Private Credit – Why now?

An Evolving and Attractive Opportunity Set

What is Private Credit?

An Evolving and Attractive Opportunity Set

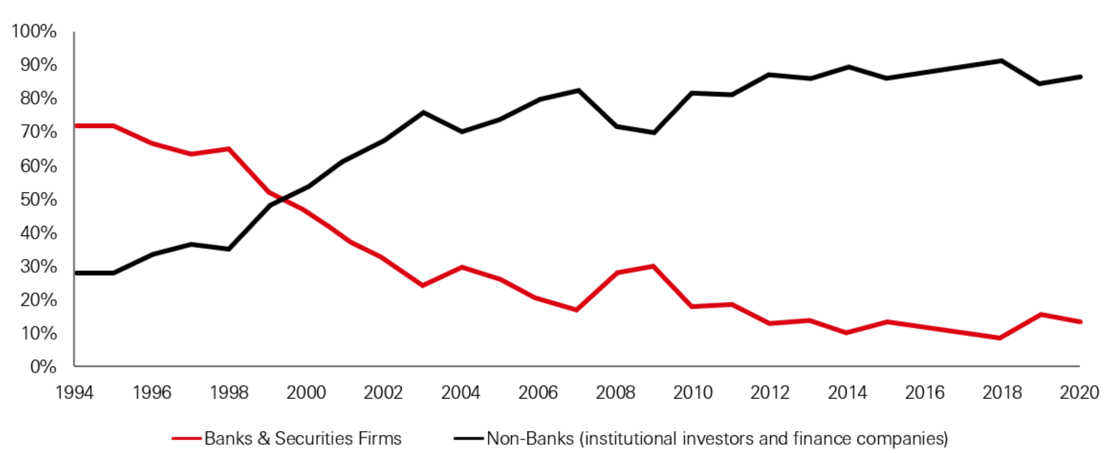
Introduction

- Banks are the traditional lenders to mid-market companies, but activity has been significantly curtailed due to a range of regulatory changes which accelerated following the GFC in 2007/8. This has led to the growth of alternative lenders who are replacing traditional banks and are able to provide more flexible structures and greater speed and certainty of execution.
- Current investor appetite for Private Credit has been supported by its solid performance amid global central bank rate hikes and attractive yields. Lending opportunities have surfaced as banks have pulled back from the leveraged loan market, and private credit has been swift to fill the gap.
- As inflation rates continue to fall, the policy rate peak is imminent, and bond yields have most probably already peaked. We want to lock in the current high bond yield levels because they could fall when markets start to anticipate more future policy rate cuts.
- Private Credit presents a range of different investment opportunities that can accommodate a variety of investor risk profiles. Currently, we believe that the heightened disruption and volatility in global markets has created a favourable investment environment for opportunistic and distressed manager strategies, and that these strategies can also provide an interesting portfolio hedge in volatile markets.

What is Private Credit?

In its simplest form, **Private Credit** refers to lending which is provided by a non-bank lender, typically to small to medium sized enterprises that are not rated. Banks were earliest lenders to mid-market companies, but activity has been significantly curtailed due to a range of regulatory changes which accelerated following the GFC in 2007/8. This has led to the growth of alternative lenders who are replacing traditional banks and are able to provide more flexible structures and greater speed and certainty of execution.

Banks vs Non-Banks Primary Market Corporate Loan Participation



Source: S&P LCD, 31 December 2020, HSBC Asset Management, 31 March 2023

For investors, Private Credit can offer diversification within a private markets portfolio as it typically has less correlation and lower risk profile compared with equity markets. It can also offer reliable income streams and provide inflation protection if the debt has a floating interest rate.

