TOPE ADEBAYO LP

BEYOND BANKS AND DEBT MARKETS

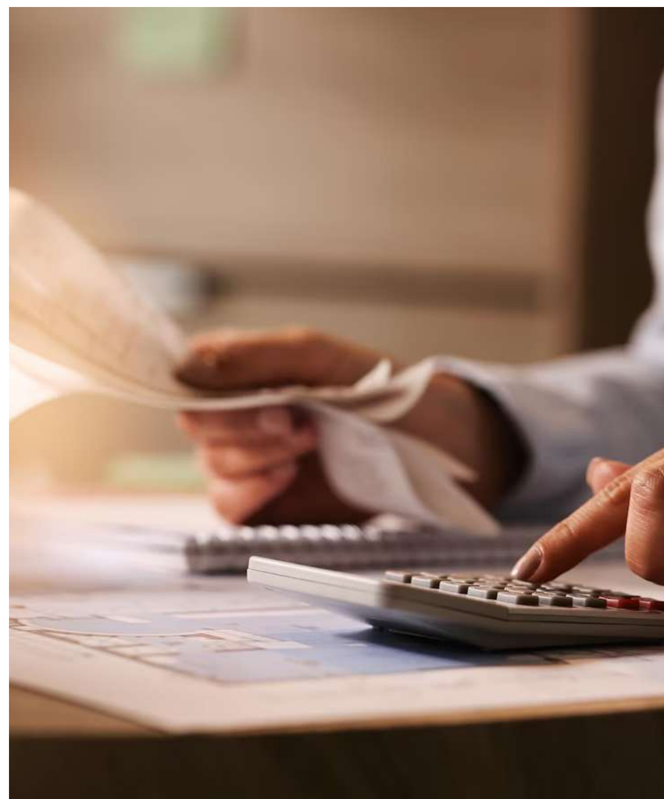
Private Credit as a More Flexible Alternative Financing Option for Businesses

www.topeadebayolp.com

INTRODUCTION

Securing capital is integral to the growth of any business and companies typically explore two primary avenues: debt financing and equity financing. While debt financing often involves traditional banks and capital markets (like issuing bonds or commercial papers), these channels are exposed to stringent regulatory hurdles. Private credit has evolved to be a more flexible alternative for businesses to access capital to finance their growth and operations.

Private credit is a form of financing where non-bank institutions provide loans and other financing options to companies. They are alternatives to traditional bank loans and are often favoured by small and medium-sized enterprises (SMEs) that may not qualify for conventional financing.



THE NATURE OF PRIVATE CREDIT

As regulatory pressures mounted on traditional banks, their ability to provide flexible financing solutions became increasingly constrained. Private credit, as a financing option, emerged in the 1980s but its popularity can be traced to the aftermath of the 2008 financial crisis.[1] In Nigeria and in other parts of the world, banking is a highly regulated industry, and banks are under strict regulations to maintain mandated Cash Reserve Requirements (CRR) and Capital Adequacy Ratios (CAR). This regulatory environment, coupled with banks' natural risk aversion when dealing with deposits, created a huge market gap—one that private credit firms were uniquely positioned to fill.

As Matt Levine humourously illustrated in a Bloomberg article,[2] if you go to borrow money at JP Morgan Chase & Co, one of the largest banks in the world, the bank will probably say "yes, I would be happy to help you find that money", but if you go to an asset management firm offering private credit options to borrow money, the firm would pull out a bag with a dollar sign on it and say "yes, here is the money". The point being that a bank may not actually have a lot of money to satisfy the funding requirements of a borrower but a private credit firm may have that kind of money. Even if a bank has that kind of money, it is constrained by laws and regulations on how much it can lend at any given time.

[1] International Monetary Fund (IMF), Global Financial Stability Report, April 2024, Chapter 2 (IMF 2024).
[2] Matt Levine, 'Matt Levine's Money Stuff: Banks Want in on Private Credit' (Bloomberg Law, 2 November 2023) https://news.bloomberglaw.com/mergers-and-acquisitions/matt-levines-money-stuff-banks-want-in-on-private-credit accessed 17 November 2024.

