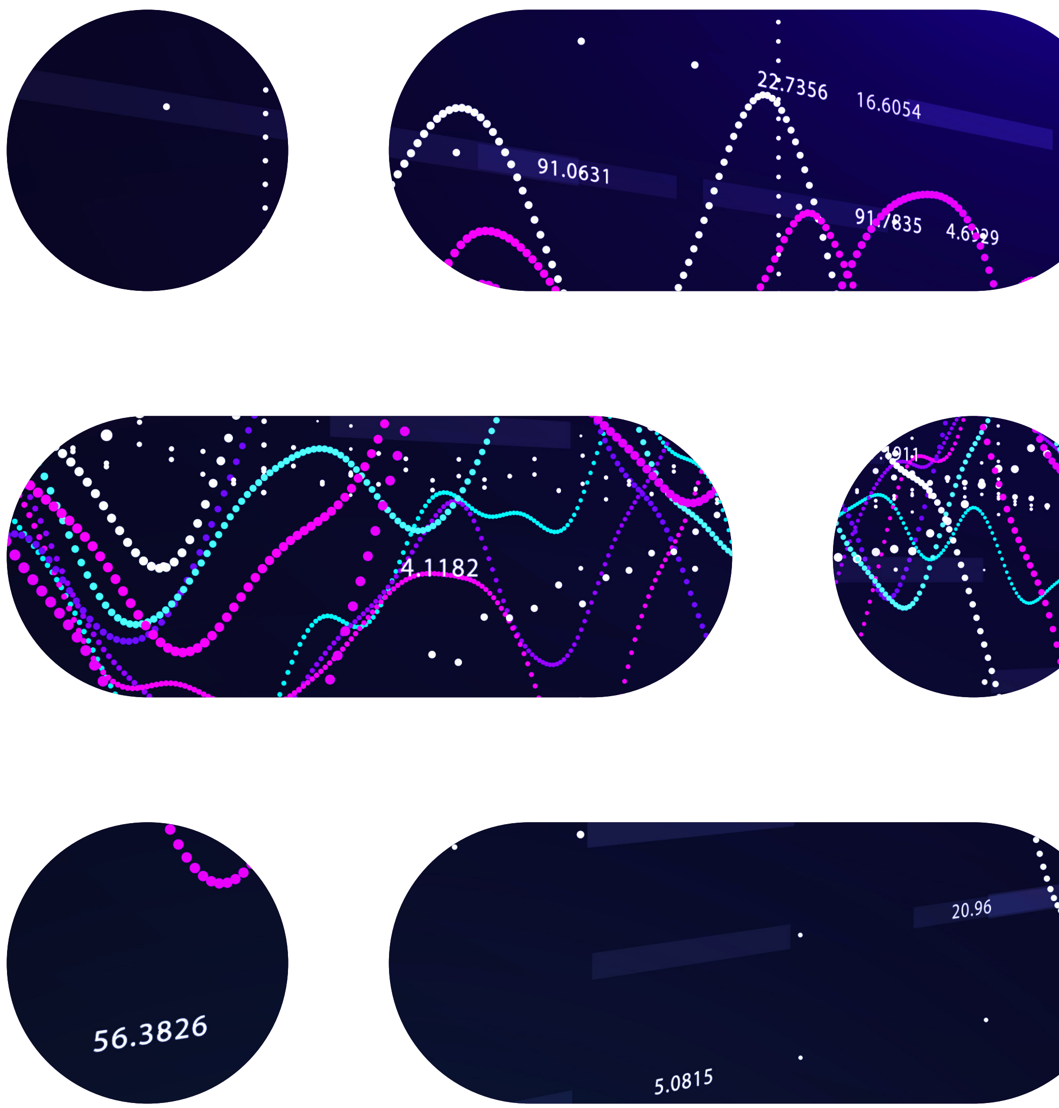
EVALUESERVE

Whitepaper

Private Credit

Moving into the mainstream amid a weakening macroeconomic backdrop



The global economy has been growing at a slow pace since around the middle of 2022 owing to rising inflation and tightening credit measures introduced by central banks to contain inflation. Technically, US is still not in a recession, as it would mean a significant decline in economic activity which is two consecutive quarters of falling real GDP. The headline inflation has been declining consecutively for the last 9 months (but is still above the Fed's target), and labor market is still strong adding new jobs and unemployment rate shows little change standing at 3.5%. We will perhaps see signs of the economy slowing down in Q2/Q3 this year. J.P. Morgan Research's baseline view assumes a U.S. recession is likely before the end of 2023. Given the recent banking crisis, the market is predicting a Fed Pivot that should result in an economic recovery, but we are still in early stages.

