAGEMENT

The task for funds is to preserve their edge while maintaining visibility over ballooning transaction volumes – a challenge that cries out for efficiency-focused advanced tech such as artificial intelligence (AI), data analytics and automation.

Bill Sacher of Adams Street Partners says: "Our entire system for collecting, storing and accessing due diligence data for deals is tech-enabled. As one of the world's largest PE fund managers, we have vast pools of track record data spanning over 50 years – all of which is digitised and highly accessible."

But the use of tech is far from widespread. Asked whether they have adopted AI or data analytics tech for pricing and/or portfolio management, a remarkable 60% of PEW's respondents answered in the negative, with no plans of doing so in the next 12 months either (see fig. 2.2).

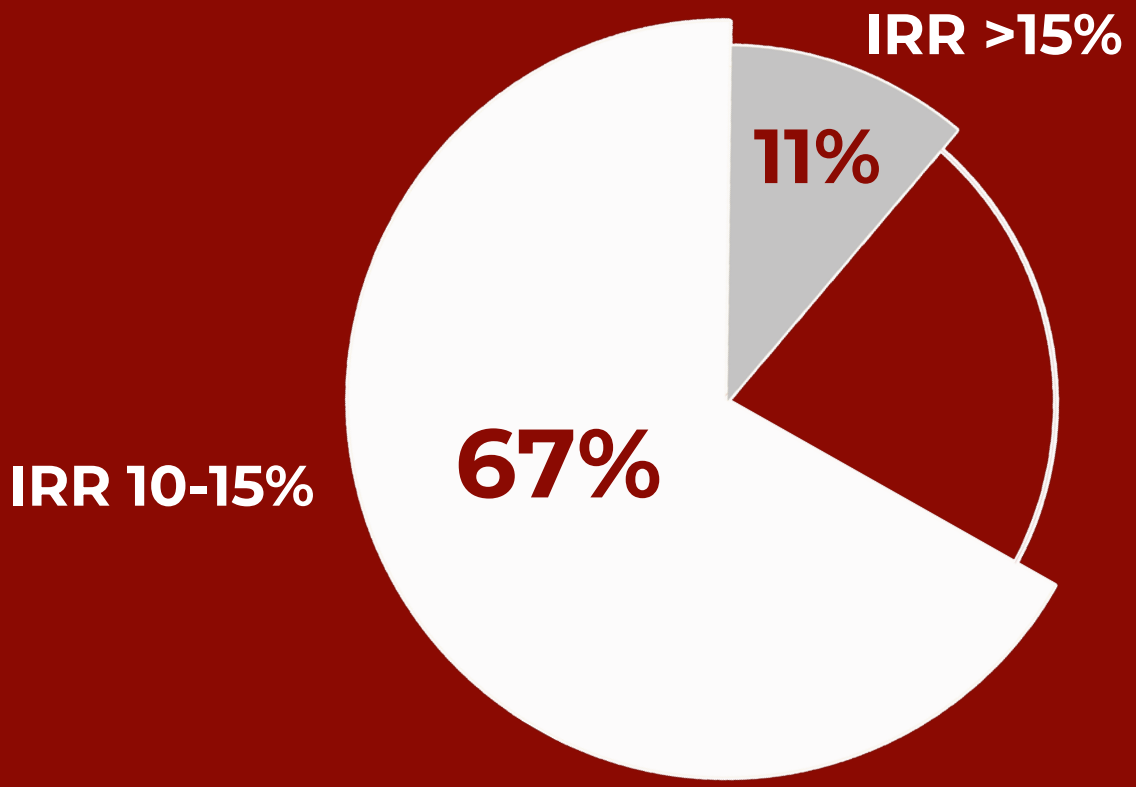
Competency of the tech itself could be one explanation here. Exciting as it is in its potential, Sacher describes AI as more of a "blunt instrument" in its current state.

Investcorp's Suhail Shaikh notes that 'off-the-shelf' portfolio management tools are useful, but adds "much work is required as an industry to standardise reporting practices and improve efficiencies with the help of technology".

KEY FINDINGS

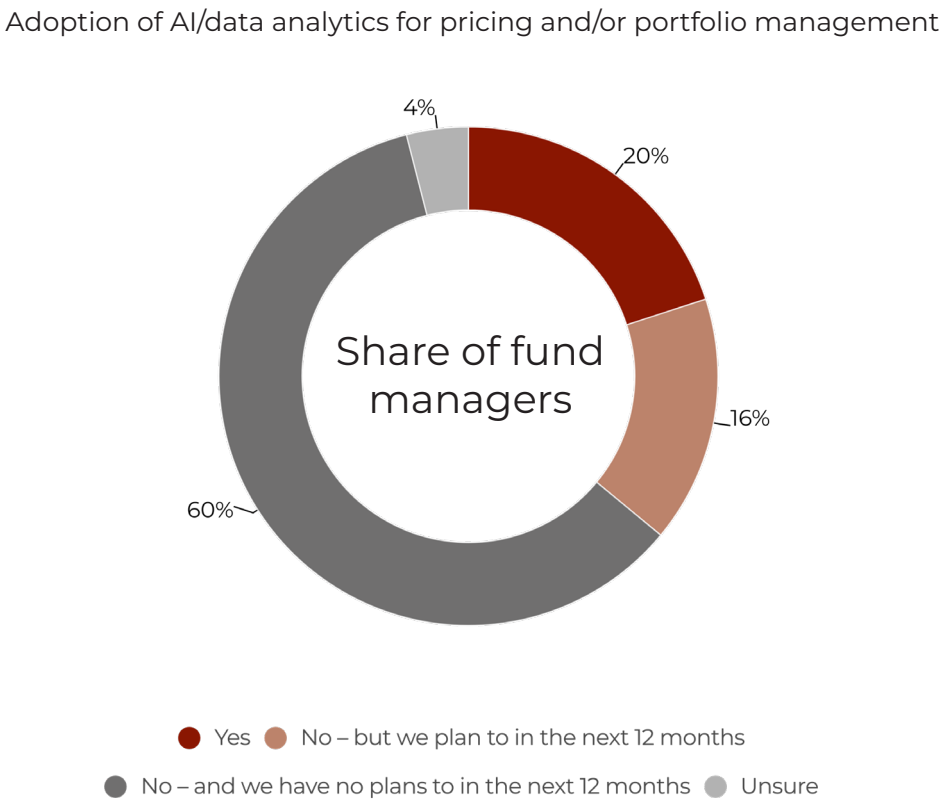
Low-risk direct lending is producing double-digit returns for most

