The Evolving Private Credit Opportunity Set

HPS

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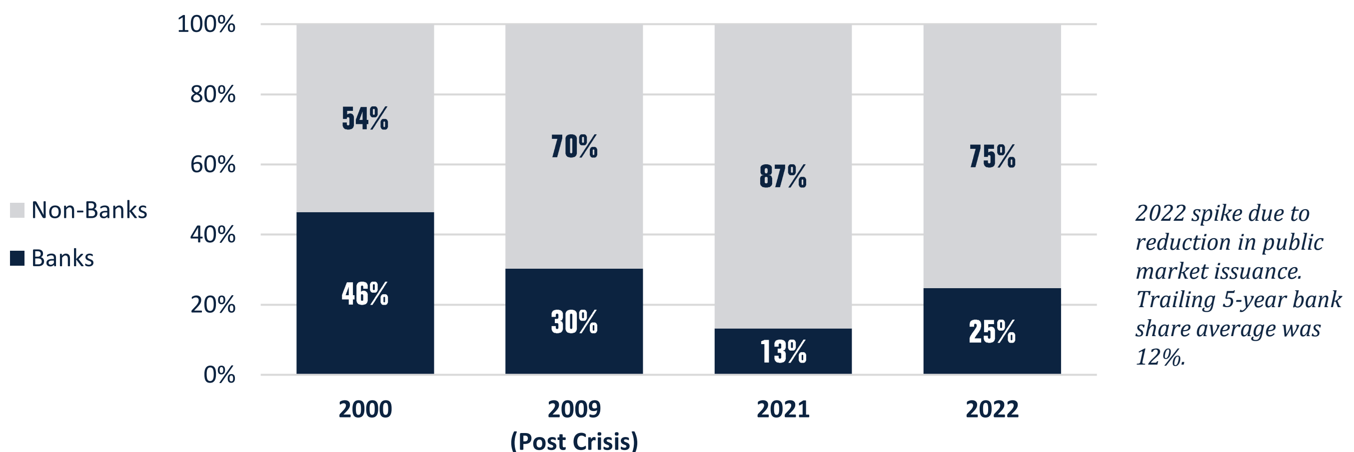
The aggressive interest rate hike cycle that the Federal Reserve began in March of 2022 may be concluding, but its impacts continue to be felt broadly across markets. We believe that one such impact on the credit market will be the expansion of the investment opportunity set for private credit, further accelerating the growth of the asset class.

Recent Bank Failures

The first half of 2023 saw the failure of First Republic Bank ("First Republic"), Silicon Valley Bank ("SVB") and Signature Bank ("Signature"), which represent three of the five largest bank failures in U.S. history[1]. In our view, the issues faced by First Republic, SVB, Signature and a number of other U.S. regional banks are different than the widespread asset impairment faced by the broader banking industry during the Global Financial Crisis ("GFC"). However, similar to the GFC, we expect behavioral and regulatory consequences of the bank failures to be wide reaching and potentially create a tailwind for the expansion of the private credit investment opportunity set.