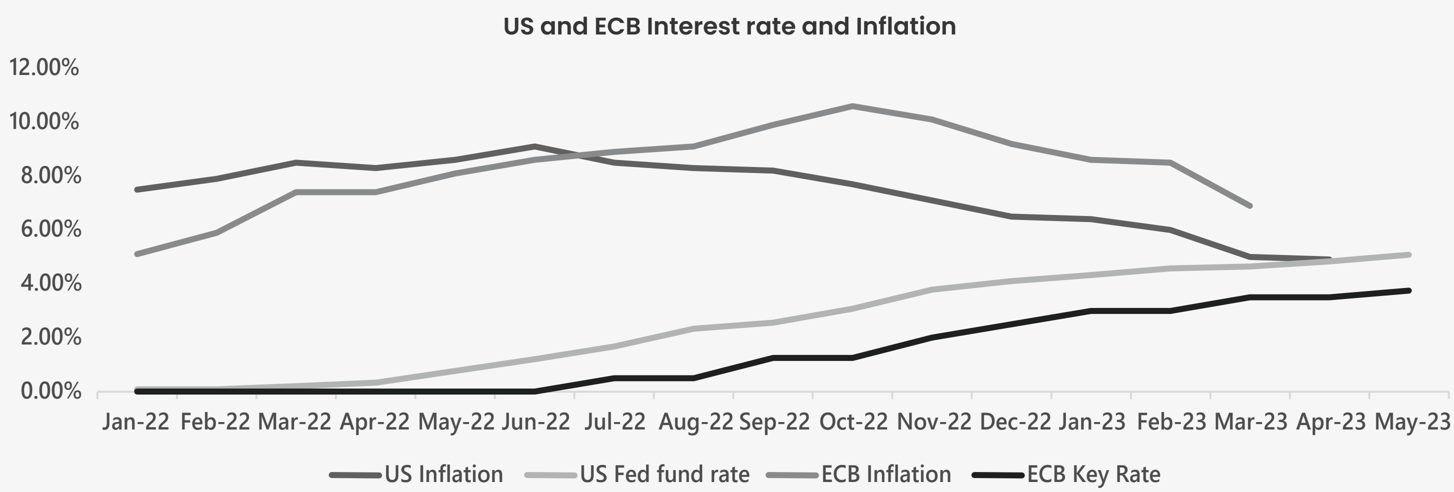
As credit availability tightens owing to rising interest rates, the private credit asset class is expected to remain resilient to the current macroeconomic situation and outperform public credit and fixed income asset classes. Investors will likely direct their funds into this asset class in anticipation of attractive risk-adjusted returns, while private credit funds will likely be looking to deploy all that cash to take advantage of the economic backdrop.

Pressure on the US and European banking systems

Banks globally have operated in a low interest rate environment over the past decade. Credit was readily available at attractive interest rates, bolstering post-pandemic economic growth, and unemployment rate was at historical lows. This led to a spike in inflation as economies started to heat up and central banks swiftly adjusted their monetary policies by raising interest rates. The Fed in the US raised interest rates from a near zero level in March 2022 to a range of 4.75-5.00% as of March 22, 2023. The ECB has also been raising rates gradually to contain inflation that stands at 8.5%, well above its target rate of 2%. The bank's current interest rate stands at 3%.

Owing to the rising interest rates, we have begun to see cracks in the global financial system, with a few mid-size, regional banks failing in the US. Silicon Valley Bank was the first casualty, followed by Signature Bank that was subsequently shut down.

Silicon Valley Bank, once the 16th largest bank in the US and a major firm for technology and start-up companies in Silicon Valley, experienced the second largest bank failure in US history. SVB's deposits had tripled to $189 billion by 2021 owing to growth



Source: BLS, Fred, ECB

in tech startups, but the bank invested heavily in US treasury bonds, which became risky when the Fed raised interest rates in 2022. To strengthen its balance sheet, SVB sold its bond portfolio and commenced an underwritten public offering, but it still reported a loss of $1.8bn. This sparked fear among investors, causing the stock price to crash, and the FDIC took over the bank. Over $151 billion worth of deposits were not insured, and two days after SVB's collapse, a second bank, Signature Bank, failed and was seized by regulators.

