THE SCANNER

MULTI-ACT
Built by investors for investors

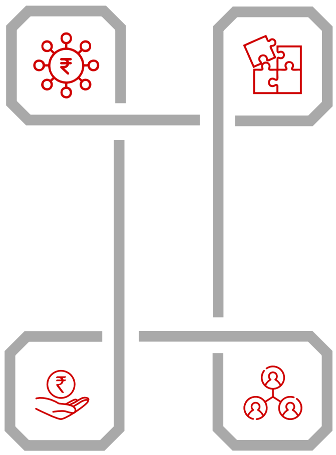
Rising opportunities in private credit: Unlocking the potential in alternative lending

In today's dynamic financial landscape, investors are constantly seeking new avenues to enhance portfolio returns and mitigate risks. One such avenue that has gained significant traction in recent years is private credit which encompasses direct lending, mezzanine financing, and distressed debt and presents a compelling opportunity for investors to access a diverse range of fixed income investments outside the traditional realm of public markets. According to reports, the global private credit arena has expanded rapidly, attaining the USD 1.4 trillion in assets under management mark in 2022 from around USD 500 billion in 2015[1]. On a domestic level, the Indian private credit market was privy to a cumulative of USD 5.3 billion in transactions in 2022[2].

An attractive addition to investor portfolios

One of the key reasons investors are gravitating towards private credit is the **diversification benefits** it offers. In an era of economic slowdowns and increased market volatility, private credit serves as an attractive complement to traditional fixed income assets. Private credit investments are typically less correlated with public markets, allowing investors to mitigate risk and enhance portfolio diversification.

Moreover, private credit investments often **yield higher returns compared to traditional fixed income** instruments. The illiquidity premium associated with private credit compensates investors for the lack of daily liquidity, providing an opportunity to capture enhanced yield potential. This yield premium is particularly appealing in a high inflation environment, where traditional fixed income assets struggle to generate meaningful income.



Private credit also offers **tailored solutions** that cater to specific borrower needs, as against traditional banks which often have rigid lending criteria, leaving certain market segments underserved. Private credit fills this gap by providing customised financing solutions to niche sectors, including technology start-ups, real estate developers, and small and medium-sized enterprises.

Furthermore, private credit managers' **active approach to credit selection and risk management can contribute to alpha generation.** Their deep industry expertise, granular due diligence, and hands-on monitoring enable them to identify attractive investment opportunities and navigate potential pitfalls. This active management approach allows investors to capture additional returns and potentially outperform passive fixed income strategies.

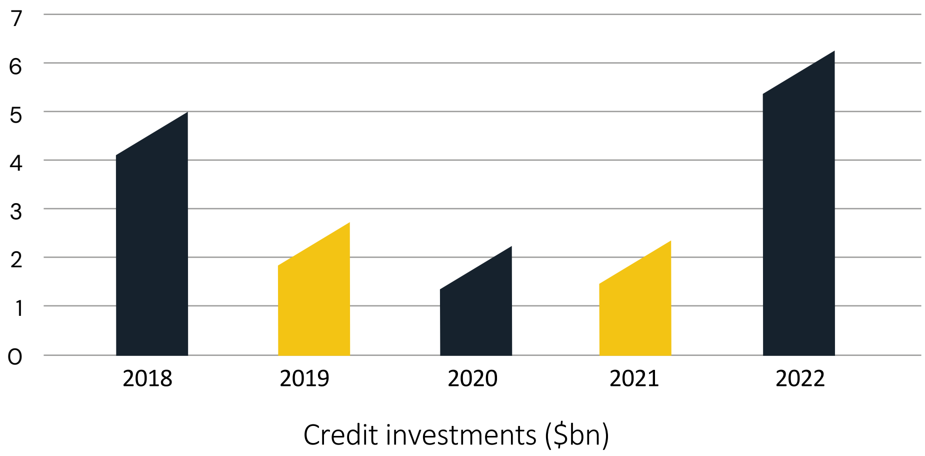
Direct lending gaining traction

Within the realm of private credit, direct lending has emerged as a significant driver of opportunity, enabling investors to provide financing directly to private companies, bypassing traditional banks and creating a win-win situation for both parties. For borrowers, direct lending offers access to flexible capital outside the constraints of conventional banking requirements. Investors have the ability to structure bespoke loan terms and benefit from higher interest rates, potentially generating attractive risk-adjusted returns.

As the private credit market continues to evolve and mature, it is crucial for investors to conduct thorough due diligence, select reputable managers, and ensure appropriate risk management practices for the most optimal outcomes.

Private credit in graphs

India's private credit investments are rising

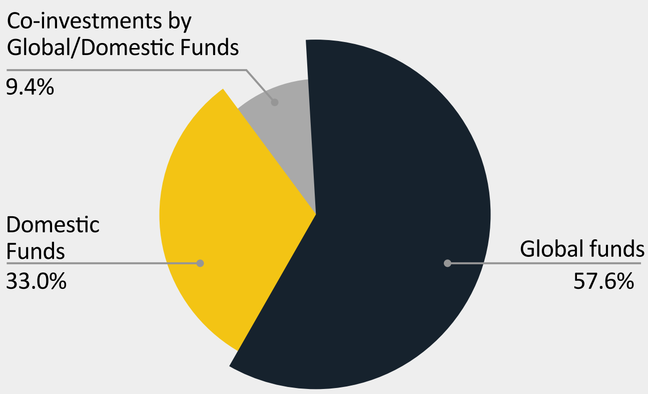


The sharp acceleration in private credit investments in India (more than doubled between 2021 and 2022) is indicative of the fertile private credit landscape currently prevalent in the country and the presence of multiple enablers that make private credit a compelling investment opportunity.