IRRs for managers prioritising direct lending deployment opportunities



INSIGHTS

Figure 2.2 Use of advanced tech for portfolio management



Analyst note: *Respondents were asked, 'Has your firm adopted AI/data analytics for pricing and/or portfolio management?'*

Source: Private Equity Wire readers survey

FLEXIBLE CREDIT

Another way for firms to win favour among investors is by offering flexibility and allaying liquidity concerns that are intrinsic to credit as an asset class. Both can be done via permanent capital – or 'evergreen' – structures, where external liquidity channels help funds offer rolling deposit and withdrawal opportunities for investors, in contrast with conventional funds where capital could be locked up for years.

It's a long-established practice that is only growing in popularity – KKR recently made news by launching a flexible, euro-denominated direct lending fund, and other managers are following suit. PEW's survey revealed 64% of managers either have an evergreen structure or plan to set one up in the next 12 months, while 49% say the same for a flexible credit fund (see fig. 2.3).

Sacher says: "Evergreen vehicles not only have intrinsic flexibility advantages, they also present investors with the opportunity to buy into and immediately gain yields from existing portfolios – bypassing the J-curve.

"These structures were originally designed to appeal to High Net Worth and retail-oriented investors. In the US, a lot of them were formed as business development companies and have grown significantly in popularity among institutional investors.

"That's a material trend that signals the market's future direction – institutional

“

An evergreen strategy allows us to track the credit cycle in terms of risk, easing, expansion and contraction, and pick our moments to jump in and out

Rick Fratus
Managing Partner, Stafford Private Markets

investors have grown more interested in these strategies as private credit has become more established as an asset class. It makes sense not to always rely on raising funds and allocating them repeatedly."

There's a macroeconomic angle to the evergreen appeal too. Stafford Capital's Managing Partner, Rick Fratus, says: "The fact that we operate an evergreen strategy allows us to track the credit cycle in terms of risk, easing, expansion and contraction, and pick our moments to jump in and out. We can secure higher risk-adjusted returns as a result without being forced to deploy dedicated funds.

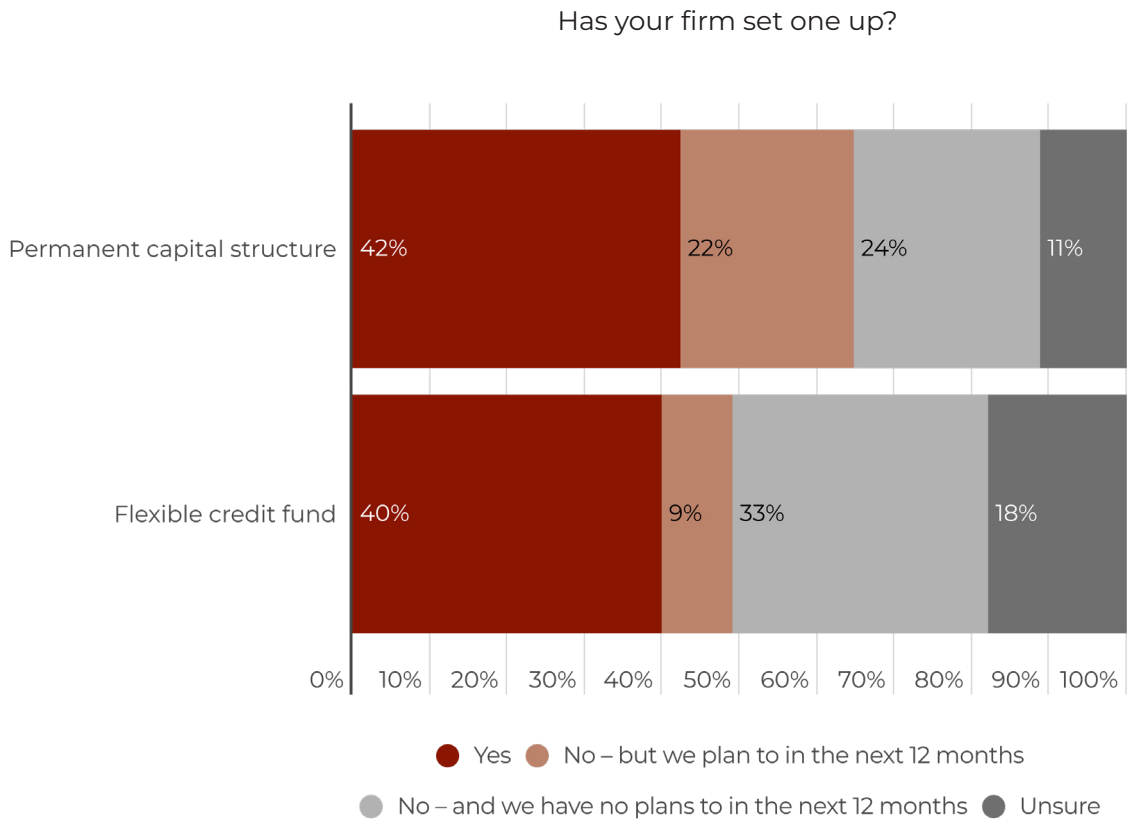
"But we like the benefits of a diverse evergreen strategy that can take advantage of market cycles. If, for instance, we saw a period of expansion or stress, it would be more challenging to deliver attractive returns with a single-strategy focused evergreen structure."

