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Private Credit – Global

Syndicated and private lenders will spar as LBOs revive, upping systemic risk

Summary

» **As leveraged buyouts (LBOs) stage comeback, credit quality will erode**. Despite a sharp drop in LBO activity over the past two years, private credit lenders have been building a considerable arsenal of dry powder – capital that must be put to work. We believe large banks in the publicly syndicated loan market – which have lost significant leveraged loan share to private credit rivals in recent years – will be competing aggressively as new LBOs emerge. This will likely cause pricing, terms and credit quality to erode, fueling systemic risks.

» **Stronger credits will prefer the syndicated market**. As LBO competition grows, stronger credits will access the broadly syndicated loan (BSL) market, which provides cheaper pricing and more flexible documentation than private credit. When targeting the BSL market, most private equity-sponsored entities now build their balance sheets to achieve a B2 or higher rating. This is because growing investor risk aversion has pushed many B3 credits – once favorites of the BSL market – into private credit, which caters to smaller, more highly leveraged companies. And unlike BSL lenders, private credit functions outside the purview of prudential regulators.

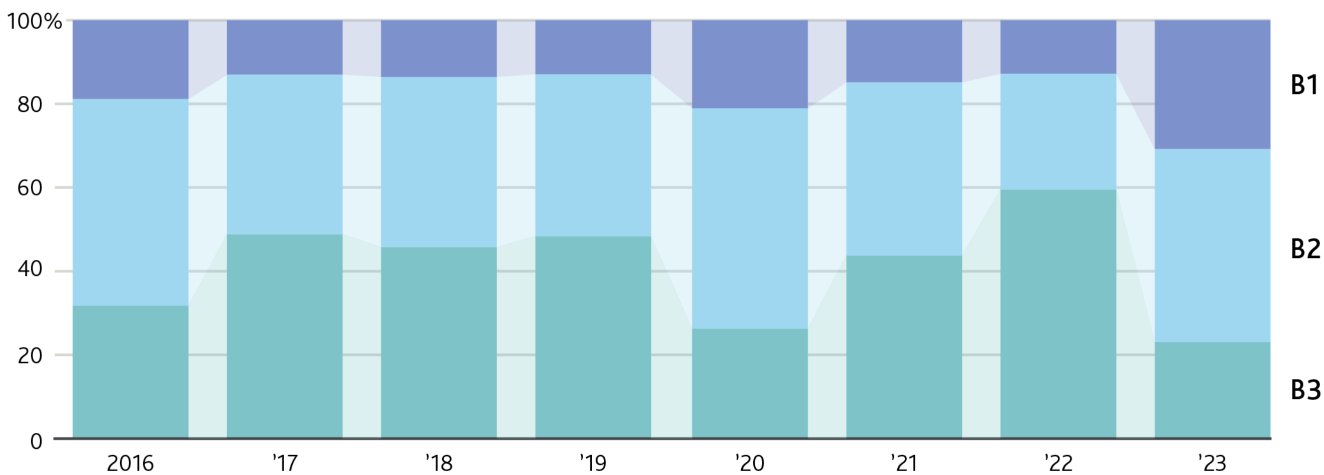
» **Private credit is increasingly concentrated as managers race for capital**. The largest private debt managers continue to dominate industry fundraising and build scale. Their growing market clout largely reflects private equity sponsors' preference for smaller groups that can write big LBO checks on quick turnaround without the headaches associated with disclosure requirements in the public market. They are also rapidly building permanent capital to avoid returning repeatedly to the markets to raise funding for their investments. In doing so, they are developing new lending and borrowing "ecosystems" that point to growing systemic risk.

» **Competitive escalations will likely raise systemic risk**. Risks are rising as major lenders jockey for capital clout and returns. Alternative asset managers are turning to individual investors, introducing liquidity risk into the private fund market where it did not exist before. Increased concentrations, conflicts of interest and lack of regulation underscore risks. The rapid growth of PE has pushed more economic activity into the hands of a few large asset managers, with strategies that increase leverage for mostly middle market businesses. Lack of visibility will make it difficult to see where risk bubbles may be building. These trends could have repercussions for the broader economy.

