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ELTIF 2.0:
INVESTING IN PRIVATE CREDIT THROUGH OPEN-ENDED FUNDS

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

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INTRODUCTION

The new European Long-Term Investment Funds Regulation (ELTIF 2.0) creates new opportunities to invest in private assets through open-ended funds. This paper discusses this innovative regulation and the additional investments opportunities it brings while focussing within private assets on private credit.

We provide an overview of private credit investments, their associated risks and returns, the benefits of integrating private credit into multi-asset funds, and the strategic considerations underpinning investments in funds with private credit exposure.

By delving into the new regulatory landscape, we describe the characteristics of the BNP Paribas Diversified Private Credit strategy and provide insights for investors navigating this new avenue for allocating to private credit markets via open-ended funds.

The paper is organised as follows:

- **In the first section**, we describe what is private credit, the key players, the types of private credit and how the Global Financial Crisis of 2008 served as a catalyst for the rapid expansion of private credit markets, reshaping the financing landscape and driving increased interest in alternative lending channels.
- **In the second section**, we discuss the sources of risk and return from investing in private credit including the illiquidity risk premium, the duration risk premium, the role of leverage in private credit investments and its potential to enhance returns, and how private credit strategies offer opportunities for return smoothing and consistent income generation.
- **In the third section**, we give the rationale behind investing in open-ended funds that include private credit as a core component and how this allocation can enhance risk-adjusted returns, including a discussion of the new ELTIF 2.0 regulation and its impact on the structuring and distribution of funds incorporating private credit strategies. To complete this section, we describe the key characteristics and strategic focus of the BNP Paribas Diversified Private Credit strategy, highlighting its value proposition and investment objectives, and apply stress-testing methodologies to assess its resilience and performance under various market conditions.

EXECUTIVE SUMMARY

This paper discusses the private credit market and how the BNP Paribas Diversified Private Credit strategy invests in these assets, taking advantage of:

- the new ELTIF 2.0 regulation in the European Union,
- the strengths of the BNP Paribas group as a leader in European lending over € 400 bn of outstanding loans for Commercial and Personal Banking in the Eurozone as of 31/12/2023 and decades of private debt origination and syndication,

and

- the expertise of BNP Paribas Asset Management (BNPP AM) in managing private credit portfolios (assets under management of over EUR 20 bn as of 31/12/2023),

to aim for:

- higher returns versus bond investments with comparable risk, with an expected gross return in the range of Euribor 3-months plus 5% to 6%,
- an objective of providing regular and material income distribution,
- lower risk than other fixed income strategies aiming for comparable returns, with both a lower probability of credit losses and lower volatility, and with limited duration exposure,
- a diversified exposure to private debt markets, investing in corporate private debt, infrastructure debt, real estate debt, and across a wide range of senior and junior debt opportunities.

WHAT IS PRIVATE CREDIT?

CORPORATE LENDING

Traditionally companies secured finance for ongoing operations, business expansion or corporate acquisitions through two borrowing channels:

1. **Public markets**: this channel is typically accessible only to big companies. Examples of public markets include the syndicated leveraged loan and corporate bond markets (both senior secured and unsecured),
2. **Direct financing**: this is accessible to companies of all sizes. Traditionally, it is provided by the banking system, however non-bank institutions are playing an increasing role in providing financing to borrowers.

Private credit refers to debt financing provided directly to companies by either non-bank financial institutions or private lenders. This type of credit is extended outside of traditional banking channels and typically targets borrowers who may not meet the criteria for traditional bank loans, are not sufficiently large to issue bonds or may require customised financing solutions.

Private credit typically involves fewer lenders. For this reason, the advantages of private credit for the borrower include faster deal execution, greater pricing certainty, and confidentiality by avoiding broad dissemination of proprietary information.

In addition, lenders experience higher recovery rates in the event of a default because of stronger covenants. The process of working out a debt structure also tends to be faster when there are fewer lenders involved. In the event of a default, the cost for the private borrower is also lower.

Private credit comes with its own characteristics. Of these, the difficulty of selling private credit due to the absence of a secondary market, i.e., its intrinsic illiquidity, is probably the most prominent.

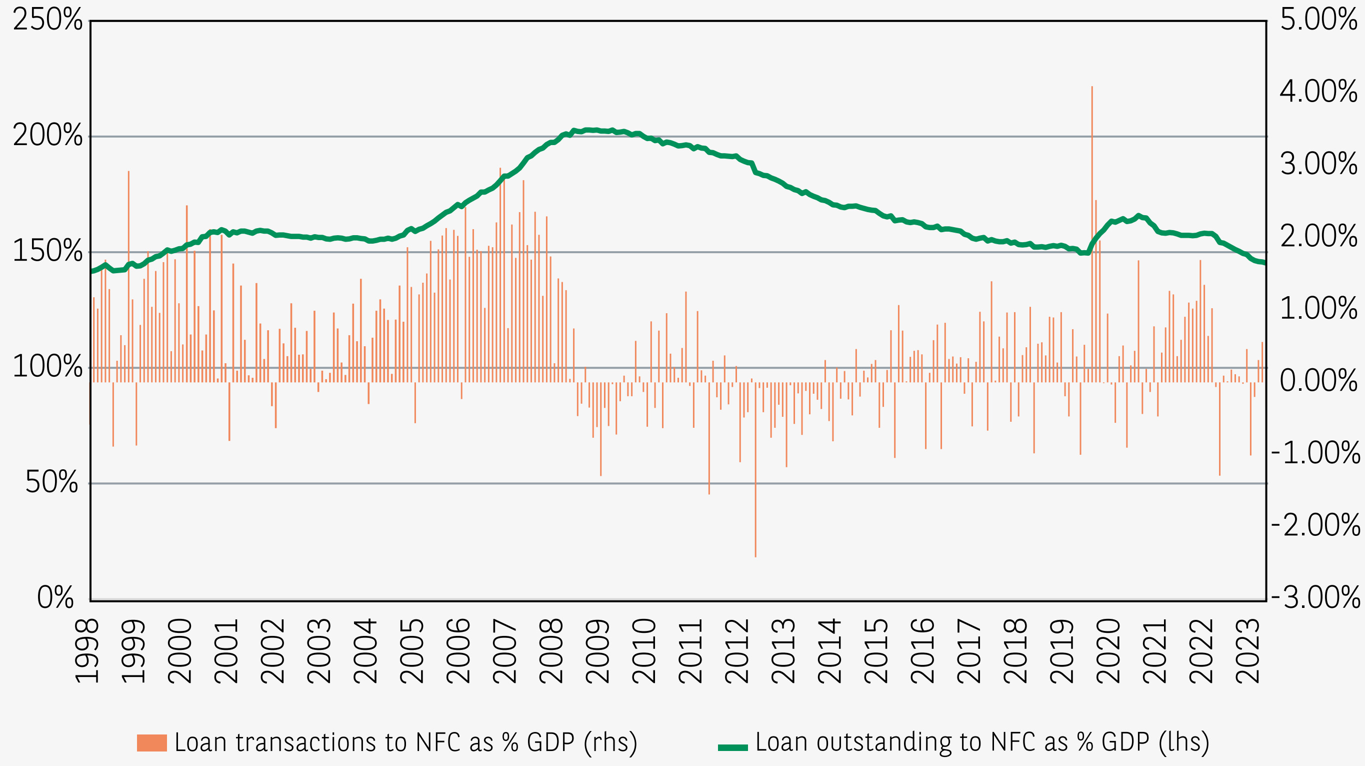
Due to the illiquidity of private credit loans, investors who are forced to sell loans tend to do so at a significantly discounted price. Similarly, and unlike public markets, it can take time to find suitable private debt deals. That is why when investing in private credit funds, or in private assets in general, the committed capital is usually not put to work immediately.

GLOBAL FINANCIAL CRISIS: THE CATALYST FOR FAST GROWTH IN PRIVATE CREDIT

The Global Financial Crisis (GFC) of 2008 fundamentally altered the landscape of bank financing. Following the GFC, more stringent regulatory requirements were imposed on banks, and banks became more risk averse, tightened their lending standards and reduced risks on their balance sheets. Consequently, borrowers were pushed to look elsewhere for their financing. This acted as a catalyst for the growth of the private credit market.