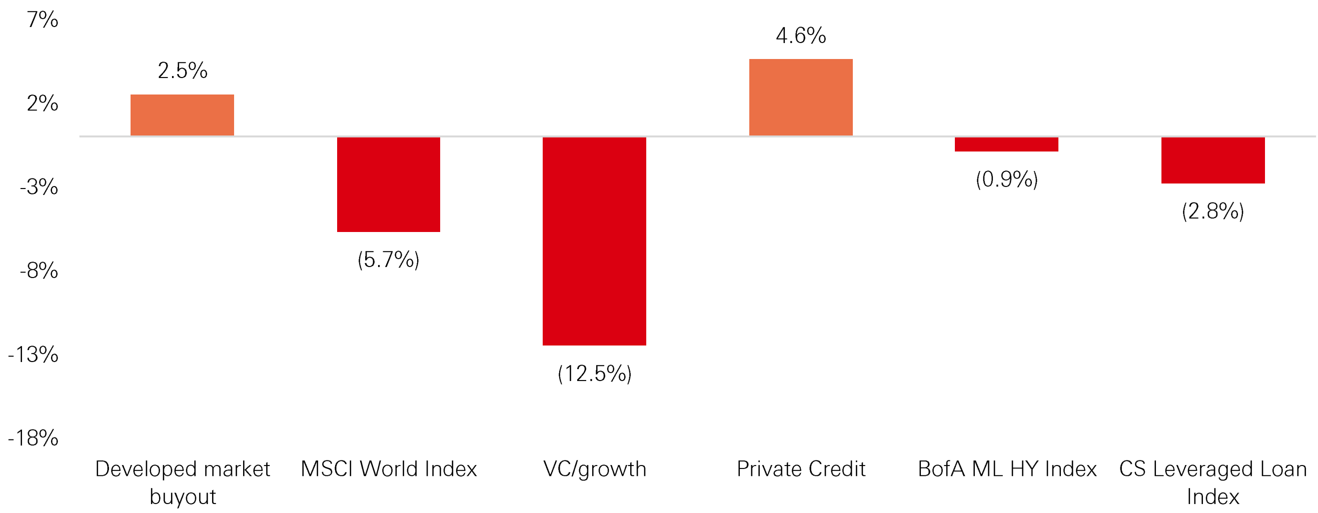
Private Credit will usually provide higher yields than public fixed income to compensate investors for the reduced liquidity, with leveraged loans offering the best liquid market proxy for direct lending exposures. High yield and broadly syndicated leveraged loans can offer an attractive pick-up in yield vs. high-grade credit, but actual liquidity in these markets has been tested and remains weak due to market stress and the retrenchment of banks and brokerages from active market-making, resulting in highly volatile syndicated loan valuations.

Furthermore, it has been shown that Private Credit has outperformed public debt markets during downturns, as during the worst five-year periods over the last 25 years Private Debt produced 4.6% returns p.a. vs negative returns for leveraged loans and high yield bonds (Figure 2).

Current investor appetite for Private Credit has been supported by its solid performance amid global central bank rate hikes and attractive yields. Lending opportunities have surfaced as banks have pulled back from the leveraged loan market, and private credit has been swift to fill the gap.

Highly Attractive Opportunity Set

Lowest 5-year annualized performance since 1995



Source: Hamilton Lane "Market Overview", February 2022, HSBC Asset Management, 31 March 2023

