

Alternative Credit Council Australia Private Credit Introductory Guide



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About AIMA & ACC



About AIMA

AIMA is the world's largest membership association for alternative investments managers. Its membership has more firms, managing more assets than any other industry body and, through our 10 offices located around the world, we serve over 2,000 members in 60 different countries.

AIMA's mission, which includes that of its private credit affiliate, the Alternative Credit Council (ACC) is to ensure that our industry of hedge funds, private market funds and digital asset funds is always best positioned for success. Success in our industry is defined by its contribution to capital formation, economic growth, and positive outcomes for investors, while being able to operate efficiently within appropriate and proportionate regulatory frameworks.

AIMA's many peer groups, events, educational sessions, and publications, available exclusively to members, enable firms to actively refine their business practices, policies, and processes to secure their place in that success.



About ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over US\$2 trillion of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

About EY & BondAdviser

About EY

EY is a global leader in assurance, tax, strategy, transaction and consulting services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.



In our wealth and asset management work today, not everything is innovation; a lot of it is evolution. And it's important to know the difference. FinTech disruptors continue to shift the rules, newer investors aren't flocking to older channels and cost pressure is relentless. From data and AI, to tech platforms and partners, the questions have never been bigger, and the stakes have never been higher.

At EY, we help clients re-think everything from pricing and operating models to competition and convergence. We bring critical questions into focus, which leads to bolder strategies, simplified operations and sustainable growth. Our sharp understanding of the state of play allows us to shift discussion from reacting to change, to helping shape it. Ultimately, we work with clients not just to stay competitive, but to change investing for the better.

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About BondAdviser

Established in 2014 as an emerging provider of financial services in Australia, BondAdviser specialises in independent investment research, advisory and data analytics focusing on public and private debt capital markets. BondAdviser is proud to be an employee-controlled business delivering investment solutions for the Wealth and Asset Management industry.

BondAdviser's Alternative and Private Debt Research team was established in 2017 to bridge the education gap in the relatively nascent Australian private debt market. It has since established itself as a specialist within the space, providing fund ratings and consulting services to funds and end-investors.

BondAdviser

Important Notes

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Introduction / Foreword

The ACC in conjunction with EY, AIMA and BondAdviser, is pleased to present the second edition of this primer on the Australian private credit market, bringing together data from our members and other sources to inform readers about this growing market. The paper provides insights on the history, context and key investment considerations of the market in Australia, as well as using data from ACC members to illustrate current fund manager mandates and investment strategies.

Over the past ten years private credit has evolved into an asset class in its own right, one which now makes up a permanent and valuable segment of investors' portfolios across the globe. More recently we have seen rapid market growth, with participants now including a broader range of fund managers, superannuation funds, insurance companies, institutional and retail investors.

Private credit has become a key source of financing for borrowers of all sizes in the Australian market. This has important benefits for the economy. A larger pool of borrowers now have access to capital and liquidity, while investors have opportunities to diversify their exposure and benefit from assets that offer an attractive risk-return profile.

The continued growth in capital allocation to private credit has helped cement its position as a dependable source of long-term financing for companies of all sizes. As the asset class has grown it has gained more recognition in the corporate sector, with fund managers evolving their strategies to include additional types of borrower and expand their product offerings. The main beneficiaries of this trend are Australian businesses, who now have greater choice when seeking finance, and Australian investors who now have more opportunities to enhance the resilience of their portfolios.

It is also notable that investors are also putting more emphasis on risk management practices of private credit managers. These have played a key role in the sector weathering the macroeconomic challenges of the past few years, enabling them to support businesses through this tough period while also protecting value for their investors.

We hope that this paper supports investors' understanding of the market today as well as the trends driving its future development.

Michael Gallagher, AIMA
Nicholas Yaxley, BondAdviser
Sebastian Paphitis, EY



Executive Summary

Within this introductory guide, and with the benefit of our 2nd Australian credit fund manager survey, a number of important key themes have emerged as outlined below. These themes reflect the development of the private credit market here in Australia and how it has matured into an important participant in the global trend towards private credit investment.

A**Private credit is now an established asset class in Australia**

The development of the private credit sector in Australia has continued to grow at a remarkable pace, with new managers entering the market, and existing managers building their platforms. The opportunity for investors remain compelling. There is now an estimated A\$188bn+ allocated to corporate and real estate private credit, accounting for ~13% of the total corporate debt market with no sign that the recent growth will end anytime soon. Australian borrowers now consider private credit as a standard rather than an alternative option when considering their financing needs.

B**Private credit lenders have diverse mandates and the capacity to underwrite larger loans**

Whilst the majority of respondents to our latest survey invest in direct lending, they are also active in other private credit strategies. These include sponsored and non-sponsored corporate lending, real estate, infrastructure and other alternatives. While most firms target loans between A\$20m – A\$50m, a considerable number of managers are now able to provide loans of A\$250m and above. Private credit fund managers remain broadly optimistic despite global macroeconomic challenges, citing strong levels of investor interest in the stable and reliable incomes that private credit can provide, even if there is an onus on selectivity in the current market.



Executive Summary

C

The floating rate nature of private credit has increased returns for lenders

Most Australian managers surveyed are operating lending strategies with target rates of return for respondents centred around 10 - 15%. While this is higher than in previous years, the increase is almost entirely due to rises in central bank interest rates. Almost all corporate loans made by private credit are a floating rate product, meaning that the rise in interest rates are automatically reflected in the interest rate on the loan. While this increases the returns to managers it also increases the debt obligations of the borrowers.

Managers have navigated this change well, with many highlighting the importance of deal selection, underwriting and proactive risk management to prevent any build up of stress in their portfolios. The relative return on private credit has also remained competitive to other credit markets. This compares well with both the 10-year horizon pooled return of the CA Private Credit Index at 8.18% and the CA senior debt index over the same horizon at 6.92%. Even in a challenging macroeconomic environment, Australian private credit managers are still able to deliver returns at or above the index, and therefore comparable international managers.

D

Favourable Regulatory and Legal Environment

While private credit managers and non-bank lenders in Australia remain subject to and must comply with a number of legal standards and industry codes, they do benefit from some similar flexibility over bank lenders as experienced in other international markets. They also benefit from creditor friendly legislation and well-developed business/asset protections that provide a stable environment to lend to sponsored and corporate borrowers and protect their portfolios.



Private Credit in Australia Survey

In 2023, the Alternative Credit Council, AIMA's private credit affiliate conducted a survey of Australian private credit managers. Responses were received from 21 private credit managers, which collectively manage private credit investments across a range of strategies, with the responses predominantly from Australian headquartered asset management firms. The survey also includes representation from private credit managers operating in the Asia Pacific region (outside of Australia and New Zealand), North America and the United Kingdom with investments here in Australia.

Respondents comprise managers as outlined below in Figures A and B, with a large percentage including managers with assets under management (AUM) above A\$1bn and with a larger than 50% allocation to private credit. Compared to our previous survey, the latest data shows that Australia's private credit market is achieving scale, with a significant increase in the number of managers with more than A\$1bn in AUM.

In line with wider trends in the global private credit market, which we captured in our Financing the Economy 2023 paper¹, this data indicates that the Australian market is also moving towards larger managers. Size is increasingly becoming more important in the private credit market, with larger managers increasingly looking to financing larger deals and targeting larger fund sizes when raising assets.

Figure A. What is your firm's total AUM (expressed at NAV)?

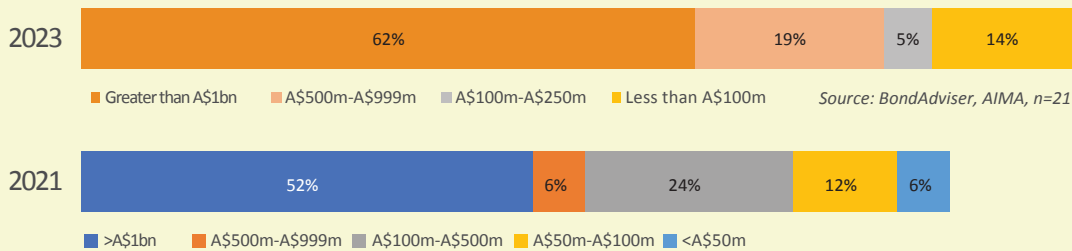


Figure B. What is the estimated percentage of your firm's total AUM allocated to private credit?

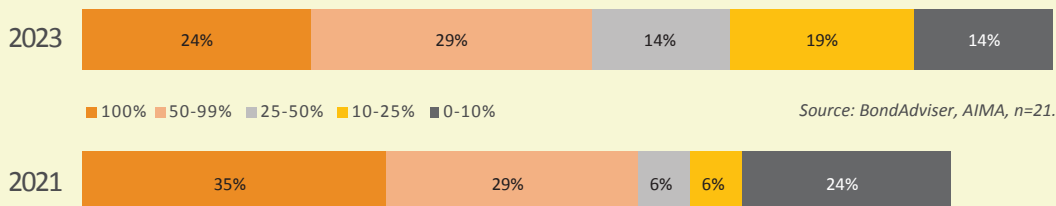


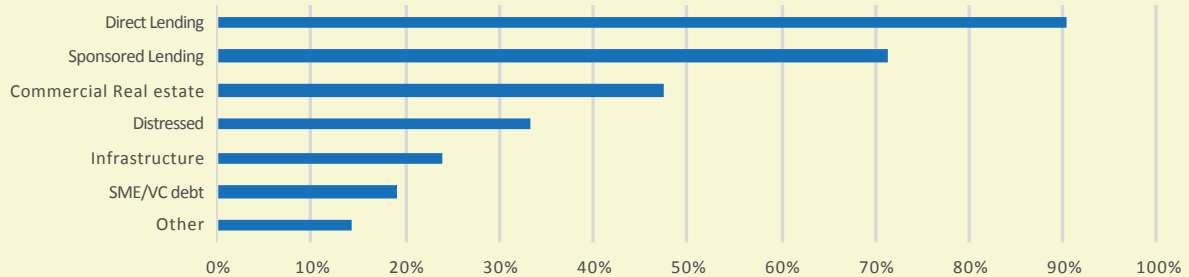
Figure B shows that the percentage of pure play private credit firms has decreased, which likely indicates that firms with various offerings have entered the market as it has grown over the past years to take advantage of attractive opportunities.

