Private Credit: Evolution and Opportunity in Direct Lending

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An asset class comes of age

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Key takeaways

- As traditional lenders continue to pull back from commercial markets, private credit has filled the gap.
- The overall demand for private credit from high-quality borrowers and the volume of dry powder should provide strong deal flow and allow managers to be highly selective when deploying capital.
- Given the floating-rate structure of most private credit, moderate rate rises should boost investors' returns, though they may increase the default risk for some borrowers.
- For investors, private senior and unitranche loans typically deliver an illiquidity premium of between 150bps and 300bps, compared with publicly-traded leveraged loans. And the difference can be significantly wider for opportunistic, distressed and subordinated debt.

Introduction

In January 2010, Steve Jobs took the stage in California to introduce Apple's iPad to the world. The reception was mixed. People asked if it was necessary, and whether it would catch on. Today, as we all know, it has changed the daily habits of millions, if not billions, of users.

That same year, private credit managers were developing an asset class that would change the world's debt markets. For years, niche managers had offered mezzanine and opportunistic debt strategies. But this new structure for private credit gave borrowers access to more sources of financing at a time when liquidity had been withdrawn by banks following the global financial crisis. For investors, it offered attractive yields at better terms than the public bond markets.

Private credit was a significant departure from the status quo. And, like the iPad, it moved from a novel idea to the mainstream over the next decade.

Today, private credit offers a range of strategies and access points for investors of all types, with more than US$1 trillion in outstanding allocations as of April 2022, according to Preqin.

Evolution: A growing asset class

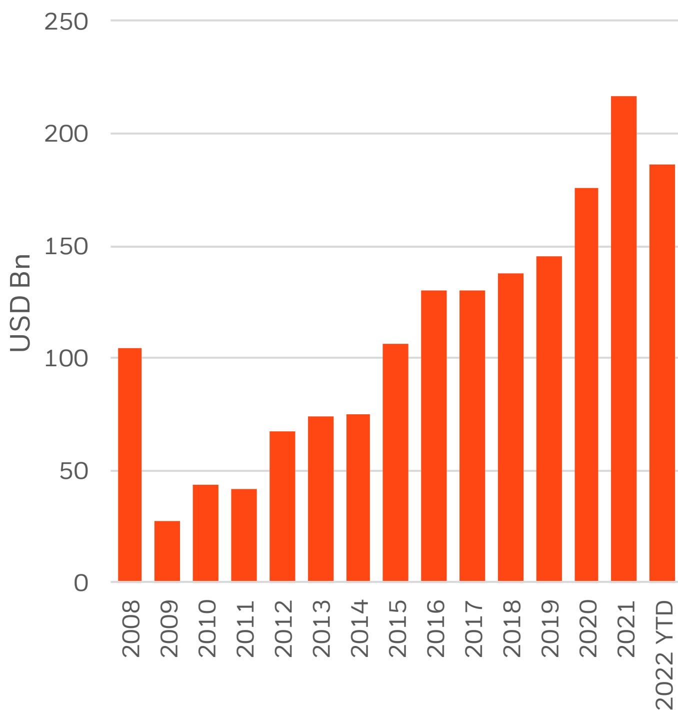
To explain the rapid growth of private credit as an asset class over the past decade, one place to start is with global M&A activity. Fueled by more than a decade of low interest rates, stock market growth and increasing private equity investment, M&A transaction volumes reached a high of nearly US$6 trillion in 2021, according to data from Refinitiv.

Prior to the financial crisis, the majority of the financing for these transactions would have come from public debt markets or banks, either individually or as a club. But regulatory changes designed to strengthen the financial system following the crisis have significantly increased the minimum size of public debt market issuances, making the market inaccessible to all but the largest companies, while also reducing the amounts that banks can lend.

Today, some estimates put U.S. banks' share of middle market financings at roughly 10% – a significant decrease from even a decade ago. While banks in the EU have maintained a significantly higher market share of middle market financings, it has shrunk in that region as well.

As a result, many private credit managers today are deeply involved in M&A, even hiring 'sponsor

Getting bigger
Private credit allocations by year



Source: Preqin, October 2022.

coverage teams' to advise private equity and other investors on the deals that they finance.

