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Inside the Expanding Universe of Private Credit

Four key trends that signal a bright future

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Introduction

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Private credit, also known as direct lending, has emerged in recent years as a standout success story within the alternative asset world. With its proven ability to deliver resilient performance in direct lending strategies, the asset class is poised to further deepen its influence on non-bank financing to global businesses.

Closer partnerships with banks and insurance groups are presenting opportunities for private credit groups to test new waters within asset-backed finance, synthetic risk transfer and large-cap hybrid lending (junior capital) deals, as the industry matures beyond its traditional confines of direct lending activities.

Corporations of all sizes, as well as an increasing number of private equity sponsors, are turning to private credit managers because of the bilateral relationship benefits. Flexibility and tailored finance solutions are leading to a wider source of uncorrelated returns across private credit, making it particularly attractive to insurance groups. This is arguably a pivotal moment in private credit's evolution.

To see where the industry is headed, look no further than BlackRock's announcement in December 2024 that it had acquired private credit firm HPS Investment Partners for approximately USD 12 billion in an all-stock deal, as the world's largest asset manager seeks to expand in the booming market.

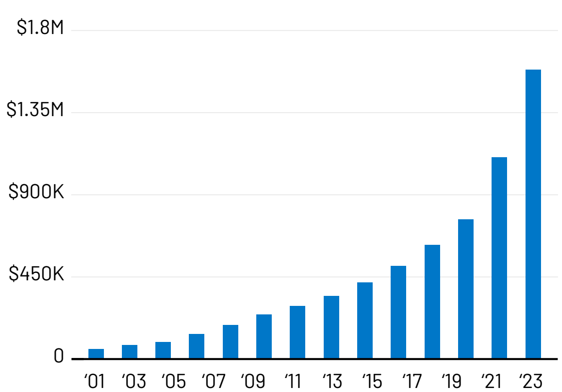
This high-profile acquisition follows Clearlake's acquisition of MV Credit in September 2024, Blue Owl's USD 450 million purchase of Atalaya in July 2024 and Brookfield's USD 1.5 billion investment to acquire a majority stake in Castlelake earlier in 2024. In 2023, TPG acquired Angelo Gordon, and in 2022, Nuveen purchased the USD one billion European private credit company Arcmont.

In this report, we highlight four key trends that illustrate why the future continues to look bright for this strategically important alternative asset class.

A Burgeoning Market

Private credit has witnessed an unprecedented rise this century. Total assets under management (AUM) have increased year on year since 2005 (see Figure 1 below). Having crossed USD one trillion in 2021, by the start of 2024 the market had accelerated sharply to USD 1.5 trillion. By 2028, that figure is estimated to reach USD 2.8 trillion.

Figure 1: Growth of private debt 2000 to 2024 (USD millions)



Source: Deutsche Bank AG

Much of that growth can be attributed to private credit's appeal to small and mid-sized companies who rely on alternative non-bank financing solutions to support their growth and expansion plans on short- and long-term bases. These firms often lack the size or credit quality to access traditional debt markets.

Given that many of these direct lending deals are underwritten to sponsor-backed companies, the synergies between private credit and private equity have continued to gain relevance, enabling private debt to play a key role in the mid-market buyout space. Companies like the fact that senior secured loans typically have a floating interest rate — although this has favored lenders more than borrowers in a higher rate environment — as well as the speed, pricing certainty and bespoke nature of private credit.

Increasingly, private credit shops are moving beyond the mid-market to focus higher up the food chain, with some of the industry's biggest names raising mega funds to support large-cap buyouts. This is evidenced by the fact that 86 percent of U.S. leveraged buyout loans were sourced from private credit, as of September 2023.

At the end of July 2024, Ares closed Senior Direct Lending III with USD 34 billion; the biggest fund ever launched (thus far) and nearly twice the size of its previous fund. Other notable funds include Blackstone's hybrid Senior Direct Lending Fund, which closed with USD 22 billion and West Street Loan Partners V, managed by Goldman Sachs Asset Management (GSAM), which closed with more than USD 20 billion in May 2024.