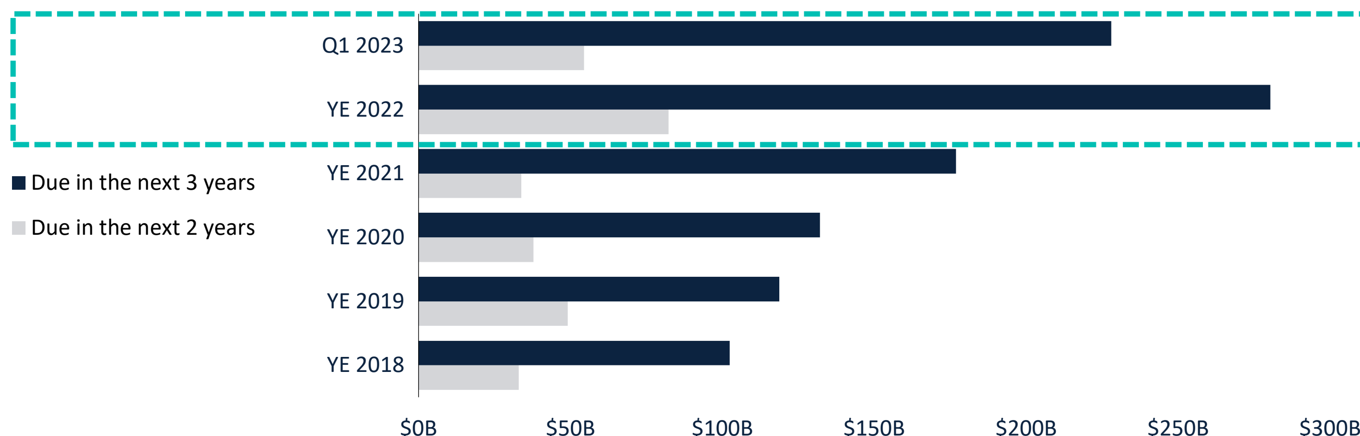
Following the GFC, increased regulation led to higher capital requirements and greater capital costs for the banking industry, with the most impact experienced by large money center banks. We believe that a resulting large-scale bank pullback from leveraged loan activity, as shown below, caused certain corporate borrowers to turn to non-bank private debt providers for their capital needs, contributing to a rapid expansion of private credit as an asset class.



The three recent bank failures and continued uncertainty faced by other regional banks, in our view, may result in regulatory action, including higher risk capital requirements, an increased cost of capital and further tightening of lending standards, especially in the non-investment grade corporate and real estate credit spaces. We also expect that large money center banks may take a more conservative approach in the face of continued economic uncertainty and shrink their balance sheets, and that public credit capital markets will continue to exhibit inconsistent liquidity levels and volatility.

Even in the face of a potential pullback by traditional lenders, we believe businesses will continue to require new

capital to finance operations and fuel growth. In addition, more than $200 billion of broadly syndicated loan maturities are expected over the next few years.[3] These financings were put into place during a significantly lower interest rate environment and will need to be restructured in light of today's base rates.



We believe large scale private credit providers will be well positioned to capitalize on the opportunity created by any decrease in bank lending and continued capital needs, including as a result of the maturity wall. Private credit providers that have investment capital in multi-year or evergreen fund formats can make long-duration financing commitments without the risk of asset / liability mismatch faced by banks that are reliant on deposits. In our view, large private credit providers, with bespoke structuring capabilities and greater relative certainty of execution at scale across market environments, will play an important role in helping to address the ongoing demand for credit and oncoming maturity wall.

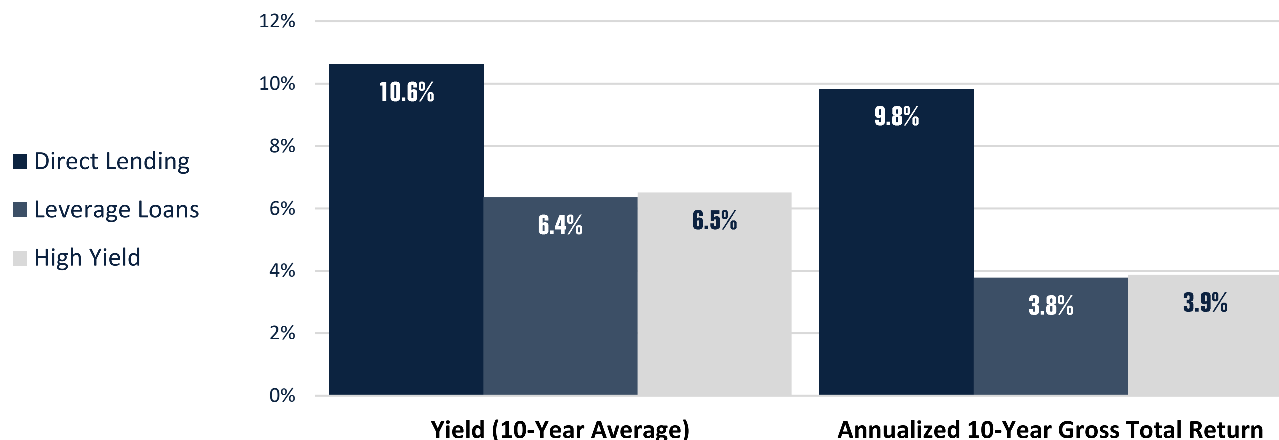
Additionally, we expect financing scarcity to support wide private credit spreads (by historical standards), as was the case throughout the second half of 2022,[4] and greater levels of negotiating power for private credit providers, leading to more robust contractual protections that can potentially help preserve investors' capital. We believe that these factors, combined with U.S. base rates of 4%+ (per current SOFR forward curve forecasts[5]), will potentially make the next 18 months a compelling risk-adjusted return environment for private credit investing.

