Private Markets

Why Private Credit and Direct Lending Are Thriving

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Powerful macro forces — soaring inflation, rising interest rates and the Russian war against Ukraine — have hit the public equity and debt markets this year, leading institutional investors to seek alternative assets that can provide diversification and returns. Many have found what they're looking for in the private markets and, more specifically, in private credit or direct lending. *Pensions & Investments* spoke with three leading managers in this space — James Athanasoulas, managing director at HarbourVest Partners; Theodore Koenig, chairman and chief executive officer at Monroe Capital; and Trevor Clark, founder and managing partner at Twin Brook Capital Partners — about what's behind the continued flow of capital into private markets and the underlying fundamentals that support attractive valuations.

Pensions & Investments: How has the current macro-environment affected private markets?

THEODORE KOENIG: While all markets are affected, private markets are not affected as much as public markets. They are a bit insulated from the volatility of the public markets, which have real mark-to-market valuation changes.

In many respects, private markets are more transparent [in that] there's much more information available to us as lenders. We get quarterly financial information, monthly financial information and, sometimes, weekly financial information, as necessary. It allows us to have a steadier hand on decision-making. We can plan better, we can execute on plans, we can ask for — and receive — more investor support. If necessary, private equity funds, mezzanine funds, junior capital providers can step up, invest more capital, restructure as necessary, to effect change.

If you have a recession or an economic slowdown, private market lenders have more options in our toolbox than managers of public debt funds. There is very little managers of publicly-held corporate bonds can do other than to wait and see if a company performs or they can trade out of the security, typically at a point where they would suffer a loss due to market conditions versus company fundamentals. But in the private markets, we have covenants in all of our deals: debt-to-EBITDA [earnings before interest, taxes, depreciation and amortization] covenants, leverage covenants, fixed-charge covenants, etc. If companies breach covenants, we have a fair amount of maneuverability far before they miss a payment or experience a debt-service default.

JAMES ATHANASOULAS: One of the things that is attractive about private credit is that it's an inflation hedge, in that all our loans, especially on the direct-lending side, are floating-rate loans. Investors are benefiting from those floating rates which act as an inflationary hedge.

When you look at previous periods of rising rates, inflation or stagflation, an inflation-protected asset like direct lending has historically performed better than other private and public asset classes. Having a floating-rate [asset] should offset some inflationary pressures that may affect other types of investments.

If you look at the types of private credit deals that are being done or the industries that are being invested in over the last 10 to 20 years, the vast majority of businesses have high revenue certainty, strong cash flow conversion and fewer inflationary inputs. The three industries that make up the vast majority of the private credit market are business services, health care and software and technology, which [all] tend to be less capital-intensive, less cyclical and have lower input costs. As with the floating-rate inflation hedge, this gives private credit deals a bit of downside protection during economically stressed periods.

TREVOR CLARK: In periods of economic stress, the attributes that make direct lending, also referred to

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as private debt, so attractive — stability, consistency of cash flows — get renewed focus. These attributes look a lot more attractive because investors notice the weaknesses of other asset classes that they might have normally considered turning to for the returns they need, especially in fixed income.

P&I: Private debt/credit is now the third-largest private markets strategy, behind private equity and venture capital. What underlying fundamentals account for its strong growth?

CLARK: Private debt's floating rate aspect has to be one of the biggest ones. Private debt's stability, because it's not marked to market, is another; you're not typically going to see wild variations during an investment period. It's also a diversification play, with its general lack of correlation with public credit. And the risk-adjusted returns, on balance, can provide a significant premium to what you're getting in some of the public markets.

Historically, one factor that has sometimes come up as a point of concern is the fact that private credit assets don't trade. However, many investors in the market, I think, have come to understand the perception of liquidity versus the reality of liquidity. They thought they had liquidity in the public markets, but during the worst of the pandemic, how many bids were there to sell that piece of investment-grade corporate debt they owned? If there were any, we saw that they were generally pretty low. I think there's been a greater appreciation for what real liquidity looks like and the trade-off when you move into the world of direct lending or private debt.

