Access the opportunities.

Investing in Global Listed Private Credit

February 2024

Executive Summary

The giants of the investment world have been allocating more and more to private credit.

The private credit market has been growing steadily for many years and its yield characteristics have been attracting investor attention.

Private credit companies have been filling a lending void left by banks that, since the GFC are subject to greater capital requirements and investment in these companies has been becoming popular because of the higher yields they have paid.

Private credit companies generate income by lending to and investing in non-public businesses using a variety of sources, such as debt and hybrid financial instruments, outside of the traditional banking system. In short, they provide capital to small and medium-sized private businesses, and in turn, give investors access to the growth and income potential of private credit.

While investments in private credit is generally exclusive to large institutions and difficult to access, that is changing.

In this paper, we articulate the benefits of investing in listed global private credit. The paper identifies:

1. characteristics of private credit companies;
2. a historical context of their growth;
3. the potential income benefits for investors of including an allocation to global listed private credit in their portfolio; and
4. the different options available to Australian investors when looking to invest in this sector.

We think an investment in global listed private credit securities could be used to enhance the yield of an income portfolio to the degree that matches the investor's risk tolerance. Because the companies using the loans are typically smaller, middle-sized companies and the loans issued can be riskier, the interest rates associated with private credit tend to be attractive relative to more traditional income-generating asset classes. However, there is a higher credit risk associated with these companies and loans, hence the higher risks compared to traditional credit.

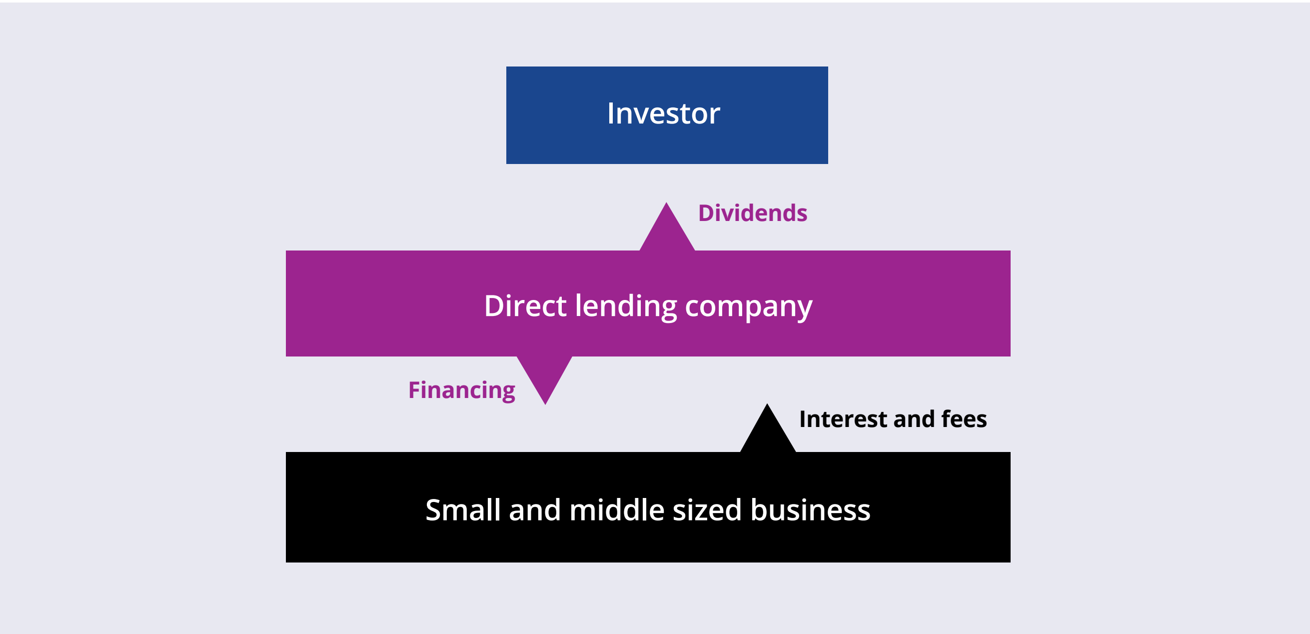
Global listed private credit securities could be susceptible to equity market volatility, so most investors likely should not consider these as a replacement for their traditional income exposure, rather an 'add-on'.

