

# Rede Private Credit Report

2022





## Contents

INTRODUCTION	1
BACKGROUND	3
IT'S ALL ABOUT THE PEOPLE	5
THE 'GREY ZONE' IS GETTING COLOUR	7
SPECIALTY FINANCE IS THE NEW BLACK	8
A NEW DAWN FOR DISTRESSED	10
PRIVATE CREDIT MANAGERS BEWARE: THE ESG TRAIN IS LEAVING THE STATION	14
THE PRIVATE CREDIT FUNDRAISING MARKET IS BECOMING MORE CREATIVE	16
CONCLUSIONS	18





# INTRODUCTION

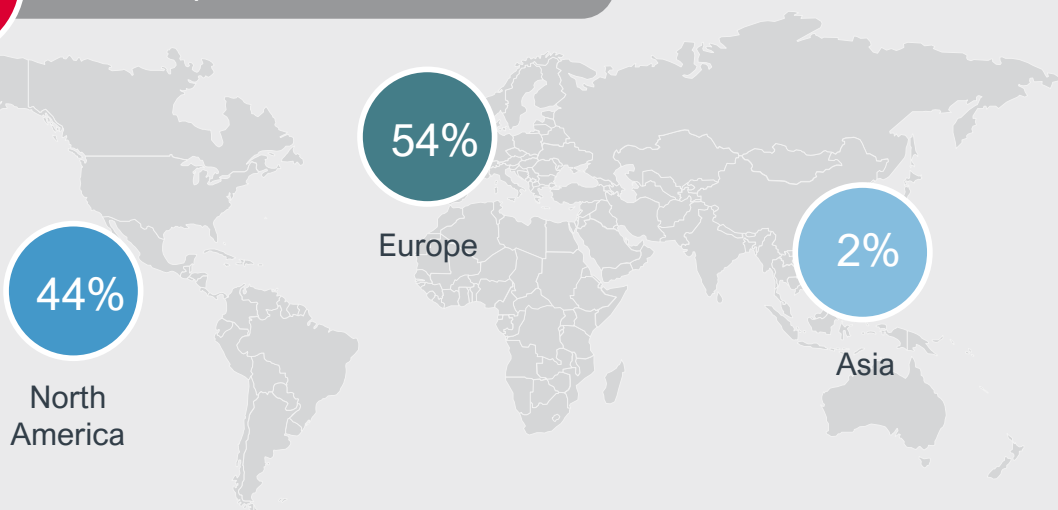
Rede Partners is delighted to publish the inaugural Rede Private Credit Report, identifying key trends within the asset class and examining LP sentiment towards a variety of Private Credit themes and strategies. The findings are based on in-depth interviews with 50 leading institutional LPs drawn from a broad variety of investor types across

North America, Europe and Asia-Pacific – including many of the leading global investment consultants. In aggregate, we estimate that our participants' Private Credit assets under management accounted for c. 25% of the world's total institutional private debt allocation, based on Preqin's latest data.

## SURVEY OVERVIEW

50

LPs completed 45 min interviews



The participants in this survey comprised a diverse group of LP types – including consultants, fund of funds, pensions, endowments, foundations and family offices – with a variety of allocation preferences. Aggregate assets under management or advisement totalled \$24.3trn, with allocations to Private Credit amounting to \$336bn (approximately 25% of the market, according to Preqin<sup>1</sup>).



Consultants

+



Fund of Funds

+



Pensions

+



Endowments

+



Foundations

+



Family Offices

Aggregate assets under management or advisement totalled:

**\$24.3trn**

Allocations to Private Credit amounting to:

**\$336bn**



# INTRODUCTION

## KEY FINDINGS

1

### **IT'S ALL ABOUT THE PEOPLE**

Specialist Private Credit investment teams have fundamentally changed the way LPs allocate to the asset class

2

### **THE 'GREY ZONE' IS GETTING COLOUR**

Greater sophistication and flexibility amongst LPs is supporting the emergence of a 'rainbow' of investment strategies across the full spectrum of risk-return opportunities

3

### **SPECIALTY FINANCE IS THE NEW BLACK**

LPs cite Specialty Finance as a key area of interest more frequently than any other category

4

### **A NEW DAWN FOR DISTRESSED**

While Private Credit is well-positioned for a downturn, we expect notable winners and losers – with a potential resurgence in demand for distressed strategies

5

### **PRIVATE CREDIT MANAGERS BEWARE, THE ESG TRAIN IS LEAVING THE STATION**

Strong ESG policies and practice are becoming mandatory for GPs

6

### **THE PRIVATE CREDIT FUNDRAISING MARKET IS BECOMING MORE CREATIVE**

Increasing sophistication within LPs is driving a newfound enthusiasm for first time funds, co-investment and secondary transactions



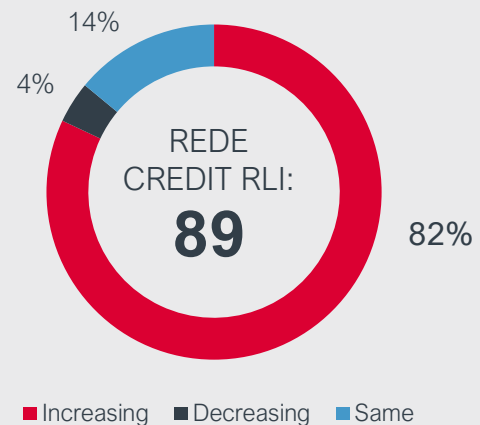
## BACKGROUND

### Room to grow; commitment to get there

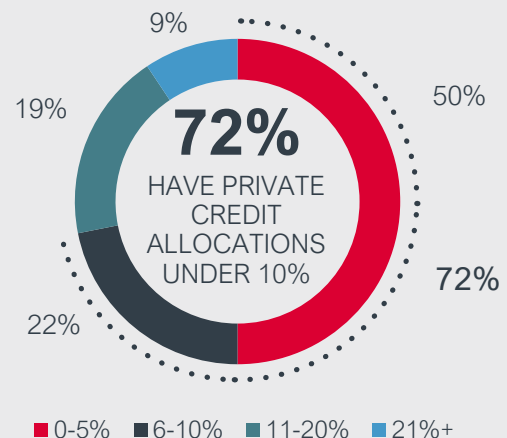
At the time of publication, figures from Preqin show that Private Credit assets under management rose to \$1.21trn in 2021. This follows a decade when growth averaged 13.5% annually, putting the growth of this asset class ahead of private equity, venture capital, and real estate. Our survey suggests this growth will continue, with 82% of participants expecting to increase their allocation to Private Credit in the year ahead, with a further 14% expecting to maintain their allocation. This equates to a Rede Liquidity Index (“RLI”) score of 89, depicting strong positive LP sentiment towards deployment to Private Credit.