Given the reversal in monetary policy since the start of 2022, deal volumes may not reach new heights this year. But we're confident that demand for private credit will remain strong for the foreseeable future.

Large-cap companies that can access the public debt markets have also been increasingly choosing private credit, for several reasons. For one, private credit is flexible when compared to financing from traditional sources.

Borrowers also value the certainty of execution offered by private lenders when compared to club solutions or public debt market issuances, where investor appetite and pricing can change quickly and substantially. And some borrowers seek out private debt because it can come with less complexity than they often encounter when issuing and managing debt in the public markets.

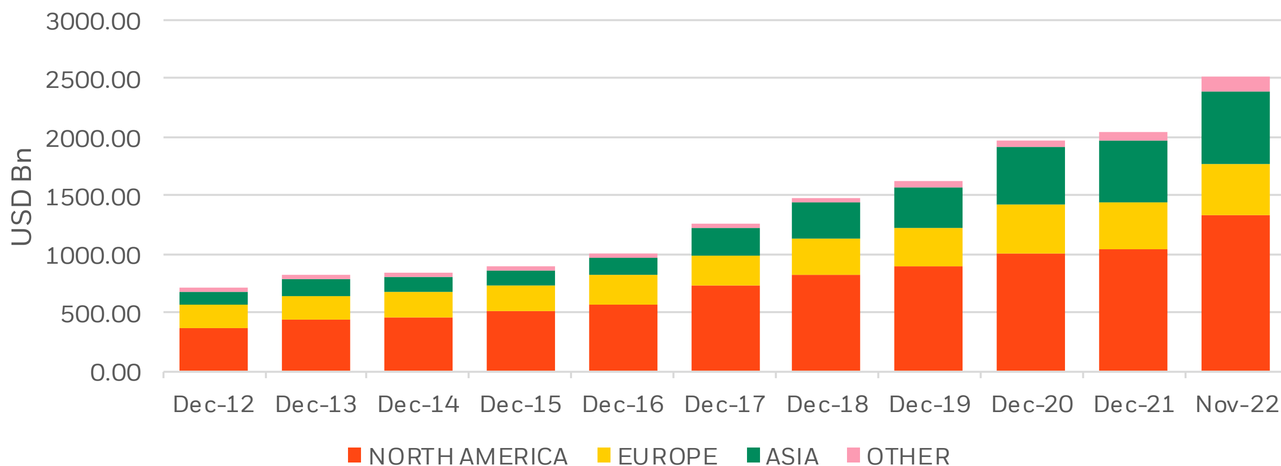
While private debt offers lenders an illiquidity premium, the costs to borrowers may not be much higher, because borrowers don't pay the same fees that they would with a public issuance. Rather, those underwriting costs are captured by investors in a private deal through original issue discounts, and call premiums.

Private credit also finances much of the M&A and leveraged buyout deals orchestrated by private equity investors. As a result, it has grown in-step with the expansion of private equity over the past decade.

In 2021, private equity buyout activity peaked at US$851 billion, or about 15% of global M&A transaction volumes, according to Preqin. While private equity funds are taking longer to raise capital in 2022, most have exceeded their size targets every year for the past five years, even amid greater dispersion of returns. Still, we believe this year's inflows could possibly surpass 2021's figure.

Fresh capital has increased private equity sponsors' already-healthy dry powder (cash that's waiting to be invested) to more than US$2.5 trillion, according to Preqin. While there is reason to view those reserves with some concern, they can also be considered a potential tailwind for private credit. That's because dry powder, especially if deployed in the LBO space, will likely require significant financing in the form of private credit.

Dry powder
Undeployed private equity reserves continue to grow



Source: Preqin, November 2022. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

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Regional Views

U.S.

- Regulations in response to the financial crisis, such as the Dodd-Frank Act, have left banks with less appetite for smaller, less-liquid credit issuance.
- Acquisitions of distressed or underperforming companies by stronger peers should create opportunities for lenders to invest in well-covered (collateralized) assets with an element of complexity that likely will require unique financing solutions.
- Public credit markets remain closed to many growth-oriented companies, leading them to seek private lenders to diversify their capital sources.
- Higher commodity and labor costs are forcing quality companies to seek financing, which creates opportunities backed by strong assets with equity-like return upside.
- There are openings for credit strategies to align with private equity sponsors and banks to shore up balance sheets or to fund portfolio companies' acquisitions.