DEPLOYMENT

Another focus for Stafford Capital, Fratus says, is seeking deployment opportunities in the lower middle market, which he describes as the "less crowded space" in private credit. Climbing interest rates have boosted the fund's returns for those segments significantly.

Risk-reward ratios are playing out somewhat unpredictably in the private credit market. Fratus suggests stressed and distressed opportunities might be clocking attractive figures in the current economic landscape, while higher-risk unitranche, hybrid and

Figure 2.3 Popularity of evergreen strategies among private credit managers



Analyst note: *Respondents were asked, 'Does your firm have a permanent capital structure?' and 'Does your firm offer a flexible credit fund?'*

Source: Private Equity Wire readers survey

Premium upgrade

A 2019 piece in the FT described private credit funds as the "underbelly of the American debt market" that was "thriving in the shadows".

The asset class came up as a financing alternative for companies that were too small for public markets and didn't meet the tighter covenants and requirements for bank lending, so it's no surprise it was largely associated with a lower grade of investment.

That's all changed – now firmly out of the shadows, private credit is catering to investment-grade, blue-chip companies that are seeking respite from high interest rates and inflationary pressures, the FT reported in June this year.

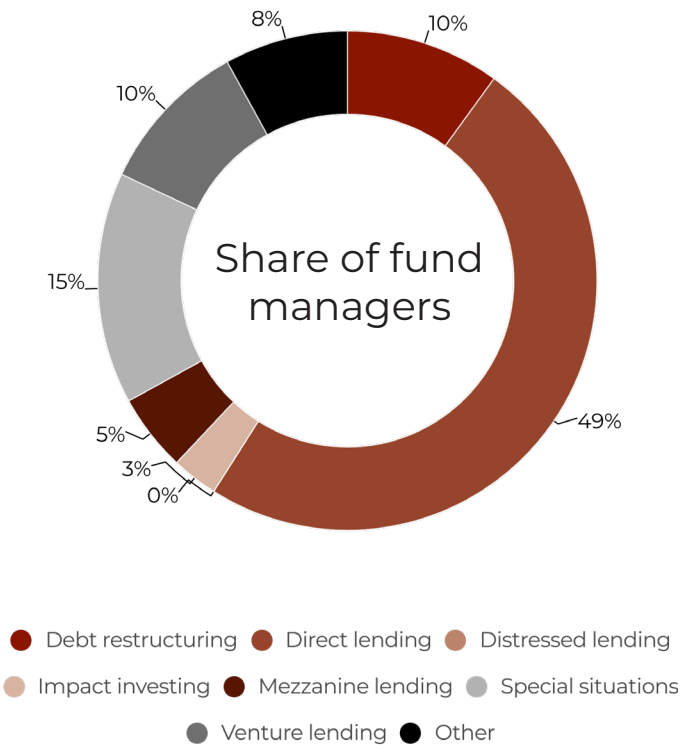
AT&T and PayPal are two examples cited in the report of premium deals made via credit instruments by some of the world's largest alternative asset managers, who are fuelling these investments with billions of premiums collected via newly acquired insurance companies.

With interest rates and spreads being where they are, a healthy double-digit return is par for the course even on lower-risk, premium-grade direct lending, as is evidenced by PEW research.

Following the big players' lead, managers across the board could be rethinking their approach to lending and capital deployment in general. As noted in the FT's report by Carlyle's Head of Credit Strategic Solutions, Akhil Bansal. "Private credit is going investment grade."

> "now firmly out of the shadows, private credit is catering to investment-grade, blue-chip companies

Figure 2.4 Biggest deployment opportunities in private credit



Analyst note: *Respondents were asked, 'Which of the following do you consider the biggest deployment opportunities for private credit over the next 12 months?'*

Source: Private Equity Wire readers survey

mezzanine opportunities are where the higher double-digit deals lie.

"If you're looking to make plain vanilla, senior secured direct lending deals with nice cash flows in the lower middle market, you can expect to just about reach double digit returns. As much as we've been hearing about 15% plus returns, I haven't come across a risk-adjusted number in that region," he says.

Sharp's characterisation of Alcentra's strategy tells a similar story – there's a clear focus on senior secured lending with the goal of clocking 8-10% IRRs or a 1.3x multiple.

Shaikh notes direct lending is a clear favourite: "Private credit is primarily used by borrowers and sponsors as an alternative to bank financings so most of the opportunities are in the traditional par loan space. Distressed or restructuring-driven investments are made by fewer managers."

Indeed, direct lending is the clear winner among deployment opportunities according to PEW's survey data (see fig. 2.4) and most seem to be getting eyewatering returns. A striking 78% of those prioritising direct lending strategies reported IRRs higher than 10% – of which 11% are in excess of 15% IRRs (see fig. 2.5).

