The evolution and opportunity of private debt

By Sanan Pillay

19 Apr 2024

The proliferation of private credit is a positive development for South Africa, as it potentially fuels more growth activity and drives critical capital injections into impact and alternatives investments like infrastructure.

Source: Supplied. Sanan Pillay, portfolio manager at Sanlam Investments Multi-Manager.

Globally, private credit has seen explosive growth to over $1tn in outstanding allocations in April 2022 (Preqin). South Africa may lag, but the opportunity is immense.

As traditional lenders such as banks have been driven from riskier lending by regulations, private debt has stepped in to meet the demand. Here, we deep dive into the evolution of private debt, its burgeoning local boom – and what's next.

Where the boom began

Prior to the Global Financial Crisis, private debt did exist as a nimbler alternative to public debt. However, the financial crisis catalysed the growth of the space, and forever changed the world's debt markets.

Post the crisis, regulatory shifts and restrictive lending policies to improve banks’ risk management had a two-fold effect on the financial markets. Firstly, the catapulting capital rate meant many banks no longer wanted the riskier forms of private debt lending on their books. In many cases this led to people with specialised debt origination and structuring skills leaving the banking industry to set up their own firms, which prompted a boom in the private debt industry.

In a time of limited liquidity being offered by banks, the new structure of the private credit market provided borrowers with access to alternative forms of financing from private debt managers that were often more nimble and able to structure lending arrangements that spoke to the needs of the borrower in a more bespoke fashion.

At the same time, low interest rates in the US made private credit an attractive means of financing deals at a time when the private-equity industry was growing rapidly.

This meant that this private equity boom was accompanied by a large increase in ‘sponsored lending’ which is when a non-bank lender provides debt funding to a business that is backed by a private equity firm.

So, it was a combination of regulatory shifts, restrictive lending policies, mergers and acquisition (M&A) activity and more that started the private debt ‘boom’.

Developed markets' boom status

The proliferation of tech, such as virtual data rooms and private company trading exchanges (e.g. Nasdaq Private Markets), has enabled private markets investing to gradually move towards closing the accessibility and ease-of-use gap that existed relative to public markets.

The increased investor interest in private-equity investing has meant that companies are able to raise larger sums of capital privately, which results in them staying private for longer.

M&A activity may have reduced in the past year, but the rise in interest rates means that better yields are being achieved on private debt funding that’s being extended now – given that most private credit has a floating-rate structure.

Impact manager Acre raises $100m for African climate infrastructure
Virginia Furness 17 Apr 2024

Floating-rate debt is tied to a benchmark rate, which means that during high interest-rate periods, the interest rate earned goes up. This of course does put businesses under more cash-flow strain, but if strong borrowers are selected, and the appropriate security, covenants and deal structure are in place, the net effect is for investors to earn greater returns during periods of high interest rates.

Higher yields – in a time when private equity and venture capital, for example, have been under a lot of pressure – has meant investor interest in the private debt space has increased dramatically.

Add to this the fact that there are structural regulatory factors driving debt financing out of the banking system and towards the private debt industry, and the conditions are in place for the private-debt market expansion to continue for some time.

Private credit: The SA story

Relative to developed markets, South Africa has lagged, with local asset managers only seeing a significant pick-up in interest in private debt over the last year or so. Recent regulatory shifts mean pension funds can now invest more in private markets, which has increased activity. These revised limits are also prompting more South African investors to consider including private debt investment opportunities.

Many local investors have not been achieving their desired returns in the public market space, which has further driven interest in the private debt realm.

Amplifying impact

The rise of private debt is a great opportunity for local businesses that may have historically struggled to access financing from South Africa's more 'conservative' banks.

A well-capitalised and dynamic private-debt lending ecosystem is good news for corporates and SMEs as it enables them to access debt on demand, at reasonable terms. Private debt also poses an immense opportunity for more sustainability- and impact-led investing.

Huge debt costs mean climate spending could make emerging nations insolvent
Libby George 16 Apr 2024

Within Sanlam Investments we have, for example, the Resilient Investment Fund that's focused on providing capital to entrepreneurs and commercially viable SME businesses that are well positioned to address some of South Africa's most pressing challenges, and the Sustainable Infrastructure Fund that aims to foster greater pipelines of infrastructure investment through corporate and industrial sponsors.

Private debt amplifies our impact on the ground by enabling us to lend to smaller businesses that typically have a greater cumulative effect on job creation.

As a multi-manager, we also directly engage with fund managers to track if and how their underlying investee companies are contributing towards the UN's Sustainable Development Goals.

South Africans have always had an ethos of taking care of each other, so in this sense investing with an impact lens feels like a natural fit for local investors.

What's next?

Investor interest in private debt is likely to stay strong, particularly as it's localised nature can shield it from broader macroeconomic factors at play.

With a number of new private equity funds having come to market recently and with South African firms currently being priced attractively, we expect an uptick in M&A activity, which could catalyse even more private debt activity.

Private debt is a fascinating and dynamic new part of our investing ecosystem, and we remain excited about the opportunities presented by the space for our investors - and for our country.

ABOUT THE AUTHOR

Sanan Pillay is the portfolio manager at Sanlam Investments Multi-Manager.

For more, visit: https://www.bizcommunity.com