The growth of the global listed private credit sector will continue to be driven by two structural factors: increased capital requirements for banks forcing small and medium-sized businesses to seek capital from private lenders and an increase in companies and institutions offering private credit. These factors together with the demand for income as populations age will contribute to the asset class's growth as it becomes a larger part of the income component of portfolios.

1. The characteristics of private credit companies

Private credit companies generate income by lending to and investing in businesses using a variety of sources, such as debt and hybrid financial instruments. They provide capital to small and medium-sized businesses, and in turn, give investors access to the growth and income potential of private credit that are generally exclusive to large institutions and difficult to access.

Most listed private credit companies are closed-end funds that hold a portfolio of loans and distribute to their investors most of the net income from the borrowers they lend to.



You can see in the above, that private credit companies issue loans to small and middle-sized non-public companies. They collect fees and interest on the loans they issue.

In some jurisdictions, there are rules about how much listed private credit companies are required to distribute to their investors. For example, in the US, given their status as a registered investment company under the Investment Company Act of 1940, private credit companies are required to distribute at least 90% of their net investment income to shareholders. For this reason, investing in private credit companies is associated with income investing.

One of the advantages of private credit is that typically, the rate structures are 'floating' with no duration in the portfolio. The rate is often linked to a short-term index such as SOFR (Secured Overnight Financing Rate) and private credit companies typically use "SOFR+ a margin" as a pricing mechanism. Older loans may use LIBOR as index.

In its "Listed Private Credit White Paper", leading research house in the field of listed alternatives and index company, LPX provides the following example of a listed private credit company.

Case study SLR Investment Corp.

SLR Investment Corp. is a yield-oriented business development company based in the US. The company invests in leveraged middle-market companies in the form of senior secured loans, including first lien (first lien debt refers to a type of secured debt that holds the highest priority in the repayment hierarchy in the event of a borrower default) unitranche and second lien debt instruments.

Characteristics:

- Since inception in 2011 average yield of 9.8% p.a.
- 101 sector-diversified portfolio companies
- Total Assets > USD 2.18 bn; +90 industries

Example of loan investment by SLR Investment Corp.:

alimera	Alimera Science
Principal	USD 20 million
Interest rate	Libor +7.65% (floor)
Type of loan	First lien
Maturity year	2024
Industry	Life Science

Listed private credit is not the only way to access private credit.

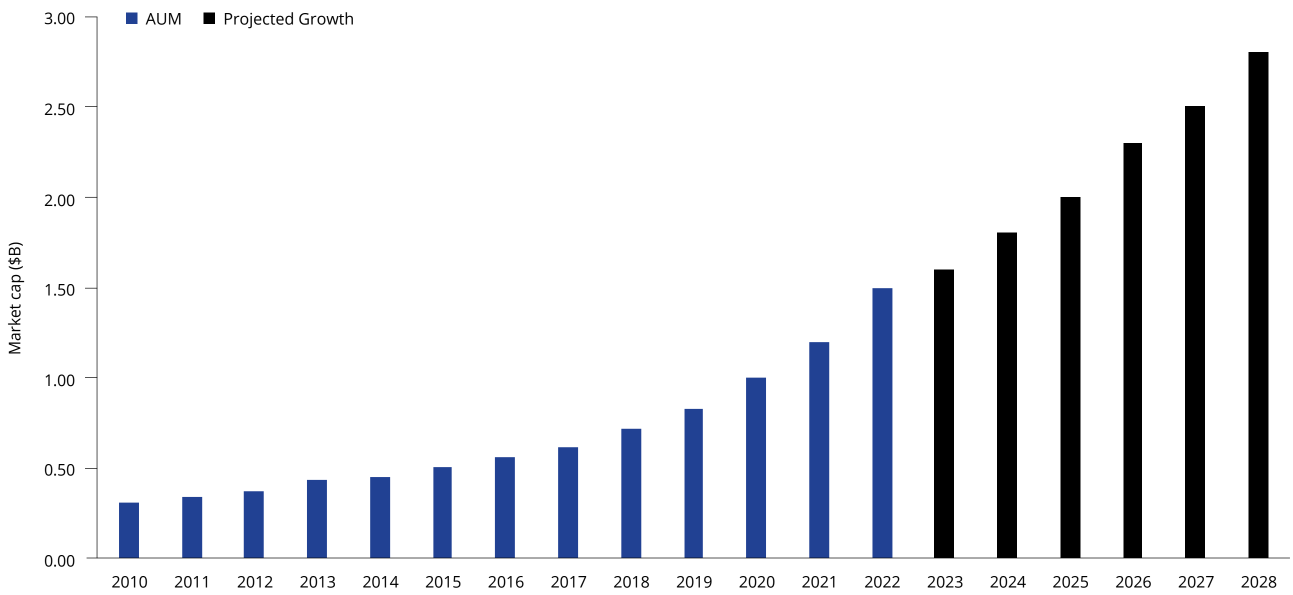
For Australian investors, private credit investment has been generally limited to high net worth and the large institutional investors such as industry superannuation funds who don't require immediate access to cash. These investors can take concentrated positions directly or allocate to large closed-end funds with long lock-up periods and large minimum investment requirements. Some large institutions and superannuation funds may invest directly with inhouse specialist teams.