When viewed against a context of Private Credit allocations typically accounting for only a very small percentage of LPs’ total AUM, the strong expectations for deployment growth we report suggest significant headroom for sustained growth over the coming decade. At present, 72% of our survey participants have Private Credit allocations of less than 10% of AUM, while 50% of investors report that Private Credit accounts for less than 5%. This compares to an estimated 40-50% allocating to public fixed income assets. Given the strong momentum and LP sentiment shown in our survey results, we expect a substantial increase in Private Credit allocations in coming years, potentially reaching 6-10% of total AUM by the end of 2026.

### PRIVATE CREDIT ALLOCATION TRENDS



### % AUM ALLOCATED TO PRIVATE CREDIT



### What is the REDE LIQUIDITY INDEX (RLI)?

The RLI is a forward-looking, quantitative measure of LP sentiment and liquidity. In regular ‘spot’ LP surveys, investors are asked whether they expect to increase, decrease or maintain their deployment to a certain category within the private markets asset class. Following a similar logic to the IHS Markit Purchasing Managers’ Index (PMI), it results in a score between 0 and 100. If 100% of respondents reported an increase, the index would be 100. If 100% reported a decrease, the index would be zero. If 100% saw no change, the index would be 50. So, an index score of over 50 indicates an improvement and, therefore, positive growth expectations.

**Index Score 50+ = Positive Growth Expectations**



## BACKGROUND

### HOW DID WE GET HERE?

Demand for Private Credit has thrived for more than a decade due to low (or negative) yields in public credit markets and the 'once in a generation' market opportunity generated by the shift away from banks using their balance sheet to underwrite leveraged loans. More recently, demand has grown further due to lending inefficiencies created by the Covid-19 pandemic; as well as fears around inflation and rate rises, driving investors towards floating rate debt. As concern over an economic downturn grows, we are now also seeing opportunistic credit and Special Situations strategies gaining traction.

### Before the GFC, LPs mostly focused on Private Credit with 'PE-like' returns

Before the Global Financial Crisis ("GFC") Institutional investors typically viewed their allocations to Private Credit as a diversifier to private equity. They often focused on strategies with 'equity-like' returns, such as mezzanine, Special Situations and distressed. Capital for these strategies was largely deployed from existing private equity and alternatives allocations, overseen by private equity-minded professionals whose focus often tended more toward the absolute than risk-adjusted returns.

The aftermath of the GFC saw a major growth and expansion of the Private Credit asset class, driven by two key changes in supply (LP capital) and demand (potential investments) for Private Credit. From the supply side, after negative experiences during the crisis, allocators became keen to diversify their existing public fixed income allocations, with Private Credit appearing to be a logical outlet to achieve this.

At the same time, on the demand side, a sea change in banking regulation, most notably Basel III, introduced punitive capital charges for banks holding private business loans on their balance sheets. This reduced banks' ability to lend to private businesses, creating an urgent need for alternative financing sources to sustain continued high levels of demand from the Leveraged Buyout ("LBO") market. All this coincided with a dramatic reduction in public market yields driven by central bank quantitative easing programmes, laying the foundations for Direct Lending to emerge as a key new category within the asset class. Together, this helped establish Private Credit as a distinct asset class with a relative versus absolute return focus, paving the way for its dramatic expansion.

### Direct Lending: the big post-GFC winner

Since then, Direct Lending investors have proliferated and scaled, raising ever-larger funds for senior and unitranche debt strategies. With backing from yield-hungry pension and insurance investors, numerous recognisable brand name credit platforms have emerged, such as Ares, Bluebay (now Arcmont), GSO and Golub. Today, the Direct Lending market is dominated by these large players – 42% of private debt capital raised in 2021 came from the top 10 managers<sup>2</sup> vs 31% in PE<sup>3</sup>. This has led to a rapid increase in dry powder for Direct Lending (\$17.8bn in December 2012 vs. \$117.5bn in May 2022 according to Preqin), in turn causing increased competition and a stronger position for borrowers to drive margin compression and looser documentation including the removal of protective covenants.

### What next?

As a result of the above, Direct Lending became the dominant Private Credit strategy, accounting for c. 50% of LP private debt AUM. However additionally, as the market has grown and become more sophisticated, Rede's survey shows that LPs are increasingly looking for complementary Private Credit strategy exposure that can increase overall yield in their Private Credit portfolios. Over the following pages, we explore Rede's understanding of how LP appetite for Private Credit is changing, and what this means for Private Credit managers in coming months and years.

<sup>2</sup>Preqin Private Debt Report 2022, <sup>3</sup>Preqin Fund Size and Performance Report



