The evolution and outlook for private credit

Chris Wyke, Joint CEO, MA Financial

August 2024

MA Financial Group

We invest. We lend. We advise.

Introduction

A career that started as a graduate in the late 90's

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Plenty of application forms…

CHASE
Goldman Sachs
LAZARD
UBS
citi
LEHMAN BROTHERS
MORGAN STANLEY DEAN WITTER
Rothschild & Co
Deutsche Bank
Merrill Lynch
MORGAN GRENFELL
SBC Warburg
A DIVISION OF SWISS BANK CORPORATION
SALOMON SMITH BARNEY
BANK OF AMERICA
Cazenove Capital
BZW
Schroders
Dresdner Kleinwort

A career that started as a graduate in the late 90's

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18 becomes 10…

J.P.Morgan
Goldman Sachs
LAZARD
UBS
citi

LEHMAN BROTHERS
Morgan Stanley
Rothschild & Co
Deutsche Bank

Merrill Lynch
MORGAN GRENFELL
SBC Warburg
A DIVISION OF SWISS BANK CORPORATION
SALOMON SMITH BARNEY

BANK OF AMERICA
Cazenove Capital
BARCLAYS
Schroders
Dresdner Kleinwort

Investment Banking, a career allowing international experience

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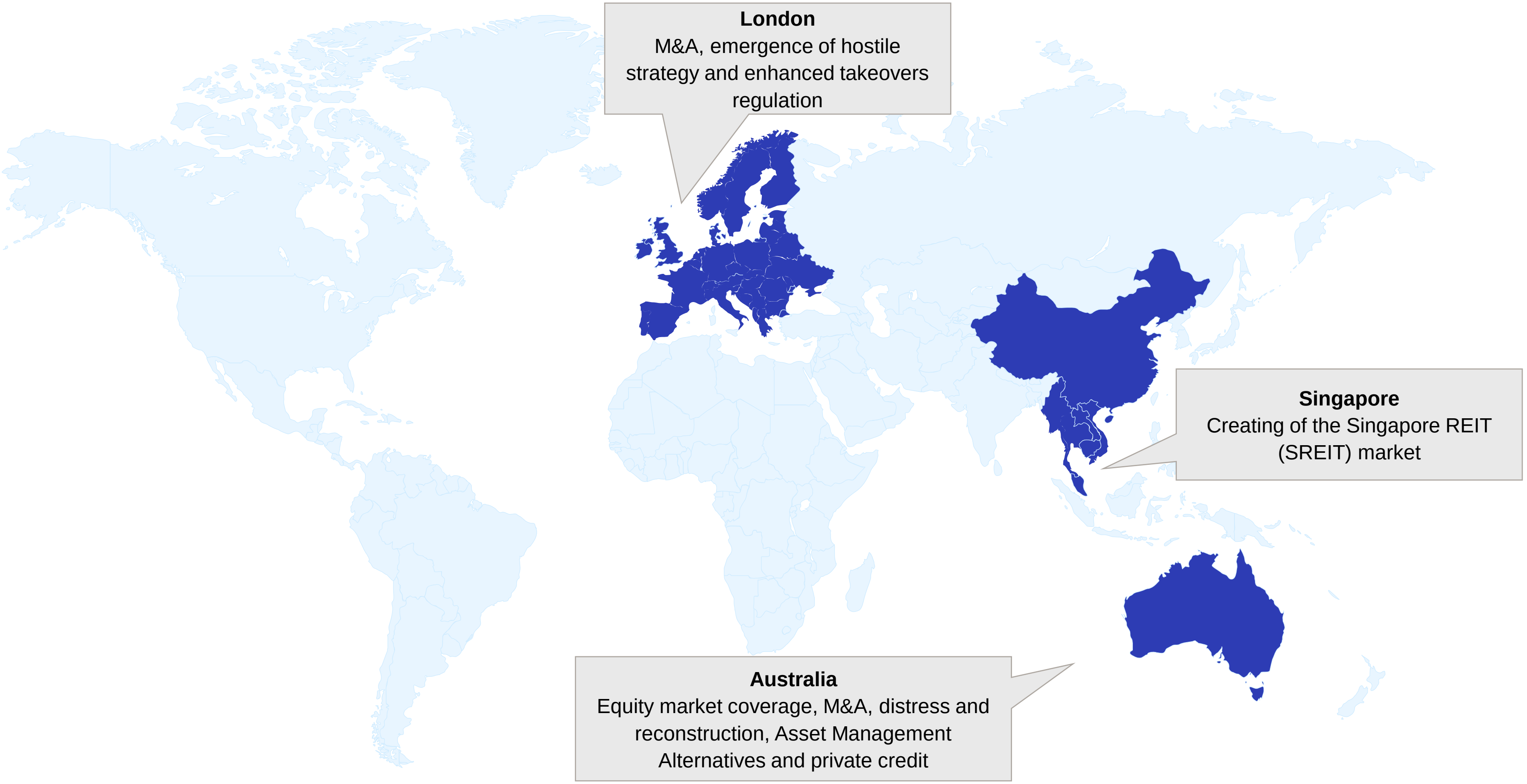
An overview of my career

1998 – 2005
SBC Warburg (UBS)

2005 – 2009
JP Morgan Chase

2009 – present
Moelis Australia JV
to MA Financial



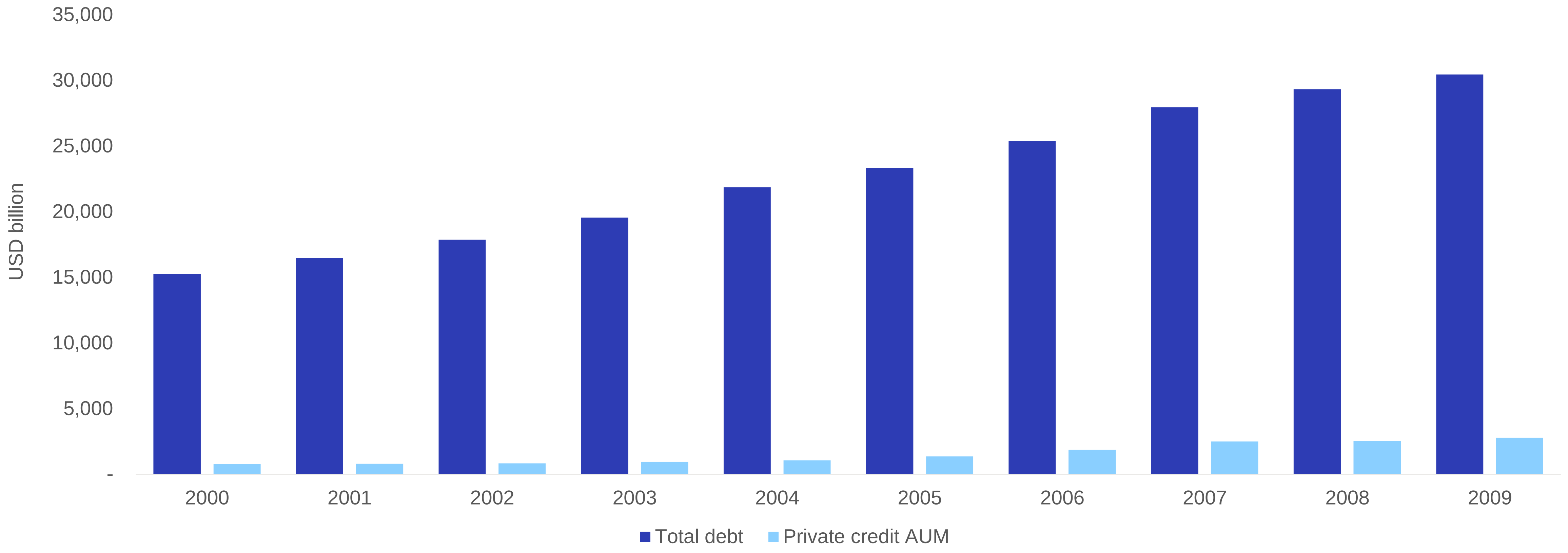
The Global Financial Crisis – origins of private credit

02

Banks & capital markets (public credit) dominate lending

Banks dominated lending, with private credit funds accounting for less than 10% of total debt outstanding

US private credit assets under management vs total debt



Source: Preqin

Explosion in nature and scale of niche distressed debt funds

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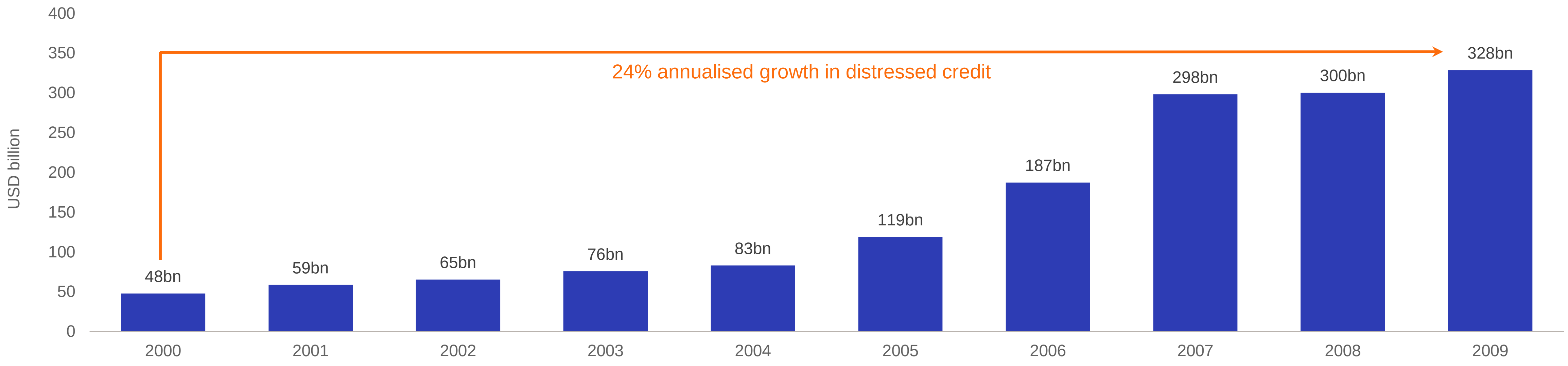
GFC created a once in a generation opportunity