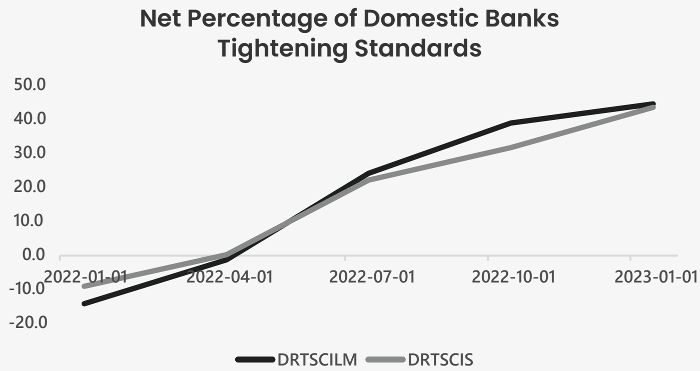
Shortly after the trouble started at these two banks, the stock price of a third bank, First Republic, plummeted, with depositors afterward rushing to withdraw their money. As per the Wall Street Journal, depositors withdrew almost $70bn, as most of its deposits were uninsured, and like SVB, it had invested heavily in US treasury bonds. The Fed was quick to react and as a backstop offered additional liquidity to the bank. A few days later, it received uninsured deposits totaling $30 billion from a consortium of US-based banks led by JP Morgan Chase.

Meanwhile, in Europe, shares of Credit Suisse were in free fall and its credit default swaps spiked to their highest levels, indicating the bank was in financial distress. Credit Suisse auditors also reported material weaknesses in the bank's financial reporting earlier this year. The Swiss National bank intervened and facilitated an emergency rescue deal in which UBS agreed to acquire Credit Suisse, thus reassuring financial stability and investor confidence in the Swiss banking system.

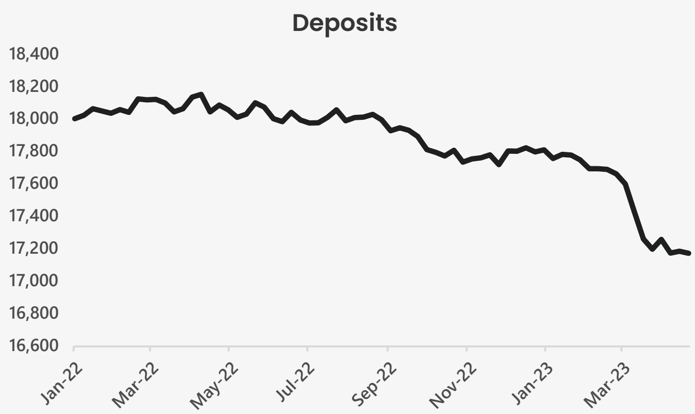
Further tightening of regulations, restrictions, and credit conditions

Given the rising interest rates combined with the stress in the banking sector, there is the potential for a credit crunch, as banks will likely look to strengthen their balance sheets and reevaluate their credit and loan portfolios. There should be increased scrutiny that would restrict credit availability for businesses. Also, the small/mid-sized banks with less than $250bn in assets that had been previously exempted from Dodd-Frank regulations will now be expected to set aside large amounts of capital as a cushion to avoid another financial crisis. As seen in the chart below, over the past 12 months banks have already started tightening their lending standards. The banks will also be less likely to extend large volumes of loans amid concerns over recession. Businesses will be looking to the banks primarily to help them overcome the credit crisis, but the banks on the other hand will be more restrictive in offering credit and if they do, then it would carry high rates of interest, collaterals, restrictive covenants, and substantial due diligence, all of which for a small business is hard to meet. Historically, small, and mid-size businesses turned to small/mid-size banks for their capital requirements, but now with the credit tightening, regulatory restrictions, and some of the banks having shut down, it will become difficult for businesses to source capital for running or expanding their operations.

Bank deposits in the US have also been shrinking because of the banking crisis, with a lack of clarity from the FDIC as to whether all deposits will be guaranteed in the event of a bank's failure. Treasury Secretary Janet Yellen told a Senate committee that she is not considering expanding the FDIC's insurance limit of $250,000 and that the FDIC has not considered blanket insurance or guarantees for all depositors. She also stated that if there is contagious bank run, then the Treasury on a case-by-case basis would likely pursue an exception that would permit the FDIC to protect all depositors of the failed bank. Given concern over whether the run-on banks will continue, a certain percentage of businesses have been withdrawing their money and deposits levels have been going down. Moreover, in addition to the lack of security, the average rate of return on bank deposits stands at around 0.48%, which is significantly lower than the 10-year T-bill rate, which also explains the flight of capital from bank deposits to money market instruments.