The advantage listed private credit companies have over other ways of accessing private credit are outlined in section 5. In summary, there is no minimum investment for an investment via a listed private credit company/fund. In addition, the investment can be traded daily via the stock exchange. Furthermore, it should be noted that some private credit funds may only focus on individual credit strategies or sectors. An investor who seeks to invest in a broadly diversified portfolio of different credit strategies must therefore participate in several funds.

2. Understanding the growth of private credit

Preqin estimates private credit will grow to US$2.8 trillion globally by 2028.

Chart 1: Private credit booms



Source: Preqin Pro, Bloomberg

To understand the growth of private credit, it is important to understand the historical trends that have led to it becoming one of the fastest-growing asset classes in the investment world. Loans between non-bank lenders and borrowers have been around as long as banking, but before the 1980s this was a tiny part of all money lent. It is difficult to track private credit before that time.

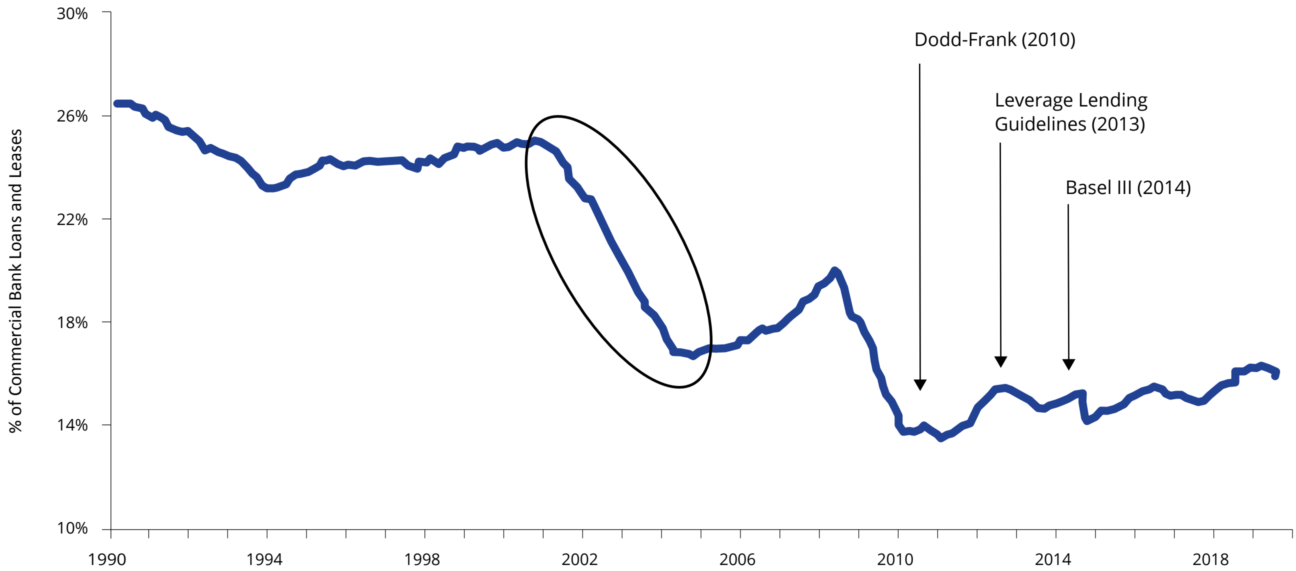
Prior to the development of the private credit market, the US high-yield (then known as junk bond) market came into existence in the late 1970s/early 1980s. These alternatives provided loans to small- and mid-sized companies that were not investment-grade rated so couldn't access long-term, fixed-rate debt financing. Before this time the US corporate bond market was focused on investment-grade rated companies. That changed and these new, riskier, bonds opened long-term debt financing avenues for companies not yet rated, or those in distress. As you would expect the interest rates on these loans were higher than investment-grade bonds.

