

Introduction and Overview

Welcome to our May 2024 monthly report. As is our practice in these commentaries, we aim to highlight topical matters and assess their potential impact on financial markets.

I recently had the honor of discussing my views on the program [Bloomberg Surveillance with Tom Keen and Paul Sweeney](#). Our conversation delved into various subjects, with one question in particular resonating deeply with me. Mr Sweeney inquired, "Being a former leveraged lender myself, I would never give away deals to guys like you. How are you coming in there and taking business from me?" I provided an honest answer centered around the impact of regulation.

On further reflection, though, it occurred to me that a more profound and philosophical question begs consideration, one that probes the almost existential matter of "Why private credit?" To answer that, one needs to explore the current state of private credit markets, and we will do just that in this letter.

Indeed we will devote most of this month's report to a highly topical review of private credit but, first, let's briefly examine the significance of recent economic and market events.

When it Comes to Economic Releases, High Inflation and Low Growth Persist

Over the past few weeks, three points have hovered ominously over markets like the prongs of a trident. They are the general recognition of persistent inflation, the expectations of higher interest rates for longer, and the weak first-quarter GDP estimate. We have consistently harbored doubts about the feasibility of a soft landing, which, in our perspective, is a combination of low inflation, steady economic growth, and a stable federal deficit. Recent economic data, particularly the lackluster 1.6% GDP growth for Q1 and the soaring GDP price index, validated our stance. Thus, we'd like to say, "I told you so!" We will check ourselves, though, and acknowledge the nerdiness of the analysis that led us to the correct conclusion, by quoting our beloved Dr. Sheldon Cooper to say instead, "I informed you thusly."

We believe the main culprit here continues to be excessive federal deficit spending. Deficit spending can initially spur demand and consumption in the short term, but it has its limits. While some commentators interpreted the underlying data in Q1 to indicate a healthy economy due to the robust final demand component of GDP, we remain skeptical. We are yet to see whether this expansion in final demand, fueled by deficit financing of government transfers, is a sustainable driver of growth.

Going Back to "Why": Private Credit is a Better Mouse Trap for Lending than Deposit-Based Lending

Private credit, which we define as the utilization of closed-end fund structures to extend credit, offers a much more efficient mechanism for lending compared to the models traditionally used by deposit-funded banks. In deposit-based lending, banks depend on funding from depositors to finance their lending activities. This model carries inherent risks, as depositors are led to believe that they can access their cash on demand, while the assets being financed typically have longer-dated maturities.

The inherent asset-liability mismatch is ingrained in deposit-based lending models. Over the centuries, governments have endeavored to tackle these shortcomings by

employing a combination of regulations (aimed at making banks “safer”) and utilizing central banks as the lender of last resort (to bail out depositors and prevent runs on banks).

Even in the regulatory environment following the 2008 crisis, bank regulators persisted in favoring deposits as a stable source of financing. They even established financial and regulatory metrics to incentivize deposit-taking institutions, such as the LCR (liquidity coverage ratio) and NSF (Net Stable Funding Ratio), which encourage banks to rely on retail deposits.

While an asset-liability mismatch has historically been a weakness of the banking system, this risk has been exacerbated over the last decade as payment technology has improved. In particular, the elimination of delays and inefficiencies in money transfer processes has subtly also removed a kind of stabilizing time buffer to the old hierarchy.

The velocity by which even retail depositors can move their funds has significantly increased. Electronic payments, including wire transfers and ACH, along with technological interfaces such as Venmo and PayPal, have accelerated the movement of cash. This has rendered reliance on deposits for extending credit a much riskier proposition for banks.

Pitfalls of Deposit-Based Lending: Stability and Costs

The impact of changes in payment mechanisms on the suitability of deposits has been twofold:

1. Firstly, it has rendered deposits significantly less stable than regulators had envisaged even 15 years ago.
2. Secondly, the cost of deposits is beginning to exhibit greater dynamism and elasticity, a trend we highlighted in our previous letter.

These two factors are somewhat interrelated. Since it is easier for end customers to transfer their deposits between different banks, or between their bank and brokerage accounts, and since most retail deposits are insured, bank depositors are highly motivated to shift their funds to accounts offering the highest possible returns.

Even if a bank is perceived to be secure (e.g. large banks like JP Morgan), they inevitably must begin offering higher payouts to their depositors to maintain their satisfaction.

Here Comes Private Credit: Fixing Asset Liability Mismatch, Predictable Liability Structure

When it comes to extending credit, especially in non-traded and illiquid forms, private credit structures hold an advantage over deposit-funded banks because most private credit structures address the asset-liability mismatch. The structures used for extending private credit, ranging from drawdown funds to BDCs to Interval Funds, generally possess capital structures that provide them with a certain degree of stability in funding.

Furthermore, investors understand that they are exposed to risks and may lose part or all of their capital, a different scenario from bank depositors who expect to be bailed out.