EMEA

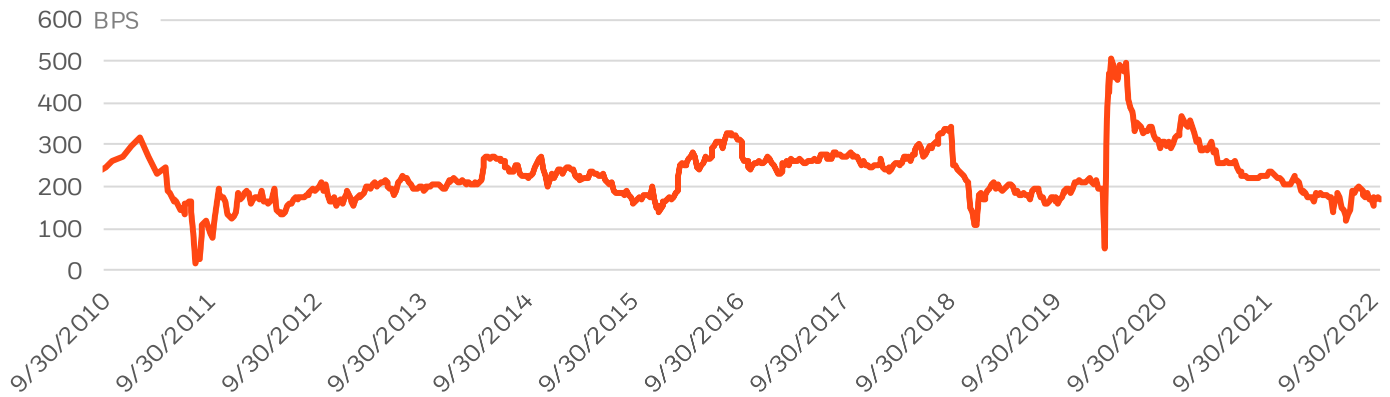
- A reduction of approximately US$2 trillion in bank lending since the financial crisis, as a result of regulatory changes such as Basel III, has led European companies to increasingly rely on non-bank lenders.
- We expect the ECB's gradual rate increases to inflict less financial distress on borrowers, when compared with the Fed's aggressive hikes.
- In the U.K., we see more opportunistic lending situations as a result of elevated uncertainty, the prospect of more rapid rate increases relative to continental Europe, and rising energy costs.
- Regional differences across Europe's major economies allow for private credit deployment through economic cycles.
- We see the risk/return profile of low-levered first lien investments as particularly attractive given strong borrower demand.
- Companies affected by rising commodity prices are increasingly turning to private lenders for liquidity to avoid or cure defaults under existing lending agreements, or to accelerate their transition to sustainable energy sources.

ASIA

- Since mid-2021, volatility and illiquidity in public debt markets have led to a slew of credit events related to redemptions, particularly in Chinese high yield.
- Investor confidence in public debt markets is low, leading to a meaningful decrease in high-yield and leveraged loan issuance, with a corresponding increase in private-credit deal flow.
- Public debt markets in economies such as India do not exist, creating more private credit opportunities, including large-cap companies that are high on the credit quality curve.
- Divergent economic cycles and asynchronous rate hike cycles between Asia and the U.S. continue to drive the complexity surrounding investment decisions.
- Our private credit strategy in the region is designed to take advantage of situational complexities that drive up the lender's negotiating power.
- We continue to see robust deal flow in private credit for new-economy growth, with deals having high contractual yields, low starting loan-to-value ratios and high equity upside.

Illiquidity premium

U.S. middle market loans offer more attractive pricing over leveraged loans



Source: Leveraged Commentary & Data, September 2022. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

Adaptation: A new environment

Private credit came of age in the financial crisis and developed during the mostly benign markets of the 2010s. But recent years have seen a change of regime, and investors now face rising rates, higher inflation and the prospect of financial stress in some borrowers. Each poses a distinct challenge – and opportunity – for private credit.

