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Understanding Private Debt/Private Credit

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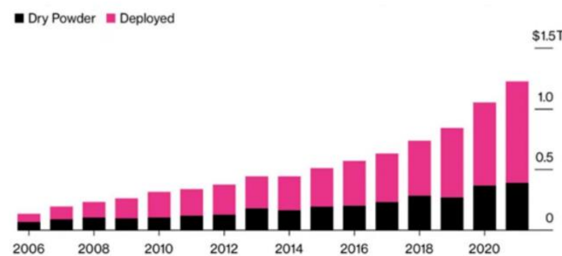
Private Debt has served as an alternative source of capital for market participants for several decades, offering a valuable alternative to traditional bank lending. The Private Debt market experienced exponential growth following the 2008/2009 Global Financial Crisis. Preqin estimated that the global Private Debt market was valued at approximately US$ 43 billion in 2000. Today, it has grown exponentially to about US$1.5 trillion (September 2022), and it is projected to reach US$2.2 trillion by 2027.[1] For investors, Private Debt is an alternative asset class which falls outside the 'traditional' asset class categories.

Figure 1: Global Private Credit Asset Class, and Available Dry Powder



Source: Preqin
Note: 2021 is to September. All other years are to December

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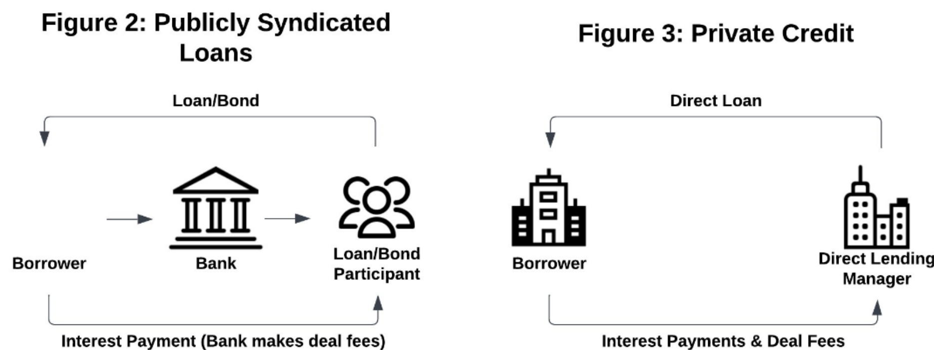
What is Private Debt/Private Credit?

The term 'Private Debt' typically refers to debt investments that are not financed by banks (i.e., traditional lenders), traded or issued on the public market. It is important to note that the term 'private' refers to the investment instrument itself rather than the borrowing entity. In other words, both public companies and private companies can borrow via Private Debt. Private Debt falls into a broader category termed 'alternative debt' or 'alternative credit', which encompasses debt or credit provided by non-bank lenders. It is often used interchangeably with terms like Private Credit, Private Debt, and Direct Lending.

In the Private Debt market, alternative lenders play a role similar to that of banks, providing debt capital to entities. Every business requires capital to expand, operate, or pursue a new market opportunity. Traditionally, companies obtain debt financing through banks, who typically sell (i.e., syndicate) these loans or bonds to a large group of lenders who will own or trade these securities while the bank earns origination fees (*figure 2*).

In contrast to conventional lenders like banks, non-bank lenders (i.e., private credit) offer companies a more direct and efficient way to access capital. Private Debt managers raise capital directly from investors and subsequently lend this capital directly to the investee entity (*figure 3*). This direct approach, without a bank intermediary, often results in greater efficiency, confidentiality, and flexibility in structuring loans and ensuring security for investors.



The Growth of the Private Debt Market?

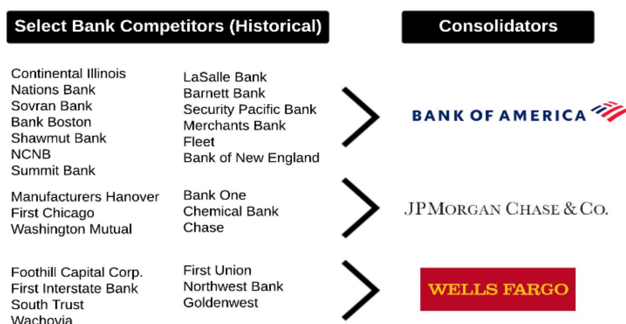
Over the years, the global Private Debt market has evolved into a much deeper, sophisticated, and varied market. It caters to businesses of various sizes and creditworthiness, coupled with a diverse investor base, including institutional investors, high net-worth individuals, family offices, and occasionally retail investors. To understand the growth of the global Private Debt market, it is essential to examine the cause-effect relationships of the historical trends that preceded the current Private Debt market. The growth of the Private Debt market has evolved in two stages over the last few decades.