"The outlook for investors continues to be favorable in private credit," comments Amitayush Bahri, co-head, European direct lending at, Goldman Sachs Asset Management. "The key is to work with managers who have scale, tenured investing teams and a differentiated platform. Depending on what estimate you look at, the private credit market has doubled in the last five years and is forecast to double from here on in."

He explains that the underlying driver of that growth is twofold. On the one hand, borrowers like the fact that it's a more customized, more efficient way to borrow. On the other hand, investors like private credit because it can provide an attractive risk-adjusted return.

"We are at an interesting inflection point where private credit is an attractive proposition for both investors and borrowers. Following the wake of the Global Financial Crisis, it became less attractive for banks to hold sub-investment grade credit on their balance sheets. As the liability structure of private credit managers is longer dated and more stable, and they can essentially pre-syndicate by fundraising, the model makes a lot of sense for the alternative investment industry," adds Bahri.

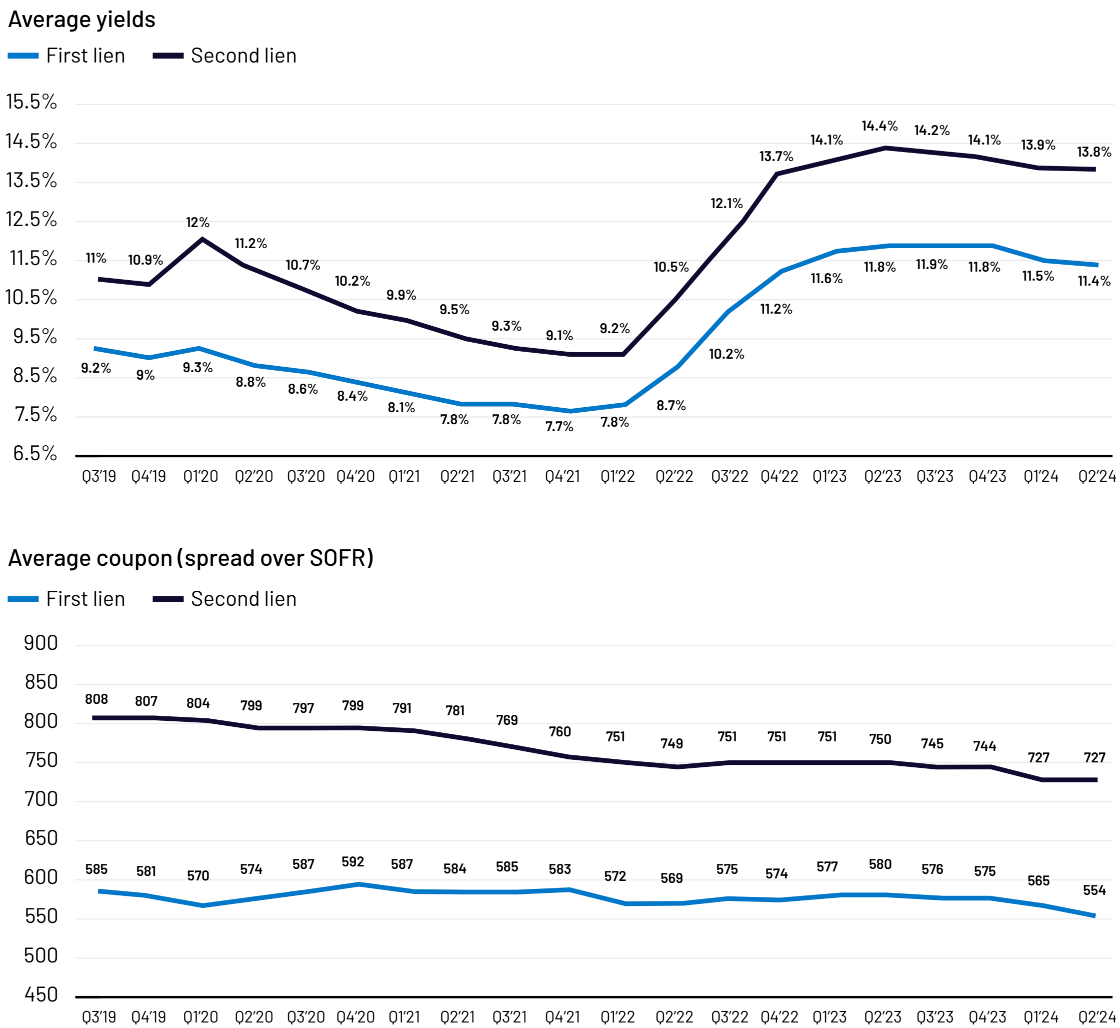
Direct lending performance review

"This is a very exciting market for private credit. It keeps expanding. It's not just direct lending. Private credit includes all different types of asset-backed lending, specialty lending, NAV lending," says Cindy Ma, global head of portfolio valuation and fund advisory services at Houlihan Lokey, a leading global investment bank.

