



Not all private credit is created equal



In a short space of time, private credit has gone from being an asset class in the ascendency to front-page worry. Goldman Sachs estimates the asset class is worth about \$3tn today and could grow to \$4.5bn by 2030*, yet recent headlines have focused on gated funds, high-profile failures (Tricolour, First Brands and MFS), concerns over non-bank underwriting standards, and the risk of fire-sales disposals to meet redemptions.

That doesn't mean that we should throw the baby out with the bathwater, according to Phil Kent, CEO at Gravis. It means that three things matter more than ever.

Firstly, 'private credit' covers a wide range of asset classes, structures, and associated risks, so understanding which bit you own is critical.

Secondly, the structural protection of debt versus equity has not gone away.

Finally, investors (and particularly retail investors) should favour structures where fund and asset liquidity are aligned, rather than relying on hope that the mismatch won't be tested.

We still see a strong role for select areas of private credit as a defensive diversifier in portfolios, particularly in light of the current macro backdrop of geopolitical uncertainty and the material and wide-ranging potential impact of artificial intelligence ("AI").

How to understand the risk in private credit

As with any asset class, you can only understand the risk in private credit if you understand what sits beneath it i.e. the loans, borrowers and collateral.

There exists a variety of underlying asset classes in private credit, with different structures, levels of security valuation approaches. The table over page sets out the three main types we see, together with the key points investors should consider for each.



The three main asset classes in private credit

	Direct lending	Real estate	Infrastructure
Description	Lending directly to operating businesses across a range of sectors	Lending against properties	Lending against infrastructure (real assets providing a long-term service to society)
Valuation	EBITDA / earnings multiple as a 'perpetual value'	Discounted net operating income yield and residual value	Discounted cash flow over an asset life
Nature of debt sizing	LTV – lending against earnings multiple	Interest coverage and LTV – operating income pays interest and asset covers capital	Debt service coverage – cash flow covers interest and capital amortisation
Investor benefits	Typically lower leverage on day one	Protection from intrinsic value of asset and contracted (rental) yields	Repayment and income underpinned by contracted / monopolistic or regulated cash flows
Key underlying risks	Corporate risk (business strategy, management team, market conditions) Refinance risk (raising new debt to repay old debt)	Interest rate risk (long-dated rates drive residual value), Occupancy risk Refinance risk	Leverage risk (cash flow stability drives higher leverage) Political risk

Investors rely on upfront due diligence to understand what they are lending against. That work needs to be detailed and multi-faceted, covering anything that could affect cash flows (legal, property, market, technical, insurance, finance and tax). Record levels of dry powder and pressure to deploy capital quickly (to avoid cash dragging on returns) may have increased the risk that weaknesses are overlooked, or that key assumptions are not challenged as hard as they should be.

Much of the recent growth in private credit has been in direct lending – stepping in where commercial banks used to lend directly to operating companies. It is here where the spotlight has shone in recent weeks, as funds run by Ares, Apollo, BlackRock, Blackstone, Blue Owl and Morgan Stanley have gated redemptions. These funds have exposure to software and services businesses, which account for more than a quarter of holdings by Business Development Companies (“BDCs”), where valuations have fallen by, on average, 25% in recent months amid uncertainty over the impact of AI.

To judge the risks properly, investors need to think about how the original lending case has changed and what that means in practice. For example, if a 5-year bullet repayment loan was sized at a 6x net debt / EBITDA ratio, and the enterprise valuation has reduced from 15x EBITDA to 10x, on paper, the debt is still covered from a value perspective. The problem comes at refinancing. If that business needs to raise new debt to repay the bullet at maturity, and lenders are no longer willing to lend at 6x (or the same loan-to-value) it may not be able to refinance in full and could default or be forced into



more expensive subordinated or special situation debt finance. In other words, investors should consider likelihood of default (which in this case has increased) and loss given default (which in this case remains low).

So while recent headlines reflect pressures in asset-light corporate lending and increasing liquidity mismatches in open-ended retail funds, this is not the case for private credit as a whole. Asset-backed strategies continue to offer a very different, more defensive profile. Infrastructure and real estate debt both benefit from contracted cash flows and the intrinsic value of real assets. As a result, valuations are less correlated with public markets and offer defensive characteristics that help protect against downside risks. The flip side is that these strengths often support higher day-one leverage than in other parts of private credit.