The First Stage - *Bank Consolidation*

The first stage, known as bank consolidation, was a significant catalyst for the growth of the Private Debt market space during the early 1990s. This consolidation had a significant impact on the supply of capital

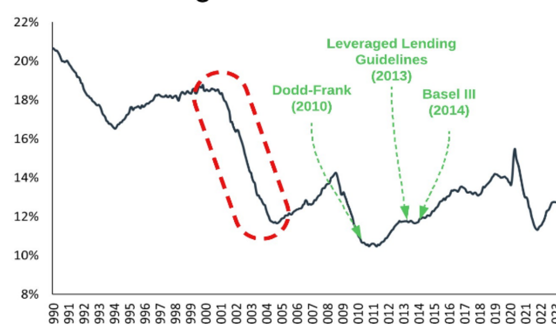
available to small and medium-sized companies (SMEs)[2]. For example, in the United States (US), bank mergers involving smaller regional banks merging with larger national banks (*figure 4*), ultimately led to a decrease in banks' commercial and industrial loans (C&I loans) as a percentage of bank holdings (*figure 5*). In other words, as smaller banks merged with larger ones, it often prioritised catering to larger clients, inadvertently reducing the availability of capital for smaller borrowers.

Figure 4: Bank Consolidation Over Last Decades



Source: Ares - For illustrative purposes only

Figure 5: Commercial & Industrial Loans as a Percentage of Bank Assets

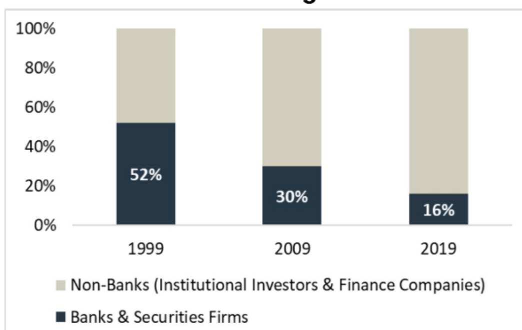


Source: Federal Reserve H8 data

The Second Stage – *Increased Regulation*

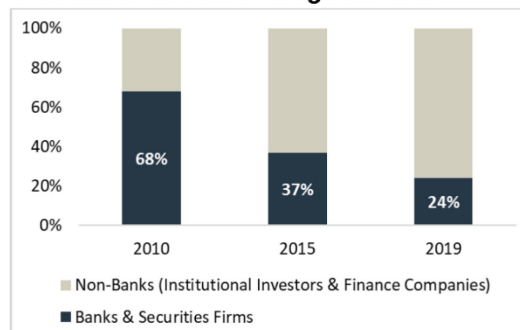
The next important event that catalysed the exponential growth of non-bank lending was increased regulation, particularly in the banking sector. This resulted in the implementation of key reforms like Dodd-Frank and Basel III, designed to mitigate risks in the international banking industry. Consequently, banks began narrowing their range of lending products, becoming more risk-averse, and thus reducing lending activity.[3] As a result, banks accelerated their transition to the 'underwrite and distribute' model for non-investment grade and illiquid debt investments. This approach involved banks underwriting loans that were higher risk under the new regulations and subsequently syndicating them to non-bank lenders. This strategic move allowed banks to offload the credit risk associated with these loans from their balance sheets while benefiting from the growing role of the private non-bank sector by earning origination fees. An example of the increased participation of non-bank lenders is the change in holders of leveraged capital over time (a sector which traditional lending institutions once dominated - see figure 7 and figure 8).[4] Due to banks' reluctance (or inability) to hold leveraged credit, non-bank lenders have played (and continue to play) an increasingly important source of capital to small and medium-sized companies.