She notes that the competitive landscape of direct lending remains at "record levels." Since both competition and dry powder remain at elevated levels, market spreads and yields for private credit have generally not witnessed the same level of volatility as observed in the public markets.

Pricing dynamics are such that average coupon spreads over the Secured Overnight Financing Rate (SOFR) for first-lien loans are at their lowest in five years (525 basis points), as the U.S. Federal Reserve begins to cut rates. In addition, average yields are starting to flatten. After peaking at 11.9 percent in Q3 2023, they have since fallen to 11.4 percent in Q2 2024 (see Figure 2). For context, before the U.S. Federal Reserve began aggressively hiking rates in 2022, average yields were in the seven to eight percent range.

Figure 2: Average yield and coupon for first and second lien loans, 2019 to 2024



Source: *Houlihan Lokey Direct Lending Update, Fall 2024*

With private credit able to generate double-digit returns, it is unsurprising that so many investors have chosen to increase their exposure to the asset class.

Against this backdrop, several interesting trends are emerging that indicate how private credit might become even more dominant over the coming years, in response to broader financial trends and specific sector needs.

Jason Colodne, co-founder and managing partner at Colbeck Capital Management, a leading U.S. middle-market private credit manager explains, "Many private equity-backed companies and middle-market firms increasingly turn to private credit for refinancing and managing loan maturities, providing for steady activity, particularly in high-demand sectors such as Healthcare, Business Services and Technology. Sectors like Manufacturing and Retail have shown softer demand due to their sensitivity to economic cycles and significant capital expenditure requirements."

Direct Lending Deal Diversity

Ares, Eurazeo and Goldman Sachs were the largest European direct lenders in the first half of 2024, according to Reorg's latest rankings data. Ares held onto the top spot, completing 36 deals while Eurazeo completed 26 deals. Goldman Sachs Private Credit completed 25 deals over the period, holding a 4.9 percent share of the market.

The direct lending space has continually evolved over the years, as more and more sponsored and non-sponsored companies in the middle market and lower-middle market turn to alternative credit providers to support capital expenditure and expansion activities.

Prior to the rate hikes two years ago, equity sponsors focused on growth at any cost; especially in the technology sector. As interest rates shot up, that focus pivoted more toward companies with reliable cash flows. Ashwin Krishnan, co-head of North America private credit at Morgan Stanley Investment Management, recently observed that one potential trend will be to fill the gap left over by providing growth capital "in a way that allows high-quality companies to re-invest earnings at attractive incremental returns with minimal equity dilution while generating attractive returns for the investor."

At Colbeck Capital Management, the team sees compelling opportunities in sectors with stable, recession-resistant cash flows. According to Colodne, Healthcare is a top sector, largely due to consistent demand and recurring revenue models. He says that key focus areas include Healthcare Services, Senior Living and Pharmaceuticals "where performance remains strong despite broader economic challenges."

"Technology, notably in Enterprise Software and IT Services, also attracts significant interest. Companies in these segments frequently provide products with high client retention, appealing to private lenders seeking stability alongside growth potential."

To some extent, there has been a bifurcation of deal activity, with mega funds underwriting huge loans at one

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Nicolas Nedelec, Eurazeo

end of the market and specialist funds underwriting loans to companies at the lower end of the middle market. A huge number of participants populate the middle market.

Nicolas Nedelec is partner, private debt at Eurazeo, one of Europe's leading investment groups, where private credit currently represents about 25 percent of Eurazeo's EUR 35.5 billion in total AUM. The team focuses on smaller, bespoke deals that are able to return a premium to investors relative to large-cap funds. "Our 15-year track record shows that default rates and loss rates are better at the lower end of the market," says Nedelec.