Source: India Venture Capital Association

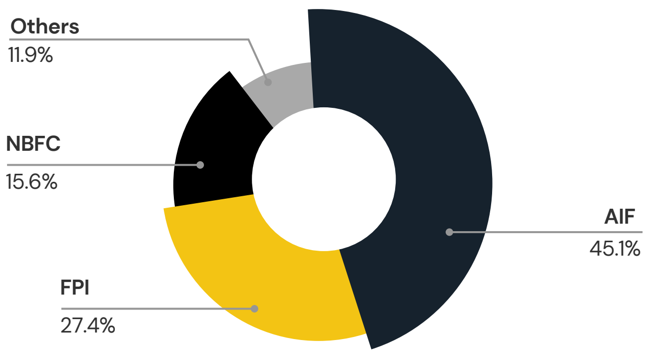
Deals in the Private Credit Space in India

Private Credit 2022 Deal Value by fund type



In 2022, private credit transactions worth more than US$5.3b were executed by global funds and domestic funds. Correspondingly, the preferred investment route was through Alternative Investment Funds (AIFs) followed by the Foreign Portfolio Investor (FPI) and Non-Banking Financial Company (NBFC) routes.

Private Credit 2022 Deal Value by investment route/vehicle used



AIFs are the preferred invest route for private Credit transactions in 2022

For private circulation only

Source: https://www.ey.com/en_in/strategy-transactions/onwards-and-upwards-a-positive-outlook-for-private-credit-in-india

Q&A

Built by investors for investors

Vikas Biyani

Head, Investment Advisory

What is your view on the private credit landscape in India? Do you think it will grow?

Yes, absolutely. Due to institutional and other bottlenecks /imbalances, capital in the form of 'Credit' is yet to fully reach the 'unbanked' segments in the private sector. This includes mid-segment corporates as well as emerging businesses at the initial phase of their business life-cycle. Herein lies the opportunity for private debt investments to bridge prevailing gaps, particularly in areas of M&A financing, working capital financing, bridge/mezzanine financing, growth capex, stake buyouts etc.

What are the factors that will contribute to the growth of private credit in India?

- A fast-growing Indian economy and robust growth in requirement of credit as capital to fund this growth, remains the key factors precipitating the growth of the private credit segment. Mid-Segment corporates which are the backbone of the economy, (accounting for more than 50% of the economy) are the primary focus area for private credit investments.
- One also needs to be cognisant of slowing growth and declining share of bank credit to small-mid size corporates (mainly due to weakness of asset quality, lack of servicing robustness of PSBs, and the need for their recapitalisation, banks' focus on retail lending).
- Further, past events like ILFS-DHFL fiasco and sub-optimal outcomes in real estate financing strategies have also given fillip to private credit as an alternate asset class.
- Regulatory support and a conducive ecosystem (NCLT, IBFC, ARCs) can also support private credit growth in India.

Specific/Distinct types of private credit strategies that will add value to investor portfolios:

- Structured Credit (especially performing credit)
- Venture Debt
- Aviation Finance

In investor portfolios, will private credit come under the purview of debt allocation?

We prefer to bucket all the investments/securities in the alternatives' space separately in the overall Asset Allocation Grid in order to align the same with higher risk generally associated with such investments. While one could also classify private credit as a separate item within the fixed income bucket (and some of our clients prefer to do so), if you think about it, private credit doesn't necessarily carry the duration (interest rate sensitivity) or marked-to-market risk which traditional fixed income instruments might carry. On the other hand, they do carry credit risk which is one of the key factors making them equivalent to conventional fixed income investments in some sense.

Can you throw light on the private credit fund review/analysis process at Multi Act?

We look at following tangible/measurable factors (including but not limited to) while analysing private credit funds:

- Tenure
- Sector and name diversification
- Cost Structure, including performance fee, hurdle rate, catch-up, etc.
- Past performance analysis (of previous series funds, if available), including return of capital criteria
- Targeted pre-tax and likely post tax returns for potential investors
- Intermittent coupon flows- yields and frequency
- Capital rotation or reinvestment during the lifetime of fund
- Deal structures, including collateralisation, etc. (if any)
- Skin in the game

Besides the above-mentioned measurable factors, its pertinent to pay attention to following intangible factors also, as part of private credit fund analysis:

- Management pedigree and experience
- Proactive approach to investing in mid-market debt segment
- Other advisory support/auxiliary services provided to the investee companies
- Case studies of how they handled stress/default situations with the investee companies

Any private credit funds or strategies that you would like to recommend? Details, if any?

While we refrain from suggesting (or distributing) any specific name currently, we draw upon our repository of deep dive on 8-10 private debt funds/structures in India which we have analysed over the last few years, for our client advisory purposes.

On the global side, something like aviation credit financing (which we offer through our overseas group entity- MAEG) is an interesting opportunity which offers a potentially attractive return proposition (~7% YTMs in $ terms; global diversification). Additionally, this strategy also offers other features like easier to value assets, attractive loan to value, readily available resale market and market value, alternative use asset, etc., which make it a compelling investment option. Further, this is done under the ambit of standardised financing structures with a well-developed international legal framework.

In addition to aviation financing, there are also other opportunities in global private credit that family offices in India can actively consider.

[1] https://www.bloomberg.com/news/articles/2023-01-13/what-is-private-credit-industry-poses-regulatory-risks#xj4y7vzkg
[2] https://www.ey.com/en_in/strategy-transactions/onwards-and-upwards-a-positive-outlook-for-private-credit-in-india

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