Private Credit in a Post-Rate World (Third of a Series)

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As we've noted, the banks and private credit managers occupy different places in the corporate finance ecosystem. That's not to say, of course, that large corporate financings don't represent real investment opportunities for the right buyers. Or that the expansion and evolution of private capital won't lead to interesting and constructive solutions for a wide range of market challenges. But it's important to understand the elements that differentiate the two. And more broadly, what makes an alternative allocation in the 60/40 model so rewarding to investors.

Let's take a step back and see where private credit is in its decades-long journey. Since 2007 the asset class has grown to $1.7 trillion. Whether in recessions or growth spurts, zero or record-high rates, pandemics, supply-chain crises, open or closed public credit markets, expanding or compressing spreads, and hot or cold M&A, nothing has stopped its fundraising and investing. The steady, up-and-to-the-right growth of private credit is a testament to its durability through all sorts of economic and market conditions.

Private credit investors understand this all-weather characteristic contrasts with more liquid assets whose values shift with every market, economic, or headline move. And when that happens with CLOs in the broadly syndicated market, issuance ceases. This experience has taught buyers of non-traded loans over the years it's a great asset to own. The question now is how to grow with private credit through its next stage of evolution.

On a credit panel last month, we cited an institutional investor survey in which 98% of responders said they planned to maintain or increase their private allocation over next three years. Almost two-thirds said they would do so regardless of rate expectations. This is further evidence we are living in a post-interest rate world. Investors have priced in the Fed's soft landing and its hawkish stance keeping rates at or near present levels. They've also factored in future rate swings between zero and 2024 highs.

The benefits of PC are viewed differently depending on market conditions. When rates are low, as they were in the post-GFC period until the Fed began raising rates in 2022, relative yields were quite attractive. That was the beginning of the real growth spurt. When rates were high, close to where they are today, absolute yields hit double-digits. Add a little fund leverage and you're challenging private equity returns with senior debt!

From a supply/demand perspective, middle market sponsors specialize in developing growth strategies in niche industries. Using some version of an operating partner model, these firms combine talent with experience to find platforms with competitive "angles" and "moats" to protect their franchise. Then they find smaller acquisitions to expand the platforms and enhance valuations. These dynamics help offset the periods of slow M&A global markets have experienced in the last several years.

Despite these benefits, fewer PE exits have clearly negatively impacted realizations and made it harder for LPs to commit to new funds. Next week we look at 2025's outlook for this dynamic.