Figure 7: Market Share of Primary Investors for US Leveraged Loans



Source: S&P LCD Quarterly Q4-19 Leveraged Lending Review

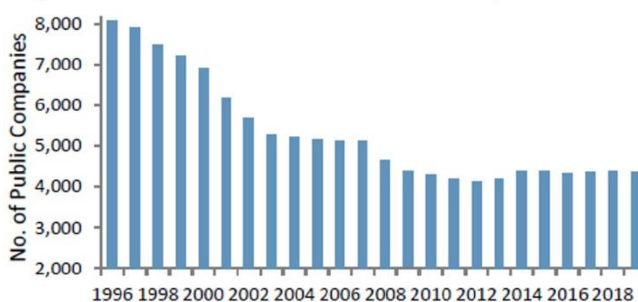
Figure 8: Market Share of Primary Investors for EU Leveraged Loans



Source: S&P LCD European Quarterly Q4-19 Leveraged Lending Review

Another important contributor to the expansion of the Private Debt market was the secular changes in public and private markets. These changes were marked by a growing trend of small and medium-sized publicly traded companies transitioning to the private market. This transformation was primarily attributable to the evolving regulatory environment within public markets, which escalated listing costs and regulatory costs, creating high barriers to entry for SMEs seeking to access capital markets.[2] The heightened regulatory requirements ultimately halved the number of listed companies in the US (*figure 9*).[5]

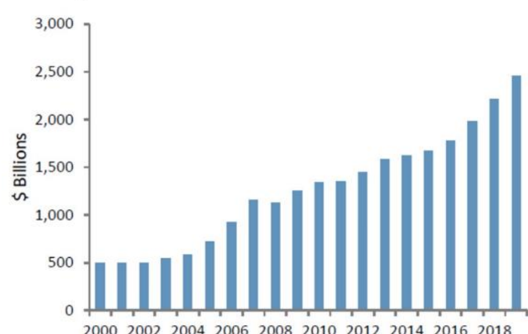
Figure 9: Number of US Public Companies



Source: The World Bank: Would Federation of Exchanges Database and FactSet, December 2019

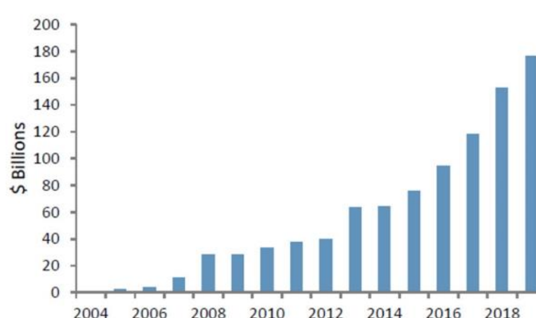
Consequently, SMEs, which constitute a crucial part of many economies (e.g., In the US, SMEs account for approximately one-third of US GDP [2]), needed an alternative solution to access capital. In response to the decline in public funding sources to support SMEs, private market capital (comprising private equity and private debt) filled the void. This shift ultimately led to the growth and increased sophistication of private markets. The demand for and supply of private capital, comprising private equity and Private Debt, is evident in the substantial year-on-year growth in AUM in both these markets (*figures 10 & 11*).

Figure 10: US Private Equity Assets Under Management



Source: Preqin, June 2019

Figure 11: US Direct Lending Assets Under Management



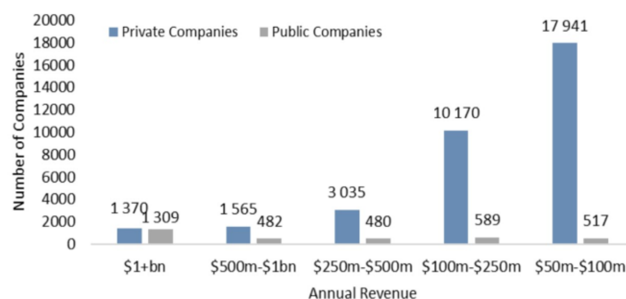
Source: Preqin, June 2019

Who are the borrowers?

A 2018 report from the World Economic Forum offers valuable insights regarding the size (by revenue) of the companies accessing capital through private markets (*figure 12*). Figure 12 shows the number of private companies versus publicly traded ones by annual revenue bracket. This analysis highlights two noteworthy findings: (1) the annual revenue generated by private companies is material (e.g., the number of US privately held companies generating revenue over $1 billion per annum was 1 370), and (2) there are c. 34 000 US private companies generating revenue between R50 million and +$1 billion who would approach private markets for their capital requirements. In other words, companies that access capital via private

markets include well-established businesses. These companies often recognise the value in partnering with sophisticated private equity investors with a long-term investment horizon, who can often provide advisory, strategic, managerial, and operational assistance to support the growth prospects of these entities.

