Wealth Investing Finance

Investors reap the spoils of private credit as banks pull back

Private credit can be both a defensive and lucrative addition to a portfolio. But the return of offers with echoes of the GFC era is adding to a long list of risks.

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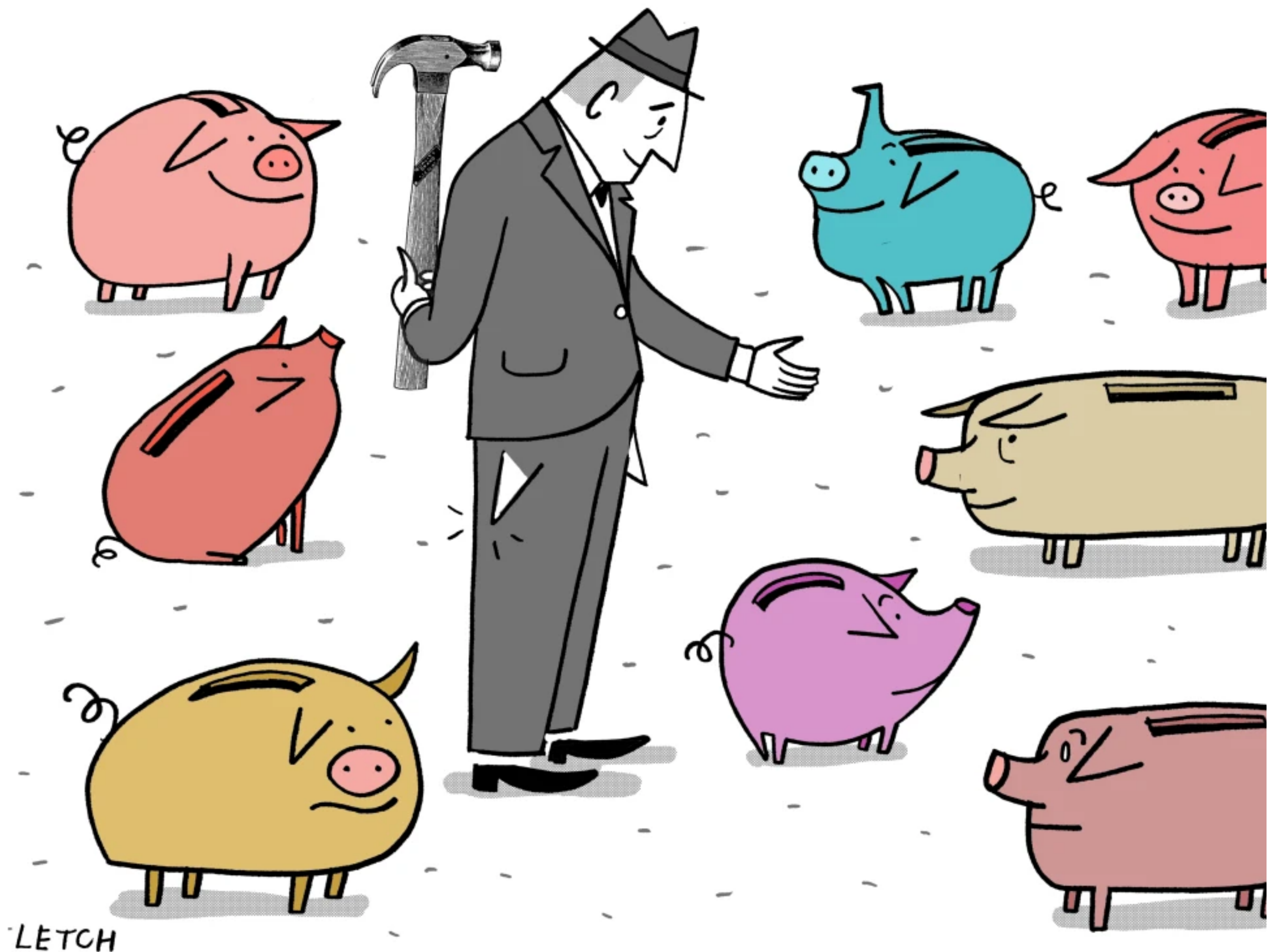
A spike in interest rates and tighter regulation have made it much harder for businesses and wannabe homeowners to secure funding from traditional sources [https://www.afr.com/property/commercial/super-funds-ready-to-lend-to-hotel-investors-as-banks-pull-back-20220503-p5aib0] like the big banks.

That's proving good news for investors – at least for those with an appetite for the types of risk that the banks increasingly won't take on. Private debt markets more than doubled in 2021 to $1.4 billion, says the Australian Investment Council (AIC), a lobby group for private markets investors.

