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THE END IS NEAR FOR PRIVATE CREDIT, RIGHT?

Wrong. Here's our case for why private credit will outperform.

By Drew Schardt, Global Head of Credit Investments

Context is an important thing

We have been here before. What if I told you the headlines above are not related to private credit, but rather, are from the early-to-middle 2000s and were written about *private equity's* rapid AUM growth? Looking back, it is clear now that all the calls for 'doom-and-gloom' regarding private equity as a viable, long-term asset class were unfounded. Since then, and despite a Global Financial Crisis along the way, the asset class continues to grow, and LP allocations continue to increase. And for good reason. By and large, private equity has continued to live up to its mantra of outperformance over long-term horizons and compared to public benchmarks. History shows that the concern over increasing AUM and dry powder in PE has turned out to be a non-event. The reality is that this build-up was, simply, a tiny asset class getting bigger.

Private credit is in a similar spot today compared to where we were roughly a decade ago on the equity side of the private markets. There has been much written of late about the rapid growth of the private credit asset class and the potential of a "bubble" forming. Our view, rather, is that we are again just experiencing the growth and natural evolution of a nascent asset class.

This growth is healthy. It provides LPs with previously unavailable choices in credit, all while addressing investor needs of attractive risk-adjusted returns, cash yield and shorter duration in the alternatives space. Importantly, a large portion of the growth in the asset class has been driven by a once-in-a-life-time phenomenon of bank retrenchment, particularly related to middle market corporate lending. As a result, a massive void of debt capital has been created, which privately focused lending groups have begun to fill.

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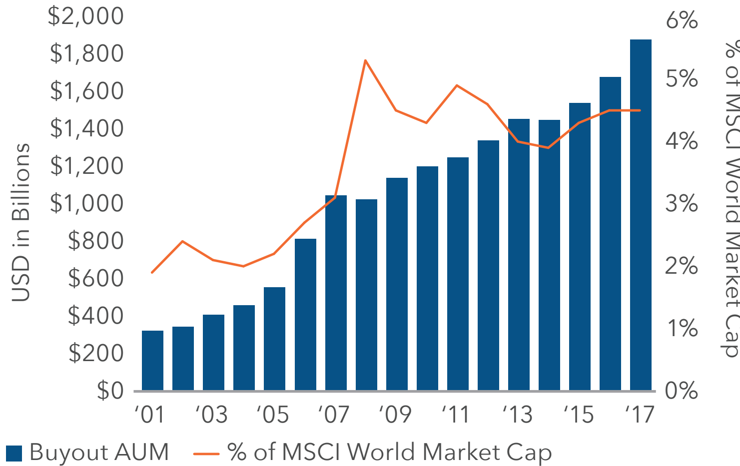
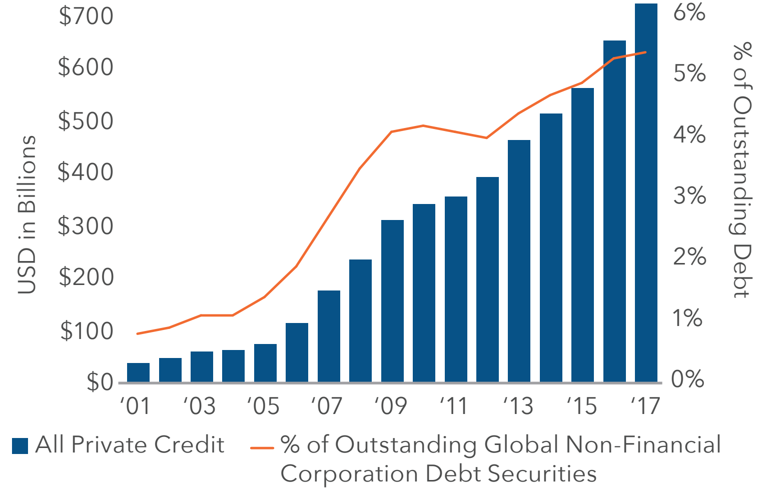
The side-by-side charts below also help put the AUM growth of private equity and private debt into context. You can see the similarities. Despite growth, both are still small on a relative basis and, when viewed with respect to the total addressable market and investable universe, private credit AUM accounts for less than 6% of global non-financial corporate debt outstanding.