As LBOs stage comeback, credit quality will erode

Following a sharp contraction in LBO activity on the back of surging interest rates and volatile markets, we expect deal activity will gradually revive in 2024. This will jump-start competition among the broadly syndicated leveraged loan (BSL) market and direct lenders in the private credit domain. As public and private lenders compete over pricing and terms, credit quality will erode, increasing defaults. We have forecast that the US speculative grade default rate will be 4.6% in a year, reflecting how the transition to a higher rate environment has made many capital structures unsustainable, particularly LBOs. A tougher credit environment will create fresh challenges for the private credit market, where borrowers tend to be smaller and more highly leveraged than those in the BSL market. Moreover, within the private credit market, which is less regulated and more opaque, defaults are difficult to measure. During the slowdown, private credit experienced an influx of B3 borrowers as risk-averse investors in the public BSL market (not long ago dominated by B3 credits) now focus on higher quality B2 issuers (Exhibit 1).

Exhibit 1
The BSL market has been spurning first-time B3 issuers in favor of higher quality issuers

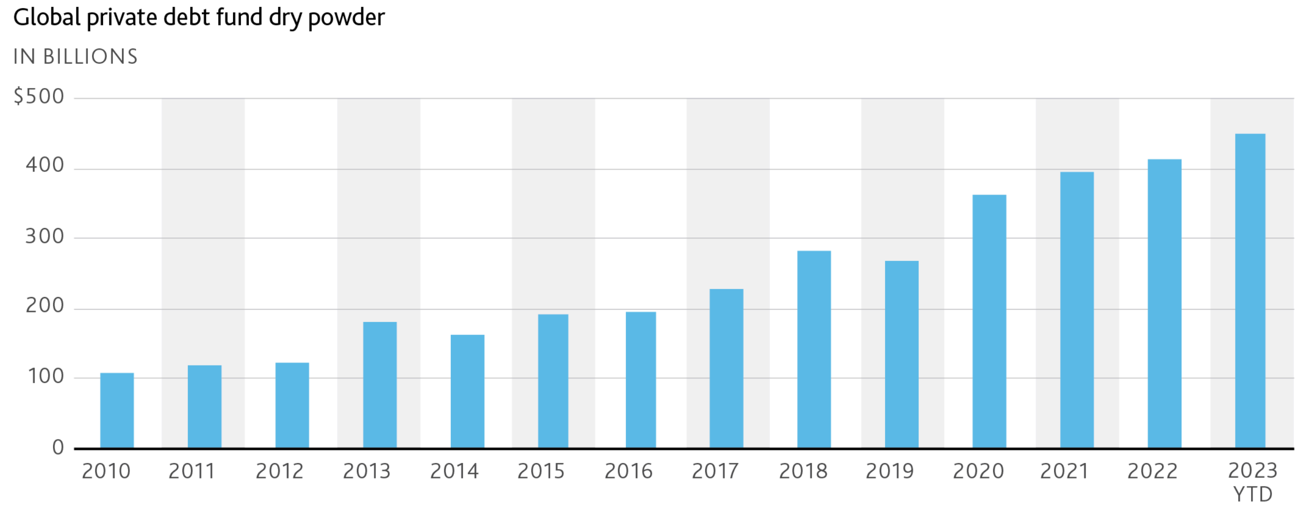


Source: Moody's Investors Service

Any "race to the bottom" over LBO terms and pricing has broader systemic risk implications in an environment where the economy is already weakening. At the same time, a growing segment of the riskier leveraged loan market is being swept into private credit, beyond the purview of prudential regulators. "Systemic risk" traditionally refers to the risk that problems in a single asset class will create problems throughout the financial system, causing significant harm to other asset classes, financial market participants and the broader economy. Competition between lenders is likely to grow just as private credit faces its first real test in a sharply higher interest rate environment.

The cost of debt has jumped, hurting operating performance across industries, especially weaker companies. At the same time, purchase price negotiations for new LBOs have gotten more complicated as higher rates, inflation and an economic slowdown have pressured sellers to modify their price expectations. Private equity firms have significant dry powder on hand. That means sponsors will need to keep investing to satisfy their commitments to limited partners. Direct lending funds (the largest segment of private debt funds) also remain flush with dry powder, with a current balance of close to $214 billion. Despite the slowing rate of growth in dry powder balances, direct lenders are still putting capital to work. As Exhibit 2 illustrates, dry powder across private debt funds globally – of which North American private debt funds hold a majority – continues to ramp higher.