Types of Private Debt

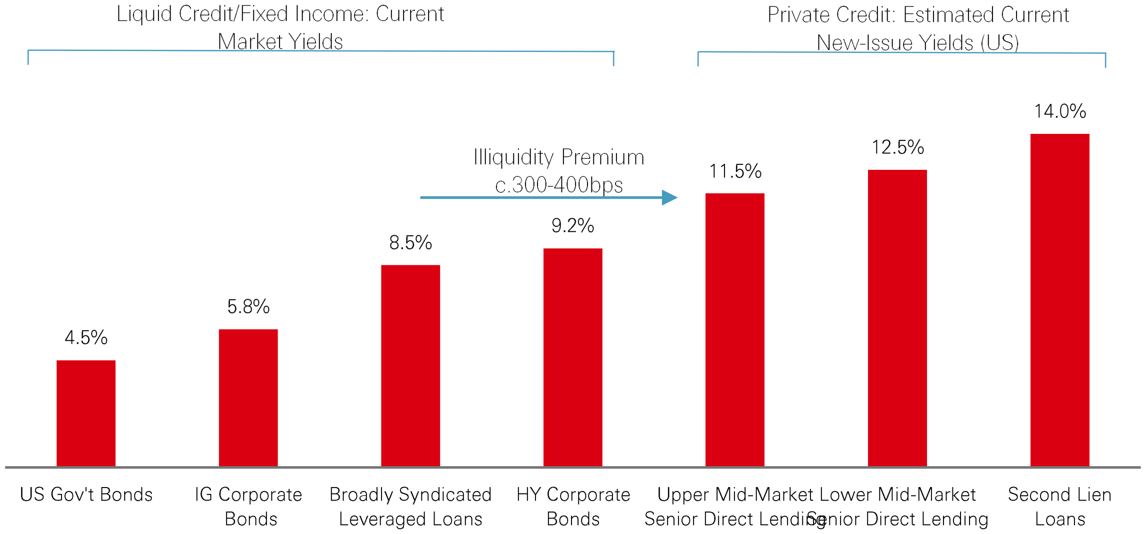
Private Credit investments are typically made through a variety of vehicles (e.g., hedge funds, closed-ended funds, business development companies [BDCs], and interval funds). There are numerous different types of Private Debt, each coming with unique risk / return profiles and differing seniority structure. The main types we will focus on in this paper are Direct Lending, Mezzanine debt and Opportunistic, which pursue different investment strategies and therefore exhibit unique risk / return profiles.

Direct Lending is debt where non-bank lenders provide loans to middle-market businesses, without the use of an intermediary (such as a bank). It is a subset of the broader leveraged credit markets, which are characterised by mostly financing leveraged buyouts by Private Equity sponsors. Typically, such companies are too small or have financing needs which are too complex to be financed in the public markets.

A key attribute of Direct Lending assets for investors is that loans are typically senior secured, usually with 1st or 2nd lien over collateral and often with strong covenants that provide greater structural protection compared to junior or unsecured debt and high yield bonds.

Direct Lending loans are mostly structured with a floating rate where the interest rate is adjusted based on a base rate (usually every 1 or 3 months). This provides protection against rising interest rates and inflation as the base rate increases. Base rates typically also exhibit a floor (often between 0% and 1%). Deals are underwritten on sufficiently high interest coverage ratios to provide a cushion against rising borrowing costs.

Current Market Yields and New Issue Yields of Credit Instruments (USD)



Source: Hamilton Lane "Market Overview", November 2022. 10Y gov't bonds reflects the YTW on the S&P US Gov't Bond Index (USD); IG credit reflects the YTW of the S&P 500 IG Corp. Bond Index; BSL loans reflects the YTM from the Morningstar LSTA U.S. LL 100 Index; HY reflects the YTW on the S&P US HY Bond Index. All illiquid credit yields reflect Campbell Lutyens estimates based on private market observations. HSBC Asset Management, 31 March 2023

Direct Lending is the largest area of the Private Debt market and sits at the top of the capital structure. The long-term Cliffwater Direct Lending Index gross performance since September 2004 is 9.31% p.a. (USD). Our long-term target return for Direct Lending is 6-8% net IRR (USD), which provides a significant premium to public fixed income but is less than other type of Private Debt such as Mezzanine and Opportunistic. However, it also carries lower risk versus Mezzanine and Opportunistic, due to being higher in the capital structure and the strong covenants which are typically built in.

