Park Square

Park Square Perspectives: Why Private Credit is a *"no-brainer"*

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Park Square has been working in the European credit markets for almost two decades, yet it is hard to recall a time as exciting as this for private debt investing.

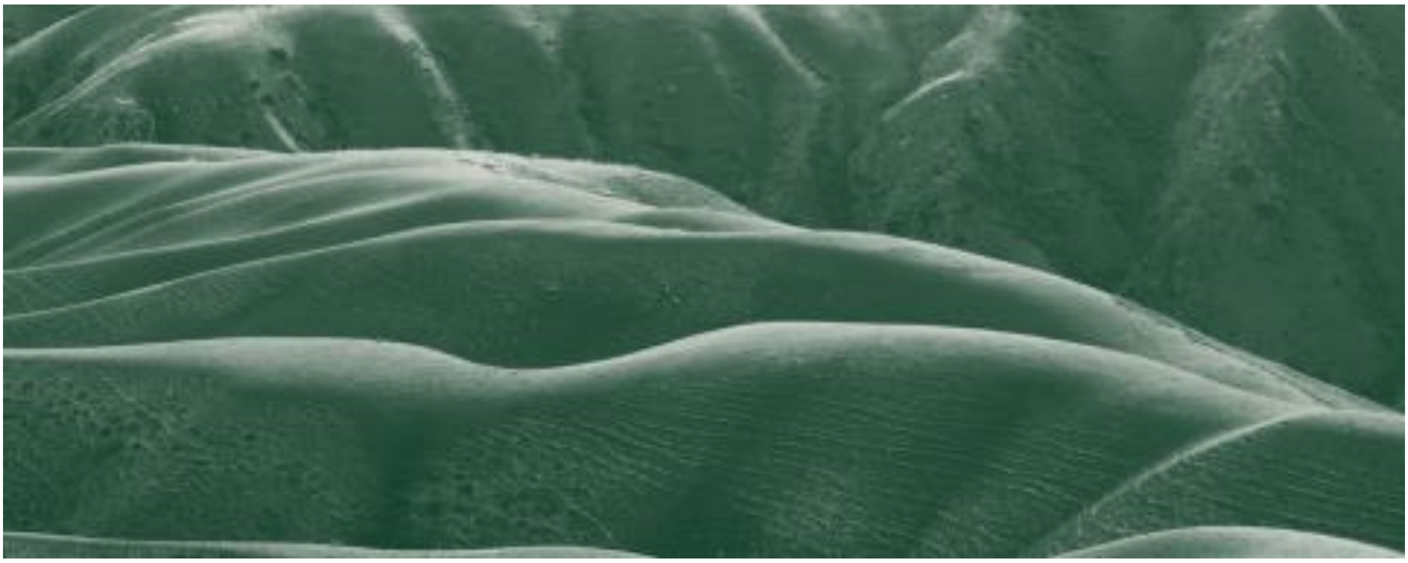
Over the past few months, central banks in the US and Europe have been raising base rates in a bid to tame inflation. The Fed has said rates could peak over 5% [1], their highest since 2007. The ECB is also forecast to keep raising rates through the first half of 2023.

This has had the inevitable knock-on effect of making borrowing for companies significantly more expensive and is one of the main reasons leveraged buyouts are thin on the ground. Those increased debt servicing costs not only mean companies have less cash to plough back into their businesses, but it also threatens to take a meaningful chunk out of equity investors' returns.

Here's how it works. Say an equity investor is considering launching a $2bn buyout and contributing half of the deal value - $1bn in equity, leaving them having to find $1bn in debt funding. With an interest rate climbing around 4%, that's an extra $40m a year that the target has to find to spend on interest payments. Relative to where we were a year ago, this is a huge bite out of equity returns.

> *"This is the most exciting confluence of events and market dynamics for a generation"*

This simple math is giving buyout shops a big headache – they are having to recalibrate their investment plans and likely hold periods which, in turn, affects their returns. Traditional lending markets – the banks – are drying up because regulators don't much like levered lending. Syndicated loan markets have slowed dramatically, making private credit the only game in town. This trend is expected to continue, especially in light of the recent SVB and Credit Suisse events, which have roiled financing markets and made regulators increasingly weary of risk taking by banks.