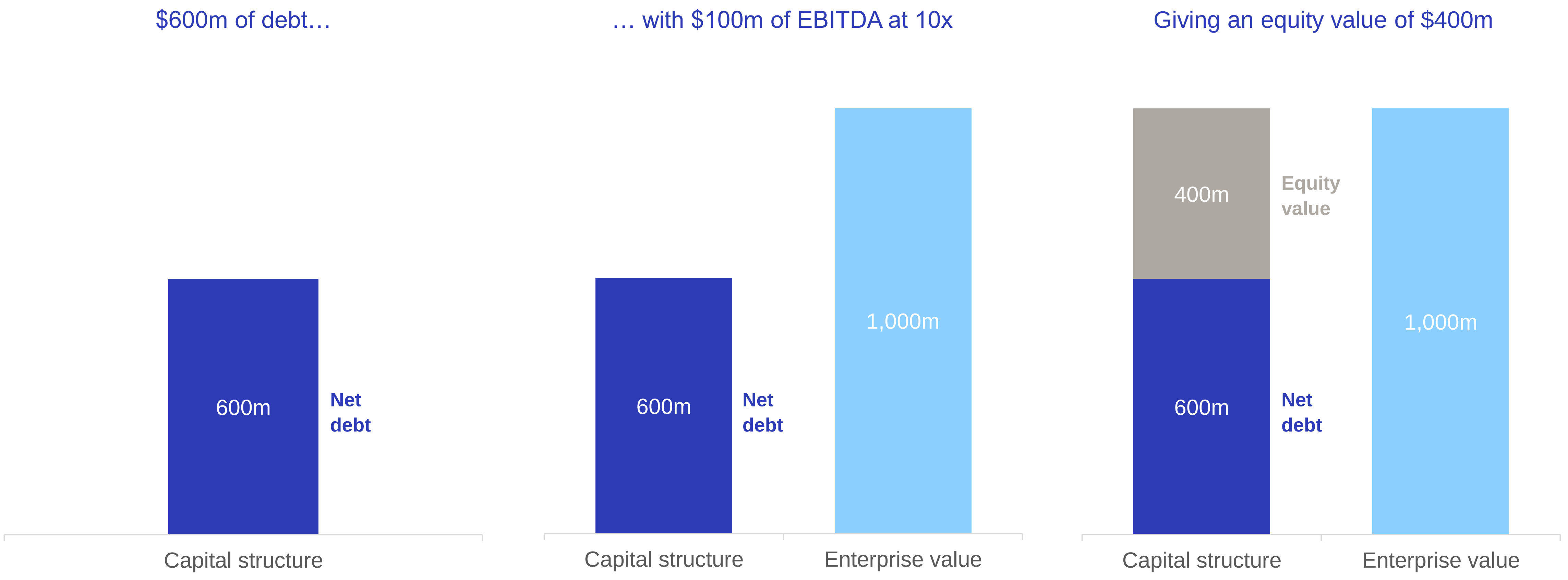
Distressed credit and turnaround funds stepped in to buy distressed loans



Source: Preqin

Quick teaser - Distressed M&A, a new frontier in strategy and deal doing

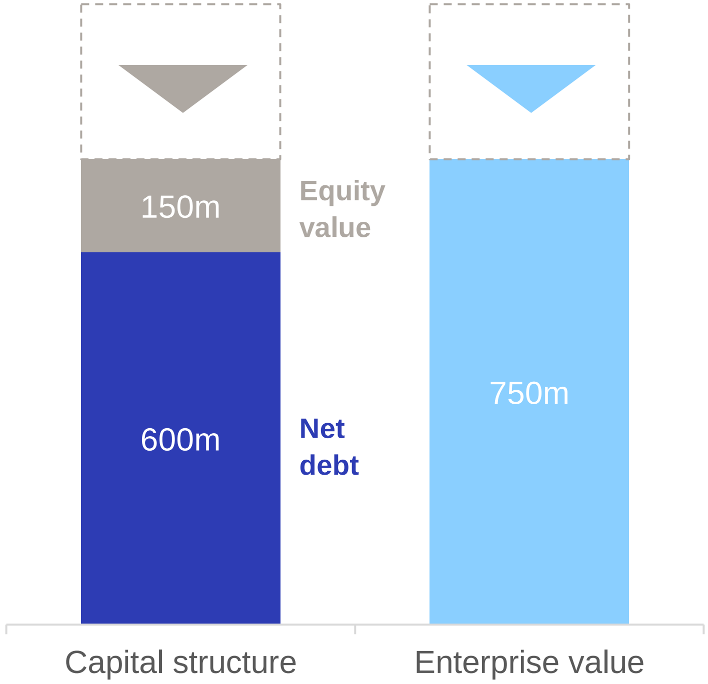
Let's look at a theoretical example at the value of a business, WidgetCo



Quick teaser - Distressed M&A, a new frontier in strategy and deal doing continued…

Imagine that, suddenly, people like widgets less. Volumes decline and WidgetCo's sustainable EBITDA declines to $75m. What happens to the EV and equity? The outcome is relatively easy to determine…

$25m drop in EBITDA…

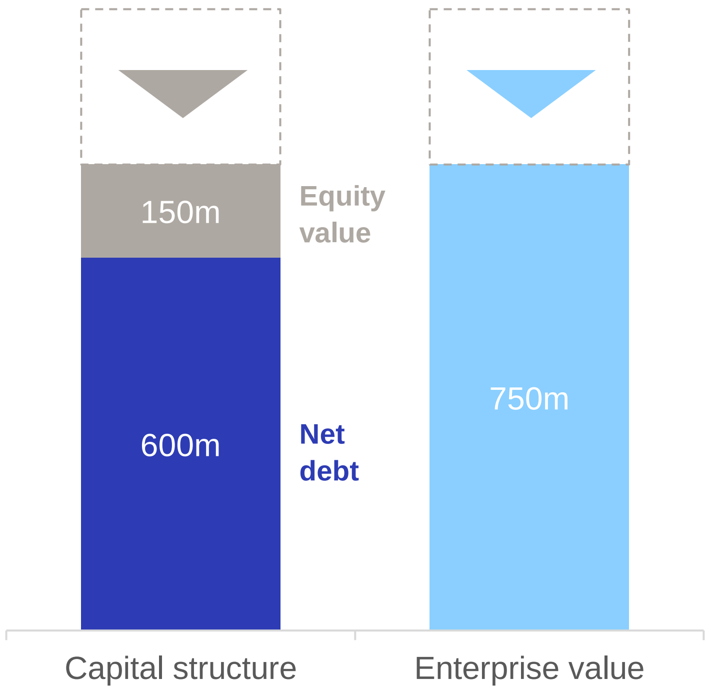


Value of WidgetCo	
EBITDA	$75m
EV / EBITDA Multiple	10x
Enterprise Value	**$750m**

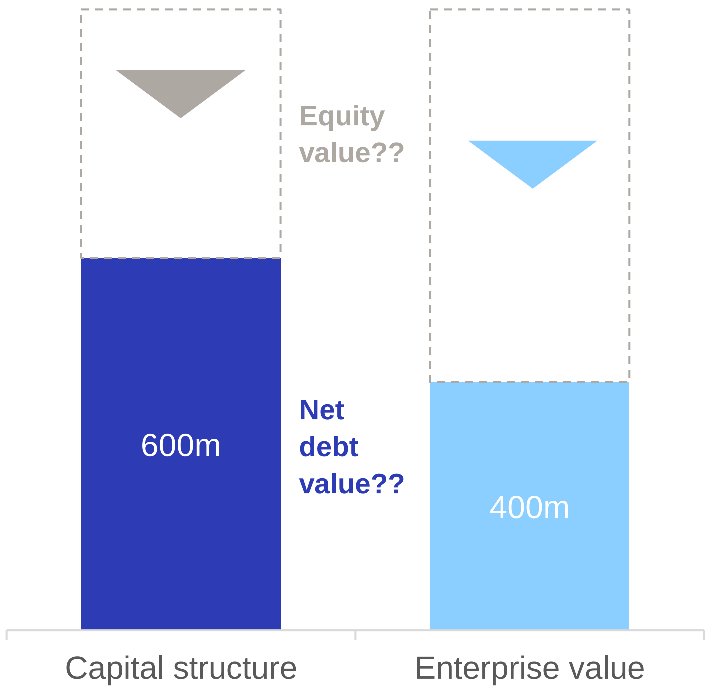
Quick teaser - Distressed M&A, a new frontier in strategy and deal doing continued…

Now assume things go from bad to worse. People are buying less widgets and WidgetCo gets blindsided by uncontrollable cost increases. Its margins decline and so does its EBITDA. Now what?