Central banks around the world, including the U.S. Federal Reserve, the European Central Bank and the Bank of England are tightening monetary policy by unwinding asset purchase programs and raising interest rates to regain some control over inflation.

But the moves aren't uniform across the globe. While rates are projected to reach nearly 5% in the U.S. over the next 12-24 months, and exceed 4.3% in the U.K., the Eurozone is projected to see rates of almost 3% during that period. And rates in the Asia-Pacific region are not expected to change significantly from their current near-zero levels.

This wide dispersion may also influence the relative value and attractiveness of businesses in different markets, particularly those with import- or export-driven earnings.

The benefits: Rising rates can actually be good news for private credit investors. Unlike bonds, most private loans are floating-rate instruments, which means when interest rates rise, so do the borrowers' interest payments.

And while many private loans have index-rate floors of between 0% and 0.5%, which dampened the initial upside from recent increases, we expect future rate increases to have a more significant impact on yields now that rate levels have generally exceeded those floors.

There is also an illiquidity premium for private credit. On a like-for-like basis, private senior and unitranche loans typically deliver a premium of between 150bps and 300bps, compared to publicly traded (leveraged) loans. That premium can be significantly wider for opportunistic, distressed and subordinated debt.

While market-wide default data isn't available for private credit, we have observed lower default rates than are reflected in the index data for both high yield bonds and leveraged loans, as well as higher recovery rates and, consequently, lower loss rates.

The risks: Higher interest payments on floating-rate debt could stress borrowers' balance sheets, leading to an uptick in defaults. Although borrowers are increasingly starting to hedge their rate exposure, this is a risk private lenders must consider.

Historically, low GDP growth has had little impact on private company defaults when compared with inflation. And for highly levered businesses, inflation can magnify the impact of slow growth, significantly increasing the probability of default.

More moderately leveraged businesses are less likely to default, although more cyclical businesses are exposed to greater risk of leverage spikes, which can lead to default, highlighting the benefits of conservatively-structured non-cyclical credit in investors' portfolios.

Inflation poses the greatest risks to businesses that are exposed to rising costs, yet unable to pass them on to their customers. For example, higher energy prices are a major threat to manufacturers and service providers, increasing production costs while at the same time decreasing consumer spending.

Recently, inflationary pressures have become increasingly pronounced for businesses, consumers and investors globally.

While most persistent in the U.S. and Europe, price increases in Asia are still ahead of central banks' targets.

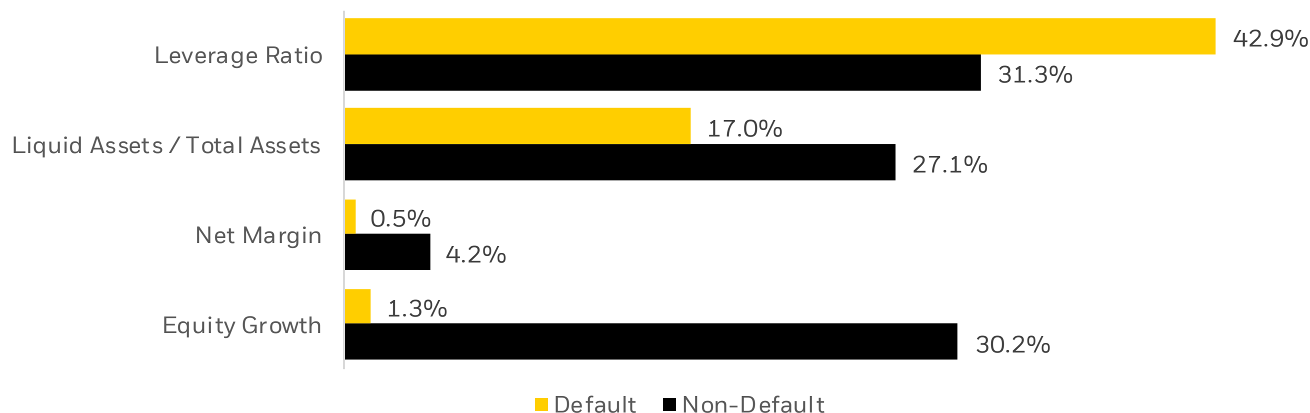
The link between leverage and default risk highlights the importance of disciplined investment structuring. In private loans, the covenants and other protections agreed on between the borrower and lender at the outset will largely dictate the risk of losses in the event that the borrower defaults.

