

Feb 26 - Private Credit

Private Credit has started filling column inches again, the asset class made headlines last year after two large investments collapsed, both First Brands (car parts) and Tricolor (subprime car lender), left questions about the quality of the lending and prompted the famous “you see one cockroach” comment from the head of J P Morgan.

This is a relatively new asset class which grew out of the financial crisis after bank regulation tightened. This created space for private credit to fill a gap in the market, lending across a number of areas banks had pulled back from, and being able to generate higher rates of return as a result. In turn these higher rates attracted a number of investors, initially from the private equity market, but this grew to institutional investors such as insurance and pensions, attracted by the stable cash flow. More recently, the sector has been attracting more retail money. The numbers are significant, the sector has grown from about \$500mln a decade ago to \$1.5-\$2 trillion today, effectively replacing a significant part of the modern banking system.

More recently a Private Credit vehicle, Blue Owl, has suspended redemptions, the highly opaque nature of private credit, its increased significance and its illiquidity are leading to raised eyebrows from the market.

The concerns around the opaque nature of private credit are focussed first of all on the credit quality, especially as interest rates are higher and floating interest rates have been favoured. As with private equity, business conditions have changed since the low-interest rate environment in 2020-2021, whilst many other costs have risen. Further concerns are focussed on the far more competitive environment, meaning lending standards have become looser as funds chased lending opportunities.

In turn this leads to the second issue, which is valuation; if the market has concerns about the quality of a company’s debt, its public bond price would fall, reflecting the risk. In the opaque private credit market, this is not clear, leading to the transparency concerns that funds have been delaying or smoothing falls in valuations, and the sales of debt between funds has raised some concerns.

Therefore, over the last decade, a significant amount of money has moved into opaque and illiquid funds, which an open market is unable to price, investors cannot easily exit and where there are rising credit concerns. Adding the fact this is a relatively new and untested sector, herein lies the markets concerns, bear in mind the US Federal Reserve’s Balance Sheet is \$6 trillion dollars to understand the scale of the market.

As ethical investors we have not directly invested in any private credit funds given our need for high transparency. The risks in our view are more general market risks should things deteriorate. We have limited listed financial exposure in our bonds and equities. The market weathered last year’s scandals relatively well, partly because the sector is opaque leaving little room for reactions. Should any major issues arise, we would expect a greater impact on the market, and this remains a risk we keep in sight.

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