PRIVITY CREDIT

Privity Credit's Private Credit Outlook 2025

Privity Credit's Private Credit Outlook for 2025

Executive Summary

- Privity Credit expects the growth of private credit to continue at pace in 2025 with further acceptance of its importance in investors' portfolios due to its stable cashflow and lower volatility.
- Prudent managers including Privity Credit are still structuring transactions as though economic conditions warrant pessimism despite increasing green shoots including corporates now planning for their capital requirements on the 'other side' of peak interest rates.
- Companies with healthy balance sheets are getting ready to capitalise on market opportunities. More than 25% of Privity Credit's portfolio made proactive equity raises to best position themselves for opportunities in 2025 and we expect this to continue.
- In our opinion, private credit managers with diversified portfolios and those who are overweight in defensive sectors may face lower incidences of restructurings.
- Privity Credit remains cautious of construction and development real estate (CRE) in general given our expectations that there will be further asset valuation adjustments in this space. CRE is expected to experience a higher than average percentage of defaulting loans in 2025.
- Private credit managers with extensive and through-the-cycle restructuring experience are expected to outperform those managers without such experience, as the mini wave of restructurings ripple through the peripheries of the portfolios.
- Despite changing governments and discussion of trade wars and tariffs, companies are more resilient to shock news now and better prepared to continue to perform in the face of increased uncertainty.
- The market currently values the future earnings of private credit lenders at a higher P/E multiple as compared to banks' earnings, thus reinforcing long-game potential for investors in private credit.

The rise of private credit.

Private credit in Australia generally and direct lending specifically continue to benefit from the structural changes that have unfolded in the US and Europe for the last two decades. These trends are now entrenched in the Australian lending market, with private credit currently estimated to be worth A$205 billion.

Globally private credit has earned its way into portfolio allocations as a sub-asset class producing attractive returns per unit of risk (Exhibit 1). As of June 2024 it accounted for 0.9% of global market portfolios and 11.7% of the global alternative allocation (Exhibit 2).

Exhibit 1: Private Credit Has Outperformed

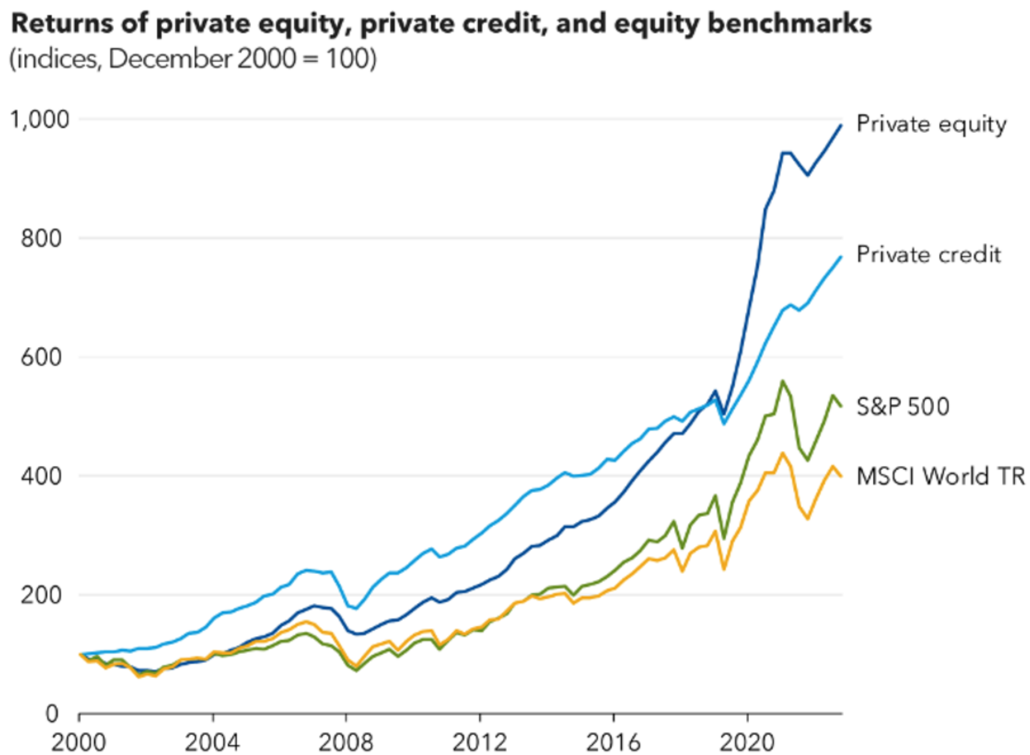


Exhibit 2: Global Market Portfolio Weightings

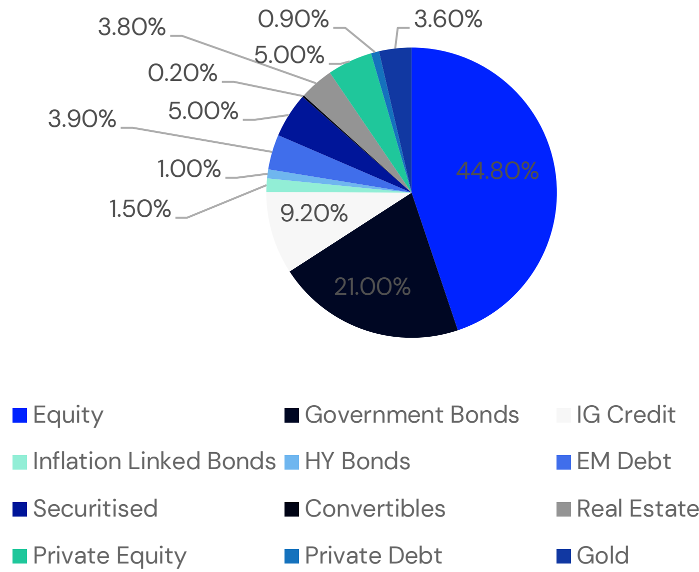
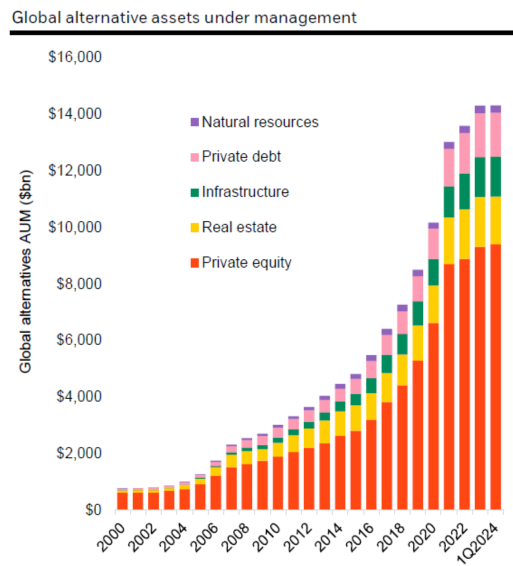