But those with a higher risk appetite might just be eyeing other opportunities in this economy. Sharp reveals that among other offerings, Alcentra does have a healthy stressed distressed arm, and more managers are likely to get involved in the space.

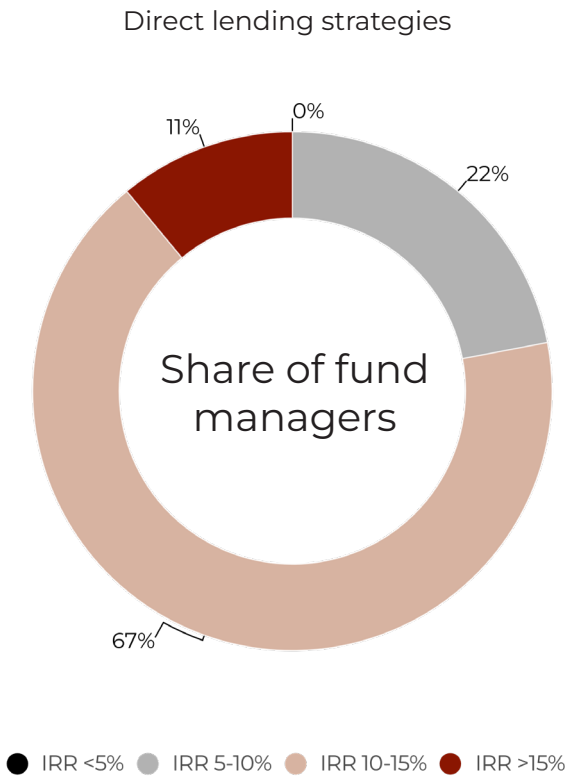
"For a long period when the economy was relatively benign and interest rates were low, it was hard for companies to get themselves into distress – aside from a handful of large, heavy capital expenditure businesses.

"Now there is a more ready-made pool of both distressed companies, which are in trouble and need a capital structure reset, and stressed businesses that need to tide over temporary challenges. The latter might cause a price dislocation on the secondary market, in which case it's just a matter of buying a company's debt and waiting for it to come back to par. In both these situations investors could potentially generate 2x returns and 20% IRRs or higher," Sharp says. ■

KEY TAKEAWAY

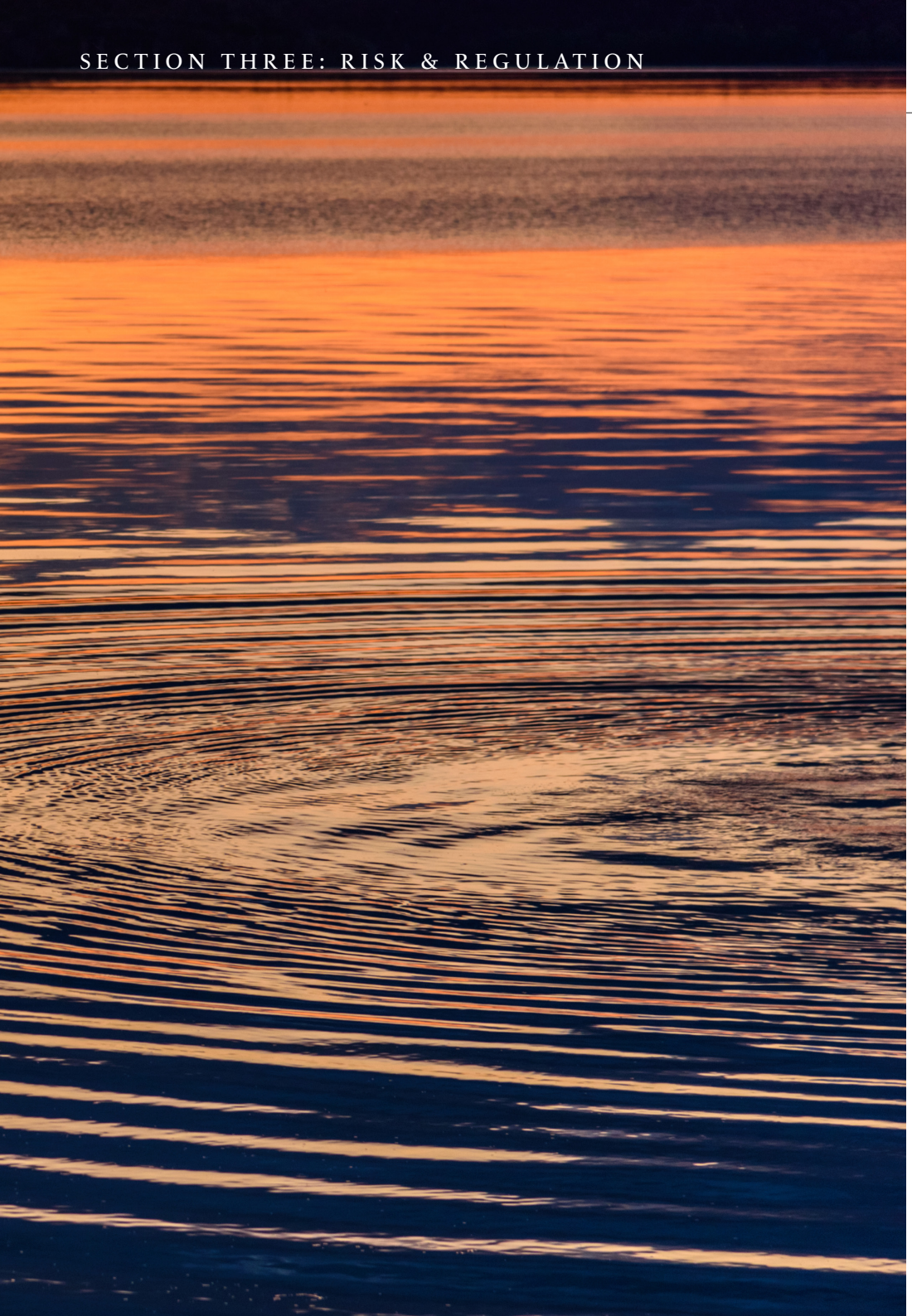
Most private credit funds view direct lending as their top deployment opportunity and are recording healthy, double-digit IRRs therein – evidence of the low risk, high reward dynamic at play in the market.