Private Credit Could Become Part of the Answer for “Too Big To Fail”

Given that private credit investors, encompassing those in private funds or shareholders in BDCs or other RICs such as interval funds, are classified as “investors” rather than “depositors,” they possess a higher tolerance for losses and a diminished expectation of receiving direct bailouts. Naturally, there’s always the possibility of a moral hazard and indirect bailouts, such as the theoretical scenario of a Federal Reserve sacrificing price stability to implement quantitative easing, but we’ve moved beyond that stage.

It suffices to say that — at least in terms of aiming to avoid direct bailouts — having a credit extension ecosystem that relies more on investor risk-taking than on implicit and explicit government guarantees makes private credit a much more favorable option compared to deposit-backed lending.

There is No Free Lunch in Private Credit: Borrowers to Pay More for Credit Extension

While private credit doesn’t generate the systemic risks linked to using deposits for lending, there are a few considerations worth noting. One of these is that investors in private credit generally have higher return targets compared to banks relying on deposits and central bank emergency lending. From a policymaking perspective, there’s a trade-off between the cost of credit and creating systemic risk.

[According to Federal Reserve Data](#), private credit spreads reached 651.10 basis points in 2023, compared to 405.45 for the leveraged loan market in the same year.

By shifting credit extension away from banks, policymakers could foster safer deposit-taking institutions that are less prone to accidents.

Private Credit Has Its Risks Too

While private credit lending isn’t subject to the risk of deposit runs and bank failures, it carries its own set of risks, with two categories being particularly noteworthy.

One of these risks involves investors in private credit locking up their liquidity. While locking up liquidity doesn’t inherently increase the risk of capital loss over the investment’s lifetime (and some argue it may actually reduce the risk of losses in certain circumstances), it does limit investors’ flexibility to access their capital. Therefore, investors must carefully consider their liquidity needs when allocating to private credit and make well-informed decisions based on the lock-up periods of private investments.

The other notable risk stems from the fact that most private assets aren’t traded, which can lead to subjective valuations. Implementing robust internal controls, third-party valuations, and frequent monitoring of cash flows and loan performance for private credit assets can help mitigate this risk. Additionally, the structure of private credit vehicles, where certain fees are tied to realized investment income rather than mark-to-market, also helps mitigate this risk to some extent.

Not All Private Credit is Created Equal: Each Sector Has Its Own Dynamic

While Private Credit is a widely used term, it encompasses various asset classes, each with its unique pricing dynamics. This categorization is somewhat subjective, and different market participants may classify them differently.

These categories are:

1. **Direct Lending:** covering middle-market and large-scale lending, which primarily involves typical corporate lending. This segment witnessed significant growth in the past two decades, particularly post the 2008 crisis, and remains a cornerstone from where private credit lending originated. Many private credit investment vehicles operate actively within this realm.
2. **Specialty Finance and Private Asset Backed Lending:** encompassing lending collateralized by financial assets, such as loans and receivables, and lending to other non-bank lenders. This sector has seen noticeable growth in recent years.
3. **Structured Credit and ABS:** somewhat akin to publicly traded credit, including asset classes like CLOs and esoteric ABS. While traditionally invested in by insurance companies, these asset classes have increasingly become targets for private credit vehicles. Notably, they are less liquid compared to conventional corporate bonds and loans. Additionally, certain loans intended for the Direct Lending market can also serve as collateral for CLOs, such as broadly syndicated loans and middle-market loans.
4. **Special Situations and Distressed Investments:** comprising lending to challenged capital structures, both pre- and post-petition, utilizing instruments typically secured with the lender having material control over collateral
5. **Private Real Estate Lending:** which, despite the historical dominance of banks and government-sponsored enterprises (GSEs), this sector has witnessed private credit lenders becoming increasingly active in recent years.
6. **Hard Assets, Energy, and Infrastructure lending:** involves lending backed by assets ranging from aircraft and shipping to infrastructure. This sector, often characterized by long-term contracts and, at times, limited competition, represents a significant segment within private credit.

Given the broad sway of the assets that are covered in Private Credit, each market and asset class can be subject to its own unique set of dynamics.

Current Status of Private Credit

Although we acknowledge the benefits private credit funds and structures offer to the credit extension ecosystem, they remain susceptible to cyclical bouts of irrational exuberance that periodically affect, well, all markets. Presently, we observe indications of such behavior, notably within the first sector mentioned above: Direct Lending, including lending to middle market and large companies.

In the past year, credit spreads (in both investment grade and high yield) have seen a significant rally, nearing historically tight levels. Conversely, risk-free rates and US Treasuries have experienced upward movement.