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ATHANASOULAS: As with all markets, it really starts with supply and demand. The market for private credit has reached nearly a trillion dollars. It has grown from a cottage industry when I started 20 years ago to a permanent fixture in the private markets landscape and a separate, distinct asset class. If we look at demand, the dry powder in the private equity industry remains high. Private equity deals typically come with a private credit component; so the continued growth of dry powder is going to pave the way for future demand for private credit. This is due to the fact that there is four times more dry powder in private equity than in private credit.

The direct-lending market has grown at a 21% compound annual growth rate since 2014, whereas high-yield and leveraged loans have only grown 6% or 7%. That tells us that direct lending is gaining share relative to the way in which deals were historically financed. We see three drivers of this trend.

The first is that private equity sponsors have grown accustomed to, and like, the private credit as a solution. Sponsors have a lot of flexibility because they can craft a financing package specific to the borrower, for example, a portfolio company, that helps them accomplish [their objective].

The second is the rise of unitranche deals over the last five years. Large unitranches of $2 billion or more

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are taking share away from syndicated bank loans because the unitranches tend to be privately financed.

The final driver is that private credit has performed really well over the last 15 years through various market cycles. If you go back to the Great Financial Crisis, through Brexit, through COVID, direct lending's performance, and default and recovery rates, have been very strong, especially relative to other fixed-income sectors.

KOENIG: These are all important drivers, but I might underscore the importance of safety, the quality of returns, and performance consistency and predictability as key factors appealing to institutional investors. The absence of a 'J' curve also can't be overlooked, particularly for investors seeking to diversify their alternatives allocation because the income returns are immediate. The depth of the market and the diversity of asset managers also appeal to sophisticated institutions. There are large-, mid- and small-market product types; sponsored and non-sponsored product areas; industry specializations like health care, infrastructure, software, fintech, technology and real estate; and opportunistic, distressed and special-situations portfolios. There's enough breadth of product available and depth of quality managers that institutions can allocate across the board to different areas and not feel that they have any overlap; the diversification is really the key.

P&I: What asset allocation considerations are driving institutions toward private markets generally, and private credit, specifically?

KOENIG: I alluded to some of these considerations earlier, but the top factor is the quality of returns. The Great Financial Crisis, COVID, the war in Ukraine, these are black swan events that are hard to plan for, yet in each of these instances, returns in private credit were largely unaffected. Public market returns have been volatile while private market investments, particularly private credit, held steady. Stability and safety are big positives for institutional investors. Over the decades, private credit's default rates have averaged less than 2% and recovery rates have averaged north of 70%. That provides very stable and predictable patterns around which investors can build out assumptions to ensure their returns are adequate to meet long-term liabilities.

CLARK: Private credit has different flavors, in terms of what people include in that broad bucket. In addition to direct lending, there's aircraft leasing, life insurance settlement lending, music royalty lending, etc. Today, there are a number of different segments outside the world of direct lending, and when investors are starting to think about whether they should consider other forms of diversification within their private credit allocation, they're asking questions like, "What are the depths of some of these other markets? What's the return profile? Am I getting a replacement for what I was getting in direct lending? Am I introducing a different risk profile?"

Of the investors that have private credit allocations, we've seen that private debt can be the largest sub-allocation. Large investors often use scale as a major driver of selection when it comes to where to allocate those dollars. Direct lending is one of the largest segments within the world of private credit, as measured by scale of dollars raised. So, by its very nature, it would make sense that direct lending makes up a significant proportion of the dollars that institutions and other large investors direct into private credit.

P&I: Are you seeing new investors in private markets as well as bigger allocations by existing investors?

ATHANASOULAS: We're seeing both. There are brand-new investors to the asset class that either haven't invested in private markets or have only had a liquid fixed-income portfolio and are now starting to see the alpha that exists in private credit relative to other fixed-income asset classes. We've seen public pension plans or endowments whose growth in size has compelled them to up their private credit allocation from 5% to 10%. We've also seen a mix shift from investors that may have had an 80% or 90% public fixed-income portfolio to increase their private credit allocation at the expense of their other fixed-income sectors. In addition, we've seen non-institutional investors, like high-net-worth investors, start to invest in the asset class as a result of the strong performance during down periods.

KOENIG: If you look at allocations 10 years ago, sophisticated institutions had 1% to 2% of their alternatives allocation in private credit. Five years ago, the number was 5% to 10%. Today, it's approaching 15%.