Figure 2.5 IRR distributions within direct lending



Analyst note: *Direct lending produces double-digit IRRs for most funds*

Source: Private Equity Wire readers survey



TAMING THE BEAST

Lack of transparency in a booming private credit market could breed risk which, if deemed contagious for wider financial markets, could get regulators involved

The rate of growth in private credit, while promising from a fundraising viewpoint and a healthy financial inlet for the global economy, is also raising questions around the level of risk involved in a rapidly growing body of transactions. A potential increase in default rates could put credit portfolios under immense pressure.

A Moody's report from April noted a lack of data available on the private credit market, which, combined with a looser regulatory framework than banking, could mean the segment is "harbouring risks that are not currently visible".

Declining asset quality and higher withdrawal rates, the report noted, are risks that could be contagious for other financial markets if they play out in private credit – which is yet to be tested by an economic downturn of this scale (see fig. 3.1).

"The unknown unknowns are always the biggest concern," says Rick Fratus of Stafford Capital. "What happened with Silicon Valley Bank in March signalled how easy it is for unforeseen systemic risks to cause massive ripples and distress. Thankfully the US Federal Government stepped in at the time to prevent

any contagion, but when you examine the kind of practices that led us to that point – it's hard to foresee that kind of event."

The best thing for fund managers to do is strengthen their own mitigation frameworks. Fratus says: "Central banks globally have been advertising higher rates for a while, which has given us enough time to make adjustments to operational costs and burn rates. We've worked with our direct lending managers to stress test our portfolio companies for various levels of revenue decline.

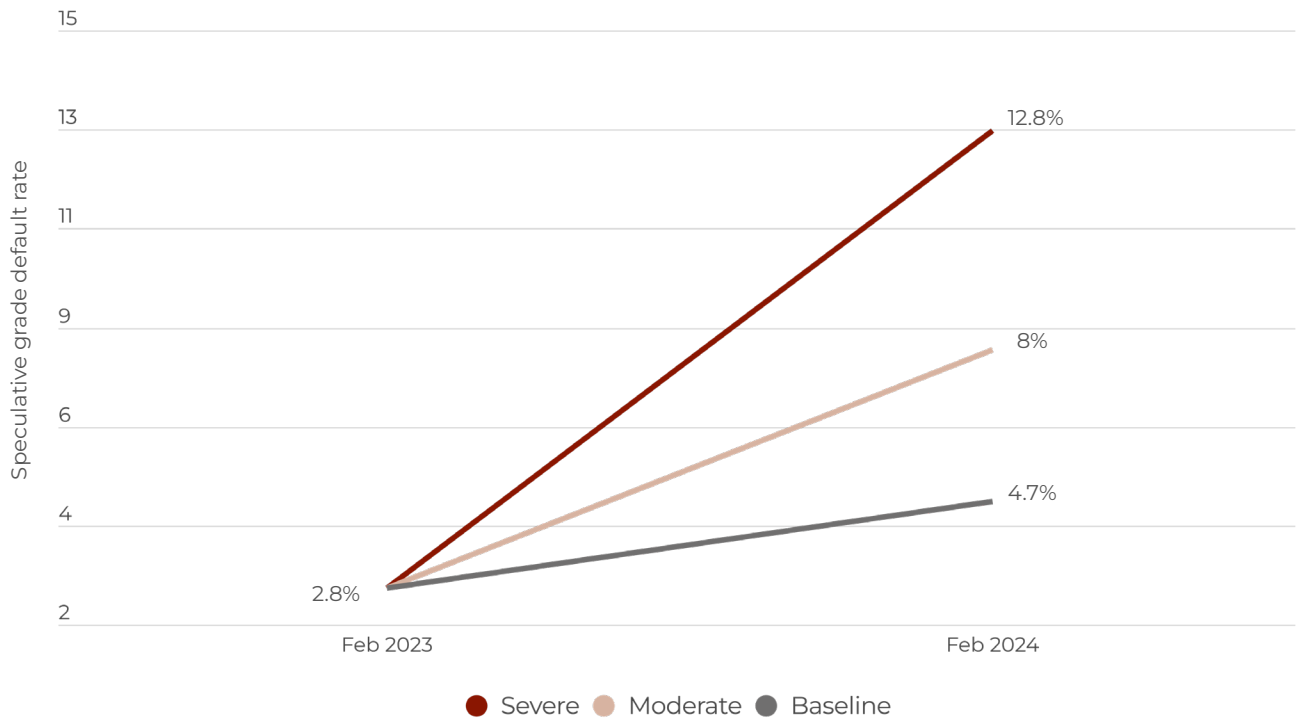
"We work in the smaller and lower-middle market, where loan-to-value levels were low to begin with – so there was some headroom and rising interest rates haven't put companies under distress."

