THE GOLDEN AGE OF PRIVATE CAPITAL: WHAT LIES AHEAD FOR 2024 AND BEYOND

PANEL

HOWARD SHARP
–
SPEAKER
Chairman and Co-Head
of Private Credit
Alcentra

ALBERT COSTA CENTENA
–
SPEAKER
Head of European Credit
Apax

SARAH PRINCE
–
SPEAKER
Chief Financial Officer
Arcmont

MARK HICKEY
–
SPEAKER
Chief Operating Officer
Pemberton

MARIE-GWENHAELLE GEFFROY
–
MODERATOR
Global Head of Sustainability and
Private Capital Practice, Financial
Institutions Coverage
BNP Paribas

We are in the midst of what's been termed a golden age for private capital. Billions of dollars are flowing into soaring numbers of private credit vehicles. But what does the future hold?

A recent BNP Paribas' Securities Services business panel session in London gathered industry experts to share their insights into current market conditions, effective ways to navigate the operational challenges, and how to take advantage of the opportunities that lie ahead through 2024 and beyond.

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INDUSTRY ON THE RISE

As Geffroy observed, private credit has enjoyed rapid growth in recent years and is here to stay. Despite the current macro and higher rate environment, the asset class has been enjoying continued support from investors who remain committed to private credit. That is expected to translate into a double-digit compound annual growth rate (CAGR) between 2022 and 2028, leading global AuM to almost double to $2.8 tn over that period, according to forecasts from data provider Preqin.

A positive performance track record and returns outlook are fuelling that growth. The return of interest rates to more normal historical levels creates a propitious environment for private credit investors, because there is a compression between private equity returns, which are coming down under pressure, and private credit returns going up, said Alcentra's Sharp.

And while managers are entering the space and expanding, continued market growth means the demand/supply dynamic has not pushed spreads significantly tighter, observed Hickey.

"So whilst we think interest rates will come down in the second half of next year, we still think returns are going to be at or around double digits on a gross basis."

MARK HICKEY, PEMBERTON

DEFAULT RISK SPOTLIGHTS RESTRUCTURING CAPABILITIES

Default risk is a concern though for investors in the current environment and as we move into next year, noted Prince, with today's higher interest rates pressuring borrowers' ability to repay.

The 'refinancing wall' that will start in 2024 and peak in 2025 will add to the restructuring onus and test managers' ability to adapt.

In the upper direct lending arena, the direction of travel is towards a club market and mutualisation of risk, contended Sharp.

In the mid-market, where funds have loans they can't trade out of, financial and operational restructuring become essential if managers are to protect value for LPs when a loan goes wrong, which is why restructuring is a core skillset within Pemberton's investment team, observed Hickey. That is much easier to do when you are the sole lender, Sharp added.

"How managers cope, and whether they have that restructuring expertise embedded in, will be a differentiator over the next couple of years."

SARAH PRINCE, ARCMONT

''In Europe, the top 10 direct lenders control approximately 60% of the market, whereas in the more mature US it is around 15%. Funds will increasingly work together on transactions, particularly making headway into the traditional broadly syndicated loan space, and move towards an American style model, which is 20 years older than the European market.''

HOWARD SHARP, ALCENTRA

COMPELLING OPPORTUNITIES AMID THE MARKET STRESS

Looming refinancing demands will also throw up opportunities, noted the panel. A key difference between the financial crisis and now is that central banks slashed rates in 2008, said Prince. "We're in a different situation today because there will be companies really burdened by higher rates, so you'll have opportunities to refinance the capital structure."

Those opportunities span a range of sub par investing strategies, from short-term mispriced assets that will come back to par, through to stressed and proper distressed assets, said Sharp. Previously there was a limited number of "shonky deals" doing the rounds that together weren't enough to form a proper distressed strategy. Now a ready-made group of companies is emerging in different categories that you can build a stressed or special situations fund around to meet investor appetite, he noted.

For Apax's Costa Centena, many of the opportunities are being spurred by liquidity challenges. In some cases, they are M&A-driven liquidity issues, where companies see attractive M&A deals and are happy to pay a higher cost of capital because the value creation is even greater. But a lot of companies have liquidity issues because they came into this rate environment with poor financial controls and did not hedge, said Costa Centena. That's especially the case in America, whereas in Europe hedging has been higher and rates haven't risen as much. "We're spending a lot of time in the US with well-managed companies that are doing well, they just have liquidity issues. That's the big opportunity for the Apax Credit Funds."

> **"The key to delivering high returns for the fund investors is to have flexible credit strategies that can invest in a range of options and different sizes, and have the nimbleness that smaller managers can bring to take advantage of the broad opportunity set."**
>
> ALBERT COSTA CENTENA, APAX

And then, given the margin of safety is lower on companies' day-to-day cash flows at today's base rates, conducting thorough due diligence to avoid mistakes and keep a clean portfolio will be more important than ever.

IMPROVING SUSTAINABILITY

Decarbonisation and digitisation of the economy present further powerful long-term trends, with Sharp highlighting the opportunities they are creating in the infrastructure space. Trying to bring some standardisation to the impact fund arena, to develop definitions and targets that everyone can agree on and buy into, with clear regulation that people understand, will be key challenges though,

added Prince. "So a lot of the focus is on getting the delivery correct to investors." Data will be vital. Pemberton has been on a journey to get detailed, relevant data out of its portfolio companies, Hickey noted, with every borrower now having one-on-one sessions with Pemberton's sustainable investing team. "And when do you get it? Is it pre-commitment to the loan? Post commitment? What are the ongoing data obligations?"

Given 70% of global carbon emissions come from the corporate sector, and the private side is responsible for 40% of that, asset manager engagement to influence portfolio company behaviour will be crucial As Costa Centena observed, private equity firms that control the companies in their portfolios are in a strong position to shape their carbon reduction programmes. In European private credit, noted Sharp, the move is towards Sustainability Linked Loans.

This focus on sustainability is becoming ever more existential. The growing external scrutiny of funds and GPs means those that don't make the necessary investment in people and systems could fall back to becoming Article 6 funds, and as Sharp cautioned:"If that happens it will become more difficult to raise capital."

PROFITING FROM RETAILISATION

As for raising capital, the next El Dorado for the industry is widely seen as the high-net-worth class of retail investors and the colossal pool of assets they control. Successfully attracting allocations though will depend on structuring vehicles that can balance the tension between private capital's illiquidity profile and retail investors' redemption expectations, and doing it to regulators' satisfaction.

As firms migrate into the open-ended space, ensuring products fit the bill and getting the liquidity right to avoid major issues is crucial, concluded Prince.

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