The asset allocators that tend to invest the most in private credit are U.S. insurance companies and pension funds, non-U.S. banks and sovereign wealth funds. They all need yield in a world in which yield has been very low for a very long time. Pension funds need 7% to 8% [yields] just to stay solvent and pay benefits out to their members, while insurance companies

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generally need slightly less to stay solvent and meet short- and long-term liabilities. Unless these institutions can generate a current yield of 6% to 8% to pay their obligations, they're going backwards. There are very few asset classes like private credit that will allow you to generate a consistent annual current yield of 6% to 8% with the downside protection I mentioned earlier.

In the last two years, we've seen high-net-worth retail investors starting to seek these same yields. That is a whole new channel that has opened up to private credit. There's been significant fundraising efforts by asset management firms devoted to this space as well, which we expect will continue over the next several years.

CLARK: Looking at the private debt market, we've definitely seen investors in the space continue to allocate to the asset class, as well as new groups expressing interest in the space. We believe interest in direct lending continues to grow.

P&I: Why does so much direct lending focus on the middle market? In which industries do you see the biggest opportunity? Do you expect direct lenders to expand their client base to include larger borrowers?

KOENIG: The U.S. middle market is the largest and deepest source of companies, deals and transactions. Historically, large companies have not been among the borrowers accessing private credit. Instead, they've tapped into more of the liquid, syndicated markets for leverage. We are seeing larger direct lenders increase market share at the expense of the syndicated market participants.

CLARK: One of the things that has made direct lending, specifically, so attractive is the very significant scale of the addressable market. In the U.S. alone, you have well over 200,000 unique middle-market companies. That is a very target-rich marketplace. It's a broad market that we think is consistently robust, versus some of the more esoteric parts of the marketplace that might look attractive for a very short period of time, but ultimately don't have as much depth.

There are certain industries in the lower-middle market, which is where we focus, that have the level of stability we demand. For us, the largest single industry we focus on is health care, which has definitely garnered increasing attention for some time — both from a lending and private equity perspective. Health care has been a prominent industry, and we don't see that changing any time in the near future.

Tech, for example, is an industry that has received greater lender attention over the last five-plus years. Just as there have been private equity investors that specialize in tech, now there are lenders coming out and declaring that they're tech-focused lenders. We think tech will continue to be a very busy area, but one that's probably going to feel a bit more pressure, particularly for lenders who focus on enterprise value loans.

Looking at the marketplace today and other notable industries — environmental services, financial services and insurance-focused businesses, for example — there isn't just one that I expect will be the new standard in terms of an exclusive area of focus for lenders over the next five years. I think you're going to see private equity sponsors focus more time and attention on certain industries where they see an opportunity, and you're going to see lenders do the same thing.

ATHANASOULAS: There are four reasons why direct lenders focus on the middle market. The first is just the sheer size and growth of the middle market and the number of private companies in it. Second is the premium you can get relative to what you can get in the larger or upper end of that market. Third is downside protection, because with middle-market loans, there's a relationship between the lender and the company. The loans typically have better documentation, better financial covenants and lower risk. Finally, many private equity sponsors that can arrange financing

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choose direct lending because the financing structures are tailored to the needs of the company and the needs of the sponsor and provide greater flexibility.

Direct lenders definitely are trying to widen their client base by pursuing larger companies. Lenders like ourselves are moving up market, especially with smaller companies that are expanding and growing, where oftentimes you can get the same structural protection in the large market as you can in the middle market.

P&I: When investors are evaluating managers of private credit or other private markets, what are the most important capabilities and characteristics they should look for?

CLARK: If you have credit experience through multiple cycles, that's really a key differentiator. If you want to be considered a relevant provider of middle-market debt and a manager to be taken seriously, you have to have that — it's the cost of admission.

Furthermore, over the past decade, investors have come to realize that there's diversification within the world of direct lending. Lenders' strategies can vary significantly, and it's not one size fits all. With that in mind, asking prospective managers specific questions is important: Are you industry-focused? Are you a participant versus a lead in a facility? What size of company do you lend to? Do you do private equity-backed or non-sponsored transactions? Are you at the very top of the capital structure? Are you playing lower in the capital stack? Are you targeting industries that maybe have some inherent volatility that other ones don't have? Do you do cash flow lending or asset-based lending? All of these things affect not just the composition of the yield you can produce, but also its stability.

