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Private Credit – The Final Reckoning (Second of a Series)

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Those who talk about risks in private credit should also keep in mind that investors always look at *relative* risk. For example, Moody's analysts observe that without a sustained downturn since the GFC, "private credit has not been truly tested, only quizzed."

Fair enough. But how did public credit fare over that period? As the analysts also remarked, "Covid defaults could have been materially worse without private credit." And when the Fed started cranking up interest rates in 2022, the leveraged loan market went off-line *for two years!* Direct lenders again came to the rescue. Failing quizzes is still failing.

As one top manager put it, when a bond-issue hits the market and trades at 40, why does no one write about the risks of high-yield? In a liquid market, those risks are considered "part of the deal." Your 60 bps loss doesn't crystallize unless you sell.

For middle market loans, there's no true trading market. While that stabilizes valuations, it demands a different perspective on recoveries from investors. Direct lending workouts require close relationships between lender and borrower, and (as importantly) among lenders. Regardless, recoveries improve with more restrictive documents middle market deals provide.

Liquidity and transparency in private credit is likely to increase over time, but the traditional middle market is fundamentally different than public credit in those aspects. Its benefits are *not* to be subject to the same volatility investors hope to avoid with private credit in the first place!

If you consider private credit to be risky, given where it is in the capital stack – senior and secured – what does that say about public equity? Since 1980, the DJIA and S&P have earned 11.6% and 11.8%, respectively. Apply modest leverage to a senior debt fund today, and you can approach mid-teens returns. Even doing so when interest rates were zero can get you to 10%.

Private credit has grown in sophistication ("We're not just unitranche anymore"). Capital arrives up and down the balance sheet. It's also more resistant to headline risk and general market swings. When liquid loans trade down amid volatility, it's a challenge setting primary issuance terms. "Pricing on panicked capital" is not optimal under those conditions.

Convergence is a two-edged sword. At the upper end of the market, private credit looks more like publics. Investors benefit from enhanced liquidity and ease of access. But to generate deal flow from larger corporates and growth sectors for the next decade, top private managers will compete with banks and, increasingly, among themselves, so terms must reflect that.

Finally, private credit risk varies depending on where in the ecosystem you reside. We know that structural innovations favorable to borrowers tend to flow from publics to privates. Three decades ago, high-yield bond incurrence-only covenants ("cov-lite") were passed down to broadly syndicated loans. Then those same aggressive terms migrated (in risk-off markets) to upper middle market private credit. Great for borrowers, but for credit investors…not so much.