DRTSCILM - Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms
DRTSCIS - Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Small Firms
Source: FRED

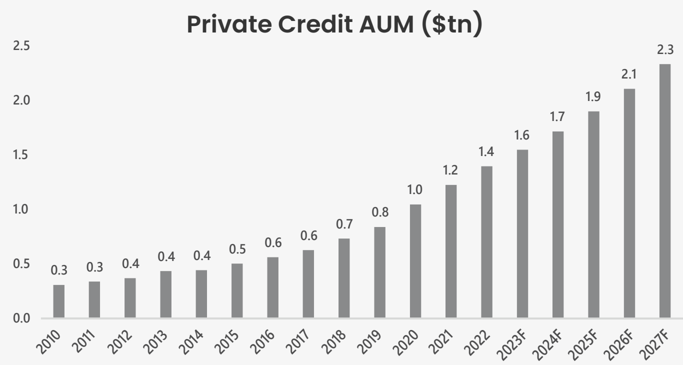


Source: FRED

Amid the current market environment in which smaller banks are expected to face regulatory restrictions, the consolidation among larger players and tightening credit conditions should leave a major funding gap. Some of the small/mid-market firms will be left underserviced and will likely look to private credit options to fuel growth and run their businesses.

The case for private credit

Private debt AUM has been steadily increasing over the past decade. Each time there has been a downturn or banking crisis, companies largely turned to private credit as a funding source. Private credit operates in wide array of spaces including direct lending, project financing, mezzanine loans, distressed loans, and other credit opportunities. Investors are also upbeat about investing in private credit, as it offers a stable income as well as risk-adjusted returns, given some of the credit is shielded from interest rate fluctuations since the credit is generally given to companies on a floating interest rate basis. Investors are also looking to diversify their portfolios owing to the risk from high inflation and rising interest rates, and private credit provides a good hedge against both.