(1) Based on March 22,2023, Federal Open Market Committee Projections materials

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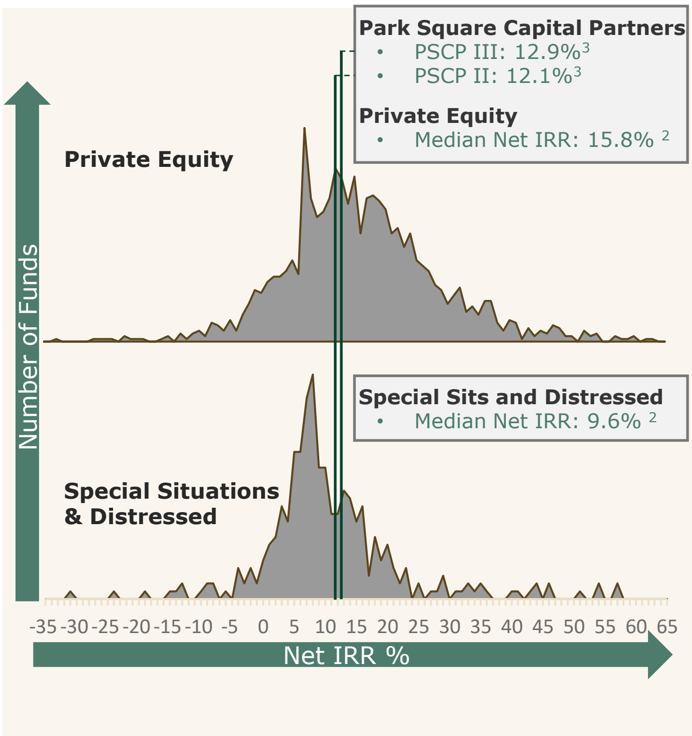
On the demand side, credit investors enjoy an unprecedented opportunity to put capital to work. Park Square's preference is to back stable, predictable industries such as software, business services and healthcare, and there has never been a better time to advance funding in these sectors.

For many investors in alternatives, private credit is merely a sub-set of the broader private equity market, for which they are seeking returns over between 20% - 25%. There are funds that will deliver this, however, the average return from a private equity fund is significantly lower than the target. Across a universe of 3,000 private equity funds globally, the median IRR (internal rate of return) was 15.8%[2].

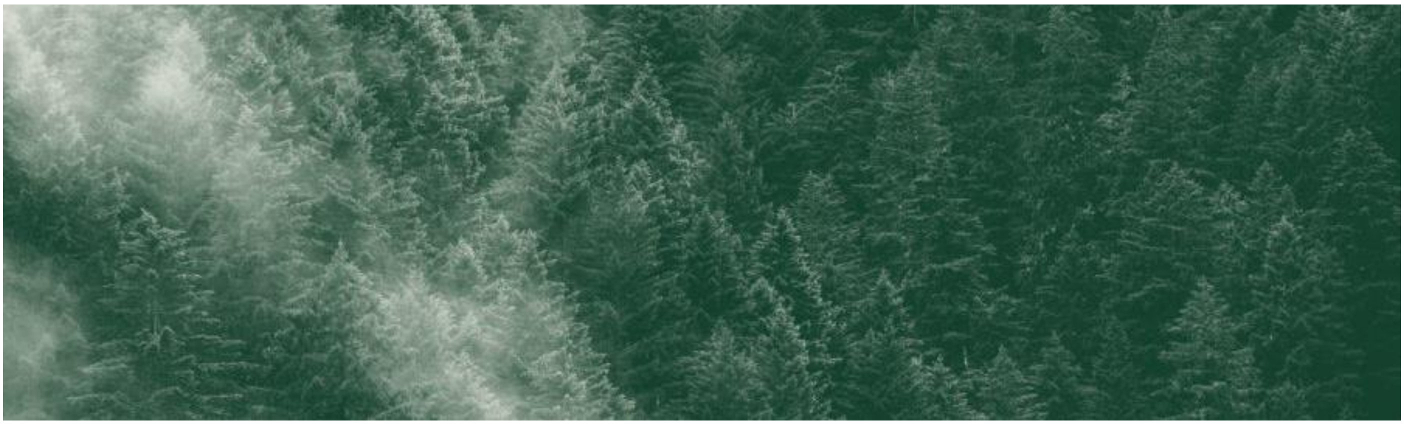
Compare those figures with private credit. Park Square's higher-returning strategies were delivering returns in the region of between 12% and 15%[3]. Even at the lower end of this range, on a risk-adjusted basis, this is a very attractive number in comparison with the firm's peers in the equity world, particularly given private credit ranks higher in the financing structure and is supported by equity cushions of over 50%. From an investment perspective, this might traditionally be regarded as a "no-brainer".

It is the combination of these two sides of the coin that make this the most exciting confluence of events and market dynamics for a generation.

One may argue that these dynamics are just a snapshot in time and may ask how long this set of circumstances will hold up. That's hard to say, but the fallout from the global financial crisis took years to play out. With inflation still at historically high levels, the conflict in Ukraine showing no sign of ending, and consumers around the world feeling the pinch, there is reason to think the current malaise will continue for a good while yet. It is up to private credit firms to provide, in market terms at least, a bright spot.



Distribution of returns by asset class[2]



(2) Source Preqin, X axis shows +/- range of returns from one standard deviation from the mean for each strategy as at 31 December 2022. Sample sizes: PE (Buyout) 3,019 funds, Mezzanine 480 funds, Special Sits 272 and DD 313 funds, for the period 2005 - 2018. (3) Net IRR figures as at 31 December 2022, standard deviation for PSCP II and III not meaningful and shown for illustrative purposes only.

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