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360 Perspective

Private credit and its role in portfolios

WS Global CIO Office

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Private credit is by no means a new asset class. Lending has existed since ancient Mesopotamia, though private credit as we know it today has grown and transformed significantly, after the Global Financial Crisis (GFC). The asset class has expanded from $320 billion in 2010 to an impressive $2.1 trillion in 2023 (IMF, 2024). Today, private credit rivals traditional bank lending, offering a diverse array of strategies that span the capital structure and borrower profiles.

What is private credit?

When companies need debt financing, they have several options.

- **Bank loans:** They can secure a bank loan, which may be retained on the bank's balance sheet or syndicated to other investors.
- **Bond Issuance:** Issue bonds that trade in public markets, particularly for larger companies.
- **Private credit:** Work with a single lender, typically a non-bank entity, for a privately negotiated loan or private credit.

Private credit refers to a privately negotiated loan provided by non-bank entities, typically pension funds, private credit funds or insurance companies. These loans are tailored to the borrower's specific needs and are not publicly traded. They typically offer higher yields and spreads than public markets to compensate investors for the relative market illiquidity.

Most private credit instruments are tied to floating rates, which makes them less sensitive to fluctuations in interest rates. Furthermore, direct agreement between borrower and lender often allow for a more efficient recovery process in the event of a default, as compared to the complexities of publicly syndicated debt involving multiple creditors.

Fig. 1

Private credit, a less liquid but potentially higher yielding alternative to public credit

Public vs private credit

	Public Credit	Private Credit
Market Type	Publicly syndicated and sold	Privately originated and held
Traded	Yes	No
Coupon Structure	Typically fixed rate	Typically floating rate
Credit Rating	Rated	Not rated
Call Protection	Varies	Yes
Liquidity	Liquid	Illiquid
Valuations	Frequent	Infrequent

Source: Standard Chartered

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Different forms of private credit

Private credit strategies span an array of strategies that differ in terms of risk, return and borrower profiles.

Direct lending: The largest segment by AUM, involving both senior and junior loans made directly to companies. It typically offers higher yield than traditional fixed income securities. This is because loans are made to middle-markets companies that may not have access to public markets and thus, higher risk. Volatility is typically lower given direct lending agreements include floating rates, which adjust with market conditions.

Asset-based lending: Loans secured by specialised assets such as royalties, receivables, inventory, or real estate. These assets serve as collateral, ensuring the lender has a claim in case of default. This strategy focuses on the value of the underlying asset rather than the creditworthiness of the borrower. It comes with lower risk for lenders due to the secured nature of the loan.

Mezzanine debt: Loans positioned between senior debt and equity in the capital structure, offering subordinated debt with higher yield and greater risk. It is typically used for leveraged buyout, acquisitions or growth financing. Typically offers higher yield to compensate for the subordinated position in the capital structure. Returns can be enhanced through equity participation if the borrower's business succeeds.

Distressed debt: Loans extended to companies in bankruptcy or near bankruptcy, with the aim of earning outsized returns through restructuring or recovery. Distressed debt investors often purchase loans or bonds at steep discounts. Strategies include restructuring the borrower's finance, converting debt to equity, or profiting from asset sales during bankruptcy proceedings. Return potential is high, but it comes with significant risk, as the borrower may fail to recover or restructure successfully. May lack income, and significantly reliant on capital appreciation.

Fig. 2

Types of Private Credit Strategies

Direct lending	Mezzanine	Distressed	Special Situations	Venture debt	Real Assets	Specialty Finance
Loans made directly to companies without an intermediary. Often floating rates and are senior and secured against borrowers' assets and earnings.	A hybrid of equity and debt financing, generally with features like preferred equity. Subordinated debt (typically non-secured) and can be converted to equity if borrower defaults.	Direct lending to companies that are in bankruptcy or likely to enter bankruptcy. Debt issued tends to be senior and typically bought at significant discount.	Loans extended based on a special situation, such as a merger, buyout offer or company spin-off. Can include both debt and equity investments.	Loans extended to early-stage companies with venture capital backing. Serves to extend the runway to exit without further diluting ownership.	Loans extended to finance the purchase of real estate or the development and improvement of infrastructure assets.	Niche strategies that involve lending against cash-flowing assets such as auto and equipment loans and even revenue streams generated by royalty payments.