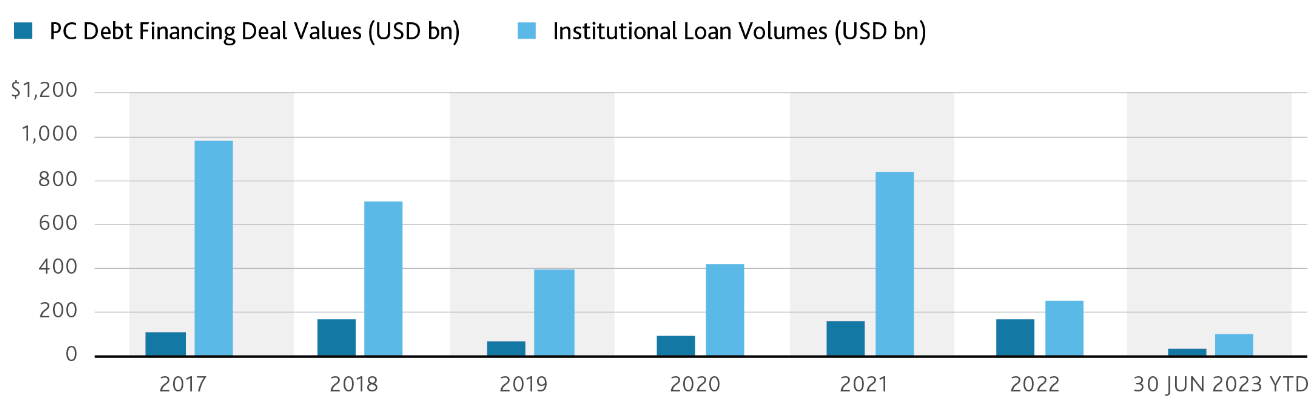
Exhibit 2
Private credit has a growing store of capital to spend
The US accounts for more than 50% of global dry powder



Source: Prequin, Moody's Investors Service

As deals return, the syndicated banking participants will play to their competitive strengths – offering cheaper debt and laxer contractual protections. BSLs are typically deals syndicated via an agent sponsor to a group of commercial banks and dedicated investors – mostly collateralized loan obligations (CLOs), which are securities backed by loans. CLOs have been gaining an increasing share of the BSL market, even if they are experiencing inroads from private credit. In recent years, the BSL's share of the leveraged loan business has been steadily falling, as Exhibit 3 shows. This deep liquidity base allows underwriters to scale costs and offer cheaper pricing than that of direct lenders, for which business is concentrated in fewer, private hands and therefore less liquid.

Exhibit 3
LBO sponsors are shifting activity to private credit and increasingly to larger transactions



Source: Prequin

Pullback of BSL investors has reduced banks' share of leveraged lending

In recent years private lenders have grown their share of the leveraged loan business, while the banking world's traditional hold on that business has weakened. This started with regulatory guidance in 2013 that encouraged banks to lower leveraged deal multiples. However, the impact of that guidance was fairly muted because of limitations on regulators' ability to enforce it. More significantly, since 2022, concerns around rising interest rates along with growing macroeconomic and geopolitical uncertainty have led to a substantial drop in demand for riskier BSL loans (particularly those rated B3 or worse) from non-bank investors, including CLOs. As a result, global investment banks, which rely heavily on such investors in their syndication of term BSL loans, became far more reluctant to commit to new leveraged loans, opening the door for private credit lenders to step in. Private credit firms – non-bank lenders that provide leveraged loans to typically small and medium sized companies – have since taken an increasingly large share of leveraged loan volume.

But the true challenge for banks is not private lenders' willingness to offer loans that other institutional investors are unwilling to underwrite, but rather the risk of private lenders disintermediating banks' role as underwriters and placement agents, which would rob banks of a significant source of fee revenue. Even so, banks will continue to retain a strong competitive advantage through their broad distribution networks as well as their unique ability to provide revolving credit facilities. These strengths will limit disintermediation by private credit lenders.

Stronger credits will prefer the syndicated market

Historically, smaller middle market borrowers were the purview of the direct lenders. But with substantial capital now raised by direct lenders with the view that "bigger is better," much larger transactions are now also executed privately. BSLs and private credit will see their competitive divide narrow at least in terms of deal size, as direct lenders such as business development companies (BDCs)[1] take on larger deals, often as a club. For example, many BDC investment portfolios generally stagnated following the onset of quantitative tightening (QT) and the contraction in LBO deal flow. BDCs have been slowly building investment capacity by moderately reducing debt-to-equity leverage from peaks reached in 2022. And while privately originated loans are inherently illiquid, a very small number of BDCs have also sold loans to free up capital for new investments. Although capital raising has been sporadic, the doors are opening and could swing wider as inflation, interest rate and economic performance expectations come into sharper focus.

