HSBC Private Bank

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Navigating Challenges and Leveraging Opportunities in Private Credit - Transcript

Neha

Hi, everyone. Welcome to a new episode of our CIO Zooming In series, where we discuss burning market and investor questions. Today's topic of discussion is private credit, a fast growing segment of private markets. To understand how investors should navigate the challenges and opportunities of investing in private credit, today I'm joined by Mathieu Forcioli, our Global Head of Alternatives. Mathieu, welcome and thanks for joining us today. So Mathieu, for the benefit of our viewers who are very new to this asset class, please can you explain what exactly is private credit?

Mathieu

Well, Neha, in theory, private credit covers any loan negotiated privately between two parties. Now these days, when investors talk about private credit, it's most often they're actually referring to a specific part of private credit, which we call direct lending. What is direct lending? Direct lending is effectively providing a loan to a corporate, often backed by a private equity manager who's doing a leveraged buyout of that company. Now historically those loans were provided by banks, and when the loan was large enough, the banks would sell and syndicate that loan into the market to public investors. And that's what gave rise to what we call broadly syndicated loan, which is today a very large part of the fixed income asset class. But the corporate might be too small to be able to access that market, might want specific terms that are not suitable for public markets or might want to keep its loan private. And that's what we would call direct lending. Now, banks historically would provide these kind of loans, but regulators have encouraged them to step out of these loans because of the risks that they carry. And that's when direct lenders have stepped in. Those direct lenders are asset managers that are managing money for their clients and trying to get the best returns by providing direct loans to companies.

Neha

So Mathieu, why should a typical investor holding a 60/40 portfolio consider having an allocation to private credit, especially when they already have a big chunk of their portfolio allocated to public fixed income markets, which theoretically should provide them with downside protection in times of market stress.

Mathieu

Private credit and direct lending tends to show greater returns and lower volatility in a portfolio. And that's the main reason why investors have been allocating to the asset class. Now there's no free lunch. And why do investors benefit from these better attributes. It's because they are taking illiquidity risk. That's the most important part that our listeners should understand. So, investors that have a long term investment horizon and can bear that illiquidity risk do allocate to the asset class, in particular, pension funds, insurance companies, including HSBC’s own insurance companies. And we see more and more of our clients, those who can take that illiquidity risk and are eligible to buy such private credit funds, we do see those investors starting to allocate to the asset class for the benefits that they bring.

Neha

Thanks, Mathieu. I think this is a great reminder that if one is investing for the long run and is able to withstand some illiquidity, then their portfolio should benefit from higher returns and potentially lower volatility if there were to have an allocation to private credit. At this point, I'd also like to show our viewers a chart which shows that historically, private credit has had the lowest of drawdowns and the fastest of recovery times in comparison to all other asset classes which are shown in this chart. Mathieu, let us now discuss a key challenge that's facing private credit. Recently, the IMF warned that nearly half of the corporates that are borrowing through these direct lenders are actually operating on negative free cash flows, which effectively is keeping them hooked on to the so-called ”payment-in-kind” notes, wherein they put off their interest payments until a later date, but often at punishing rates. Do you think fundamentals are deteriorating in direct lending?

Mathieu

Well, as usual Neha, the devil is in the details, right? First thing I really want to remind our listeners today is that in direct lending and in private credit in general, there's no upside, and only downside. What do I mean by that? The most you can get back is effectively the principle of the loan that you've lent out and the coupons that you've negotiated and that the borrower is paying, But your downside risk is that you can lose all of your money. So it's very important that you select managers that can manage effectively that downside risk. Now, when it comes to your specific question on ”payment-in-kind” or PIK, as we call it, broadly speaking, I would say that there's two kinds of PIK. The ones that have being negotiated at the beginning of the loan between the borrower and the lender, because, it was expected to provide the best outcome for both the lender and the borrower, because of certain characteristics of the company. The second kind of PIK structures are those that are negotiated during the life of a loan because suddenly the borrower cannot pay its coupons anymore. And obviously, these second kind of PIK structures are those that deserve a little bit more attention, because they are a sign that the borrower might have some difficulties paying back. What I would say overall is that today the environment is still relatively healthy for direct lending and private credit. But of course, the asset class may suffer and may go through a credit cycle, if the economy and the economic situation deteriorates, like other asset classes. Our job is to make sure that eventually our investors in the asset class will keep on benefiting from an outperformance versus the more traditional liquid credit asset classes, when they invest into direct lending.

Neha

Mathieu, data show that direct lending has started to rise again, especially in the US. But geographically, as we seek regional and geographical diversification, where else do you see opportunities emerging other than the US? Are you seeing any interesting opportunities in, for example, in Europe or in Asia?

Mathieu

US is the most developed market when it comes to direct lending, but also the most competitive market. And we're starting to see overlap in the portfolios of the different managers that we work with. About 10 to 20% of one manager's portfolio would overlap with another manager's portfolio of loans, right. And then a region that is quite interesting to look at is actually Europe. It's a very fragmented market. As a direct lender, you need local presence in each of the countries that you operate. And that provides a very interesting opportunity for investors and diversification. So I would definitely put Europe on the map for investors. Asia is still in the early days, the market is still mostly dominated by banks. But it's clear that they would probably at some point follow a similar path to what we're seeing in the US and in Europe.

Neha

So to conclude, private credit, by the virtue of being private has a very different risk return profile versus its public market counterpart. Secondly, investors who are investing for the long run in a typical 60/40 portfolio and who are willing to withstand some illiquidity, should benefit from having an allocation to private credit especially as it helps in bringing higher returns and lower volatility over the long run. But the downside risk of investing in private credit is that one may lose their entire capital. Therefore, investing in the right type of private credit managers is very essential. And lastly, whilst the US remains the most active market in private credit, there are some green shoots of opportunities emerging in Europe and as Asia, develops there will be some very interesting private credit opportunities to be tapped in Asia as well. Thank you, Mathieu, for sharing your razor sharp insights on private credit with us today.