

A diversified offence in private credit as the best defence

Private credit is seen as a promising asset class. Its ‘multiple engines’ in particular present compelling opportunities, says Scott McClurg from HSBC Asset Management. Financial Investigator spoke with him about the opportunities that warrant detailed consideration, and about his idea of a ‘diversified offence’.

By our editorial team

What do you mean by ‘multiple engines’ within private credit?

‘Amid elevated uncertainty, investors are increasingly drawn to private credit as a resilient asset class that can deliver attractive risk-adjusted returns, diversification, and income stability. The global private credit market is projected to reach \$3 trillion by 2028, driven by lower interest rates, declining default risk and solid economic strength¹.

Investment opportunities vary across sub-asset classes and regions. Direct lending is the largest private credit sub-category and involves providing loans to predominantly private equity-backed companies. Direct lending offers higher yields than public credit markets (+200 to 300bps), driven by illiquidity premiums and customised terms. These returns are comparable to equity returns, with credit-like risk. Loans also feature floating rate

structures that adjust with benchmark rates, providing an important natural hedge when rates are elevated.

Infrastructure debt is another private credit strategy, involving financing of essential projects such as transportation, energy transition, and digitalisation. Our approach focuses on originating, structuring, and negotiating often bespoke bilateral transactions backed by infrastructure assets that benefit from long-term cashflow visibility and resilience across the business cycle. By focusing on lower-mid-market assets in developed countries, and working with well-regarded institutions, investors can benefit from opportunities that deliver annual returns of 8% to 10%+, with a favourable positioning in the capital structure.

Investors can also access different regional engines of growth. For example, in the UK, Europe, and North America, the focus is on renewable energy projects and digital infrastructure, driven respectively by the energy transition and the growth of AI. In Asia, growing demand for transportation, urban development, and logistics infrastructure is underpinning rapid economic growth and urbanisation.’

What other opportunities do you see in direct lending?

‘While news headlines are full of big-name private credit deals, we believe the most attractive opportunities are in the often-overlooked lower-mid-market space. These are growing companies with EBITDA of € 5 to 30 million that are often market leaders in niche sectors with loyal customer bases and proven cashflow resilience.

There has been a liquidity shortfall in the mid-market space as some banks continue to reduce their presence. This allows investors to step in and provide tailored financing solutions to companies.

Companies in this space are smaller and nimbler with simpler capital structures. They have largely domestic operations and customer bases, so are less affected by global factors, such as the US tariffs. Consequently, they tend to show greater resilience through economic cycles. Many small to medium-sized companies are also in sectors with thematic tailwinds, including healthcare, IT and software, and financial services.

‘Lower- and mid-market companies often present the most attractive opportunities, offering resilient cashflows, thematic tailwinds, and less competition among lenders.’

In a recent Mercer survey of 57 asset managers globally, 74% of respondents indicated the lower- or mid-market contained the most attractive private debt opportunities in terms of potential risk-adjusted returns².

Lower mid-market deals typically face less competition among lenders, meaning deals are usually more competitive on pricing than the upper market. The ability to negotiate robust leverage and interest-coverage covenants also results in better documentary controls.

Manager selection and selective credit due diligence are especially important in lower-mid-market lending. Transactions are often relationship-driven, which is where HSBC, our parent company and one of the world's largest banks, stands out, having access to proprietary deal flow sourced directly from longstanding client relationships. The close integration with our parent company provides us with early visibility into financing needs across private companies and infrastructure sponsors, as well as access to off-market transactions with attractive terms in key growth markets.³

How does a 'diversified offence' look for private credit in 2025 and beyond? How can correlation risk across the different private credit 'engines' be managed?

'Diversification is paramount for institutional investors when accessing private credit. Intra-asset class diversification balances the higher-risk, higher-reward profile of direct lending with the more defensive attributes of infrastructure debt.

Diversification across sectors and geographies can also mitigate correlation risk. We have launched direct lending strategies in the UK and Europe, with Asia and the US expansion in development, enabling clients to access different regional return drivers and sources of diversification. Incorporating assets with varying maturities and credit qualities can further enhance portfolio resilience and support consistent income generation.

Importantly, a private credit allocation can provide diversification within a wider portfolio of stocks and bonds due to low correlation to public markets. Direct lending exhibits lower mark-to-market

volatility as loans are typically held to maturity. It also offers downside protection through covenants, collateral, and close borrower relationships.

Regular stress testing and scenario analysis are vital tools in assessing potential correlation impacts. These analyses allow us to simulate adverse market conditions and evaluate how different assets might behave. Furthermore, we maintain a robust risk management framework, including continuous monitoring of asset correlations. By staying informed, we can swiftly adapt our approach to changing conditions.⁴

Where do you see interest for private credit?

'The surge in interest in private credit in recent years has been driven primarily by institutional investors seeking higher yields than public fixed income returns (around 200-400bps), driven by an illiquidity premium that long-term investors can harvest.

For pension funds, endowments and family offices, private credit's diversification benefits and resilience are also attractive. Private credit historical loss rates are lower than leveraged loans during crises such as the COVID pandemic⁵.

For insurers, certain private credit strategies, including investment-grade infrastructure debt and senior secured loans, can qualify for lower Solvency Capital Requirements arising from lower volatility and strong covenants. Furthermore, infrastructure debt and certain direct lending deals offer longer-term fixed or inflation-linked cash flows that provide good liability matching. Under the Solvency II Matching Adjustment mechanism, insurers can recognise part of the illiquidity premium in their discount rate, boosting return-on-capital ratios.

The rise of semi-liquid evergreen funds is further enhancing private credit's appeal among both institutional and non-institutional investors by offering (among other things) improved liquidity and continuous capital deployment.⁶ ■



Scott McClurg

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SUMMARY

The most attractive opportunities in direct lending are in the often overlooked lower-mid-market space.

Companies in this space are smaller, have largely domestic operations and customer bases, and tend to show greater resilience through economic cycles.

Lower mid-market deals typically face less competition among lenders, and are often relationship-driven.

By combining direct lending with infrastructure debt, investors can achieve a more balanced risk-return profile within their private debt portfolios.

Diversification across sectors and geographies can mitigate correlation risk.

1 <https://www.moodys.com/web/en/us/insights/credit-risk/outlooks/private-credit-2025.html>

2 <https://www.mercer.com/insights/investments/alternative-investments/private-markets-in-motion/>

3 <https://www.morganstanley.com/ideas/private-credit-outlook-considerations#:~:text=Private%20credit%20may%20also%20offer,%25%20for%20high%20yield%20bonds>