Buyout AUM vs. MSCI World Market Cap



Source: Hamilton Lane Data via Cobalt, Bloomberg (April 2018)

Credit AUM vs. Outstanding Global Non-Financial Corporate Debt Securities



Source: Hamilton Lane Data via Cobalt, Bank for International Settlements (March 2018)

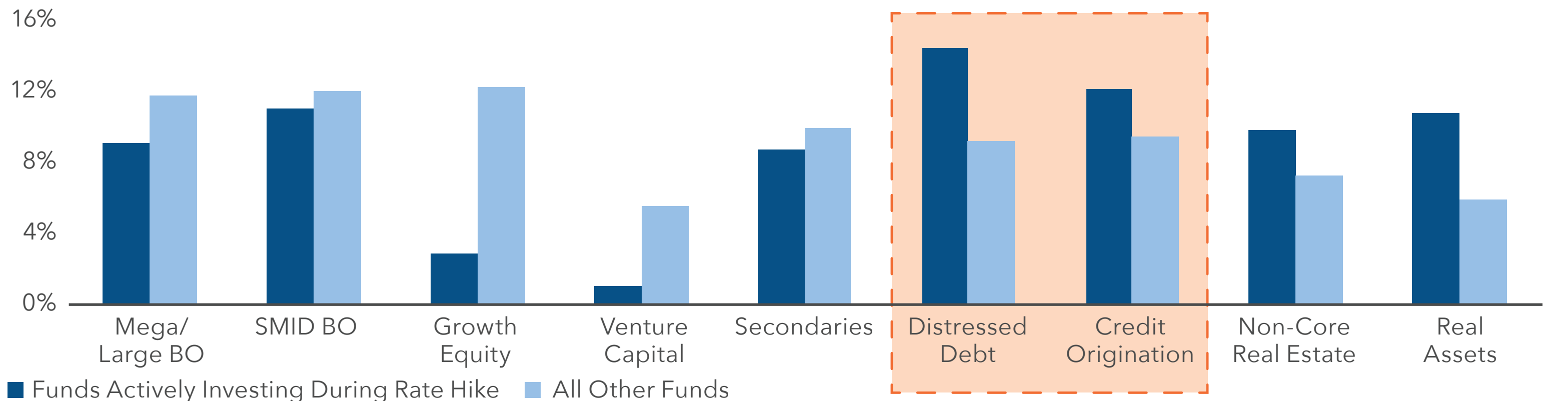
But what about the cycle coming to an end? Won't this end badly?

As you may know, we at Hamilton Lane are big fans of data and turn to it often to help answer life's "tough questions." So what happens when the music stops? Rates are already rising, global GDP growth will inevitably slow at some point, and valuations have to come down. Well, the data suggests that heading into and coming out of an economic cycle is when private credit crushes it.

Importantly, 86% of the asset class is floating rate, meaning in a rising rate environment, existing credit investments benefit in the form of a higher cash coupon.[4] Plus, it isn't just about the absolute level of returns with credit investing; risk needs to factor in as well. And that is a big part of the allure of this asset class: downside protection and risk mitigation, which help generate outperformance in a downturn.

The chart below shows the relative performance of private credit strategies compared to others in the private markets during periods of rising interest rates. Simply put, more often than not, credit is the place to be in this kind of economic climate.

U.S. Private Equity During Rate Hikes Median Net IRR
Vintages 1985-2010



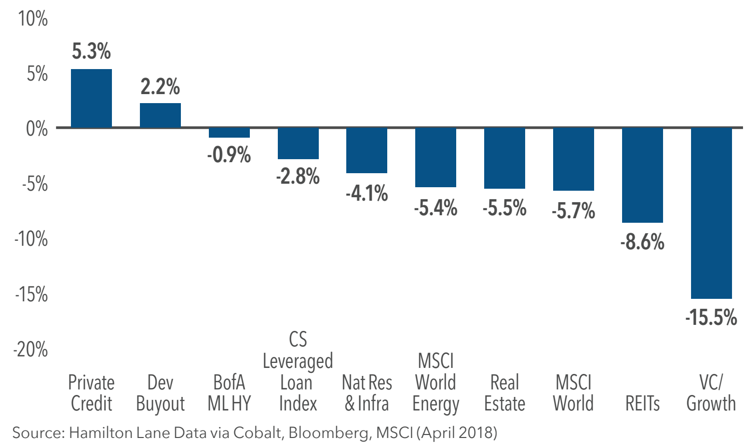
Source: Hamilton Lane Data (April 2018)