Figure 1

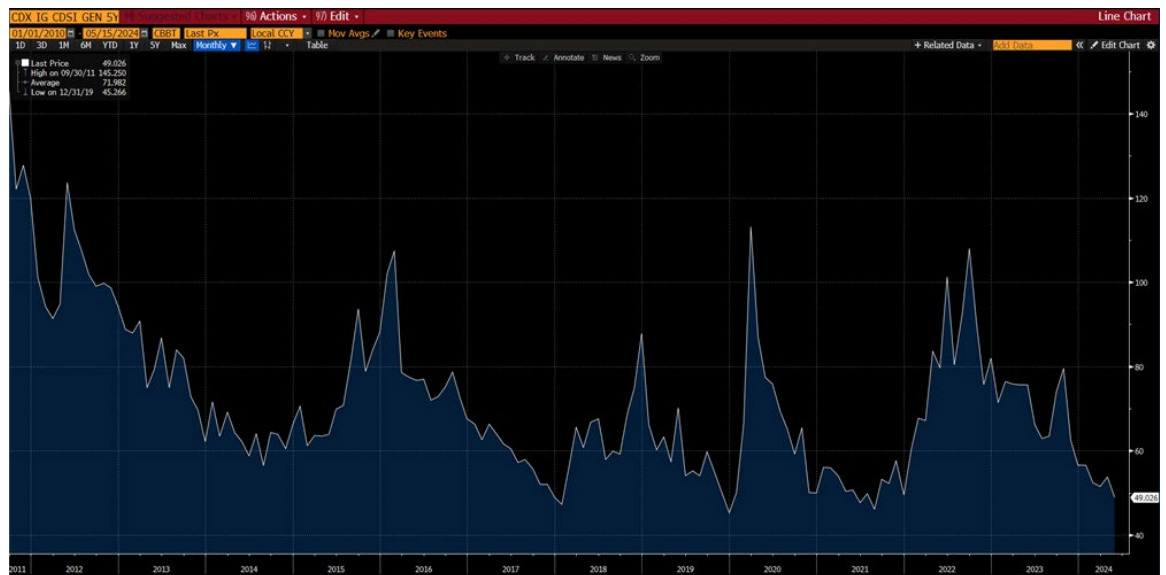


Figure 2

Some commentators and observers have been highlighting the relatively higher yields accessible to credit investors as a rationale for engaging in credit investments in the current environment. In our judgement, though, if these elevated credit yields primarily stem from increased interest rates rather than broader credit spreads, it doesn't present a compelling case for investing in credit markets.

At the end of the day, while higher yields may be found in the Treasury market, the primary consideration for extending credit should be the attractiveness of credit spreads compared to the associated credit risk.

We are seeing indications of overheating in the direct lending market, as some of the largest private credit funds are now directly competing with banks to provide loans to large corporations. The competition between the syndicated loan market, typically driven by banks' capital markets desks, and direct lenders in private credit has led to a loss of pricing power and looser covenants in certain cases.

In our opinion, the relaxation of credit standards in private credit due to direct competition with bank syndicate desks could result in future underperformance.

Some Rating Agencies and Regulators have Raised Some Concerns About Possibilities of Losses in Private Credit

Over the past few months, there's been a noticeable focus on the risks associated with private credit. These concerns derive from a range of considerations, from uncertainties surrounding valuations to the quality of credit and underwriting. From our perspective, these concerns are especially pertinent due to the increased competition between banks and direct lenders.

Moreover, given that certain borrowers in the direct lending corporate sector are experiencing constrained cash flows, paying 'higher for longer' interest rates could exacerbate credit deterioration.

Among the rating agencies, Moody's has recently lowered its outlook on the credit rating of certain BDCs due to a rise in non-performing loans. To be clear, a negative outlook doesn't equate to an immediate downgrade, but it does signal an increased possibility of further downgrades. For some issuers like KKR, BDC and Oaktree Specialty Lending Corp, the dollar amount of non-accrual loans has doubled, now accounting for 4.5%-6.5% of their holdings.

Though these percentages are still relatively small, the trend is worrisome.

Likewise, in its recent release of the [Global Financial Stability Report](#), the IMF has issued warnings regarding private credit investments and identified data gaps. Notably, it underscores the vulnerability of leverage providers to private credit funds, stressing the necessity of regulatory oversight. While the IMF report indicates that risks from private credit are currently manageable, it emphasizes the need for regulators to delve more deeply into certain areas for investigation.

Monachil's Approach to Private Credit

At Monachil, we aim to generate attractive risk-adjusted returns for our investors by targeting less saturated areas within private credit and retaining flexibility in capital deployment.

Specifically, we avoid the Direct Lending space and instead prioritize opportunities where our capital can support borrower flexibility and help them foster growth. Generally, most of our exposure is within Specialty Finance and Private asset-backed transactions, where we serve as senior lenders backed by financial assets and further enhanced by robust covenant and collateral packages.

Additionally, we understand that simply achieving higher yields is not sufficient grounds to assume credit risk, and our investors need to be compensated with a higher spread. We have also adopted a flexible approach to deploying our capital where we have the ability to “toggle” between the public and private markets. For example, during the upheaval of 2023 following Silicon Valley Bank’s implosion, we strategically increased our exposure to structured finance instruments in one of our funds, as we perceived the space to offer a more favorable risk-reward profile. As spreads have since tightened, we have scaled back our presence in the traded ABS sector and have shifted into more private market transactions.

We are confident that our approach, which centers on lending to the specialty finance sector while maintaining flexibility in capital deployment, positions us to generate attractive risk-adjusted returns throughout the credit cycle.

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Portfolio Manager

Monachil Credit Income Fund

If you would like to subscribe to receive monthly commentary, please contact us at ir@monachilpartners.com.

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