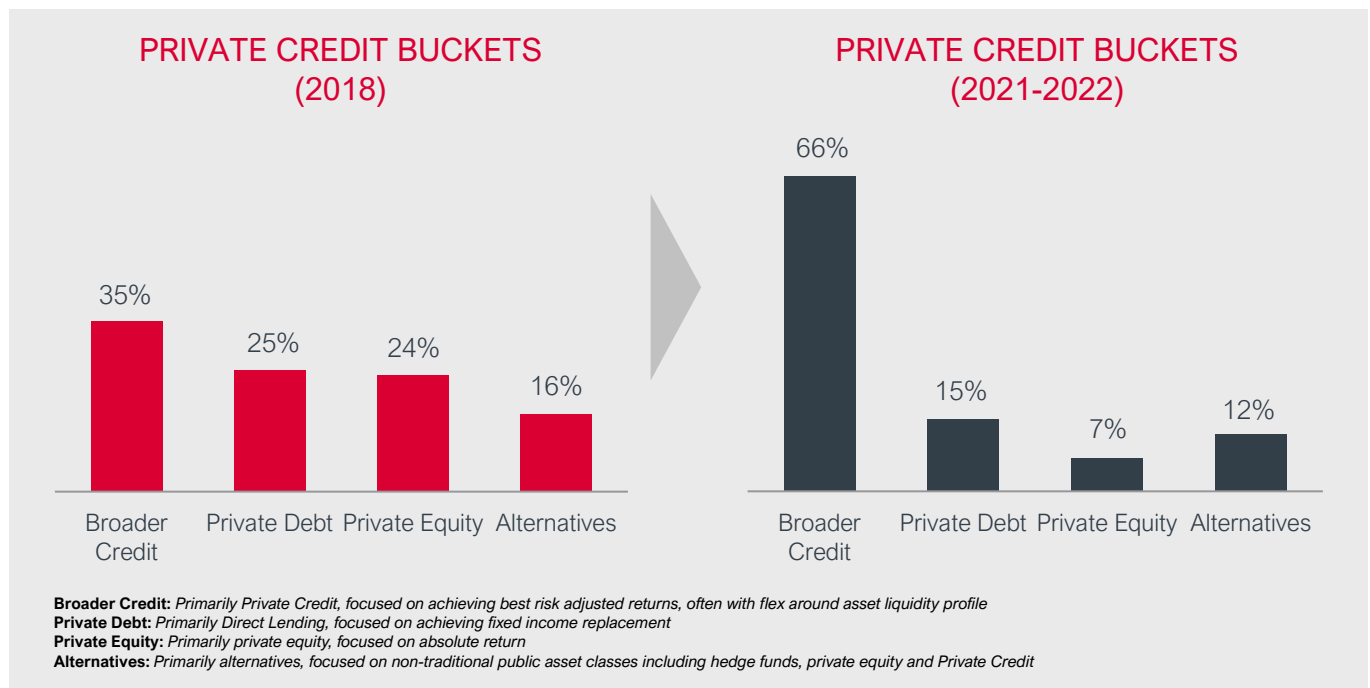
# 1. IT'S ALL ABOUT THE PEOPLE

## SPECIALIST PRIVATE CREDIT INVESTMENT TEAMS HAVE FUNDAMENTALLY CHANGED THE WAY LPS ALLOCATE TO THE ASSET CLASS

Our survey lays bare a clear shift in the organisational structures of institutional investors allocating to Private Credit. When compared with data collected in a similar survey in 2018, we found a notable increase in LPs investing from dedicated Private Credit allocations, overseen by a dedicated credit team or a specific individual responsible for credit within the broader private markets team. This is not, however, just an organisational observation. It has important consequences for strategies that will reshape the asset class over the long term.

## More LPs investing from dedicated Private Credit allocations, fewer from PE pockets

In 2018, close to a quarter of LPs were still allocating to Private Credit from their private equity allocations. In our latest survey, however, this had dropped to 7%, with most LPs having created dedicated credit allocations – often labelled ‘Private Debt’ or ‘Broader Credit’. The minimum return hurdle inherent in investing from a ‘Private Equity’ allocation severely constrains the breadth of credit strategies available to LPs. In contrast, investing from dedicated credit pockets frees LPs to broaden their horizons. In particular, in our experience ‘Private Debt’ allocations tend to focus almost exclusively on Direct Lending, whilst ‘Broader Credit’ allocations have a wider remit.





## IT'S ALL ABOUT THE PEOPLE

### 'Broader Credit' allocations provide much greater flexibility for LPs

Discussions with investors highlighted that 'Broader Credit' allocations are typically designed to accommodate a wide range of credit strategies, allowing investment professionals to select those they see as most attractive on a risk adjusted basis. Notably, many programmes now include flexibility to invest in both illiquid and liquid credit, including hedge funds, further broadening the opportunity set. In some cases this approach has meant LPs almost entirely dispensing with dedicated fixed income allocations.



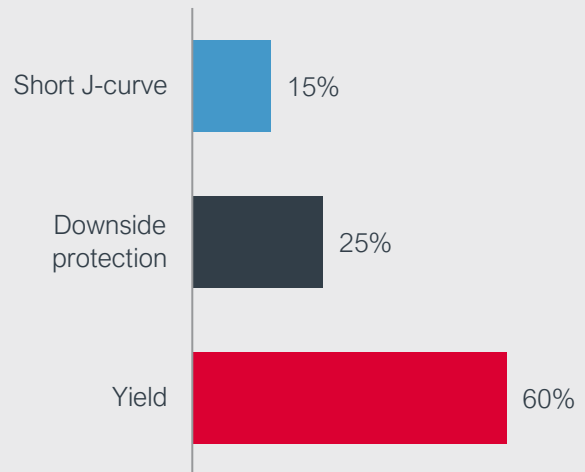
***There is no need for public fixed income in our portfolio. We meet our short-term liabilities with cash yield easily found in a variety of Private Credit strategies within our broader credit allocation.***

*– US endowment*

### Cash is king

For most institutional investors, particularly pensions and insurance, public fixed income still dominates AUM – a typical public fixed income allocation would be in the region of 40-50%, compared with just 5-10% for Private Credit. The predictability of regular cash income from a clearly rated and easily traded asset class helps tick many portfolio construction boxes. When discussing what LPs looked for from Private Credit it was therefore not surprising that the familiar characteristics of public fixed income were of most importance. Cash yield was the main motivation with 60% citing it as their top priority. In particular, LPs sought to allocate to less liquid and non-rated credit strategies in order to access a cash yield at a premium to the public markets and often assessed this premium against the relative liquidity the so-called "illiquidity premium."

### WHY DO YOU INVEST IN PRIVATE CREDIT?



Our survey results suggest that Private Credit managers who can ensure fast deployment, 'day one distributions' and relatively low fee burn to keep J-curves to a minimum will gain most traction. Shorter investment periods and fund lives are important too, with some LPs stating as short as a six-year life limit for their Private Credit investments. For both public fixed income and Private Credit, LPs expect a low risk, predictable return profile with low defaults rates and high recovery rates. To achieve this in Private Credit, LPs tend to rely on manager selection, diligencing GPs to ensure they back managers who will provide sufficient portfolio diversification, a strong asset picking track record and a proven ability to protect value in cases of underperforming investments.





## 2. THE 'GREY ZONE' IS GETTING COLOUR

### GREATER SOPHISTICATION AND FLEXIBILITY AMONGST LPS IS SUPPORTING THE EMERGENCE OF A 'RAINBOW' OF INVESTMENT STRATEGIES ACROSS THE FULL SPECTRUM OF RISK-RETURN OPPORTUNITIES

For many years there was a 'Grey Zone' within Private Credit – strategies targeting high single digit or low double digit IRRs which struggled to find investment as they fell between allocations. These strategies were deemed too risky for lower returning 'fixed income replacement' allocations, while at the same time lacking the absolute returns required to fit into equity-like PE allocations (which typically required net IRR targets of at least 15%).

