

## FUND FINANCE FRIDAY

## Fund Finance Credit Availability in 2023: Not Just Banks

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As remarkable as the year has been for banks, 2022 will be remembered in part for the continued ascent of private credit. The scale and significance of these non-bank lenders became clear this summer when private credit funds stepped in to close a number of multi-billion unitranche loans as banks retreated from the leveraged loan market.

The growth path in private credit has been well documented. Prequin, for example, forecasts private credit AUM to more than double from \$1.21 trillion in late 2021 to \$2.69 trillion by 2026. To put that in context, private credit AUM grew from one-sixth the size of the U.S. ABS market at the end of the GFC to now nearly equaling the total size of that market. Of course, this is not a perfect comparison, but it illustrates that private credit has become a globally significant source of capital.

Given these trends, it's natural for fund finance market participants to think through the future significance of non-bank lenders to our market. To this point, it is important to highlight some differences between traditional direct lending and fund finance. For a corporate borrower, the attraction of a single-lender, bought deal is compelling, especially at this moment in markets. For one thing, borrowers, which are most often sponsors, can transact knowing that financing is locked in. That's been a challenge this year. Then, after origination, a single lender or small group can be much more responsive to a borrower's needs than a syndicate.

In fund finance, we don't have the same challenges. Execution works because of the relationship depth, pre-commitment credit approval, and an originate-to-hold business model. Our loans are not structured with the same price-flex mechanics as leveraged loans. And the majority of loans (91% by deal count in the first three quarters of 2022) in fund finance are bilateral. Add to that the pristine historic loan performance, and it becomes clear that we don't have the same problems for private credit to solve.

So, if private credit is to grow in fund finance – we think it will – the growth may be more about what challenges fund finance can solve for private credit lenders. Private credit funds are sitting on \$425 billion of dry powder based on PitchBook data. Sponsors get paid on deployed capital,

so the clock is running on the committed capital while significant underwriting resources are already in place.

Average fund performance in 2022 also shows that private credit funds would benefit from broader diversification. Private credit returns softened in 2022 and generally tracked the broader loan market fairly closely. Fund finance exposure could reduce that correlation and help funds with both the deployment and the diversification challenge.

Answers, however, as we've [previously written](#), are unlikely to come from subscription lending. Even with one-month term SOFR up by 420 bps so far this year and subscription facility margins moving wider, unlevered returns don't quite pencil out. Aside from the hurdle return issue, there are also relative value considerations. Private credit funds are now able to hit double-digit returns in their core direct lending programs. Then, even if subscription pricing widened further, we think the LP borrowing base underwriting process will still fit best at banks. NAV lending is a more natural fit as loan margins align better with private credit cost of capital. Subordinated subscription debt could potentially be another avenue for growth in 2023, especially as the product evolves and in the event banks move to lower advance rates or sizes on new credit facilities.

Then there's the under-developed market for structured fund finance. Bank lenders have more incentives than ever to advance credit risk transfer solutions. Here, a private credit fund as a subordinated investor could gain exposure to a pool of high-quality subscription loans at a levered return.

Collateralized fund obligations may be another potential growth area where private credit funds can provide financing on a diversified basket of funds with the benefit of structural subordination and a credit rating. While the CFO market has been around since the early 2000s, LPs may be more motivated in 2023 to look for portfolio management tools, and CFOs can help free up liquidity.

So while we think bank credit availability is secure, we look forward to the evolution of fund finance in 2023 that may see more tapping into the vast and growing pool of private credit capital.