He notes that some European mid-market managers have tried to scale over the past few years, but the market opportunity has not fully materialized: "You end up having 20 to 30 firms that are all chasing the same deals and competing on price, on deal terms and on leverage." In Europe, deal flow at the lower end of the market remains robust with Nedelec confirming that 18 deals were closed in Q3 alone. "We are confident that 2024 will be ahead of 2023. When you've been around for many years and you have set up a true pan-European network, origination is less challenging."

Geographic Diversity

One trend likely to gain momentum in Europe is deeper penetration in markets beyond the U.K. and France. For example, in Germany and Southern Europe, direct lending accounts for around 50 to 70 percent of the market. The Netherlands is trailing Germany by one or two years while in Scandinavia direct lending is still only 20 to 30 percent of the market. However, Nedelec notes, "it's growing very quickly." If European banks retreat further from the middle-market, for regulatory cost of capital reasons, this could open up a far bigger opportunity for mid-market direct lenders.

Large-cap deals turn hybrid

A recent report published by McKinsey & Company points out that leading managers are likely to drive scale across "more and larger vehicles while also developing more sophisticated internal and external syndication capabilities to increase relevance to larger borrowers." On the technology side, this could also lead to further streamlining and consolidation of middle- and back-office loan operation capabilities to enhance flexibility, profitability and speed to market.

> "I think we're going to see an uptick in deal flow and investment opportunities. Rates are coming down. The market is looking more positive. That makes for a very good backdrop for deal volume."

Amitayush Bahri, Goldman Sachs Asset Management

For those lending to large-cap global businesses, speed to market is vital in completing deals when billions of dollars are at stake. Some of the mega funds referred to earlier — such as Ares and Blackstone — are pushing direct lending activity further into the broadly syndicated loan space traditionally dominated by banks, such is the size of the loans being underwritten.

Sponsor M&A volumes are rebounding from a cyclical low. This is proving to be an exciting moment for investors, given that some of the largest leveraged buyouts (LBOs) in the last two years have been financed by private credit. "Given the need for scale in the large-cap market and the barrier to requirement associated with scale, we think this is a segment that we are well positioned to compete in," says Bahri. "I think we're going to see an uptick in deal flow and investment opportunities. Rates are coming down. The market is looking more positive. That makes for a very good backdrop for deal volume."

Through the first half of 2024, European M&A and buyout activity showed signs of recovery as lenders' appetite for larger deals increased, with buyouts (34.6 percent) exceeding bolt-on acquisitions (33.8 percent).

Recent rate cuts signal that central banks feel that inflation is back under control. This should unplug what has been a largely stagnant M&A market and lead to greater deal flow and LBO activity.

"We're seeing sequentially quarter over quarter, M&A volumes picking up. There has been a number of very large transactions announced," adds Bahri, noting that one big theme this year has been the hybrid deal:

"For example, in some of these jumbo LBO deals the senior part of the capital structure is a broadly syndicated loan while the junior capital is a privately placed tranche led by our mezzanine fund."

A couple of prominent deals this year have included, for example, Swedish private equity firm EQT, Neuberger Berman Private Markets and the Canada Pension Plan Investment Board who agreed to acquire Nord Anglia Education for USD 14.5 billion. Also, Sanofi has agreed to sell a controlling stake in its consumer health unit Opella to U.S. private equity group, CR&R for USD 16 billion.

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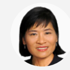

Cindy Ma, Houlihan Lokey

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Bahri also notes that take-private deals have been an important aspect of the large-cap deal landscape this year. These deals are great for private credit because of the need for certainty, confidentiality and a more structured or bespoke solution. This is something GSAM is very focused on. "We have a lot of experience financing take private deals. These deals require certainty, confidentiality and a one-stop-shop solution which plays to scaled private credit players like ours," he says.

Non-sponsored activity

Colbeck Capital Management seeks out non-sponsored companies in the U.S. middle-market to provide strategic lending. This space — which requires more due diligence work when underwriting loans — is rich in opportunities and offers distinct advantages, often providing more attractive risk-adjusted returns. Non-sponsored companies tend to be less leveraged, potentially reducing credit risk.

