Insights

TCP Outlook for 2025: It's 2024 2.0

February 2025

Inflation and economic uncertainty to persist. And what policies will President Trump enact?

Private credit continues to offer investors an attractive opportunity heading into 2025. Investors may benefit from regular income, strong investor protections and low volatility in an uncertain economic and political environment, especially in light of an uncertain set of US policies.

At the start of 2024, private credit was valued at approximately US$1.5 trillion. It is expected to climb to US$2.6 trillion by 2029[1]. As tight bank lending conditions endured through 2024, borrowers continued to appreciate the speed and adaptability of private credit solutions. At the same time, investors valued the role private credit can play to diversify portfolios, as well as the high cash income and low volatility of a senior secured credit product. Consequently, the private credit sector finished 2024 with strong performance.

Competing asset classes also finished the year positively, but with more volatility. Australian equities shook off economic concerns and the impact of higher rates to notch up a strong end to 2024; the S&P-ASX 200 Index was up 7.5 percent and close to $2 billion was added to the value of the benchmark index. Domestic residential property valuations remain elevated, although they did experience some softening in Sydney and Melbourne.

Heading into 2025, several concerns have not been resolved: inflation remains sticky, expectations as to the timing and quantum of central bank rate cuts have been lowered, and geopolitical risk continues to be elevated. The market continues to pay close attention to President Trump's policies on trade, immigration and taxes with the uncertainty reflected in increases in US Treasury yields in spite of rate cuts. At the same time, equity and residential property valuations appear stretched and at risk from continued, higher rates.

[1] Preqin, Future of Alternatives 2029 Report, December 2024

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The global environment – same, same but different

While inflation has been reduced and rate cuts have started in some jurisdictions, market risk lingers on a number of fronts. This contributes to the attractiveness of private credit.

Inflation has moderated but is lingering: Despite lower inflation, in Australia it remains above the RBA's targeted 2-3 percent rate. Consequently, the RBA is unlikely to drop rates as far or as fast as other central banks. In the US there is a risk of inflation ticking up this year as a result of tariffs, tax cuts, immigration controls, etc. A trade war, in particular, would be inflationary.

Rates to remain elevated: Consensus is Australia will cut rates twice in 2025 after holding at 4.35 percent; however, with above target inflation resulting from higher energy and food prices, coupled with a constructive labour market, the RBA will remain cautious. This positions the Australian private credit market to offer attractive returns versus overseas markets such as the US, where the Federal Reserve has already cut rates by 100 basis points, with an additional 50 basis points priced in for 2025.

US policy uncertainty: The only certainty to result from President Trump's policy statements with respect to trade, immigration and tax cuts is global uncertainty. concerns over global trade wars have increased. The US has announced tariffs against China (10%), Canada (25%, 10% on energy) and Mexico (25%). A crack down on legal and illegal immigration (as well as an effort to end birthright citizenship) may lead to wage pressure. US tax cuts, with a resultant increase in the budget deficit, could also lead to higher inflation.

Higher default rates: As corporations service debt with higher interest rates, the risk of default increases. US leveraged loan market defaults are now approximately 4.5 percent[1]. A similar increase is evident in Australia where Australian insolvent companies are at record numbers[2]. Weakness is especially felt in consumer focused corporations and property developers.

Historically expensive valuations: Equity valuations remain at all-time highs with the US S&P500 within 0.1 percent of its peak[3] and the ASX200 reaching an all-time high of $8,514.50 in December 2024. At the same time, despite some pull back in house prices, affordability for Australian residential property remains low, with a median dwelling value-to-income ratio of 8.0 times[4]. In other sectors, commercial real estate is grappling with ~US$4.7 trillion[5] of debt.

Ongoing uncertainty creates a supportive environment for private credit allocations. While the Australian private credit market is not entirely immune to global economic forces, it exhibits a degree of insulation from the volatility experienced in larger markets such as the US. This stability, coupled with the attractive yields offered by private credit, makes it an attractive investment proposition irrespective of the prevailing economic conditions in 2025.

[1] JP Morgan, Credit Strategy Weekly Update, 17 January 2025
[2] ASIC, Weekly Insolvency Statistics, accessed 21 January 2025
[3] Market Index, Morning Wrap: ASX 200 to fall, S&P 500 near record highs, Market breadth flips negative, 23 January 2025
[4] ANZ, Housing Affordability Report, November 2024
[5] Houlihan Lokey, Commercial Real Estate – Debt Market Update, October 2024

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The bottom line

Private credit offers investors diversification into an attractive, defensive asset class that, in the current environment, enjoys features and characteristics that mitigate market concerns:

Attractive return profile: Private credit may provide regular income and attractive risk-adjusted returns. The current net return (8.9 percent as at end November 2024) for the TCP Private Debt Income Fund is in-line with long term equity returns, while benefitting from first lien security and downside protection features. The fund also seeks to invest in steady, contract based businesses or those with demographic tailwinds or government support (e.g., infrastructure). It avoids businesses more cyclical in nature such as property development and mining.