In the US, the disclosure and process for issuing high-yield bonds is governed by the SEC. While this new market became an important financing vehicle for small- and middle-market growth companies that found banks too conservative and often unwilling to lend it was expensive, and required credit ratings, disclosure and large minimum sizes. They started to look elsewhere.

According to Tim Hall (2022) "To address the financing needs of smaller companies, a private market alternative to public high-yield bonds began to develop, known as the "mezzanine market." The most important investor contingent that developed during the 1990s, according to Hall, were dedicated mezzanine funds focused specifically on investing in private mezzanine financings.

This private credit market broadened and expanded throughout the 1990s and 2000s. One of the significant drivers of this expansion was a significant increase in merger and acquisition activity with the US banking sector, consolidating the industry. This was having an impact on the supply of capital for many small and medium-sized enterprises. The percentage of commercial and industrial loans held by banks declined as a result.

Chart 2: Commercial and industrial loans as a percentage of bank holdings



Source: Ares, Federal Reserve H8 data, December 31, 2019.

The result was a focus on larger commercial and industrial borrowers, with banks overlooking smaller and medium-sized borrowers. The mezzanine market grew.

The aftermath of the GFC represented the next evolution of the private credit market. New regulation, introduced after the crisis, to prevent it from reoccurring, led to higher capital requirements for banks not only in the US but also in other countries that are part of the Basel Committee on Banking Supervision.

The impact was that riskier loans would incur higher capital costs. The impact of this was that banks around the world were less willing to lend to small and medium-sized borrowers.

As the saying goes, when one door shuts, another opens. As the bank doors shut to these companies, the door opened for the growth of private credit funds and companies to provide direct lending to the 'riskier' small and medium-sized companies in need of capital.

Direct non-bank lenders, which initially consisted of private credit fund managers, focused on providing debt capital directly to non-investment grade companies. In most cases, this debt was 'senior' and secured by hard assets. Private credit fund managers packaged up these loans as funds. For investors, investment in these funds, often closed-end, was restricted to those with large balances and involved large lock-up periods. It was during this time large funds, with long-term investment objectives like large superannuation funds and the Future Fund, started to invest in private credit.

According to Hall, "As independent credit funds proliferated, more well-established institutional asset managers began focusing on the strategy and raised direct lending funds to capitalise on the attractive returns from lending to small- and medium-sized companies."

Listed private credit companies started to proliferate. These are companies that are traded on a regulated stock exchange. A representative example of a listed private credit company is Oaktree Specialty Lending, which is listed on the Nasdaq Exchange. The regional focus of the private credit investment portfolio is in North America and is diversified across a broad array of industry sectors.

LPX counts, as of 31 December 2023, 42 listed private credit companies in exchanges around the world.

According to LPX, "A key challenge is the identification and categorization of the relevant universe of publicly traded companies that provide debt capital to medium-sized companies ("Listed Private Credit"). Since Listed Private Credit is a niche market there is no standard definition available to identify a global universe of Listed Private Credit companies.