RISK HOTSPOTS

But not all companies are as well protected – as noted by Moody's, many deals that were conducted in the low-interest-rate, highly competitive environment of 2021 are now in trouble. Bill Sacher of Adams Street Partners notes a concerning "rearview mirror" outlook for private credit – many of those companies are now facing debt levels that are making it difficult to pay their bills and support interest expenses.

"The smaller the company, the riskier," says Sacher, who points to Adams Street Partners's focus on the more stable middle market, which he defines as between $150m and $1bn in market capitalisation. "These are companies

Figure 3.1 Forecast for global speculative-grade default rate



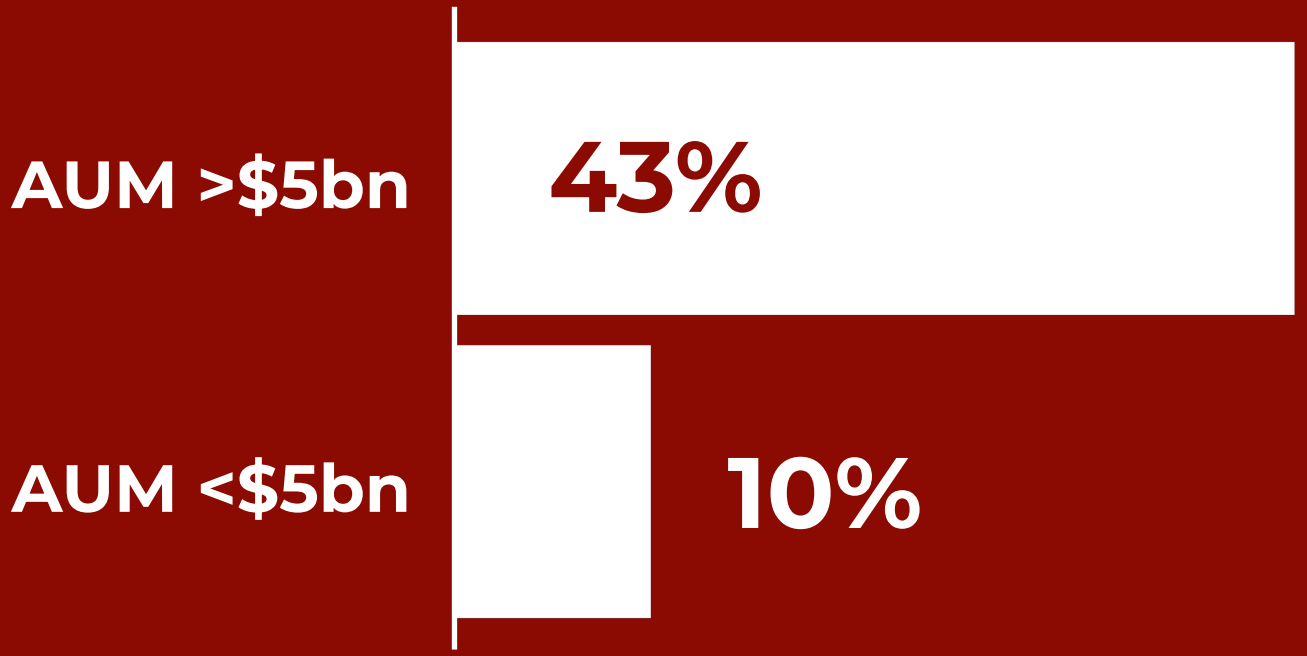
Analyst note: *Default rates are expected to rise under inflationary and interest rate pressure*

Source: Moody's

KEY FINDINGS

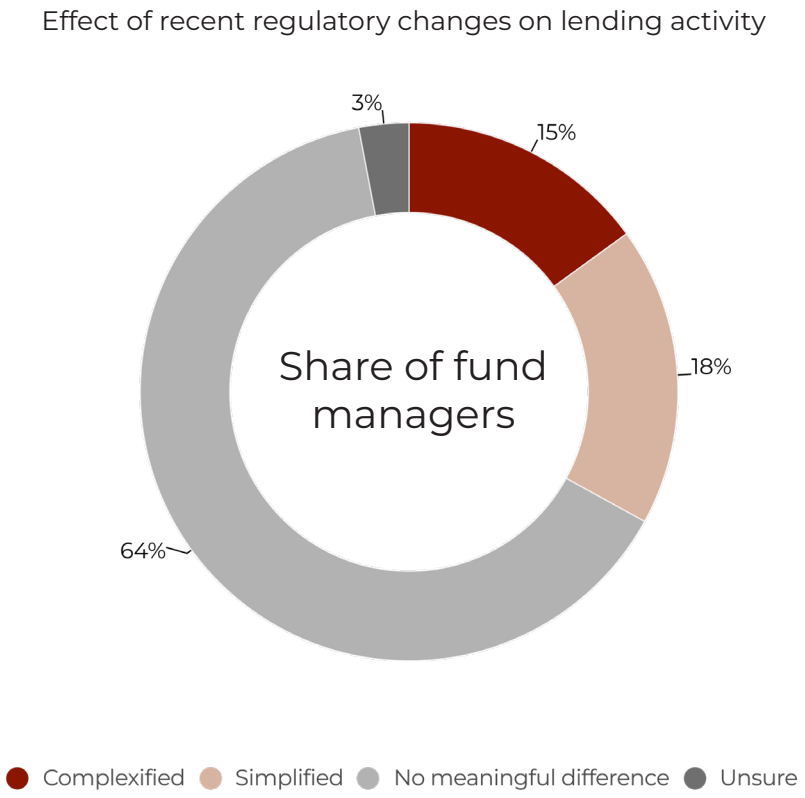
Bigger firms are facing more regulatory challenges

Share of fund managers who believe regulatory changes in the past 12 months complexified expansion of direct lending portfolios



INSIGHTS

Figure 3.2 Changes to the regulatory landscape for private credit



Analyst note: *Resspondents were asked, 'How have regulatory changes in the past 12 months affected your firm's ability to expand direct lending portfolios?'*

Source: Private Equity Wire readers survey

of scale that have professional management teams and some resilience as a result, but even here on a go-forward basis we'll be looking for tighter covenants and better creditor protections. You don't want aggressive, highly adjusted pro forma EBITDAs. Companies should have moderately leveraged capital structures with as much equity supporting it as possible."