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

Private credit also encompasses a variety of strategies that allow it to cater to specific borrower needs. These include direct lending, where companies borrow directly from non-bank lenders; distressed debt, which involves buying debt at discounted rates from companies in financial trouble; and venture debt, a key option for startups with high growth potential. Other strategies such as mezzanine finance and special situations lending[3] further highlight the flexibility and breadth of private credit offerings, making it a versatile solution for businesses of all sizes.[4]

Although direct lending accounts for about 40% of the private credit market, private credit also includes debt-like securities such as bonds that are not publicly issued or traded and are primarily extended to middle-market firms. Private credit has also evolved beyond its initial role of middle-market financing to encompass a wide range of capital solutions, including funding for infrastructure projects, real estate, and asset-based lending. This diversification has enabled private credit to meet the varying needs of businesses across industries to become a dependable alternative to traditional bank lending for both mid-sized and larger firms.[5]

For investors, private credit provides diversification benefits by reducing exposure to general market volatility. Primary investor base of Private Credit includes pension funds, insurance companies, and sovereign wealth funds, which are drawn to its potential for higher returns compared to public bonds and loans.

The numbers tell a compelling story: Private credit Assets Under Management (AUM) have experienced an extraordinary eight-fold increase, rising from US$271 billion in 2009 to over US$2.1 trillion in 2023. Industry projections suggest even more dramatic growth ahead, with AUM expected to reach US$2.69 trillion by 2026, representing a compound annual growth rate of 17.4%.[6]

[3] Special situation lending refers to the provision of credit to companies experiencing unique circumstances, such as mergers and acquisitions, restructuring, turnarounds, or other transitional events.
[4] National Association of Insurance Commissioners (NAIC), Private Credit Primer (Capital Markets Bureau, March 2024) http://www.naic.org/members_capital_markets_bureau.htm accessed 18 December 2024.
[5] National Association of Insurance Commissioners (NAIC), Private Credit Primer (Capital Markets Bureau, March 2024) http://www.naic.org/members_capital_markets_bureau.htm accessed 18 December 2024.
[6] FCMB, 'The FCMB-TLG Private Debt Fund Launches to Bridge Nigeria's Credit Gap' (FCMB, 2023) https://www.fcmb.com/node/732#:~:text=%22The%20FCMB%2DTLG%20Private%20Debt,of%20the%20Nigerian%20economy%20while accessed 17 November 2024.

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

WHY PRIVATE CREDIT AND NOT PRIVATE EQUITY?

The choice between private credit and private equity is an important decision for companies seeking capital. While both funding sources offer alternatives to traditional bank financing, they serve different purposes and come with different implications for business ownership and control.

> Private credit is particularly attractive for companies that want to maintain their current ownership structure while accessing substantial capital.

Unlike private equity, which focuses on ownership stakes and often requires that a company cedes significant control rights, private credit focuses mainly on a borrower's ability to service and repay debt.

INTEREST RATE COMPARISON: PRIVATE CREDIT VS. TRADITIONAL LOANS IN NIGERIA

Interest rates are a key consideration for a company deciding whether to obtain financing from private credit or through traditional lending. In Nigeria, the interest rate environment is generally high[7]. This higher rate environment influences the cost of borrowing for both private credit and traditional loans.

Currently, the CBN's Monetary Policy Rate is 27.5%[8] . However, this serves as a benchmark for other interest rates and it influences broader interest rates in the economy. The actual interest rates can vary depending on factors such as the borrower's creditworthiness, the loan amount, and the loan term. For example, short-term interest rates in Nigeria, as reflected by the 3-month Nigeria Interbank Offered Rate (NIBOR), reached 26.37% per annum in October 2024.[9] For private credit, the average interest rate can be higher than the average bank lending rate. This could be due to the higher risk profile of private credit borrowers and the illiquidity of the investment. The specific terms and conditions of each loan, as well as the borrower's circumstances, will determine the actual interest rate.

