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Top Ten Myths About Private Credit (Third of a Series)

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We continue our special series this week with :

Myth #2: "Private credit is the next market bubble."

The same notion that private credit is crowded drives the view that strong investor demand will lead to a burst market bubble.

It's a myth that's applied regularly to leverage loans. The universe of broadly syndicated loans is as large as that of high-yield bonds, so that must be a bad thing. But growth in loans is a classic result of demand by both issuers and investors, thanks to the benefits of the asset class.

Similarly, private credit has expanded from about $200 billion five or so years ago to the $800 billion – $1 trillion range today. This is just under its public credit counterparts. Private credit's popularity is a natural response to the challenges faced by users and buyers of broadly syndicated loans, not artificially inflated by some unsustainable factor.

The migration of more than $4 trillion in loans from banks to non-banks over the past quarter-century was a tectonic shift in the capital markets. It moved floating-rate secured assets to more efficient holders. Rather than being originated to pass through to other buyers, they were sourced to own and manage themselves.

Non-regulated entities also differed from banks in another respect. Rather than valuing loans based on regulatory guidelines, non-banks use a mix of third-party estimates, borrower performance, and (in the case of liquid loans) secondary trading prices.

It is true that private equity valuations are at all-time highs, and is leading to concerns of the credit risk consequences for "overpaying." But so far direct lenders have benefited by having greater equity cushions in LBO financings.

Unlike equities, debt valuations can't grow to the sky. Getting "par" for your loan, or 100 cents on your principal dollars, is the expected result (See *Chart of the Week*). Yes, distressed buyers can earn double-digit returns by buying very low and selling high, but that's not the regular way for private credit.

What about a credit bubble formed by aggressive lenders financing borrowers at too-high leverage with weak covenant structures? As with every bull market, we see evidence of poor underwriting standards, mostly from inexperienced managers or firms where quantity of credit invested is valued over quality.

But that's like outlawing all nautical traffic when a speedboat runs aground on a clearly marked sand bar. The best credit managers distinguish themselves over time and multiple business cycles, knowing where the menaces to navigation are hidden.

? Next week: Myth #3: “We’re late in the cycle, and loans now are risky.”