Exhibit 3: Global Alternative Assets Under Management



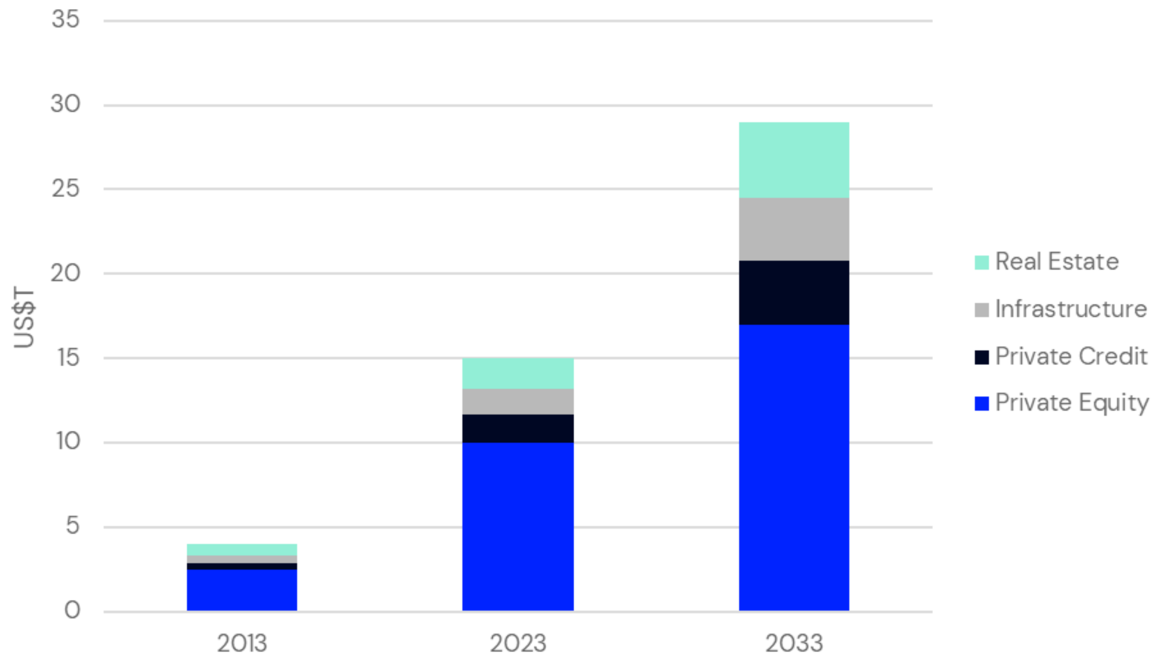
Source: Preqin, BlackRock. As of March 31, 2024 (most recent available as of December 5, 2024). To avoid double counting of available capital and unrealized value, fund of funds and secondaries are excluded. Preqin's universe includes closed ended vehicles.

The Outlook for Private Credit.

We expect favourable outcomes for private credit in coming years, driven by several prevailing tailwinds:

The universe in which private credit sits is expanding. The private market's growth cycle is well understood with its size expected to almost double over the decade ending 2033.

Exhibit 4: Forecasted Growth by Sector



Private credit lending as asset class has more than doubled in size to over US$2 trillion over the last 5 years and is expected to grow by 1.5x over next 3-4 years on the back of changes in how credit is provided and consumed (Exhibit 5).

Exhibit 5: Private Debt Global AUM (Unrealised Value & Dry Powder), and AUM Forecasts

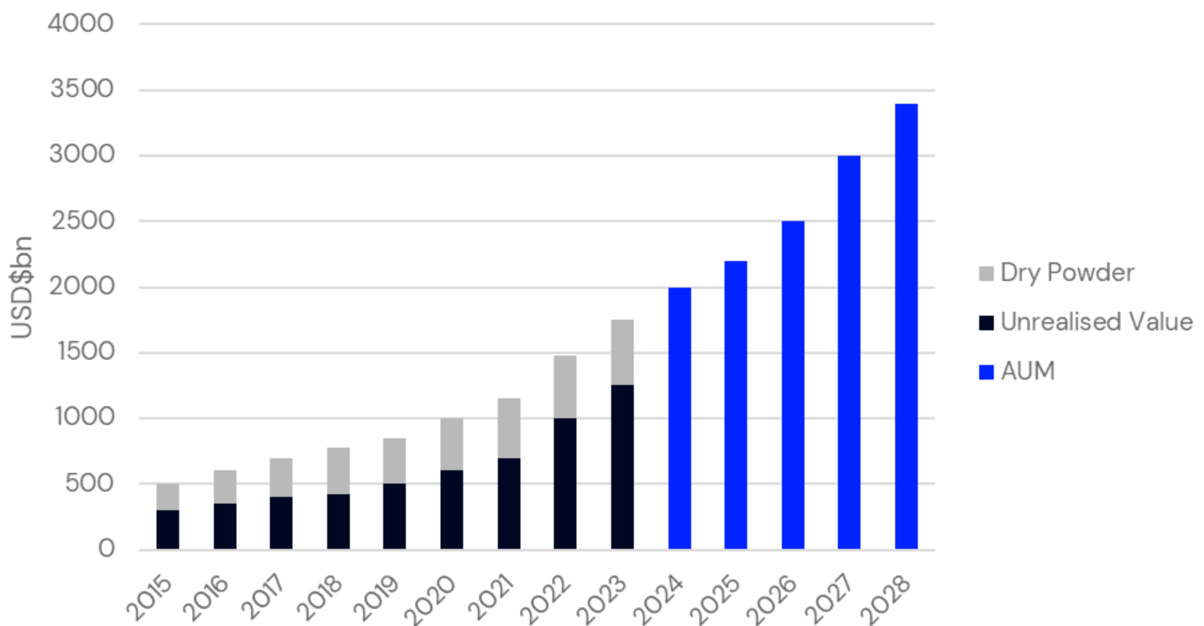
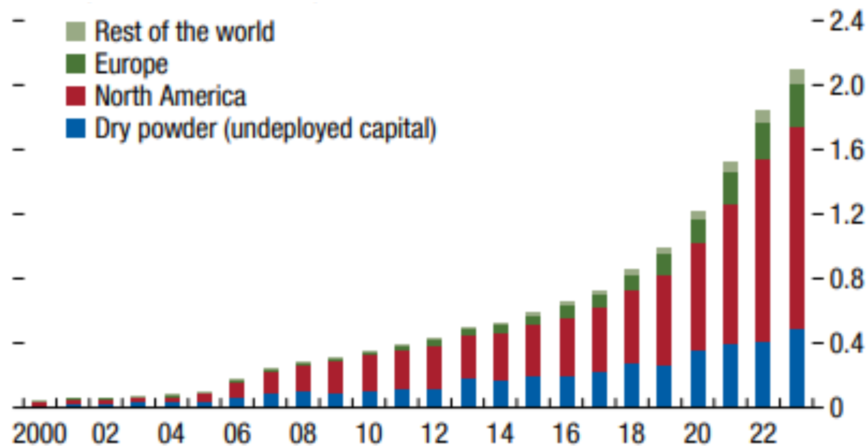


Exhibit 6: The Growth of Private Credit Markets (US$ Trillion)



The Outlook for Private Credit in Australia.

Within the growing private credit world, APAC and Australia are among the faster growing markets, albeit from their existing low base when compared to offshore markets.

Exhibit 7: Banks' Share of Total Credit Provided to the Private Non-Financial Sector – Select Regions