Risk management is the need of the hour, and Sacher says the market is self-correcting. "With current rates interest expense has practically doubled in the last 12 months – companies can't afford to put as much leverage on businesses as they were before, which is making capital structures safer in general."

And while there are widespread concerns around a high instance of risky 'covenant-lite' deals done in the private credit market in recent years, Alcentra's Howard Sharp suggests the market is on solid ground. "There are a handful of big players in the market that are very publicly doing cov-lite unitranche financing – they focus on the upper mid-market where companies are assumed to have less financial stress and so the risk appetite is higher for investors. Then there is the broadly syndicated loan market, where the majority of deals are covenant-lite and also focused on the upper-mid market.

"But neither are indicative of systemic trends in private credit, where the majority of lenders still operate on a strict covenant basis. There are variations – established players such as Alcentra and some of our competitors can be

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a number of well-known firms such as Ruya Partners, Investbridge Capital, Shuaa Capital and Franklin Templeton are now active in the GCC’s private credit market

ADGM: Paving the way

Regulators may eventually intervene to install some guardrails for private credit’s astronomical growth, though the trend for now is to step out of the way and let the increasingly popular asset class fuel economic growth.

A case in point is the Financial Services Regulatory Authority (FSRA) of the Abu Dhabi Global Market (ADGM), which announced in May that it had tweaked its regulatory framework to allow fund managers in the region to make credit deployments.

The announcement cited the “relative attractiveness of returns on lending compared to other asset classes” as a key reason for the change, alongside credit’s potential to “finance dynamic, growth-stage companies”.

ADGM FSRA’s CEO, Emmanuel Givanakis, said in a statement that the change “will help support and bolster the growth of companies, while providing greater investor choice and ultimately contribute to the growth and diversification of the economy of Abu Dhabi, the UAE and the broader region”.

In May, Debtwire reported a number of well-known firms such as Ruya Partners, Investbridge Capital, Shuaa Capital and Franklin Templeton are now active in the GCC’s private credit market, while institutional investors in the region are upping their exposure to the asset class as well.

quite selective about our transactions, but new entrants who are under pressure to raise funds fairly quickly might engage more in riskier investments."

A WATCHFUL EYE

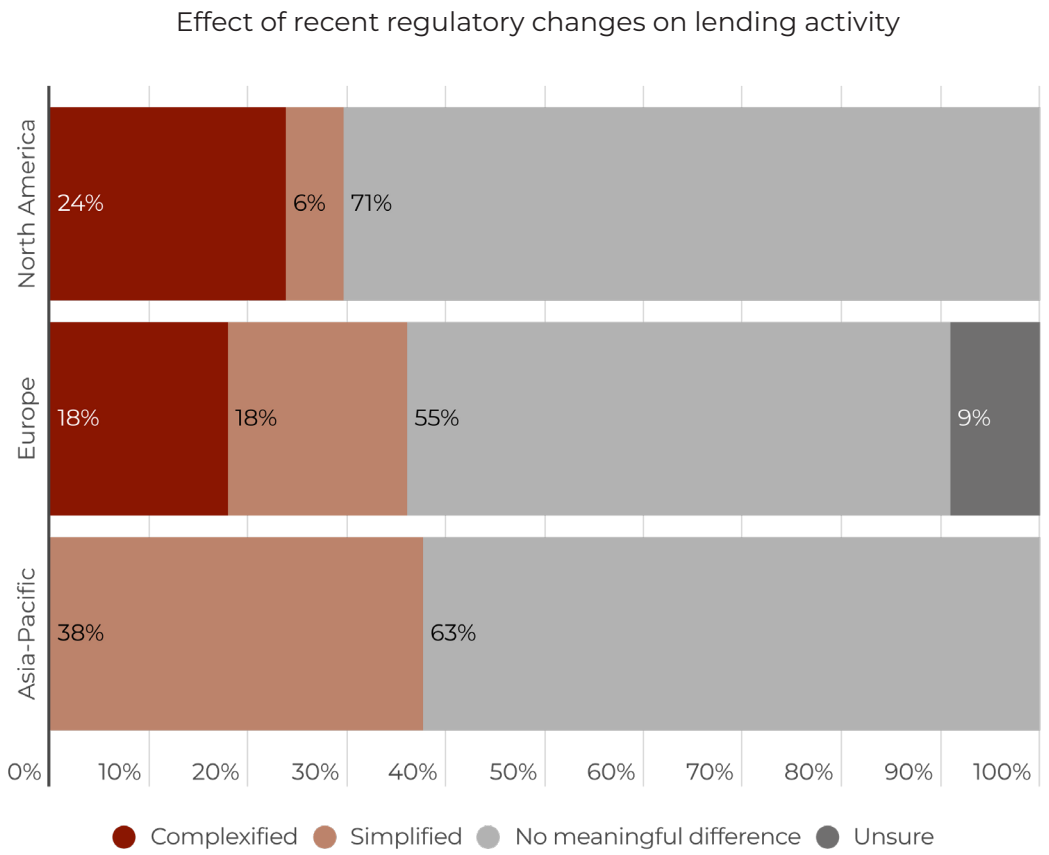
Funds will take their own measures to hedge against default risk – the question remains of whether regulators will get involved to protect against systemic pitfalls. Sharp believes they will keep their distance. "Private credit funds are here to steward third-party capital – investors such as pension funds, insurance companies and family offices pay us to take a level of risk and deliver return. As such, the government is not directly responsible here in a way that they perhaps need to oversee the world of banking."