¹ <https://www.aima.org/compass/insights/private-credit/financing-the-economy-2023.html>

As depicted in Figures C and D, most respondents primarily engage in direct lending investments, understood as a broad category, with sponsored/non-sponsored lending and commercial real estate being core strategies for the majority of firms. While the typical loan target falls within the range of A\$10 million to A\$100 million, a significant number of respondents operate at both ends of the spectrum, with ~19% offering loans less than A\$5 million and ~14% targeting transactions exceeding A\$500 million. Due to the relatively smaller scale of private credit managers in Australia compared to European and North American markets, smaller loans play a vital role in these managers' efforts to diversify credit risk among their underlying borrowers. As firms have raised larger funds, they are also now able to lend larger sums of capital.

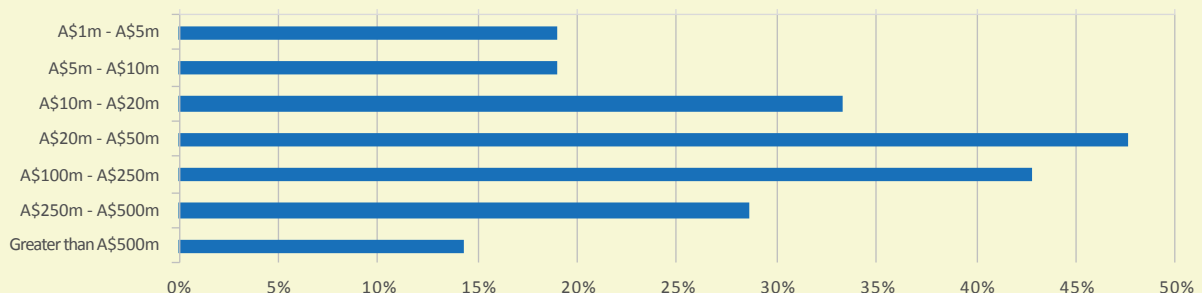
This data indicates that private credit lenders are now a viable finance provider for borrowers of all sizes. This broad diversification is also attractive to investors, which can choose from a wide range of managers to tailor their exposure to small-cap, mid-cap or large-cap borrowers.

Figure C. What private credit markets do you invest in?



Source: BondAdviser, AIMA, n=21.

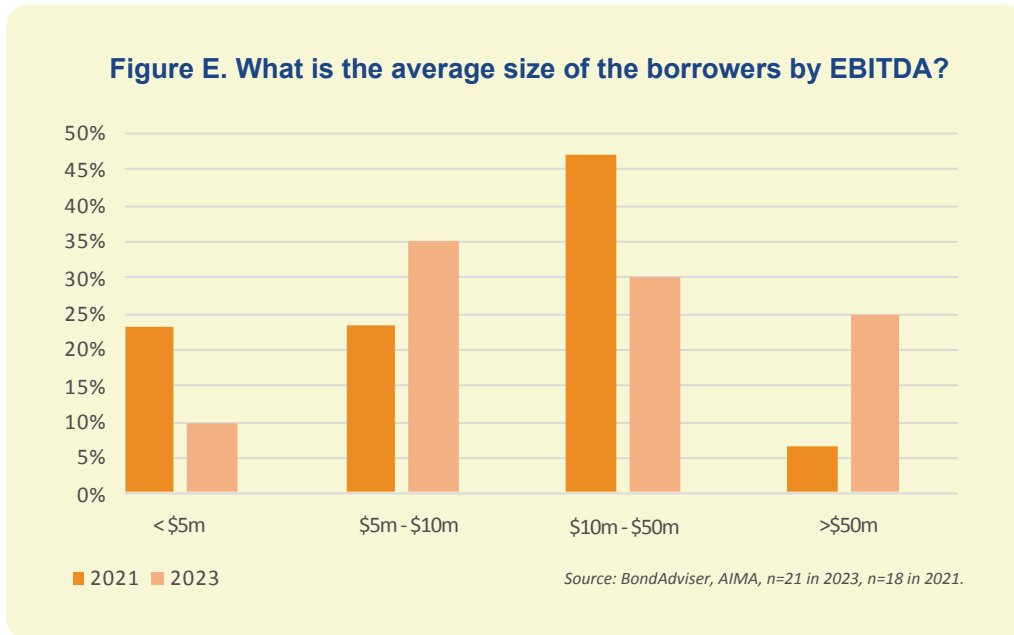
Figure D. What sized transactions do you target?



Source: BondAdviser, AIMA, n=21.

As Figure E illustrates, private credit managers have traditionally focused on medium-sized corporate and real estate borrowers with 47% of respondents in 2021 reporting an average borrower size by EBITDA in the range of \$10-50 million. In recent times, there has been a noticeable change in the credit market landscape, marked by a reduced influence of conventional banks. This evolution has created new prospects for private credit managers to reach a wider array of borrowers than in the past and are now a full finance vertical serving everything from startups and SMEs all the way to large cap firms.

This change is particularly evident in the increased diversity of borrowers' EBITDA levels. Historically, private credit was primarily utilised by borrowers with an EBITDA of less than \$50 million. However, Figure E reveals a significant departure from this trend, showcasing a substantial increase in borrowers both with an EBITDA exceeding \$50 million and smaller borrowers between \$5-10 million in 2023.



Borrowers within the private credit sector predominantly pursue funding for purposes related to acquisitions, expansion, and refinancing. However, amid the COVID-19 pandemic, a significant number of corporate entities turned to private credit as a means of bolstering their liquidity positions. This shift was driven by the quicker transaction processing offered by private credit channels and the fact that their financing needs surpassed the risk tolerance of traditional banking institutions. The activity of private credit markets during the pandemic demonstrated that it is a non-cyclical and permanent source of capital even in challenging markets. This was reinforced in the post-pandemic context when direct lending continued its growth and accessed increasingly larger deals during the downturn in leveraged loans and high-yield markets. These new opportunities played a role in the resilience of private credit deal flow in 2022-2023 by compensating for the slowdown in M&A and private equity deals, allowing private credit lenders to grow and take refinancing opportunities away from banks.

Since the last survey in 2021 however, borrowers have slightly altered their financing requirements. Recently there has been a relative increase in utilising private credit for refinancing, bridging and working capital in comparison to property development and stressed situations. The increase in the provision of bridging capital has built on the activity of private credit lenders during the pandemic, during which lenders provided liquidity bridges for fundamentally sound businesses undergoing pandemic-related difficulties and therefore preventing defaults, destruction of value and loss of jobs. This increase, along with the rise of refinancings, in recent years can be linked to the higher rate environment, which again has been a test to the soundness of borrowers.

Figure F. For what purpose do the borrowers generally require finance?

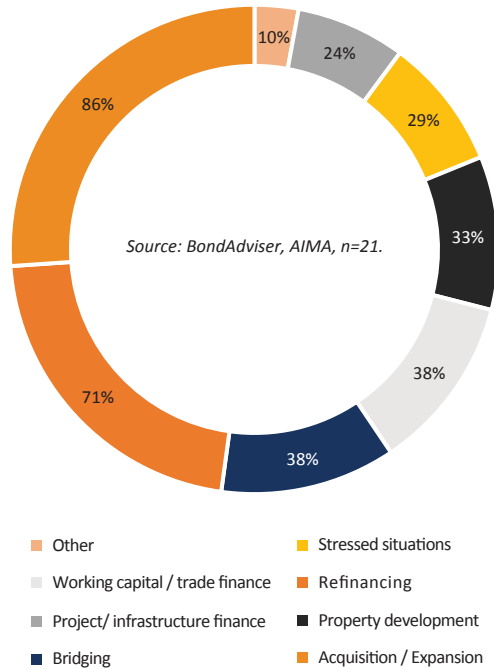
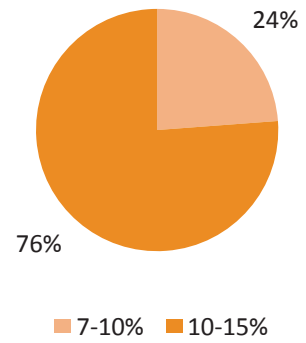
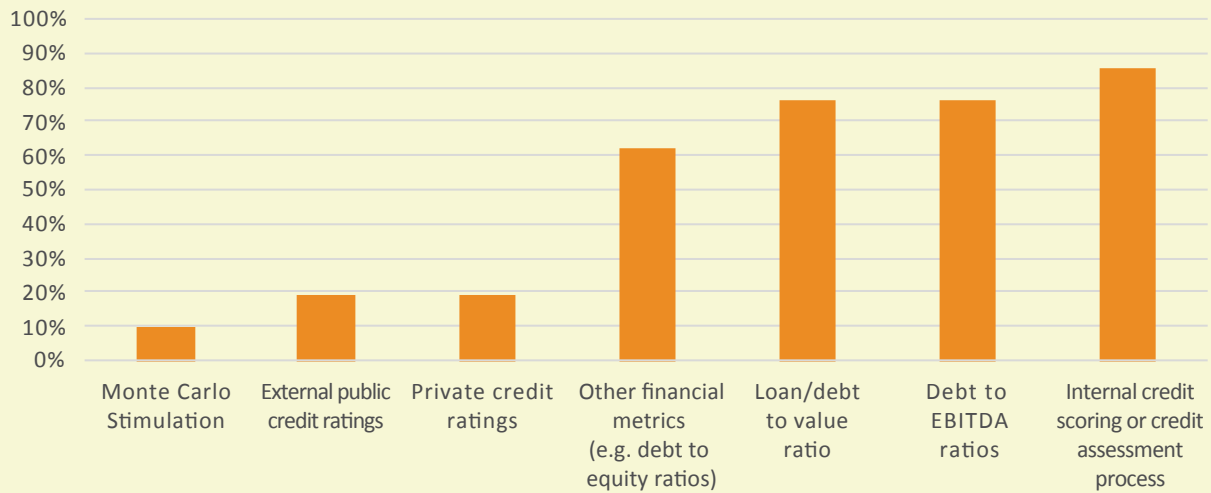


Figure G. What is your target rate of return before fees for the fund?



