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Private Credit – Why Now? (Third of a Series)

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The clock is ticking on interest rate hikes. Who will win the fight on inflation: the Fed with a soft landing or a recession with a hard one? The answer could either push buyers deeper into illiquid credit or reinforce indecision.

But private credit has never been a timing game. Opportunistic, distressed and liquid credit are influenced by market or economic conditions. Since private credit doesn't trade its returns depend on all-in coupons, fees and principal repayments. Minimize losses and you drive alpha. But can that be done through all cycles?

Long-term data suggests middle market loan recoveries are better than BSLs because direct lenders in tight buy-and-hold groups cooperate to improve outcomes. Larger syndicates are often composed of funds with different strategies and entry prices, making workout coordination a challenge.

When loan and bond prices fall and yields widen it's tempting to jump into these opportunities. But don't mistake a short-term phenomenon as a substitute for the consistently higher returns characteristic of private credit. When inflation and rate dynamics are eventually restored to more normal levels, public yields will settle well below privates' historic range.

Private credit portfolios are rooted in defensive sectors. By avoiding cyclicals where market timing matters, orienting financings towards healthcare, technology, software and business services creates an all-weather mix.

As our *Chart of the Week* highlights, financing activity this year for public credit has been decimated. To earn higher yields with weak primary flow leads to low priced and over-leveraged leftovers in a picked-over secondary market.

Private credit terms have never been more investor-friendly. With sponsors providing record levels of fresh cash equity, lenders' loan-to-value and debt-to-ebitda ratios are at low levels not seen in years. Senior debt yields are at record highs and financial covenants are meaningful again.

But this is contingent on investor access to high-quality opportunities. Direct lenders have long-term capital insulating them from market ups and downs. Their buy-and-hold models are ideally suited for conditions when the buy-to-distribute model is impaired. Private equity clients have long investing horizons and operating partners experienced in all cycles.

No surprise that new deal private issuance is up sharply this year, with no end in sight.