#### New interest in strategies returning 10-14% IRRs

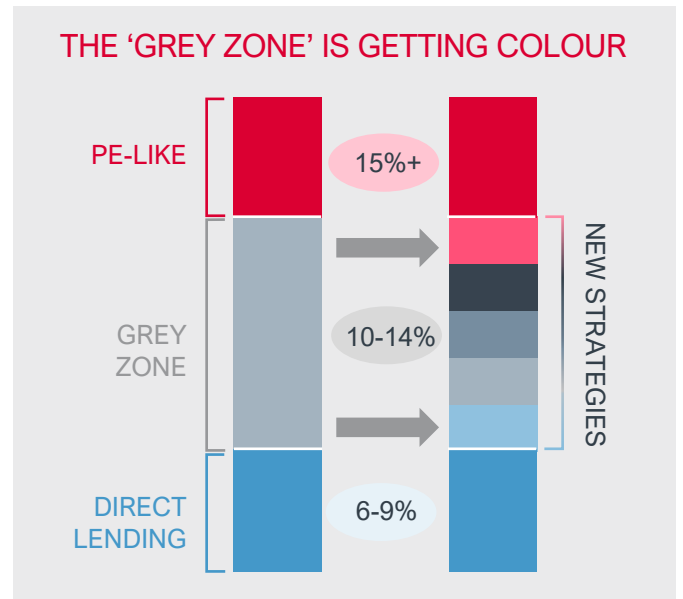
It is within this previous 'Grey Zone' between Direct Lending and private equity that investors are now increasingly seeking differentiated risk-adjusted returns between 10% and 14%. A range of niche strategies have emerged. Some of these lie within the new category of 'Specialty Finance', while others are essentially reconfigured Special Situations strategies sometimes rebadged as 'Opportunistic Credit', with a lower target return and greater flexibility to invest in both non-performing and performing credit.

The emergence of new opportunities filling in the 'Grey Zone' is closely allied with the development of more specialised Private Credit teams within LPs.



*We are definitely seeing more interest for low teen IRR credit strategies. It tends to be from clients with more mature credit portfolios who are looking to diversify their Direct Lending allocation. I would say our North American clients are further along with this. Given there are a range of very different and quite complex strategies within this area it makes sense that they are turning to us for help in navigating and selecting these opportunities.*

– Global consultant





### 3. SPECIALTY FINANCE IS THE NEW BLACK

#### LPS CITE SPECIALTY FINANCE AS A KEY AREA OF INTEREST MORE FREQUENTLY THAN ANY OTHER CATEGORY

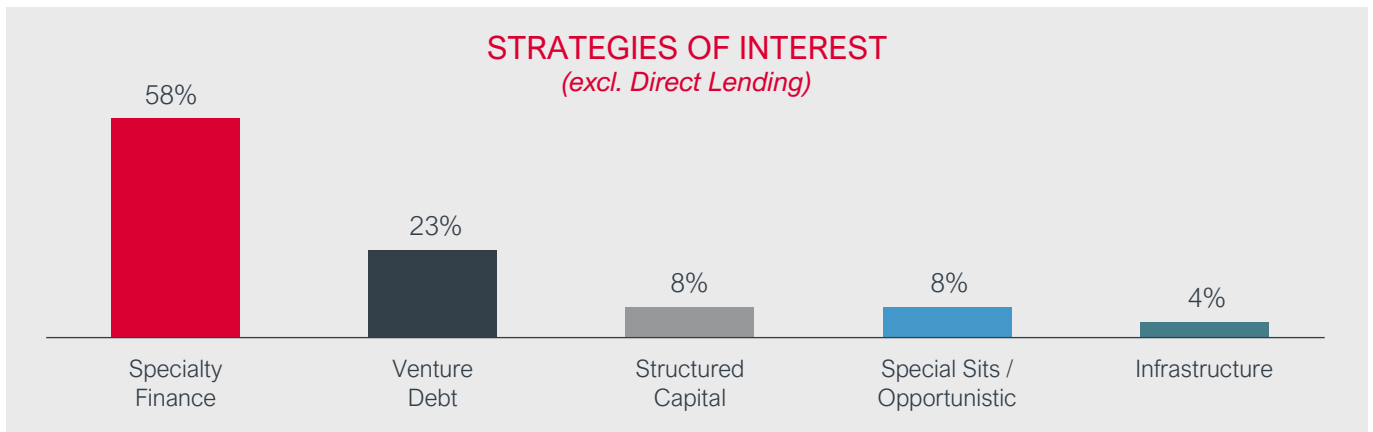
Digging in further to the strategies filling in the former 'Grey Zone', we asked LPs which areas of Private Credit are currently of most interest, excluding the traditional heartland of Direct Lending. In line with the shift toward more flexible allocations and greater focus on low double digit IRRs, LPs consistently mentioned the recently emerged category of 'Specialty Finance' as a key area of interest. Specialty Finance strategies are typically defined as niche lending strategies, offering net IRR return targets of around 10-14% and additional benefits either in reduced correlation with broader market returns or asymmetric downside protection.

LP interest in Specialty Finance has been reinforced by strong recent performance of the category - as one LP commented,



**Generally we saw our underlying strategies within Specialty Finance performing well through Covid and coming out of it, which has helped to increase our confidence that these uncorrelated strategies can help our portfolio navigate macro shocks.**

*– Global family office*





# SPECIALTY FINANCE IS THE NEW BLACK

## Variety is the spice of life – especially when it’s uncorrelated

When pressed further on what is attracting them to this area, investors frequently cited the competitive dynamics of a relatively new category, as well as the wide range of different niche sub-strategies available. Many LPs saw the diversification opportunity offered by Specialty Finance not so much as a shift away from Direct Lending, but as a means to receive current cash flow in a form that was less correlated to their wider corporate credit exposure.



*I’d say about 10-15% of what we do for our clients each year is within Specialty Finance and that has been steadily growing. The broad range of fundamentally different credit strategies within Specialty Finance allows LPs to significantly diversify risk exposures and potentially generate a return premium versus other areas of the Private Credit universe.*