$25m drop in EBITDA



… to a $60m drop in EBITDA

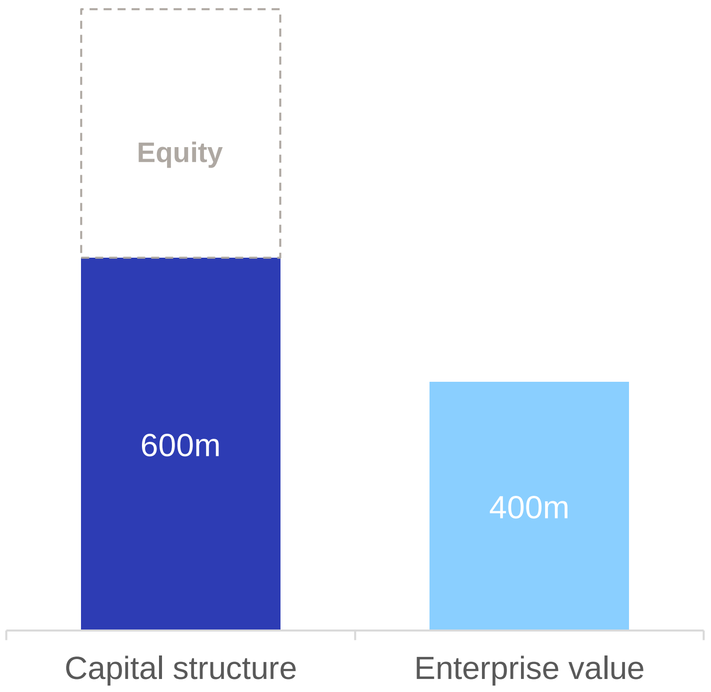


Value of WidgetCo	
EBITDA	$40m
EV / EBITDA Multiple	10x
Enterprise Value	**$400m**

Quick teaser - Distressed M&A, a new frontier in strategy and deal doing continued…

Is there any intrinsic value to the equity? Does this mean equity value is zero?

Example: price of consent

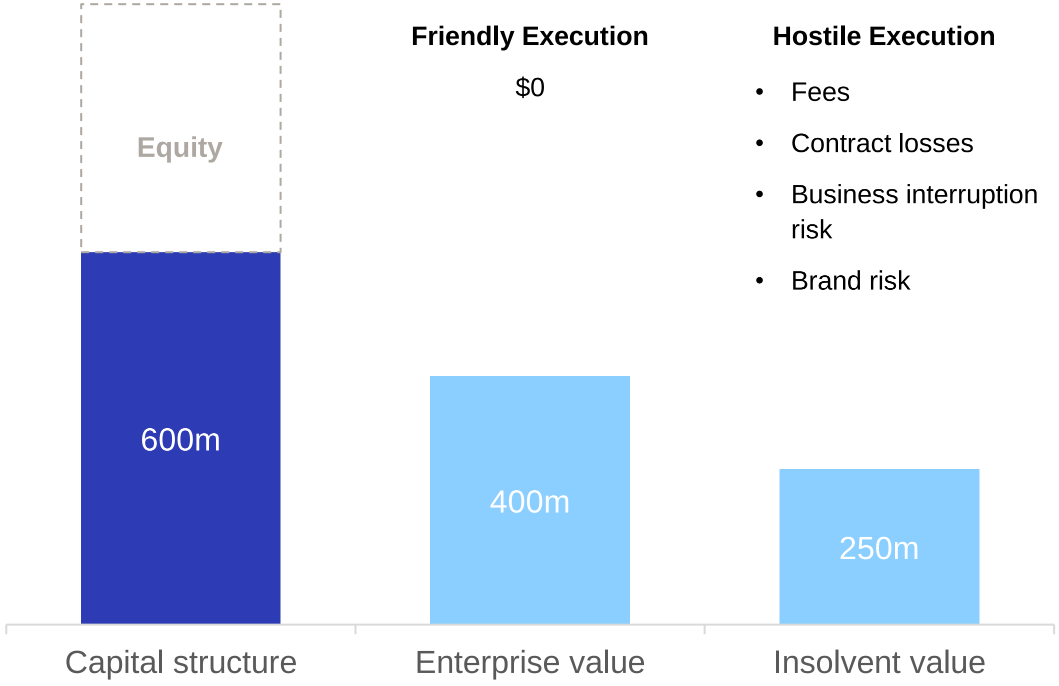


Now what would you pay for the equity in this business?

Quick teaser - Distressed M&A, a new frontier in strategy and deal doing continued…

Emergence of distressed for control transaction saw lenders assume control and ownership of companies. The process to do this required value to be placed on the equity

Example: price of consent



DISTRESSED M&A, A NEW FRONTIER

- In the real world, transactions are not made solely based on value – good example is a "consent fee"
- The impact of insolvency is a good example of why 'consent fees' arise
  - There are significant costs of going down an insolvent pathway to affect a recapitalisation
  - What might you therefore be willing to pay to avoid that scenario?

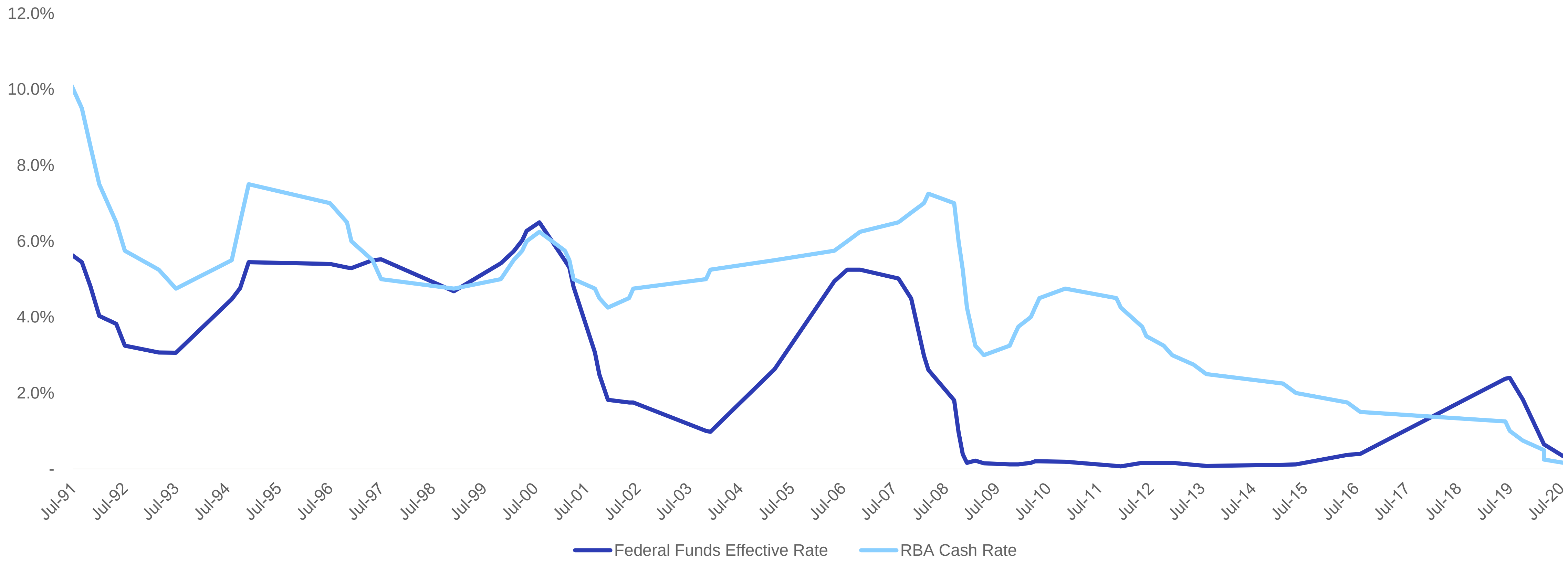
Cementing its place in a portfolio: private credit 2010 - 2020

03

Post digesting the GFC – All quiet in world of distress

Impact of a zero rate environment – a rolling loan gathers no loss

If you didn't fail within a few years, low interest rates kept you alive



Key drivers sowing the seed for private credit

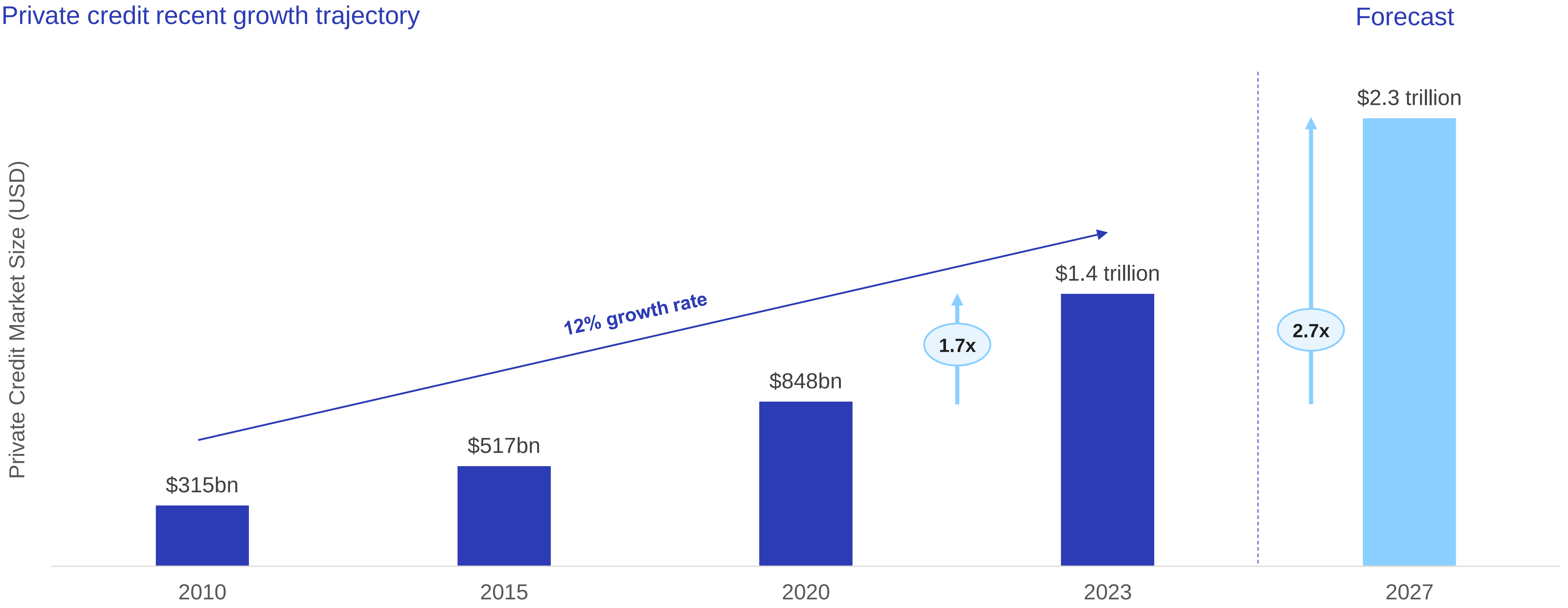
There are numerous tailwinds driving growth in private credit