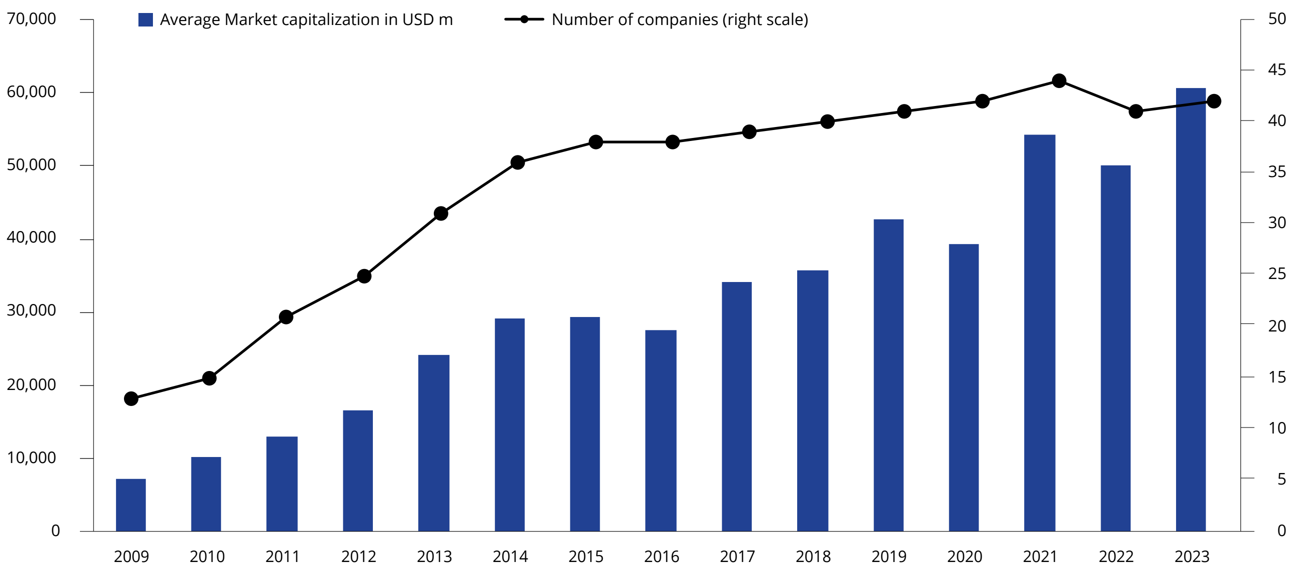
To create an index of private credit companies, LPX required the following for admission:

- Provision of debt capital
- At least 50% of total assets must be provided as debt to unlisted companies
- Listed on a regulated stock exchange
- Banks are excluded

Due to the stock exchange listing, the companies/funds are subject to transparency and publication requirements, which allowed LPX to gather information about investment strategies as well as the composition of the loan portfolio.

Chart 3 shows the historical development of the market capitalisation and the number of companies at the end of each calendar year. The universe was traced back to 2009.

Chart 3: Number of listed private credit companies & aggregate market capitalisation over time



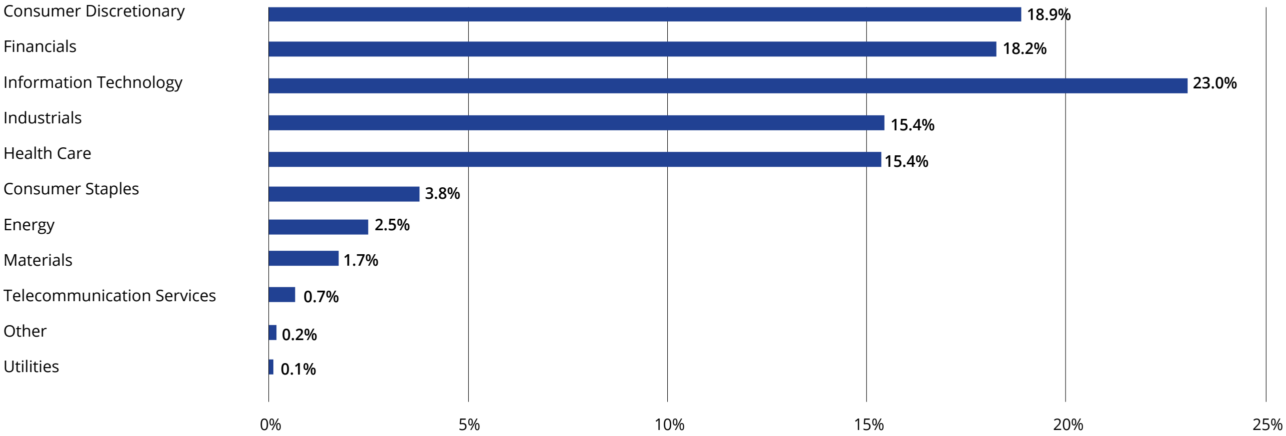
Source: LPX AG.