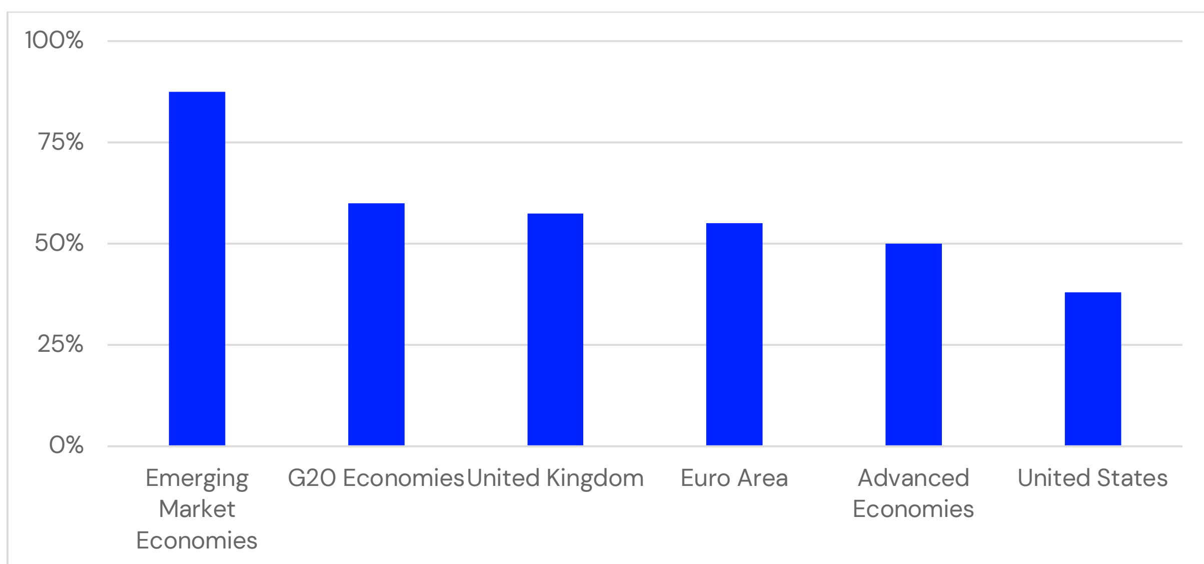
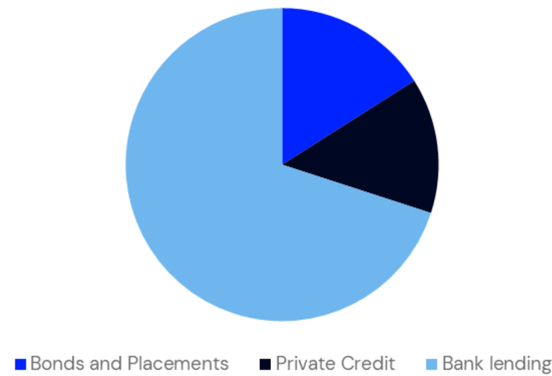


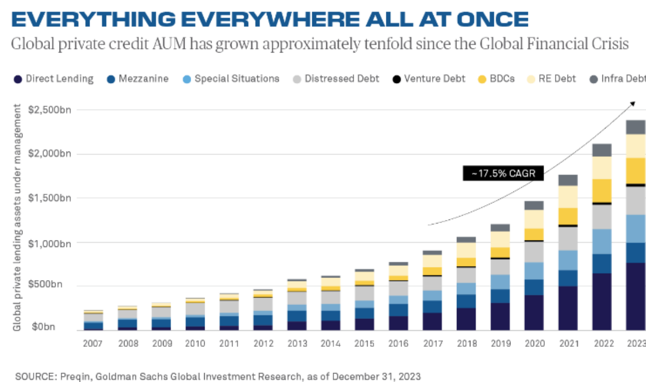
Exhibit 8: Australian Corporate Lending Market



Australia is a G20 economy. It has creditor friendly legal framework and no capital account control (free currency convertibility and repatriation of profits). Yet, its banks' share of total credit in the economy (varying from estimates between 85% to 70%) is closer to an emerging market percentage. This underpins our view that the private credit growth runway is both long and wide in Australia, with room for banks as well as local and global private credit providers.

Alvarez & Marsel's recent report estimates the Australian private debt market is A$205 billion as at the end of 2024. Within the private debt market, business related lending is estimated at A$120 billion or circa 14% of the total lending in Australian market.

Exhibit 9: Growth in Global Private Credit AUM



Australian banks are well capitalised and continue to concentrate on standard lending arrangements. They tend to focus on large cap corporate borrowers, where it also makes economic sense to offer structured lending, and to offer property backed retail lending for small businesses. This is driven by the higher capital allocation requirements dictated by prudential regulations and the higher costs that come with servicing the mid-cap corporate lending segment. As a result, mid-cap corporates have turned to private credit lenders in order to meet their structured lending needs.

Exhibit 10: Australian Private Debt Market

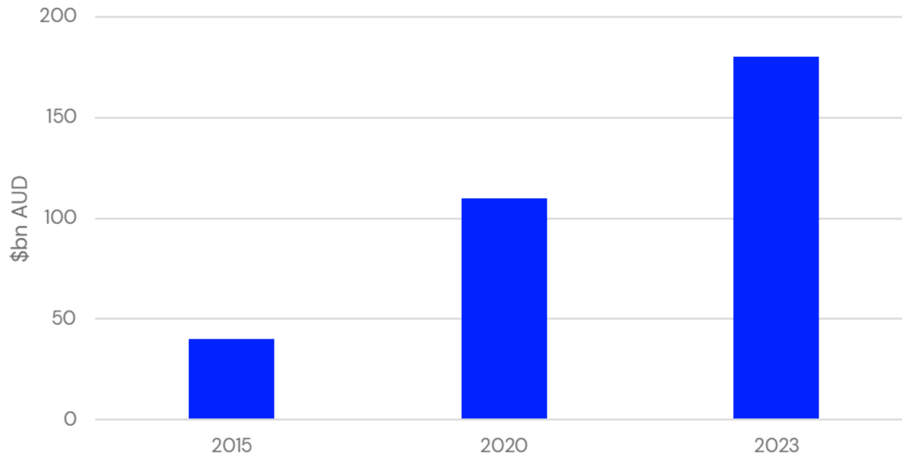
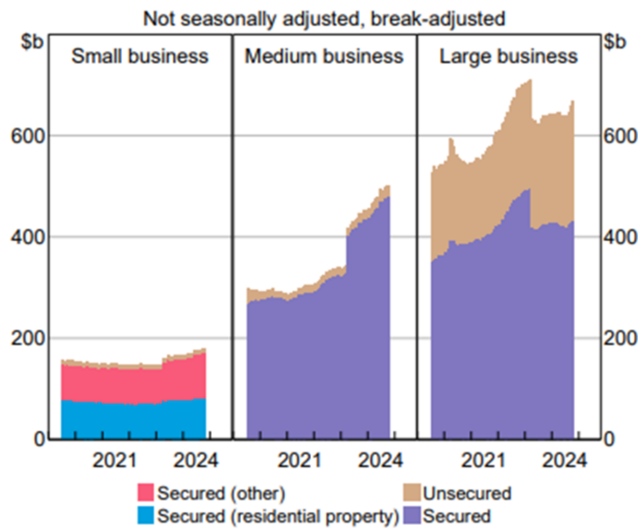


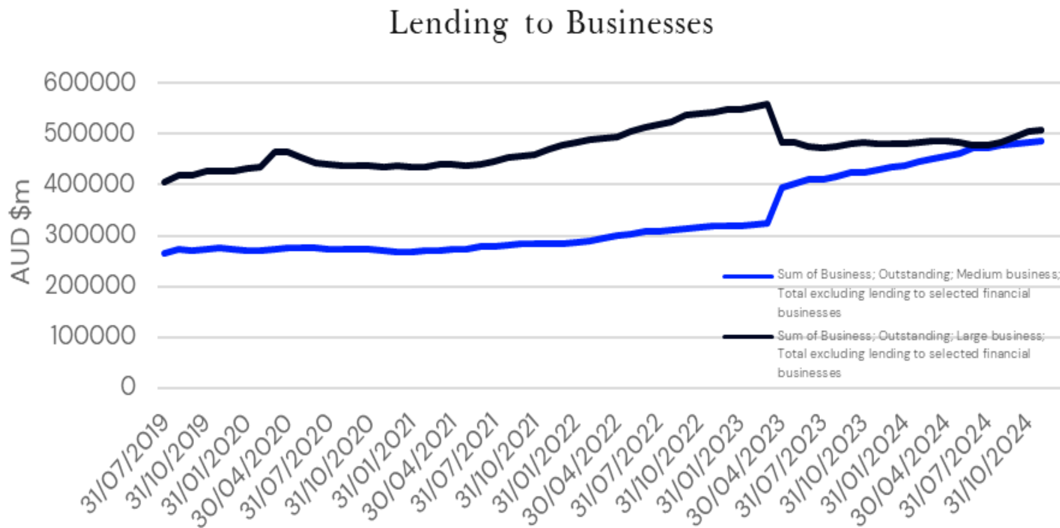
*Exhibit 11: Lending to Businesses**



* Changes to business size definitions in April 2023 resulted in some large business credit being reclassified as medium business credit and some medium business credit being reclassified as small business credit.