The bottom line:

- Floating rates protect or even add value in rising rate environments.
- Underwriting standards are key to managing risk.
- Deals struck 18 months ago are being tested today, so default rates may go up in the near term.
- Leverage is a major factor in determining which companies default.
- Today's high volatility and limited liquidity make it easier to negotiate favorable terms on new debt.
- New credit deals also have the advantage of being made in a higher absolute rate environment.

Leverage and default

Warning signs of a borrower's default risk



Source: Aladdin Private Issuer Database, S&P LCD & CreditPro, July 2022. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

The terms of the majority of private credit investments outstanding today would have been agreed to at least 18 months ago, assuming a three-year average life. At that time, inflation in the eurozone, for example, was close to zero, and the focus was on the immediate impact of Covid and the recovery from it.

Those investments were made against a very different economic backdrop from today's. And subsequent developments have the potential to significantly affect the performance of those companies, their debt and the funds that invested in them.

Inflation's impact on new investments is likely to be less significant, because potential borrowers can take measures to mitigate its impact through the terms of the investments being agreed upon today.

Opportunity: A view on the markets

As lenders and investors in company debt, we see non-cyclical businesses in sectors such as segments of healthcare, along with software, technology and business services as being better insulated from inflationary pressures.

This is partly because they tend to be less exposed to cost pressures. In the case of software and technology, their products and services are critical to their clients' businesses. In healthcare, many services are essential to the wellbeing of patients, and are typically paid either by public or private health plans.

As a result, these companies can usually pass a greater portion of cost increases to their customers, which helps them maintain profitability through the cycle.

From a lender's perspective, non-cyclical businesses also tend to make attractive investments because, as shown above, they are typically less-highly levered,

Driving better outcomes

As lenders, private credit investors don't control their portfolio companies in the same way that equity investors do. But for many companies, the experience and support that a lender can bring to their business can be a deciding factor for many borrowers as they look for private financing.

with more stable valuations. These factors provide equity cushions, which can protect lenders in the event of underperformance.

Beyond investing in the debt of non-cyclical companies, we see slightly higher-risk opportunities to capitalize on a potentially more challenging economic backdrop by lending in the following areas:

- Outperforming companies in cyclical sectors.
- Companies experiencing or recovering from financial stress.
- Non-sponsor companies seeking capital to grow.
- Secondary-market opportunities caused by increased volatility.
- Companies otherwise unable to access financing from traditional sources.

These situations should be attractive to traditional direct lenders who have the flexibility to supplement the returns of their core portfolios with more opportunistic loans. Given the relatively thin margins for error involved in direct lending, we prefer a differentiated approach with individual allocations to direct lending funds – unitranche or senior – as well as opportunistic strategies.

The landscape for new investments

In private credit, success depends on quantifying investment risk, ensuring that risk is effectively priced, and managing changes in risk throughout an investment's life.

Because the Covid-19 pandemic had such a significant impact on businesses globally, it made projecting future cash flows of a business to service a new debt package much more difficult. Today, with the benefit of more recent trading performance and a clearer view of where interest rates are likely to go, we have a stronger base for making and stress-testing projections.

Private credit keys to success in the current environment:

- Local presence and global relationships to access attractive deals through multiple channels.
- Breadth of deal sources.
- Experience to price risk effectively.
- Disciplined approach to negotiating investments.
- Robust risk management process from sourcing to payoff.
- Micro- and macro-perspective to effectively monitor risk across portfolios.
- Flexible capabilities for different deal types, to adapt to market conditions and opportunities.
- Expertise and scale to deal with troubled loans.