Regulator	Bank lending	Private credit funds
Globally synchronized efforts to regulate banks	Capital requirements impacting bank profitability	Explosion in financial innovation in global jurisdictions
"Too big to fail"	Focus on balance sheet repair following market uncertainty, reducing credit availability	Growth in skills and human capital outside of the banking system
"This must not come to pass again"	Increased regulatory requirements have reduced competitiveness vs private credit funds	Testing the documents and setting legal and commercial precedent around loan writing and restructuring (this is critical DNA for current asset allocation decisions)
	Market dislocation resulting in high credit spreads, particularly in the $10-50m range which is too small for many large global financial institutions or mega-size credit funds	Capital formation around this skill set and return generation
		Increase in base rates

Post digesting the GFC – All quiet in world of distress continued…

Human capital and physical capital formation around distress wanted to find a new path – growth in private credit

Private credit recent growth trajectory



Source: Preqin

Fertile demand and supply dynamic for private credit

Return generated per unit of risk provides attractive investment thesis driven by regulatory arbitrage – banks can't lend, and new lending is at a higher interest rate

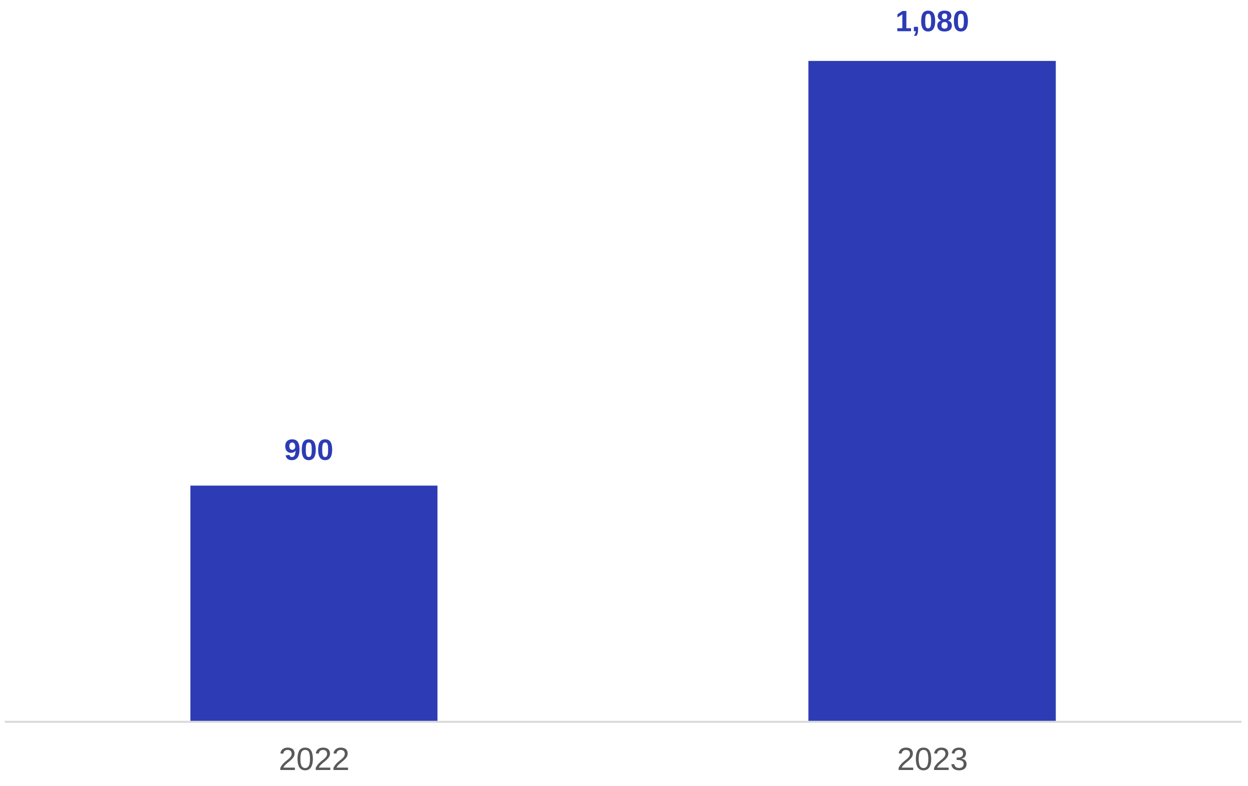
Select private credit fund managers have had tremendous experience through the GFC

01 Documentation / deal structuring

02 Managing credit through distress

03 Business due diligence

Number of private credit funds globally



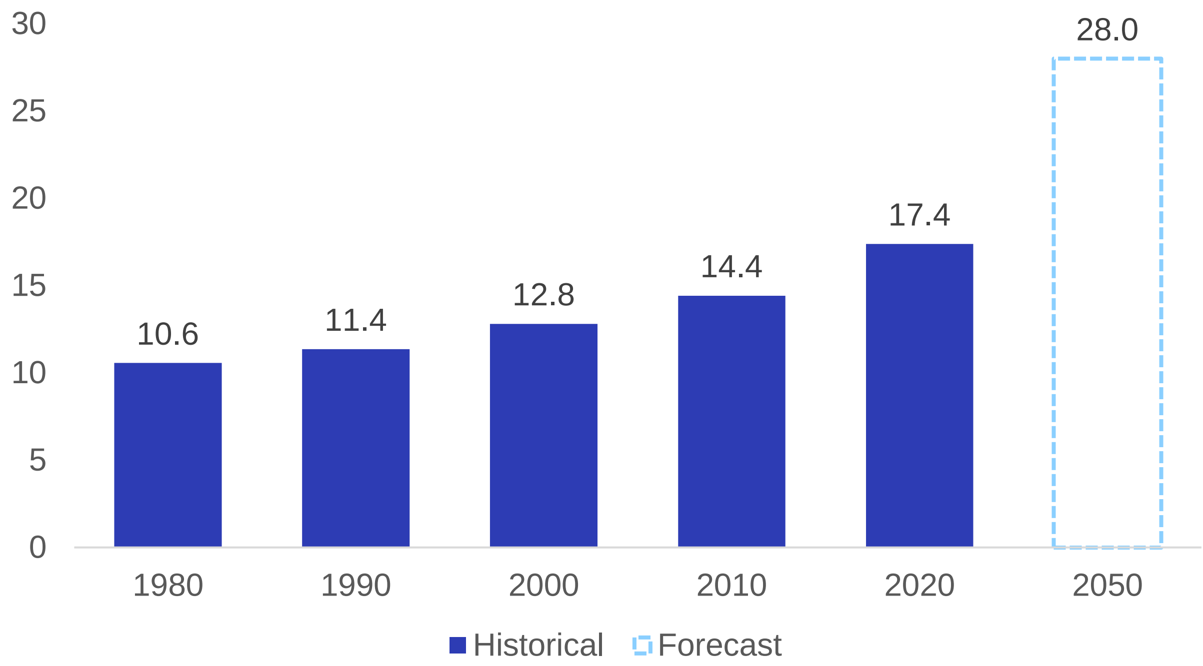
Source: Preqin Global Report 2024: Private Debt.

Investor demand for private credit

Ageing population

Proportion of population aged 65 years & over (%)

By 2050, approximately **1 in 4 people will be aged 65 and over**



Private credit’s advantages for an ageing population

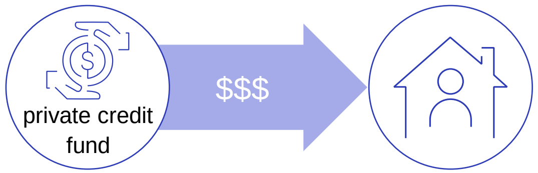
Income stability	Reliable and consistent income stream, which is particularly attractive to retirees
Risk mitigation	Lower volatility compared to equities, providing a safeguard against market fluctuations
Diversification	Diversification benefits from incorporating private credit into investment portfolios to reduce overall portfolio risk

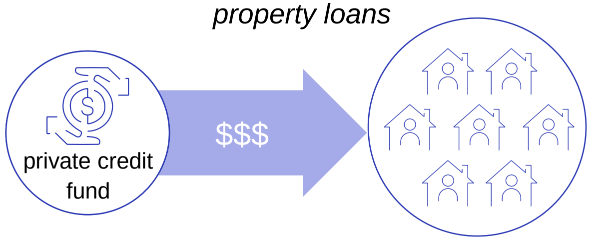
Source: Organisation for Economic Co-operation and Development (OECD)