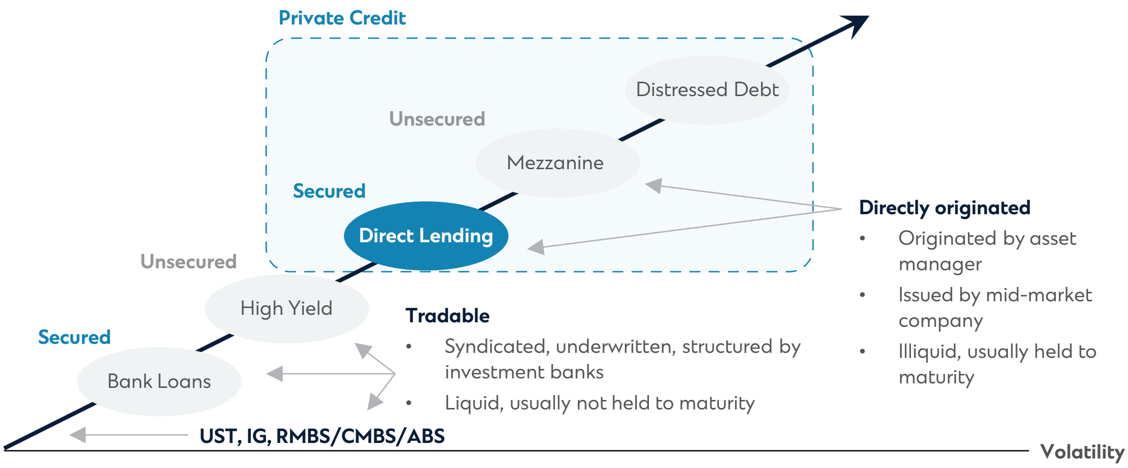
Source: Standard Chartered

This variety of strategies allows private credit portfolios to be customized to meet a broad range of objectives, tailored to individual investor goals.

Fig. 3

Fixed income spectrum

Illustrative returns



Source: Standard Chartered

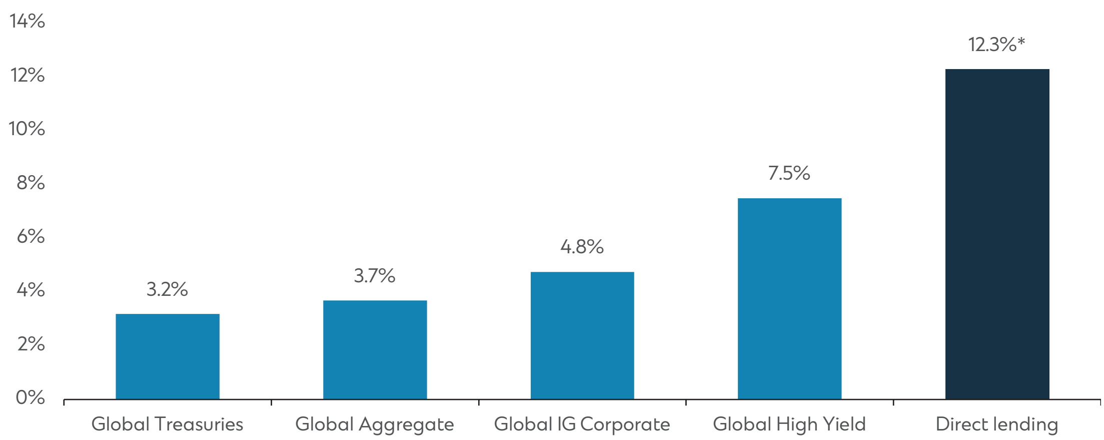
Why invest in private credit?

Private credit can be a useful complement to traditional fixed income assets, offering the potential for higher yields, return enhancement and diversification benefits.

