The accelerated growth of private credit

Navigating its complexity and operational growing pains

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The rise of private credit

Private credit was born out of the chaos of the great financial crisis of 2008. With banks forced to tighten their lending criteria, a huge hole emerged in corporate financing that private investors were happy to fill.

Though banks continue to lend, their level of risk aversion has remained high – laying the groundwork for the private credit asset class to grow exponentially in recent years, far exceeding market expectations.

Coupled with the fact that institutional investors have a higher level of comfort with the liquidity of their portfolios, there is now a shift towards allocating components of a traditional fixed-income portfolio into the private credit space, where returns have been historically strong.

Assets in private credit funds now total USD 1.6tn, a rise of 53% over the past five years. Intertrust Group's review of research by data analytics company Convergence Inc[1] identified 3,967 private credit funds at the end of March 2022 – a 56% increase since 2017.

This is despite private credit's esoteric nature and inherent risk. Private credit isn't subject to regulatory oversight. When the authorities tightened up on banks, they left these non-bank alternatives largely alone.

Today, private capital plays a critical role in meeting rising demand for credit. Private credit meets the demands of sophisticated investors – usually pension or sovereign wealth funds – perennially hunting for higher yield. This is not a broad investor base, but it is a deep one, flush with money. It also has the expertise to understand and balance risk.

Thanks to its rapid growth, the simplest form of private credit – direct lending – is already quite a mature market. The hunt for new opportunities has seen the emergence of niche private credit subsets such as litigation finance, aviation lending and supply-chain finance.

These have created lucrative new opportunities to create funds, pushing private credit ever deeper into the core of business operations.

As a result of the 2008 subprime crisis and the advent of greater regulatory requirements in some countries, traditional banks now tend to stay clear of risky credits. This provides significant opportunities for non-banking institutions such as private credit funds to cater to a huge number of middle-market businesses that need finance.

Venkat Srinivasan

Opportunities and challenges

Private credit is now spreading its wings, drawing in more limited partners (LPs) from other areas. That in turn is leading to more complex funds, a trend towards faster fund creation and calls for greater transparency. Managers are grappling with novel demands. Their need for better, more customised data has never been greater.

They need help. This report will investigate the booming private credit market in detail, looking at emerging trends and considering the challenges posed by this rapid growth. We'll also look at how outsourcing can help managers meet many of these challenges.

[1] Intertrust Group's report was powered by proprietary data and research from Convergence Inc as of 2/28/2022 (i.e. derived from its database of 40,000 fully profiled investment advisers and their 250,000 private funds that invest in a range of credit and non-credit strategies), providing the most comprehensive data-driven insights into growth trends powering the alternative credit marketplace. Founded in 2013, Convergence provides data-driven insights that helps its clients increase revenues, improve margins and identify commercial and client risk.

A diversifying market

About USD 5tn is invested in alternative fixed income-oriented funds worldwide (excluding mutual funds and business development companies), with about 2,500 advisers managing almost 15,000 credit and fixed income funds, according to Convergence.

Private credit funds are just one of a number of alternative funds, although the term is often an umbrella covering asset-based finance such as infrastructure and real-estate lending. It can also cover other alternative credit classes, such as distressed funds, structured credit and diversified credit.

This report defines private credit as funds engaged predominantly in secured, unsecured and mezzanine finance. For a more in-depth look at the different "flavours" of alternative credit, see appendix A.

Our review of the Convergence research found numerous strategies among the 2,491 active managers of credit funds, such as:

- Private credit, including direct lending
- Specialty finance
- Asset-based finance
- Structured credit
- Diversified credit
- Non-distressed and distressed assets