Highly Attractive Opportunity Set

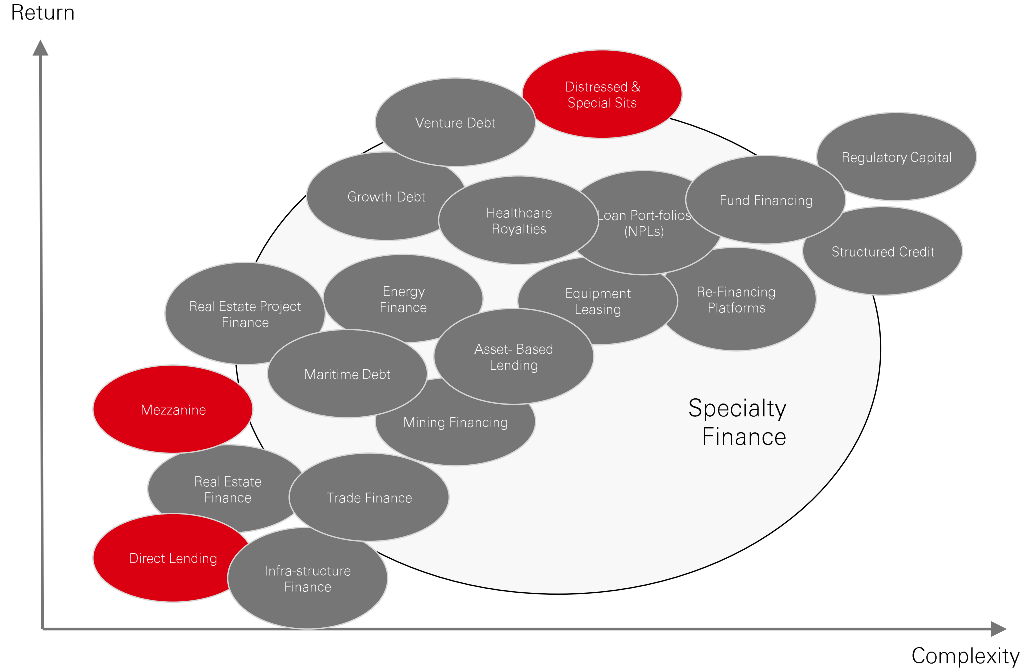
Mezzanine Debt falls between senior debt and equity financing. It is subordinated to senior debt and therefore has a higher risk profile. It may also entail an element of equity upside achieved through warrants or through an actual equity investment.

This type of debt can be attractive to borrowers as it allows them to raise additional financing without immediately relinquishing ownership or control and also to lenders / investors as it produces higher returns, compared with other debt investments, via contractual interest payments as well as embedded equity instruments, usually in the form of warrants, which act as additional sweeteners. Mezzanine financing is frequently associated with acquisitions and buyouts.

In terms of risk, Mezzanine usually takes the form of unsecured, subordinated debt which exists between senior debt and equity in the capital structure, meaning that senior debt holders (such as Direct Lenders) will be repaid first in the event of default. However, this higher risk compensates investors with higher returns compared with Direct Lending, typically 10-15% gross IRR, as well as the potential to own equity in the company in the future.

Opportunistic Credit refers to strategies where investors seek to capitalise on opportunities and dislocations across the entirety of the credit spectrum (both private and public), with a flexible mandate using a combination of income yield and capital appreciation to generate returns. The flexible mandate approach allows managers to shift their investments across the credit market, depending on where they see the best risk-adjusted returns, often to where return potential is increased due to barriers that arise in financial markets, increasing the complexity of transactions.

Overview of Private Debt Sub-Strategies



Source: HSBC Asset Management, 31 March 2023

Many Opportunistic Credit managers, look at opportunities in underlying assets that are facing some degree of stress, since more traditional credit managers will usually have limitations on their ability to invest in lower-rated credit loans or in companies that are in danger of bankruptcy.

Opportunistic Credit strategies often complement, or serve as a substitute for, more traditional fixed income portfolios and can enhance investment returns, as well as increase overall portfolio diversification. Annualised returns of Opportunistic strategies are typically between 12-25% gross IRR, to compensate for additional complexity and risk involved.

Turnaround (or Special Situations) investment is an example of an Opportunistic strategy which can combine debt and equity. This strategy seeks to provide equity capital to good companies with bad balance sheets that find themselves in financial difficulty.

The goal is to ease liquidity constraints until the circumstances that caused the distress are corrected and stability is restored. Turnaround investors will usually look to take controlling equity stakes of companies in order to protect their investments and implement turnaround plans focused on cost reduction and capital investment, rather than operational improvements and revenue growth like more traditional private equity managers.

Given the distressed nature of the investments, entry valuations are typically very conservative meaning that the upside potential can be significant if the turnaround strategy is executed successfully.