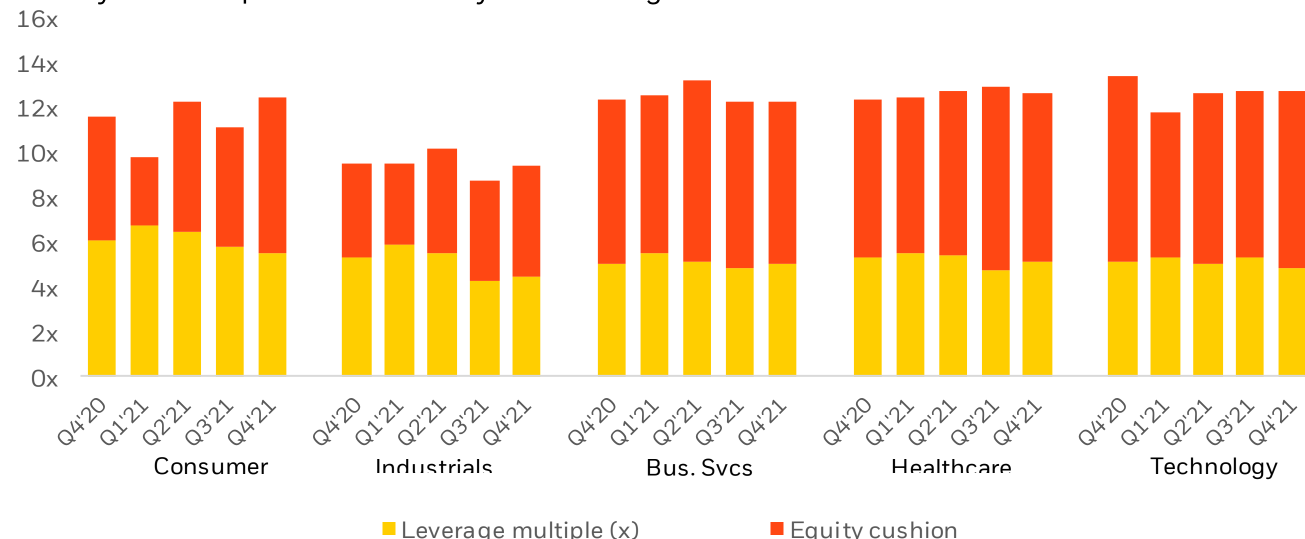
As a result of these improved projections, as well as the volatility in global markets, we have observed a widening of spreads and more lender-friendly terms in recent months. And the increased risk in the current environment is leading borrowers to pay more than before for financing, with greater returns for investors.

Given the connection between spreads, leverage and defaults, we expect a greater dispersion in private credit in the months to come. And this dispersion is why experienced investment selection, prudent financial structuring, and disciplined negotiation of terms will be essential in generating alpha in the coming year.

Much like the iPad, private credit has become an essential tool, finding new applications with each passing year. And in the current environment, we see fresh uses for it as an asset class that can potentially thrive amid the unique challenges of the new market regime.

Less leverage

Non-cyclical companies tend to carry lower leverage



Source: Lincoln International 2021 Valuations Report. The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.

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Risk warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. The investor may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

Risks associated with Equities

Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Investments in value securities involve the risk that the market's value assessment may differ from the manager and the performance of the securities may decline. Investing in securities of smaller companies tends to be more volatile and less liquid than securities of larger companies. Investing in distressed companies (both debt and equity) is speculative and may be subject to greater levels of credit, issuer and liquidity risks, and the repayment of default obligations contains significant uncertainties; such companies may be engaged in restructurings or bankruptcy proceedings. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Investments in companies engaged in mergers, reorganizations or liquidations may involve special risks as pending deals may not be completed on time or on favorable terms. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Diversification does not ensure against loss.

Risk associated with Private Equity

Limited Regulatory Oversight - Since private equity funds are typically private investments, they do not face the same oversight and scrutiny from financial regulatory entities such as the Securities and Exchange Commission ("SEC") and are not subject to the same regulatory requirements as regulated investment companies, (i.e., open-end or closed-end mutual funds) including requirements for such entities to provide certain periodic pricing and valuation information to investors. Private equity offering documents are not reviewed or approved by the SEC or any US state securities administrator or any other regulatory body. Also, managers may not be required by law or regulation to supply investors with their portfolio holdings, pricing, or valuation information.

Portfolio Concentration; Volatility - Many private equity funds may have a more concentrated or less diversified portfolio than an average mutual fund. While a more concentrated portfolio can have good results when a manager is correct, it can also cause a portfolio to have higher volatility.