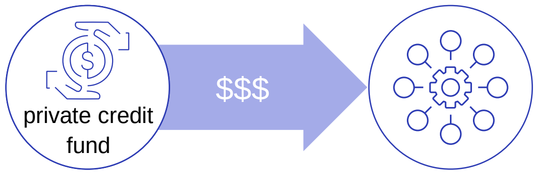
Private credit spans different lending verticals

There are three core lending strategies within private credit

	Direct Asset Lending	Private Asset-Backed Lending	Direct Corporate Lending
Overview	Lending to real assets (such as real estate) as a senior secured financier	Financing diversified pools of assets (such as loans or receivables) with collateral & structural protections This can be Traditional or Specialty Credit loans originated by non-bank financiers, or even banks	Lending directly to established businesses at sensible loan-to-value ratios, secured over the business and its cash flow generation potential
Typical Structure	Senior secured	Senior secured (generally specialty finance) or structured credit facilities (generally traditional loans)	Senior secured
Advantages	✓ Real asset security ✓ Short loan tenor, long economic lifespan assets ✓ Low loan-to-value ratios (LTVs)	✓ Self-liquidating loan pools ✓ Highly diversified & granular collateral ✓ Short duration portfolios ✓ Structural credit protection features	✓ Appropriate covenant structures ✓ Non-cyclical &/or resilient characteristics ✓ Sensible leverage
Example	*A private credit fund lends directly against a property*	*A private credit fund lends against a portfolio of property loans*	*A private credit fund lends directly to an industrials business*

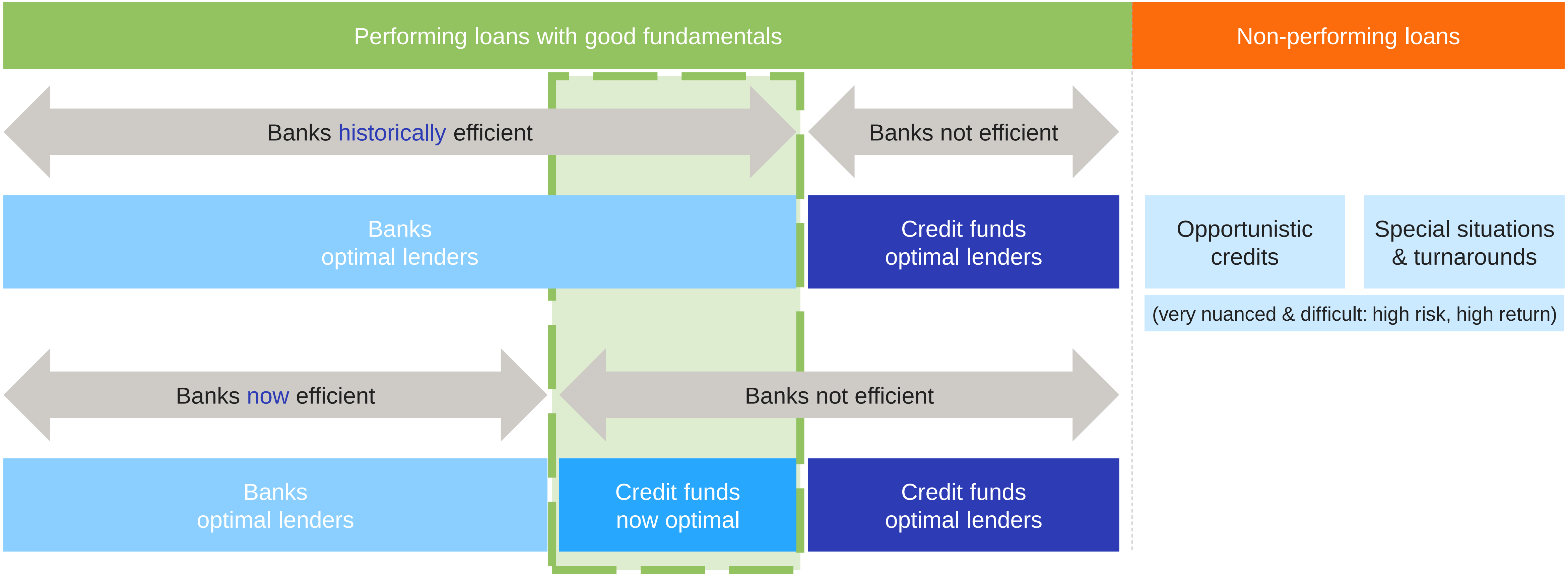






Regulatory arbitrage opens up opportunity

As banks streamline their focus on a narrower sub-set of lending – not only by choice, but also driven by changing prudential standards – there are large opportunities that emerge for outsized returns relative to risk



Explosive growth 2020 – present

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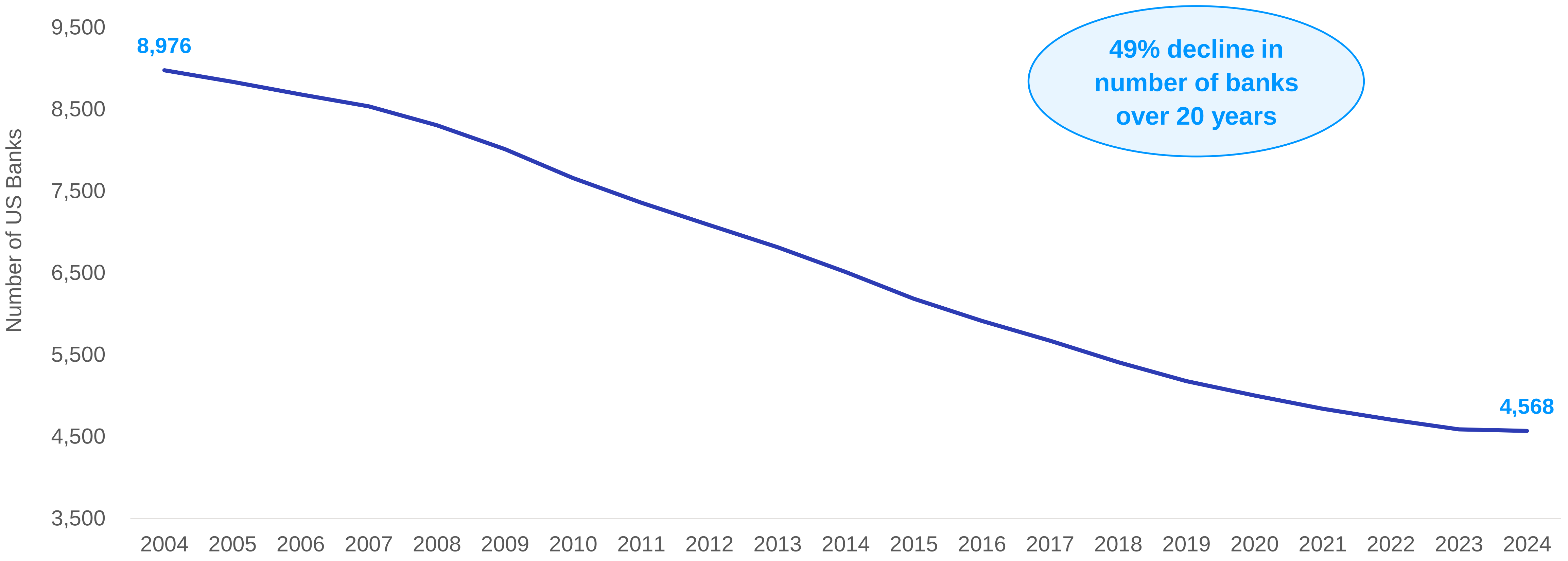
04

Mid-market banking distress opens up further opportunities

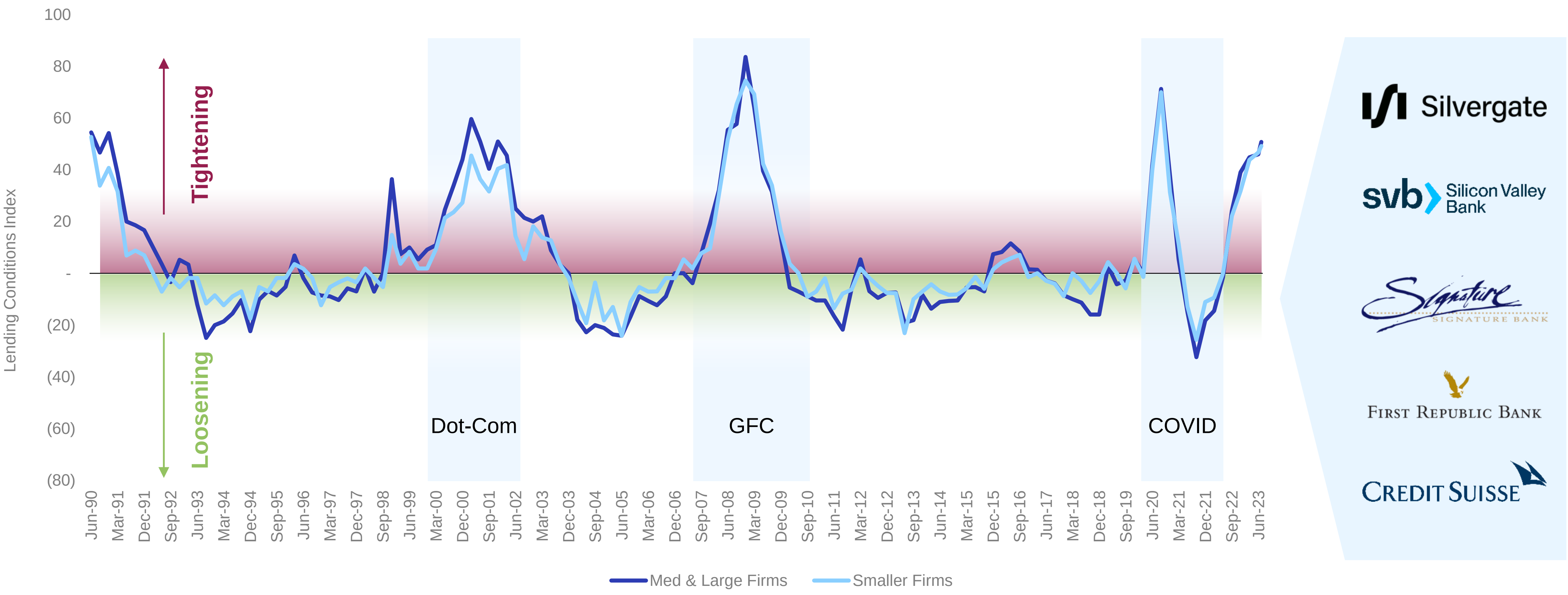
Asset/liability mismatch highlighted by Silicon Valley Bank failure



