Managers Crowd into Private Credit to Capture Slice of Growing Market

By Lisa Fu March 11, 2020

Asset management firms are bolstering their private credit capabilities as they seek to capture institutional investors moving money to the asset class.

In late January, insurer Sun Life Financial's asset management arm told *Reuters* that it was seeking a private credit acquisition. Franklin Templeton expanded its private credit business in 2019 with the purchase of B**enefit Street Partners**. Meanwhile, J.P. Morgan Asset Management in December appointed **Meg McClellan** to the newly created role of head of private credit to lead an expansion of the asset class.

As low interest rates limit the return potential from traditional fixed income, institutional investors are in search of alternative sources of income such as private credit, says J.P. Morgan **Asset Management**'s global market strategist **David Lebovitz.** Some investors find that Treasurys are not providing sufficient returns, and deem high-yield strategies unattractive because of their high correlation to the equity market, he says. Meanwhile, private credit has been performing rather well, regardless of the market environment because of the low correlation over the last 15 years or so, he adds.

"You're getting the same kind of income [from private credit] but you're not taking as much equity risk in your portfolio," Lebovitz says. Meanwhile, investor interest in private credit has been increasing, as demonstrated by the long-term fundraising growth over the last few years.

Private credit strategies raised $497 billion over the last four years, from 2016 to 2019, according to Preqin data. In comparison, private credit funds raised just $313 billion from 2012 to 2015. Though 2019 marked a decrease in annual fundraising levels with capital commitments dropping from $120 billion in 2018 to $107 billion, interest in the strategy remains robust. The number of private debt funds in the market have increased for three years straight with 436 funds in market in January 2020, compared with 399 in January 2019 and 354 in January 2018.

Institutional investors are likely to continue flocking to private credit strategies, according to eVestment data. More than half of the U.S. institutional investors in the eVestment survey reported that they were under-allocated to their private debt policy targets by 200 basis points or more,

according to an August 2019 eVestment Asset Allocation Report. The shortfall has been caused by U.S. public pensions increasing their policy allocation to private assets, including private credit, over the past few years. In comparison, U.S. institutional investor portfolios are slightly under-allocated to public market debt by around 4 basis points.

Traditional asset managers are placing greater emphasis on private credit not only because institutional investors are showing interest but because traditional active managers have faced enormous pressure on fees, says **Jon Yoder**, Goldman Sachs Asset Management's co-head of credit alternatives. Active managers are looking for asset classes that command higher fees as the market increasingly rotates into low-fee index funds and exchange-traded funds (ETFs). Private credit and other alternatives still command relatively high fees, he explains.

Institutional investors are also looking to private credit to access better risk-adjusted returns than higher-yielding fixed income strategies, Yoder adds.

Private credit comes with financial maintenance covenants, which provides additional protection that does not exist in the high-yield bond market and remains rare in the syndicated leveraged loan market, he explains. These covenants give the lender more security and constrains the activities of a borrower.

"[Institutional investors] might not want to go into public or private equity but they do need a greater return," says Aon partner and private equity and infrastructure group lead **Karen Rode**. "Private credit is a good place to look."

Asset managers selling a private credit strategy will need to show a good track record to win over investors. Private credit is a sophisticated asset class, which requires more than just picking stock, **Sondhelm Partners** CEO **Dan Sondhelm** says. Firms need to be confident that they can continue to manage the private credit strategy effectively.

"I don't think institutions are going to be buying from firms that have never done this before, even if they say they have done it somewhere else," Sondhelm says. "I think it's going to be an uphill battle when you already have lots of firms that have been doing this for a long time."

Asset managers that want to grow a private credit team organically will have a harder time gathering assets than those that lift out existing teams or acquire an established private credit firm, according to Sondhelm.

An asset manager cannot simply build a private credit product and expect investors to come, Sondhelm adds. Asset managers should know the customers and have existing relationships with the top decision makers to target the right institutional investors, he says. Having marketing to create a strong brand alongside the sales team is one way to speed up the process, he adds.

Given the increasingly crowded market, going to a niche area is one way to distinguish a firm, as long as it can demonstrate a solid track record, Sondhelm says. As more managers compete in the private credit sector, he expects more niche strategies to emerge.

However, the private credit market is not without risks. The higher yield in private credit is driven in part by an illiquidity premium that requires institutional investors to set aside the capital for around five years, a longer period than traditional fixed income, Yoder says. But institutional investors may take comfort in the fact that compared to other alternatives like private equity — which requires around a 10-year lock up period — private credit has a relatively short hold period, according to Rode.

On the asset manager side, private credit continues to present high barriers to entry. A manager needs strong existing relationships to source deal flow, according to **Bob Morgan**, head of **50 South Capital Advisors**, a Northern Trust subsidiary focused on alternative investments. As the amount of capital grows higher in the private credit space and new entrants pile in, there are also concern over the many managers that have yet to be tested by an economic downturn.

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