Private Credit

Private credit remained resilient over the second quarter and demonstrated its value to institutional portfolios, despite public credit coming under pressure because of increased market volatility. Investors' overweight income strategies generated steady returns as performance was driven by contractual payments, which generally offset any declines in mark to market valuation.

The performance of distressed and special situation strategies was more mixed, as gains through the monetization of seasoned private investments related to the COVID recovery trade were offset by the decline in value of recent securities purchases in secondary markets.

As of the end of Q2, the US private credit market has grown to more than $1.2 trillion, more than doubling since 2015 with institutional investors continuing to pour money into the asset class - especially with traditional fixed income no longer providing the same income and diversification benefits as it has in the past. This trend will likely continue and some forecasts have private credit assets reaching $2.69 trillion in AUM by 2026, overtaking real estate as the second-largest private capital asset class after private equity.

Inflows have been far from proportionate, however, with the larger established GPs receiving the bigger slice of the pie, tilting market concentration to a select group, and making it harder for newcomers to compete for capital. According to Preqin, nearly 40% of aggregate capital raised last year went to the 10 biggest funds, which is up from about 27% in 2017.

Fundraising is running at a rapid clip as well, with GPs returning to market every 15 to 18 months, an acceleration from the historical norm of three years, which has motivated established firms to launch even more new funds. Of the 2,800 individual funds launched over the last five years, 80% were from existing GPs. This has raised the barrier to entry, creating a problem for first-time fund managers, as both the number of funds closed by new managers and the aggregate capital raised fell to levels not seen since the GFC.

Despite certain industry headwinds, RockCreek continues to believe that backing experienced teams seeking to raise their maiden fund remains attractive. The increased presence of these mega sized direct lending funds has morphed the strategy from one that had historically focused on middle-market companies to a staple of multibillion-dollar buyout transactions. As a result, the market has seen an increase in both the number and size of large private credit transactions. Prior to the GFC, the biggest deals were a few hundred million dollars, but now multi-billion-dollar transactions are not uncommon.

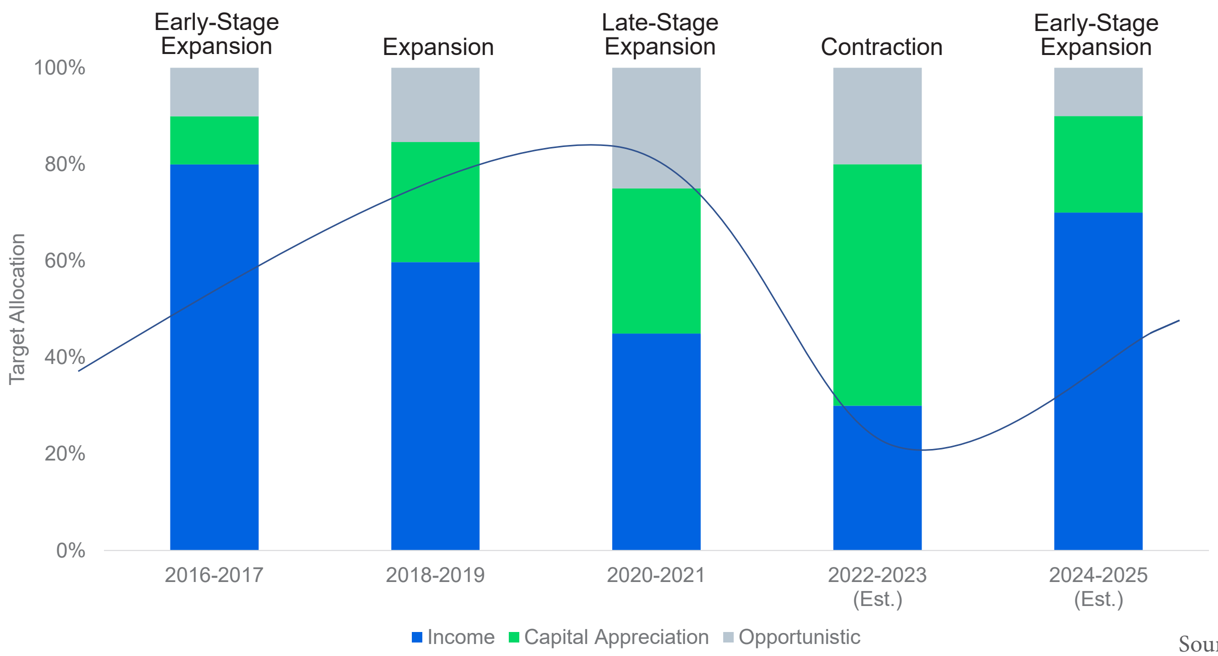
The first half of 2022 has seen this trend accelerate as banks have moved to the sidelines, given increased market volatility and these mega sized direct lending GPs have stepped into the spotlight. They are willing to provide capital, sometimes even at rates below what's available in the syndicate loan and high yield market, in order to build relationships and access deal flow from premier private equity firms.

Given these dynamics, RockCreek has avoided much of this space. Underwriting cash flows or a company's enterprise value has become especially challenging in the current environment. We have stayed away from all forms of corporate lending. We view specialty finance and asset-based lending strategies, where yields remain relatively healthy and there is hard collateral value supporting the loans, as being more economically favorable.

Recent areas of focus include loans backed by commercial real estate assets or working capital assets such as accounts receivables or inventory.

As the market environment continues to be challenging and the likelihood of a recession increases, we have focused our attention on commitments toward more distressed and opportunistic strategies. The combination of policymakers having to raise rates to tame inflation, against a backdrop of persistent supply chain disruptions and fallout from the war in Ukraine, is setting the stage for increased financial distress, especially for small and mid-sized companies.

How we think managers in the private credit space are likely to target their allocations to private credit strategies over a market cycle is as follows:



Source: RockCreek

One sub-strategy that is increasingly popular is a focus on venture debt. The strategy has gained increased traction with some investors over the past few years as a means to amp up their private credit portfolio returns through upside from warrants and equity participation that were typically structured into the transaction. We had generally avoided the strategy previously, as we believed that pricing had become tight, loan underwriting standards had weakened, and base case return expectations assumed that there would be some return from the equity participation.

Today this dynamic has shifted. Capital has now become a scarce resource and venture debt has become valuable as it can act as a liquidity bridge for cash-starved companies to avoid raising a new equity round at a potentially lower valuation. Some noteworthy growth equity investors, including Coatue and Viking, are seeking to raise multi-billion funds to provide structured liquidity solutions to such companies.