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The New Order: Leverage Finance in an Asset Management World (First of a Series)

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We were perusing recently a piece on the future of private equity in an excellent state of the market study from Evercore's private funds group. One of the paragraph section subtitles read: "The corporate governance fix that became an asset class."

The thesis was that private equity sponsors solve strategic problems for growing (or challenged) businesses by giving management upside in the performance of the company in exchange for capital and corporate support. That fix, of course, has led to the development of an industry that so far has amassed, according to the article, AUM of $14 trillion.

In the same way, we think, private credit has grown from a back-water of middle market lending in the 1980's to beachfront in the fastest growing element of the capital markets. We would suggest private credit is "The regulatory fix that became an asset class."

Regulatory bodies such as the Fed, OCC, and FDIC have been pushing against banks for decades to not hold leveraged loans on their balance sheets. The GFC brought a sense of urgency to that mission, and sparked interest and investments in non-banks raising long-term capital and zero consumer deposits.

Post-pandemic private markets have survived Covid shutdowns, supply-chain crises, high inflation, high interest rates and persistent threats of recessions. At the same time, banks further retreated from high-yield credit as liquidity was drained from the financial system. Private credit managers, propelled by investor appetite for consistent, premium yields for less-correlated assets, took over buyout financings with a vengeance.

Today the outlook for higher interest rates has softened. While the timing of cuts shifts with each PDI report, expectations for lower rates later this year still prevail. In the meantime, the BSL market has shown signs of renewal, though mostly in the form of refinancings.

Some have seized on this revival as the first volley in the battle banks are waging to regain lost market share. BofA Global Research (quoted by PitchBook LCD) highlighted $10 billion of direct loans refinanced by banks, thanks to the "DL spread premium over BSL recently hitting 250 bps, the highest in a decade, thereby incentivizing issuers to cut interest costs by rotating into syndicated markets."

What is the outlook for the private vs. public struggle for corporate transactions? How do credit solutions of these players differentiate themselves? Can banks regain the share of buyouts they lost over the past three or four years? And most importantly, will heightened competition among top lenders lead to increasingly aggressive terms and higher defaults?

Over the next few weeks, we'll examine these and other related questions in this special series, with the goal of more transparency and better education on both the liquid and illiquid asset classes.