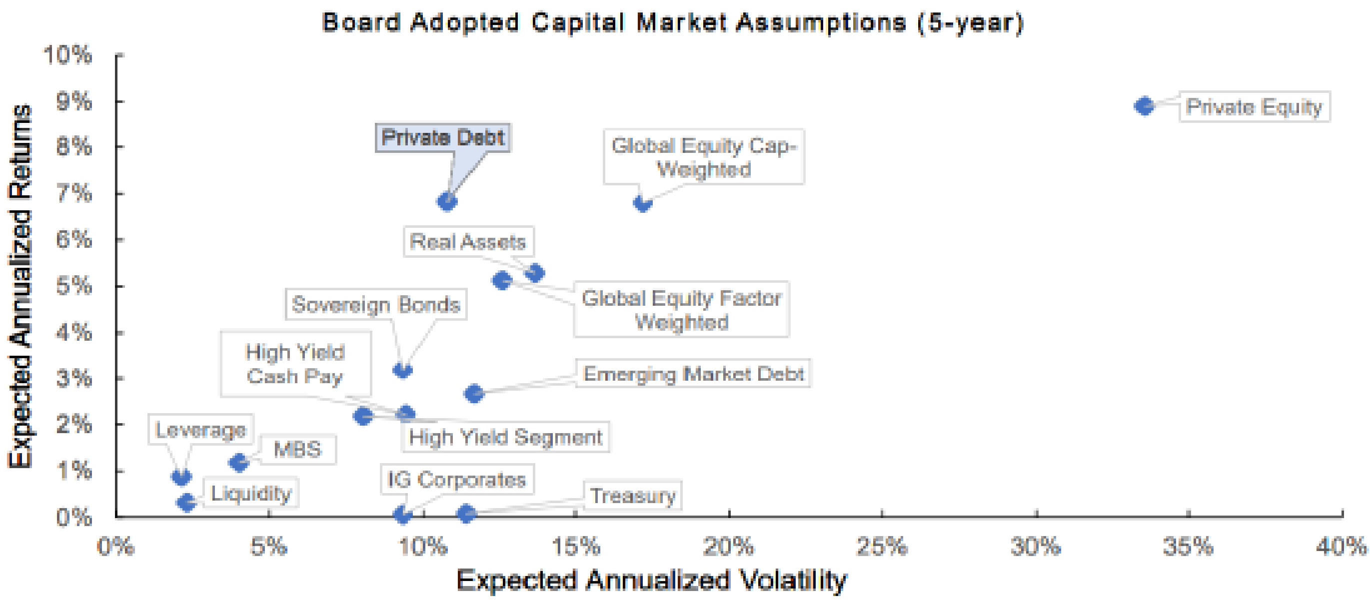


Source: Whitecase, Preqin

As per Preqin, private debt AUM is expected to rise from $1.2tn at the end of 2021 to $2.3tn by the end of 2027, almost doubling, which is substantial growth as it has historically increased at a much slower pace. Based on fundraising data as of the end of Q3 2022, $172.1bn was raised by private debt funds globally and the number of funds closed decreased substantially (137 for Q1-Q3 2022 versus 273 for 2021).

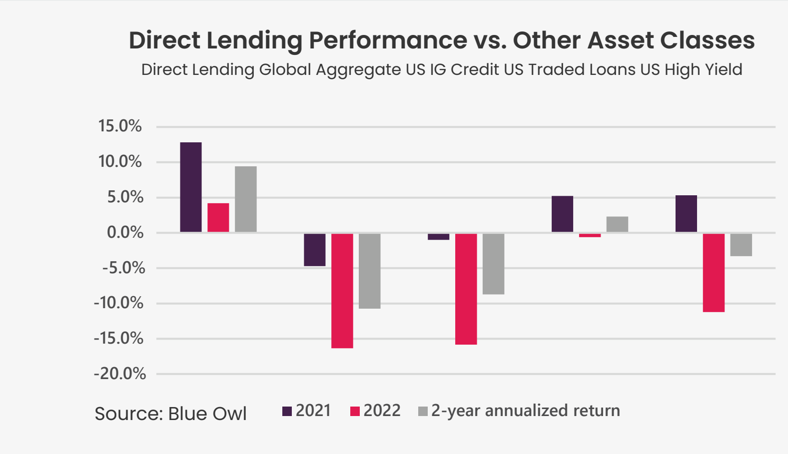
As shown by a recent study on private debt investments published by Calpers, private debt investments have provided attractive returns with low volatility over the past decade. For instance, the direct lending to companies usually carries floating interest rates so they are protected against the interest rate risk and the thorough due diligence process ensures high credit quality, stable cash flow companies with covenants/collaterals and lower loan defaults.

Attractive Risk : Adjusted Returns



Source: Calpers

As per a study published by Blue Owl, direct lending has outperformed other asset classes over the past two years, with each year having had a different kind of market and macroeconomic scenario, which supports the point that private credit is one of the safest and most attractive asset classes.



Given the recent banking crisis, we expect to see banks tightening credit conditions and as a result, there should be a significant reduction in the general availability of loans for businesses, particularly small and medium-size enterprises , or even if the loans are available, banks are expected to charge high interest rates to compensate for rising interest rates but also tighten the conditions required to obtain a loan to limit risk exposure to their capital reserves. Bankruptcies among small and mid-sized companies are already on the rise, and with the lack of capital required to operate and invest, we think they will be looking to private credit to maintain operations and fund growth plans.
As a result, we expect to see substantial growth in private credit in the coming years as the Fed's monetary policy likely continues to weaken capital markets. This alternate asset class is particularly expected to deliver strong returns in the near future, as we have already seen the momentum of cash inflows increasing.

As the private credit AUM grows, there will be a large need for portfolio monitoring activities to ensure credit investments are safe. Funds would benefit from streamlining their research and monitoring to provide support across the deal life cycle – from origination to reporting. Credit portfolios need to be monitored for detailed P&L

analyses, credit modeling, project cash flows and IRR, and loan default probability analyses, among other measures. Firms for which funding has been provided through direct lending need to have their financials monitored regularly, including the newsfeed related to the market or industry in which they operate and the broad macroeconomic and regulatory environment, as it could have implications on future financials, loan covenant monitoring and maintenance, and risk/return scenarios.

How Evalueserve can help

Evalueserve closely engages with private credit firms to streamline and accelerate deal sourcing and execution as well as portfolio monitoring processes. We combine our suite of technology platform offerings with private credit research to increase efficiencies in the portfolio monitoring process.

Our support offerings include monitoring the following stages of a deal's life cycle:

- Deal sourcing and evaluation
- Performance reporting and portfolio monitoring
- Custom analytics

Our tech-enabled suites such as Spreadsmart, InsightFirst, and Performance Dashboard support across all the mentioned stages. Please click our Private Credit link to learn more about our offerings.

Sources:

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