According to LPX, the underlying aggregated loan portfolio of the 42 listed private credit companies as of January 1, 2024, comprises a total of 5,486 borrowers with an aggregate credit volume of US$139 billion (at fair value). Overall, LPX states, "the identified universe of listed private credit companies provides access to a broadly diversified loan portfolio".

LPX breaks down the 42 companies by industry sector (chart 4), by collateral allocation (chart 5), by floating versus non-floating (chart 6) and by secured versus non secured (Chart 7). Additionally, much of the credit consists of senior debt.

An interesting feature of most of the underlying yields is that they are index-linked, hence they offer protection against rising rates.

Chart 4: Sectoral allocation of the loan portfolio



Source: LPX AG. As of December 31, 2023 according to GICS (Global Industry Classification Standard).

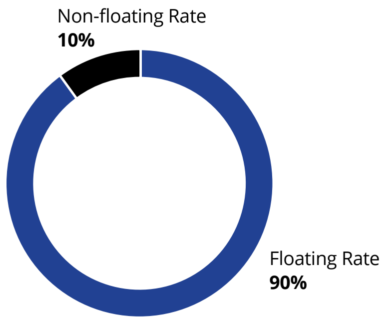
Figure 5: Collateral allocation of the loan portfolio

Source: LPX AG, December 31 2023

Figure 6:Breakdown into floating and non-floating rates

Floating vs. Non-floating

Floating Rate	90.02%
Non-floating Rate	9.98%
Total	100.00%

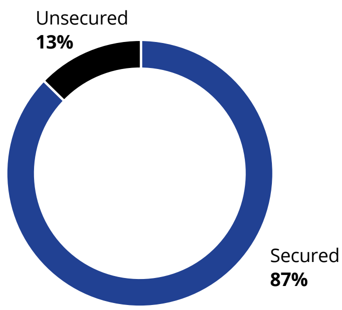


Source: LPX AG, December 31 2023

Figure 7 – Loan types

Loan types

Secured	87.35%
Unsecured	12.65%
Total	100.00%



Source: LPX AG, December 31 2023

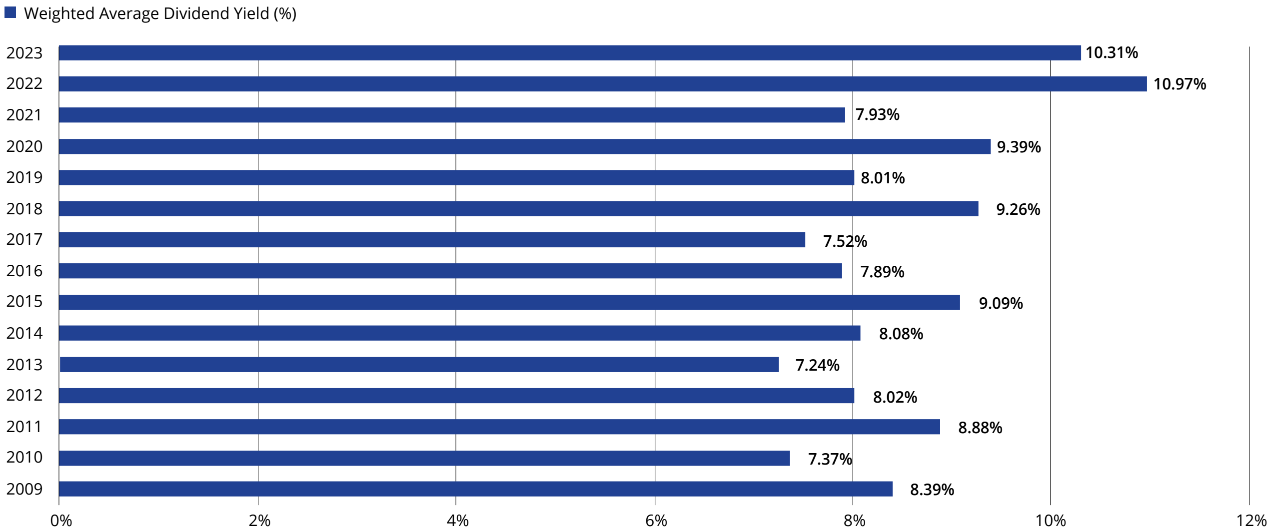
From its analysis, LPX created an investable index, the LPX Listed Private Credit AUD Hedged Index (LEND Index) which includes 25 global listed private credit companies.