Figure 12: US Public & Private Companies by Revenue



Source: World Economic Forum, April 2018

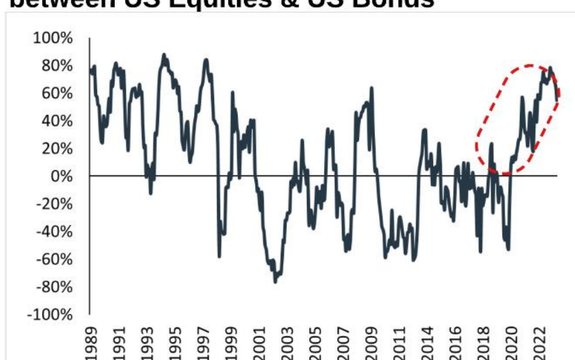
The Role of Private Debt in Investment Portfolios

Private Debt has shown to be an attractive component of an investment portfolio, where it is a powerful complement to traditional fixed-income strategies (i.e., investment strategies which invest in publicly traded fixed-income securities). To appreciate Private Debt's role in an investment portfolio, it is important to recap the fundamentals of portfolio construction and understand why the 60/40 portfolio has been the go-to portfolio allocation for long-term investors. At its core, portfolio construction is allocating capital to a combination of assets that produces the highest level of return at a given level of risk.

To achieve this objective, it's important to consider the correlation between investment assets. A lower correlation between assets held in a portfolio tends to lead to higher risk-adjusted returns. As seen in Figure 13, equities and bonds (i.e., publicly traded debt) have exhibited low to negative correlation for decades. This historically low correlation has been advantageous for diversifying an investor's portfolio. This means that holding equities and bonds provides diversification benefits to an investor's portfolio.

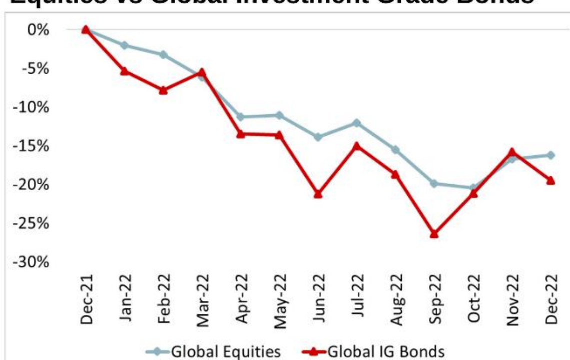
Today, equities and bonds have become positively correlated as they are exposed to similar inflationary risk factors (i.e., interest rate risk). In other words, the diversification benefits of holding equities and bonds have significantly diminished in the current market environment. Consequently, both asset classes (the core assets of the 60/40 portfolio) experienced material drawdowns in 2022 (*figure 14*).[7]

Figure 13: 1-Year Trailing Correlation between US Equities & US Bonds



Source: Bloomberg
Note: US Equities is represented by the S&P500 Index. US Bonds is represented by the Bloomberg US Aggregate Bond Index

Figure 14: Cumulative Monthly Return of Global Equities vs Global Investment Grade Bonds



Source: Bloomberg
Note: Global Equities is represented by the MSCI World Index. Global IG Bonds is represented by the Bloomberg Global Aggregate Bond Index

On the other hand, Private Debt offers investors an alternative asset class that allows them to get exposure to the fundamental benefits of holding fixed-income assets, which are (1) contractual and predictable cash flows and (2) higher levels of security relative to equity investments. Due to Private Debt not being traded in secondary markets, investors are not subjected to the impact of market price moves in response to changes in interest rates. Consequently, this asset class boasts lower levels of volatility when compared to publicly traded debt and lower levels of correlation to publicly traded markets. Although the lower volatility associated with Private Debt comes at the expense of liquidity, investors are compensated by earning a liquidity premium. Aided by the liquidity premium coupled with the overall yield premium borrowers pay for the efficiency, confidentiality and flexibility of private capital markets, private credit has historically outperformed traditional credit segments, such as high-yield bonds, leveraged loans, and investment-grade bonds (*figure 16*).

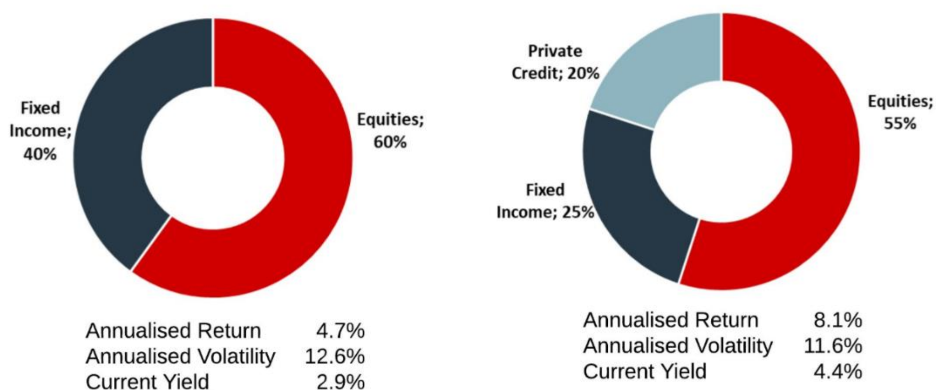
Figure 16: Private Credit vs Traditional Fixed Income