More immediately, credit quality is shaping up to be a deeper divide than deal size in the next LBO cycle. Stronger credits will access the syndicated loan market, which provides cheaper pricing and more flexible documentation than private credit. In the public markets, most balance sheets are now being built to achieve a B2 or higher among sponsors in the syndicated loan market. We have observed more conservatively capitalized transactions accessing the public debt markets, especially in the context of higher for longer rates. Leverage levels of 7X debt-to-EBITDA and above that were common before QT are unlikely to be sustainable in the current environment of higher rates and slower growth. A greater proportion of common equity is also showing up in deal negotiations. However, borrowers will once again seize the upper hand in deal negotiations as competition heats up – reversing the conservatism that emerged as risk aversion grew after the Federal Reserve started tightening monetary policy in March 2022. Despite higher for longer rates, competition between the BSL market and the BDC market, as well as among lenders in each market, will heighten with increasingly borrower-friendly terms, a cycle we have seen in the past.

In the BDC market, a rejuvenated BSL market will competitively drive down lending spreads, increase transaction leverage and loosen loan covenants, especially for upper-middle-market transactions that can be executed in either the BSL or private credit markets. In 2024, BDCs will likely revert to a more typical pattern, accepting higher risk lending opportunities compared with the BSL market, though at generally higher spreads and with generally stronger covenants. This could increase operating performance risks for BDCs, especially because warning signs in the economy are growing.

Private credit is increasingly concentrated as managers race for capital

While the explosive growth of the private credit market brought a burst of new competitors into the market, the share of private financing to LBOs remains concentrated in a smaller group of larger-scale managers. The largest private credit managers, such as Apollo, Blackstone, KKR and Ares, continue to dominate new fundraising and build scale (measured by assets under management). This concentration has resulted from private equity sponsors' preference for working with fewer, larger-scale lenders who are able to consistently participate in the private equity sponsors' deal flow. These bigger lenders are also able to scale check sizes to match increased LBO deal sizes. In addition, a small number of other managers are growing rapidly and will come to have greater influence, including Carlyle, Brookfield and HPS Investment.

Asset managers are also buying up or affiliating with insurance companies to drive deeper diversification into long-term recurring revenue streams. In this way, financial sponsors obtain direct access to long-term capital that they can deploy through their lending arms. US life insurance companies, although still largely investment grade fixed-income investors, have been compelled to enter into some deals because of their need to invest premiums in long-term assets with reliable, above-average long-term yields. Private equity sponsors, meanwhile, need debt capital to fund LBOs.

All of this is contributing to the development of an ever-expanding, interrelated lending and investing loop. In this loop, alternative asset managers become investors in private credit, which supports private equity deals. Private equity sponsors, which used to go to banks, are increasingly partnering with private credit entities or starting their own private credit arms to source capital, improve fee income and build capital for investing. The more long-term capital asset managers can shore up, the less frequently they have to go back to the markets to raise funding for their investments.

New SEC Private Fund Adviser rules point to more transparency in future

The US Securities and Exchange Commission (SEC) recently took an important step toward bringing more transparency to the activities of private fund advisers through the adoption of Private Fund Adviser rules. The new rules, aimed at providing investors in private funds better protections, go into effect in November 2023.[2] Private fund advisers registered with the SEC will now be required to provide investors detailed disclosures on fund fees, expenses and performance on a quarterly basis and independent audits of funds' financial statements on an annual basis. The new rules also serve to limit a private fund adviser's ability to continue to provide certain investors preferential treatment through side letter agreements and charging certain adviser-related fees back to the fund without investor consent.

The new rules provide the SEC with more regulatory oversight of the private fund market, which should bring more transparency to the private markets over time. However, the private credit market will still remain opaque following these latest rules because the distribution of increased disclosures will be limited to private fund investors. For alternative asset managers, the rules' new reporting and compliance requirements will drive up the cost of doing business, while increased fee disclosures will shine a brighter light on the fees they charge. Previously, greater fee disclosure has led to fee compression and lower revenue. Small to medium-sized asset managers will experience the biggest impact from the new rule requirements, potentially leading to further industry consolidation. While significant, these provisions do not match the prudential requirements applicable to large banks.