Previously, most managers were operating traditional, lower risk lending strategies with target rates of return for respondents centred around 7-10%. Although, in more recent times there has been an increase in the amount of fund managers that are targeting returns between 10-15%, as per Figure G. This is likely a manifestation of the changing macroeconomic environment, where there has been a significant increase in the risk-free rate of return over the past 18-24 months. The floating rate nature of private credit loans means that increases in central bank rates have increased the returns on loans on a commensurate basis, with asset managers achieving greater returns than in previous years. In cash markets, 4% is the new 0%, which flows onto 12% being the new 8%. The time series in Figure G shows how the rise in interest rates has impacted target returns for private credit managers, with 76% of respondents targeting returns between 10%-15%, as opposed to only 17% in 2021.

Higher rates, however, are not automatically beneficial for private credit lenders. While they have reaped higher coupons, higher rates also raise debt servicing costs for borrowers, challenging their ability to repay the loans. While private credit is not immune to the impact of higher rates on borrowers' ability to service their debt, many features of the market have helped lenders and borrowers mitigate the impact. For example, bilateral relationships with borrowers encourage stronger initial credit selection, negotiation of terms provides stronger creditor protection while regular monitoring supports a proactive approach to risk management. As we showed in our Financing the Economy 2023 paper, private credit lenders have generally managed the impact of increased base rates well and continued to provide their investors with an important source of returns despite these challenges.

Figure H. How do you measure and monitor credit risk?

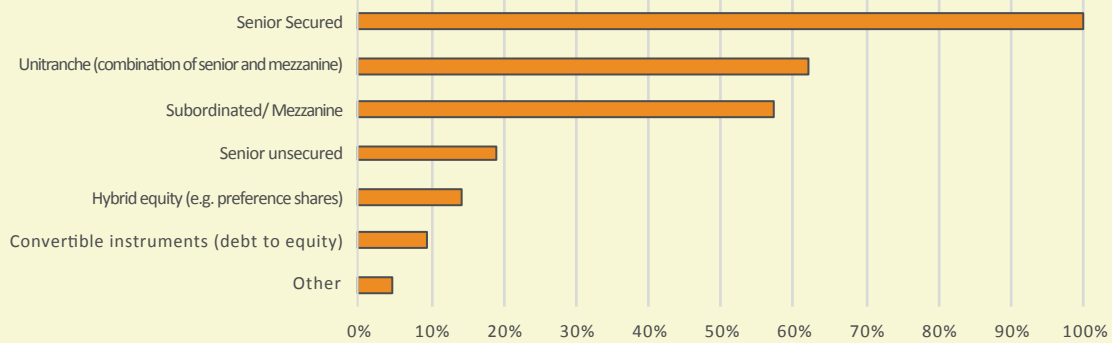
Source: BondAdviser, AIMA, n=21.

Nearly all respondents are utilising internal credit ratings to measure and monitor risk, which are often coupled with a range of key credit metrics to filter potential borrowers. This is one of the key differentiators between private credit and other lending markets like BSL or HY. The lower use of public credit ratings to measure and monitor credit risk is a natural consequence of the types of borrowers targeted by respondents. They are more focused on mid-sized corporates, as they are better suited to private financing than public capital markets.

The absence of public ratings from private credit does not mean that the asset class is riskier and can be explained by the nature of the market. Public ratings are not an efficient instrument for the private corporate lending market, as larger traditional investors have not focused on the market sufficiently to warrant public ratings. Because of this it is unlikely that public ratings will permeate the market in the near future, even though borrowers continue to demonstrate good quality and reaffirm the history of low defaults and preservation of value.

Lenders and investors maintain a rigorous credit underwriting assessment process in other ways, for example through internal credit ratings. The buy and hold nature of private credit means that this underwriting is extremely detailed, taking into account multiple factors to the same (or greater) level than that which takes place in other credit markets. For example, portfolio managers undertaking the credit underwriting themselves will undertake rigorous analysis of the financials of the firm, thorough due diligence of the company management, as well as a consideration of business risks and other external risk factors. Ultimately, the reliance on an internal credit assessment is a key differentiator for private credit and it is also part of the value creation that takes place in private credit markets, as this bilateral detailed assessment allows managers to focus on the characteristics of each potential borrower and find value for their investors.

Figure I. What level of capital structure do your investments usually take?

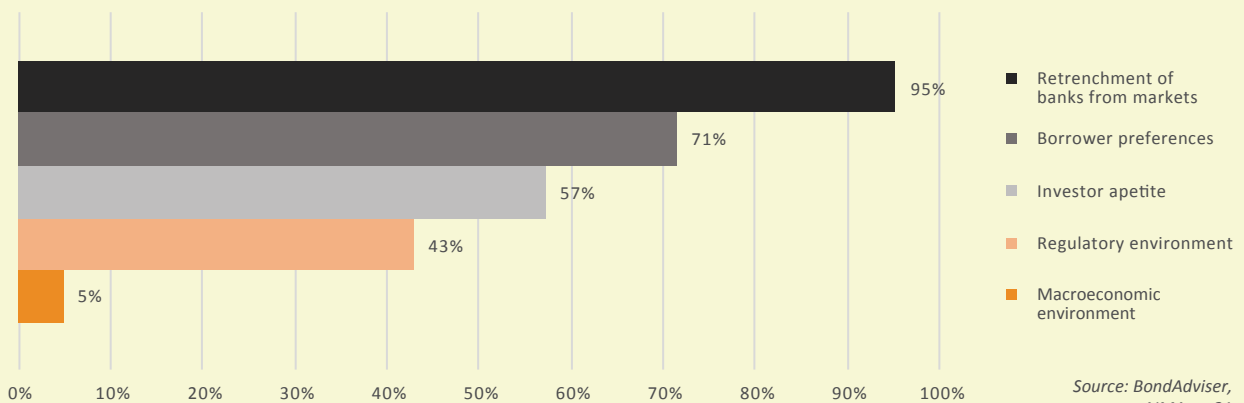


Source: BondAdviser, AIMA, n=21.

In private credit, structural safeguards are as important as traditional credit risk metrics. All respondents invest at the senior secured level but many also invest in subordinated and unitranche positions. While the majority of capital is targeting senior opportunities, private credit managers with additional risk tolerance and enhanced risk management skills also target special situations and opportunistic lending to support firms that are facing liquidity challenges. These deals are generally based on a ‘good firm/bad balance sheet’ approach, during which private credit lenders focus on protecting the value of the company to avoid a default.

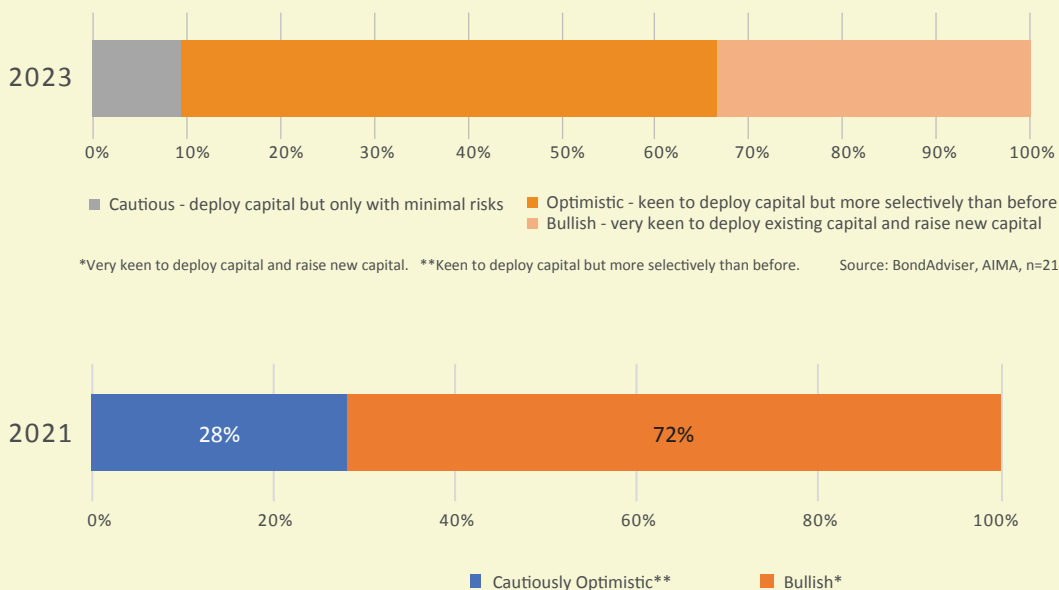
Figure J shows that opportunities in Australian private credit stem from the global trend of traditional banks exiting markets due to regulatory changes and evolving business models. Shifting preferences for financing amongst borrowers is also a notable driver.

Figure J. What do you view as the primary drivers of growth in the private credit market?



Source: BondAdviser, AIMA, n=21.

Figure K. How do you assess your overall appetite to deploy capital over the next 12 months?



As reflected in Figure K above, the survey indicates that the majority of players in the sector are either optimistic or bullish about its prospects in the short-term. However, compared to the 2021 data, there has been a rise in cautiousness among investors. This likely reflects the more challenging economic environment following interest rate increases over the past years, as well as other macroeconomic trends.

Private Credit Strategies

Private credit, also called private debt, non-bank lending or direct lending, can be broadly defined as any non-bank debt (typically loans) provided to companies – generally middle market companies. The debt is not issued or traded on public markets and is an asset class that consists of high-return and illiquid investment opportunities, which ranges from senior secured debt with fixed income-like features to distressed debt with equity-like risk and returns.

Importantly, private credit is not a homogenous asset class and there is a diverse array of strategies that sit underneath this label. The diversity of the asset class means that investors can access private credit strategies with markedly different liquidity, risk and return profiles to suit their needs and preferences. Each of these will have present different potential benefits and risks to investors, some of

which will be more familiar than others to investors depending on their previous experience with the asset class.