Interest Rate Environment and Quantitative Tightening

Restoring price stability has been a primary goal of the Fed's monetary policy over the last 15 months. Despite the U.S. economy slowing dramatically from January to March and certain economists predicting even weaker Gross Domestic Product growth for the current quarter, the Fed has maintained that rates may need to stay at or near current levels for a period of time to bring inflation back near its 2% target level.[6] However, following the recent banking failures, the bond market seems to be pricing in rate cuts as early as the summer and continuing into next year.[7] We believe that the slowing economic conditions and tightening lending posture from banks is generally in line with the Fed's objectives. As a result, we do not expect that rates will dramatically drop in the near term.

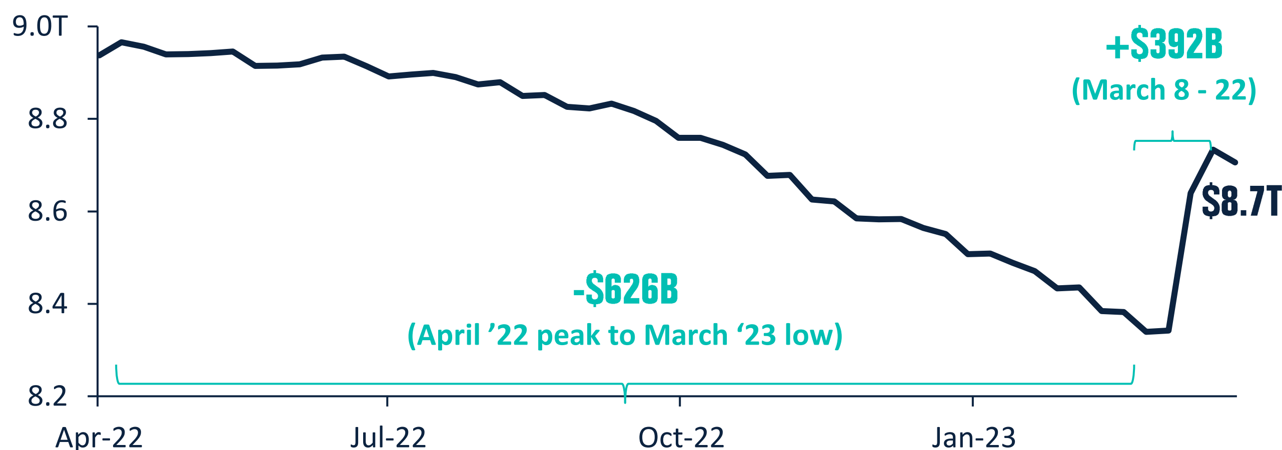
Private credit investors have historically received higher yields and returns than investors in traditional non-investment grade fixed income alternatives, as illustrated in the following chart.[8] Further, private credit investor returns generally have limited reliance on market-based capital appreciation of underlying investments. Instead, returns from private credit investments are often primarily contractual, coming from cash and payment-in-kind coupons, original issue discounts, and other fees. This profile offers the potential for consistent income and returns, even during periods of market volatility. Given private debt's – particularly senior secured private debt's – typical floating rate structure, private credit investors generally benefit from increased coupon payments in high interest rate environments.