Exhibit 1 illustrates this trend of shrinking bank lending in the eurozone by showing the loans banks provide to non-financial corporations (NFC) as percentage of nominal GDP. It shows both the monthly transactions and the amount of loans at the end of the month as a percentage of nominal GDP (we used a 12-month rolling average of GDP). Loans as a percentage of GDP rose until end of 2008 but started falling in the aftermath of the GFC. As a result, non-banking lenders have been taking an increasing role in providing loans directly to borrowers, filling in the gap created by less direct bank lending.

Exhibit 1: total outstanding loans (left hand side) and loan transactions (right hand side) to non-financial corporations (NFC) as a percentage of GDP.



Source: ECB, 29 February 2024

Private credit plays an important role in financing corporate activities in the European Union (EU) economy and beyond by fulfilling part of the loan demand from non-financial corporations.

Although private credit is quite diverse, the loans are ultimately owned by non-financial institutions banks often act as intermediaries syndicating most of the loans to non-financial institutions.

Alternatively, lending can take place completely outside the banking system, where lenders directly originate and negotiate terms with borrowers. Negotiations between lenders and borrowers can be on a bilateral basis or through a club deal, i.e., a transaction in which a syndicate of direct lenders provide a loan to a single borrower.

PRIVATE DEBT MARKETS

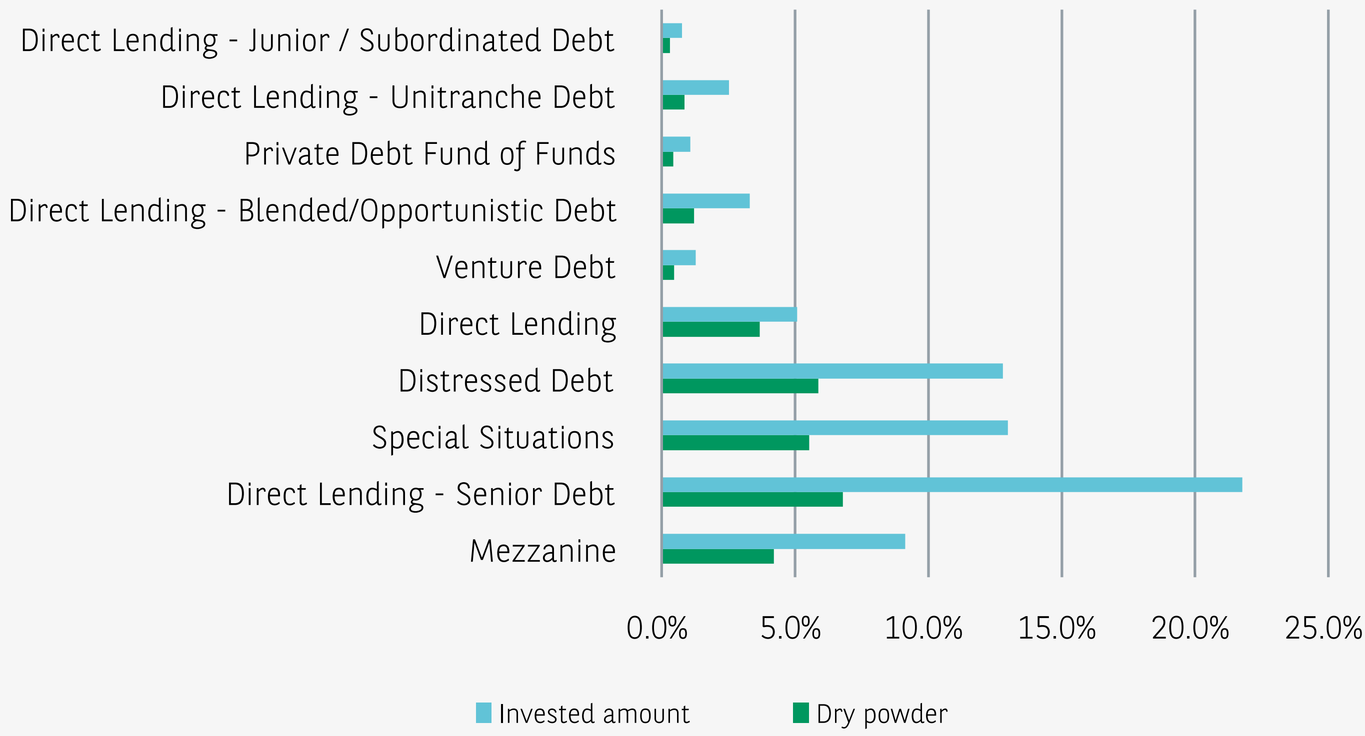
In addition to private corporate credit, the private debt market includes real asset debt, such as infrastructure debt and real estate debt, issued by non-bank institutions.

Exhibit 2 below shows a breakdown of the private debt market by segment. Each segment is shown as a percentage of total private debt assets under management globally. It is based on global data collected by Preqin, a leading data provider for the alternative asset market.

The breakdown focuses on the type of activities financed and the seniority of the loans. It also splits the assets under management (AUM) into *dry powder* and the *invested amount*.

> *Dry powder* is the amount of capital that has been committed by investors to private assets but has not yet been allocated while the *invested amount* is the net asset value of the capital already put to work by investing it in private assets.

Exhibit 2: breakdown of the private debt market by segment as a percentage of total assets under management, as of June 2023.



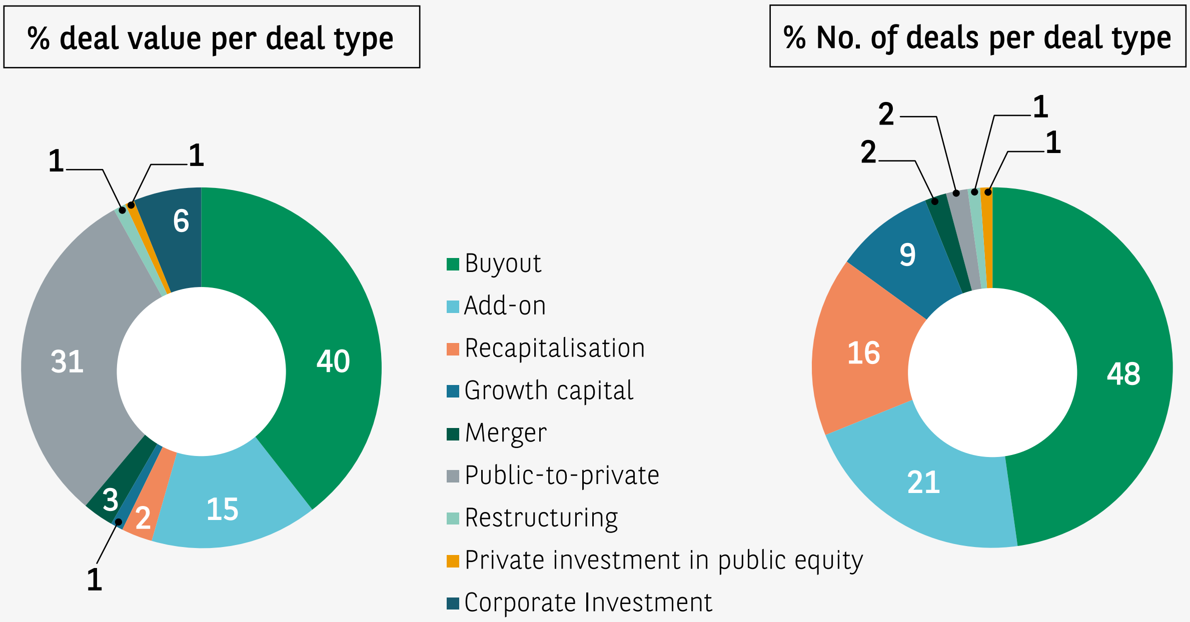
Source: Preqin as of 30 June 2023

Private credit plays an increasingly important role in financing leverage buyout activities, a generic term for the purchase of a controlling stake in a company using mainly borrowed capital to finance the acquisition. This could involve a buyout by its own management, by a group of outside investors, or by another company.

