Resilient private credit fills a growing need across U.S. and Europe

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The U.S. and European private credit markets have been a significant success-story of asset management for the last decade. Having begun life as a source of financing for mid-market companies that could not raise funds elsewhere, private credit has grown into a serious and credible competitor to both traditional bank debt and the liquid markets (i.e., the leveraged loans and high yield bonds), something that would have seemed fanciful just a few years ago. Now, private credit players are regularly financing the entirety of multi-billion-dollar debt structures.[1]

The industry was turbo-charged by the global financial crisis, after which, regulated lenders on both sides of the Atlantic were discouraged from holding leveraged loans. Each subsequent crisis only served to underline the attractiveness of the asset class. From the European sovereign debt crisis, to the U.S. taper tantrum, and to Covid – private credit has remained on a steady upward trajectory, driven by the fundamental supply/demand imbalance for credit in both these regions, increasing capacity of private lenders and the greater efficiency of a private alternative.[2] The lack of dependency on ratings agencies is another advantage.

The most recent wave of macro troubles – inflationary pressure and war in Ukraine – have been no exception to the trend. As liquid market activity fell significantly, private credit was able to step up and step in. The combination of locked-up capital and experienced managers, who are able to discern the appropriate credit opportunities, has meant private credit is taking even more share from banks and the liquid markets.[3]

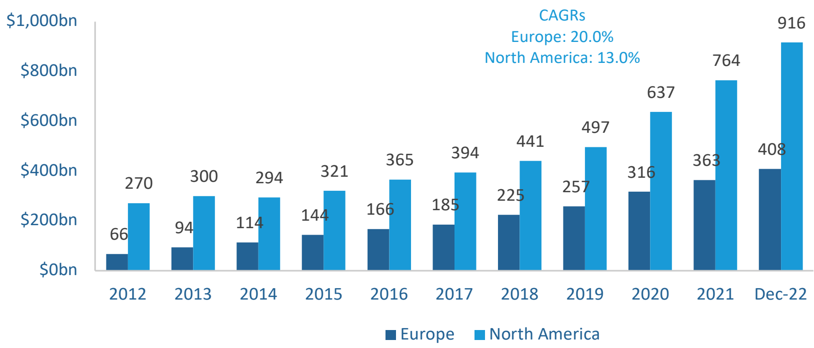
Even as private credit is entering a new phase of "liquid market substitution", the risk/return profile of the asset class in the U.S. and Europe remains attractive.[4] Private credit managers are able generally to extract better terms and pricing in this new environment.

We see the benefits of these trends largely accruing to the scaled, established managers in both regions. To be a counterparty to top-tier private equity, a private credit manager needs an established track record of providing finance, as well as the fund sizes to go along with this. Therefore, we see the mid-to-upper end of the private credit market as being the most attractive place to be – it gives access to high-quality investment opportunities with reduced competition, and therefore often better terms.

Undoubtedly, there are challenges facing the industry. While some macroeconomic worries have subsided, the global economy is not quite out of the woods just yet. Notably, it is clear that interest rates will be elevated for at least another one to two years. This puts stress on borrowers, whose interest costs have suddenly ballooned. There will certainly be difficult conversations to be had between lenders and borrowers as to how the capital structure can be made sustainable. Ultimately, however, the quality of the underlying credit will be the determinant to fund performance – capital structure issues are easier to fix as long as the business is performing. We take comfort from the facts that private credit is exposed to more defensive industries than the market at large,[5] the private credit market has generally better structural protections than the liquid markets,[6] and private credit managers can typically take action more decisively than a large club of disparate lenders can.

The U.S. and European markets therefore share a large number of similarities, structure, and outlook.

Figure 1: The relentless growth of private credit AUM[9]



Differences do remain, such as the multi-jurisdictional nature of Europe, compared to the more homogeneous U.S. legal system.

We believe private credit is well placed to overcome the challenges that both the U.S. and European economies will face:

- A focus on companies operating in defensive, non-cyclical sectors, that have historically proven to be more resilient through economic cycles.

- Typically superior covenant protections mean private credit managers have an earlier chance to get around the negotiating table to protect their debt positions.

- Smaller private credit lender clubs with experienced managers will mean that underperformance issues requiring restructurings can often be more easily resolved than in the liquid markets, involving large group discussions with investors with often differing objectives.

- Private credit has the long-term, patient capital structures, more able to withstand short-term downward pressure.

Private credit has been a rapidly growing asset class with attractive investment characteristics.

The growth has been largely driven by the increased demand by borrowers for the reliability and flexibility that private credit offers, particularly in periods of market volatility where banks continue to retrench from their lending activities and the liquid fixed income markets are highly restricted in their ability to offer new financing solutions.[7]

Similarly, investors have continued to increase allocations to private credit,[8] attracted by the premium absolute returns the asset class can generate versus the liquid markets, as well as the typically lower risk profile due to less cyclical underlying businesses, often better structural and legal protections and the lower volatility of long-term debt structures.

Private credit has proven its resilience through difficult economic environments, is of a size and scale where it represents a meaningful and attractive financing alternative to the liquid markets and we believe that the asset class will continue to demonstrate strong growth for many years to come.

FOOTNOTES
1 https://www.ft.com/content/7c4a994b-024e-4e6e-992c-7409de8943ed
2 Deloitte Alternative Lender Deal Tracker Q4 2022.
3 LCD Quarterly European Leveraged Lending Review: Q1 2023
4 Q1-23 Cliffwater Report on US Direct Lending.
5 Leveraged Loan: LCD Research – S&P Global Market Intelligence, S&P European Leveraged Loan Index components as of September 2023 – sector categorisation through Arcmont internal analysis; Direct Lending: Deloitte Alternative Lender Deal Tracker – Spring 2023 (deals during 2022).
6 Proskauer 2022 Private Credit Insights. Data points refer to (i) 88% of transactions in Private Credit included a covenant for 2022
7 LCD Quarterly European Leveraged Lending Review: Q1 2023
8 Preqin Investor Outlook: Alternative Assets H2 2023 - Preqin Jun'23 Investor Survey
9 Preqin, Sept-23