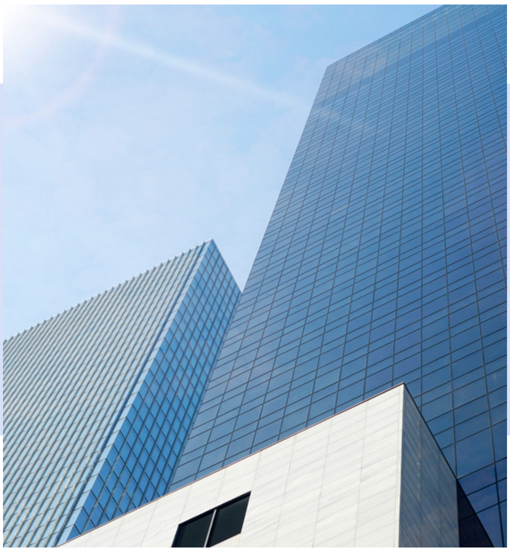
Insights

January 2024

TCP Outlook for 2024: Risk of Inflation Lingers



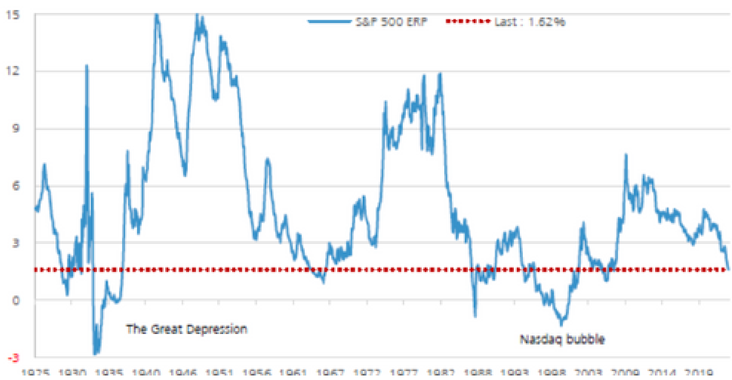
Private Credit offers investors an attractive opportunity to benefit from regular income, strong investor protections and low volatility regardless of what economic conditions prevail during 2024.

Private Credit finished 2023 with strong performance[1] which is expected to continue into 2024. Australian equities and residential property surprised most market participants by finishing the year near all-time highs. This was on the back of the global economy avoiding an expected recession, as well as positive market sentiment on lower inflation and expectations of early central bank rate cuts. However, given an expectation of slower global GDP growth, valuations for these asset classes appear stretched.

Despite strong performance over the past year, investor outlook for 2024 remains complicated by a number of concerns that are yet to be resolved:

- Although inflation has moderated, it remains above central banks' targets of 2-3% risking interest rates being maintained higher for longer to contain any upside risks
- Higher interest rates are negatively impacting consumers and businesses with the full impact of higher rates likely to be felt in 2024
- Whilst a recession was avoided in 2023, the risk of economic contraction in 2024 still looms over key markets
- Historically expensive valuations: of note equity risk premia at extremely low levels (US S&P 500 at 1.6%[2]: lower only during the Great Depression and 2000 Nasdaq bubble. See ***Exhibit A***); poor and deteriorating affordability for Australian residential property (median dwelling value-to-income ratio of 8.1x[3]), whilst commercial real estate is grappling with ~US$6.5 trillion of debt[4]

Exhibit A: S&P 500 Equity Risk Premium since 1925[2]



- Fraught geopolitics with ongoing conflicts in Ukraine and the Middle East, whilst elections in 60 countries including major markets such as the US, India and Taiwan during 2024 is likely to add further volatility

With so much uncertainty, it remains a challenging environment for investor allocations. Whilst cash rates at ~4% now arguably offers a reasonable return in nominal terms, it is less attractive in real terms considering inflation. We believe Private Credit offers investors an attractive opportunity to benefit from regular income, strong investor protections and low volatility regardless of what economic conditions prevail during 2024.