With so many credit shops to choose from, how managers get their deal flow is also critically important: How are you creating your lending opportunities? Have you invested in strong, experienced people who have deep, longstanding sponsor relationships and a demonstrated, consistent ability to get you access to the really good transactions? Or are you more of a participant shop, meaning that you're sitting back and waiting for somebody else to call and offer to sell you a piece of their loan? We believe this wait-for-a-call approach is a higher-risk model because you only get shown the deals that somebody wants to sell and those may not be the most desirable transactions.

KOENIG: Those are all important. Given the competitive dynamics today, sourcing capabilities are becoming a more important factor to drive consistent returns. Does the manager have a sourcing edge? And just to reiterate an earlier point, the depth and experience of the investment team are becoming table stakes. How long have they been together? During which cycles have they been together? Experience in private credit is everything. What kind of turnover has the firm had? How good is the leadership? Has it been stable? What are its priorities? The culture of the firm, similarly, can influence their approach. Is there an alignment of interests between the asset manager and its clients? Is the firm generating real alpha or just gathering AUM to generate more fees?

The final factor is the strength of portfolio management. How well has the fund or predecessor vehicles performed? How good is the firm's workout record when credits default? What's been the team's history on recovery rates?

These are all important factors when evaluating private credit asset managers.

ATHANASOULAS: Managing private credit is all about credit selection. When there is inflation, when there is potentially a looming recession, it places greater scrutiny on credit selection and the teams that are evaluating and choosing those credits prior to those periods. A lot of individuals making the call on credits may not have been through many market cycles before.

Avoiding adverse credit selection is crucial and requires three things. One, you have to have a great sourcing engine. Second, you have to have the pattern recognition and the technical skills to evaluate credits and determine which ones are the best deals. And third, unlike in public markets, in private credit you have to secure an allocation. You can do all the work on the best company with the best sponsor. But if you can't get an allocation to that deal, all of that is irrelevant.

I believe that private credit firms that don't have a component of [each of] these three things may be challenged as their portfolios mature through a difficult economic cycle.

P&I: What's your outlook for the next 12 to 18 months on private markets, as a whole, and private credit, more specifically?

ATHANASOULAS: Private markets are going to be fascinating over the next 18 months. I think private markets as an asset class are here to stay. We have learned that you're better off staying in the market and not timing it. Private equity funds have realized that as well and can cautiously approach investing in all periods rather than pressing the pause button. But having said that, there is uncertainty from a macroeconomic standpoint, an inflation standpoint. Only the best assets or trophy assets are going to be traded in the next few months.

I think the level of activity in private markets should be pretty much unchanged because of its long-term performance record, but the nature of the activity may be different, given the types of industries and focus on portfolio companies. With respect to private credit, this should be another shot in the arm for the asset class relative to publicly traded credit.

In times of uncertainty, private equity sponsors are looking for direct lenders or private credit providers that can deliver solutions. Those solutions allow the sponsors to get their deals done with certainty rather than taking [the] market risk they would in the syndicated markets. We're starting to see that incremental financings that were done in the syndicated market are now being privately placed, and that there's way more private activity for larger deals that typically would have gotten syndicated in less volatile times.

KOENIG: Private credit has had its best-performing vintages in down economic periods. Over the last 20 years, our firm's best returns and the industry's best reported returns have been during and after the dot-com crash, the Great Financial Crisis between 2007 and 2009, and post-COVID. That's when spreads have been the widest and risk-adjusted returns have been highest.

As long as we don't go into a deep recession, there's nothing wrong with a slight economic downturn for private credit. Unlike private equity, we're not relying on multiple expansion or significant EBITDA growth to create value or generate returns. Operating at the status quo is a really good thing for private credit.

Something else we see looking ahead is the increasing globalization of alternative investments, as a whole, and private credit, specifically. Historically, private credit developed in the U.S. and spread to Europe because, much like in the U.S., European financial regulators changed the rules and increased capital ratios and tightened banks' ability to hold certain risk assets. We're starting to see the same thing happening in Asia now. Private credit is becoming a globalized effort, both by investors and asset management firms. ■