In terms of the key reason for pursuing this asset class, it boils down to one word: yield. A decade of central bank stimulus caused yield to evaporate in the usual places, such as the debt of blue-chip corporations. Loans in the private credit market are usually more lucrative and provide a good alternative to investment grade fixed income investments, so managers can offer investors new ways to generate returns ranging from the low-single digits to more than 20%. Because of this range, assessing the return target of a prospective credit strategy is not enough, investors must examine the nature and quality of the underlying investments that generate those returns.

Investors also benefit from the portfolio diversification, with this being a key consideration for many institutions in this market, and so have encouraged their external managers to extend into private credit. We expect this trend will continue.

(Sourced from Private Credit Strategies: An Introduction (2017), Cambridge Associate)



Overview: Private Credit Investment Strategies

Figure L. Summary of private credit strategies

	Capital Preservation		Return-Maximising		Opportunistic / Niche	
	Senior Debt	Mezzanine	Capital Appreciation	Distressed	Credit Opportunities	Specialty Finance
Also known as	Direct lending	Subordinated capital	Subordinated capital, structured equity	Distressed debt, special situations	Special situations	Asset-backed finance, esoteric assets
Strategy	Capital preservation through senior instruments with extensive creditor rights.	Origination of par, performing junior debt.	Origination of par, non-dilutive, private equity substitute capital in the form of junior debt, preferred equity.	Purchase of stressed and distressed debt.	Providing more complex corporate financing arrangements.	Structure or purchase of cash flow streams generated by either a physical or financial asset.
Return drivers	Coupon	Coupon	Equity gains, fees	Recovery in debt prices, interest payments or restructurings.	Interest income, original interest discount and equity upside.	Cash flow recovery or enhancement through active servicing.
Targeted Returns through the cycle	Unlevered 6 – 10% Levered 8 – 14%	9 – 15%	> 13%	> 14%	> 11%	6 – 15%
Investment duration (years)	2 – 4	4 – 5	4 – 5	2 - 4	2 - 4	2 - 4
Term of fund (years)	5 – 8	8 – 10	8 – 10	6 – 10	5 - 7	5 - 8
Competition	Intense competition from other direct lenders, CLOs and hedge funds.	Stiff competition in covering PE sponsors.	Less competition than traditional mezz as the unsponsored market is much larger.	High level of competition from hedge funds and credit opps funds.	Competition varies but is highest in crowded trades.	Generally limited competition but with some crowded trades.
Funds' ability to influence restructuring process	Influence correlates with control. Fewer lenders mean greater control and influence.	In distress, mezz funds must pick sides by aligning either with equity or with senior lenders.	Capital appreciation providers can assume control in distress.	Can be very high and is frequently part of the strategy.	Similar to that of distressed credit managers and capital appreciation strategies.	Don't typically seek to influence.

1. Capital Preservation Strategies

Capital preservation strategies include sponsor-oriented senior debt, stretched senior and mezzanine funds operating in the private credit market. The vast majority of managers in this space finance private equity-led leveraged buyouts and a mix of other direct lending strategies. Returns flow primarily from current pay coupons and some fees; equity participation is a less important driver of returns and loss mitigation is essential as the possibility of outsized gains is limited.

1.1 Senior Debt

Senior debt ranks above equity and is unsubordinated to all debt except in the rare instance that there is a split-lien senior loan. In this case, a senior loan can also be structured as stretched senior or be second-lien working in tandem with senior facilities secured by working capital, fixed assets or PP&E.

Senior debt funds generate the majority of their returns from interest payments, some funds do trade their loan portfolio and as such can generate capital gains from the sale of a loan. Typically, senior funds are floating rate at a spread above a reference rate. Domestically, this reference rate is usually the bank bill swap rate (BBSW).

Direct senior lending to middle market companies is also a typical focus of private credit providers in Australia. Loans for the purpose of acquisition, growth and development across infrastructure, commercial real estate and specialist sectors are common.

Investors in senior debt funds should be wary of the ability of fund managers to leverage at the fund level. Unlevered gross returns for senior debt funds in Australia typically ranges from 4% to 10% while levered funds may reach 12% or more, with leverage at the fund level increasing the volatility in net returns. Debt funds are exposed to a number of risks, including its sponsor-oriented business model and a correlation of the fund's pipeline with the merger and acquisition (M&A) cycle.

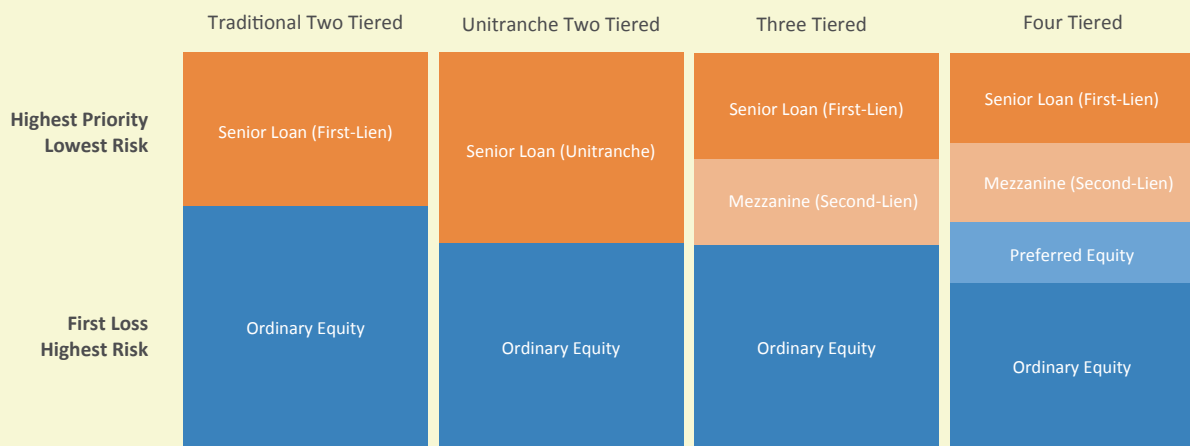
1.2 Mezzanine

"Traditional" mezzanine refers to those managers that seek to develop relationships with private equity sponsors and senior lenders to provide junior capital to finance buyouts or acquisitions. Mezzanine managers tend to make subordinated loans to lower-middle-market and upper-middle-market borrowers and generate most of their return from current cash pay coupons in excess of 8%. These funds also generate returns from prepayment penalties and paid-in-kind (PIK) interest, although to a much lesser extent than funds pursuing capital appreciation strategies. Mezzanine managers can also capture equity exposure through purchased equity or warrants, as well as penny warrants. Their ability to negotiate documentation is constrained by the demands of equity owners and senior lenders, and pricing frequently takes a strong cue from the market.

A primary risk for these managers is that credit losses overwhelm gains from equity exposures. In theory, equity gains from the rest of the portfolio should compensate the investor for limited credit losses, but this is not always the case. Targeted gross returns hover around the mid-teens, depending on market conditions. Mezzanine funds usually have eight- to ten-year lock-up periods with limited liquidity from current pay interest.

Mezzanine finance is also often associated with the construction of commercial real estate (CRE). In this case, the mezzanine finance is deployed at the higher risk stage of development and will precede the deployment of first-lien (senior) loans. Through an intercreditor agreement, the first- and second-lien lenders can share the same security package whereby the senior lenders are the priority if assets are to be sold. The intercreditor agreement will restrict repayment of the mezzanine finance until certain conditions have been met by the borrower. Mezzanine finance is also used by private equity firms in leveraged buyouts (LBOs) to finance acquisitions where limits on first-lien loans are present.

Figure M. Examples of private credit capital structures



Source: BondAdviser



2. Return-Maximising Strategies

Return-maximising credit strategies are more opportunistic, and as a result of the higher inherent risk, typically yield higher returns. Funds in this space typically purchase either performing or distressed credit assets. The strategy behind buying distressed loans at a discount is to eventually sell the loans at or closer to par for a capital gain, or otherwise hold to maturity.

Distressed loans are regularly originated to borrowers with weaker credit quality and as such do have higher yields if the payments are being made. This can contribute to net returns for an opportunistic fund, but the primary objective is to on sell the loan for a higher price than the Fund paid.

2.1 Capital Appreciation

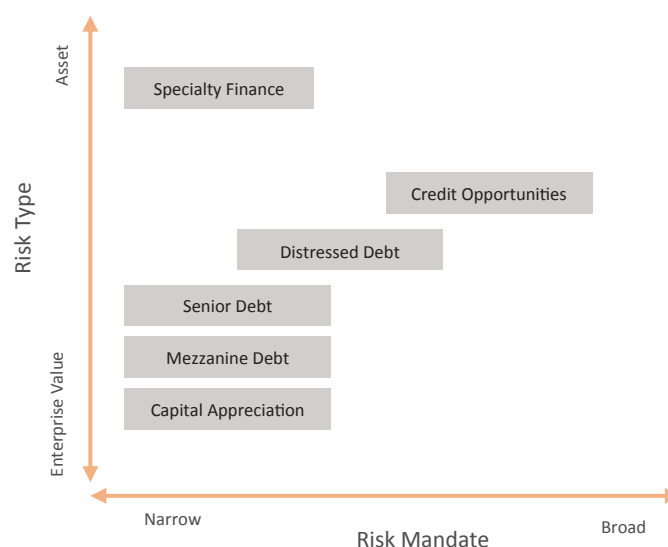
Capital appreciation strategies tend to be either equity-like or deeply subordinated debt instruments that often function as a substitution for private equity. Firms owned by entrepreneurs or families seeking capital but reluctant to surrender control will turn to structured equity or subordinated capital appreciation providers to meet their financing needs. Being deeply subordinated, these strategies offer higher returns but with subordinated debt typically offering lower returns than that of equity-like investments.

Debt instruments receive lesser returns as a result of stronger borrower protections in the form of liens, covenants and other measures. The loans for these strategies are issued at par and as such the objective for the Fund is to generate higher returns from higher interest payments along with fees, penalties and other measures. Net returns for the Fund will be quite dispersed, dependant largely on the manager's preferences.

2.2 Distressed Credit

Distressed credit fund managers typically buy deeply discounted debt securities, either in the market or bilaterally. Most endeavour to generate returns through negotiation, taking advantage of their rights as creditors and the prevailing bankruptcy code. Distressed credit managers are expert financial analysts with deep expertise in legal documentation. Target IRRs typically exceed mid-teens yet the primary risk affecting these strategies is that many parties are typically involved in a debt restructuring.