Income generation and return enhancement: Private credit provides an illiquidity premium, offering higher yields, as much as 5% pickup, over publicly traded high yield credit. Borrowers are willing to pay the premium, as the direct nature of transactions allows for more flexible and expedited financing, while offering lenders more access to in-depth due diligence. Recovery rates in the event of a default can often be higher, unlike a syndicated deal that features multiple lenders with competing priorities.

Fig. 4

Private Credit offers higher yields than many traditional fixed income assets



Data as of Q4 2024 unless otherwise stated. Source: Bloomberg, unless otherwise stated, Standard Chartered. Global Treasuries represented by Bloomberg Global Treasury Total Return Index. Global Aggregate represented by Bloomberg Global Aggregate Index. Global IG Corporate represented by Bloomberg Global Aggregate Corporate Index. Global High Yield represented by Bloomberg Global High Yield Index. Direct Lending represented by Cliffwater Direct Lending Index. *3-year takeout yield (Source: Cliffwater 2023 Q3 Report on US Direct Lending)

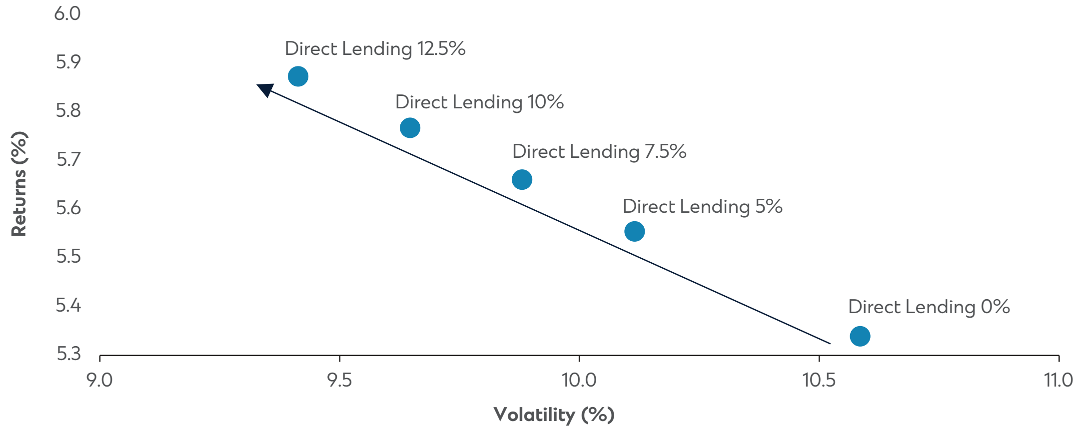
Volatility mitigation: Floating-rate loans make private credit less sensitive to rising rates and inflation. As public markets become increasingly correlated, as shown during the post-pandemic periods, the illiquid nature of private credit can reduce the temptation to sell during market downturn, acting as a hedge against market volatility short-term.

Diversification: Private credit has low correlation to public equity and fixed income markets. This asset class offers exposure to unique drivers that span across industries, borrower profile, company size, economic cycles and interest rate environments.

Fig. 5

Increasing allocation to Private Credit helps to diversify and improve risk-adjusted returns of portfolios

Portfolio returns and volatility*



Source: Bloomberg, Cliffwater, Standard Chartered
*Starting portfolio is based on a 5% allocation to cash (fixed), 5% to gold (fixed), 0% to direct lending and a 60-40% split of the remaining portfolio to equity and bonds. Allocation to direct lending is then increased, while allocation to equity and bonds is proportionately reduced. Cash and gold are fixed at 5%. Based on data from Q3 2004 to Q3 2023

US vs Europe: Key differences in Private credit markets

The US has been by far the dominant supplier of private credit globally. However, in recent years, Europe has also been gaining attention as a source of debt opportunities for both managers and investors. While the asset class is broadly similar in terms of structure across the two geographies, notable distinctions do exist, and investors need to be aware of the nuances in both markets before making any investment decision.