Fig. 1: Credit and FI assets

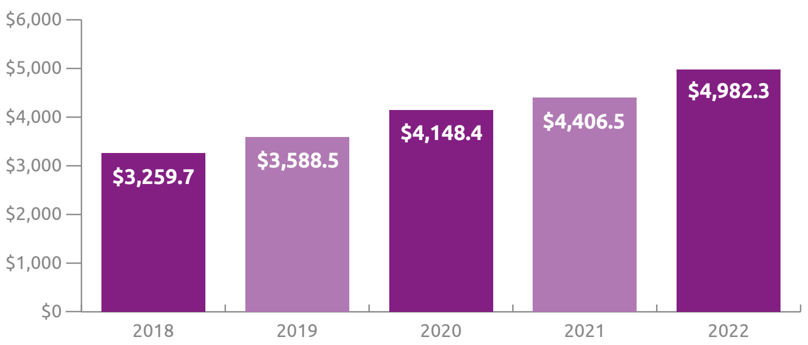
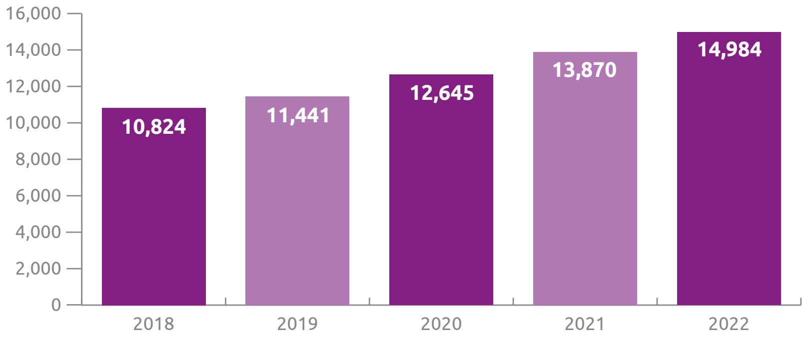


Fig. 2: Credit and FI funds



What many investors are coming to terms with is that the term 'credit funds' covers multiple strategies.

John Phinney
Chief Executive, Convergence

Private credit's growth

More new funds are launched in private credit than in any other credit fund strategy, according to our review. Private credit funds have increased assets under management by USD 475bn over the past five years.

Fig. 3: Growth of # funds by strategy over five years

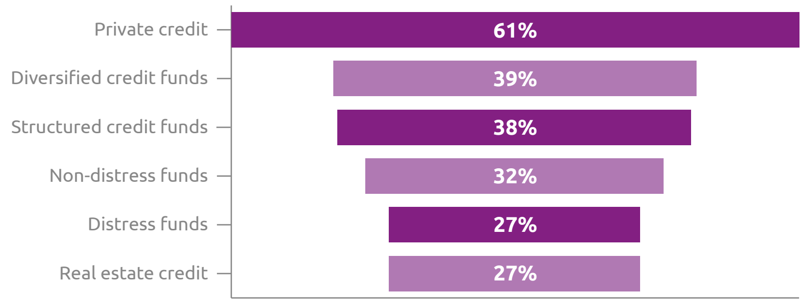
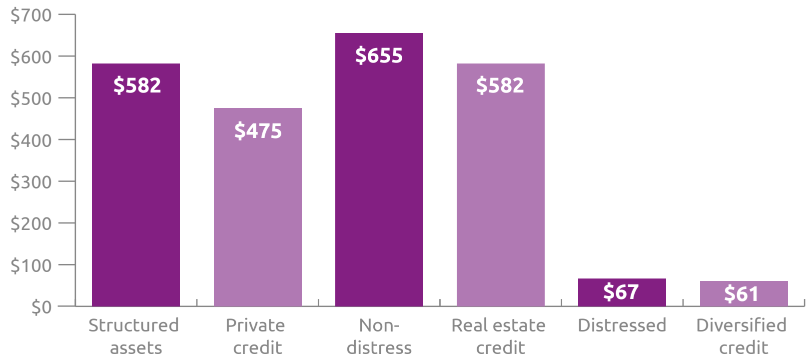


Fig. 4: Asset growth by strategy over five years (USD bn)



All the sub-strategies that might come under the 'private credit' umbrella are growing. Private credit – direct lending – has grown exponentially, and there is a lot more opportunity and appetite in the market – which is evident, looking at the dry powder available in private credit strategies.

Venkat Srinivasan

As private credit has grown, it has changed. As more funds enter the market – picking off the low-hanging fruit of direct corporate lending – established managers seek to drive returns in ever more creative ways. This has led to the emergence of a range of niche asset classes, including:

- **Supply-chain finance:** private credit funds the purchase of invoices at a discount, giving suppliers faster access to money and buyers longer payment terms
- **Litigation finance:** funds provide money for court actions, receiving a share of the proceeds if the case is successful
- **Sports finance:** a football club (for example) may fund buying players using private credit
- **Aviation finance:** this provides loans for buying or leasing commercial aircraft and other aviation assets

The trend towards diversification has brought higher returns, but also new complexity. Private credit funds require specialist expertise – niche private credit funds even more so. Many have relatively short life cycles, further increasing pressure on administrative functions.

Another trend that creates challenges for the back office is the speed with which firms launch follow-on funds. Today, that might happen in 15 to 18 months – rather than the three years that was the historical norm – as managers grasp opportunities and react to investor demand. Some 80% of more than 2,800 private credit funds launched over five years were from existing managers.