Private credit provided 65% of loans for the leveraged buyout (LBO) market in 2021 and 86% as of September 2023[1]. According to deal data collected by Preqin, 40% of the total private credit deals since 2010 were to finance buyouts (see Exhibit 3 below). These are leveraged buyouts focusing on financing with borrowed capital (at least partially) the acquisition of a controlling stake in a private company. Thus, these are a specific type of leveraged buyout.

1 https://pitchbook.com/news/articles/as-markets-rally-us-leveraged-loan-activity-roars-in-q1

Exhibit 3: breakdown of private credit deals by value of deals for each segment, and, by number of deals in each segment, both relative to the total value and total number of private credit deals since January 2010.



Source: Preqin, deal data 1 January 2010 through 16 February 2024

Another related category is public-to-private where the capital is used to transit a publicly owned firm, with stock floating on an exchange, to private ownership by acquisition of most of its shares. This category represents only 2% of the total deals recorded by Preqin but constitutes 31% of the deal value.

Combined buyout and public-to-private transactions represent 71% of the total deal value. Financing these activities comes with its own specific risk. Thus, in a well-diversified portfolio, we recommend a lower exposure to private credit than their market cap of 71%.

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THE RETURNS AND RISKS ASSOCIATED WITH INVESTING IN PRIVATE CREDIT

THE ILLIQUIDITY PREMIUM

An illiquidity premium refers to the compensation/higher return investors receive for investing in less liquid assets.

Investors anticipate higher returns for investing in illiquid assets than for investing in comparable assets that trade in public markets.

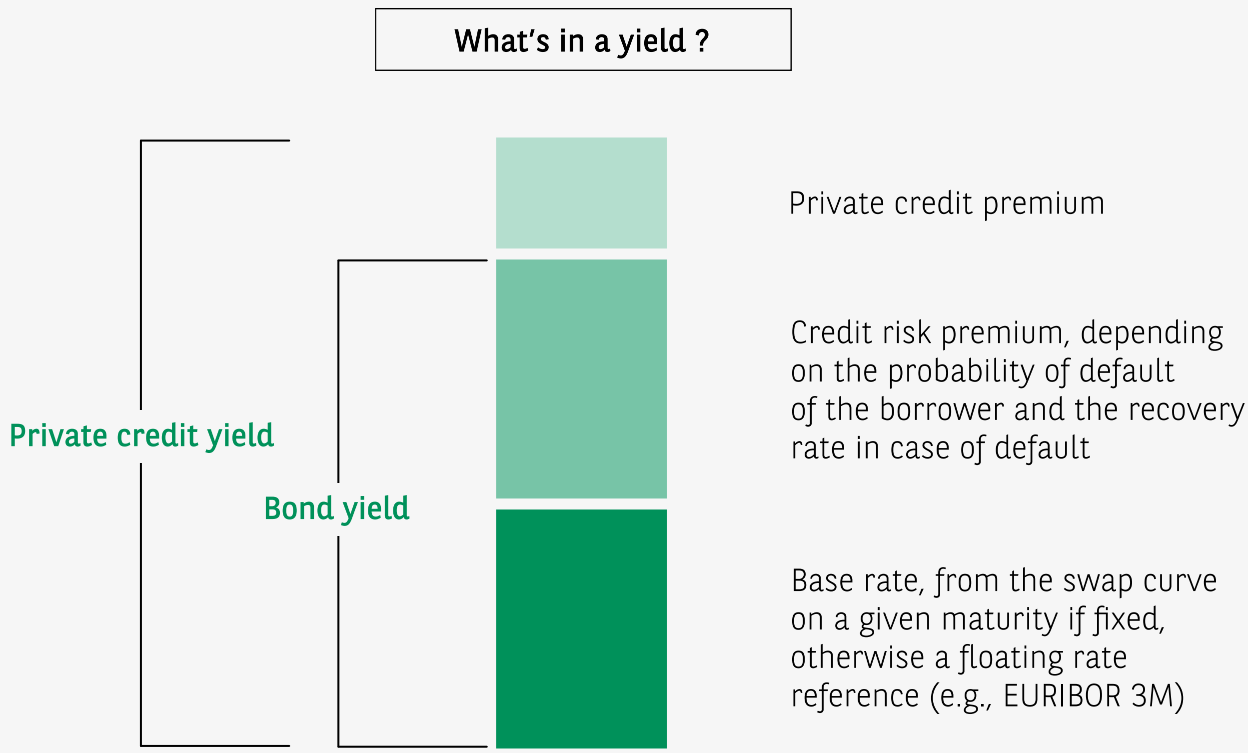
Investing in private assets typically requires locking capital away for several years. Without this illiquidity premium, investors would have little to no financial incentive to invest in private assets over public assets.

In private credit, there are bilateral agreements between the borrower and the lender(s) with limited bank involvement. Therefore investors reap most of the rewards from financing the loan, and the illiquidity premium translates into a higher yield than for a comparable corporate bond.

Exhibit 4 shows a breakdown of yields earned from private credit and a liquid bond with the same duration and for the same/similar company. The illustration shows that for liquid corporate bonds, the yield is the sum of what investors could earn from government bonds of similar duration and the credit spread to compensate for the typically larger risk of default of a company when compared with the government. In private credit there is an additional premium over the corporate bond yield to incentivise investors to take the illiquidity risk. In a recent paper[2], we reviewed the evidence and size of the illiquidity risk premium in private assets.

2 https://viewpoint.bnpparibas-am.com/the-illiquidity-premium-in-private-asset-markets/

Exhibit 4: breakdown of private credit yields compared to corporate bond yields.

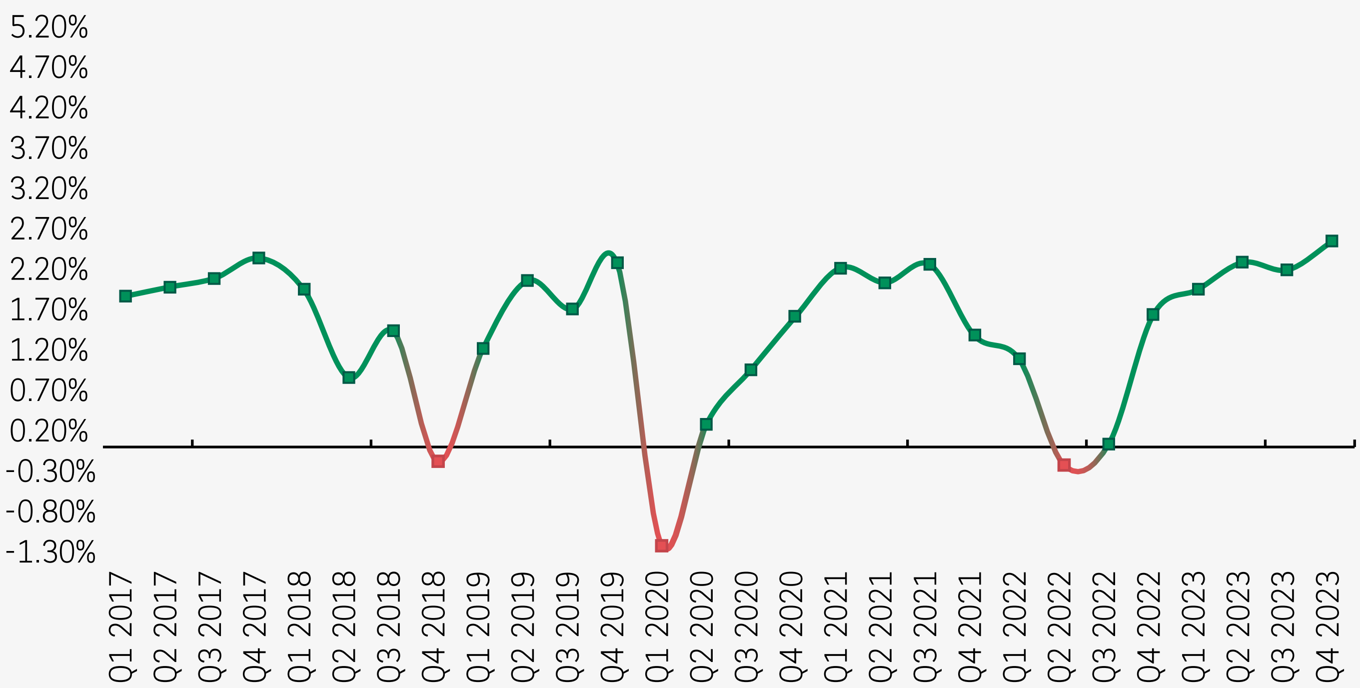


Source: BNP Paribas Asset Management.

