

Private Debt: Not Your Average Asset Class

Let's Level Set: What is Private Debt?

You've likely heard of private debt, or at the very least seen headlines in the news. And for good reason; private debt is projected to increase 11.4% annually, to \$1.46 trillion at the end of 2025, from \$848 billion at the end of 2020, according to recent survey by Preqin¹.

Private debt refers to loans made to private companies by non-bank lenders. The companies are usually described as the "middle market," with revenues between \$10mm and \$1 billion. Because of their size, they often cannot access the public markets to raise capital. The non-bank lenders are generally asset managers who have developed an expertise in originating these types of loans; meaning they research the market, the companies, and the financial prospects, they perform extensive due diligence and are experts in structuring the loans.

They loan out the capital and usually hold the loan until maturity. Because the loans are illiquid and the companies have no other sources of capital, the loans are justified to have higher yields than the public markets. These loans can provide lower than expected default risk because of the extensive due diligence, and can possibly recover more when they do default, due to the specialized knowledge, experience and flexibility of the lender.

What is the Appeal?

Private debt appeals to those who may want to consider income-producing assets in their portfolios. In past decades, U.S. Treasury securities or corporate bonds were often the go-to asset, and portfolios holding 40% of their assets in bonds, the "60/40" portfolio, were considered the norm.

As the chart below shows, interest rates have been on a downward trajectory for decades. Given the low-interest rate environment the Federal Reserve has committed to, many economists feel that this trend is likely to continue, or at least yields will not recover substantially anytime soon. Bloomberg notes that the typical investment-grade corporate bond now pays a yield of around 3%. By comparison, private credit markets can offer yields several hundred basis points higher.

FIGURE 3: Interest Rates are Well Below Historical Averages



Source: Refinitiv LPC.

Why Businesses (Borrowers) Are Turning to These Alternative Lenders

Borrowers are increasingly turning to the private credit markets, even at the upper end of the valuation scale where they could potentially access bank funding or public markets. This is because going to a private lender, rather than a bank, allows for greater customization of loan structures, including longer maturity profiles that may match their financing needs, and more certainty. Because these lenders are often asset managers with access to flexible capital, they can often conclude deals with greater speed, and the borrower has a greater assurance of the deal being completed.

To Lend Well Requires Very Specific (Manager) Skills

We talked about the illiquidity premium that private loans can provide. There is also a complexity premium, in that the manager must have a very high degree of expertise to compete in this market. Originating loans often requires thorough review and analysis.

Having a track record demonstrating a manager has avoided meaningful defaults and losses and consistently selected performing loans creates a virtuous circle. The more loans a manager makes, the more companies they see, the more selective they can be.

A manager with a reputation for completing deals will also be well-placed to properly structure a loan with necessary covenants that provide more control. And finally, being on the ground with a big footprint will give a manager the ability to select very high-quality companies.

Where is Private Debt Headed?

On the borrowing side of things: A recent survey by the National Center for the Middle Market looked at the trends for revenue growth and found that over the last several years, upwards of 70% of companies report that they expect to grow revenue year-over-year. However, for 2020 and 2021, that percentage ended up in the 40s. In many instances, these are companies that have good businesses, but the current situation has created revenue shortfalls that are now impacting their capital structures. This may create opportunity for managers to invest in very high quality companies at attractive entry points.

On the investor side of things: Investors of all stripes are increasing their allocation to private debt. Institutional investors responding to the Preqin survey reported that 58% expect to increase allocations to private debt over the coming five years. Individual investors are also including the asset class in their portfolios.

The Bottom Line

As the democratization of investing and lending continues, investors looking for an income-producing assets and struggling with the lack of yield in the public markets may want to expand their horizons to include private debt as part of their credit allocation.

¹. Preqin Special Report: The Future of Alternatives 2025. December 4, 2020

RISKS

As with any asset class, there are certain risks associated with non-investment grade debt. Credit risk is the risk of nonpayment of scheduled interest or principal payments on a debt investment. The risk of default may be greater. Should a borrower fail to make a payment, or default, this may affect the overall return to the lender. Further, illiquid investments require longer investment time horizons than other investments. For these and other reasons, this asset class is considered speculative and may not be suitable for everyone.

The information contained within is for educational and information purposes ONLY. It is not intended nor should be considered an invitation, inducement to buy or sell any security or a solicitation to buy or sell any security. The information is not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from us or any of our subsidiaries to participate in any of the transactions mentioned herein. Any commentary provided is the sole opinion of the author and should not be considered a personal recommendation. This is also not intended to be a forecast of future events nor is this a guarantee of any future result. Both past performance and yields are not reliable indicators of current and future results. Information contained herein was obtained from third party sources we believe to be reliable; however this is not to be construed as a guarantee to their accuracy or completeness. Observations and views contained in this report may change at any time without notice and with no obligation to update.

All investments carry a certain degree of risk, including possible loss of principal and there is no assurance that an investment will provide positive performance over any period of time. There are specific risks associated with investing in various types of financial assets and in different countries. The information contained within should not be a person's sole basis for making an investment decision. One should consult a financial professional before making any investment decision. Investors should ensure that they obtain all available relevant information before making any investment. Financial professionals should consider the suitability of the manager, strategy and program for their clients on an initial and ongoing basis.