Let's play this topic out further. But first, one simple observation—it's very difficult, if not impossible, to know exactly when the next downturn is coming or what that downturn actually will look like. Are we closer to the end of the cycle than the beginning? Probably. Will there be an economic recession at some point? Absolutely. However, predicting this with any level of precision is a tall feat. I would also observe that there has been much commentary about being "in the later innings of a cycle" for the past five-plus years (whatever that actually means). At some point, that statement will turn out to be accurate, at least more so than it was five years ago.

But many of us—particularly the downside-focused credit investors—tend to be cynics. So let's think about it from the perspective of "how bad can it get?" Again, using our data, we measured the worst rolling five-year performance by asset class over the past 20+ years. How does private credit compare? Not too shabby! The results show that the strategy stacks up well on both an absolute and relative basis even in this most draconian of performance views.

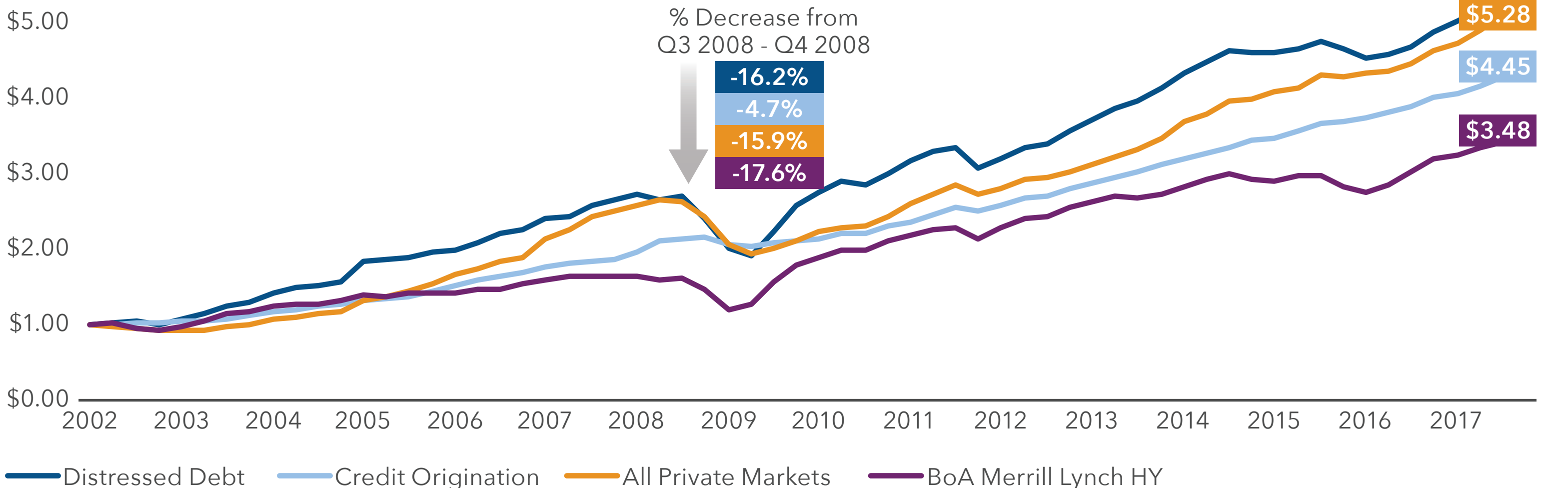
At the same time, the chart to the right helps point out that not all yield is created equal. Compared to other "yield" oriented benchmarks and asset classes, which can also benefit from rising rates, private credit often has the added benefits of tighter structures, better lender information and more downside protections than what you might see in the more efficient public debt markets (for example, compared to debt syndications in the public high yield or leveraged loan markets).