In Exhibit 5 we show the difference between private debt yields and yields from comparable liquid corporate bonds over time. This difference, the illiquidity premium, tends, as expected, to be positive.

However, the illiquidity premium measured in this analysis appears to have vanished briefly in 2018, 2020 and 2022. This is due to the spreads of comparable liquid corporate bonds, which are based on mark-to-market data, reacting faster to deteriorating market conditions than the spreads on private credit, which are based on deal data, i.e., based on the spread of the most recent negotiated loans. Deal data tend to be intermittent and irregular.

Exhibit 5: the illiquidity premium of private credit, i.e., the difference between private credit yields and yields from comparable liquid corporate bonds between 2017 and 2023



Source: BNP Paribas Asset Management, Bloomberg

THE CREDIT RISK PREMIUM

Credit risk refers to the risk of loss due to a borrower defaulting on a loan or not meeting contractual obligations.

As with publicly traded corporate bonds, investors in private credit can expect to earn a credit risk premium as compensation for taking credit risk (see Exhibit 5 above).

Credit risk can be divided into the risk of default and the risk of a deterioration in the rating quality, when there is a significant drop in rating quality (from an investment grade to a high-yield rating) such bonds are referred to as fallen angels.

For both publicly traded bonds and private credit loans, the risk of rating quality deterioration or even becoming a fallen angel is typically significantly higher than the risk of a bond defaulting, especially for higher-quality bonds and loans.

For bonds this deterioration in rating quality is likely to lead to a fall in their market price, and the losses will materialise if the investor decides to sell those bonds. However, if the bond is held until maturity and a default is avoided, the loss will gradually diminish as the bond approaches maturity. Private credit loans are generally held until maturity. Changes in the rating quality could force the revaluation of a loan but this happens much less frequently in private markets. Consequently, the risk of default is the primary risk and a source of the credit risk premium in private credit markets.

Another difference is that private credit loan bonds tend to have covenants and security packages to safeguard lenders repayments, whereas corporate bonds are typically senior unsecured standardised instruments. That means that for private credit, if the borrower is unable to service the debt or is otherwise in default, the lenders may, by foreclosing on the security interests[3], sell the assets subject to security and use the proceeds to repay the financing. Moreover, in case of stressed market environment, covenant breaches trigger early warnings and allow lenders to engage with borrowers to prevent a worsening of the situation. This pre-emptive attitude helps in the case of restructuring or default, with historical recovery rates at 60% to 70% for private credit versus 30% to 40% for unsecured bonds. Therefore, for comparable probability of default, private credit has expected higher recovery rates and lower losses.

3 A security interest on a loan is a legal claim on collateral that the borrower provides. It allows the lender to repossess the collateral and sell it if the loan goes bad.

THE DURATION RISK PREMIUM

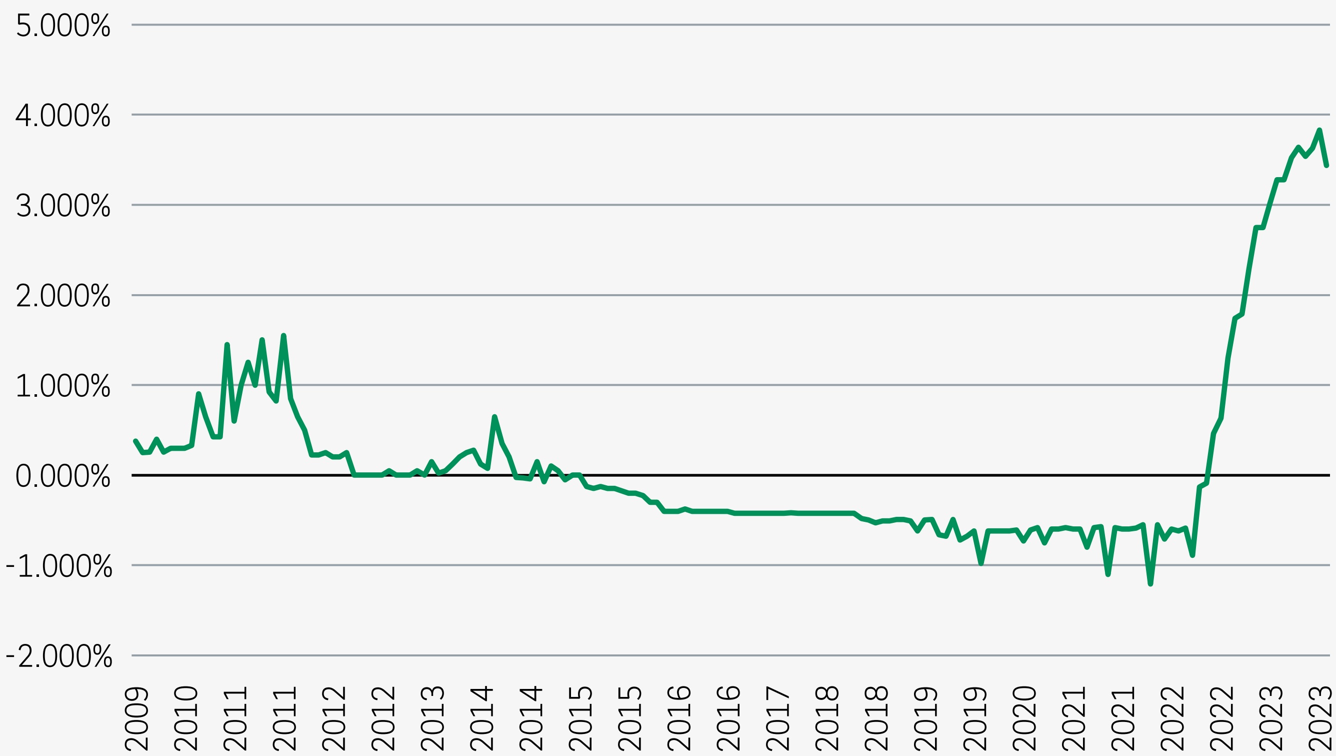
Duration risk premium is the compensation for the risk arising from changes in market interest rates during the life of a bond. It is applicable to bonds with fixed interest rates.

Liquid bonds tend to have a fixed interest rate, which means that a bond pays a fixed amount of interest over the lifetime of the bond. If interest rates increase during the life of the bond, then investors earn higher returns if they invest in bonds with the new higher rates than from the bonds they purchased before, when rates were lower. Conversely, they will be better off if interest rates fall.

However, most loans are issued with floating rates, which means that the interest payments vary according to the changes in interest rates. When investing in loans with floating rates, investors earn cash rates plus a spread which varies over time. This makes private credit loans less sensitive to changes in interest rates and therefore less impacted by duration risk.

A good example is the interest rate hikes we have seen over the recent years. Using overnight rates as a proxy for cash rates, Exhibit 6 shows how interest rates have increased since June 2022 from negative territory to near 4%. The interest paid on floating rates has increased accordingly. However, the mark-to-market value of fixed rate bonds has fallen significantly because they now pay very low rates when compared with the new market rates.

Exhibit 6: changes in euro overnight (mid-market) rates since 2009 illustrate how significantly the level of interest rates has changed in recent years.



