Handelsblatt

“A new dimension of financial engineering”

Lending by private credit funds is the subject of intense debate. The head of Deutsche Credit explains where he sees opportunities and risks.

Frank Wiebe, Frankfurt

Private credit (PC), lending by funds rather than banks, has become the subject of considerable debate. More than a year ago, the European Central Bank (ECB) warned of potential risks in the sector. The central concern is that specialist PC funds – also known as private debt funds – sometimes provide loans that banks are unwilling or unable to hold on their balance sheets because of stringent regulatory requirements.

At the same time, some of these funds are themselves financed by banks, meaning that the associated risks can ultimately find their way back into the traditional financial system. In October, the Basel-based Bank for International Settlements (BIS) also criticised the lack of transparency in private credit and raised questions about some of the credit ratings assigned to these investments.

More recently, concerns have been fuelled by private credit funds moving aggressively into the multibillion-dollar data centre financing market, driven by the boom in artificial intelligence (AI). This gives them indirect exposure to what some regard as an AI bubble, a trend fuelled by excessive optimism. Against this backdrop, there has been particular nervousness over the decision by major US private credit fund Blue Owl to pull back from the roughly $10 billion financing of a data centre for technology company Oracle. Its experts apparently concluded that the risk was too great after all.

Experienced banker Nicolaus Loos takes a different view. The founder and head of private credit firm Deutsche Credit tells *Handelsblatt* where, despite the risks, he sees opportunities to generate double-digit annual returns. “We are seeing a new dimension of financial engineering,” he says, describing the growing interconnectedness between private credit, private equity (PE) and the traditional financial system, which can result in complex structures. But the industry veteran primarily sees opportunities: “Many of the financing structures currently attracting criticism have been established in the market for years,” he says. His argument is that private credit is moving into attractive areas of the market that other providers are leaving underserved.

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Nicolaus Loos

Deutsche Credit

Although data centre financing is not part of Deutsche Credit’s business, Loos has formed a view based on his experience of the sector. “It is important to bear in mind that the customers commissioning these projects are often very large, financially strong US technology companies," he says. "That provides a degree of security and long-term visibility on the offtake side." He is referring to companies such as Alphabet, Amazon and Microsoft.

Deutsche Credit itself focuses primarily on financing Germany's mid-market. Loos knows the segment well. From 2009 to 2018, he held a senior position at Düsseldorf-based mid-market lender IKB.
In his view, bank financing with maturities of three to five years or longer has become progressively less attractive for lenders, creating significant opportunities for specialist private credit funds. He sees similar potential in lending to companies below investment grade, meaning businesses with weaker credit profiles.
The challenge for banks is that higher-risk exposures require them to hold more regulatory capital to ensure that their balance sheets can absorb potential losses. Private credit firms do not face the same constraint because profits and losses do not sit on their own balance sheets. Instead, they are passed directly through the funds to investors.

Private credit can be more straightforward than bonds

For companies, issuing bonds is another alternative to bank loans and private credit. But Loos says: "A bond issue is generally not economical for smaller mid-market companies that do not meet the necessary thresholds in terms of revenue, profitability or issuance volume." Issuers also generally have to obtain and pay for two ratings from established rating agencies. Private credit financing, with "private" referring to instruments that are not publicly listed, can therefore be more straightforward than issuing bonds that are subsequently traded on an exchange.
Another form of financial engineering involves leveraging private credit funds by financing part of their capital through debt. This increases potential returns for investors but also increases their risk.

In Loos's experience, institutional investors such as insurers and pension funds generally invest in unlevered funds because of stringent risk requirements. Leveraged funds, by contrast, are often attractive to wealthy private banking clients, family offices and some international investors, he says. They can also serve as an alternative to private equity. Loos says: "European fund managers are beginning to consider leveraged private credit strategies for international investors as well as domestic multi-family and single-family offices. They generally establish separate sub-funds for this purpose, alongside their conventional unlevered institutional sub-funds." Such structures are already widespread in other countries, particularly the US, where regulatory requirements are less stringent.

Avoiding conflicts of interest with private equity

Loos sets out the comparison: "If the average private equity fund now generates net annual returns of only around 15 per cent or less over its lifetime, while private debt with leverage of 25 or 50 per cent can also achieve net returns of between ten and 15 per cent on the basis of senior loans, then private equity is not necessarily the better proposition from a risk-return perspective." The investment risk in PE is generally significantly higher than in private credit. If a company becomes insolvent, equity investors rank last in the capital structure and therefore have the lowest prospect of recovering their investment. Loos also points to the "stability of private debt, with regular and highly predictable distributions" as an advantage over PE funds.

Although Loos generally considers concerns over complex structures to be overstated, he does identify one critical issue. Combining PE and private credit financing under the same provider, whether directly or through more complex structures, is not a model he favours. Such arrangements can create internal conflicts of interest. A private credit fund is primarily concerned with protecting its capital, while a PE fund is focused on maximising returns, and both are accountable to their respective investors, he explains.

Conflicts can also arise between different lenders. One potentially difficult situation occurs when a new lender enters the capital structure and is given priority over existing creditors. This would mean that, in the event of payment difficulties, the new lender would be repaid ahead of them. Loos says: “It can certainly happen that new lenders enter at the top of the creditor hierarchy. But the other creditors generally must approve this.” While such an arrangement may initially appear disadvantageous, Loos says experience shows that it can nevertheless be in the interests of existing creditors. This is particularly the case where the alternative would be a liquidity shortfall or where the company’s funding could otherwise not be secured.

The conclusion for investors is that private credit can offer compelling opportunities. But careful analysis of the individual structure and the risks associated with it remains essential.