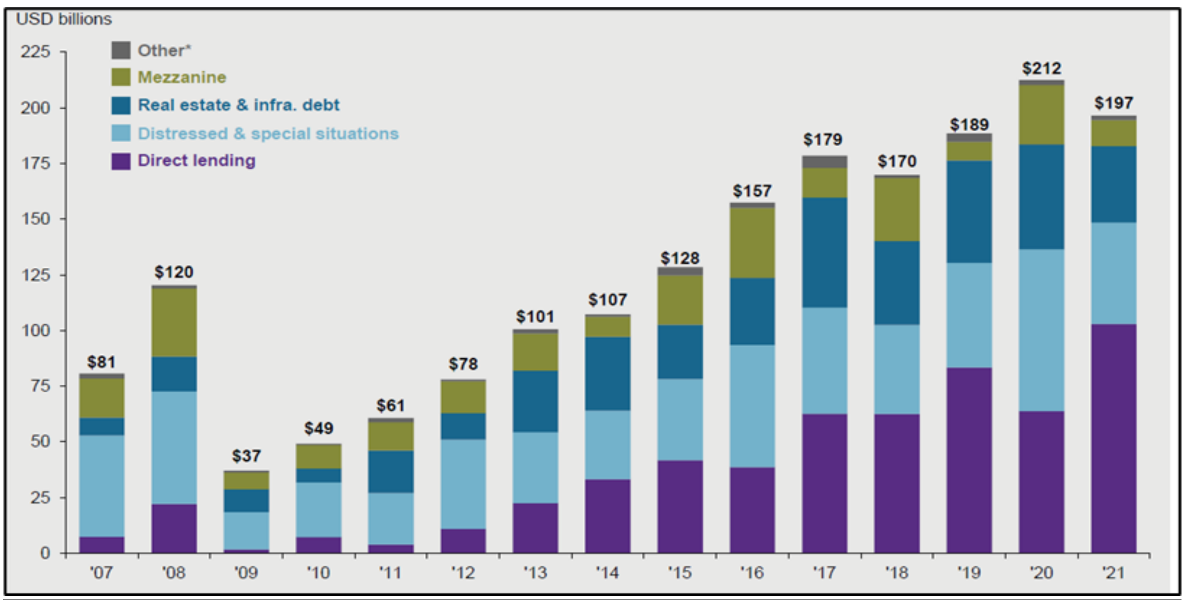
# PRIVATE CREDIT

Private credit strategies had another strong quarter alongside an improving economy, surging liquid credit markets, and low default rates. The asset class is poised to continue to provide solid risk-adjusted returns in 2022 and act as a strong complement to institutional portfolios. While our outlook remains positive, it is not without risks. In sponsored direct lending, growing amounts of dry powder are pressuring deal structures and pricing. As depicted in the chart below, private debt fundraising continues to be near peak levels, with a large portion driven by direct lending related investment funds.

*Private Debt Fundraising by Type (2007 - Q3 2021)*



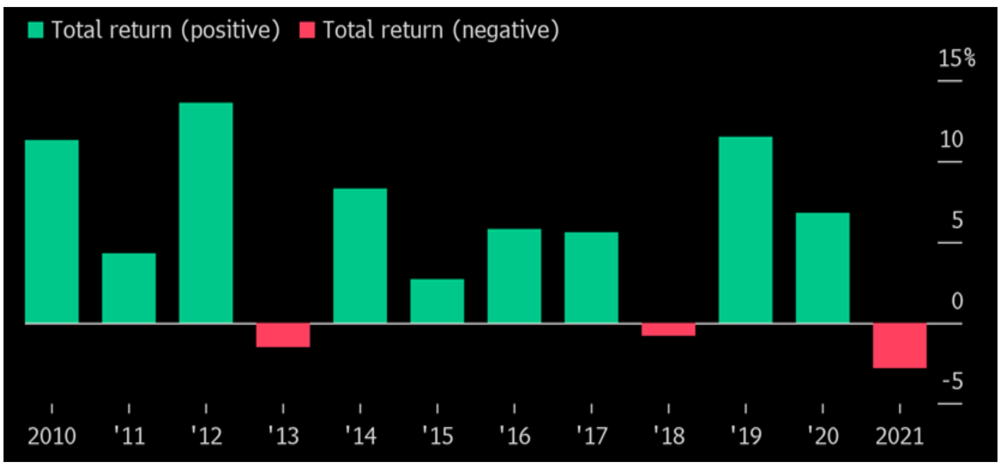

**Source:** Preqin (2021)

As discussed in [our Q3 letter](), we have been shifting our focus to strategies where the secular outlook is strong and demand for capital is outpacing supply – areas such as venture debt and homebuilder finance. With credit spreads at all-time historical tights, a more defensive positioning is warranted, focusing on lending opportunities collateralized by asset value rather than enterprise value. These strategies can provide a hedge against potential headwinds facing the market and deal structures.

## CONTINUED VOLATILITY IN THE CHINESE PROPERTY MARKET

Q4 brought continued volatility to the China property sector, given continued pressure on liquidity resulting in highly indebted property developers facing difficulties in making debt payments. China Evergrande and Kaisa Group, two of the largest but highly levered property developers, missed bond payments followed by a string of credit rating downgrades of indebted developers, triggering a sell-off in the broader market. In the first week of November, the yield on the ICE BofA Asian Dollar High Yield Corporate China Issuers Index topped over 25 percent for the first time since March 2009, near the height of the Global Financial Crisis (GFC). As seen below, Asia credit had its worst return in over a decade in 2021, not surprising given that China accounts for half of the Asian high yield bond market and Chinese property developers accounting for a significant share.

*Asia Credit Market Returns (2010 – 2021)*




**Source:** Bloomberg EM Asia Dollar Credit Total Return Index (2021)

Moving into 2022, we are looking into investment opportunities in the Chinese property sector, given a more dovish shift in policy, improving onshore liquidity conditions, and the handling of the offshore debt restructuring at Evergrande with the government seeking to limit any spill-over impact.

## DEATH OF DEDICATED DISTRESSED FUNDS

Distressed opportunities in the Chinese high yield market look attractive, and we are seeking to take advantage of this opportunity through accessing both primary and secondary investments in the Chinese debt markets. Traditional distressed funds are no longer a viable strategy given the paradigm shift in market dynamics – during times of stress, governments and central banks no longer stay on the sidelines for long. Rather, they seek to avert the crisis through intervention, thereby eliminating the possibility of a long-term distressed investment opportunity. This has been the case since the 2008 GFC and was no different in 2020 in the aftermath of the pandemic outbreak when there was significant government and central bank intervention resulting in only a short-term dislocation.

As a result, special situation strategies that have a broader mandate with the flexibility to shift between performing and distressed investments as the market environment changes are more attractive. While having exposure to distressed is important when the opportunity presents itself, as economic cycles have become more episodic in nature, a more flexible approach is preferable. Moreover, distressed funds that are raised in benign credit environments either tend not to deploy the capital or invest in secularly declining sectors – both of which are suboptimal to an investor. There are a number of GPs that have the ability to originate differentiated new financing opportunities in a benign environment but can move to distressed if and when the opportunity presents itself.