"This was aided by stricter bank regulations implemented after the global financial crisis. Banks cutting the size of their balance sheets and APRA guidelines led to tighter lending conditions, opening a gap in the market for private debt funds," the AIC says.



Businesses and borrowers are having to cast a wide net to obtain credit. **Simon Letch**

While private credit is still only 2 per cent of local lending compared with 12 per cent globally, the council says the conditions that propelled the US private debt market in the 1980s and 1990s such as bank consolidation, strong M&A activity, and an increase in leveraged buyouts are now in Australia.

“Banks focus on lending to larger companies and businesses rather than smaller and mid-sized ones, offering a funding void that private credit firms can fill,” it says.

As fears of a recession swirl [https://www.afr.com/link/follow-20180101-p5bhug], banks further tighten their credit criteria and home in on a much more select component of the lending market, leading to the rise of non-bank lenders [https://www.afr.com/companies/financial-services/non-banks-could-step-up-on-risky-loans-s-and-p-20220726-p5b4r3] (primarily targeting mortgage markets) and private credit funds, also servicing businesses.

The growing space is attracting interest from a wide range of investors in retail investor-focused, ASX-listed funds like Metrics Credit Partners, to contributory funds targeting sophisticated and wholesale investors including self-managed super and high net worth individuals, to those offering leveraged debt to big companies aimed at institutional investors including superannuation funds, like IGC.

Initially lured by the promise of higher returns versus deposit markets when interest rates were low, many investors in private credit continue to see their fortunes grow as the rates cycle turns and both private and bank lenders increase their rates in line with the Reserve Bank.

Banksia blueprint

While loans are getting harder to secure for many borrowers, the Australian private credit market is also growing in sophistication, giving companies more choice – and often more leverage – when it comes to their borrowings.

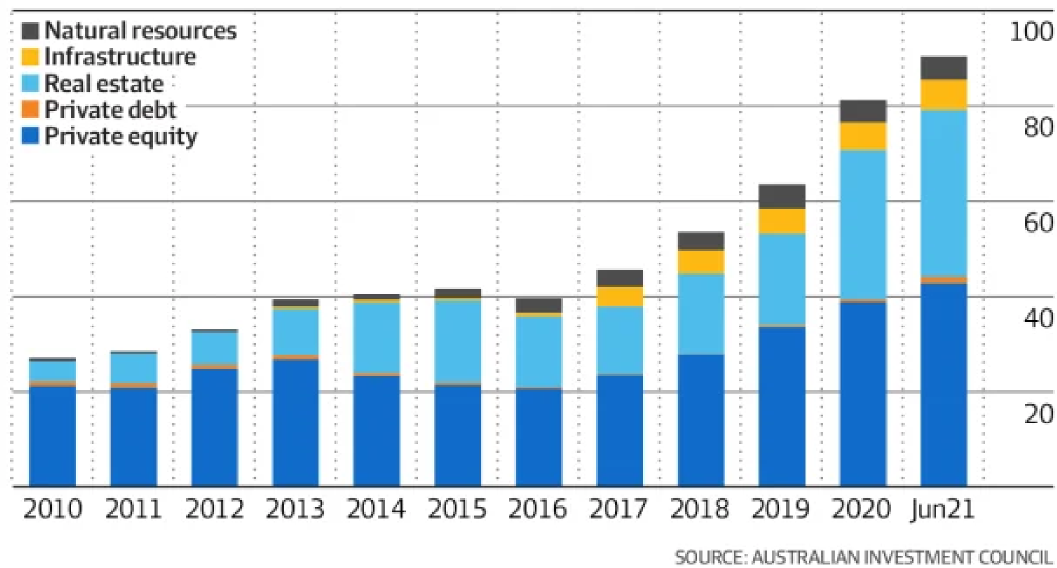
“Private credit comes in a number of different forms, but at its essence it used to be called peer-to-peer lending,” says Chris Morcom, partner and wealth adviser at Hewison Private Wealth.

“Essentially people are investing into funds that provide finance to other people. And so, when you’re looking at that as an investment, clearly you’ve got to look at the risk-return trade off.”

Morcom says high-profile failures such as Banksia Financial Group [https://www.afr.com/rear-window/costs-double-the-blow-in-banksia-saga-20211012-p58zca] show the risks of lending long and borrowing short in housing, where maturities are at odds with investor funds.

“If the provider of the fund is offering a monthly liquidity to their investors, they’re lending their money on loan terms greater than three years, then there’s clearly going to be a mismatch if there’s a run on the fund,” he says.

But he still classifies private credit as a defensive part of some clients' portfolios, as long as the underlying assets being financed are not highly structured or difficult to understand.