In dislocated markets, these turnaround investment strategies can also be executed in a similar way through the purchase of corporate debt, rather than equity. **Distressed-for-control**, or ‘loan-to-own’, involves the purchase of near bankrupt companies, with the aim of converting that debt into a controlling equity stake following the restructuring process.

The position could then be sold soon after the debt-for-equity exchange (which itself can take multiple years), or held for a longer period with a view of implementing similar turnaround plans, as described above, to allow the equity value to appreciate.

Alternatively, **distressed debt trading** is the short-term trading in distressed company debt, without the goal of owning equity. Performing corporate loans are often sold at a discount to par and can be attractive opportunities to investors that believe the debt has been undervalued or see value in the underlying turnaround strategy. Positions are normally held in a trading book, and marked on a mark-to-market basis, with a view to selling at a profit once the value has traded up.

Opportunistic Credit in the current market environment

Over the last 12 months, we have seen four main factors which are impacting the global credit market: inflationary pressure, high interest rates, financial performance/default risk and elevated market volatility.

Inflationary pressures have been intensifying and, in the US, UK & Eurozone where inflation has soared to record highs. This has combined with fading growth momentum, impacted by rising energy prices and supply chain disruption, to create a stagflationary backdrop. We expect an increase in margin compression if borrowers are unable to pass on rising costs, see a reduction in cash available to service debt and increasing technical leverage in capital structures, which could all lead to borrower health being negatively impacted.

Furthermore, in an attempt to curb inflation, central banks have meaningfully **hiked interest rates**. Rising borrowing costs have lead to stretched balance sheets and impacted corporate health. Which could lead to an increased number of covenant breaches and ultimately a **spike in default rates**. As a result, we expect to see an increase in forced seller and corporate restructures as firms face refinancing challenges.

Lastly, we are seeing more market volatility and a lack of liquidity in public credit markets. We have also witnessed material public credit markets sell offs during 2022 which has lead to a reduced appetite from banks to underwrite new deals and a widening of pricing with tighter terms.

Overall, increased **market volatility** is expected to create substantial deployment opportunities for opportunistic strategies. Recession fears may increase bilateral negotiations and force a closure of the valuation gap between buyers and sellers. We believe global dislocation from higher interest rates, financial market volatility and economic uncertainty may lead to an increase in forced seller situations and potential restructurings of defaulted companies, generating robust opportunities for Opportunistic strategies.

But looking further ahead, as inflation rates continues to fall in, bond yields have most probably already peaked. We want to lock in the current high bond yield levels because they could fall when markets start to anticipate more future policy rate cuts.

Conclusion

Overall, Private Credit presents a range of different investment opportunities that can accommodate a variety of investor risk profiles. Currently, we believe that the heightened disruption and volatility in global markets has created a favourable investment environment for opportunistic and distressed manager strategies, and that these strategies can also provide an interesting portfolio hedge in volatile markets.

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Glossary of terms

Absolute return – The nominal return on an investment irrespective of any given specific benchmark.

Alternative investments – Non-traditional investments with low correlations to traditional assets which are typically used to improve portfolio diversification.

Annualised return – The yearly increase (or decrease) in the value of an investment, including the effects of compounding.

Annualised volatility – The estimated spread of returns of an asset on an annual basis. Volatility is usually used as a measure of risk, as a highly volatile asset may offer large negative as well as large positive returns.

Asset allocation – The apportioning of investment assets between different asset classes such as equities, fixed income, liquid assets (cash), real estate, etc

Asset class – Assets are aggregated into groups that share similar characteristics. Asset classes include 'Equity,' 'Fixed income,' 'Liquid assets,' 'Real Estate' and 'Commodities'.

Benchmark – A single or a weighted collection of indices used as a reference or comparison of investment performance.

Credit risk – The risk of loss to your investment arising from a counterparty (eg a bond issuer or a bank) which does not, or cannot, make the required payments as promised or agreed on in a contract.

Cumulative return – Actual (non-annualised) performance over a given period of time.

Derivatives – Instruments such as futures, options and swaps that derive their value from the movement in the price of an underlying asset.