PEW's survey reveals minimal oversight on private credit for now – 64% of managers say regulatory changes in the last 12 months have made "no meaningful difference" to their ability to expand direct lending portfolios (see fig. 3.2). Another 18% say the regulatory landscape has actually simplified lending.

Fratus says: "Small, regional banks such as SVB, Signature and First Republic accounted for a significant share of lending in the US market. With them out of the equation, there is talk that the federal government will adjust the capital requirements to make regional lending more secure.

"These changes might not go through because of their potential to choke the regional

Figure 3.3 Regional variations in private credit regulations



Analyst note: *North America faces the most complex regulatory landscape for private credit*

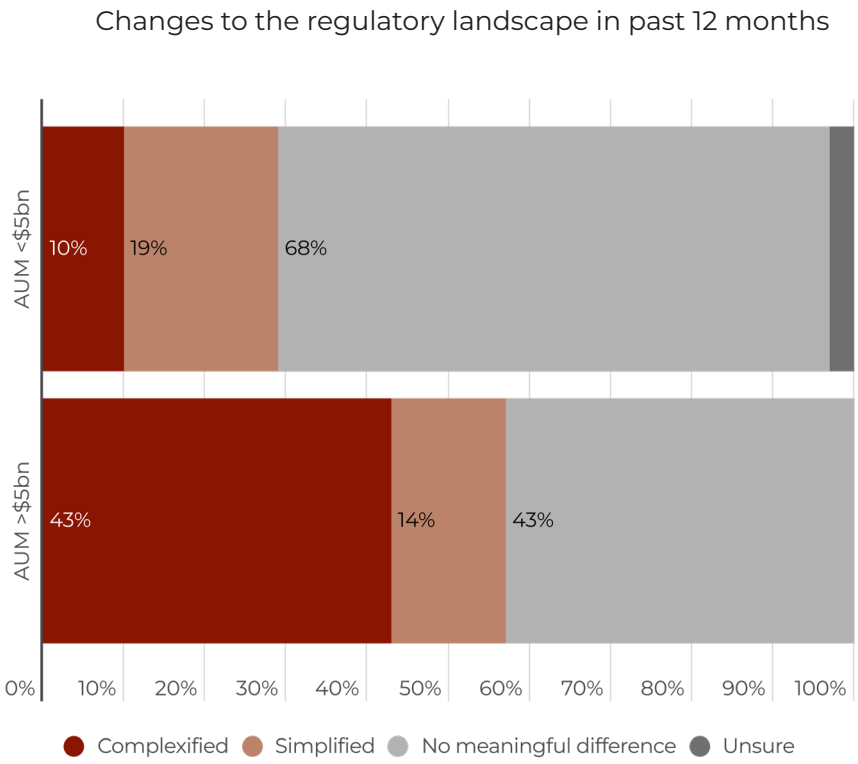
Source: Private Equity Wire readers survey

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New entrants under pressure to raise funds quickly might engage more in riskier investments

Howard Sharp
Managing Director, European Private Credit

Figure 3.4 Variations by fund size in regulatory complexity for private credit



Analyst note: *Larger funds face a more complex regulatory landscape*

Source: Private Equity Wire readers survey

economy, but if they do it might cause regional banks to pull back their portfolios – leaving more of the market open for private credit players."

Interestingly, North America is the region where the biggest share (24%) of PEW's respondents said the regulatory landscape has become more complex (see fig. 3.3). In contrast, 38% of Asia-Pacific respondents believe things have gotten simpler, with the rest feeling no meaningful difference.

Suhail Shaikh of Investcorp says: "The regulatory environment in the US has not changed much for direct lenders in the last five to seven years. The biggest change was moving leverage for BDCs from 1x to 2x equity, which allowed direct lenders to be more competitive with banks while pricing deals. In Europe, our understanding is the spotlight on direct lending regulation has increased – though we don't have a presence there so it's difficult to provide details."

There are variations by size too – 43% of firms with AUMs higher than $5bn are observing more complex regulations for direct lending, compared to only 10% for those below the $5bn threshold (see fig. 3.4).

The numbers reveal a fairly relaxed landscape for private credit as a whole, with some hints of change in a rapidly expanding market. The Head of Private Credit at a prominent investment house says: "On the one hand, concern around the health of the banking community has been helpful for the private credit market. But it isn't unreasonable to expect that as private credit edges more into the banking market share and takes a bigger piece of the global financing pie, regulators will start to get involved.

"The US and Europe remain the two main geographic centres for private credit – regulation will probably tighten in both markets, though the latter will likely be more fragmented as it'll be country-specific. For regulators, the key is to strike a balance – oversight will be important, but they wouldn't really want to hinder one of the most robust capital formation vehicles on the market at present and hurt the economy as a result. It remains to be seen how they'll approach that problem." ■

KEY TAKEAWAY

Regulatory intervention in private credit remains low at present, though views are mixed about whether stipulations will grow stricter or remain moderate in the near future.

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