Figure N.
Private Credit Matrix:
Risk and Breadth



Source: BondAdviser

3. Opportunistic and Niche Strategies

For investors looking between the typical credit strategies of either protecting capital or return-maximising strategies, there exists a wide array of other credit strategies. Two major strategies in this bracket are typically referred to as “credit opportunities” and “specialty finance.”

3.1 Credit Opportunities

This strategy seeks to deploy debt capital opportunistically wherever market liquidity is lowest. This includes assisting borrowers in staving off a liquidity crisis (rescue finance). Due to the urgency on the borrower’s behalf in these instances, yields are typically high for these funds. There are similarities here to distressed credit managers and likely an overlap in lending to similar companies. Rescue finance is typically held to maturity or repayment. Moreover, credit opportunities funds differ from distressed funds in their ability to source, structure, manage, and exit par instruments across a broad array of industries and markets.

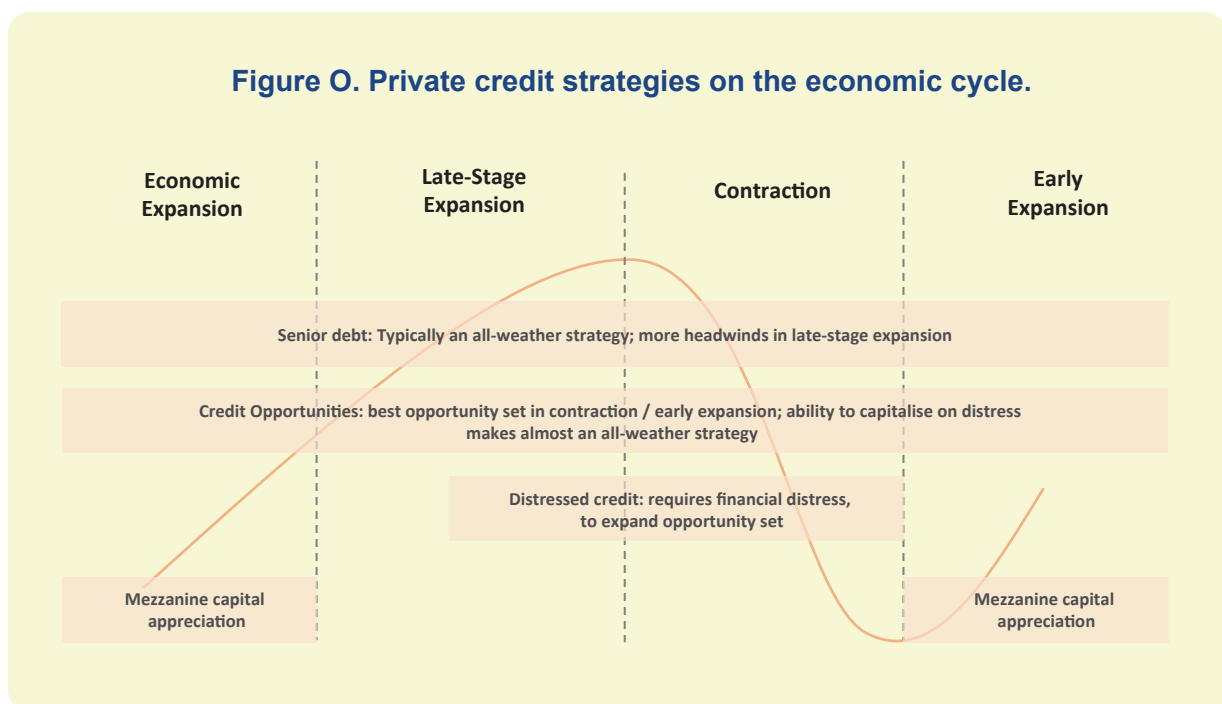
3.2 Specialty Finance

Specialty finance managers each pursue a very niche strategy, often targeting one small industry, requiring highly specialised expertise. Within specialty finance, the most capital has flowed to funds that purchase nonperforming loans (NPLs). The extremely narrow nature of these funds makes them very difficult to perform due diligence on because each strategy requires in-depth understanding of the industry that the lender specialises in. Targeted gross returns for this fund type tend to begin in the mid-single digits and can range into the upper-teens, however most offer less upside potential.



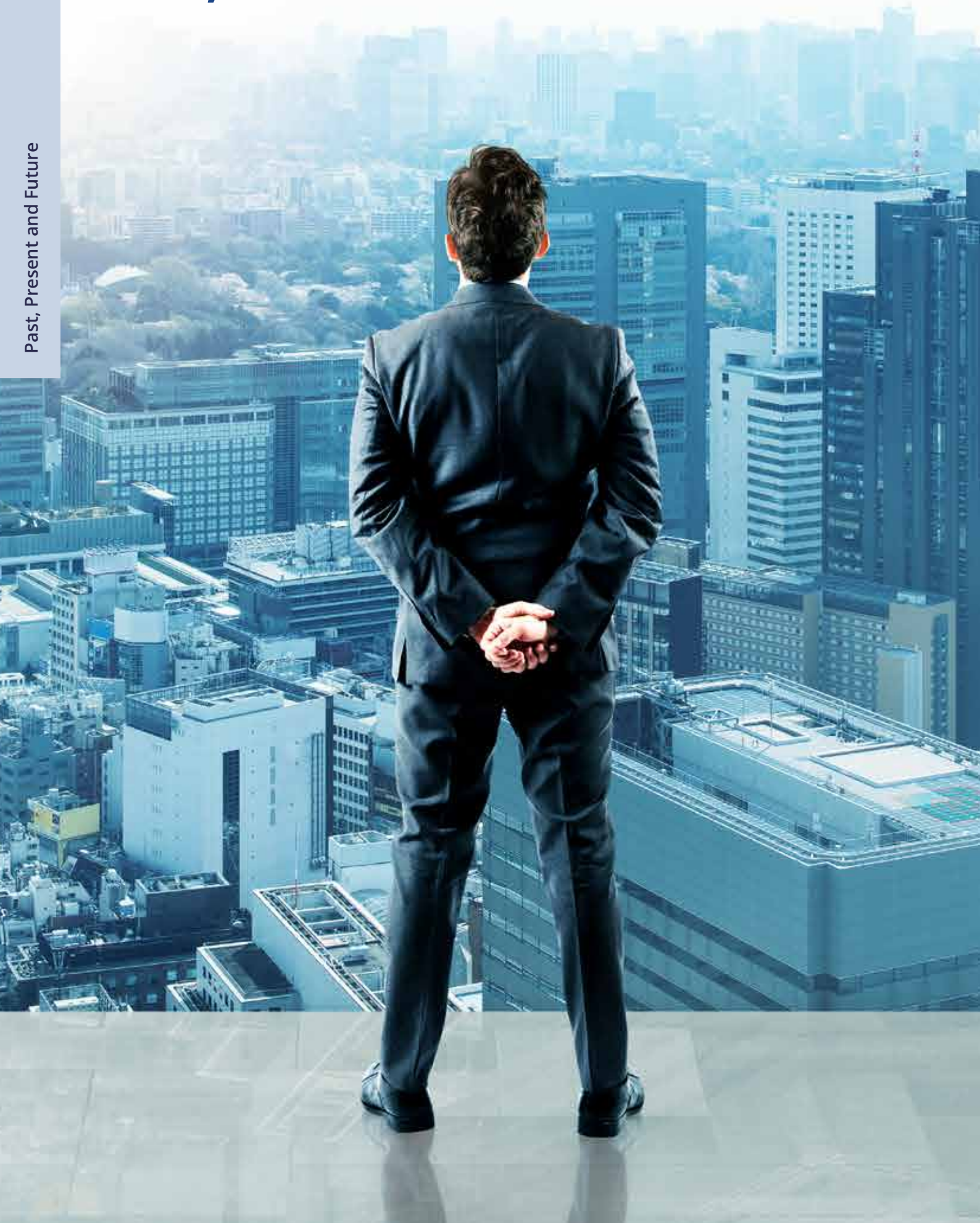
Strategies over the Economic Cycle

These different strategies will have different relative appeal moving along the economic cycle. Whilst some strategies, namely senior debt and credit opportunities, will be attractive across all phases of the cycle due to their inherent structural protections and earnings generation capacities, others such as distressed credit, will be more appealing at specific stages. This is summarised in Figure O below.



Source: BondAdviser

Past, Present and Future



Australia

Over the past decade the private credit sector in Australia has experienced remarkable growth, benefiting from the tightening regulatory environment on both domestic and global banks and the opportunity to offer institutional investors a new asset class. However, to properly understand the rise of the private credit market it is necessary to look back further into the history of the market as a whole.

Up until the 1990's the lending market in Australia was dominated by the banks, that was until they faced a lot of difficulties and suffered extreme losses exceeding A\$9bn (before tax) between 1990-92². The cause of these severe losses is understood to be the deregulation in the mid-1980s which led to an increase in competition among financial institutions as well as an urgency to build their balance sheets. This was all occurring at a time when asset prices (in particular commercial property) were increasing rapidly, and credit procedures were updating to the new accommodative environment resulting from deregulation.

At the time, the big banks were expanding and diversifying into funds management, cross selling their financial products and as a result taking more of the market share of both consumer and corporate lending. Foreign banks were also entering the scene, mainly focusing on wholesale banking and funds management, adding to competition in those areas. This, combined with the entrance of mortgage managers offering more competitive rates and taking a share of the housing loan market, forced the leading lenders to reduce their rates.

In the early 2000s and in the lead up to the GFC, the Australian economy was in a good state with strong economic growth, increasing productivity and declining unemployment rates. In the early 2000s there were two shocks which affected the financial market. The first was the tech bubble burst, which Australia got through relatively unharmed; and the second was the 2001 collapse of HIH, a major insurance company, which led to a more significant disruption to the economy as the government was forced to step in to provide compensation to policy holders. Apart from these two shocks, the market remained relatively stable and showed growth through the decade, yet these disruptions kept regulators on alert.

