Private Credit vs. Public Debt (Second of a Series)

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In this series we are examining the characteristics of public debt, such as high yield bonds, compared with those of private credit instruments. Last week we covered interest rate risk and relative default rates. Now let's turn to relative yields.

As our *Chart of the Week* shows (reprised from last week), there's been a steady increase in the differential between junk yields (as measured by the BofA ML HY Index) and middle market loans (per the CDLI Index).

Besides pointing to the stable returns of senior secured credit, it demonstrates how bond yields fluctuate with market sentiment. Investors were spooked in early 2016 by fears that anemic economic growth would slip into a recession. That sent bond yields soaring and prices dropping. Equilibrium was regained as the year went on, but fixed income accounts were buffeted in the event. Private credit funds sailed through.

Indeed commentators suggest that with equities riding at record levels, volatility is poised to make a comeback. Currently the VIX is around 11.25, having settled down since its near-term peak of 22.5 just before the November election. As we highlighted in our 2017 outlook [link], any number of global surprises could trigger a VIX uptick.

Note also that the 10% loan yield is generated by assets held by BDCs. The dividend requirements of those vehicle tend to prod their managers towards higher coupon loans. But otherwise the CDLI Index is an excellent proxy for private credit. (See the *Lead Left Spotlight* for our interview with Cliffwater's CEO Steve Nesbitt for more).

What's a more normalized yield expectation for middle market senior debt? Thomson Reuters LPC reports leveraged yields first-lien term loans weighed in around 6.5% for the quarter ended Jan. 31. S&P LCD data shows a similar yield of 6.5% (90-day rolling as of March 2).

Second lien observations for smaller deals are few and far between, but S&P pegs those yields somewhere around 11%. Unitranche, also a tough bird to get good metrics for, is generally found to be in the L+600-650 range, or all-in of 7.5-8.0%.

Compare that with the "public" loan equivalent of high-yield bonds – the broadly syndicated loan market. This is effectively public debt because many borrowers are so-called cross-over bond issuers, and/or carry public debt ratings. The debt is also widely traded with tranches over $500 million. Recent LPC and LCD yields for large, liquid loans are 4.40% and 4.67%, respectively.

That represents a major discount to the middle market, thanks to the "illiquidity premium" placed on smaller loans by institutional investors. And as our *Spotlight* guest points out, middle market lenders deliver real value by having direct influence on deal structures and pricing – something you can't manage from a Bloomberg terminal.

Next week we examine duration and credit risk for both public and private debt