Source: Datastream, as of 31 January 2024

Therefore, the risk arising from changes in interest rates in a typical private credit fund arises from interest payments being on floating rates, i.e., a spread plus cash rates. Any change in the cash rate will have an impact on the amount of interest paid. The remaining interest rate risk for these loans is what is known as spread duration, i.e., the risk arising from changes in the spread over cash over time. While this remains a risk, it is clearly smaller than for fixed rate bonds, which are exposed not only to this risk of changes in spread but also to the risk of changes in interest rates for the underlying government bonds of similar duration.

LEVERAGE FACTOR

Investing in private credit often involves leverage, which is applied in different ways. First, there is **credit leverage**, i.e., the debt-to-EBITDA[4] ratio of a borrower. It is generally above 4 in private credit funds, which would make these borrowers eligible for a speculative grade rating in public credit markets.

But the leverage does not stop here. Private credit funds can also borrow to leverage the purchase of loans as a means of increasing returns to investors. This leverage can go beyond 200% of the investors' capital. Banks provide credit lines to those funds, securing them with the portfolio of loans as collateral. In essence this is leverage (a bank providing funding to a private credit fund using the loan portfolio as collateral) on leverage (the debt-to-EBITDA ratio of the borrowers in the portfolio).

In the absence of mark-to-market valuations, a bank may be forced to sell loans at distressed prices during market downturns due to deteriorating credit metrics, with no secondary market to facilitate the transaction. Distressed fund buyers could potentially purchase the distressed debt at a price good enough for the bank to recover the initial loan amount and for the distressed fund to restructure the debt, with profits ahead. However, all this would be at the expense of the private credit fund investor. Thus, moderate use of leverage is the more responsible option for investors willing to strategically – and not opportunistically – allocate to private credit.

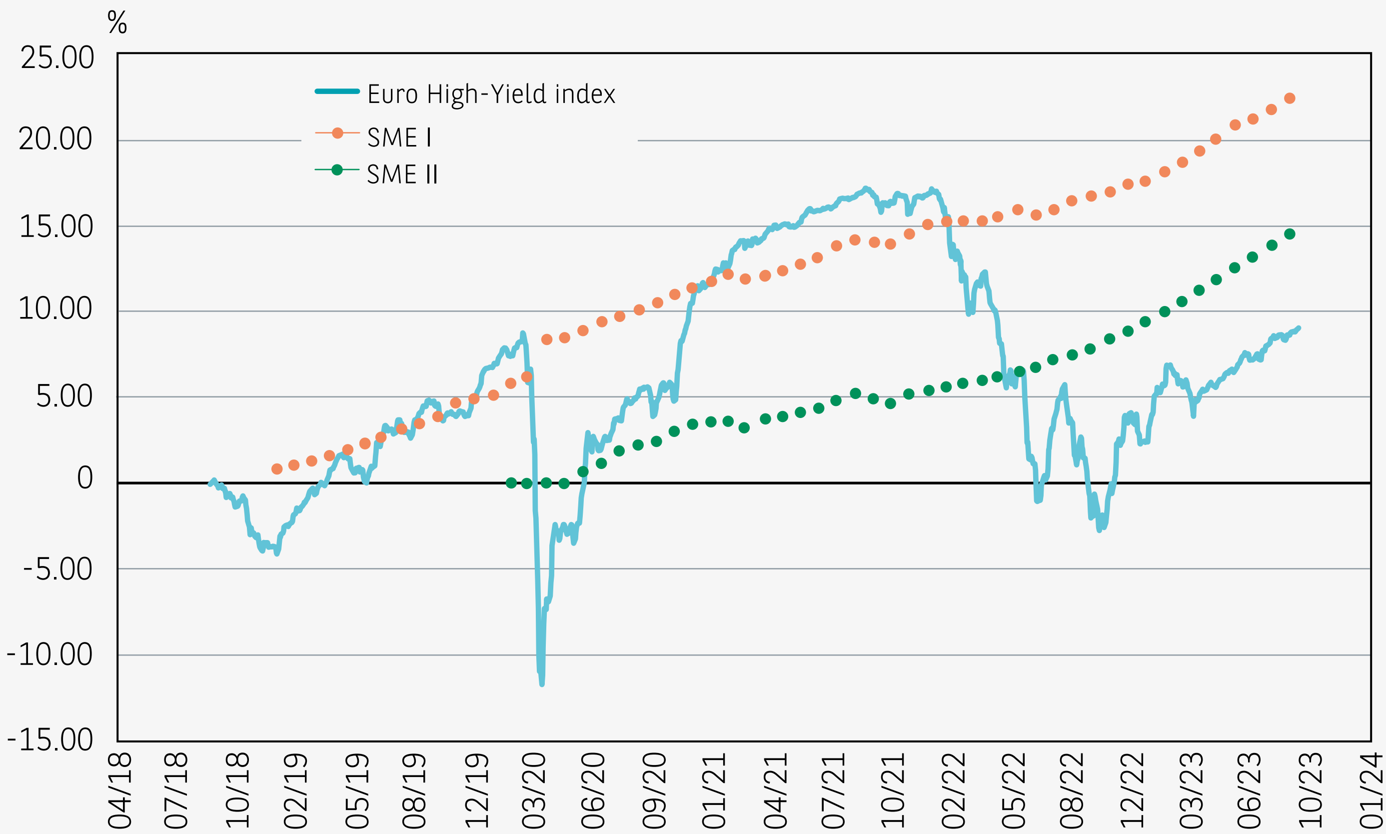
4 Debt-to-EBITDA measures the total amount of company debt divided by the total amount of company earnings, with EBITDA the earnings before interest, taxes, depreciation and amortisation.

RETURN SMOOTHING AND INCOME GENERATION

As a result of less frequent valuations, private credit's returns are 'smoother' and the asset class is considered as less volatile, see Exhibit 6. Private credit also brings stable income generation. In Exhibit 6, we compare the cumulative performance of the ICE BofAML Euro High-Yield Bond (BB-B) index with that of two European SME debt funds (Senior Loans and Unitranche) over the past five years.

The market-to-market pricing of high-yield bonds resulted in a significant drawdown during the Covid-19 crisis, in February 2020, and again later during the period starting in February 2022 and through December 2022. For private credit, however, because a significant portion of the returns are contractual and not subject to mark-to-market valuations, this not only provides a source of income yield but also results in a smoothing effect which can materially benefit portfolio returns over a cycle.

Exhibit 7: cumulative performance of the ICE BofAML Euro High-Yield Bond (BB-B) index, BNP Paribas Euro SME Debt Fund I and BNP Paribas Euro SME Debt Fund II.



Source: Bloomberg, BNP Paribas Asset Management. For illustration purposes only.
Past performance is not indicative of future performance.