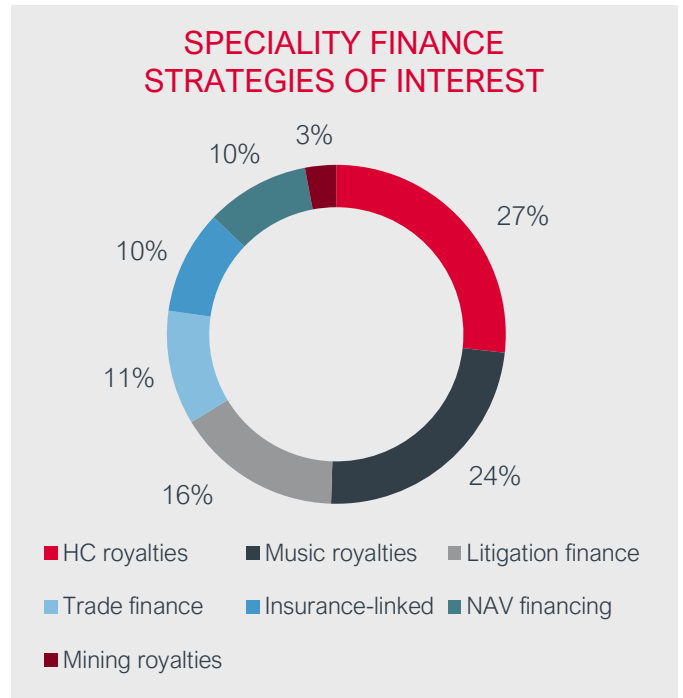
– Global consultant



## On the other hand, too much choice can be overwhelming

The chart above shows the frequency with which specific Specialty Finance sub-strategies were mentioned by the LPs surveyed. Royalty stream strategies and litigation finance dominated the field – both of which have clear decorrelation benefits whilst providing regular ‘yield-like’ income streams to investors.

Beyond these two areas, the variety of strategies that lie under the umbrella of Specialty Finance is huge, ranging from consumer and SME finance, factoring and receivables finance, regulatory capital lending and a variety of private equity portfolio financing and leverage solutions.



While the sheer number of options creates obvious diversification opportunities, it also presents a real challenge in crafting an effective allocation strategy. The different strategies are unrelated to one another and often require very specific skills and competence to understand. This can make it difficult for less sophisticated LPs to form a clear and nuanced view and ultimately gain sufficient conviction to put capital to work.

## Consultants step into the breach

In the short term, consultants clearly have a role to play here in a similar way to when Direct Lending first emerged as an asset class. In the longer term, Rede expects that as this area of the market matures, we will see the emergence of blue chip, trusted GP brands; while LP understanding will increase and the consultant role will diminish.



## 4. A NEW DAWN FOR DISTRESSED?

### WHILE PRIVATE CREDIT IS WELL-POSITIONED FOR A DOWNTURN, WE EXPECT NOTABLE WINNERS AND LOSERS – WITH A POTENTIAL RESURGENCE IN DEMAND FOR DISTRESSED STRATEGIES

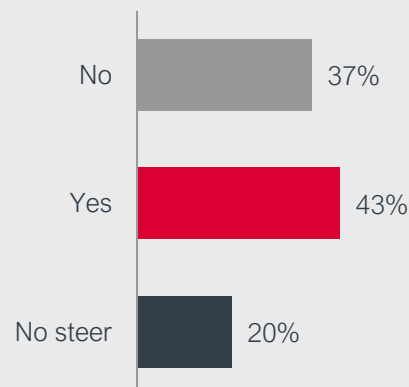
#### Clear consensus amongst LPs that we are heading into an economic downturn

Although much of our survey data was gathered before the outbreak of the Russo-Ukraine war, a number of macroeconomic factors were already pointing to a potential tipping point within the economic cycle. By March 2022, when we conducted a second spot-check on LP sentiment at the SuperReturn Credit conference in London, LPs demonstrated a very clear consensus that an economic downturn is now built in to their investment activities. Since March, major spikes in inflation, a cost-of-living squeeze, continued supply chain disruption and rapid central bank rate rises have only added to the concerning macro picture.

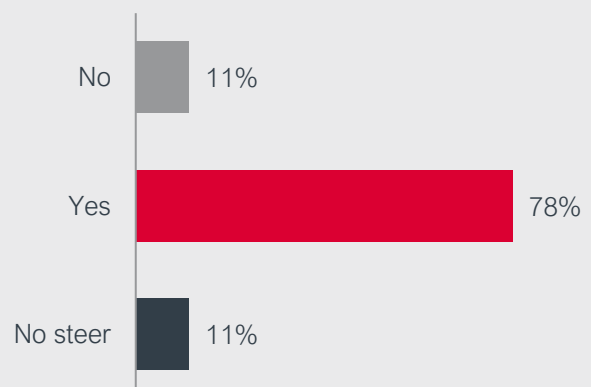
#### In general, Private Credit should be well-positioned to weather economic storms

It is Rede's belief that whilst Private Credit as an asset class will perform strongly in a more challenging macro environment, we will see notable winners and losers. Those managers who have remained disciplined and have sufficiently large, high calibre teams and prior downturn experience are expected to navigate the market most successfully. Furthermore, we expect particular outperformance from strategies focusing on the most senior layers within the capital structure, and those benefitting from reduced market correlation.

#### DO YOU EXPECT A CYCLE CORRECTION? (OCTOBER 2021-JANUARY 2022)



#### (MARCH 2022)





## A NEW DAWN FOR DISTRESSED?

### Within the asset class, a downturn will affect each niche in different ways – with some clear winners and losers expected

The diagram shows Rede's view on the impact of the expected economic downturn on each key segment within Private Credit. It shows a complex picture – for example, while Direct Lending benefits from strong inflation and

downside protections, the overall addressable opportunity is expected to become more constrained during a downturn as buyout activity inevitably slows. Conversely, while the investment opportunity pool typically becomes more abundant during tighter macro conditions, investors may not benefit from the inflation protections offered by more straightforward floating-rate lending strategies.

	INFLATION PROTECTION	DOWNSIDE PROTECTION	INVESTMENT OPPORTUNITY
Direct lending / Unitranche	●	●	●
Subordinated / Pref	●	●	●
Specialty finance	●	●	●
Asset-backed	●	●	●
Opportunistic credit	●	●	●
Special sits / Distressed	●	●	●
Venture debt	●	●	●
High yield bonds	●	●	●





## A NEW DAWN FOR DISTRESSED?

### In a tougher market, GPs who maintained strong discipline through recent years will emerge strongest

Across the Private Credit asset class, we expect a more challenging macro environment to shine an unflinching spotlight on the discipline GPs have maintained over recent years.

In general, the level of downside protection offered will reflect seniority in the capital structure, leverage levels, lending documentation robustness and business size. Managers who have remained disciplined in their underwriting and conservative in their structuring are expected to perform better, whilst we may see an uptick in defaults and losses where managers have not put suitable structures and protections in place.