"Loans in this segment frequently contain more lender-friendly documentation with stronger protections and rights compared to the covenant-light transactions often seen in the sponsor-backed market, helping mitigate risks of liability management transactions," comments Colodne.

Also, loans to non-sponsored borrowers are generally priced wider due to market illiquidity. This enables lenders to lock in potentially higher yields than the more competitively priced PE-sponsored market. More firms are choosing to expand their strategies into the more nuanced, non-sponsored space to move away from the crowd. This is highlighted by the fact that 70 percent of the estimated USD 341 billion in U.S. dry powder is dedicated to sponsor-backed deals.

Wells Fargo and Centerbridge Partners launched a USD five billion vehicle last year to use 50 percent of the fund to back non-sponsored firms, while HPS Investment Partners have a multi-billion-dollar vehicle. Yet there are clear barriers to entry, most notably origination, timing and underwriting.

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Nicolas Nedelec, Eurazeo

Colodne observes sponsored deals are deemed to be attractive due to more predictable exit strategies, including refinancing, acquisition or sale. "However," he says, "sponsors are increasingly looking at both private credit and syndicated loans to secure favorable terms, which fuels competition, leading to spread compression and more borrower-friendly documentation."

Too much risk, too much uncertainty

In Europe, some managers hold the view that the non-sponsored space is not attractive, especially at the lower end of the middle-market, as there is "too much risk, too much uncertainty".

"We think non-sponsored deals make sense for junior (i.e., mezzanine debt), where you are compensated for taking risk, but certainly less so for senior debt," remarks one European manager. In their view, those who claim there is a huge opportunity in Europe for senior debt deals "are probably struggling to deploy capital to sponsor-backed businesses."

Most private credit firms prefer dealing with sponsors because there is usually a better level of due diligence, more standardized information, strong alignment of interests and governance best practices. The quality of the management team is also a vital consideration, to avoid the risk of backing a "one-man show."

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Synthetic Risk Transfer

In *The Barbell Tolls for Fixed Income Investing*, Oliver Wyman notes that 14 major banks have formed partnerships with private credit firms to distribute their loans over the last year.

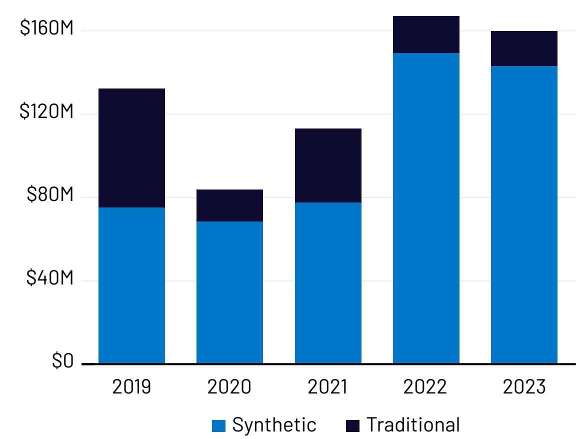
For example, Citigroup have partnered with LuminArx Capital to launch Cinergy, a private lending venture backed by over USD two billion from LuminArx Capital. Also, Société Générale have partnered with Brookfield Asset Management to create a private investment-grade debt fund targeting a total of EUR 10 billion.

As banks come under regulator pressure from Basel III/IV, they are increasingly offloading riskier parts of leveraged loans to private credit managers to reduce their capital requirements. This has led to the emergence of synthetic risk transfer (SRT).

Synthetic risk transfer is an effective financial mechanism for banks to move the risks associated with second lien and other junior debt to non-bank investors while retaining ownership of the assets. In this risk transfer arrangement, which often applies to the first-loss tranche of a loan portfolio — the bank agrees to pay the investor(s) for bearing the risk.

Speaking in *U.S. Leveraged Finance & CLO Weekly* on June 24, 2024, Deutsche Bank Research CLO strategists Conor O'Toole and Jamie Flannick observed, "SRTs have seen greater market adoption in Europe so far than in the U.S. In 2023, the deal volume of SRT transactions with performing loans was roughly EUR 155 billion, with synthetic transactions taking the bulk of the volume compared to cash transactions." (See Figure 3.)