This makes sense. If you are invested in more senior parts of the capital structure and have relatively stronger protections/ loan documentation, then these private debt securities should protect value more effectively than more junior parts of the capital structure or equity-oriented investment positions. For the same reason, when an economic recovery eventually occurs, value in credit securities snaps back faster coming out of a downturn.



Source: Hamilton Lane Data via Cobalt, Bloomberg, MSCI (April 2018)

Also, let's not forget about another major segment of the private credit asset class: distressed and secondary debt strategies. Generally, these areas have received less publicity than performing or origination oriented strategies and AUM growth, but as the chart below demonstrates, distressed/secondary credit is a sub-strategy of the asset class that can generate equity-like returns heading through a cycle. LPs have recognized this as another attractive and potentially counter-cyclical lever within the credit space.



Source: Hamilton Lane Data via Cobalt, Bloomberg (April 2018)

Why private credit makes sense — two perspectives

Private credit providers have filled a significant void left by the banking system, particularly for middle market borrowers and in more levered capital structures. At the same time, from an investor perspective, private credit offers cash flow and return characteristics that are unique in the context of a broader private market (or equity-oriented) portfolio. Both components have helped drive the recent growth of this asset class:

From a borrower/company perspective a key question is: why utilize private credit when, particularly of late, the public debt markets have been so accommodating for borrowers? There are a multitude of factors influencing this. Even if the cost of debt may be lower via an efficient and robust public debt market, the borrowers (which are often the private equity owners of these companies/borrowers) value flexibility and the ability of private capital to provide a bespoke financing solution, particularly if a transaction involves a more complex capital structure or set of deal dynamics.

Similarly, there is an element of control for the borrower. By utilizing private debt financing, a company can select one or less than a handful of their preferred lending partners compared to having limited to no control in a public debt syndication with many potential debt holders. There are also vastly different confidentiality and information sharing considerations with each of these circumstances. Lastly, it isn't always about the lowest cost of capital or "loosest" debt structure for a borrower. For example, a company seeking to acquire another business may value having the certainty of a private debt structure over dependency on a potentially fickle public debt syndication process or financing contingency.

From a limited partner/investor perspective there are also a number of factors driving increasing allocations across nearly all classes of LPs into private debt. We highlighted the rationale and potential for private credit outperformance, especially when compared to public debt markets.

Private credit brings something very different in terms of expected investment duration (shorter) and J-curve profile (better) compared to the experience those investors gain from a more traditional PE exposure. There is more predictability and consistency both in terms of cash yield and overall return performance with credit. Volatility is lower. For example, looking at asset class data from the past 20+ years, the IRR spread between top-and-bottom quartile credit fund managers (i.e. the best and worst GPs within the asset class) is roughly 500 basis points narrower than the spread an investor would experience in equity buyout oriented strategies. Private credit returns also have a much lower probability of negative overall returns compared to buyout.

Final views

Private credit is here to stay. What we have seen recently in terms of AUM growth across private credit strategies is a natural maturation of the asset class driven by both LP demand as well as secular shifts to the supply side dynamics within credit to the benefit of private lenders.

Another important footnote on all of this is that nothing is absolute, and reality will show exceptions. So with that in mind, here is what we ***ARE NOT*** saying about the asset class: All private credit funds/strategies will outperform; All credit managers are created equal; Private credit will not lose value in a downturn; Navigating the increasingly complex private credit landscape will be easy for investors; Private credit will not get more competitive from a lender standpoint; Investors do not need to be cautious.

What we ***ARE*** saying is that we believe private credit will continue to prove its worth over time. As an investment strategy, it can provide LPs another tool to deliver cash yield and shorter duration, while generating attractive risk-adjusted returns on both an absolute and relative basis. Many investors will continue to lean in to private credit and develop focused strategies in the asset class. We think this makes sense. No need to head to the underground bunker just yet.

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Endnotes

[1] Private Equity Analyst, Sept 2005
[2] The Kansas City Star, April 2007
[3] Private Equity Analyst, 2006
[4] UBS, 2017

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As of April 25, 2018