The benefit of structural protection

Investors should also not forget the structural protection that debt provides. In a downside scenario, lenders are paid before equity holders and typically benefit from security over assets and/or shares, as well as financial and non-financial covenants that act as early-warning indicators and give them increasing ability to step in and influence outcomes.

We prefer covenant-heavy loan documentation with detailed information and reporting obligations. Financial covenants provide triggers that can, for example, block cash distributions to shareholders or constitute events of default, whilst non-financial covenants restrict what a borrower can or can't do that may increase risk or erode value from a lender's perspective.

It has been suggested that fraud is the reason for defaults and likelihood of low debt recoveries in some high-profile cases recently (e.g. MFS). This does not imply a systemic failure of private credit: by definition, fraud is designed to evade due diligence processes and underwriting. Both bank and non-bank lenders have been caught out, so it is hard to argue this is simply about weaker underwriting quality. While vigilance and fraud prevention are essential, we must start from an assumption that most businesses are run honestly and in good faith, and avoid extrapolating what should be isolated examples to the wider sector.

The importance of matching liquidity

Private credit is an illiquid asset class. Loans that have been written on a bespoke basis for businesses or assets that do not benefit from independent ratings are not easily traded in the secondary market. Any potential buyer needs to work through bespoke documents and conduct due diligence on the underlying assets, to form their own view of risk, creating friction that makes secondary transactions time-consuming and costly.

The 'semi-liquid' funds that have recently gated did so because redemption requests exceeded available capital. There is a risk in such structures that fund-level liquidity demands can force managers into the fire sale of otherwise sound loans, crystallising unnecessary valuation hits even when the underlying credits are not impaired. In our view, semi-liquid structures are better suited to institutional investors who redeem less frequently, effectively providing an option on liquidity rather than a core feature of the allocation. As the proportion of retail investors in these funds has increased, so has the risk of a fund/asset liquidity mismatch.

It is therefore critical that fund liquidity is aligned with the liquidity of the underlying assets. We have long favoured UK listed Investment Companies – closed-ended structures that allow investors to trade shares on the stock market, without impacting the capital available in the underlying fund. This means the pool of capital backing the asset is stable and illiquid loans or assets can be bought and sold when market conditions are optimal to do so, protecting value for investors.



GCP Infrastructure Investments is a good example. It's a FTSE 250 constituent that is focused on UK infrastructure debt in assets that benefit from public-sector backed cash flows. We are wary of semi-liquid structures that cope well in normal markets but may be forced to sell assets at the wrong time when conditions turn. For institutional investors, we believe fully private closed-ended fund structures, where capital is returned through the natural amortisation and maturity of loans, are a better match, as they align with the long-term nature of both infrastructure assets and investor capital.

Infrastructure and real estate provide a defensive diversifier

Debt is often described as having asymmetrical risk: limited upside but full downside. In the best-case scenario, lenders get their interest and principal back as agreed. In the worst case, they can still lose some or all of their capital. That can create a potential mismatch between when lending to high-growth companies, where equity holders have significant upside potential for the risk they are taking, but lenders do not share in that upside to the same extent.

AI is a great example here. The wide ranging and uncertain potential for positive and negative disruption it brings with it means that any corporate valuation that relies heavily on long-dated, perpetual cashflows now attracts a higher risk premium. The question for lenders is whether they should be exposed to that kind of disruption risk when they don't share in the equity upside.

If private credit is to play a defensive role in portfolios, we think that, for now, the focus should be on debt secured against hard assets (real estate and infrastructure) that benefit from contracted cash flows and the intrinsic value of hard assets with limited AI-related obsolescence risks (the HALO trade). In these cases, there is justification for accepting lower returns as a debt investor in exchange for stronger asset protection. Equity investors can earn higher returns from asset life extensions / re-leasing, operational efficiencies and asset aggregation – not risks a lender has to, or indeed should, be taking.

What more can be done?

There is more the industry can do to improve both understanding and perception of private credit. Disclosure needs to improve so investors can understand the ultimate risk of the underlying companies or assets. Tools such as Carapace, Gravis' proprietary investment management and reporting tool, can be used to give clearer, more consistent portfolio information. Private market asset valuations can also be made more transparent and frequent, with robust independent oversight, so investors have greater confidence that reported values fairly reflect underlying reality.

*Source: Preqin



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