Private Credit - Growth Drivers and Interactions with the Corporate Bond Market

ECB Bond Market Contact Group

Tatjana Greil Castro

12 March 2024
Private Debt Opportunity as Banks Retreat from Middle-Market Lending

The number of private debt transactions in Europe grew by 91% between 2019-22

Weight of Bank Lending by Geography

- Banks’ retreat from Middle-Market lending continues to create significant opportunities for direct lenders.

Cumulative Number of Private Debt Deals Across Jurisdictions

- Different levels of Private Debt penetration across jurisdictions favors continued growth in the Private Debt Market for the foreseeable future.
- Less penetrated jurisdictions experienced 7.5-10.0x number of transactions in 2022 vs. 2015, whereas more advanced jurisdictions such as the UK, France and Germany grew by 4.5-6.0x


Muzinich views and opinions not to be construed as investment advice. Please refer to Important information regarding forward-looking statements.
Illiquidity Premium and Low Volatility vs. Public Markets

Since 2004, Private Debt has offered on average c. 4% illiquidity premium, limited volatility and 9.4% average return.

The Cliffwater Direct Lending Index is used as a proxy for Global Private Debt as it provides publicly available data.

Yield Comparison - Private Debt vs. HY and Leveraged Loans, 2005-2023

Private Debt Offers c. 4% Illiquidity Premium vs. Public Markets

- Despite temporary dislocations (2008 and 2022), Gross yields for direct lending have averaged c. 4 percentage points above traded high yield bonds and Leveraged Loan Indexes over the last 19 years.

Reduced Volatility, with just 3 Quarters of negative returns since 2005

- Direct Lending has shown a robust track record through the cycle, with average gross returns of c. 9.4%.

Past performance is not indicative of current or future results.

Source: Cliffwater Direct Lending Index (CDLI) data as per Cliffwater 2023 Q2 Report on U.S. Direct Lending as of June 30, 2023. Data is updated on annual basis. Please see index definitions at the end of this presentation. Index performance is for illustrative purposes only. You cannot invest directly in the index. Muzinich views and opinions not to be construed as investment advice.
Drivers and Corporate Bond Market Interaction

Growth Drivers

Borrowers
- Desire for customized funding solutions and no need for public disclosure of proprietary and confidential information

Investors
- 28% investors currently invested in private debt vs. 63% in private equity
- Estimated average target private debt allocation just over 6% of total assets vs. 15% in private equity
- Offers significant yield pick-up versus high yield bonds and leveraged loans
- Newish ELTIF structures allow retail investors to access the asset class

Structural Changes in Public Markets
- Growth in public market deal sizes (due to asset price inflation and need for liquidity) has broadened opportunity set for private debt funds which need not worry about liquidity mismatch
- Growth of ‘barriers to entry’ in public markets for smaller borrowers

Bank Lending Regulation
- Changes in bank regulation contributed to banks’ retreat from corporate lending, especially for companies with gross debt/EBITDA above 4x (European Central Bank’s supervisory expectation on bank leveraged lending)

1. Source Prequin, as of March 2024. Muzinich views and opinions for illustrative purposes only.
1. Impact on the broader credit market
The private credit market is impacting the functioning of the public debt markets. Amend and extend restructuring are a new feature in the public debt market. The Asset Management Industry does not fall under the Basel Banking Definition of Default.
How might the public market further change in response to growth in private debt?

2. Diverging Leverage
Current bank regulation has put a lid on lending to highly levered companies in the banking sector but has not stifled unregulated risk taking across private credit funds. More than 90% of private debt deals had a leverage of >5x, more than 40% had a leverage of >6x in 2023. PIK and Toggle (pay-when-you-can) option offered to borrowers might create ‘zombie’ companies.
How much of a concern is the level of leverage in private debt markets?

3. Diverging ability to fund refinancing and restructurings
On top of the Basel Banking Regulation, the ECB has issued the Calendar Provisioning Regulation under which Non-Performing Exposure must progressively be written off against Tier 1 capital. This rule is EU specific and encourages banks to fire sale. This regulation does not apply in Asset Management and in Non-Bank Lending.
Against this backdrop will private debt continue to grow at the expense of public debt issuance?
Important Information

Muzinich and/or Muzinich & Co. referenced herein is defined as Muzinich & Co., Inc. and its affiliates. Muzinich views and opinions. This material has been produced for information purposes only and as such the views contained herein are not to be taken as investment advice. Opinions are as of date of publication and are subject to change without reference or notification to you. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Rates of exchange may cause the value of investments to rise or fall. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

Any research in this document has been obtained and may have been acted on by Muzinich for its own purpose. The results of such research are being made available for information purposes and no assurances are made as to their accuracy. Opinions and statements of financial market trends that are based on market conditions constitute our judgment and this judgment may prove to be wrong. The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only.

This discussion material contains forward-looking statements, which give current expectations of a fund’s future activities and future performance. Any or all forward-looking statements in this material may turn out to be incorrect. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Although the assumptions underlying the forward-looking statements contained herein are believed to be reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurances that the forward-looking statements included in this discussion material will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation that the objectives and plans discussed herein will be achieved. Further, no person undertakes any obligation to revise such forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Issued in the European Union by Muzinich & Co. (Ireland) Limited, which is authorized and regulated by the Central Bank of Ireland. Registered in Ireland, Company Registration No. 307511. Registered address: 32 Molesworth Street, Dublin 2, D02 Y512, Ireland. Issued in Switzerland by Muzinich & Co. (Switzerland) AG. Registered in Switzerland No. CHE-389.422.108. Registered address: Tödistrasse 5, 8002 Zurich, Switzerland. Issued in Singapore and Hong Kong by Muzinich & Co. (Singapore) Pte. Limited, which is licensed and regulated by the Monetary Authority of Singapore. Registered in Singapore No. 201624477K. Registered address: 6 Battery Road, #26-05, Singapore, 049909. Issued in all other jurisdictions (excluding the U.S.) by Muzinich & Co. Limited. which is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ, United Kingdom.