3. The benefits for investors of including an allocation to global listed private credit

We think an investment in private credit companies could be used to enhance the yield of an income portfolio to the degree that matches the investor's risk tolerance. Because the companies using the loans are typically smaller, middle-sized companies and the loans can be riskier, the interest rates associated with private credit tend to be attractive for investors. However, there is a higher credit risk associated with these companies and loans, hence the higher risks compared to traditional credit.

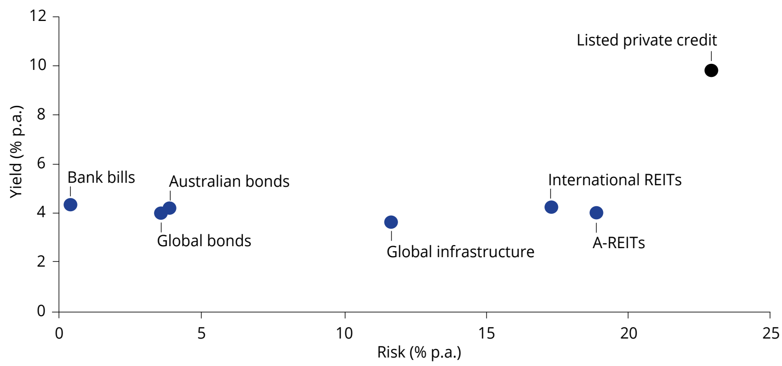
Listed private credit companies are equity securities, they are thus susceptible to equity market volatility, so most investors likely should not consider private credit as a replacement for their traditional income exposure, rather an investment should sit alongside or be a part of a well-diversified income portfolio.

According to LPX, as of December 31, 2023, the yield of Listed Private Credit was 10.31% and since 2009 it has averaged around 9%.



Risk-adjusted income

In bond markets higher income generally comes at the cost of higher volatility. This is true of global listed private equities, which, while paying a higher yield, experience more volatility, or risk.



Asset Class	Standard Deviation (%)	Yield (%)
Bank bills	0.4	4.35
Australian bonds	3.9	4.21
Global bonds	3.6	4.02
Australian property	18.9	4.01
International property	17.3	4.26
Global infrastructure	11.7	3.68
Listed private credit index	22.9	9.82

Source: Morningstar Direct, 15 year risk-reward. Yield is either yield to maturity or dividend yield. Yield to Maturity (YTM) is the estimated annual rate of return that would be received if the fund's current securities were all held to their maturity and all coupons and principal were made as contracted. YTM does not account for fees or taxes. YTM is not a forecast, and is not a guarantee of, the future return of the fund which will vary from time to time. Dividend Yield is the weighted average of each portfolio security's distributed income during the prior twelve months before management costs. If applicable it does not include franking credits Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Indices used Bank Bills – Bloomberg AusBond Bank Bill Index, Global Bonds – Barclays Global Aggregate Bond Index A$ Hedged , Australian Bonds – Bloomberg AusBond Composite 0+ years, Australian Property – S&P/ASX 200 A-REITs Index, International Equities – MSCI World ex Australia Index , Australian Equities – S&P/ASX 200 Accumulation Index, Emerging markets equities – MSCI Emerging Markets Index, Listed private equity – LPX Listed Private Credit Index.