**Direct Lending is predominantly a mid-market business financing solution. With increased competition we have seen looser protections in some situations. Mid-market businesses are also inherently more susceptible to certain cost pressures compared to larger companies and I think you are already seeing some issues in a number of portfolios.**

– *German consultant*

Another large consultant predicted some of the more specific repercussions from these challenges, “I expect we will see more default activity and with it more battles over assets between sponsors and different lenders. If that starts to happen the tightness of documentation becomes paramount but even then things can get messy in the courts around intercreditor agreements etc. I expect we will see GPs moving origination team members over to the workout side in large numbers.”

### Expect greater focus on GPs’ workout capabilities during LP diligence

With a market downturn expected, LPs are increasingly focusing on diligencing managers’ workout experience and their ability to successfully take the keys to a struggling company. However, in the context of the last decade’s sustained run of benign market conditions, it may not be straightforward for managers to collate strong evidence of these capabilities.



**When we do DD on credit managers we aren’t just looking at the yields they are generating and business portfolio performance, we spend a lot of time understanding the team’s workout capabilities and if they have sufficient resource to handle problems in the portfolio. Given the length of time since the last proper downturn it’s sometimes hard to find teams who have been properly tested on this.**

– *US endowment*



To pass LP scrutiny, managers will need to demonstrate they have the investment size and influence to ensure they get a seat at the restructuring table, and that they have the right people to fill those seats. Ideally, a GP team will include experienced, senior professionals with strong prior workout track records. More generally, we expect LPs to favour well-resourced managers, given the resource that workouts can suck away from day-to-day investment activity. Managers who solve for any currently underinvested areas ahead of a planned fundraising will avoid an increasingly important potential LP roadblock.



## A NEW DAWN FOR DISTRESSED?

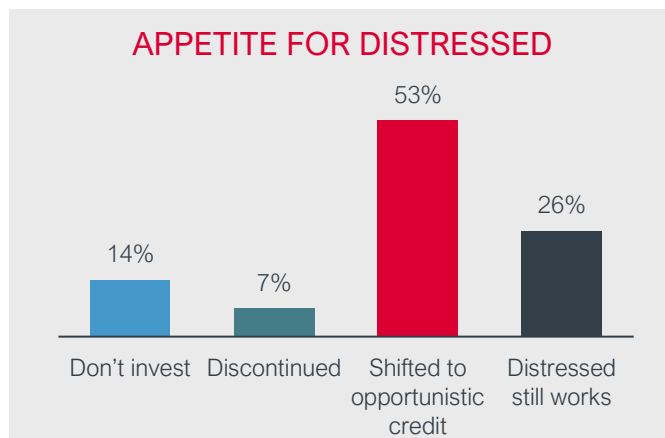
### We have witnessed a sustained shift in LP appetite away from ‘Distressed’ strategies in favour of ‘Opportunistic’ ones

In recent years we have noted a clear shift in LP appetite from ‘distressed’ strategies to ‘opportunistic’ approaches – a shift reported by 53% of our survey respondents. When asked about this, LPs typically cited a desire to back managers with a broader investment remit that can flex according to market conditions – for example, playing across both performing and non-performing credit or both public and private investments.

This coincides with the 1H 2022 Rede Liquidity Index (“RLI”) report released in June, where 20% of participants are looking to expand in distressed / turnaround plays. This represents a rise of 15 percentage points since the last edition of the RLI in 2H 2021<sup>5</sup>.

The extended bull run we have lived through in recent years has underlined the need for such flex. Many noted that pure distressed and Special Situations managers, particularly at the larger end of the market, had underperformed in recent vintages due to their investment scope being too narrow and ill-suited to the market environment.

Furthermore, the numerous ‘dislocation funds’ raised at the onset of the Covid pandemic have struggled to deploy following the end of the short-lived market dislocation, further exacerbating the view amongst some investors that ‘distressed’ strategies have had their day. Indeed, in November 2021 Oaktree<sup>4</sup>, one of the pioneers of the distressed market, released a report stating, “*Distressed investing has evolved and expanded... we believe the right move has been to broaden one’s mandate, eschewing boundaries – including those around countries, investment areas, sectors and forms of ownership.*”



### A market turndown could represent a new dawn for ‘Distressed’ strategies, particularly at the smaller end of the market

With around a quarter of LPs surveyed still citing appetite for pure distressed strategies, we believe that the current market uncertainty may stimulate a resurgence in interest in this segment.

In particular, we believe that the alpha generation potential of smaller, highly focused distressed strategies will attract greater attention over coming months.



***We like backing Special Situations strategies at the smaller end of the market. There are always plenty of niche and varied opportunities that we see being sourced and there really aren't that many players competing for opportunities. I'm very pleased we have some European distressed exposure given the current market.***

*– US endowment*



Conversely, it remains unclear whether appetite for distressed strategies at the larger end of the market will rebound, with LPs preferring to hedge their bets with more flexible investment mandates when they are making substantial commitments to large funds. As one German consultant put it, “*There have been a lot of larger businesses, especially in the leveraged loan market that have raised finance on the basis of questionable EBITDAs and with relatively elevated leverage levels. If we go into a downturn, I can see that those more distressed, broken balance sheet opportunities could re-emerge. However, in the larger market I'd still favour a more nimble manager with a flexible strategy who can take advantage of these opportunities, but can also flex to other sorts of credit investments with a similar return profile.*”

<sup>4</sup>Global Opportunity Knocks: The Evolution of Distressed Investing  
<sup>5</sup>Rede Partners RLI 1H 2022



## 5. PRIVATE CREDIT MANAGERS BEWARE: THE ESG TRAIN IS LEAVING THE STATION

### STRONG ESG POLICIES AND PRACTICE ARE BECOMING MANDATORY FOR GPS

In recent years, we have seen LPs' focus on environmental, social and governance ("ESG") issues gaining increasing prominence across the entire private markets asset class. In general, this has developed further and faster within equity ownership strategies such as buyouts, venture capital and infrastructure. However, Private Credit LPs are now turning their attentions with increasing frequency to the ESG policies and practices of their investee GPs.

### Private Credit LPs are increasingly focused on ensuring investee funds have strong ESG policies in place

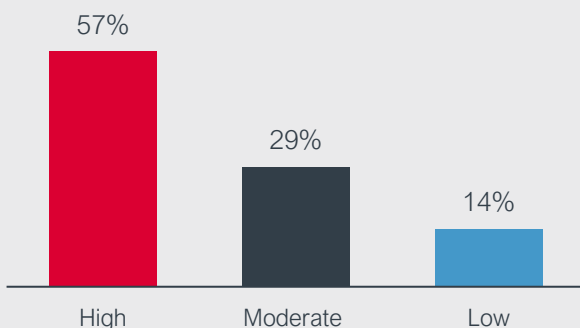
57% of our Private Credit LP respondents now consider the importance of ESG in decision-making to be high. As a result, credit businesses will need to hardwire ESG policies and practices into their corporate DNA. Successful GPs will have best in class policies, a forward-thinking (rather than 'tick-box') approach, and be well-prepared to fill out increasingly detailed DDQs and face specialist ESG diligence during fundraising.