[7] CEIC, 'Nigeria Bank Lending Rate, 2006' https://www.ceicdata.com/en/indicator/nigeria/bank-lending-rate accessed 15 December 2024
[8] Central Bank of Nigeria, https://www.cbn.gov.ng/ accessed 07 January 2025
[9] CEIC, 'Nigeria Short Term Interest Rate, 2010–2024' https://www.ceicdata.com/en/indicator/nigeria/short-term-interest-rate accessed 15 December 2024

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

ADVANTAGES OF PRIVATE CREDIT OVER TRADITIONAL BANKING

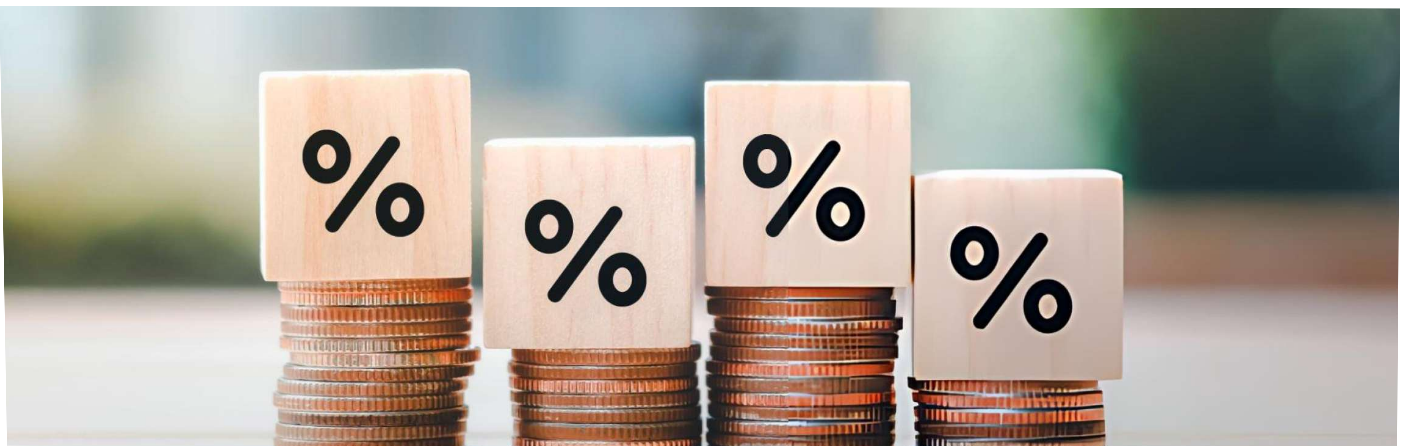
Private credit offers several distinct advantages that explain its growing appeal. Unlike traditional banks' one-size-fits-all approach – banks' facility agreements are notorious for their inflexibility - private credit firms provide funding to match business realities. For example, a seasonal agricultural business might secure financing with lower repayments during planting seasons and higher repayments during harvest periods—a structure rarely available through traditional banks.

More significantly for businesses, private credit firms often complete due diligence and funding within weeks, unlike traditional bank financing which can take months of approvals and due diligence. For example, if a manufacturing company spots an opportunity to acquire a distressed competitor's equipment at an attractive discount—private credit can provide quick funding to seize such time-sensitive opportunities, whereas traditional bank processes might cause the company to miss the window entirely.

Moreover, private credit providers evaluate opportunities beyond just financial statements. For instance, a healthcare company expanding into a new healthcare offering might find traditional banks focused solely on historical performance, while private credit providers would consider the market opportunity, management team's expertise, and industry trends. These lenders are also more accessible as advisors, and they offer sector insights and valuable network connections alongside capital.

DRAWBACKS OF PRIVATE CREDIT FOR BORROWERS

However, borrowers also face certain disadvantages when opting for private credit. The most obvious drawback is the higher interest rate and stricter covenants[10] which reflect the increased risk taken on by private lenders, who often finance borrowers that banks might consider too risky. These covenants can limit a borrower's flexibility in managing their business and making financial decisions.



