Prescient
INVESTMENT MANAGEMENT

# PRIVATE CREDIT FUNDS OFFER SA INVESTORS A UNIQUE ASSET CLASS WITH ATTRACTIVE INVESTMENT QUALITIES

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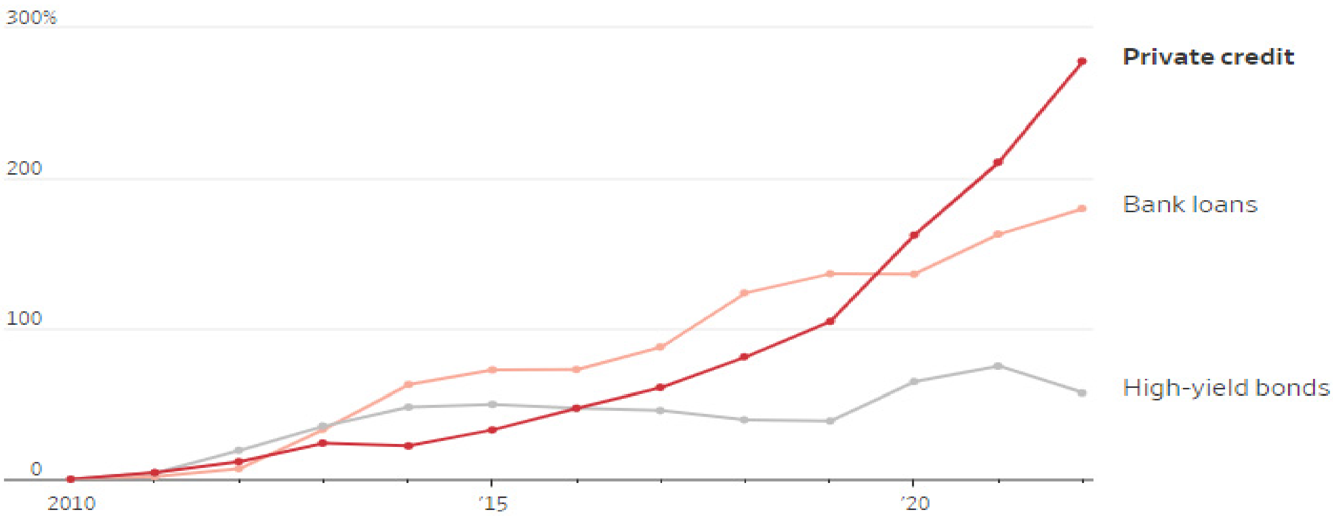
In recent years, there has been a significant shift in the landscape of lending and financing in the US, with a notable surge in the popularity and growth of private credit funds. These funds have gained traction as an alternative to traditional bank lending, and their rise can be attributed to various factors reshaping the financial sector.

Private credit funds invest in private debt, which encompasses debt issues offered privately by lenders to corporate borrowers, enterprises or projects that are not traded on listed exchanges. Non-bank entities, such as institutional investors, debt funds, insurance companies, and private investors, provide debt financing through various debt instruments, including senior loans, mezzanine debt, and other debt-related securities. Private debt allows businesses to finance general corporate expenses, growth initiatives, acquisitions, and projects.

An interesting article published in the WSJ [1]highlighted the significant growth of US private credit over the last decade. It notes that elevated interest rates resulting from the Federal Reserve's prolonged higher-rate policy is causing a shift in the landscape of corporate loan transactions because the sharp increase in rates has put some banks under considerable pressure and necessitated them to curtail their lending activities. As these 'traditional' lenders have scaled back, managers of private credit funds have seized the opportunity, actively funding US corporate loans, many of which have been jumbo loans[2]. This growth is shown in the graph below:

**FIGURE 1: GROWTH IN DEBT OUTSTANDING IN THE USA SINCE 2010:**




**Source: Barclays**

Interestingly, JP Morgan released statistics noting a marked increase in Private Debt investments. At the end of the third quarter of 2023, the private debt market made up $1.6 trillion of global assets, representing an annualised growth of 21.1% since 2019, relative to other international asset classes. Private debt assets under management (AUM) are expected to reach $2.7 trillion by

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[1] https://www.wsj.com/finance/fed-rate-hikes-lending-banks-hedge-funds-896cb20b?mod=finance_lead_pos2
[2] A jumbo loan, or jumbo mortgage, is a loan that exceeds the borrowing limits

2027, according to a forecast by Preqin. This is partly driven by fixed income and credit offering investors good value, resulting in an increased allocation to alternatives, with private debt taking centre stage.

## FACTORS DRIVING THE GROWTH OF PRIVATE CREDIT FUNDS

1. **Regulatory environment**

   One of the primary reasons for the substantial growth in private credit funds is the evolving regulatory environment in the banking sector. The increased regulatory scrutiny and stringent requirements imposed on traditional banks have resulted in a more cautious approach to lending. Consequently, borrowers have turned to private credit funds for more flexible lending options.

2. **Enhanced flexibility and tailored solutions**

   Private credit funds often provide borrowers with more customised lending solutions tailored to their specific needs. Unlike traditional banks, private credit funds have the flexibility to structure deals, loan terms, and covenants in a way that can benefit both parties involved.

3. **Diverse investment opportunities**

   Investors have also flocked towards private credit funds due to the diverse investment opportunities they offer. These funds invest in a broad range of assets, including direct loans to companies, real estate financing, infrastructure projects, and more. According to research, the diversity offered by private credit funds can potentially lead to higher returns and portfolio stability.