Source: FDIC

Mid-market banking distress opens up further opportunities continued…

The US regional banking crisis resulted in banks reducing credit availability while those institutions focus on balance sheet repair. This reduces access to lending in traditional funding channels for otherwise good borrowers

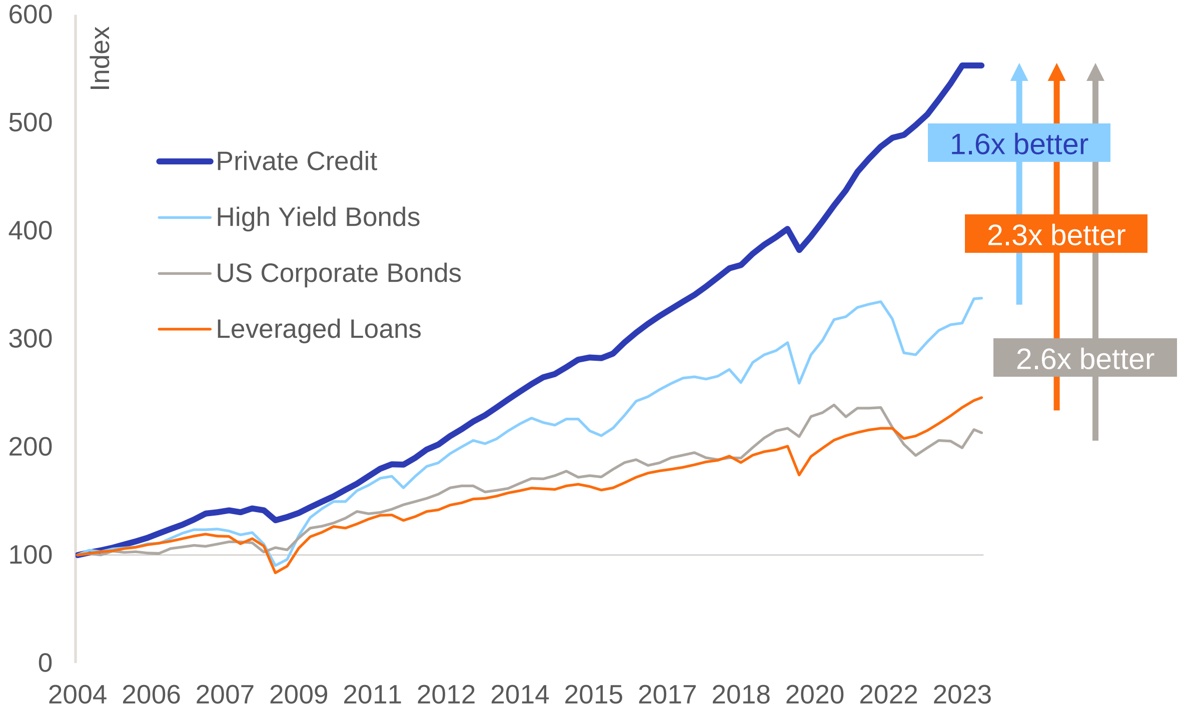


Source: 1. Bloomberg, Net % of Domestic Respondents Tightening Standards – C&I Loans for Large/Medium firms (BBG: SLDETIGT) and Small firms (BBG:SLDETGTS)

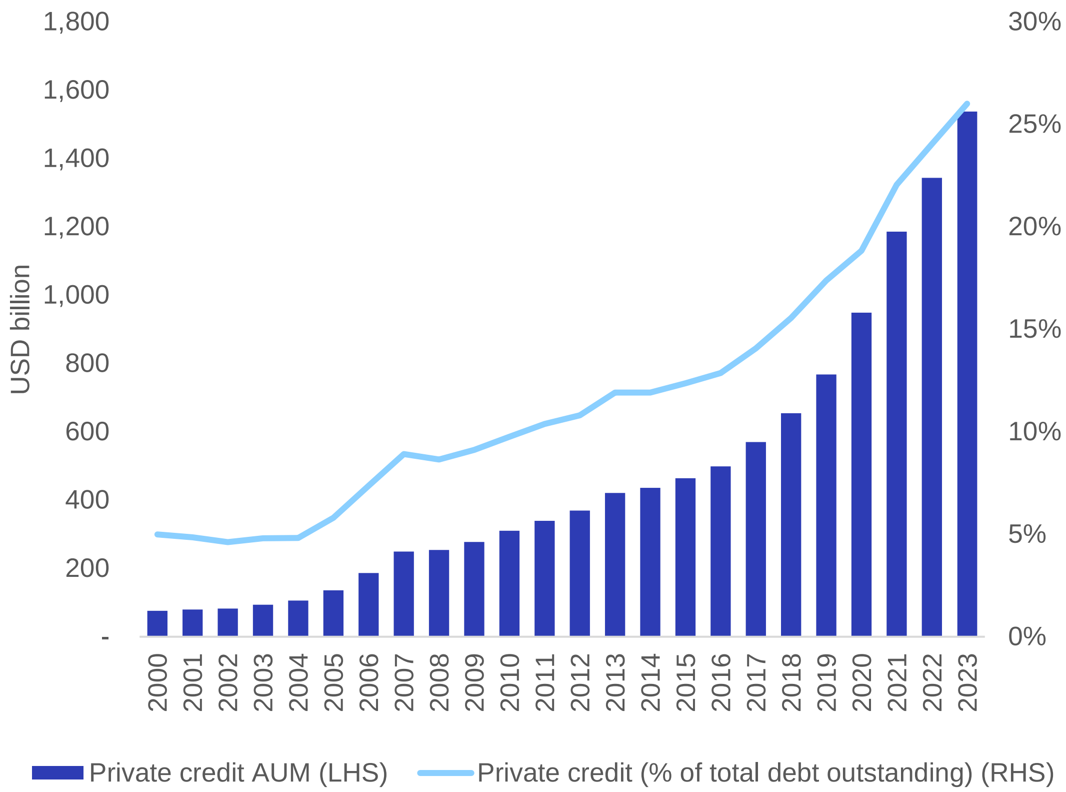
Growth in private credit

Established track record of attractive risk adjusted private credit fund returns compounds growth and investor demand

(Out)performance of private credit vs traditional fixed income



As a result, private credit has grown to ~25% of total debt outstanding

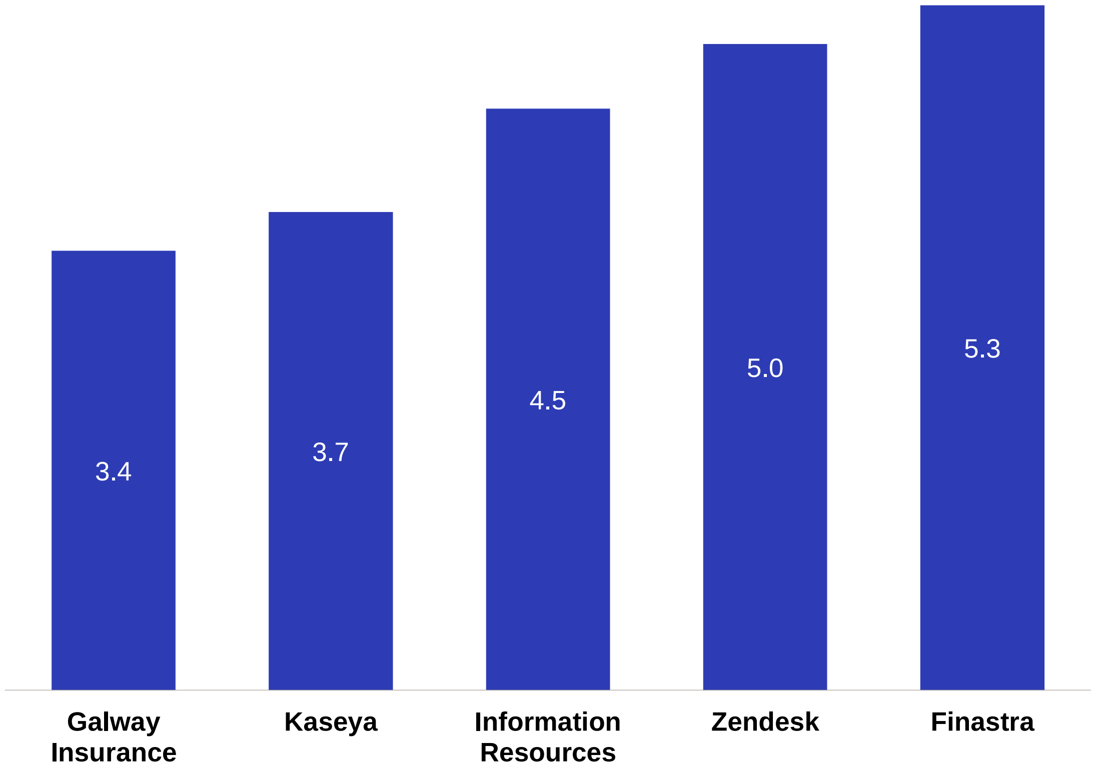


Source: Bloomberg, Preqin, MA analysis. private credit globally represented by the Cliffwater Direct Lending Index.