In 2007 the GFC exposed leverage in the financial system and whilst Australia was impacted, the extent of the disruption was more limited compared to other countries, particularly compared to the US and Europe. The Australian banks had less exposure to the sub-prime crisis; however, the effects of the crash were felt indirectly in Australia as the weaknesses in international capital markets spilled over and began to affect local markets and institutions. The effective closure of international securitisation markets had a direct impact on the banks, which relied heavily on international wholesale financing, leading to their cost of funding increasing, the impact of which was transferred to borrowers. Overall, the policies put in place at the time by the Australian Government meant that the impact of the GFC was minimised and the markets coped relatively well through the global economic downturn.

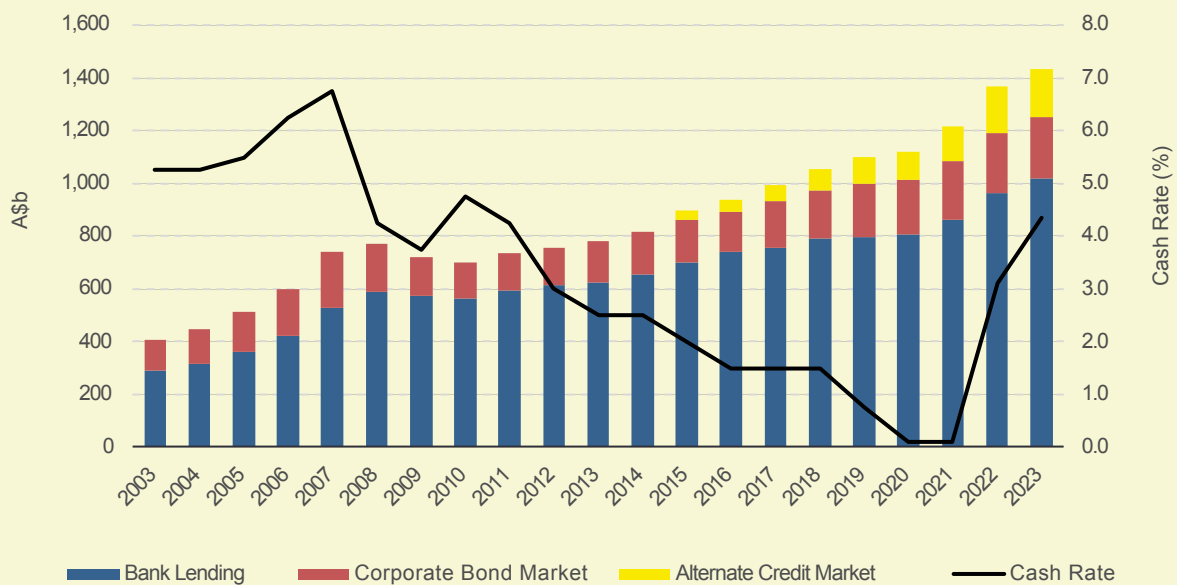
Post GFC the banks were still forced to repair their damaged balance sheets and were also faced with tighter regulation including increases to capital requirements. These factors forced banks to curtail corporate lending and take a more conservative approach to origination. This in turn provided an opportunity for fund managers, institutional investors and high net worth individuals to access a larger portion of the private credit market in Australia. As a result of this, private credit started to gain traction in the Australian market with fund managers such as Challenger and IFM emerging. Additionally,

² <https://www.globalcapital.com/Media/Documents/Euroweek/Import/576/86249/ew-aussie-cap-markets-2012.pdf>

Macquarie was lending through its corporate and asset finance (CAF) division. These companies all capitalised on the Federal Government's wholesale funding guarantee and in the case of Macquarie, more broadly on demand from institutional investors because of the yield on offer.

The growth since the late 2000s has been aided by rapid technological developments and awareness of private markets leading to a wider range of available routes to access capital. Borrowers are no longer limited to relationship teams at banks but can now directly access sophisticated origination and support teams of non-bank lending institutions and credit funds. This has resulted in a wider range of private credit financing solutions with greater flexibility and as such, more ability to meet the borrower's specific needs, especially for companies with higher risk profiles that traditionally need to overcome restrictions imposed by banks. Per EY analysis, there is now over A\$188bn in allocated corporate and real estate private credit, accounting for roughly c.13% of the total corporate debt market in Australia in 2023. That can be compared to around A\$35bn in 2016. This rapid growth has occurred due to a range of factors, including the increased appetite for private credit from institutional investors including superannuation funds and insurance companies.

Figure P. Corporate Debt Market Volume in Australia



Source: RBA, ABS, EY estimates as at December 2023

In addition to this, in recent years we have seen the regulations on the Big Four Australian banks become tighter, particularly in the wake of the Royal Commission. This has had the result of opening even more of the private credit market as banks pull further away from selected lending segments, allowing new participants to enter.

Investors can also expect to see more growth in the private credit market over the coming years. This is a function of the relative returns on offer, heightened awareness of the market as a result of more news coverage of deals and transactions, and information gradually becoming more available about the sector.

In more recent times in an environment of major shifts in global economic and market conditions, lenders are becoming more selective, increasing their levels of due diligence and having an expectation of higher returns in line with global market pricing. Additionally, there has been increased scrutiny on performance of existing loans with secondary pricing on some sub-investment grade and leverage loans falling below par – though these challenges are not limited to private credit investors.

Broadly there are four key trends expected to continue to play out, these being:

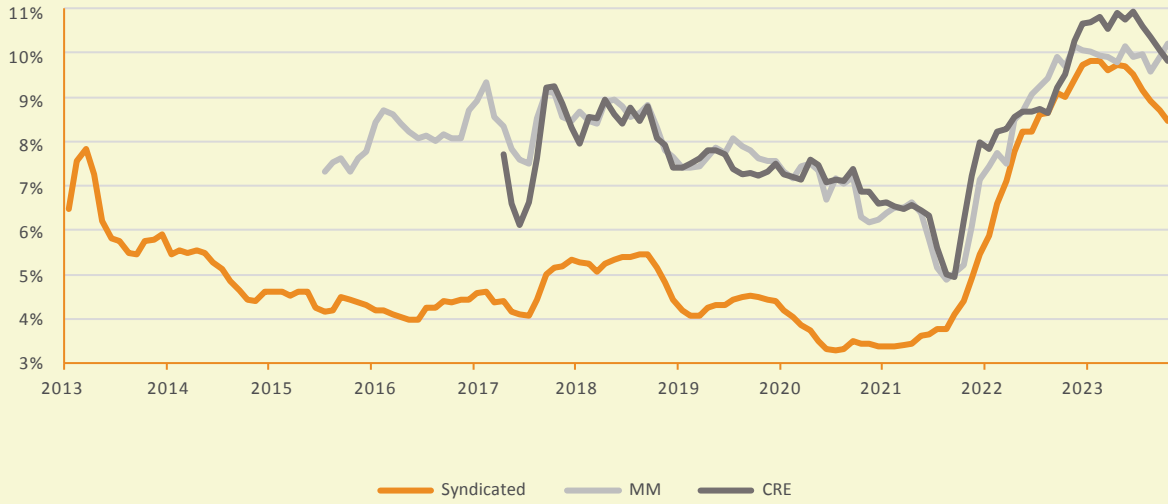
1. **Margins Improved** across corporate debt markets for borrowers in the last 12 months, albeit in the lower middle market and in less favored sectors a premium remains.
2. **Interest Rate Outlook** is now seeing improved visibility on long term rates and shift to reductions.
3. **Leverage** for acquisition financing remains available although credit views remain selective so leverage is deal and sector specific.
4. **Increased Focus on ESG and Climate Standards** across both bank and private credit markets are expected to accelerate the shift of lender appetite from “.heavy emitters”.

The private credit market is also expected to play an important role as a source of funding for businesses in a range of different structures which provide high levels of flexibility. These structures allow companies to have access to longer tenors with high levels of flexibility and provide opportunities for companies with higher risk profiles to overcome restrictions imposed by traditional bank debt such as strict covenants and issues arising from being unrated or below investment grade.

On the other hand, a key attraction for investors looking at Australian private credit is the access to stronger risk-adjusted returns than are available in other markets as a result of the demand/supply imbalances in the Australian banking system. Larger yield premiums are generally available in the private credit space as each transaction is specialised to each borrower’s needs and the market is underserved as a result of unfavourable bank capital treatment.



Figure Q. Net Returns to Investors in Australian Private Credit – by strategy (last 3 months annualised on a NAV basis)



Source: BondAdviser, Fund Reports. As at 30 June 2024.

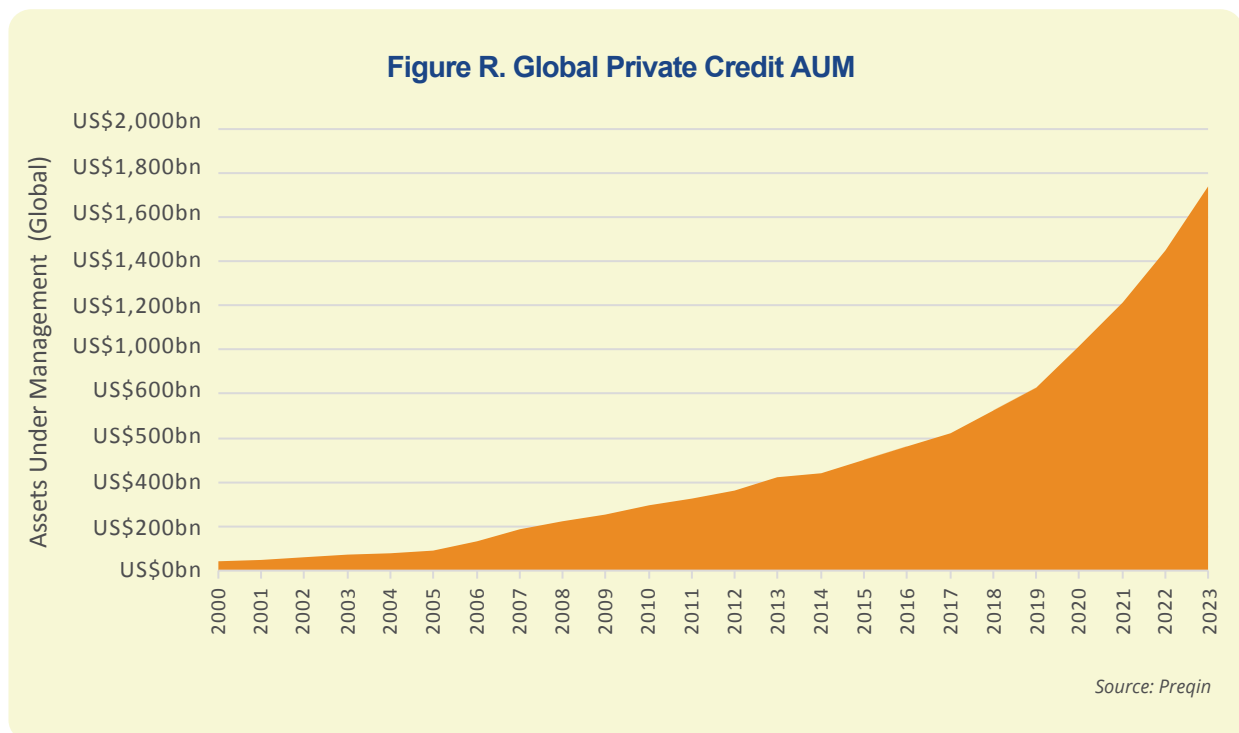
The relative attractiveness of these premiums compared to other global credit markets, is also complemented by the inflation hedge available due to the floating interest rate structures typically utilised in these private credit instruments. Overall, this provides a compelling opportunity for investors to diversify into Australian private credit markets.