Diversification – The process of spreading a portfolio's holdings over a range of securities and asset classes with the aim of reducing volatility.

Duration – The weighted average maturity of a bond's cash flows or of any series of linked cash flows.

Expected return – The weighted average of a probability distribution of possible rates of return.

Fund of funds – A fund whose purpose is to invest in other funds. Applicable to all asset classes.

Hedge – A transaction made with the intent of reducing investment risk, for example using options or forwards.

Hedge fund – An unregulated fund which is allowed to use strategies that are unavailable to the majority of unit and investment trusts. Hedge funds can be exempt from many of the rules and regulations governing traditional funds. Usually considered as an 'Alternative' asset class.

High yield – Corporate bonds that are rated below investment grade (defined as BB and below).

Hold – Maintain a current level of investment in a particular asset class, market, sector, security, or investment vehicle.

Illiquid asset – An investment that cannot be realised at short notice.

Inflation – Rising prices of individual or a basket of goods and services.

Long duration – A fixed income security that has a modified duration that is longer than 7 years.

Long term – An investment time horizon of five years or greater.

Market capitalisation – Refers to the total value of a company or stock exchange. Usually calculated by multiplying the number of shares outstanding for a company or a stock exchange by the value of a single share.

Market risk – The risk that the value of your investment can fall as well as rise by taking exposure to a particular market. Market risk cannot be diversified away from by increasing holdings of similar securities.

Medium duration – A fixed income security that has a modified duration between 3 and 7 years.

Medium term – An investment time horizon of between three and five years.

Neutral – A portfolio position that is the same as the benchmark would suggest, or: a seven to ten year time horizon.

Overweight – A portfolio position that is higher than the benchmark would suggest.

Private equity – Securities of unlisted companies which are generally illiquid and are therefore held for longer periods of time than more traditional securities.

Relative return – The return that an asset achieves over a period of time compared to a benchmark.

Short duration – A fixed income security that has a modified duration between one and three years.

Short term – An investment time horizon of between one and three years, or a tactical view of less than six months.

Strategic asset allocation – The proportional mix of asset classes which should meet an investor's risk and return objectives over a seven to ten year time horizon.

Tactical asset allocation – An active management strategy that deviates from the long-term strategic asset allocation in order to take advantage of current market views.

Total return – A measure of the return over a stated period that incorporates both the return from price appreciation and investment income, such as coupons and dividends.

Traditional investments – Equities, bonds, and cash.

Underweight – A portfolio position that is lower than the benchmark would suggest.

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures

- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or cancelled. Investors may face uncertainties over when and how much they can receive such payments
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (ie in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (ie contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (ie statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate.

Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to- market valuation.

Illiquid markets/products
In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Default risk
Worst Case Scenario: The issuer of the bond may be unable to meet the required payments on its debt obligations. Investors may lose their entire invested principal in the event of default, insolvency and/or bankruptcy of the relevant issuer (as the case may be).

Risk disclosure on Dim Sum Bonds

Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.

Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.

There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.

Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks. Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets; (b) economic and political uncertainty;
(c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate; (c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies

When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan (“CNY”) risks

There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

Illiquid markets/products

In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

Alternative Investments

Investors in Hedge Funds and Private Equity should bear in mind that these products can be highly speculative and may not be suitable for all clients. Investors should ensure they understand the features of the products and fund strategies and the risks involved before deciding whether or not to invest in such products. Such investments are generally intended for experienced and financially sophisticated investors who are willing to bear the risks associated with such investments, which can include: loss of all or a substantial portion of the investment, increased risk of loss due to leveraging, short- selling, or other speculative investment practices; lack of liquidity in that there may be no secondary market for the fund and none expected to develop; volatility of returns; prohibitions and/or material restrictions on transferring interests in the fund; absence of information regarding valuations and pricing; delays in tax reporting; - key man and adviser risk; limited or no transparency to underlying investments; limited or no regulatory oversight and less regulation and higher fees than mutual funds.

Investments in Commodities

Investments in commodities may involve substantial risk, as the price of the commodity may fluctuate significantly.

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