Private Direct Lending Yield and Returns vs. Fixed Income Alternatives[8]



In addition, the Fed has already resumed quantitative tightening ("QT"), reducing its balance sheet and removing liquidity from markets, after pausing the program following the initial two bank failures in late March. Between April 2022 and early March 2023, the Fed had reduced its balance sheet by more than $600 billion, but nearly $400 billion of that impact was reversed in March as a result of the liquidity funding the Fed provided to the banking industry.[9] If the Fed continues its QT program, we believe it will place additional pressure on already inconsistent levels of liquidity in the public markets, contributing to further volatility over the next several months and providing ongoing support for wide credit spreads (by historical standards) in both public and private credit markets.

U.S. Federal Reserve Total Assets[9]



Slower Economic Growth

Economic growth is undoubtedly slowing, and many experts believe a mild recession in the U.S. is likely later this year. A slow-down in economic growth would generally lead to reduced revenue growth and cash flows for companies, putting pressure on margins. Potentially reduced revenue, deteriorating margins and declining enterprise values create risks for all credit providers, including private credit providers. As a result, we believe that lenders must continue to be selective in their investments, conservative in their underwriting assumptions and thoughtful about loan-to-value ratios and covenants when making investments. At the portfolio level, lenders should also emphasize defensive positioning, including significant diversification by borrower and sector and a weighting towards industries that have historically been recession resilient. Such an approach to private credit investing should be applied across credit cycles and market environments in seeking attractive risk-adjusted returns for investors.

REPRESENTS HPS'S SUBJECTIVE VIEWS AND OPINIONS AS OF THE DATE HEREOF AND IS SUBJECT TO CHANGE DEPENDING ON THE MARKET ENVIRONMENT.

We believe that incorporating downside protection is an important aspect of private credit investing. A key element of the due diligence process should entail analyzing a company's ability to be nimble with its costs and working capital, allowing it to harvest cash flow in the event of rapid and unexpected changes in operating conditions. This type of analysis is particularly important in periods of economic downturn. We believe that a slowing economic environment, resulting in part from prolonged high interest rates (by recent historical standards), will cause companies to execute on this playbook, shifting from growth to cash preservation mode. We also expect this pressure will lead to more capital raising and refinancing needs, further expanding the opportunity set for private credit.

Difficult economic conditions will inevitably cause credit challenges, even in relatively well underwritten portfolios. However, lenders that proactively engage with portfolio companies to take action ahead of issues, and that have the resources and expertise to work through adverse credit situations are more likely to maximize recovery values for investors in such instances.

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End Notes

[1] Source: Federal Deposit Insurance Corporation.

[2] Source: LCD, a part of PitchBook, as of December 31, 2022.

[3] Source: LCD, a part of PitchBook, based on the Morningstar LSTA US Leveraged Loan Index. Data through March 24, 2023.

[4] Source: Lincoln International, Selected Valuation Guidelines Quarter Ended March 31, 2023.

[5] Source: Bloomberg. U.S. Dollar SOFR forward curve as of May 16, 2023.

[6] Source: Federal Reserve Board FOMC Statement May 3, 2023; Federal Reserve Chairman Jerome Powell's remarks at press conference on May 3, 2023.

[7] Source: Bloomberg World Interest Rate Probability as of May 16, 2023.

[8] **PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS**. Data as of September 30, 2022 (latest available for all constituents). Private Direct Lending is represented by Cliffwater Direct Lending Index (CDLI), Yield represents yield-to 3-Year. Leveraged Loans is represented by Credit Suisse Leveraged Loan Index Yield to 3-Year. High Yield is represented by Credit Suisse High Yield Index Yield to Worst.

Index Definitions:

The Credit Suisse High Yield Index is designed to mirror the investable universe of the USD denominated high yield debt traded in the US credit market.

The Credit Suisse Leveraged Loan Index tracks the performance of senior floating rate bank loans and is designed to mirror the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The Cliffwater Direct Lending Index seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset weighted performance of the underlying loans held by business development companies (BDCs), including both exchange traded and unlisted BDCs, subject to certain eligibility requirements.

[9] Source: Federal Reserve Economic Data as of March 29, 2023.

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