Sources: APRA; RBA.

Exhibit 12: Lending to Businesses (Data impacted by change in definitions)



* In 2023, changes in business size definitions resulted in some large business credit being reclassified as medium business credit and some medium business credit being reclassified as small business credit.

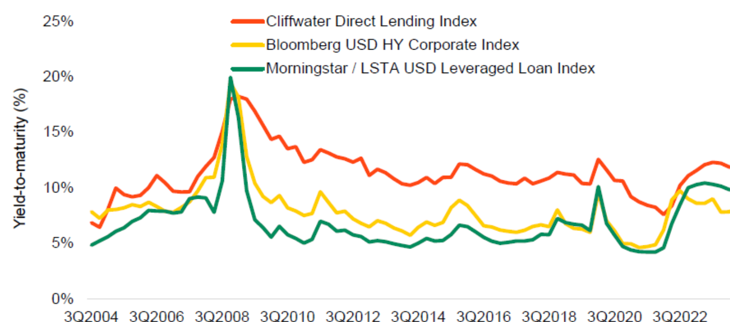
**Changes to business size definitions in April 2023 by RBA led to anomaly in growth curves in the two graphs above. Without, such change in definition the decline in large cap lending trend line and increase in mid cap lending trend would not be significant.*

Higher interest rates have lifted yields for lending across the board. While true for NIM (Net Interest Margin) for banks and other lending platforms, those private credit funds who lend on a "variable rate plus margin" basis are one of the key beneficiaries. The advantage is more pronounced for the funds who have also included floors as protection for a falling rate environment. The longer interest rates remain elevated, the higher the cumulative returns in this sub asset class, provided the underlying credit does not deteriorate.

U.S. direct lending has historically offered a yield "pick-up" vs. public markets.

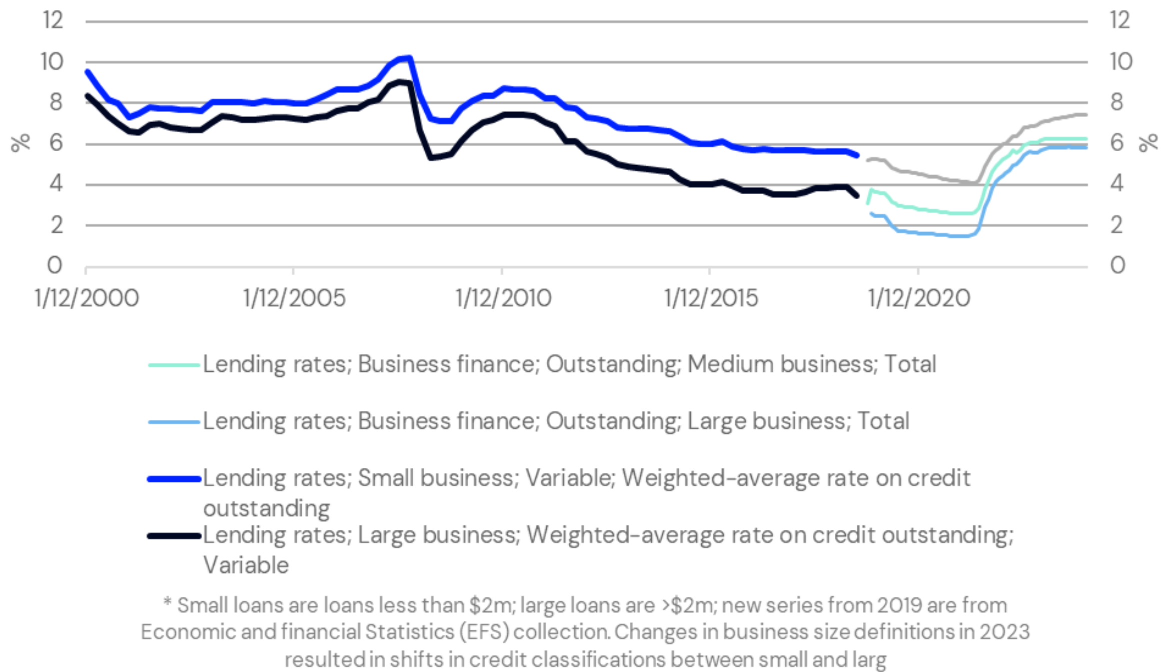
Exhibit 13: Comparison of Yields Across Various Indexes

Average index yield-to-maturity levels for the Cliffwater Direct Lending Index (CDLI), Morningstar/LSTA USD Leveraged Loan Index, and the Bloomberg USD HY Corporate Index



Source: Cliffwater LLC, Bloomberg, Morningstar / LSTA, Pitchbook LCD, BlackRock. As of 2Q2024 (most recent available for the CDLI, as of August 20, 2024). Chart shows yield-to-maturity for all three indices. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

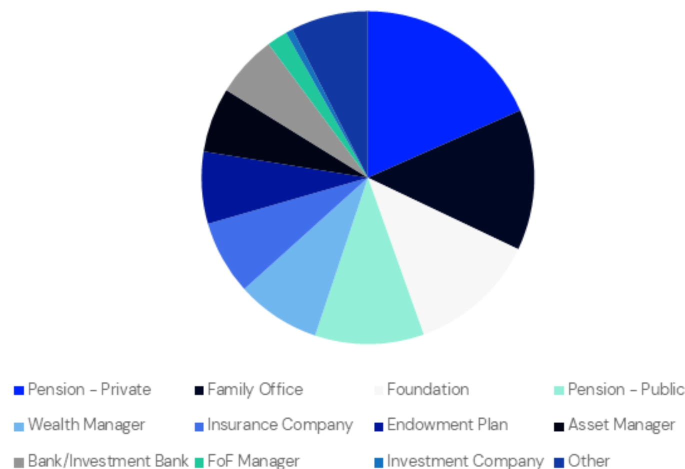
*Exhibit 14: Australian Business Lending Rates**

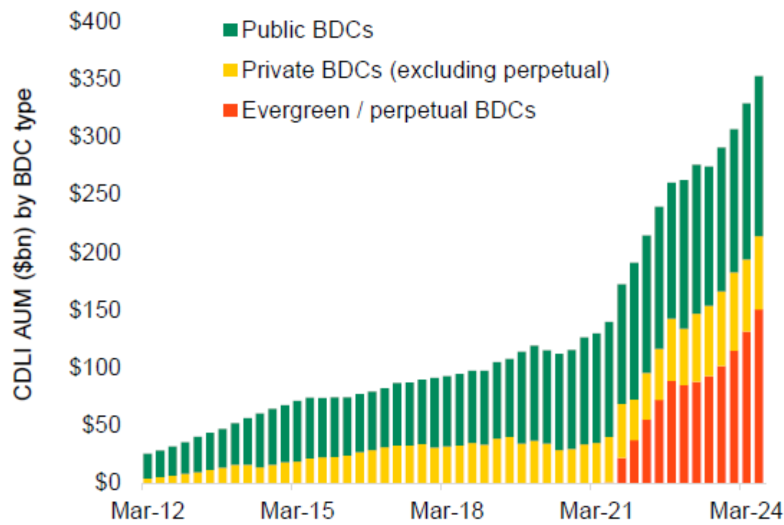


In Australia private credit managers are typically able to extract 2-4% premium in pricing as compared to bank pricing for a similar quality risk. This is because businesses often require customised credit solutions and quick decisioning available from credit funds rather than off-the shelf bank offering.