Global

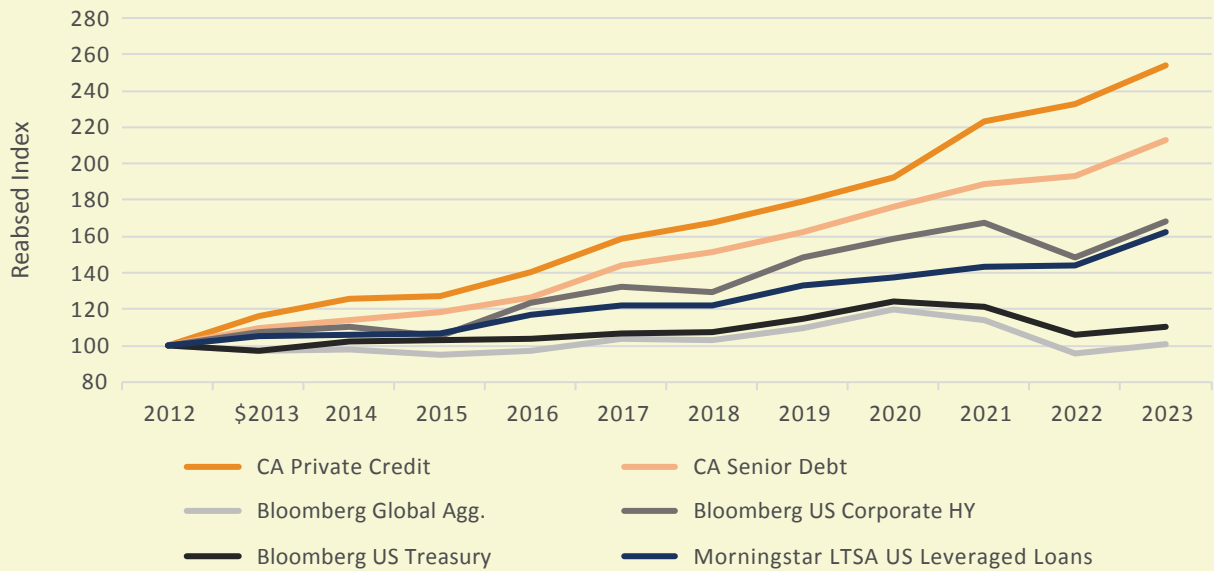
Private credit is an increasingly important asset class for both investors and businesses in the global economy. Over the past five years the sector has grown from a relatively niche part of the alternatives market to a permanent part of the capital allocation portfolios for some of the most sophisticated investors in the world. Simultaneously, private credit became an essential source of finance for the real economy allowing businesses to grow, thereby driving employment opportunities and innovation.

The appeal of private credit to both investors and borrowers has caused the volume of capital allocated to the sector to grow substantially. From December 2000 to December 2023, the size of the market grew from US\$41 billion to US\$1,741 billion (~17.6% CAGR) according to Preqin, and it is estimated that the market will grow to US\$3.5 trillion by the end of 2028 globally by Blackrock's forecasts. More than half of private credit investors are in North America (54% at the end of August 2024), with emerging markets in both Europe (23%) and Asia (14%).



Historically, private markets have outperformed public credit and the leveraged loan market, and have done so at a lower volatility due to lower susceptibility to market movements. Investing in private credit involves illiquidity risk, and generally underlying loans will price with an illiquidity premium relative to public credit, potentially delivering greater returns relative to an otherwise identical public credit investment.

Figure S. Private Credit cumulative returns



Source: Cambridge Associates, Bloomberg.

In Europe, similar to Australia, private credit funds started expanding rapidly after the GFC when tight capital regulations put limitations on traditional bank loans. The reduction in lending to meet EU regulatory capital requirements occurred at a time when many midsize European firms had urgent needs to refinance their debt, as a result the gap was filled by private credit investors. Moreover, the low rate environment that predominated in Europe over the past decade created an increase in demand from investors for higher yields that they could not gain in traditional asset classes or bank debt.

In Europe, the private credit market is dominated by UK, French and German issuers. It is estimated that 20% of private credit managers are based in Europe and the number will continue to grow as more new private credit funds emerge to take advantage of the increasingly popular asset class. As such, over the coming years the market in Europe and the UK will continue to close the gap with the US market.

The private credit market in the US was the first to emerge and has been the market with the most capital circulating since its inception, with the focus mainly being on leveraged loans. The first notable surge of corporate lending in the US was when the leveraged buyout transaction boom took off in the 1980s and banks involved in the transactions needed to share the credit risk of these loans. This momentum slowed when the recession hit in the early 1990s and the credit sources available to high-risk investors reduced dramatically due to regulation restrictions imposed.

At this time however, a secondary loan market began to emerge to allow banks to reallocate the distressed loans and also to facilitate institutional investment. There were a number of factors that allowed this secondary US corporate loan market to become sophisticated and operate with high

efficiency. These included performance measures that were put into place, credit ratings being used, data collection and centralisation, and most importantly, the formation of the Loan Syndications and Trading Association (LSTA) – which is the independent body that works to improve the overall quality and efficiency of the market. The growth of the market and the high levels of regulation increased the attractiveness of the asset class and allowed the transfer of risk to become more efficient, which in turn improved the liquidity and stability of the US economy.

Following the crash of the stock market during the GFC and the collapse of many US lenders, more private credit funds stepped in to fill the capital gap. The difference between America and the rest of the world is that the private credit market was already well established amongst investors who were seeking floating rate exposure to higher yields. Since the GFC the market has shown consistent growth.

Growth when compared to other regions, in particular Europe, can be considered to be moderating, but the sheer size of the US market still makes it the largest global contributor. In the US there are a number of private credit investors currently holding large amounts of dry powder to be allocated and as such, we can expect to see the market show further development.



While their total footprint remains diminutive, investors from various Asian countries like China, South Korea and India are also increasingly drawn to the unique characteristics of private credit. Thus, significant growth is expected from many countries within Asia, where banks have been overwhelmed with nonperforming loans (like India and China) or in countries where the public debt markets are not as deep or well established. The pivot toward Asia is not limited to investors. Faced with increasingly mature markets at home, fund managers also see the region as a fertile source of investment opportunities.

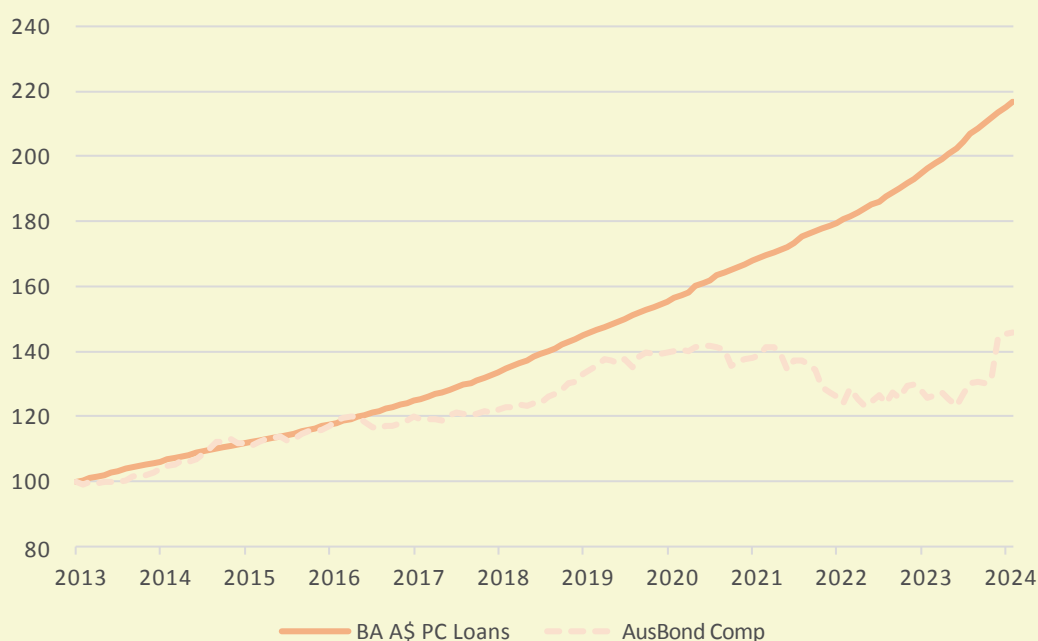
Performance Comparison: Private Credit Index

Comparing the performance and development of private credit markets across jurisdictions on a like-for-like basis is difficult, due to different economic landscapes, legal frameworks and limited benchmarks.

