Private credit and direct lending
By Nathaniel Nyika, Chief Investment Officer, Norsad Finance

How has competition among private lenders affected deal terms and returns?
Private credit can be segmented into several sub-classes, including vanilla senior debt, subordinated debt and mezzanine, which strategies can range from venture debt, growth capital, to distressed debt and acquisition debt. Although the number of private debt players in Africa has increased, the asset class remains in its early stages. Direct competition amongst private credit firms remains relatively low; however, in risk-off environments, institutions such as banks sometimes enter the private debt space despite the cost to their capital. In such cases, instead of playing a complementary role, they become direct competitors, often offering more attractive pricing due to their lower cost of capital. However, they remain limited in terms of structures and this creates an opportunity for private credit players. Private equity players have also ventured into private debt as an approach to limit downside risks, given the poor performance over the years. This also has a substitutive effect on pure-play private credit players.

What's your view on the sustainability of private credit growth relative to traditional bank lending?
Traditional bank lending is highly regulated, and this limits its capacity to reach specific credit opportunities where private credit can invest. Credit in general is a better-understood asset class compared to private equity and usually offers advantages to entrepreneurs in terms of protection from dilution. Further, as private credit can be the bridge between senior debt and equity in the growth environment and in the context of growing economies in Africa, private debt remains a sustainable asset class.

How do you evaluate borrower quality in a less transparent private market?
Information remains limited, and most regional private credit firms do not have access to credit bureaus in most countries, as these are typically reserved for banks or local firms. It is very critical that regional private credit firms invest alongside senior local lenders who have a better understanding of the borrowers. The evaluation of credit opportunities is similar to the approach used by private equity, as the private credit firms do not act as the bank of the borrower and therefore do not have a view of their cash flows, which reinforces the need for partnerships with local banks.

Financials should be audited by a reputable audit company and abide by certain standards. On sector information, it is important to invest in sectors that the private credit firm is highly familiar with and lessons are transferable even in different jurisdictions. The use of tools such as World Check could assist in finding out information about borrowers. Finally, understanding the regulatory and legal environment remains a key factor in shaping the outcome of investment.

What types of borrowers or deal structures are you avoiding right now?
We are avoiding long-term (more than 5-year) tenures due to global uncertainty and the risk that policy shifts could render projects unviable. Highly leveraged projects have also become less attractive for solutions such as subordinated loans and mezzanine, whose cashflows are further down the waterfall and there is a shift towards stretch senior debt with pari passu ranking.

Sectors such as agriculture and microfinance seem challenged. For microfinance institutions, the indebtedness levels of consumers seem to have risen unsustainably post-COVID and also due to the high-interest-rate environment, which has eroded incomes and resulted in a sharp rise in non-performing loans for MFIs. Agriculture has seen several DFIs curtailing investment and this has reduced the layer of first loss. Further, the sector is highly impacted by climate and has made the space unattractive for private credit.