Market maturity and scale

US: The US market, with US$1.5 trillion in AUM, is larger, more mature and better developed, benefiting from a long-standing trend of banks retreating from the corporate lending. The market is 50% larger than Europe, as a result, increased competition among lenders may weigh on yields and deal quality.

Europe: Though smaller and more fragmented, Europe is growing rapidly. However, regional idiosyncrasies and stricter regulations make the market more complex. European banks have also been more aggressive in defending their share in corporate lending, hampering private credit growth.

	US	Europe
Private credit market size[1]	~$1.5 trillion	~$1 trillion
Estimated number of alternative lenders[2]	c. 250 managers	c. 60 managers
Number of funds closed at or above $10 billion in last 10 years[3]	13	2
Competition	High (crowded market, with many large and sophisticated lenders)	Low (fragmented market, with differences in legal jurisdiction necessitating smaller local teams)
Fund leverage[2]	Unlevered and levered vehicles offered; leverage of 1.0 – 2.5x investor commitments	Typically unlevered, but funds may offer levered sleeve for US investors
Yield[2]	Typically three-month SOFR + spread	Typically three-month Euribor + spread
Average middle market leverage[4]	4.5 – 6.0x debt / EBITDA	4.0 – 5.0x debt / EBITDA
Covenant requirement	Lower (especially for large deals)	Higher (but growing use of “Covenant-lite” requirements)

[1] US dollars. Source: Ares Management, Standard Chartered; [2] Source: Cliffwater Research; [3] Source: Pitchbook, Preqin. As of July 2024; [4] Source: Pitchbook, LCD EuroStats

Yield and credit quality

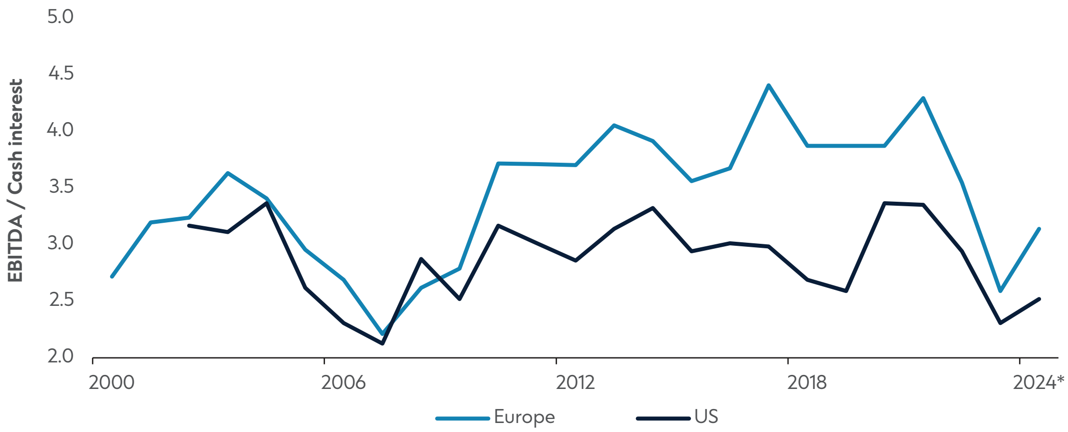
US: Yields are higher due to higher base rates in recent years, but terms are looser, and loans generally carry more leverage and default risks.

Europe: European loans feature higher interest coverage ratios and lower leverage, translating to lower default rates and higher recovery rates. Sponsor-backed borrowers (80% in Europe vs 72% in the US) provide additional protection.

Fig. 6

Loans in Europe tend to have higher interest coverage ratios

US vs Europe interest coverage ratios



Source: LCD, Goldman Sachs, Standard Chartered. As of March 2024

Economic and legal systems

The US bankruptcy and restructuring framework (eg Chapter 11) is well-established and more creditor-friendly, simplifying recoveries for lenders. In Europe, insolvency laws vary by country.

Northern European countries such as the United Kingdom, Germany, or France have well-established bankruptcy codes. Southern Europe and Eastern Europe may come with higher risks, making recoveries potentially more uncertain and time-consuming. Investors with deep local investment and regulatory knowledge are hence generally in better position to manoeuvre in a more fragmented market.