MULTI-ASSET PRIVATE CREDIT FUNDS

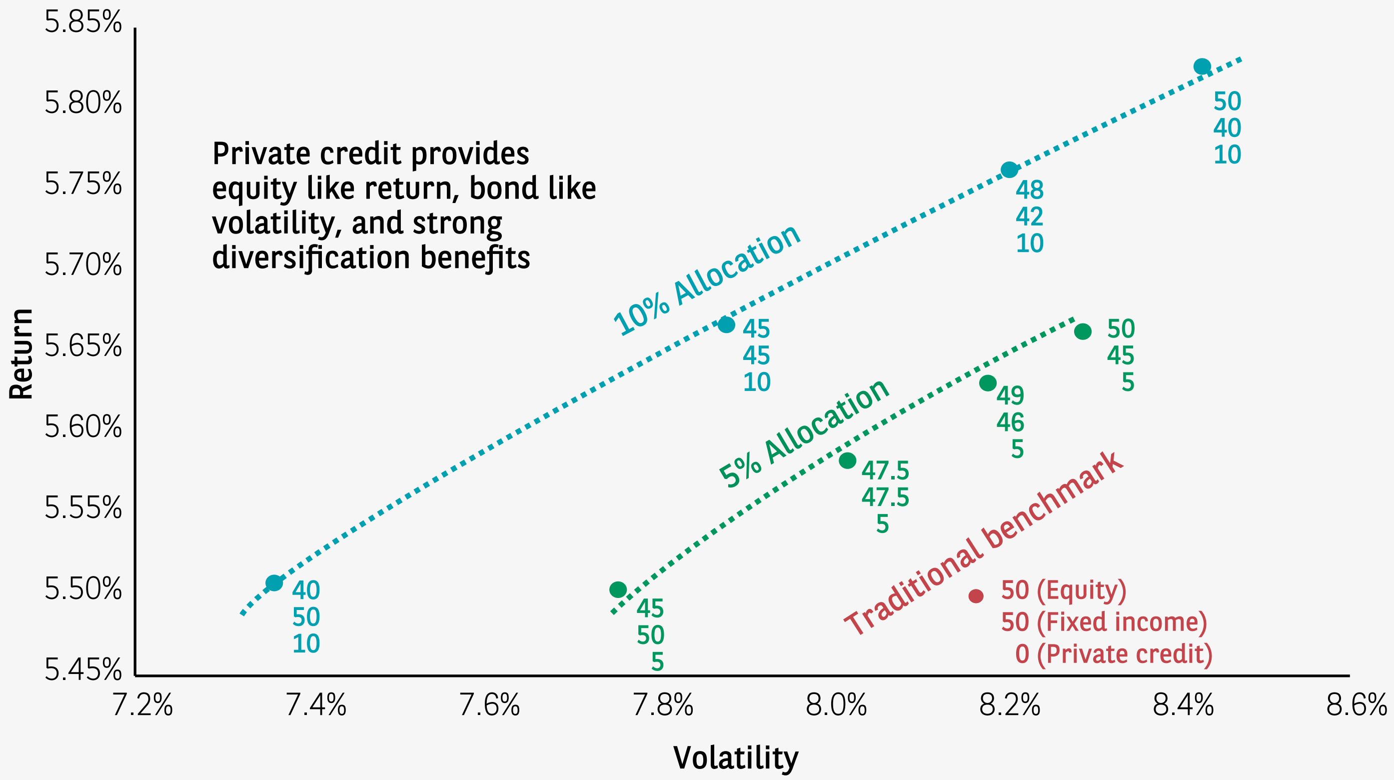
BENEFITS FROM ADDING PRIVATE CREDIT TO MULTI-ASSET FUNDS

We conducted a forward-looking analysis of nine portfolios with varying allocations to equity, fixed income and a diversified portfolio of private credit (comparable to Exhibit 8). This analysis shows that for a given level of volatility, introducing private credit increases the expected return of the portfolio.

The allocation to private credit can be introduced by reducing the allocation to equities, which results in a portfolio with lower volatility but similar levels of expected return. This is because the expected return of equity and private credit is comparable while the volatility is lower for the latter.

Alternatively, private credit can be introduced by reducing the allocation to fixed income. In this case it is possible to construct a portfolio of similar volatility but with higher expected returns because the portfolio of private credit under consideration has volatility comparable to that of traditional credit but has a higher expected return.

Exhibit 8: expected return versus volatility over 10-year investment horizons of different portfolios invested in equities, fixed income, and private credit.



Source: BNP Paribas Asset Management. For illustration purposes only.
Past performance is not indicative of future performance.

RATIONALE FOR INVESTING IN FUNDS WITH PRIVATE CREDIT

Until recently, the easiest way to allocate capital to private credit was through investments in closed-ended private debt funds. Under this approach, investors mandated a fund manager (the general partner of the fund) to find suitable deals and, by investing in a fund with several private credit loans, benefited from some diversification.

Investors committing capital to such funds face minimum investment requirements typically starting at EUR 100 000, and often much higher. Once committed, the capital is often locked in for eight or more years. However, the committed capital is not invested immediately. Instead, it is *called by* the fund manager, in stages, over the first years, as and when suitable deals are found. Usually, there are several calls for capital, for different amounts, on different occasions. After a few years, the fund starts distributing the capital from loans that reach maturity.

One way of avoiding locking capital for such long time is by investing in an evergreen fund, i.e., an open-ended fund with no fixed end-date, invested in loans of different maturities, which are called vintages. There are several advantages from investing in evergreen funds as opposed to closed-ended funds.

Firstly, evergreen funds provide more flexibility than closed-end funds because the capital is not locked: investors are allowed to redeem units of the fund periodically. By investing in loans of different vintages, a portion of the underlying loans mature every year, and the fund also collects interest payments over time. This creates cash flows which can be either reinvested or used to manage the fund's liquidity requirements. These cash flows also allow the fund manager to rebalance the portfolio allocation more efficiently as required, deciding how much capital should be committed each year to the different types of private credit investments so that the composition of the portfolio stays close to the strategic allocation targets over time. This requires funds with big enough size, managed by skillful fund managers.

A second advantage is that the deployment of the committed capital is delegated to the fund manager, who should be able to manage the calls and distributions more efficiently while minimising the allocation of dry powder to cash. In this way, the portfolio allocation strategy should avoid the dilution of the juicier returns from private credit by putting to work as much of the committed capital as possible at any given point in time, while allocating the rest to liquid assets.

Finally, evergreen funds are more likely to have lower investment minimum requirements, making it easier for smaller investors to access the private markets.

For these reasons, there is a good rational for bundling private credit investments into an evergreen fund structure.

ELTIF 2.0 REGULATION: DEMOCRATISING INVESTING IN PRIVATE ASSETS IN THE EUROPEAN UNION

While funds invested in private credit loans can be created as Alternative Investment Funds (AIF), the new version of the Long-Term Investment Funds Regulation (EU) 2023/60612 (ELTIF 2.0), which has been applied in the European Union since 10 January 2024, provides new possibilities to create and distribute such funds, in particular evergreen funds accessible to retail investors. One of the most far-reaching and innovative amendments is to differentiate between ELTIFs that target either professional only or ELTIFs that also target non-professional investors.

The ELTIF 1.0 framework was too rigid even for funds reserved only for professional investors. However, the ELTIF 2.0 was made more attractive by abolishing portfolio composition, diversification, and concentration rules altogether. Moreover, the leverage limitation in ELTIFs for professional investors was increased from 30% of the fund's capital to 100% in ELTIF 2.0. In addition, leverage in ELTIF 2.0 can be used to finance loans. Conflict of interest rules have also been softened by removing the ban on (minority) co-investments. ELTIF 2.0 now allows the fund managers who manage both ELTIFs and other funds to co-invest on the condition that any conflicts are identified and appropriately managed.

For retail investors, ELTIF 2.0 includes several amendments designed to facilitate access to private assets. The mandatory investment advice to be obtained prior to investing in an ELTIF has been abolished. For retail investors with a total portfolio smaller than EUR 500 000, the 10% cap on the exposure of their portfolios to ELTIFs was abolished, as well as the minimum investment requirement of EUR 10 000, while the level of permitted leverage is increased to 50%.

ELTIF 2.0 also imposes less prescriptive diversification rules, allowing ELTIFs to invest in a wider range of permissible investments, such as direct investment in loans or in funds, and eligible assets, such as green bonds issued by *qualifying portfolio undertakings*[5] under the EU legislation on environmentally sustainable bonds and securitised assets with an *STS-label* under Regulation (EU) 2017/2402.

5 Is either not listed or has a market capitalisation of not more than EUR 1.5 billion at the time of the initial investment by the ELTIF; is not a collective investment undertaking; is not a financial undertaking except if it has been organised or registered less than five years before the date of the investment by the ELTIF or if it exclusively finances qualifying portfolio undertakings or eligible real assets; is established either in the EU or in a third country, which is not identified as a high-risk third country under the EC list as per the delegated act of the Anti-Money Laundering Directive, and not included in the list of non-cooperative jurisdictions for tax purposes.

The definition of real asset is also revised to cover any asset that has intrinsic value due to their substance and properties, broadening the scope of the real asset investment strategies available to ELTIF managers. The regulation also allows (*a majority of*) eligible assets and investments to be in third countries.

