

# Unleashing the Potential: The Role of Indian Private Credit Funds in Driving Economic Growth



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As India's economy continues to evolve and mature, the need for alternative sources of financing has become increasingly important. In this context, private credit funds have emerged as a vital component of India's financial landscape. In this article, we will explore the role of Indian private credit funds and how they contribute to the nation's financial ecosystem.

## Addressing the Financing Gap:

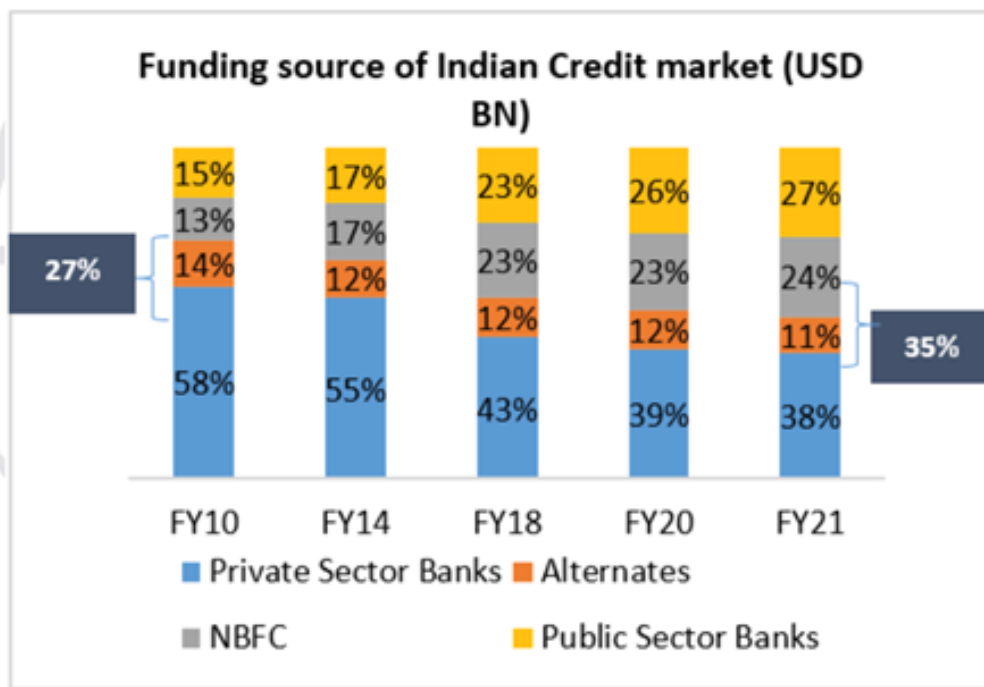
India's robust economic growth has given rise to a vast number of small and medium-sized enterprises (SMEs) seeking capital to fuel their expansion plans. However, traditional financing options such as bank loans often fall short due to stringent eligibility criteria or limited availability. Private credit funds bridge this financing gap by providing flexible and customized credit solutions tailored to the unique needs of SMEs. By focusing on cash flows and underlying business fundamentals rather than solely relying on collateral, private credit funds offer a lifeline to these enterprises, allowing them to flourish and contribute to India's economic progress.

## The Changing Dynamics of the Indian Credit Market:

Given the shallow bond market, historically, banks have been the primary source of financing in India. However, over the past decade, banks have reduced their exposure to riskier credit segments, such as the industrial and manufacturing sectors, as well as to smaller enterprises. This shift is evident in the changing composition of banking

assets under management (AUM) as follows:

1. Decline in lending to Industry / manufacturing sector from 45% to 28% and increase in personal loans from 18% to 31%
2. Moreover, the proportion of loans yielding returns of 13% or higher has reduced from 38% to 6% in this period.



To fill the void left by banks reduced risk appetite, NBFCs and Alternate credit providers emerged as potential solutions. While NBFCs and Alternate funds now account for 35% of India's total credit market, NBFCs have shifted their focus towards consumer finance and housing finance, leaving additional gaps in the market.

