



Mick Wright-Smith

PRIVATE CREDIT



Private credit offers opportunities for smart investors

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between 4 per cent through to 15 per cent depending on the borrowers' risk profiles, which also varies widely.

Overall returns from mid-market direct lending are typically in the high single digits, whereas large syndicated loans are a little lower than that as lenders compete on price. Interestingly, long term rating agency statistics suggest that the risk of suffering losses are lower when lending to medium sized companies than larger companies.

defensive characteristics. In an inflationary environment where interest rates are rising, the loan interest rates that borrowers commit to increase because of the floating rate coupons," says Wright-Smith.

"Corporate borrowers can deliver consistent cash yields, capital preservation and low volatility. An increasing interest in direct lending globally suggests that borrowers are happy to compensate lenders for the illiquidity risk and credit risk involved."

THE PRIVATE CREDIT MARKET AND DIRECT LENDING – THE LOW DOWN

The Australian private credit market encompasses a broad range of strategies, including direct lending. It provides lenders and investors with exposure to companies, mostly private, and the risk/return profiles are very diverse depending on the risk of the borrower and loan.

The corporate or business private credit market is worth about \$1 trillion in Australia, with middle market growth loans comprising a \$70 billion segment of this. Middle market companies in Australia have annual revenues between \$25 million and \$500 million. In the middle market most loans are provided directly, hence the term "direct lending", which means the lender doesn't have to work through intermediaries in order to evaluate, structure and document a loan. Private credit can take different forms, including direct lending, real estate loans and many other loan types.

The non-bank corporate loan market has been difficult for middle market borrowers to access in Australia, with lenders focussed on real estate and larger corporate borrowers, where lending opportunities are largely arranged and structured by banks, investment banks and brokers. Middle market companies have less influence over loan structure, terms and conditions than larger borrowers. That is because there are fewer lenders in the middle market, with more competition between borrowers for loans.

FUND MANAGER EXPERTISE KEY TO GOOD RETURNS

Middle market corporate loans are predominantly bilateral in nature – that is, there is one borrower and one lender as party to the loan agreement. Lenders need broad industry contacts to access the most compelling lending opportunities.

Loan terms and pricing are often idiosyncratic, so private credit managers with expertise and experience are best placed to lend to borrowers; the asset selection process is key to creating a solution for borrowers that combines a good return with managed credit risks.

"To build a sustainable private credit business, we've made a conscious decision to focus on lending to companies in defensive sectors such as healthcare, food staples and telecommunications. We think this will serve us well as we head into potential economic headwinds.

"It also serves companies in Australia well, because historically the major banks and established private credit funds have tended to focus more on real estate lending and consumer discretionary sectors such as hospitality."

Epsilon is a non-bank lender and private market asset manager specialising in middle market direct lending, providing bespoke financing to high quality, resilient Australian and New Zealand middle market companies. Epsilon was established in 2019, by Mick Wright-Smith, Joe Millward and Paul Nagy.

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There are many drivers of these statistics and one is because direct lenders tend to have greater influence over terms and conditions and also have greater control when company performance doesn't go to plan. Syndicated lenders generally adopt loan structures created by intermediaries, and they must negotiate amongst themselves initially when company performance is off track.

"Middle market borrowers have

The corporate loan market (excluding bonds) in Australia is worth over \$1 trillion. Unlike bonds, private credit is not issued or traded in public markets. Wright-Smith defines mid-market loans as those sized between \$10 million and \$100 million. Above that level, larger loans become broadly syndicated and there are many lenders (including domestic and offshore banks and credit funds) who participate in this segment.

"The market for large corporate loans is crowded with lenders; there are many lenders chasing the same deals and so there is an oversupply of capital. But in the mid-market, borrowers don't have much choice of lenders other than the Big Four banks."

INCOME FOCUS

Corporate loans deliver a regular income stream for lenders, and it often comes with a hedge against inflation. Corporate loans typically have floating rate coupons, which are linked to the bank bill swap rate and reset regularly, often every 90 days. The interest rates on loans have a wide range of

KEY POINTS

- Australian-based private credit asset manager
- Providing growth loans to middle market businesses
- Offers wholesale investors access to this asset class

Epsilon Direct Lending is an Australian private markets investment manager focused on lending to middle sized companies, having identified that this section of the private credit market offers relatively better returns compared to other private credit strategies, according to Mick Wright-Smith, founding partner of Epsilon.

Direct lending to middle market companies has emerged in Australia as traditional bank lenders have reduced lending activities to these companies, due to regulatory, capital and cost pressures. Epsilon has entered the space to meet corporate borrowers' demands for loans and says the returns are attractive.

"We like mid-market corporate lending because the market is still dominated by the Big Four banks and the availability of capital is limited. So, from a lender's perspective, there is an opportunity to access loans which offer good relative value, that is, loans with relatively higher returns and lower risks compared to other private credit strategies such as larger broadly syndicated corporate loans, for example," says Wright-Smith.