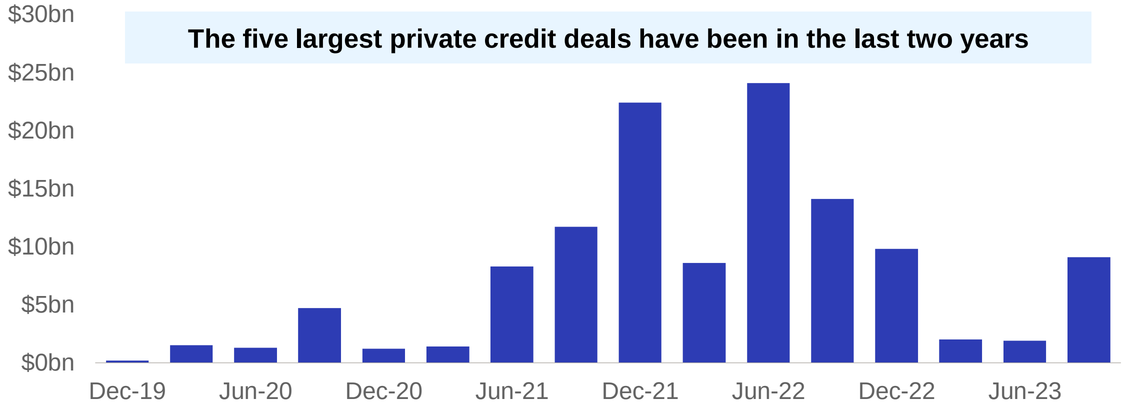
Are we seeing a private credit bubble emerging?

Ensure the executives managing private credit capital have seen real life GFC action

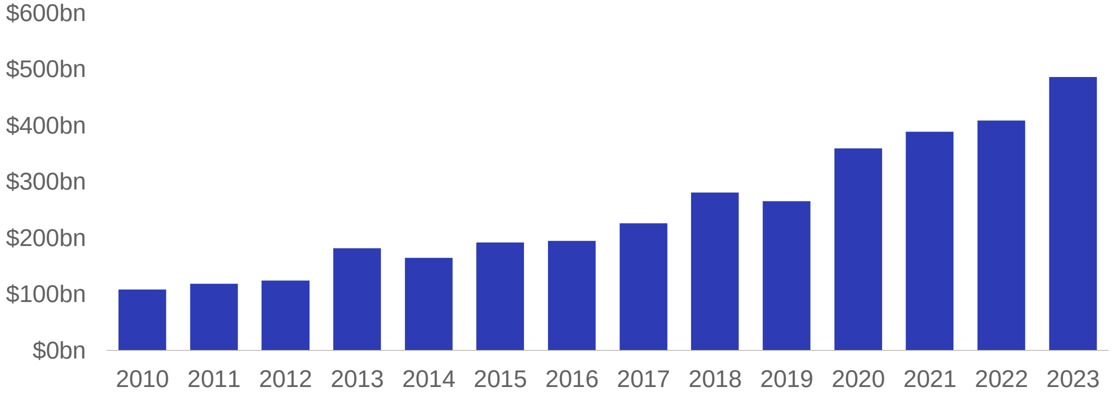
Largest US private credit loans ($'bn)[1]



Value of loans greater than or equal to $1bn



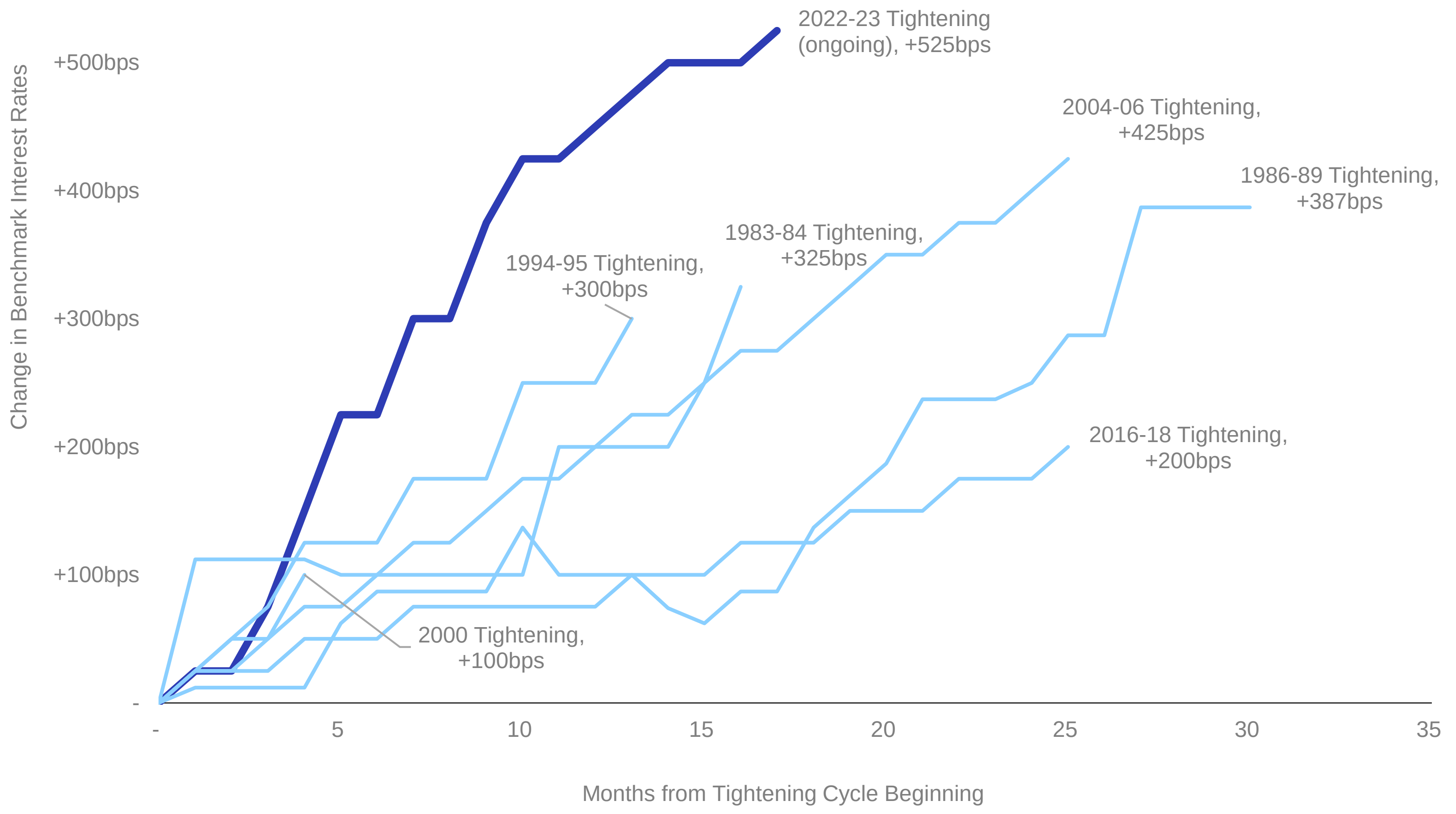
Private credit 'dry powder'[2]



Source: 1. Bloomberg, KBRA DLD, MA Financial Analysis (Aug-23)
2. Bloomberg, Preqin Pro, MA Financial Analysis (data to Mar-23)

Are we seeing a private credit bubble emerging continued…

We have just been through the most aggressive, globally coordinated interest rate tightening cycle on record



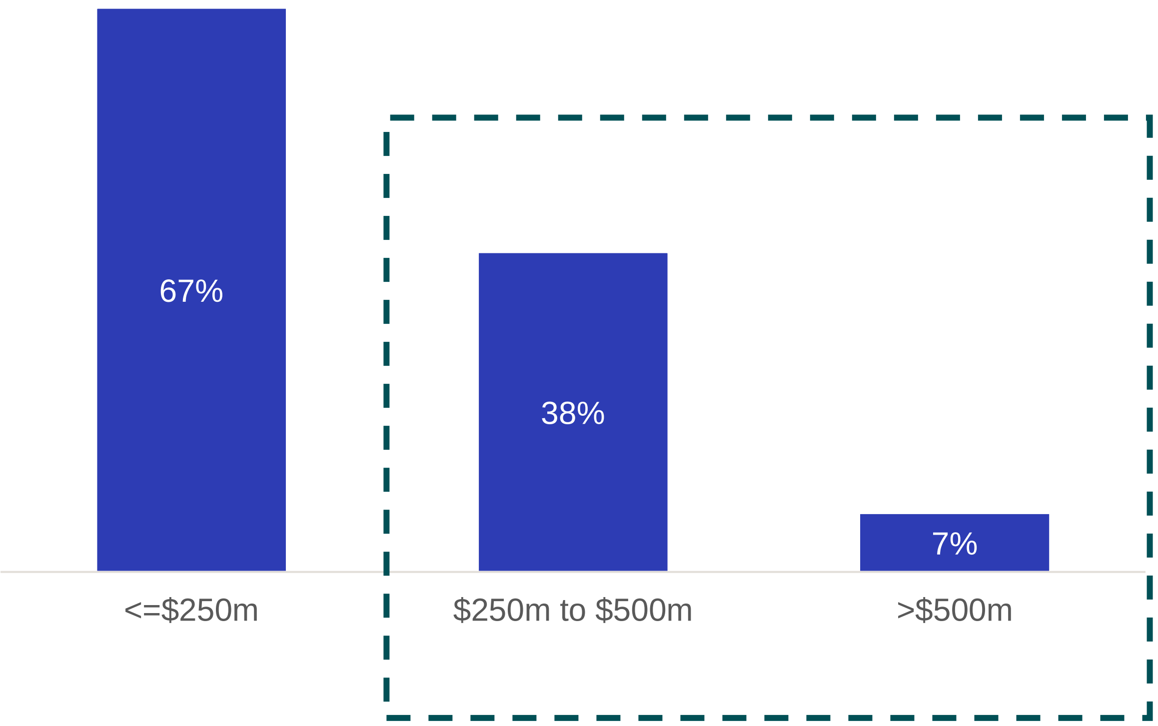
Tightening Cycle	Rate Change	Months to Peak	Starting Rate	Ending Rate
2022–23 (ongoing)	+525bps (so far)	17	0.25%	5.50%
2016–18	+200bps	25	0.50%	2.50%
2004–06	+425bps	25	1.00%	5.25%
2000	+100bps	4	5.50%	6.50%
1994–95	+300bps	13	3.00%	6.00%
1986–89	+387bps	30	5.88%	9.75%
1983–84	+325bps	16	8.50%	11.75%