[10] International Monetary Fund, Global Financial Stability Report, April 2024: Chapter 2 The Rise and Risks of Private Credit (IMF eLibrary, 2024) https://www.elibrary.imf.org/view/book/9798400257704/CH002.xml accessed 15 December 2024

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

Similarly, private credit may offer less flexibility in terms of loan restructuring and repayment schedules compared to traditional bank loans.[11] This reduced flexibility can be a drawback for borrowers who may need to adjust their repayment terms due to unforeseen circumstances. Also, relying on private credit can limit a borrower's access to capital markets in the future.[12] For example, if a borrower already has a significant amount of private credit debt, public investors might view the company as over-leveraged or too risky, making it harder for the company to issue bonds or raise funds in public equity markets.

Furthermore, private credit deals can involve complex structures and terms that may be challenging for borrowers to fully understand.[13] This complexity makes it crucial for borrowers to seek expert advice to ensure they fully comprehend the terms and conditions of the loan. In addition, private credit is typically provided by a small group of investors, such as private equity firms, asset managers, or institutional investors, rather than being widely distributed like publicly traded debt instruments. This can potentially lead to concentration risk for borrowers.[14] This concentration can make borrowers more vulnerable to the decisions and actions of a small group of investors.

PRIVATE CREDIT IN EMERGING MARKETS: THE NIGERIAN EXAMPLE

The transformation promised by the emergence of private credit is evident in emerging markets, where the need for alternative financing solutions is acute. In Nigeria, for instance, 55% to 68% of mid-sized companies are either unserved or underserved by financial institutions, contributing to a total credit gap of US$4.9 trillion across emerging markets.[15]

> The launch of Nigeria's first Naira-denominated Private Debt Fund by FCMB Asset Management Limited (FCMBAM) illustrates how the private credit model is being adapted to address local market needs.

The fund's N100 billion programme, with an initial Series 1 raise of N10 billion, targets sectors crucial to Nigeria's economic development, such as agriculture, healthcare, education, clean energy, transportation/logistics, and IT/technology.[16]

[11] IMF, Global Financial Stability Report, April 2024 (n 8)
[12] IMF, Global Financial Stability Report, April 2024 (n 8)
[13] Stock Analysis, 'What Is Private Credit? Pros, Cons, and How to Invest' https://stockanalysis.com/article/what-is-private-credit/ accessed 15 December 2024.
[14] Stock Analysis, 'What Is Private Credit?' (n 9).
[15] BusinessDay, 'How Nigeria's First Private Debt Fund Will Improve Access to Capital' (BusinessDay, 15 November 2023) https://businessday.ng/news/article/how-nigerias-first-private-debt-fund-will-improve-access-to-capital/ accessed 17 November 2024.
[16] FCMB (n 6)

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

This landmark initiative, with its N100 billion program and initial N10 billion raise, signifies a crucial step towards bridging the substantial credit gap hindering Nigeria's economic progress. By targeting sectors critical to national development, such as agriculture, healthcare, and clean energy, the fund aims to catalyze growth and job creation. The decision to denominate the fund in Naira is particularly noteworthy, as it mitigates currency risk for local businesses and promotes stability in the domestic financial market. FCMB's reputation and expertise lend credibility to the initiative, potentially attracting further investment and encouraging the expansion of private credit in Nigeria.

However, regulatory hurdles such as the intricacies of obtaining and renewing money lending licenses and other licenses (which are mandatory for non-bank lending entities in particular and financial institutions in general) pose significant challenges. These regulations, while aimed at protecting borrowers and ensuring financial stability, can inadvertently stifle lending activity and limit access to credit. Therefore, a supportive and adaptable regulatory environment will be essential for this pioneering fund to thrive and effectively address the credit needs of Nigerian businesses. Its success could stimulate economic growth and a more dynamic financial ecosystem.

ARE BANKS JUST LOOKING ON?