The US economy benefits from a steady pipeline of high-growth companies, while Europe's slower economic growth and greater reliance on traditional industries may limit opportunities.

While the US remains the global leader in private credit due to its scale and maturity, the European market offers unique opportunities, particularly for investors seeking geographic diversification and lower correlation to the US markets. Each market thus has its strengths, depending on the strategic goals of investors.

Potential risks

Limited liquidity
Private credit investments are not publicly traded and lack a robust secondary market, making it difficult for investors to sell before maturity. Unlike public securities, which are priced daily, private credit valuations are infrequent, creating uncertainty about their current value. Most private credit funds also enforce lockup period or redemption caps, preventing investors from accessing their capital for several years.

Manager selection risks
Private credit requires skilled managed to source quality credit deals, assess credit worthiness, negotiate terms and monitor performance. Unlike in equity or growth-oriented investment, private credit has limited upside, as returns are primarily driven by loan repayment and interest income. Poor risk management and risk management can lead to significant losses. The disparity in managers can be stark, and an unperforming manager may erode returns or fail to minimize losses during downturn.

Interest rate and default risks

Many private credit instruments are tied to floating interest rates, reducing sensitive to rising interest rates compared to traditional fixed income assets. However, this feature does not eliminate all risks. As borrowing costs rise, weaker borrowers may struggle to meet debt obligations, increasing default risks.

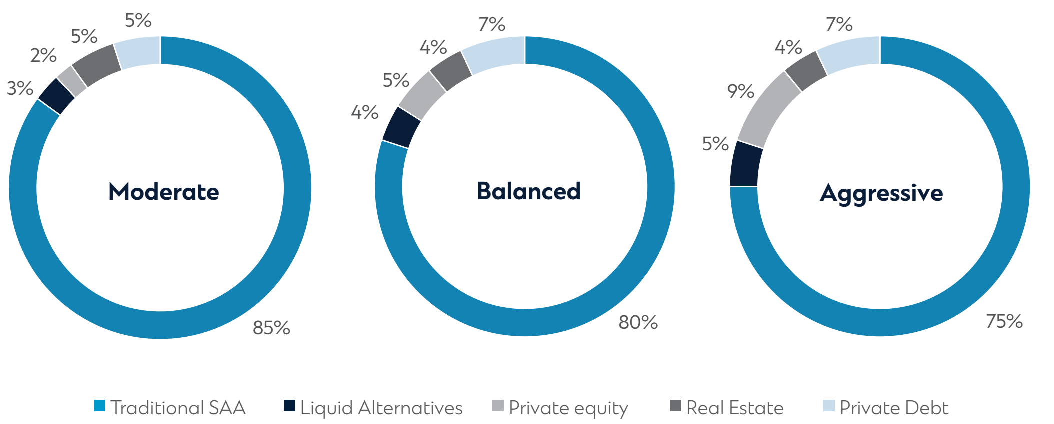
Since its post Global financial crisis (GFC) growth, private credit has not faced any systematic crisis. Its performance in such an environment thus remains largely untested. While private credit offers strong returns in stable environment, its risk profile could shift significantly under deteriorating economic conditions.

Conclusion

Private credit has established itself as an increasingly vital component of the modern financial landscape, offering investors the potential for attractive returns and portfolio diversification while addressing the needs of businesses that have been underserved by traditional lenders since the GFC.

However, like all investments, private credit comes with risks, and its limited liquidity and lack of transparency may not be suitable for some investors. Understanding the nuanced differences between the more mature US private credit market and the fragmented but growing European market is also essential for informed decision-making.

As private credit continues to grow globally, its role in a diversified portfolio will likely expand, presenting both opportunities and challenges for investors.



	Moderate	Balanced	Aggressive
Expected return	6.0%	6.6%	7.1%
Expected volatility	8.2%	10.7%	13.2%
Risk-adjusted return	0.7	0.6	0.5
Expected outperformance relative to liquid SAA	26bps	42bps	51bps

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