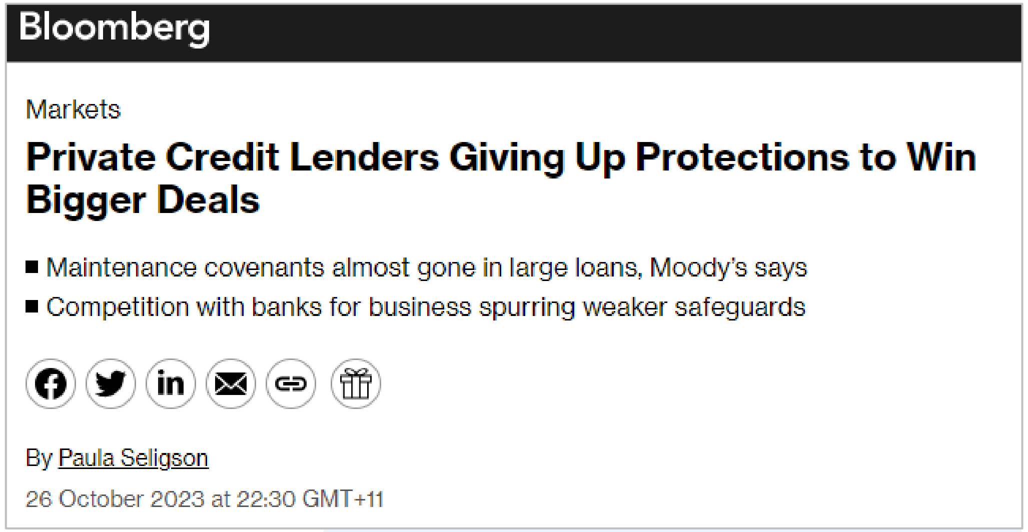
Note: Based on Federal Reserve tightening cycle to represent a global benchmark.
Source: Bloomberg (FDTR Index, which is the upper bound of Fed Funds Rates target), MA Financial analysis.

Weakening protections, giving up “sacred rights”

In some private lending verticals, the “sacred rights” and lender protections which are fundamental to being a debt investor have been progressively eroded

Sponsor backed deals with maintenance covenants (%)




Bloomberg

Markets

Private Credit Lenders Giving Up Protections to Win Bigger Deals

- Maintenance covenants almost gone in large loans, Moody’s says
- Competition with banks for business spurring weaker safeguards

By Paula Seligson

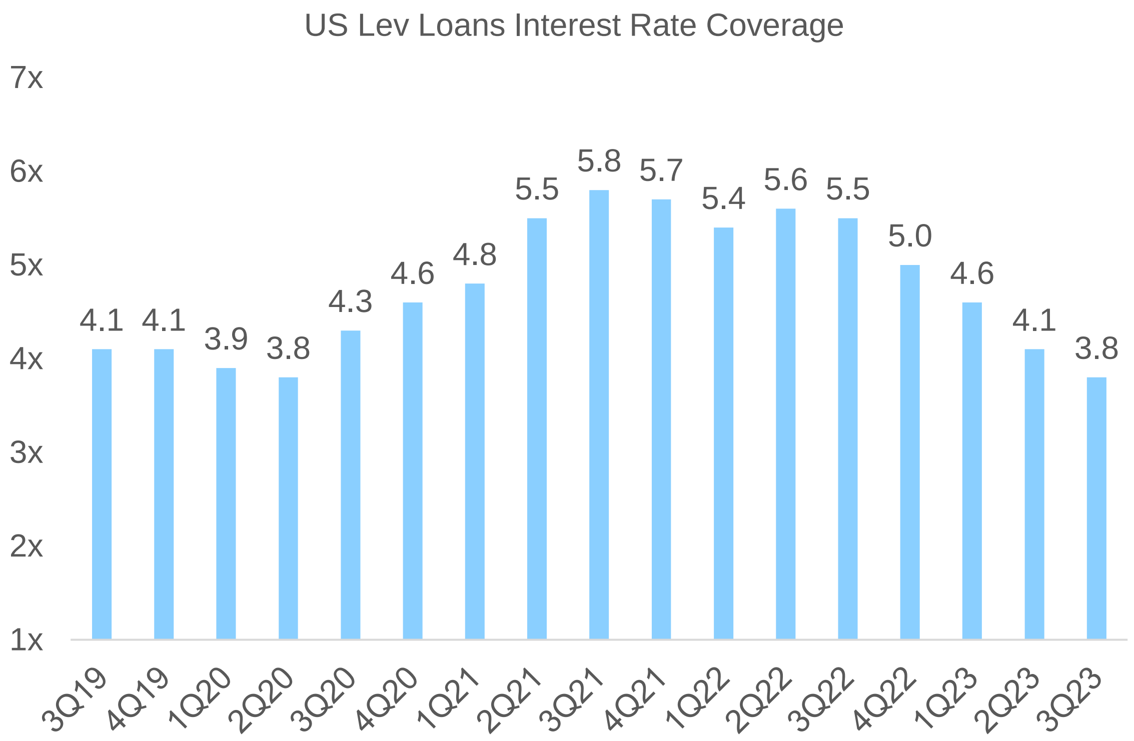
26 October 2023 at 22:30 GMT+11

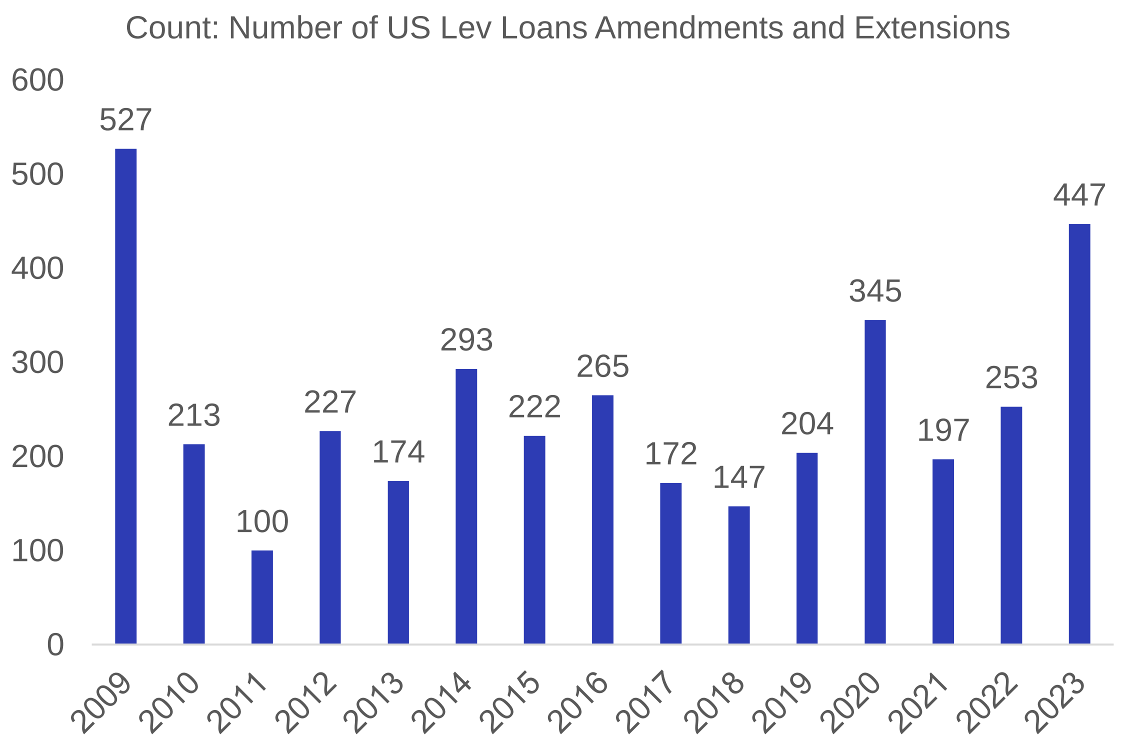
85%

of leveraged loans now estimated to be Covenant-Lite[2]

1. Bloomberg
2. Fitch.

Beware of “Amend & Pretend” instead of a real fix





Source: LCD, Bloomberg, Moody's

Closing comments

- Private credit is here to stay… however it needs to earn its right in a diversified portfolio
- Some managers may lack the expertise and experience required
- Critical to understand the systems and processes of private credit managers
- There may be some tough lessons to learn as the space matures

Thank you

Q&A

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