Private credit is already popular with institutional and wholesale clients. With democratisation of investment opportunities and the rise of wealth management platforms, private credit as an asset class is finding traction in model portfolios through advisers, evergreen vehicles, ETFs and listed funds open to retail investors.

Exhibit 15: Proportion (by count) of Private Debt Investors by Investor Type





Source: Cliffwater Direct Lending Index, BlackRock. As of 3Q2024 (most recent available).

The industry is evolving, aiming to provide a level of liquidity to previously illiquid pools of loans originated by private credit managers. During the last 12 months, various asset managers and banks have launched ETFs backed by private credit loans, such as State Street, Blackrock and Apollo.

While the non-US macro environment had somewhat deteriorated, private credit funds based on disciplined lending and risk management have buffers for downside protection including:

- Structured direct lending with robust covenant protection
- Security over borrowers' assets; and
- Seniority if it comes to enforcement.

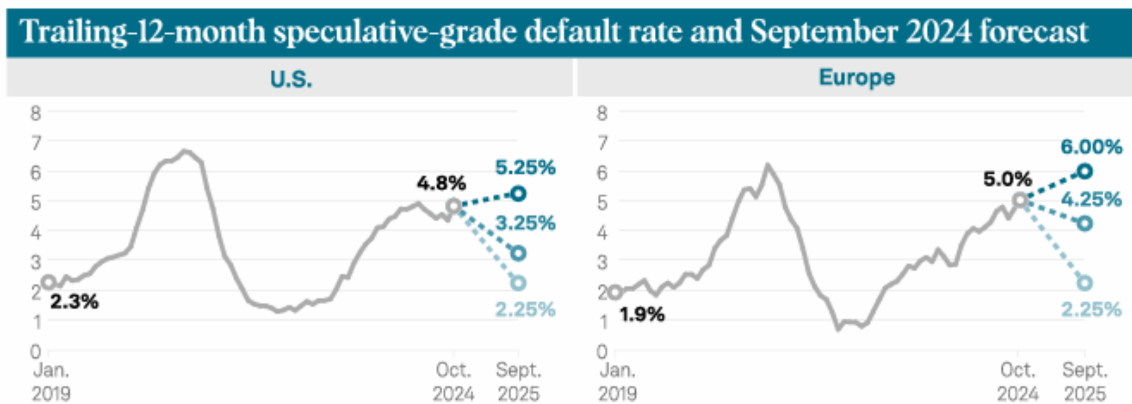
Private credit isn't always a competitor to traditional lenders—sometimes, it's a strategic partner. Banks and insurance companies are increasingly collaborating with private credit funds to fill gaps in financing, whether due to regulatory constraints, risk appetite, or deal complexity. These partnerships aren't just a passing trend; they reflect a broader shift in how capital is deployed, offering businesses more flexible and tailored funding solutions.

The macro environment.

The macro landscape, though weaker, is not as severe as during the GFC – the most recent major trough in the credit cycle.

A proxy for credit deterioration is credit default rates. S&P tracks such default rates across the cycle for various rated issuers or lending instruments/bonds. Exhibit 16 shows the credit default curves for B- corporates in the US and Europe which are not only significantly lower than default rates during the GFC (double digits), but also interestingly S&P's projected base case points to the default rates further declining - for the US at 3.25% and for Europe at 4.25% by September 2025, as compared to 4.8% and 5% respectively in October 2024.

Exhibit 16: Credit Defaults for B- Corporates in the US & Europe



Absence a black swan event or policy (such as a trade war or onerous tariff regime which could induce a major economic shock), we expect the global credit metric as depicted through default rates to stay flat or marginally worsen over the next 12 months. Our view is thus more conservative than the forward-looking S&P base case.

In the Australian context and using the Reserve Bank of Australia's (RBA) data as a proxy, credit contraction seen during the GFC was significantly higher than the post-Covid adjustment impacting the current economic cycle.

Exhibit 17: Credit and Broad Money Growth

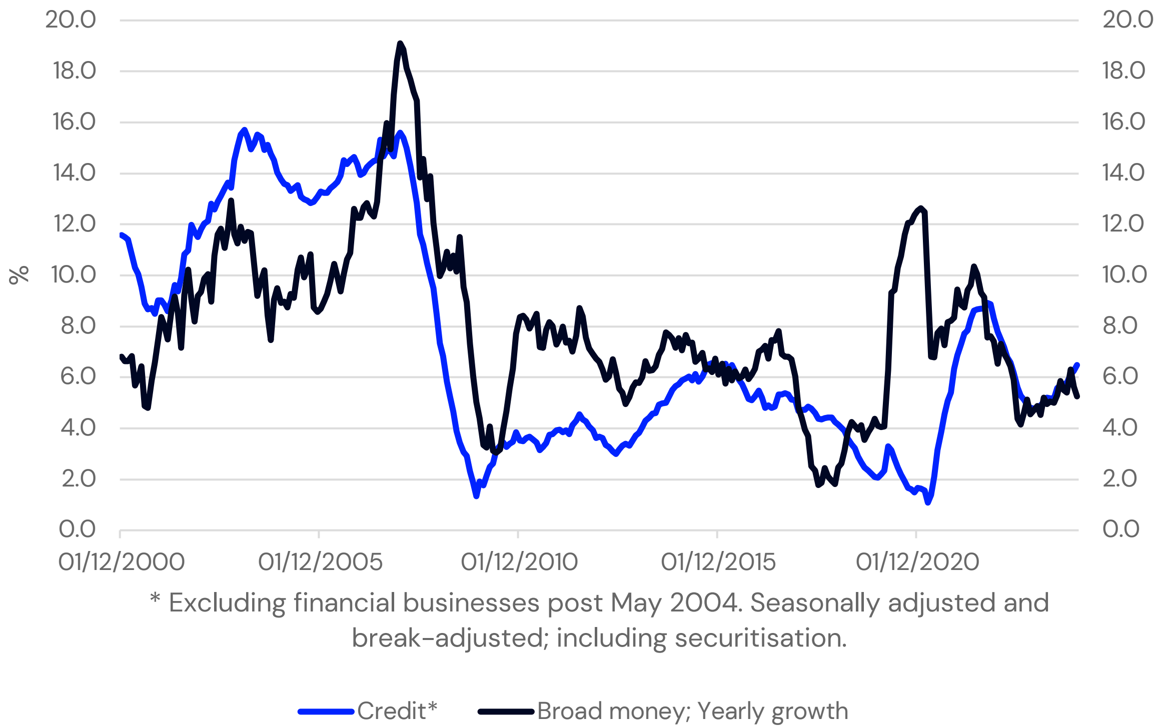
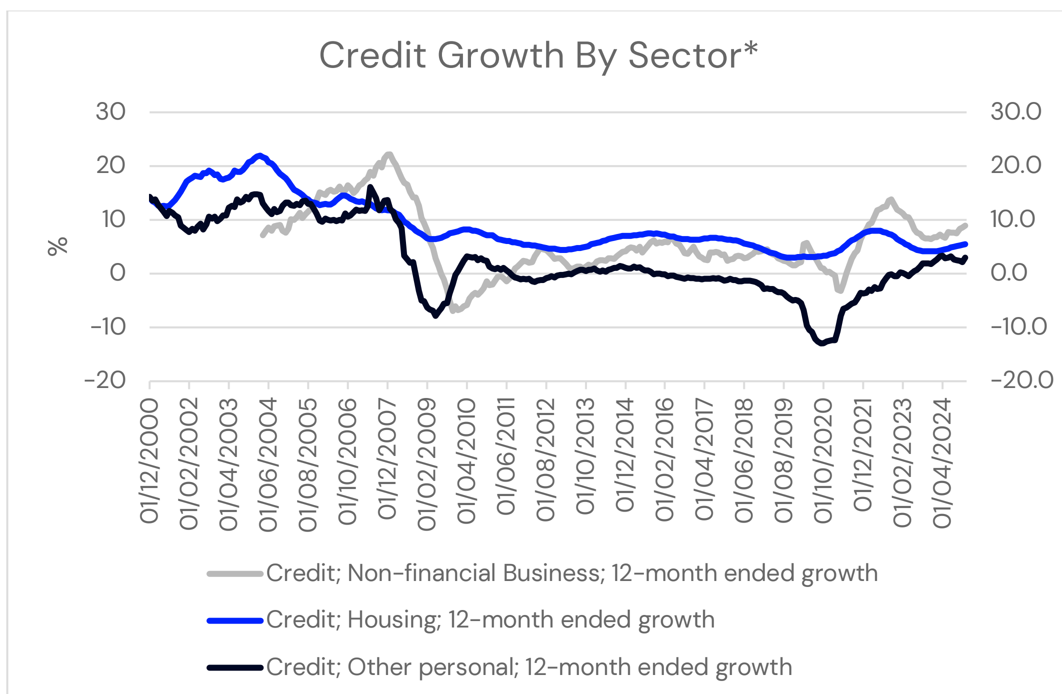


