23 November 2023

MEDIA RELEASE

High quality borrowers and downside protection minimise risk for private credit investors

It is a myth that only uncreditworthy borrowers who cannot access bank loans will seek private credit financing, and the asset class also attracts quality corporate businesses, says managing director of Tanarra Credit Partners (TCP), Graham Lees.

According to a recent whitepaper from TCP, "Private Credit – higher returns vs. bank lending does not always equate to outsized risk.", there are several tools that lenders can use to mitigate the risks of private credit financing. When combined with the returns available, this creates an appealing risk-return proposition for investors.

Private credit as an asset class has enjoyed strong growth in recent years with total global assets under management (AUM) rising to over US$1.4 trillion in 2022. Within Australia, there is growing demand for private credit from Australian corporate borrowers as it offers greater flexibility and access to credit.

Mr Lees says borrowers frequently benefit from greater speed of execution compared to traditional bank loans and more importantly the risks of investing in the asset class can be reduced through diligent lending practices.

"When it comes to private credit, investors should seek out those providers experienced in structuring deals that have experience investing through cycles, and that conduct detailed due diligence on prospective borrowers including review of third party financial, legal and commercial due diligence reports, and detailed financial modelling to assess a range of downside scenarios.

"These checks enable lenders to better understand the credit profile of the businesses they may finance, and it gives a high degree of comfort around the ability of the cashflows of the business to service their debt."

He says there are several downside protections available for private credit investors, and that not all private credit funds are the same.

"For instance, for those that largely invest into senior secured loans as we do, there is meaningful equity capital sitting underneath the debt financing in the capital structure. This means significant value would need to be eroded before the senior debt is at risk," he says.

"Our loan investments also typically have maintenance financial covenants that are tested quarterly and provide early warning signs if there is any deterioration in the credit quality of borrowers. This means the lender can take quick action to protect investor capital and increase pricing, if warranted."

Mr Lees says it is important that loan documentation is structured to impose restrictions on the borrower that protect the lender's position. "This includes provision for cashflow sweeps to repay debt should the business underperform, restrictions on the borrower's ability to make acquisitions and sell assets without debt repayments, and not allowing distributions to be made to shareholders until debt has reduced."

"While borrowers typically do pay a higher interest rate for private credit financings versus regular bank loans, the higher cost is compensation for the benefits offered by private credit.

"Bank loans typically require more restrictive terms and conditions, and borrowers may prefer to pay a higher interest rate in return for greater flexibility offered by private credit finance," he says.

"Private credit financiers also typically offer faster and more transparent decision-making compared to a bank's credit process.

"Borrowers are often prepared to pay more in return for the greater certainty and speed of execution. This is particularly important for borrowers who are under a strict deadline to conclude a corporate activity such as a borrower seeking financing to complete an acquisition.

"We believe that private credit as an asset class will continue to benefit in a world of high benchmark interest rates with its floating-rate yield profile, and is a low volatility option against a backdrop of an uncertain economic outlook," Mr Lees said.

Unlike bonds, private credit is not issued or traded in public markets. Loans are negotiated and structured according to the individual borrower's needs. These private corporate loans typically have floating rate coupons, which are linked to the bank bill swap rate and are reset regularly. This helps provide investors with a hedge against inflation, and means that the capital value of the investment is not at risk from movements in interest rates, unlike traditional fixed-rated corporate bonds which are exposed to that duration risk.

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