Few other pools of capital available to companies / promoters were investments by Debt Mutual Funds (DMFs) and retail/ HNI participation via Market Linked Debentures (MLDs). With DMFs AUMs in credit risk category sharply receding, that avenue for demand is almost non-existent. Further with changes in tax laws / removal of indexation benefits, the net of tax return on these products for non-institutional investors is not that attractive anymore, further reducing new issuances. Given these market dynamics, Private Credit has witnessed significant growth and become increasingly relevant for both borrower companies and investors. The Private Credit market in India is currently estimated ~ USD 7 billion and is expected to reach USD 20 billion by the end of the decade. The current participants in this space include foreign banks, with ~ USD 3-4 billion invested in India, and foreign funds, which have similarly allocated USD 3-4 billion to Indian Private Credit. Additionally, Indian Private Credit Funds, primarily funded by Indian Family Offices and HNIs, currently account for USD 1.5-2 billion.

Some interesting aspects of private credit:

**Driving Financial Inclusion:**

In a country as diverse as India, ensuring financial inclusion is a pressing challenge. Private credit funds play a pivotal role in extending credit to underserved and unbanked segments of society. By leveraging technology and data analytics, these funds can assess creditworthiness more accurately, opening doors to credit for individuals and businesses previously excluded from the formal financial system. This democratization of finance not only empowers individuals and communities but also fuels entrepreneurship and innovation across various sectors, ultimately driving inclusive economic growth.

**Unlocking Opportunities in Structured Credit:**

Beyond traditional debt financing, Indian private credit funds also excel in providing structured credit solutions. They cater to the growing demand for innovative funding structures that align with the specific requirements of borrowers. Whether its mezzanine financing, asset-backed lending, or structured equity investments, private credit funds offer a diverse range of financial instruments that address complex funding needs. This flexibility enables businesses to optimize their capital structure and seize growth opportunities that would have otherwise been out of reach.

**Mitigating Systemic Risks:**

The resilience and stability of India's financial system depend on a well-functioning credit market. Private credit funds contribute to this stability by diversifying risk and reducing systemic vulnerabilities. By providing an alternative source of funding, these funds decrease reliance on traditional banks, which helps mitigate the concentration risk associated with a few dominant lenders. Furthermore, private credit funds employ rigorous due diligence processes and risk management frameworks, ensuring responsible lending practices and minimizing the potential for credit bubbles or systemic disruptions.

**Attracting Domestic and Foreign Capital:**

The success of Indian private credit funds has not gone unnoticed by domestic and foreign investors seeking attractive risk-adjusted returns. These funds have emerged as an appealing asset class for investors, offering diversification, stable yields, and potential downside protection. As investor confidence grows, so does the inflow of capital, which, in turn, fuels the expansion of private credit funds and their ability to support a broader range of businesses. This virtuous cycle of capital inflow and economic growth strengthens India's position as an investment destination.

**Investor's Perspective:**

Private Credit has gained significant popularity among investors as it presents new opportunities for credit investments with unique structures and returns that were previously inaccessible. Particularly in times of market volatility, Private Credit Investments offer an appealing option to assume a certain level of risk and generate returns in the mid to late teens range through secured credit investments.

There are several factors that investors should take into account when considering Private Credit Investments or Funds. These include:

1. Evaluating the risk profile of the underlying investments
2. Assessing the ability to conduct thorough underwriting, due diligence, and ongoing monitoring of investments
3. Portfolio diversification
4. Average holding period of investments
5. Exit strategy for investments

There are two key approaches to achieving higher returns in Private Credit — taking on higher credit risk or implementing customized repayment structures. While there is no one size fits all, idea could be to focus around themes such as acquisition financing, promoter stake consolidation, or financing growth capital requirements, where traditional banks are unable to lend due to regulatory restrictions. The intent is to finance growing businesses and prioritizing the higher credit quality segment. There is a clearly a case to provide investors with optimal risk-weighted returns via participation in this segment. Indian capital pool is increasingly recognizing Private Credit as a distinct asset class with a stable risk and return profile.

Looking ahead, we anticipate significant growth in Indian Private Credit Funds with foreign funds facing challenges conducting this business from their international offices. Also with prevailing forex dynamics, it becomes challenging to justify the risk-return balance when investing USD-denominated capital in INR-denominated fixed return credit instruments. Indian private credit funds are an integral part of India's financial ecosystem, addressing the funding needs of SMEs, fostering financial inclusion, and driving economic growth. By providing flexible credit solutions, leveraging technology, and mitigating systemic risks, these funds have unleashed the potential of diverse businesses and individuals across the country. As India continues its trajectory towards becoming a global economic powerhouse, private credit funds will remain a vital catalyst, propelling India's growth story and enabling entrepreneurial dreams to flourish.

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