## WHY IS PRIVATE CREDIT ATTRACTIVE TODAY?

**For borrowers**

- Flexibility: Private credit funds provide borrowers with more flexible terms and conditions, allowing for negotiations that suit their financial circumstances and growth strategies.
- Tailored Solutions: These funds can tailor lending solutions to match the specific needs of borrowers, offering a more personalised approach than traditional banking offerings.

**For investors**

- Diverse Investment Portfolio: Private credit funds offer investors exposure to a diverse set of assets, potentially leading to higher returns and a more balanced investment portfolio.
- Attractive Returns: Historically, private credit funds have provided attractive risk-adjusted returns, making them an appealing choice for investors seeking income generation and capital appreciation.

Unlike equities or government bonds, which are both more prone to market fluctuations, in our experience, these private debt investments display characteristics that offer investors something different. The key differentiators of private credit include:

1. They have a lower correlation with the broader equity market - economic and market factors typically prompt equity swings but tend to have a smaller impact on the value of credit instruments.
2. They provide investors with a regular and predictable stream of income.
3. The market for these instruments tends to be less influenced by speculative behaviour.
4. They often exhibit lower price volatility.
5. While affected by changes in interest rates, the price sensitivity tends to be lower than that of traditional government bonds. We believe this ‘predictability’ makes credit particularly attractive to investors seeking stable income, especially during periods of heightened market volatility.

Moreover, private debt allows lenders to include protective terms not usually found in the public, listed environment. Given the stage of life of many of these companies, there is more frequent reporting and lender/borrower interaction, including, at times, board representation, when lenders have observer status. These characteristics enhance the security and oversight of these investments, making them particularly attractive to risk-conscious investors.

Additionally, it's worth noting that professional investors typically undertake these investments and, as such, are generally well-considered. Significant due diligence occurs during the investment process, and the investments are closely and rigorously monitored. This professional approach further contributes to the reliability and stability of private credit investments, making them a preferred choice for investors seeking consistent returns and robust risk management.

The appeal of credit doesn't necessarily remain constant across all interest rate cycles. For example, during periods of low interest rates, the yields offered by credit investments may become relatively less attractive. Conversely, when interest rates rise, newly issued bonds tend to offer higher coupon payments, leading to potential declines in the value of existing bonds. Therefore, understanding the prevailing interest rate environment is crucial for optimising the amount allocated to credit investments within a portfolio.

For these reasons, it’s essential to consider the risks associated with private funds:

1. **Risks and Uncertainties**: The inherent risks in private credit, including credit and market risks, can impact investor returns and capital preservation.
2. **Limited Regulation:** The lack of regulatory oversight may expose borrowers to potential risks related to the terms and conditions of the loan.
3. **Lack of Liquidity**: Investments in private credit funds are often less liquid than publicly traded instruments, limiting the ability of investors to access their capital quickly.
4. **Higher Costs**: Private credit funds typically charge higher interest rates and fees than traditional banks, resulting in a higher cost of borrowing for the borrower.

## IMPLICATION FOR SOUTH AFRICA:

The US is not the only country experiencing notable growth in private credit funds. While the South African credit market is not nearly as advanced as developed markets, this is slowly changing as more funds are launched and/or scaled up. This is in line with regulatory changes allowing for larger allocations to unlisted investments, with Regulation 28 changes one of the key drivers. Furthermore, the principles driving the global increase in private credit funds, namely regulatory shifts, the need for flexibility, and providing investors with exposure to a diverse array of investment opportunities, are similarly relevant to South Africa.

What we have seen in SA is the launch of general unlisted credit funds (with broader mandates); Infrastructure debt funds supporting SA’s developmental narrative; funds specifically focussed on financing renewable energy projects; SME debt funds; social impact funds (e.g., job funds); and mezzanine debt funds that fall between vanilla private debt funds and private equity.

As the world adopts and adapts to the trend towards issuing private credit, South Africa needs to assess its own regulatory environment and consider how private credit funds can play a role in meeting the country's financial needs while addressing potential risks, including those associated with oversight and regulation.

## PRESCIENT’S ROLE IN THE PRIVATE CREDIT ECOSYSTEM:

The appeal of attractive yields, coupled with private credit’s relatively lower correlation to market fluctuations, income-focused characteristics, gradually improving liquidity profiles, and the enhanced financial stability of market participants and issuers, collectively contribute to the growing attraction of credit investments for a broadening investor base.

Prescient
INVESTMENT MANAGEMENT

At Prescient Investment Management, we have long recognised that credit investments are a pivotal source of alternative alpha within diversified investment portfolios. Credit not only blends dependable income with potential capital preservation but mitigates volatility. These unique attributes make it a valuable contributor to portfolios. Prescient, which has a 25-year investment track record, offers three credit propositions that give investors exposure to private debt and its associated benefits.

1. The Prescient Clean Energy and Infrastructure Debt Funds offer investors a bespoke offering, with a key focus on green/clean energy credit investments and a broader infrastructure and developmental focus. These vehicles have a proven track record, providing investors with exposure to a diversified portfolio and resilient commercial returns through the cycle.
2. The Prescient Income Plus Fund, categorised as the high-yield portfolio, offers investors a vehicle with a broader opportunity set, including both listed and unlisted debt, focusing on capital growth and active returns.

We are excited about the opportunities private credit offers investors, giving them exposure to an asset with unique attributes that contribute positively to the diversification of our private debt and income-generation investment products.

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