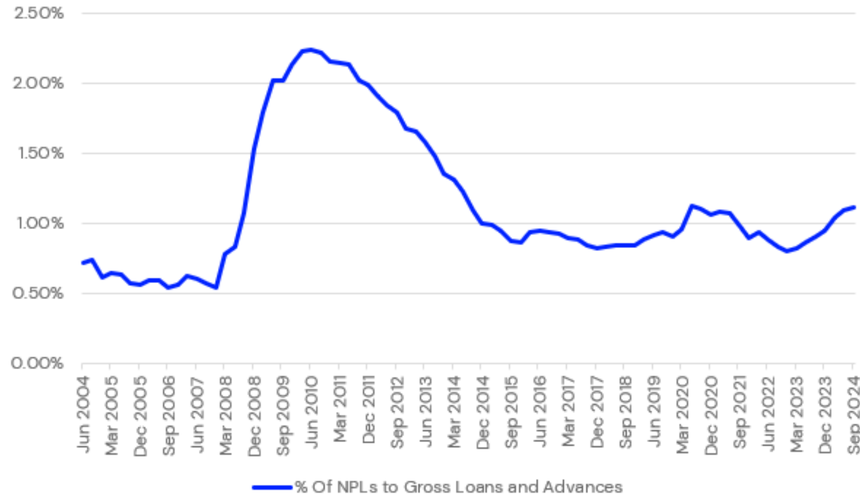
*Exhibit 18: Credit Growth by Sector**



Taking non-performing loans (NPLs) on the balance sheets of Australian banks as an indicator for credit stress, we could see that while NPLs have gone up during 2024, the percentage increase is not at levels that warrant a significant reset in credit appetite. The

slope of the curves in Exhibit 19 also exhibits a gradual build-up of NPLs and provisions rather than extreme economic shock-driven defaults. We expect these curves to taper over the next 12-18 months (typically lagging between economic stress and credit stress) on the back of an interest rate easing cycle by the RBA.

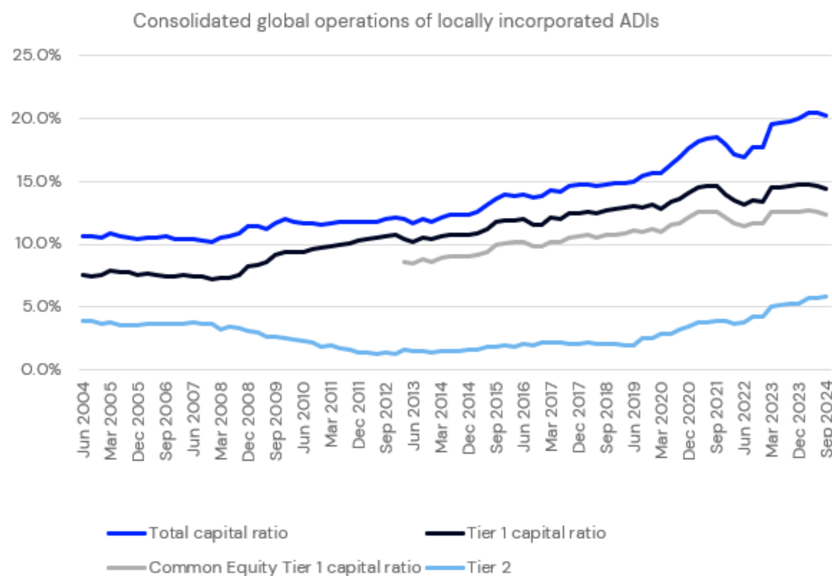
Exhibit 19: Percent of NPLs to Gross Loans and Advances



The factors pointing to a more contained risk adjustment within Australia's credit universe include that:

- Australian banks continue to lend;
- Banks' capital ratios are robust; and
- NPLs currently don't exhibit stress induced spikes.

Exhibit 20: Bank's Capital Ratio



A correction in business valuations (excluding certain sectors such as AI/technology) means lending vintages of 2023 onwards enjoy a relatively higher cushion of safety in the mid-cap segment. While a race to grow market share among private credit funds has

resulted in pricing pressures in large cap lending and covenant dilution, mid-cap lending has retained a relatively higher level of discipline on both fronts.

The future for private credit.

There are degrees of differentiation within private credit. Our views of the future are equally nuanced with returns and risks across the ecosystem viewable through various metrics and dimensions.

One such distinction is senior versus junior lending. Privity Credit's view favours a portfolio that is overweight senior secured lending compared to junior tranches and unsecured loans. Where we will selectively consider junior tranches that offer attractive risk adjusted loans is when they are in robustly securitised vehicles.

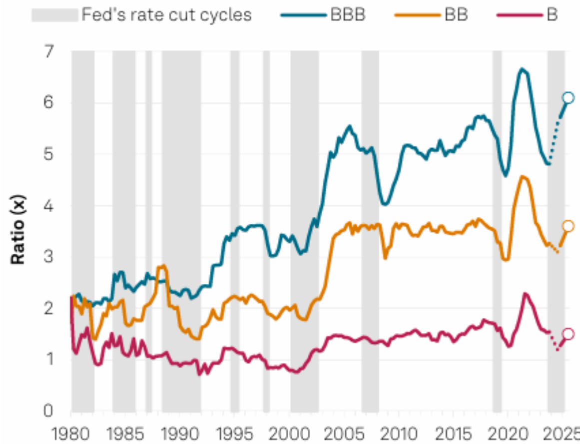
The risk premium across senior and junior tranches in markets like the US, with its significantly positive 12 months economic forecast, has compressed due to fierce competition amongst loan providers. In Europe, Asia and Australia, without the sunny economic forecast backdrop, we do not believe it is a compelling strategy to move up the risk curve. Dabbling into managers exclusively offering junior exposures for the sake of extracting alpha does not justify the increased risk.

The interest coverage ratio (ICR) and payment-in-kind (PIK) trends are playing out differently across the borrower segments. Large cap corporates have proactively pursued refinancings ahead of loans maturing and have built up cash reserves due to subdued M&A activity over the last 12 months. The risk premium for large cap lending is hence considerably compressed for credit providers. ICRs are accordingly comfortable and use of junior tranches /PIK remains low.

We expect M&A activity to pick up during 2025 thus providing opportunities for players at the large end to pursue more deals. The competition among banks and private credit players is expected to intensify accordingly.