Hedge against inflation/interest rate risk: Private credit returns reflect elevated interest rates with its floating-rate yield profile. To date, all of TCP's investments have been floating rate, with returns increasing during 2024 in line with the rise in benchmark rates. While rates may reduce, the fund is able to maintain an attractive risk premium over benchmark.

Alternative to asset classes with stretched valuations: Private credit investments are senior in the capital structure and that provides a meaningful equity buffer (on average >70 percent in TCP investments) against any deterioration in valuation. It also has low correlation with other asset classes.

Managing risks during economic downturns: Private credit has strong downside protection features that help manage the 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.

Momentum to continue: The Australian private credit market is poised to see continued deal activity in 2025, building on the momentum from late 2024, thanks to a robust pipeline of deals in the sponsor-backed market.

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The keys to success

Private credit continues its strong growth trajectory. It remains an asset class well-suited to navigate the complex economic environment ahead in 2025. To maximise the benefits offered by the asset class, it is important to partner with an experienced fund manager that has a range of attributes: a disciplined investment approach, careful deal selection, rigorous due diligence and a focus on structuring deals with downside protection features.

Since its inception in 2022, the TCP Private Debt Income Fund has continued to build a diversified portfolio of defensive, cash generative corporate credits that offers investors cash income with an attractive risk-return profile. TCP's investments typically are structured with maintenance financial covenants, providing guard rails against underperformance, and have the ability to engage with management teams if there are concerns.

Importantly TCP's investment team has invested through these cycles before. The team's experience and expertise has it focused on businesses and industries with the following characteristics:

- Defensive businesses with macro tailwinds, such as healthcare (ageing demographic), childcare (increase in dual-parent working families and bi-partisan government funding support) and infrastructure services (underpinned by significant committed future government spend on infrastructure projects). These businesses produce steady, sustainable cashflows that provide a high degree of comfort around their ability to service their debt. The fund has no property or mining exposure where credit quality relies on market pricing.

- Businesses where management teams are largely in control of their own destiny. By this, we mean businesses which are not susceptible to cyclicality, whether that be levels of consumer demand, property prices or commodity prices.

- Businesses with market power to be able to pass through input cost price increases, in order to maintain margins – important in an inflationary environment.

The team also focuses on:

- Steady cash returns to investors: currently 8.9 percent (LTM to 30 November 2024), which for senior secured debt risk is an attractive risk/return proposition in the current environment.

- An experienced fund manager: An investment team with the experience to navigate through an uncertain economic environment is critical for successful deal selection and ongoing portfolio management. TCP has decades of corporate lending experience, having successfully navigated a number of economic and credit cycles.

Private credit offers investors an attractive opportunity that may benefit from regular income, strong investor protections and low volatility, irrespective of the prevailing economic conditions in 2025.

About Tanarra Credit Partners

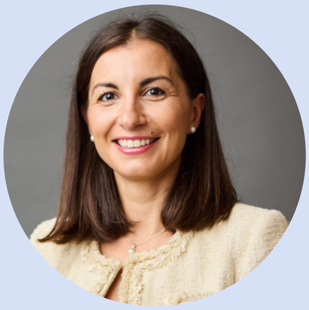
Tanarra Credit Partners ("TCP") is an Asia-Pacific private credit specialist with offices in Sydney and Melbourne. TCP's senior investment team has 50+ years of combined global credit markets experience.

Since inception in 2017, TCP has grown to manage over $900 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.

Investment Team

Peter Szekely
Managing Director



Violeta Kelly
Managing Director

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

gsfm.com.au

Note

1. While TCP Private Debt Income Fund will generally distribute its available income quarterly, there is no guarantee that any income will be generated.

Disclaimer

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In making any investment decision in relation to the Fund, each prospective investor should consider whether the investment is suitable to its own individual circumstances, and is urged to consult with its own qualified advisors with respect to the legal, tax, regulatory, financial and accounting consequences of investing in the Fund.

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TCP Private Debt Income Fund's Target Market Determination is available on the GSFM website https://www.gsfm.com.au/ETL4900AU_TCP Private Debt Income.pdf. A Target Market Determination describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.