2016	2017	2018	2019	2020	2021	2022	Annualised Return (2016-2022)
17.1% US High Yield	10.4% Global High Yield	8.1% Private Credit	14.3% US High Yield	9.2% Global Investment Grade Bonds	12.8% Private Credit	6.3% Private Credit	8.8% Private Credit
14.3% Global High Yield	8.6% Private Credit	0.4% US Leveraged Loans	12.6% Global High Yield	7.5% US Investment Grade Bonds	5.3% US High Yield	-0.8% US Leveraged Loans	5.0% US High Yield
11.2% Private Credit	7.5% US High Yield	0.0% US Investment Grade Bonds	9.0% Private Credit	7.1% US High Yield	5.2% US Leveraged Loans	-11.2% US High Yield	4.4% US Leveraged Loans
10.2% US Leveraged Loans	7.4% Global Investment Grade Bonds	-1.2% Global Investment Grade Bonds	8.7% US Investment Grade Bonds	7.0% Global High Yield	1.0% Global High Yield	-12.7% Global High Yield	3.7% Global High Yield
2.6% US Investment Grade Bonds	4.1% US Leveraged Loans	-2.1% US High Yield	8.6% US Leveraged Loans	5.5% Private Credit	-1.5% US Investment Grade Bonds	-13.0% US Investment Grade Bonds	0.9% US Investment Grade Bonds
2.1% Global Investment Grade Bonds	3.5% US Investment Grade Bonds	-4.1% Global High Yield	6.8% Global Investment Grade Bonds	3.1% US Leveraged Loans	-4.7% Global Investment Grade Bonds	-16.2% Global Investment Grade Bonds	0.1% Global Investment Grade Bonds

Source: Bloomberg, Cliffwater
Note: Private Credit is represented by the Cliffwater Direct Lending Index

Considering the attractive risk-adjusted returns that Private Debt investments can yield, coupled with low levels of correlation to traditional asset classes, including Private Debt into a traditional portfolio has demonstrated its capacity to enhance returns, reduce volatility and improve the income potential of the traditional 60/40 portfolio (*figure 17*).[8]

Figure 17: Reshaping Risks of Traditional Portfolios with Private Credit (2008-2023)



Source: Blackstone - Essentials of Private Credit

Conclusion

Private Debt plays a crucial role in capital markets, benefitting investors and borrowers. The growth of this asset class has filled the void created by profound changes in the banking sector and public markets, which has resulted in traditional sources of capital focusing on servicing larger corporations at the expense of SMEs. This has created an environment that has expedited this asset class's growth and sophistication.

Furthermore, Private Debt offers investors an alternative investment vehicle to gain exposure to fixed-income assets, which are not subject to the volatile price movements associated with interest rate expectations. Although investors must sacrifice some liquidity, they are duly compensated through the liquidity premium earned on these assets.

The level of security provided to investors depends on the instrument invested in, which ranges from junior unsecured debt to senior secured debt.

With the flexible loan structures available in the private capital market, investors can invest in highly secured loans at attractive yields, enhancing the risk-adjusted returns of their investment portfolios.

What makes Private Debt attractive for portfolio construction is that investors can reduce the level of the underlying risk in their portfolio without necessarily sacrificing returns. However, to achieve this, investing with the right manager is key!

References:

1. *Source: Preqin Global Report Private Debt, 2023.*
2. *Source: Ares Market Insights Report, "The Rise of Private Markets – Secular Trends in Non-Bank Lending and Their Economic Implications", 2020.*
3. *Source: Goldman Sachs Alternatives Report, "Understanding Private Credit", October 30, 2022.*
4. *Source: S&P LCD, December 31, 2019.*
5. *Source: The World Bank: World Federation of Exchanges Database.*
6. *Source: Ritter, Jay R., Cordell Professor of Finance, University of Florida, "Initial Public Offerings: Updated Statistics," September 20, 2023.*
7. *Source: Bloomberg and Skybound Capital.*
8. *Source: Blackstone, "Essentials of Private Credit", 2022.*

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