Competitive escalations will likely raise systemic risk

New sources of risk are on the rise as major lenders jockey for greater capital clout and returns. Not long ago, institutional investors were the primary source of capital behind the alternative asset management industry's growth. But with flows from institutional investors slowing, alternative asset managers are looking to high-net-worth investors to be the driver of the industry's next leg of growth. Alternative asset managers are attracted to the US individual investor market's $125-$150 trillion of investable assets and small allocations to private market asset classes.[3] To capitalize on this opportunity, alternative asset managers are moving away from traditional closed-end fund structures and creating new structures (i.e., evergreen funds) more suited to individual investors' needs. In contrast with the finite life structures of traditional closed-end private funds, these new structures allow investors to withdraw funds prior to maturity, subject to certain limits. Redemptions are typically capped at a percentage (i.e., 5%) of an investor's capital in the fund per quarter, with redemptions generally permitted on a monthly or quarterly basis. The liquidity promises of these new fund structures, while serving the needs of individual investors, introduce liquidity risk into the private fund market where it did not exist before, since the illiquidity risk of private funds' underlying assets has historically been offset by investors' inability to redeem from the fund. This risk surfaced last year when Blackstone's nearly $70 billion high-net-worth real estate fund, BREIT, was hit with elevated outflows as investors became jittery over the outlook for commercial real estate market and chose to limit investor withdrawals. Large asset managers, including Blackstone, have taken note, maintaining larger capital and liquidity buffers for redemption risk in perpetual non-traded BDCs under their management, which offer to redeem shares of up to 5% of net asset value per quarter. Private equity portfolio companies and targets are intentionally highly leveraged to generate returns, leaving the operating environment more vulnerable to any adverse dynamics in the overall economy and leaving multiple stakeholders at risk, including equity and debt investors, insurance policy holders, portfolio company employees, pension funds and financial institutions. Concentration risk, conflicts of interest and lack of fiduciary oversight collectively point to growing risks in the broader marketplace. Exhibit 4 shows these and other contributors to private credit risk, as well as some mitigants. In particular, the rapid growth of private equity has concentrated a larger segment of economic activity into the hands of a fairly small number of large, opaque asset managers whose business strategy also contributes to increasing leverage for middle market businesses. This both reduces the financial strength of the middle market segment and leaves the economy more exposed to the large asset managers' governance and risk management practices.

Exhibit 4
There are six major areas of risk in private credit lending

Deterioration in fundamental credit

Description	Mitigants
» Higher leverage system-wide » Capital allocation hampered » PE's aggressive financial policies	» Fewer cov-lite loans » Financial maintenance covenants more typical » Problem loan work-out capabilities

Higher concentration risk

Description	Mitigants
» Small number of asset managers (AMs) » Exposure to governance and risk management of AMs	» AMs' market access benefits portfolio company finances » PE and PC investments held through multiple funds

Reduced asset liquidity

Description	Mitigants
» Investments are (by nature) less liquid than institutional loans » Limited ability to redistribute risk	» Not reliant on trading; hold loans to maturity » PE sponsor liquidity sometimes available

Conflicts of interest

Description	Mitigants
» Potential for PE and PC portfolio overlaps » Not clear how PE and PC investor interests are prioritized	» AM investment policies typically restrict cross-investments » Many funds have independent board representation

Lower fiduciary oversight

Description	Mitigants
» Private lending is less regulated than banking	» BDCs subject to asset coverage minimum » Bank credit agreement covenants and compliance requirements

Reduced transparency

Description	Mitigants
» Incomplete or incomparable portfolio company performance data	» External valuation of portfolios (BDCs , etc.)

Source: Moody's

Another emerging risk is maturity transformation, often a key transmission mechanism for systemic contagion because it can lead to fire sales that then spread to other asset classes. If private credit products with redemption options take an increasing share of industry assets under management, maturity transformation risk will grow and perhaps supersede concentration risk. As asset managers continue to grow their private credit portfolios, their investment, risk management and funding decisions will reverberate more strongly through the financial system and the economy. But it will be difficult to see where risk bubbles may be building, especially since these asset managers are increasingly lending to and borrowing through buying and selling. If one of these large managers were hit with a serious liquidity problem, it would likely spark far more severe credit repercussions in the broader economy.

Endnotes

1 Publicly traded BDCs are registered with the SEC as investment companies under the Investment Company Act of 1940 and are subject to the SEC's oversight and examination authority

2 Compliance with the rules will be required on a staggered basis from the date of publication in the Federal Register (ranging from 60 days, for some requirements, to 18 months).

3 This figure was derived from IOSCO's recent report on Private Finance, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD745.pdf, page 36.

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