The Australian private credit market is often compared with those in the US and Europe, using the leveraged loan market as a proxy. The global leveraged loan market has historically attracted the most institutional investment and has thus received the most attention from an indexing perspective. However, while they are generally recognised as a good way of comparing markets, leveraged loan benchmarks have some limitations as a proxy for the wider Australian private credit market, as they represent only a narrow range of the universe of borrowers which utilise private credit here.

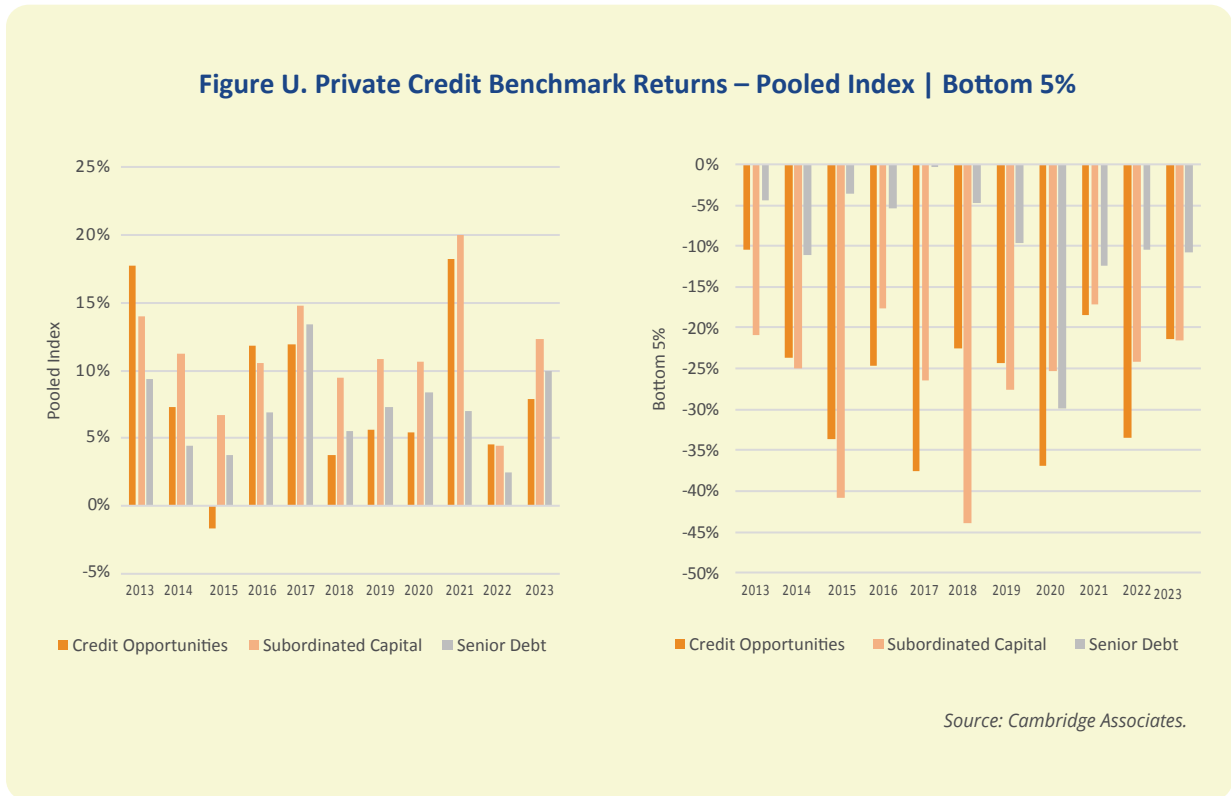
In Australia, a substantial portion of the broader private credit market is comprised of middle market borrowers and real estate lenders which carry materially different credit risks. In addition, bilateral loans will be structured differently from a covenant perspective and are less liquid in the secondary market. As such, leveraged loan benchmarks do not appropriately capture the Australian private credit market.

Figure T. BondAdviser Australian Private Credit Investor Net Returns Index



Source: BondAdviser, Fund Reports, Bloomberg. As at 30 June 2024.

The Cambridge Associates (CA) private credit benchmark is a performance benchmark measuring the performance of funds within the private credit market. This benchmark is the most like-for-like when comparing Australia with international markets. The Private Credit Index series prepared by CA is an aggregate of sub strategies including senior debt, credit opportunities and subordinated capital.



The ACC Private Credit Australia Survey, detailed in the next section, shows a mean target return for local funds of 10 – 15% which compares favourably to industry benchmarks, for example the 10-year horizon pooled return of the CA Private Credit Index and CA Senior Debt Index as of 31 December 2023 at 8.18% and 6.92% respectively. This reflects the positive impact of higher interest rates on future private credit returns and arguably greater risk appetite following a seasoning of managers.

Importantly, the CA benchmarks are global and as of 30 September 2023 included 566 private credit funds as constituents as compared to the ACC survey respondents of 21. So, while the Australian market is still in its infancy, the survey does give us a broad support for the target return similarity between domestic and international markets.

ESG Considerations

Sustainable and green funding structures have been a key part of more traditional lending in the Australian market in recent years, with this aligned to developments in international debt markets. However, we are now seeing this become an area that local credit managers are increasingly focusing on. Whilst the moment in this area has been building for some time, in Australia this has been more a voluntary approach from the financing and investor communities, compared to some international markets that have been led by regulatory developments. We note that there are upcoming Australian regulatory changes in mandatory disclosure requirements that will increase data availability for assessments, further improving ESG transparency within the Australian market

Australian credit managers have been keeping pace with these developments, with sustainability, climate and social considerations now top of mind for international investors, we are seeing Australian credit managers adjust their policies to accommodate these requirements and take a more proactive stance. Well known market leaders within the Australian credit space have been introducing measures and initiatives to better reflect their more proactive stance in addressing / aligning to ESG considerations. These are done in a number of ways such as partnerships with sustainability bodies (such as the Partnership Carbon Accounting Financials) to set key ESG targets, all the way to the development of investment screening parameters and credits written with underlying green-incentives.

Globally, the ACC has been working with private credit firms and other industry bodies to create the **ESG Integrated Disclosure Project**, a template for borrowers to provide ESG information to lenders in a harmonised and standardised way. This initiative has been widely adopted in the market, thus supporting a global baseline for borrower and investor reporting.

With the wide range of private credit strategies in the Australian market there remains a mixed approach to date, but many have been adopting broader market parameters such as the UN Principles for Responsible Investment and increasing the rigour in their due diligence of borrowers to ensure these criteria are met. At present the challenge remains the tight pricing on specific Sustainable and Green debt structures, with Australian credit managers more focused on delivering higher returns. With time, however, we expect managers here will increase their involvement and establish ESG specific mandates particularly as it continues to grow as a key feature of the Australian debt market.



Legal Framework

A high level of regulation implemented by the Australian Government and regulatory bodies on traditional banks, alongside a desire to standardise loan products and lower costs has impacted their ability to provide credit in selected market segments. Fund managers and non-bank lenders providing private credit in these and more traditional segments helping to bridge this gap are still subjected to and must comply with a number of legal standards and industry codes, including but not limited to the Australian Consumer Law, Australian Financial Services laws, National Consumer Credit Protection laws, Privacy Law and the ePayments Code. Non-bank lenders are not however, subject to the additional scrutiny of the Australian Prudential Regulatory Authority (APRA) (which is an independent statutory authority that supervises institutions across banking, insurance and superannuation sectors), nor are they required to comply with the Basel Accord standards, which mandates Authorised deposit-taking institutions (ADI's) to retain certain amounts of cash on balance to meet a minimum liquidity ratio to safeguard the funds invested by depositors during economic downturns, albeit at the cost of maximising their returns.

The predominant legal vehicle in Australia for private credit funds is a unit trust -called a managed investment scheme. A managed investment scheme is operated by a responsible entity (where it is required to be registered with the Australian Securities and Investments Commission (ASIC)) or by a trustee (where unregistered). The trustee or responsible entity offering an interest in the fund and the investment manager providing investment management services to the fund need to hold an Australian financial services licence covering the provision of the respective financial service and financial products, unless an exemption applies. To operate a registered scheme, the responsible entity must maintain a specific licence authorisation that covers the operation of a registered scheme for the scheme's asset class (which may be specifically for wholesale and/or retail investors). Where a managed investment scheme (or Fund) is made available to retail investors, the fund must be required registered with ASIC.

The current disclosure regime operated in Australia provides that there is no restriction on offering private credit funds or other types of funds to retail investors, where the respective product disclosure statement (PDS) complies with the content requirements in the Corporations Act. Funds that are offered to wholesale investors only are not required to provide a PDS. Instead, they may provide an information memorandum that describes key information regarding the fund as a matter of good practice. Additionally, the Design and Distribution Obligations (DDO) regime, which commenced on 5 October 2021, aims to ensure that consumers are not at risk of purchasing products that are inappropriate for their needs, financial situation, and objectives. It may be relevant for fund managers and non-bank lenders to consider their obligations under the DDO regime when offering private credit funds or other types of funds to retail investors.

Overall Australia continues to be a key market for many fund managers around the world looking to deploy private capital, largely due to its creditor friendly legislation and well-developed business and asset protections. Further to the above, while investors are attracted to the region for several reasons some of the key ones are as follows:

- Australia is considered to have some of the more creditor-friendly corporate insolvency laws in the world. In certain instances, enforcement and insolvency processes can be undertaken without the involvement of the judicial system. This in turn, greatly reduces resolution times and efficiently safeguards the rights of secured creditors, especially when compared to the US and UK markets. Thus, the regime in Australia is well-established, flexible and provides various options to stakeholders to protect the value of their distressed businesses/investments.
- Taxes or other similar charges usually do not present a material issue to a fund lending directly to, or taking credit support from, a company incorporated in Australia.
- Interest, fees and remuneration can generally be agreed freely between a lender and a corporate borrower in Australia, except in certain circumstances where the default interest and ancillary fees may be considered to be an unenforceable penalty.

These types of creditor protections, combined with a clear legal framework to support investments, generally stronger lending terms, comparatively more proactive lender controls alongside the withdrawal of bank financing will drive private credit to grow and play a key role in the Australian economy for many years to come.



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