Private debt is still a small slice of private capital markets. **Evelyn Barota**

"It's getting a bit interesting out there. We went through the GFC some time ago and arguably there was a good shake out of some pretty poor practices that were happening in the lead up to the GFC," Morcom cautions.

"I would argue that there are some interesting practices starting to creep back in, with people trying to seek high yield on their money and when that happens, people start to move themselves down the quality curves, and they also move themselves up the risk curve."

He says doing this with full knowledge is fine, but highly structured funds that are too complex to understand, and where it's not exactly clear what the loan is financing, are a red flag and carry additional risk.

Investors also need to know exactly what happens if things go wrong and a borrower defaults, given differences in how quickly a property can be recovered and resold, for example, across the states.

Pooled premia

Understanding the underlying assets and the risk attached to each loan is imperative, says Patrick Prasad William, Rixon Capital's co-founder and managing director.

His new fund is targeting annual net cash returns of 10 per cent to 12 per cent, paid monthly, by lending to small to medium enterprise companies looking for between $2 million and $20 million.

This area, says William, is too labour-intensive to provide enough returns for the risk involved for the banks, meaning he can charge the SME customers a "scarcity premium" while making sure the loans are secured against real assets.

Investing in anything from a fleet of helicopters to warehouse debt for non-bank lenders, William is confident that his fund can grow to $250 million quickly while providing a steady income stream for investors. He agrees with Morcom that anything that is difficult to understand and not secured against assets is a red flag, but also warns to be on the lookout for pooled funds that are highly structured.

Investors can earn comparatively attractive returns and be paid regular income, with many funds paying monthly interest rates that vary depending on the underlying assets being funded. There are pooled funds where assets like mortgages are grouped together and contributory funds, which are set up to finance a particular project or group of projects.

"Generally [contributory funds] are only available to sophisticated investors and this allows you to pick and choose which mortgages you want to invest in, for example," says Morcom.

"That's obviously at a higher level of risk because you've got less diversification. But arguably, you can control the risk by then understanding that particulars of the mortgages in which you invest."

Turning point

Adam Smyth is one of several former bankers turned private financiers at Bowery Capital, which is financing construction companies that are increasingly shunned by the banks using the contributory model.

"The banks are constrained from a regulatory point of view to be lending against assets if it's got no income, if it's got planning risk associated with it," says Smyth, Bowery's co-founder and chief investment officer.

Smyth says appetite from investors is growing, with financial planners and accountants increasingly recognising that the sector is stepping in where banks had played.

"They see the fundamentals of the sector, they see we're doing what historically would have been done by a bank, and they're seeing the sector become more probably more prudent and more sophisticated," he says.

Australia is well behind Europe and North America, where commercial real estate is funded roughly 50 per cent by the private market.

"In Australia it's been almost entirely by banks with only a small part by private lenders, but that trend is really changing. Private credit was seen as being the lender of last resort where developers would turn if their credit rating was so poor that the banks would slam the door in your face, whereas now, private lending is often a choice by borrowers because they want certainty," says Smyth.

"Obviously that makes it far more appealing to investors and that makes it more appealing to advisers."

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— Adam Smyth, Bowery Capital

Perks Private Wealth director Nick Connelly says private lending is filling the gap left by banks' retreat.

"The opportunity really came about through the increases in regulation and it's been one of the fastest growing asset classes in Australia, I think for some time now," says Connelly.

"We've seen borrowers who might have recently been able to borrow from the bank at relatively lower interest rates, now be forced to look at alternatives and the private sector has stepped in to supply that funding."

New horizons

But at the top end of town, ICG's Matthew Turner is the head of Australian senior loans, lending to big companies and counting institutional investors and super funds as clients. He says the market is building out after a slow start, but it's growing into new areas, rather than filling gaps left by banks.

"This is really around providing access to companies and borrowers to products, for instance, that their overseas counterparts have had for years," says Turner.

"Like most things, it takes a little while for them to find themselves here in Australia. And you know, it started off slowly, many years ago, but I do feel that it's really starting to build out."

Investor appetite for consistent, solid returns and the emergence of more private equity funds that are used to using leveraged loans is driving that demand from the top end, says Turner.

"Ten years ago we were saying the banks are going to be a little bit more reticent in this space because it's very capital intensive, it's really hard to do. But the product has got a life of its own and its own market, it's not really supplanting the bank market," he says.

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Companies are not the only ones keen to expand their funding sources, says Connelly. He says investors were drawn to the space by the higher yield but now see private credit as a diversification tool.

"Initially it was probably focused on yield as in the demand for the sector but also a demand for different asset classes," he says.

"We've been achieving upwards of 10 per cent, so quite strong yields in the fund that we've done so far and when you look at it from that perspective, with far lower volatility than the share market but still delivering equivalent share market returns, it can be part of a really strong diversified portfolio."

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