The end result of all this might be more private credit assets, but fewer managers. Managers with experience will find it easier to expand, but the barriers to entry for new managers are high. That could concentrate the market.

> The biggest barrier to entry is experience. It's a complicated market so investors want the comfort of a manager with a lot of know-how. That can be an experienced manager in a big firm or a manager who has earned their stripes and branched out on their own.
>
> Venkat Srinivasan

What it all means – the scalability challenge

The rapid growth and increasing complexity of private credit is a challenge for ambitious managers. Private credit's almost unlimited range has raised industry concerns that LPs could demand more standardisation over strategy definitions, transparency and the calculation of internal rate of return (IRR).

At the same time, regulators are likely to take greater interest in the sector as it becomes more important to the wider economy.

On top of all this – as we've seen – more (and more complex) private credit funds are emerging. Private credit deals are already highly customised compared with other asset classes, which makes for a lot of manual processing. They are entirely bespoke and negotiated, with few – if any – standardised elements.

So how do managers ensure they have the staff, data and pipeline to originate credit opportunities easily and administer funds to the satisfaction of savvy investors? Simply put, it isn't easy.

Hiring more good people is not always possible. Talent is in short supply in financial services generally, pushing salaries skywards. In a highly specialised area like private credit, the pool is almost dry.

All of this creates headaches for managers. Operational complexity is a major pressure point for credit funds, alongside the linked areas of technology integration and rapid capital deployment. Let's look at each in detail.

Private credit is the one asset class that normally has its own team. You might have a single operations team which covers every other asset class. But loans are complex. They need specialisation.

Venkat Srinivasan

There are firms that have built up very good reputations in the private equity space, and are well positioned to identify opportunities in private credit. So the pipeline is there, but what they don't always bargain for is a disproportionate increase in operational complexity.

Jonathan White

Operational complexity

Fund structures may vary between separately managed accounts (SMAs), traditional closed or open-end funds or interval funds. There are also more regulatory reporting requirements and more LPs than ever. Finding ways to automate and outsource are currently top priority for operating teams at many alternative credit investment firms.

Increasingly complex loan agreements add to operating costs. The move away from traditional term loans to more complicated agreements means operations teams need more time to handle information.

Within private credit there are always peaks and troughs in loan administrative work, so sizing up the administration resources required can be difficult.

From the administrator's vantage point, managers require more support in areas such as reporting, customisation, IT and due diligence. Intertrust Group clients receive access to dashboards providing a view of daily operations and processing, as well as customised reports (e.g. accrual reports) that can be uploaded into an asset management firm's in-house systems.

Deciding what to outsource and what to maintain internally is not easy for COOs. Costs must be considered. A flexible commercial model that allows managers to lean on administrators whenever they need them is increasingly popular.

Private debt strategies and portfolios can require highly sophisticated models and, as such, managers increasingly need support around data customisation and reporting. Our tech-enabled, client-centric suite means we are well positioned to provide the right operating model for our clients.

Jonathan White

Technology integration pressures

One big technological operational risk for private credit managers is that high-touch borrowing procedures often make it difficult to provide a complete picture of a portfolio at any point.

As private credit asset managers attract more capital, reporting requirements driven by the demands of institutional investors require firms to be more agile in dealing with specific allocator requests. They must also ensure disclosure meets growing scrutiny from regulators.

To add to this Herculean task, some managers still create reports manually in Excel. Others may use spreadsheets for some of the workflow, but as the number and diversity of private credit funds grow, this becomes impracticable. What's more, the influx of new investors used to high degrees of transparency will increase pressure to meet the demand for more data more frequently.

The bespoke nature of private credit makes it almost impossible to manage via Excel spreadsheets, so having the right technology to support the middle and back office is vital. Private credit is also unique because it relies heavily on human capital and intelligence."

Ram Chandrasekar

On top of this comes the need to incorporate the right data to ensure accurate portfolio valuation and meet increased demand for customisation.

As well as the standard reports in core third-party systems, such as IHS Markit and Advent Geneva, teams also need to create customised, automated reports based on clients' specific requirements. An outsourced team can extract and integrate data from different systems to create the reports that investment teams and LPs demand.

Private loans require a lot of manual work, but the core elements can be streamlined. Many processes are now widely supported by vendor applications and service providers.