Furthermore, ELTIF 2.0 abolishes the minimum investment threshold of EUR 10 million and removes the requirement that real assets are owned directly or via an *indirect holding* of qualifying portfolio undertakings. The eligible investment asset threshold was lowered from 70% of down to 55% of the net asset value enabling ELTIF 2.0 managers to better manage the liquidity and making the regulatory framework more appealing for both asset managers and investors.

Finally, ELTIF 2.0 allows ELTIFs to be structured as open-ended AIFs if redemptions before a pre-defined Target Date are subject to a minimum lock-up period, the ELTIF has appropriate liquidity management tools in place and, finally, if the ELTIF has a redemption policy which ensures that redemptions are limited to a percentage of the *liquid assets* (if redemption requests exceed such percentage, redemptions must be carried out on a pro rata basis).

ELTIF 2.0 also brings simplification to the distribution of such funds in Europe by not requiring local approval of cross-border marketing.

In summary, the new ELTIF 2.0 addresses several issues of the previous ELTIF 1.0 regulation. It is, in our view, a massive step forward towards the democratisation of private asset investing not only for professional investors but also for retail clients.

CHARACTERISTICS OF THE BNP PARIBAS DIVERSIFIED PRIVATE CREDIT (DPC) STRATEGY

The BNP Paribas Diversified Private Credit strategy is an investment strategy designed to invest into infrastructure debt, real estate debt, loans to small and medium-size enterprises (SME) and corporate loans of different seniorities. This represents quite a broad and diverse exposure to different sectors of the real economy each with their own slightly different exposure to the business cycle.

The DPC strategy invests in a broad range of private credit assets which can be categorised into exposure to the *real economy*, through direct investments in corporate debt, to *real assets*, through direct investments in infrastructure and real estate debt. In addition to private debt, the fund also invests in liquid credit assets, i.e., a combination of euro high-yield credit and asset-backed securities.

Of the senior corporate debt investments 35% constitute small and mid-market corporate debt, the remaining 10% is invested in broadly syndicated loans. A broadly syndicated loan is a loan provided to companies or individuals with considerable amounts of debt or with poor credit history.

Lenders consider broadly syndicated loans to carry a higher risk of default. As a result, a leveraged loan is more costly for the borrower and provides higher yield to the lender. Broadly syndicated loans, while still classified as private debt, have some level of standardisation which makes it easier to actively trade them on secondary markets. For this reason, broadly syndicated loans tend to be more liquid than other private debt assets and are considered semi-liquid. In turn, high-yield bonds and asset-backed securities are considered liquid because they are traded publicly on exchanges, even if transaction costs are typically higher than for government bonds and equity.

Exhibit 9: example of an allocation for an open-ended fund yielding around 8% and with leverage (12% on illiquid and 4% on liquid assets) it can increase to 9%.

Portfolio	Target Allocation	Current Yield*	Internal Credit Assessment	WAL (no prepay.)	Estimated WAL**	% Floating Rates
CORPORATE DEBT	45% (Senior)	E3M + [4-5]%	BB/BB-	7	4.5	95%
	15% (Unitranche)	E3M + [7-8]%	B	7	3.5	95%
REAL ASSETS DEBT	12.5% (Infrastructure Debt)	E3M + [4-5]%	BB/BB-	7	5	60%
	12.5% (CRE Debt)	E3M + [5-6]%	BB-/B+	5	3	50%
LIQUID ASSETS	15%	E3M + [2-3]%	BB-/B+	4	4	50%
TOTAL	**100%**	**E3M + [5-6]%**	**BB-/B+**	**6.3**	**4.2**	**80%**

* Gross yield excluding default, no leverage, before fees, and including upfront fees (total based on E3M as of 31 March 2024); **WAL stands for the weighted average life of the loans.

Source: BNP Paribas Asset Management as of March 2024

The table in Exhibit 9 above shows an example of an allocation aiming for a 9% gross yield (the yield assuming no defaults with data in March 2024) and the *rating quality* of the loans based on BNP Paribas Asset Management's internal rating assessment of private debt (there is no external rating available). The last column gives the expected percentage of floating rates, i.e., those loans for which the yield is defined as cash rate plus a fixed spread. The WAL (*no prepay*) column shows the Weighted Average Live (WAL) in years for each type of investment, assuming no prepayment.

Typically, the borrower has the option to settle a loan earlier than the official due date. This is called a prepayment. On average between 10%-20% of the private debt loans are prepaid. Borrowers usually do this if they can roll over the loan under better conditions. This optionality is reflected in the yield borrowers pay for a given loan. The Estimated WAL column shows the WAL, in years, while considering the expected prepayments.

While the market capitalisation of private credit is quite skewed towards financing leveraged buyouts (LBO) and public-to-finance deals, this Diversified Private Credit strategy deviates from market capitalisation allocation to offer a more diversified allocation to private credit better representing different economic activities. Implementing such a strategy requires sufficiently diversified access to private credit markets, only possible for larger asset managers. Investors can benefit from this sort of diversified access to private credit markets by investing in strategies such as the DPC of BNP Paribas Asset Management.

The DPC strategy is available in an open-ended fund structure allowing for monthly subscriptions and quarterly redemptions with 10 business days and quarterly notice periods, respectively. In this case, managing liquidity is a key responsibility for the fund manager. The fund invests into direct lines of private debt (i.e., not a fund of funds), which gives the fund manager much more leeway to manage the liquidity in the fund. In this case, the fund manager has various means to manage liquidity including:

- The 25% target allocation to semi-liquid and liquid assets: i.e., 15% liquid asset and within the 45% of corporate debt 10% constitutes semi-liquid investments in broadly syndicated loans,
- Cash flows from interest rate payments on the underlying assets,
- Cash flows from prepayments of bonds,
- Cash flows from loans maturing at different times, a consequence of investing in loans of different vintages,
- Cashflows from new subscriptions

- A credit line with a bank that can be used to manage the liquidity in the fund and to facilitate moderate leverage whenever other means of managing liquidity are not sufficient. Credit lines of up to 50% of the NAV of the fund are common.

All the above should be sufficient to allow the fund manager to address the liquidity requirements of this strategy. Hence, under normal circumstances, the fund manager can be expected to manage the liquidity and facilitate redemptions without any major issues. However, under stressed conditions, it may be more difficult to meet redemption requirements should a significant number of investors decide to redeem their capital invested in the fund. To avoid distressed sales, and in the interest of investors, such funds can have additional features to help managing liquidity requirements efficiently:

- A gating mechanism with a net redemption limit of 5% of the NAV of the fund per quarter. Net redemption refers to the difference between subscription amounts and redemption amounts in each period,
- A swing price mechanism to protect the investors in the fund against the impact on the NAV of the fund caused by costs associated either with the disposal of some assets at distressed prices in case of redemption during adverse market conditions or, with the purchase of assets in case of subscriptions during times of strong demand.[6]

Though it is less likely that the gating mechanism will need to be imposed in normal circumstances, the gating mechanism can be exercised, at the discretion of the portfolio manager, for every quarter in which net redemptions exceed 5% of NAV. Any unmet redemptions are carried forward to the following quarter.

6 Swing pricing is a process designed to protect investors in a fund from the costs incurred when other investors subscribe or redeem shares of the fund. It does this by imposing the costs from trades caused by subscriptions or redemptions on the investors whose orders led to those trades.

STRESS-TESTING THE BNP PARIBAS DIVERSIFIED PRIVATE CREDIT STRATEGY

Open-ended funds that invest in private assets have the additional risk that redemptions in the fund may force the fund manager to sell illiquid investments. If the allocation to private assets was not constructed to minimize this risk, then it is possible that unorderly sales of illiquid assets may follow redemptions. That would be detrimental to investors redeeming their shares in the fund and would also harm the other investors in the fund.

As discussed in the previous section, the portfolio managers have various options to manage liquidity risk. The fund is more susceptible to liquidity risk during the first four years because most loans will only start to mature after this point. To somewhat mitigate this risk the fund has a two-year soft lock-up period (investors are subject to a 5% fee when exiting the fund within two years). That leaves the subsequent two years, i.e., years 3 and 4 more vulnerable to redemptions.

