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The Business of Private Credit: History 101

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Last week we kicked off our special series on middle market industries with an overview of why they should matter for private credit investors. This week we provide some historic context. How did experienced lenders establish winning track records by learning from the lessons that previous economic cycles taught them? And what does this mean for their abilities to absorb risks successfully from future macro events?

The roots of middle market direct lending came from traditional commercial bank lending in the 1970's and 1980's. Designed to serve regional companies that lacked the size and scale to access the broadly syndicated loan or high yield markets, this arena was driven by relationships. Founder- and private equity-owned borrowers clubbed together like-minded lenders they trusted to provide their significant capital needs.

These lenders often shared a similar approach to evaluating risk and credit underwriting, informed by decades of experience with their clients. This began to change, however, as leveraged buyouts in the late 1980's and early '90s pushed leverage higher. Non-bank lenders such as finance companies carved out specialty areas in healthcare, technology, consumer goods, and light manufacturing. They also worked closely with sponsors on niche middle market sectors (think car washes) ripe for consolidation.

Then came the GFC. The worst downturn since the Great Depression swept away long-held assumptions about portfolio construction. Consumer brands lost over value. Cyclical businesses weren't solved with lower leverage. And product purchases dependent on financing were toast.

The few credit managers who survived the GFC learned from their mistakes. Industry screens for the all-cycle playbook required constant vigilance and updates. The 2015 oil crisis, COVID-induced inflation and supply-chain shocks, rate hikes and tariffs all tested underwriting models.

Our "(Smaller) Size Matters" piece highlighted how Core MM and larger issuers differed in industry focus. The bank/bond replacement market includes more momentum sectors where funds trade in and out of positions. Buy-and-hold lenders target companies with strong, predictable free cash flows in sectors offering natural buffers against headline risks. This favors service-oriented businesses and specialized manufacturers.

Wall Street identifies HALO (heavy-asset, low obsolescence) as favored industries. Think of the middle market as "ground-level" businesses – LALO (light-asset, low obsolescence) borrowers that grow even when the economy isn't.

Thus, portfolio construction for private credit in its most resilient form is found in the middle market. If you hold loans for the long run, the businesses they finance must perform in any market. As one of our good friends likes to say, in private credit your horse doesn't have to win, place or show. It just has to finish the race.