Much of this technology is provided on cloud-based solutions that can be integrated with third-party platforms to automate common tasks associated with originating loans. The challenge is choosing the right technology and support. Not all technology supports the full fund cycle, as some private credit funds have found to their cost.

We are seeing a lot of pressure on clients in terms of data customisation. Having the right data strategy is key to meeting the ever-increasing demands from internal teams and LPs. It will also help navigate any changes that may arise in the future.

Venkat Srinivasan

Rapid capital deployment

Manual origination can cause investment return and workflow headaches, especially during fund launches that happen more rapidly these days to meet new and existing client demand.

The peaks and troughs in loan administrative work make it difficult to assess the administration resources required – back-office work is concentrated in the investment phase, as managers ramp up the book. Once capital is allocated, activity tapers off.

Periodically, market developments will mean investment activity must be addressed quickly. A classic example was March and April 2020, at the peak of the pandemic; volumes for private credit managers went up fourfold on average.

In publicly traded markets, securities are standardised. But with private debt (i.e. bilateral and club loans), each deal is negotiated between lender and borrower with its own terms and conditions. Loan agreements can be hundreds of pages long.

The challenge is to identify, understand and extract the precise terms and conditions from the agreement and load them into the administration system. Various nuances associated with the terms (e.g. covenants, trigger events) must be understood and properly represented in the workflows set up for administration.

This burdensome manual process must be carried out by people who know about private credit. As funds grow, it will become almost impossible to handle the necessary workflows using Excel spreadsheets alone.

Private debt managers find themselves facing more lending complexity. While many have been able to tolerate operational pain internally, this is no longer feasible and the requirements around credit mean outsourcing becomes much more natural.

Jonathan White

Conclusion

Private credit is a victim of its own success. The sector is booming as sophisticated investors turn to alternative credit strategies to improve yield on fixed-income portfolios.

This acceleration has taken many fund managers by surprise. We now know that the private credit industry is far larger in terms of funds and assets than many observers predicted just two years ago.

As we've seen, that has created huge opportunities – and huge challenges. Investors are looking for more information and more insight. Regulators may follow. Data customisation was already the name of the game, even before private credit started exploring ever more esoteric pathways. This is a bespoke industry requiring bespoke solutions.

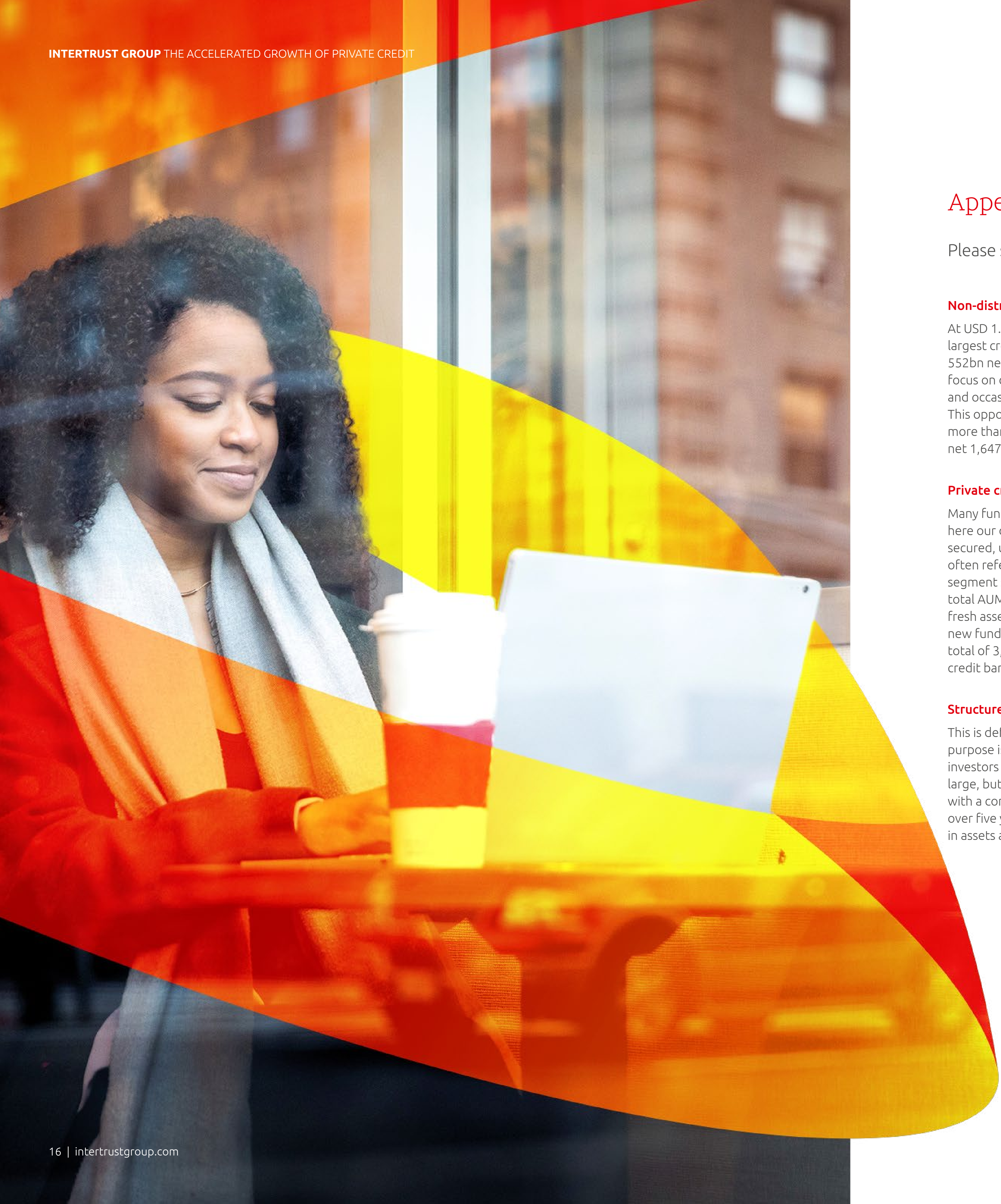
Managers need help and amid the Great Resignation, talent with specialised expertise isn't easy to find. Outsourcing can give funds the technology platforms and associated expertise necessary to meet these challenges and fill resource gaps during peak activity. At the same time, it removes the HR complexities of managing large teams.