For this reason, it is important to propose and stress-test a targeted initial allocation for liquidity risk in years 3 and 4. The initial allocation should be chosen assuming that the portfolio will be ramping up, i.e., converging towards the target allocation in Exhibit 9 by making the very first investments in unlisted loans. The stress-tests should assume that in years 3 and 4 the portfolio is still in this ramp-up phase. Because the first purchased loans are not expected to redeem in the first four years, stress-tests should simulate the portfolio under the assumption of no loan prepayments, no loans maturing and that redemptions can be met either by using the credit line or by selling semi-liquid investments at market prices.

Once the credit line is exhausted and all liquid and semi-liquid assets have been sold only illiquid assets are then left in the fund. Further redemptions would force the portfolio manager to sell those illiquid assets and trigger a liquidity event. The stress test should investigate the likelihood of that happening by simulating the allocation of the portfolio (e.g., on a quarterly) basis under different scenarios created using historical asset prices. In our case we assumed net redemptions of 5% per quarter for years 3 and 4, a total of eight quarters. The cost of leverage and the (un)used liquidity facility needs to be re-paid each quarter hence putting an additional drain of the available (semi-) liquid assets. An adequate initial allocation will pass the stress-test by showing low risk of a liquidity event being triggered in those eight quarters, irrespective of the scenario and assuming the credit line with the bank cannot exceed the agreed maximum leverage limits.

Three relevant eight quarters scenarios for the stress test are:

- 1990 (start of Q4 1989 to end of Q3 1991),
- 2008 (start of Q4 2008 to end of Q3 2010) and
- 2020 (start of Q1 2020 to end of Q4 2021)

Exhibit 10: example of an initial allocation for an open-ended fund. It is based on the same allocation as Exhibit 9 but with the 10% broadly syndicated loans allocated to the (semi-) liquid bucket and acknowledging that the remaining 50% corporate debt constitutes small and mid-market corporate debt

Portfolio	Portfolio weight (as % exposure)	Financing from investors	Financing from bank	Exposure (as % NAV)
EURO SMALL & MID-MARKET DEBT CORPORATE DEBT	50.0%	38.0%	12.0%	59.3%
JUNIOR INFRASTRUCTURE DEBT	12.5%	12.5%	0.0%	14.8%
JUNIOR CRE DEBT	12.5%	12.5%	0.0%	14.8%
SEMI-LIQUID DEBT AND LIQUID ASSETS	25.0%	21.2%	3.8%	29.7%
TOTAL	**100.0%**	**84.2%**	**15.8%**	**118.6%**

Source: BNP Paribas Asset Management as of March 2024

In the case of the DPC strategy, we found that for the initial target allocation in Exhibit 9, the fund almost never breaches the internal guideline of a maximum total leverage of 33% (i.e., the total value of the monies borrowed should not exceed 33% of the fund's NAV). It only breaches in the 8th quarter of the 1990 and 2020 scenario under the assumption of 0% interest payments during those eight quarters which, under current market conditions with 3-month Euribor already above 3.5%, is an assumption of extreme stress.

KEY TAKEAWAYS

In this paper we focus on the creation of the BNP Paribas Diversified Private Credit (DPC) strategy which allocates to private credit in an open-ended fund. This strategy allows investors to benefit from the investment case for private credit:

- **Higher Gross Yield**: private credit has a higher gross yield compared to high-yield bonds of the same rating, supported by the yield premium private credit offers,
- **Lower Credit Loss**: private credit investments come with structural features (e.g., covenants) that provides more downside protection and higher recovery rates than traditional unsecured bonds of the same rating,
- **Lower Volatility**: private credit has less price volatility than high-yield bonds, providing more stable returns over the longer term,
- **Diversification**: private credit is less correlated with traditional asset classes such as equity and bonds. It provides diversification by reducing volatility and increasing returns in a traditional portfolio.

The choice of an open-ended fund was made possible by the recent changes in the European Union, with the arrival of the ELTIF 2.0 regulation which aims at democratising investments in private assets.

This regulation creates the ideal environment for strategies with allocations to private assets such as DPC. It does this by including several changes relative to its predecessor, the ELTIF 1.0. Several of these changes are designed to facilitate access for retail investors to private assets, for example by explicitly making a distinction between ELTIFs for professional as opposed to retail investors, with lower barriers and constraints to investing, and by allowing these ELTIFs to be structured as open-ended funds.

Other amendments to the regulation, such as allowing for the use of leverage to finance investment in loans and increasing leverage limits, make it easier for portfolio managers to meet return targets while adequately managing the liquidity requirements of open-ended funds.

This regulation also makes it simpler for portfolio managers to meet the diversification rules thanks to the broadening of the range of permissible investments and to the change in the definition of real assets.

Finally, the new regulations facilitate the creation and sale of such ELTIFs by softening the conflict-of-interest rules and by simplifying their distribution in Europe.

This, in our opinion, is good news for investors. The Diversified Private Credit strategy of BNP Paribas Asset Management discussed here provides a diversified exposure to private credit markets with allocations to corporate, infrastructure and real estate private debt as well as to senior and junior debt opportunities with an objective of providing a regular and material income distribution.

Investors can benefit from our strong experience in managing private credit portfolios, and from the BNP Paribas group, a leader in European lending and in private debt origination and syndication. By adding funds with strategies like Diversified Private Credit to their portfolios, investors should be able to increase risk-adjusted returns by replacing traditional equity or credit with such strategies.

Stéphane Blanchoz

Head of Alternative Solutions
Client Solutions Manager

Koye Somefun

Head of Multi-Assets & Solutions in
Quant Research Group

Stéphane Blanchoz is Client Solutions Manager, Head of Alternative Solutions since November 2022. He was previously in charge of the Small and Mid-size Enterprises (SME) Alternative Financing business, lending to SMEs in the UK, Netherlands and Germany, and focusing on origination, credit assessment and scalability of management processes. He was appointed to his role in November 2017, having previously headed BNP Paribas Asset Management's Alternative Debt Management investment teams. As Chief Investment Officer (CIO) of Alternative Fixed Income (later renamed Alternative Debt Management) from 2010, he was responsible for defining and piloting the management process and the investment strategy implemented by the management team. He actively participated in designing and developing the product range with several innovative debt funds (including capital guaranteed and inflation-adjusted funds), structured credit and private debt strategies (CLO, SME Debt).

Stéphane joined BNPP AM's fixed income team in 2004 as Product Manager and Head of Fixed Income Solutions, after four years as an auditor in the Group's 'Inspection Générale' department. He joined Banque Nationale de Paris in 1997 (prior to its merger with Paribas in 2000) as a risk manager in Tokyo, having previously held the same role at Pechiney, where he began his career in 1994 in the finance department in Sydney.

Stéphane holds a master's degree in finance from the University of Lyon II and is a regular lecturer in several training programmes (AFG, Lyon II University).

Koye has been Head of Multi-Assets & Solutions in the Quant Research Group since the creation of the team in 2017. In this role, he oversees a team that designs and develops solutions used by the Multi-Assets and Solutions teams. The solutions cover a broad spectrum ranging from target risk solutions, potentially with protection strategies, to the incorporation of broader balance sheet considerations.

Koye joined Fortis Investments, a predecessor company of BNP Paribas Asset Management, in 2007 as a quantitative analyst for strategic asset allocation. From 2010 to 2014, he was Head of Quantitative Alpha Generation for the then Multi-Asset Solutions team. From 2014 to 2017, Koye was Head of Retirement Solutions & Innovation in this team. Prior to joining Fortis Investments, Koye was a quantitative analyst for structured products at IRIS (Robeco). He also worked for the Dutch National Institute for Mathematics and Computer Science as a researcher. He started his investment career in 1998 with ORTEC as a consultant.

Koye holds a PhD in computational economics and a master's degree in applied mathematics from the University of Notre Dame in the US. He completed his undergraduate studies at the Erasmus University in the Netherlands. In 2007, he obtained the Certificate in Quantitative Finance (CQF) in London.

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VIEWPOINT

BNP PARIBAS ASSET MANAGEMENT

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