### Credit GPs approaching fundraising should view ESG as a defensive tactic – but world- beating ESG won't get your fund raised quicker

When it comes to investment decision making, we see a broad spectrum of variation between LPs in the degree of weight given to ESG considerations. In our opinion, for the vast majority of LPs ESG is more of a negative screen (a GP lacking sufficient ESG credentials cannot be greenlit) rather than a positive screen (GPs are selected on the basis of their outstanding ESG).

From a reporting perspective it is evident that ESG is important, and managers must have a strong ESG policy in place to be considered. That means a policy that covers the manager themselves in terms of team governance and decision making, corporate social responsibility, and making efforts on the environmental side. We see managers increasingly looking to become carbon neutral or making pledges to do so within a relatively short timeframe. For portfolio companies, managers should at least be including ESG as part of their pre-investment DD and including a section in their IC papers. LPs increasingly expect ongoing monitoring, with GPs needing to develop a comprehensive set of KPIs to assess ESG performance of specific portfolio companies as well as provide portfolio level aggregated reporting.

### ESG IMPORTANCE IN DECISION MAKING







## PRIVATE CREDIT MANAGERS BEWARE: THE ESG TRAIN IS LEAVING THE STATION

### Within the Private Credit world, Impact has yet to really catch on... but managers should get ready

While the last few years have brought a dramatic increase in LP enthusiasm for Impact strategies in general, this excitement has not yet reached LPs focused on Private Credit. Indeed, to date only 8% of our survey respondents have invested in an Impact-focused credit fund.

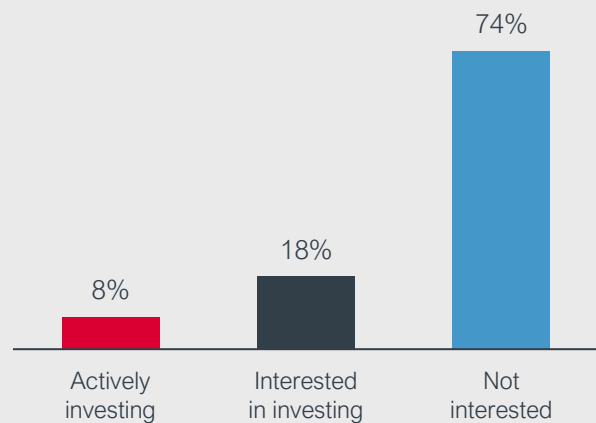
As one pension fund manager who took part in the survey noted: *“If one manager is earning 6% and another with an Impact strategy is earning 4%, then those making a decision around Private Credit would most likely choose the former. If you’re a Private Credit investor, you’re asking what is the real value add and why would I really care about this as much?”*

More specifically, many Impact Credit funds conceived to date have been related to the infrastructure or energy transition space where returns are typically 200-300bps below those of corporate Direct Lending – meaning that LPs have struggled to find a place for these funds within their allocations.

Another frequently cited reason for low levels of LP interest in Impact Credit funds is the belief that lenders will not have sufficient influence to drive real impact in the underlying portfolio businesses. This stands in contrast to control equity investors who typically have the final say in operational matters within their portfolio companies.

One potential solution to the ‘control problem’ is the creation of ESG covenants with margin incentives or

### IMPACT CREDIT STRATEGY INTEREST



penalties tied to ESG KPIs within the underlying business. This approach is already in use and we believe it could ultimately be a powerful one once there is a clearly agreed set of KPIs that can appropriately measure the most impactful areas of ESG within specific businesses.

Ultimately we believe the strength and momentum of the sustainability agenda means LP appetite and expectations for Private Credit to address this will only grow. We also predict that as seen in Private Equity, the speed of this change will outpace expectations and solutions will be found for any sticking points. Private Credit managers should get ready for this from both a defensive and offensive perspective.

## 6. THE PRIVATE CREDIT FUNDRAISING MARKET IS BECOMING MORE CREATIVE



### INCREASING SOPHISTICATION WITHIN LPS IS DRIVING A NEWFOUND ENTHUSIASM FOR FIRST TIME FUNDS, CO-INVESTMENT AND SECONDARY TRANSACTIONS

#### LPs are increasingly open to first time credit funds, particularly spin-outs from established managers

The plethora of new strategies emerging to fill in the previous 'Grey Zone' brings with it a rich opportunity for new managers to establish themselves as market leaders in each of the myriad niches along the risk-return spectrum. Historically, however, Private Credit LPs have been more reluctant than private equity investors to back first time funds and emerging managers. To understand whether these attitudes are now changing, our survey explored current LP sentiment toward emerging Private Credit managers.

It was reassuring that 48% of Private Credit LPs are now open to considering emerging managers and first time funds ("FTFs").

Most important to LPs when considering a FTF is the need to demonstrate a clear, underserved market opportunity addressed by the new fund. As new strategies emerge to fill in the former 'Grey Zone', a far greater number of new GPs are able to demonstrate a compelling 'gap' they are uniquely positioned to target, helping more new GPs across the finish line for that all-important first fundraise.

Detailed LP discussions made clear that newly formed teams who hadn't worked together previously were less desirable than those who have previously operated together in some capacity. Unsurprisingly, most desirable were spinouts from established credit platforms and where there was a verifiable, attributable and disclosable prior track record.

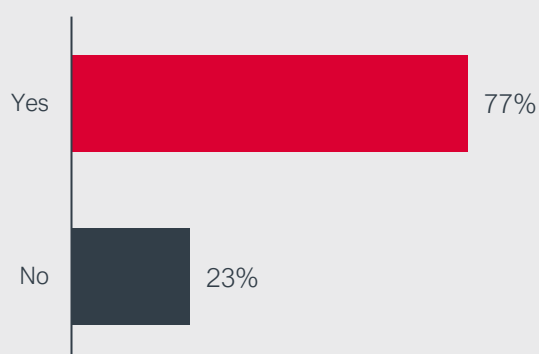
#### DO YOU INVEST IN FIRST TIME FUNDS / EMERGING MANAGERS?