Established fund managers setting up their own shops want to get on with making deals. Large firms want to grow, but struggle with administering larger and more complex funds with legacy technology or technology developed for less complex asset classes. In both cases, an outsourcer can be the answer.

But not any outsourcer. Third-party providers servicing the private credit space need specialist knowledge, scalable human resources and technology platforms that can handle the sector's unique complexity.

Intertrust Group has built the technological and operational backbone to serve any strategy at any level of growth.

> With Intertrust Group, it's not just about getting the work done. It's about providing a much more meaningful solution. It's about the years and years of experience that mean we can help drive business outcomes. It's about customising our service to meet the unique needs of managers in the sector.
>
> Jonathan White



Appendix

Please see below a concise comparison of alternative credit funds, for reference.

Non-distressed

At USD 1.7tn, non-distressed credit funds are the largest credit segment, with reported growth of USD 552bn net of redemptions over five years. Investments focus on corporate bonds, bank debt and trade claims, and occasionally include common and preferred stock. This opportunistic strategy saw 4,700 funds added and more than 3,000 funds closed over five years, making a net 1,647 new funds.

Private credit

Many funds take on the "private credit" label, but here our definition is funds engaged predominantly in secured, unsecured and mezzanine finance. These are often referred to as the "shadow banking system". This segment saw the second-best growth in assets with a total AUM of about USD 1.4tn. Roughly USD 400bn in fresh assets came over the five-year period. With 1,419 new funds created and more than 1,437 funds closed, a total of 3,748 funds can be included under the private credit banner.

Structured credit

This is defined as any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. Assets are not as large, but growth was the highest in percentage terms with a compound annual growth rate (CAGR) of 14.3% over five years. Structured credit comprises USD 866bn in assets across 2,187 funds.

Diversified credit

These funds tend to employ multiple strategies, including distressed and non-distressed, although many investors label them "private credit". The 717 diversified funds at the time of our survey totalled USD 335bn in assets. This was the only credit asset class to experience a small decline in assets from last year, but over five years assets increased by 44%.

Distressed

Distressed credit funds became prominent early in the pandemic. Essentially they most often invest in corporate bonds, bank debt and trade claims – but also common and preferred stock – of companies in distress. That usually means ones heading towards or in bankruptcy. Asset growth has slowed, but many expect this area to take off again as investors seek higher-yielding, esoteric credit strategies. More than 140 funds launched between 2020 and 2022. In all there are 965 distressed funds totalling USD 214bn, up from USD 159bn in 2020.

Real-estate debt

A small but growing subset of private credit focuses on real-estate investing in real assets via fixed income securities. Assets dipped slightly in the past year, but remain at about USD 30bn with nine funds added between 2021 and 2022.

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