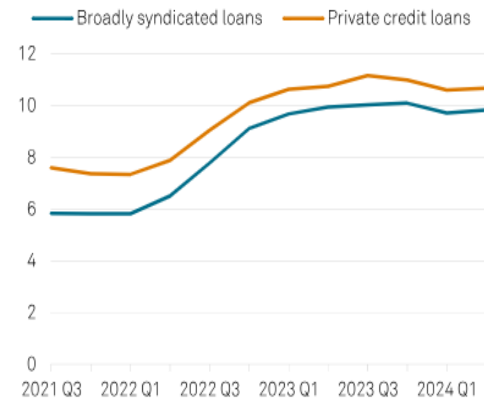
Exhibit 21: Compressed Interest Rate Cover and Declining Loan Yields

Interest coverage to recover, but less so for weaker credits
Median EBIT interest coverage by rating category
Global rated nonfinancial corporates



Shows data for the contemporaneous nonfinancial global corporate rated universe through time, excluding real estate. Financial data from Compustat from 1982 to 1994, and S&P Capital IQ thereafter. LTM data to Q3 2024, with the marker indicating S&P Global Ratings estimate for year-end 2025.
Sources: S&P Global Market Intelligence CreditPro®, Compustat, S&P Capital IQ, NBER, S&P Global Ratings.

Loan yields are coming down
Average yields, broadly syndicated and private credit loans (%)



Estimate of average yields from business development company loan assets.
Source: S&P Global Ratings Private Markets Analytics.
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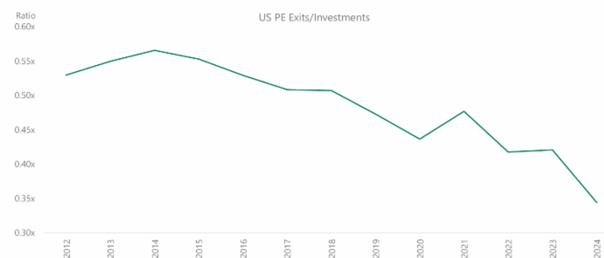
The outperformance of yield for lower-rated credit (as a proxy to mid-cap lending) is expected to continue into 2025, albeit to a more moderate extent.

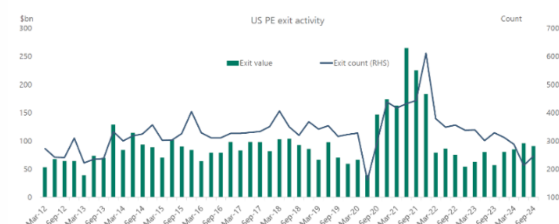
Private equity owned businesses have seen their cashflows stretched due to higher debt servicing costs (higher rates applicable to relatively high debt loads) and distribution to PE owners (to provide returns to their own LPs) because of a significant slowdown in PE exits. We expect ICR to be relatively stretched and PIK usage to be relatively high, until the exits-to-investments ratio returns to its long term average.

Exhibit 22: Slowdown in Private Equity Exits

The exits-to-investments-ratio is declining



PE exit activity declining after the Fed raised rates in 2022Q1



Private credit in the mid-market.

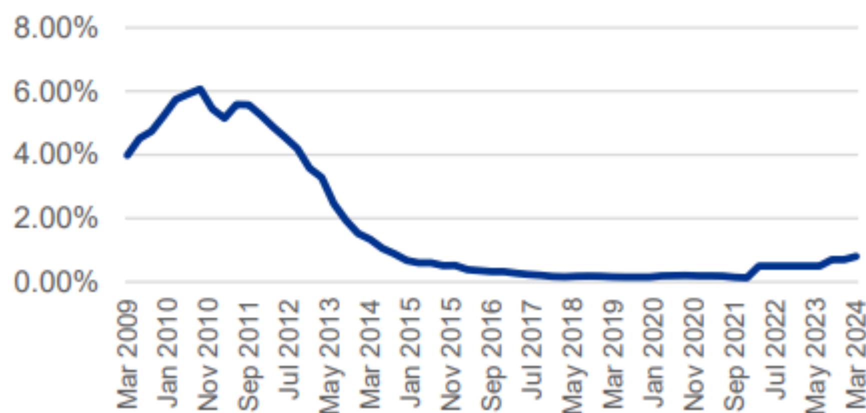
The story for mid-cap businesses is more mixed. Sectors such as construction and development real estate (CRE) are extremely stretched in terms of their ability to service debt. Non-discretionary products and service producers (food, healthcare, transport etc.)

with inelastic demand curves have fared better and have been able to pass on the higher input costs stemming from inflationary trends in their supply chain/high freight costs. With inflation reverting to its medium-term average across major economies (and ignoring ripples effects from tariffs) demand defensive sectors are expected to recuperate some erosion in ICRs previously seen during 2023/2024. Private Credit credit managers with diversified portfolios and those who are overweight in defensive sectors in our opinion may face lower incidences of restructurings.

Private credit in CRE.

While credit conditions are not stressed in general, there are pockets of higher risk such as CRE. Lenders offering construction and development finance are particularly at risk. CRE as a sector is experiencing considerable revaluation, covenant breaches and enforcements.

Exhibit 23: Non-Performing Rate (Share of Banks' Commercial Property Exposures)



Data from one of the big 4 debt advisers in Australia indicates the non-performing rate for loans within CRE is picking up albeit it remains lower than the levels seen during the GFC.

A key risk of leveraged CRE borrowers is that a fall in the asset values may lead to a breach of lending covenants if the borrower has an LVR that is too high and cash flow is too little. Currently, the cost blowouts and supplier delays are adding to the operational stress in parallel with the financial stressors of falling property values and high interest rates. We are of the opinion that if residential property prices decline, this could result in an uptick in issues within the sector although we expect the overall leverage in CRE to decline as the over-geared assets move through workouts.

Defaults and work-outs.

Credit default does not necessarily mean a full write-off or capital loss. Default may be just a breach of a covenant which typically triggers the loan's placement on a watch list, covenant waiver or in some instances a covenant reset. Strong management teams and seasoned shareholders/sponsors proactively work with their lenders to support the business back to financial performance. This may involve numerous strategies including capitalising interest and/or an equity injection by shareholders.

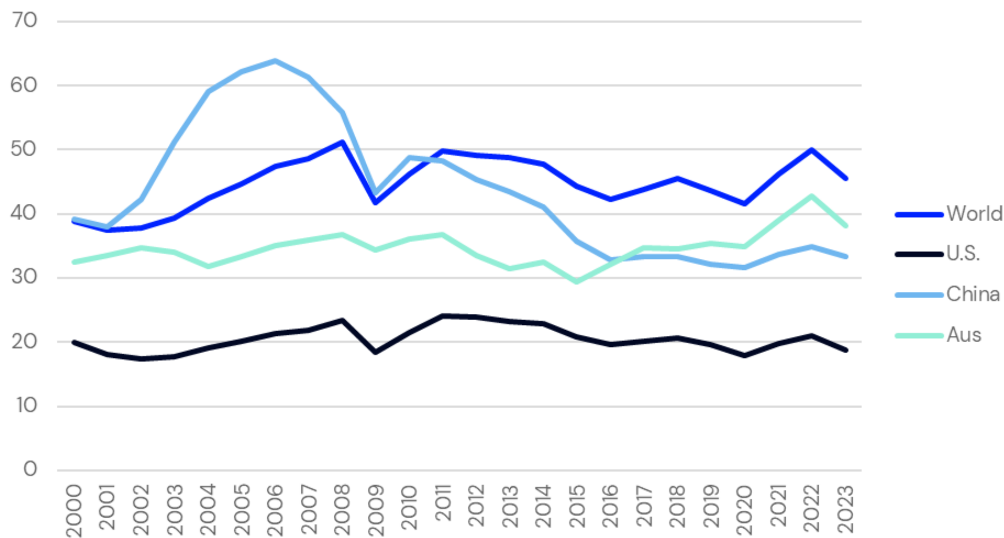
The key for maximum value retention and successful structuring is equitable alignment of interests of equity holders and debt holders.

