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The OG of Private Credit: How We Got Here

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According to iCapital, private credit refers to "*tailored financing options – typically loans – that are directly made to strategically identified companies by non-bank lenders. These…may include direct loans, distressed debt, asset-based loans or specialty finance solutions.*"

Unfortunately, the term has become a stand-in for bubble risk, panicking retail cash, and scavenging insects. This framing stereotypes the asset class and ignores the more disciplined, historically grounded aspects of the market.

Understanding the history of private credit can shed light on how the industry evolved, and why painting all managers with the same brush today clouds the strength of the underlying fundamentals that made its popularity with investors possible in the first place.

Commercial bank officers in the 1980's knew that selling leveraged loans to structured vehicles such as CLOs was better than holding them. For middle market loans, specialized teams within banks and finance companies better understood smaller to mid-sized company risk profiles.

But consolidation and regulation pushed many banks out of the middle market. Seasoned credit pros raised long-term capital from insurance companies and PE firms to build the first private credit shops. They hired underwriting and origination teams who had successfully run middle market loan portfolios and built relationships with leading private equity owners.

At first, progress was slow. With non-banks' commitment sizes limited, some banks remained competitive. But after the GFC, investors noted how well mid-cap loans performed compared to BSLs. Indeed, demand for capital did not disappear with bank exits. Fundraising for new private platforms took off, propelling their hold levels to $100 million per deal and higher.

Amid the zero-rates of the 2010's, investor appetite for higher yielding instruments soared. Investment banking executives followed this slipstream, forming firms offering bank/bond options to large corporates. Because banks could still distribute this paper, non-banks had to match their aggressive terms: high leverage, tight spreads, and weak covenants.

The game changed with the formation of "semi-liquid" vehicles, including BDCs and interval funds, often an 80/20, private credit / BSL split, allowing for the first retail access to the asset class. Enormous capital inflows allowed managers to commit over $1 billion per deal. Now non-banks could compete on almost any sized financing. Soon LBOs financings had all but disappeared from the bank market.

But the pandemic forced the Fed and Congress to pump almost $5 trillion into the system. It saved the economy but also ignited inflation and rate hikes.

Next week we see how this new regime pressured portfolios and deal sourcing, leading to vastly different outcomes between core middle market managers and their large market peers.