Strategy Risk - Many private equity funds employ a single investment strategy. Thus, a private equity funds may be subject to strategy risk, associated with the failure or deterioration of an entire strategy.

Use of Leverage and Other Speculative Investment Practices - Since many private equity fund managers use leverage and speculative investment strategies such as options, investors should be aware of the potential risks. When used prudently and for the purpose of risk reduction, these instruments can add value to a portfolio. However, when leverage is used excessively and the market goes down, a portfolio can suffer tremendously. When options are used to speculate (i.e., buy calls, short puts), a portfolio's returns can suffer and the risk of the portfolio can increase.

Valuations – Further there have been a number of high profile instances where private equity fund managers have mispriced portfolios, either as an act of fraud or negligence.

Past Performance - Past performance is not necessarily indicative and is not a guarantee of a private equity fund's future results or performance. Some private equity funds may have little or no operating history or performance and may use hypothetical or pro forma performance that may not reflect actual trading done by the manager or advisor and should be reviewed carefully. Investors should not place undue reliance on hypothetical or pro forma performance.

Limited Liquidity - Investors in private equity funds have limited rights to transfer their investments. In addition, since private equity funds are not listed on any exchange, it is not expected that there will be a secondary market for them. Repurchases may be available, but only on a limited basis. A private equity fund's manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the private equity fund.

Tax Risks – Investors in certain jurisdictions and in private equity funds generally may be subject to pass-through tax treatment on their investment. This may result in an investor incurring tax liabilities during a year in which the investor does not receive a distribution of any cash from the Fund. In addition, an investor may not receive any or only limited tax information from private equity funds may not receive tax information from underlying managers in a sufficiently timely manner to enable an investor to file its return without requesting an extension of time to file. In certain jurisdictions a lack of tax information may result in an Investor being taxed on a deemed basis at an adverse rate of tax.

Fees and Expenses - Most private equity funds charge both an asset-based management fee and a performance-based incentive fee or allocation. As a result, the fees and expenses associated with private equity investing may exceed those of a long-only mutual fund.

Reliance on Fund Manager; Lack of Transparency - A private equity fund's manager or general partner has total investment authority over the private fund. There is often a lack of transparency as to a private equity fund's underlying investments. Because of this lack of transparency, an investor may be unable to monitor the specific investments made by the private equity fund or to know whether the investments are consistent with the private equity fund's historic investment philosophy or risk levels. Due to the risks mentioned above, it is important to perform proper due diligence in evaluating and choosing private equity fund managers to place your money with. There have been occasions when private equity fund managers took on too much risk in their portfolio and lost a substantial amount of their investors' money.

Risks Associated with Private Credit

Risks associated with an investment in a private credit strategy (the Strategy) include, but are not limited to, the following: (i) the Strategy is speculative and its investments are subject to a risk of total loss, (ii) the performance of the Strategy may be volatile, (iii) the general partner of the Strategy will retain ultimate authority over the Strategy's assets and investment decisions, (iv) there are restrictions on the ability of investors to withdraw capital and on the transferability of investor ownership interests in the Strategy, (v) the fees and expenses of the Strategy may offset any profits of the Strategy, (vi) investing the Strategy may involve complex tax structures and delays in distributing important tax information, (vii) the Strategy is not subject to the same regulatory requirements as mutual funds. Investors should also be aware that as a global provider of investment management, risk management and advisory services to institutional and retail clients, BlackRock engages in a broad spectrum of activities. Although the relationships and activities of BlackRock may help offer attractive opportunities and service to the Strategy, such relationships and activities create certain inherent conflicts of interest between BlackRock and the Strategy and/or the Strategy's investors.

In addition to the above, further risks associated with instruments utilized by the Strategy include, but are not limited to, the following: i.) Credit & Interest Rate: The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. ii.) High-Yield Bonds or Junk Bonds: Investments in non-investment-grade debt securities ("high-yield bonds" or "junk bonds") may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. iii) Derivatives: Investing in derivatives entails specific risks that may reduce returns and/or increase volatility. iv) Foreign/International Markets: International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation, and the possibility of substantial volatility due to adverse political, economic or other developments. v) Emerging Markets: The above risks are often heightened for investments in emerging/developing markets or smaller capital markets

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