In the past, a company seeking financing could rely on an investment banker to present a clear picture of their options, typically with a focus on traditional instruments like bonds and bank loans. Over time this model has changed. Now, companies often have more choices. They can meet with multiple private lenders who offer alternative options. However, traditional banks are not standing still in the face of this transformation. There are two main ways banks are adapting to this change:

1. **Offering Private Credit Services:** Many large banks are capitalising on their existing resources to establish their private credit arms, for example, FCMB with its FCMB Asset Management Limited. Banks have the capital, the connections, and the asset management infrastructure to raise funds from institutional investors and high-net-worth individuals. By launching their own private credit funds, banks could offer this form of financing alongside their traditional lending products thereby broadening their service offerings.

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.

2. **Banks Partner with Private Credit:** A more immediate solution is partnerships, such as the one between Citigroup Inc. an investment bank, and Apollo Global Management, an asset management firm.[17] This partnership model addresses key market needs: banks maintain client relationships and fee streams while managing regulatory capital requirements; private credit managers gain access to deal flow after raising significant capital, and companies receive a more streamlined and comprehensive financing solution.

CONCLUSION

The transformation of corporate financing through private credit is a fundamental shift in how businesses access capital – from borrowing from banks to borrowing from non-bank entities or borrowing from a non-bank arm/partner of a bank. As this evolution continues, the combination of traditional banking relationships and private credit solutions is creating a more responsive financial system that is better equipped to meet the diverse and unique funding needs of growing and established businesses alike.

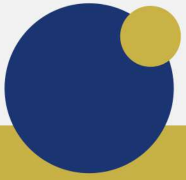
Private credit has been the fastest growing segment of the financial system over the last 15 years.[18] The growth of private credit underscores its potential to complement traditional banking. However, the illiquidity and evolving risk profile of private credit require borrowers and investors to approach it with a clear understanding of its long-term implications. As private credit continues to grow, a substantial amount of "dry powder," or uninvested capital, has accumulated, with estimates indicating that 40–45% of this capital is concentrated among the top 10 private credit managers in the United States.[19] While this highlights the availability of funds, it also raises concerns about market saturation and potential future imbalances between supply and demand.

[17] Sonali Basak and Todd Gillespie, 'Citigroup and Apollo Join Forces in $25 Billion Private Credit Push' (Bloomberg, 26 September 2024) https://www.bloomberg.com/news/articles/2024-09-26/citigroup-apollo-join-forces-in-25-billion-private-credit_push?_accessed on 18 November 2024.

[18] McKinsey & Company, The Next Era of Private Credit (March 2024) https://www.mckinsey.com/industries/private-capital/our-insights/the-next-era-of-private-credit#/ accessed 18 December 2024.

[19] National Association of Insurance Commissioners (NAIC), Private Credit Primer (Capital Markets Bureau, March 2024) http://www.naic.org/members_capital_markets_bureau.htm accessed 18 December 2024.

At Tope Adebayo LP, our mission is to be an innovative firm rendering the highest quality legal services and building enduring strategic relationships with our clients. Find out more about us and tell us how we can be of service to you by visiting www.topeadebayolp.com.



PLEASE NOTE THAT THIS ARTICLE IS FOR INFORMATION PURPOSES ONLY AND DOES NOT CONSTITUTE LEGAL ADVICE

PRACTICE KEY CONTACTS

IFEOMA EZERIBE
PARTNER
i.ezeribe@topeadebayolp.com

GBENGA OGUNDOYE
ASSOCIATE
g.ogundoye@topeadebayolp.com

EXCELLENT EPELLE
ASSOCIATE
e.epelle@topeadebayolp.com

TALP's Finance and Project Development Team.

For further enquiries, log onto www.topeadebayolp.com

Do you need to get in touch with us, to know more about how we can help you and your business?
Please contact us by using any of the details provided below:

TOPE ADEBAYO LP

25C Ladoke Akintola Street, G.R.A, Ikeja Lagos Nigeria
p: +234 (1) 628 4627
e: info@topeadebayolp.com
w: www.topeadebayolp.com