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Private Credit – Attractive Opportunity Amidst Uncertainty

Private Credit offers investors diversification into an attractive, defensive asset class in the current environment, with features and characteristics that mitigate several investor concerns:

- *Attractive Return Profile*: Private Credit provides regular income and attractive risk-adjusted returns. TCP's current net return (8.9%[5] as at end November 2023) for TCP Private Debt Income Fund is in-line with long run equity returns[6] while benefitting from 1st lien security and several downside protection features
- *Hedge against Inflation/Interest Rate Risk*: Private Credit continues to benefit from higher-for-longer interest rates with its floating-rate yield profile. To date, all of TCP's investments have been floating rate with returns increasing during 2023 in line with the rise in benchmark rates
- *Alternative to Asset Classes with Stretched Valuations*: Private Credit investments are senior in the capital structure that provides a meaningful equity buffer (typically >50% in TCP investments) against deterioration in valuation and has low correlation with other asset classes
- *Managing Risks During Economic Downturns*: Private Credit has strong downside protection features that helps us manage risks of underperforming borrowers during economic downturns. TCP investments typically feature the following protections:
  - Senior ranking security: Provides first right to cashflows and assets of borrowers hence providing a buffer against deterioration in earnings
  - Maintenance financial covenants tested quarterly: Provides an early warning signal against deterioration in credit quality of the borrower and enables us to take action if required to protect our investment

Australian Private Credit Market Update

The Australian Private Credit market has continued to grow in profile and size with estimated $175bn in FUM at the end of 2022, up 32% from $133bn in 2021[7].

We expect this momentum to continue in the coming year as the fundamental growth drivers remain in place:

- Basel III/IV forcing banks to pull back their lending activities with private credit lenders filling the void
- Borrowers seeking greater flexibility in lending terms as well as certainty and speed of execution offered by private credit vs. banks

During 2023, there has been continued bifurcation in the market between large-scale financings and the smaller mid-market financings. The large-scale deals have seen spreads tighten with terms increasingly in favour of borrowers as competition intensified amongst the large global credit providers which target this segment of the market. In contrast, the mid-market where TCP is focused remains less competitive (mainly the domestic banks) with typically more attractive pricing and stronger lender protections available.

In terms of activity, 2023 was a year of two halves. Deployment was slower than usual in 1H 2023, mainly driven by a lack of M&A volumes with the sharp increase in interest rates and uncertainty driving up the valuation gap between buyers and sellers. In contrast, 2H 2023 was a busy period with M&A activity and investment volumes picking up. We expect this momentum to continue into 2024 given our strong pipeline. Furthermore, we anticipate higher refinancing demand during 2024 from private equity sponsors facing challenges in exiting portfolio companies due to slow IPO markets.

An Experienced Manager with Focus on Deal Selection will be Key to Success in 2024

Whilst Private Credit is clearly under the spotlight for investors as an asset class well-suited to navigate the complex economic environment ahead in 2024, we believe it is important to partner with an experienced fund manager to maximise the benefits offered by the asset class.
TCP's focus is on maintaining investment discipline through careful deal selection, rigorous due diligence and ensuring deals are structured with a number of key downside protection features. This ensures the performance of the portfolio will be resilient even in the event of economic slowdown. Since inception in 2022, the TCP Private Debt Income Fund continues to build a diversified portfolio of defensive, cash generative credits that offers investors stable cash income with an attractive risk-return profile, strong investor protections, low correlation with public markets whilst the floating return profile provides a natural hedge against inflation / interest rate movements.

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About Tanarra Credit Partners

Tanarra Credit Partners ("TCP") is an Asia-Pacific private credit specialist with offices in Sydney, Melbourne and Hong Kong. TCP's senior investment team has 70+ years of combined global credit markets experience.

Since inception in 2017, TCP has grown to manage ~$800 million of investor capital and has an excellent record of originating and structuring leveraged finance transactions across the Asia-Pacific region.

TCP is the credit vertical of Tanarra Group, diversified alternative asset investment firm, headquartered in Australia, with over A$3 billion in assets under management.

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For more information about the TCP Private Debt Income Fund, speak to a GSFM Account Manager:

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GSFM FUNDS MANAGEMENT

1. JPM Credit Research: Leveraged Loan index provided a +13.17% gain in 2023, with BB (+10.23%) and B loans (+14.61%). These were the second strongest returns for loans on record
2. UBS
3. ANZ
4. JPM Global Research
5. Calculated by annualising the 1 month total net return as of end November 2023. Note, past performance is not a reliable indicator of future performance and results
6. 2022 Vanguard Index Chart (data assumes no transaction costs or taxes and reinvestment of all income): average annual returns since 1992 for Australian Shares of 9.0%, US Shares of 10.2%, International Shares of 7.8%
7. EY