#### Amongst Private Credit LPs, we are seeing growing appetite, and resources, to co-invest alongside GPs

As is the case in private equity, there is strong appetite for co-investment in Private Credit. In our survey, 77% of respondents said they make co-investments. The main motivation cited by LPs for co-investment was to achieve lower blended fees, but many also saw it as a way to access specific credit opportunities that may scale at certain points in time.

#### DO YOU CO-INVEST?



Typically, the 23% who aren't making co-investments were simply not set up to do so, as many deals are sponsor-driven and often move too quickly for teams to perform proper due diligence or structure their investments. Many are newer and smaller credit programmes, which lack the internal capabilities to underwrite co-investment opportunities or conduct necessary diligence.

The avenues by which LPs access co-invest opportunities depend heavily on the depth of their internal organisation. The most sophisticated investors with ample resources are able to act as a JV partner and invest directly alongside GPs. The majority, however, prefer to take syndicated COI, allowing a more appropriate timeline for their own due diligence and access to information that had been pre-screened by the GP. Finally, LPs with fewer resources are most likely to look for passive COI vehicles or COI strategic managed accounts with a low fee structure that can supplement the main GP fund.

# THE PRIVATE CREDIT FUNDRAISING MARKET IS BECOMING MORE CREATIVE



As LPs become ever-more sophisticated we expect to see increasing numbers of LPs taking advantage of the more resource-intensive approaches to co-investment and, consequentially, strong growth in co-investment volumes across the Private Credit asset class.

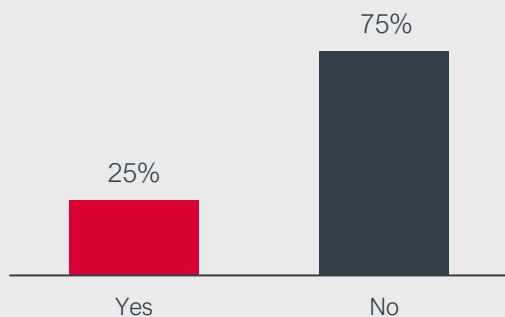
## Expect an uptick in credit secondaries – although several challenges remain

At present, 25% of the LPs we surveyed are actively investing in credit secondaries, with figures pointing towards an increased interest in the years ahead. Indeed, 65% of participants believe that secondaries will be of similar or more interest in the future, compared to 35% who are less enthusiastic.

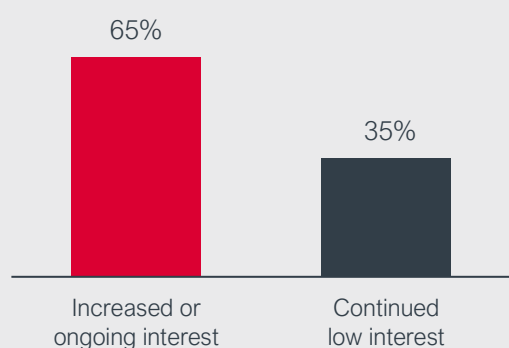
*“This makes sense if Private Credit grows as an asset class as expected,” says one of the consultants who took part in the survey. “The reality is that anyone involved in credit secondaries is buying something that is undervalued. As the asset class grows, more funds will be closing and will need to find homes for unliquidated positions.”*

Credit secondaries present some specific challenges which have delayed growth in this market relative to, for example, the private equity secondaries market. Of particular concern to LPs are valuation discrepancies and complexities; agreeing on cash-on-cash multiples; and the tendency for the highest quality credit tranches to have been refinanced out of portfolios prior to secondary transactions taking place – leaving behind a less attractive mix of warrants and equity-orientated investments.

### DO YOU INVEST IN CREDIT SECONDARIES?



### FUTURE VIEWS ON CREDIT SECONDARIES





## CONCLUSIONS

### **LP sophistication is driving growth and development of the asset class**

Our survey results suggest that Private Credit will continue to experience strong growth over the coming years – with typical Private Credit allocations potentially rising to 6-10% by 2026. With much of this growth driven by a rotation or diversification away from public fixed income, there is clearly significant scope for expansion given the 40-50% fixed income allocations many sizeable institutional investors currently maintain.

LPs are becoming more sophisticated in their approach to Private Credit, creating dedicated Private Credit allocation and hiring credit-specific professionals to focus on these allocations. This facilitates investment appetite across a broader spectrum of credit strategies and return profiles. In particular, where once growth in Private Credit was driven by Direct Lending, this is increasingly being supplemented by a range of strategies now filling what was previously the 'Grey Zone' of low double digit IRR strategies. As LP investment sophistication grows, so too does interest in investment approaches beyond 'vanilla' fund commitments, such as credit secondaries and co-investment.

Specialty Finance has now emerged as a key area of focus for LPs looking to diversify away from Direct Lending. It offers premium risk-adjusted returns in parts of the market with more compelling competitive dynamics, lower correlation and clear downside protection. This part of the market requires high levels of sophistication to pick the best managers and strategies and construct appropriate allocation from. While LPs develop their capabilities, Rede expects consultants to play an important role in the selection process, echoing the way that consultant involvement catalysed the rapid growth of the Direct Lending market over the last decade.

### **Private Credit is well-positioned to weather an economic turndown**

LPs are concerned about the macroeconomic picture. In general, we expect investors to increasingly favour

income-orientated returns and value investing over equity orientated returns and growth investing, with many Private Credit managers poised to benefit from this shift. We expect the majority of Private Credit strategies to perform well in an economic downturn, helped by their structural protections against inflation and downside, as well as their contractual return profiles and low reliance on economic growth.

In particular, we expect a resurgence of interest in distressed and Special Situations strategies. Strategies which have been rebadged from "distressed" to "opportunistic", with added flexibility to invest in both performing and non-performing credit, may have ironically shifted their message just as 'distressed' comes back in vogue. The jury is still out as to whether a genuine distressed opportunity will present itself at the large end of the market. However, Rede believes that we will see a real distressed market opportunity develop in the mid-market, with some potentially stellar fund vintages ahead.

### **Manager selection will be key to LPs seeking to navigate macro-economic change**

Across all areas of Private Credit, challenging investing environments will bring a starker separation between 'the best' and 'the rest'. LPs will need to focus squarely on manager selection and diligence as we approach this new stage of the economic cycle. For their part, GPs will need to put their best foot forward, bringing compelling evidence of their performance across cycles and demonstrating the true value of their approach. They will need to look critically at their team, ensuring they have the right talent in place to weather stormy macro-economic waters, and ensure that their organisation is fit for an uncertain future. Ultimately, against a backdrop of overall growth in the asset class, those who successfully navigate these treacherous seas will be able to reap significant rewards.

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