In an extreme scenario, such as an enforcement, recoveries heavily depend on the borrower's value proposition as a going concern and the business' sale potential, the quality of the security, the structural robustness of the debt claim structure, and how efficiently the enforcement process is run. Typically value realisation through work outs and restructuring yield better results as compared to enforcements. Private credit managers with extensive and through-the-cycle restructuring experience typically outperform those managers without such experience.

Geopolitical forces and the impact on private credit.

More than 60 countries held elections across the globe with several leading economies shifting to "right or centre right". The most impactful shift was in the US with MAGA and associated tariffs threats by President Trump which has increased volatility in global markets. Key tenants of the Trump Administration's tariff strategy currently evident are: deal driven rather than relationship driven; no one is immune – allies or foes; and frequent changes thus amplifying uncertainty. It is too early and difficult to chart out what tariffs, on whom and at what intensity for any meaningful economic and fallout analysis.

Exhibit 24: Goods Trade as a Percentage of GDP (%)



The inventory turnover ratios are expected to decline due to manufactured goods' sales channels redirecting to non-US markets. As inventories build up, price pressures are expected to impact the prices of raw materials, parts and components. Businesses supplying raw materials and parts are expected to face a slowdown in demand. The business base cases thus need sensitivities run for such scenarios to test leverage and ICR benchmarks.

Additionally, the tariffs could be inflationary for the US economy. The resulting monetary pressure could nudge the Federal Reserve into hawkish territory, putting upward pressure on interest rates and strengthening the US dollar. Thus the tariff policy has implications not only for capital markets, but also higher volatility in currency markets if tariff policies are inconsistent and change frequently. Businesses exposed to currency risks via sale or purchase chains could be exposed to further volatility unless properly hedged. The strengthening US dollar could also impact FDI and capex in non-US markets, further affecting the liquidity for businesses operating in these markets. The base assumptions for sensitivities run on business and financial plans of borrowers in relation to foreign exchange and liquidity risks may thus need further analysis as economies adjust to changes in tariffs. (S&P)

We expect well-performing private credit managers to remain vigilant on the following fronts:

- Extensive due diligence of the competitive landscape for products produced and sold by borrowing businesses.
- With the threat of potential US tariffs, European and Asian producers have already prioritised diversification of their export markets.

- Subdued demand in their local markets means volumes previously heading to US can now potentially be dumped in other open markets, thereby threatening profitability of local producers in those areas.
- Australian producers may be exposed to price pressures from cheaper imported goods as is the case for producers in other open non-US global markets.
- For private lenders, due diligence on their borrowers' ability to maintain profitability during times of sustained pressure from such activity is expected to become crucial.

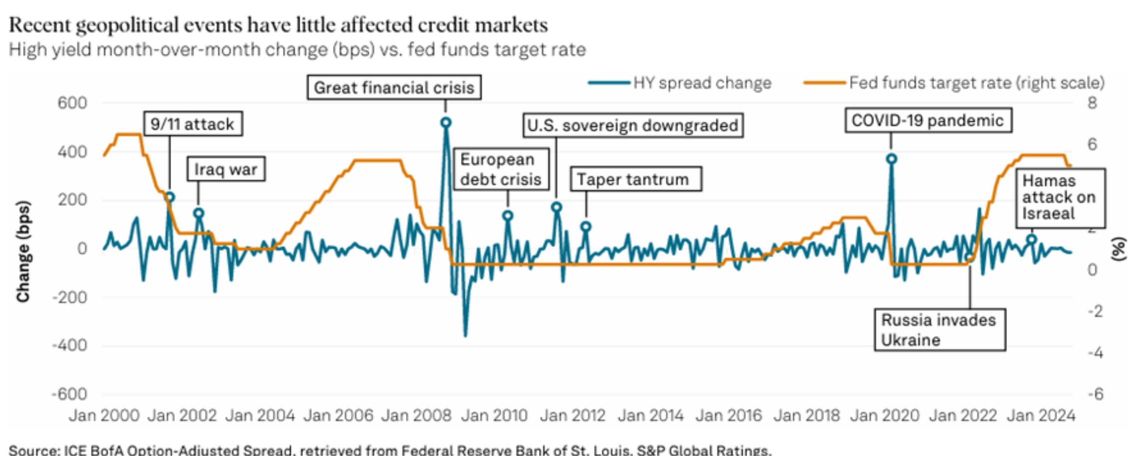
Threat of resurgent inflation.

The other trend we are monitoring in 2025 is inflation resurgence and its impact on rates. Will the narrative move from "higher for longer" to "has the headline interest rate really peaked"?

As the Trump Administration introduces tariffs, consensus among economists is that it will put pressure on inflation. This is due to a time lag between supply chains restructuring and on-shore US manufactured products' higher prices. The resulting pressure on monetary policy and a non-appeasing Federal Reserve potentially point to an upward sloping interest rate curve.

We continually ask ourselves: How will these scenarios play out for private credit? How would a major geopolitical event impact credit markets. What lessons can we learn from past events?

Exhibit 25: Impact of Geopolitical Events



Longer exit queues for PE.

The longer a private equity (PE) firm takes to return capital to investors (limited partners (LPs)), the lower the allocations by LPs to the asset class and new PE funds. Trends such

as "recapitalisation for re-distribution", NAV funding and mushrooming of secondary funds buying PE positions indicate contracting liquidity at general partners (GPs).

There are implications for private credit funds focused exclusively on PE led leveraged buy outs (LBOs), particularly Australian PE funds with pre-covid investments in their portfolios who are likely facing erosion in valuations. Maturing interest rate hedges will also be reset at rates which may create funding gaps in the capital structure and tighter cashflow for servicing.

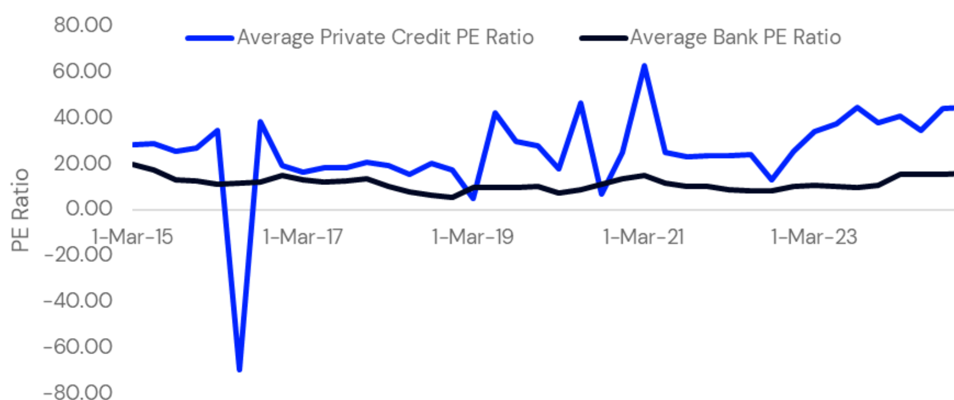
Conclusion.

Increased market volatility has been induced by shifting political sands and elections during 2024. The transmission mechanisms for global policy shifts from "globalisation" to "localisation or protectionism" are varied.

For Australia, the secondary outcomes via supply chains may have a significant impact on business and the financial health of its corporates, even if headline grabbing tariffs are not directly imposed. For private credit investors, this offers both opportunities as well as some residual risks if not proactively monitored. We expect managers' performances to disperse based on how effectively these risks are managed during next 12 months.

We leave you with our concluding view that private credit is not only here to stay but the market also puts higher value to the earnings generated by private credit funds as reflected in average P/E ratio of top listed US private credit lenders of 44.73 as compared to the average P/E ratio of top 5 US banks at 15.96.

Exhibit 26: Comparison of Average Private Credit & US Bank PE Ratios



Contact us for more information

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