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Australian investors like the yields and buy-and-hold approach of private debt — and growth is predicted

During visits to Melbourne and Sydney last month, conversations with clients and friends about private debt revealed important contexts to understanding how investors there think about the asset class.

Australia's economy is well known for being resilient. Before the Covid pandemic in 2020, it enjoyed one of the longest uninterrupted expansions — almost 30 years — among developed economies. While seeing some slowing in the current environment, that growth has given the continent a measure of stability amid global volatility.

Australia's economic stability is matched by an efficient credit market. Major banks CBA, ANZ, NAB and Westpac have about a 90% share of the leveraged loan market. And while they managed to avoid the worst effects of the global financial crisis, tighter regulation has had the same chilling effect on leveraged loans as in the US and Europe.

There's also a strong middle market in Australia. It consists of 20,000 companies with revenues of AUD10–250 million. These companies are mostly banked through the retail branches of the banks, so theoretically are ripe for opportunities among private debt arrangers.

Interest rate rise increases demand

Institutional investors told us that disintermediation from the banks to private debt managers began with commercial real estate debt. That in turn led to appetite for private corporate debt, including private equity-backed businesses. The rapid rise of interest rates over the past year shifted demand for private credit into a higher gear.

"We went from no one wanting to talk about it to everyone wanting to talk about it," one client told us. Another reported "an explosion of private credit offerings" in Australia from a number of large global asset managers. The virtues of illiquid, floating rate loans are generally well appreciated, particularly in light of recent interest rate rises that have lifted all-in returns to historic highs.

However, every geographical region comes at the asset class from its own perspective, which depends on how developed it is relative to public strategies. Banks dominate lending in MENA and APAC, while the EU and UK have seen more disintermediation to private debt over the past decade.

The story of institutional investing in Australia is one of superannuation funds. These public pensions — almost 50 in number, with 14 major ones — represent what in the US would be state retirement funds. Many of the largest supers have exposure to direct lending, including AustralianSuper, CBUS Super, HESTA and ART.

Much of their capital is allocated to European debt and is centred around commercial real estate, leveraged loans, subordinated notes and securitisation facilities. Also, as in Europe, there's been a heightened awareness of ESG as both a positive and negative screen for investments.

Relative to other asset classes, private debt is a small share in the country — roughly 5% in a typical portfolio. Public equities represent around 53% of the total, with 19% fixed income and 16% property and infrastructure. The balance is comprised of private equity, hedge funds and cash.

Pulling power of low volatility

Private debt's allocation is expected to grow to 20% over the next decade. A recent study from Mercer's chief investment officer in Australia predicted more appetite for private debt, as those "funds tend to have a buy-and-hold approach, meaning lower volatility than equivalent public market debt". And that "its illiquid nature tends to equate to higher yields".

Fund managers in Melbourne and Sydney are looking ahead. How will leveraged borrowers deal with shrinking interest coverage and higher defaults? If funds or borrowers are looking to extend terms, isn't that the start of a down-cycle? Which managers have the best chance of making it through a potential downturn unscathed?

Nevertheless, experienced credit investors like the current credit crop. "We had pulled back from private debt because we didn't like the value proposition," one told us. "Yields didn't seem to match the risk. Now it's better." Another wondered how far improved all-in yields would go. "Is this as good as it gets?"

Amid challenging macro conditions — US-China, Ukraine-Russia, tech and de-globalisation (which one Sydney investor called a "poly-crisis") — the steadiness of private debt performance has been noteworthy. "Our goal is to invest, set and forget," she said. "Private debt helps."

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