4. How to invest in private credit

Direct v Listed v Unlisted Infrastructure

Investors have several different avenues to access private credit.

Below we present the differing investment avenues and the associated advantages and disadvantages of each.

	Direct	Syndicated loans	Closed-end funds	Listed private credit
Description	Loans are offered directly to borrowers by the manager.	A syndicated loan is a loan extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and non-bank financial institutions. After origination, shares of syndicated loans can be traded in the secondary market, changing the composition of the loan syndicate.	In the case of a private credit closed-end fund, a limited partnership makes commitments which are called over a certain period of time. In the investment phase, the called-up capital is invested and the loan portfolio is built up. The cash flows from the current interest income or repaid loans are then distributed to the investors.	Companies that are traded on a regulated stock exchange.
Duration	Depends on the portfolio	Depends on the portfolio	Depends on the portfolio	No
Diversification	Low	Low	Medium	Higher
Access	Restricted	Restricted	Restricted	No restrictions
Liquidity	Low	Low	Low	Daily
Lock-up	Depends on the terms	Depends on the terms	Yes	No
Due diligence cost	High	High	Medium	Low

Source: LPX

Listed Private Credit Companies may specialise in sectors or loan types and risks vary between companies. For diversity, investors generally need to invest in a portfolio of listed private credit companies.

Accessing global listed private credit

For Australian investors, private credit investment has been generally limited to high net worth and the big end of town who don't require immediate access to cash and can take concentrated positions.

VanEck's Global Listed Private Credit (AUD Hedged) ETF (ASX: LEND) offers investors on ASX access to a diversified portfolio in globally listed private credit.

LEND tracks the LPX Listed Private Credit AUD Hedged Index (LEND Index) which includes 25 global listed private credit companies.

LEND will aim to pay dividends monthly, see Appendix 1 for a note on hedging.

You can invest alongside the 'giants' and pursue higher income opportunities, with the liquidity, ease of trading and transparency of an ETF.

Key risks: An investment in LEND carries risks associated with: listed private credit, interest rates, credit/default, ASX trading time differences, financial markets generally, individual company management, industry sectors, country or sector concentration, political, regulatory and tax risks, fund operations, liquidity and tracking an index. See the PDS for more details on risk.

Appendix 1: The importance of hedging

The objective in hedging a portfolio to the investor's local currency is to ensure the only factor influencing the return from the portfolio is the income and capital gains (or losses) generated by the underlying investments – not currency movements as well.

With a portfolio hedged to the Australian dollar, the investor is protected from the adverse impact that a rising Australian dollar can have on a portfolio. As the majority of the LPX's Global Listed Private Credit Hedged into A$ Index is made up of securities not listed on the Australia Stock Exchange, the Index is exposed to foreign currency risk. In times of global uncertainty about fiscal and monetary policy, particularly in the developed world, hedging the portfolio reduces the uncertainty of currency fluctuation impacts on the portfolio. As has been discussed, global private credit companies are associated with high income yield for investors. Where an investor is interested only in long-term capital gains such as private equity, the benefits of hedging are not as pronounced, as generally the foreign currency will exhibit low correlations with the return of the investor's portfolio and thus can act as an instrument to reduce volatility of returns. In the long-run, the investor may benefit from the compounded annual returns earned without the drag created by hedging. However, where an investor is looking to achieve income from a particular investment, by hedging the portfolio to the local currency of the investor, in this case Australian dollar, it allows for greater certainty of income in local currency terms and smooths the distribution of dividends to mitigate against some of the impact that may be brought about by currency fluctuations.

To add appeal to investors, Australian tax laws and VanEck's tax expertise allow LEND to pay a smoother flow of dividends each month than would have been possible in the past.

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Contact us

vaneck.com.au
info@vaneck.com.au
+61 2 8038 3300

VanEck-Australia
VanEck_Au
VanEckAus
VanEckAustralia