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# PRIVATE CREDIT

The combination of rising interest rates and widening spreads – a byproduct of macroeconomic uncertainty, traditional lender retrenchment, and frenetic public credit markets – continues to invigorate the institutional demand for private credit exposure. Institutions, particularly those with liability-driven liquidity and return targets, are recognizing that private credit can help achieve their objectives more reliably than other private market assets given the contractual, income-oriented nature of the investment returns. Private credit GPs are embracing the tailwinds to their asset class.

The same factors that are enhancing returns, however, also have the propensity to increase the risk of default and other adverse credit events (i.e., the added return you are receiving in the current market compensates you for taking additional risk). In fact, after nearly a decade of muted default rates, the US leverage finance markets have finally started to see an uptick in distress in response to higher debt costs and a slowing economy. The private markets are not immune. Moody's analyst Christina Padgett recently said, "This shift in macro and market conditions will mark the first sector-wide test of non-bank private credit lenders' ability to manage through recession and an increase in borrower defaults." The somber warning was associated with reference to two of the largest participants in the sponsored lending market: Ares and Owl Rock.

RockCreek's stance on the asset class is one of excitement, reflective of our belief that we can generate outsized Risk-adjusted returns through very targeted, thematic investments – and often through commitments to smaller, more nimble strategies are expected to be strong drivers of performance. Achieving success through buying the beta of the asset class – committing to the

mega-funds that are forced to buy the market – may no longer be a feasible strategy. Identifying the most attractive segments of the market and acute manager selection are paramount.

One such theme that we are excited about revolves around the expectation that banks – on the back of the 2023 “banking crisis” – will seek balance sheet improvement through asset sales. The market has considered these sales to be a positive signal – indicating prudent risk management and balance sheet enhancement – as opposed to a sign of burgeoning systemic risk. As a result, more banks are likely to pursue such equity-accretive asset sales. Although some of these transactions will occur through large, undiscerning, and widely brokered portfolio sales that cater to larger buyers willing to take the good, the bad, and the ugly, the more interesting opportunity will be the smaller, more selective assets sales that occur on a bilateral basis. Well-connected buyers will be able to acquire mispriced C&I and CRE loans at steep discounts from non-economical sellers. As mentioned last quarter, CRE debt is one sub-segment of asset-based finance that we find particularly interesting given (again) the retrenchment of traditional sources of debt finance, allowing lenders to be more selective and dictate terms and pricing. The opportunity size is massive, with an estimated \$1.5 trillion of CRE debt outstanding projected to mature over the next two years .

With companies facing pressure from increasing debt costs, lending against enterprise value (i.e., cash flow lending) would appear riskier relative to asset-based loans and/or lending against liquidation value. A recent whitepaper on Asset Based Finance by KKR projects that the market for US private asset-based lending will grow by ~70% over the next five years, driven by the growth of financial technology platforms. The market is poised to benefit from unreliable public securitization as traditional foreign and insurance buyers of senior structured credit tranches are turning to lower-risk (even risk-free) assets to achieve their yield targets. Even corporate borrowers that would usually seek more traditional enterprise value-based loans are considering asset-based financing given the ability to structure these facilities on a covenant-free basis, offering more freedom to use cash flow for accretive or other purposes. An asset-based lender that is fully covered by working capital and other liquid assets is less concerned with the protections that covenants offer.