Figure 3: SRT market size, Europe: transactions with performing loans (Euros)



Source: Deutsche Bank AG

> "Banks have a strong incentive to synthetically offload part of their loan book risk to non-bank entities. Those transactions remain nascent in the U.S., but regulation will certainly come into play any time soon and create a significant volume of SRT deals."

Nicolas Roth, Union Banque Privée

Nicolas Roth, head of private markets advisory at Union Banque Privée, says that under the Basel III/IV enhancements, SRT is one area where Europe's private credit marketplace is ahead of the U.S. He says that until a few years ago only a handful of players were active in this space.

"On the back of regulatory pressure, it is growing by an estimated 15 percent per year, and it trades in significant sizes," says Roth. "Given that private credit players have vast amounts of dry powder to deploy and given the bespoke nature of those trades, it is not surprising to see some of them becoming important in this field."

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This is an area for U.S. private credit firms to keep an eye on in 2025.

Asset-backed Finance: A Significant Growth Catalyst

Asset-backed finance is set to be a key catalyst for growth in the coming years, as private credit continues to mature and diversify, giving investors the ability to generate yield from pools of loans linked to anything from equipment leases to music royalties.

Leading investment firms such as Oaktree Capital are becoming increasingly bullish on what the future could hold as this less-well-known area of the credit market faces a potential funding void. In Oaktree's Performing Credit Quarterly 3Q2024, they state that "As traditional lenders face further headwinds, we believe the next chapter in the private credit story is the migration of asset-backed finance (ABF) toward alternative capital providers." As U.S. banks prepare for the Basel III endgame in 2025, the strictest capital requirements would fall upon the largest systemically important groups. Oaktree notes that unrated assets, which typify asset-backed lending, would incur a 100 percent risk weighting, no matter the underlying quality of the assets.

Enter private credit. Oaktree Capital's view is that mezzanine and junior capital financing, which represent the core segment of the ABF market, could be a key area for alternative lenders.

Oliver Wyman's white paper, *Private Credit's Next Act*, reveals that the total addressable market for ABF is approximately USD 5.5 trillion. Yet non-banks represent only around one-third. Dig deeper, and private credit is estimated to hold only three to five percent of these loans. By factoring in infrastructure loans and Commercial Real Estate, the potential market could be significant for private credit and outstrip an expected 15 percent annual growth rate over the next five years.

Investment-grade Securitization

At Houlihan Lokey, Ma expects more ABF-led securitization in 2025 and beyond, as private credit firms up their game to exploit emerging opportunities. Doing so, however, will require careful risk planning to get comfortable with the value of the underlying loans, especially given the diversity of assets.

"We are getting a lot of requests from big-name asset managers. As they put these structures together, they need a third-party valuation partner. You need to carefully value the loan portfolios and know the cash flows are going to flow through the capital structure to meet liabilities. This requires valuing each of the different tranches. We are very active in this space right now," she says.

Apollo co-president Scott Kleinman views investment-grade capital solutions as the "next frontier" for private credit as global conglomerates look for flexible capital to support capital expenditure and investment. Apollo estimates that high-grade corporations face USD 75 trillion of capital expenditure and investment needs over the next decade.

"While interest rates fluctuate and banks tighten capital requirements, high-quality companies are increasingly looking to private credit for bespoke solutions compared to traditional bond markets," notes Colodne.

The ability to hold investment-grade (IG)-quality assets on the balance sheets of insurance groups, as they too look for ways to diversify yield-generating revenues beyond traditional capital markets, is leading to increased partnerships among the big credit firms and insurers. Two years ago, Apollo acquired the retirement company Athene while in November 2023, KKR acquired insurer Global Atlantic.

Dan Tennant, head of alternatives at BNY's Global Client Management group, offered the following explanation: "The illiquidity premium — coupled with a PE firm's origination capabilities — can allow investors a pickup of as much as 250 basis points above an equivalent investment-grade risk."

Increased activity in the IG capital solutions arena has the potential to turn private credit into the most dominant alternative asset class. With insurers required to hold IG-rated paper, Ma postulates:

“One trend you might see is mini securitization within asset-backed finance as asset managers start to pool assets and securitize them to create different tranches, where insurers would invest in the highest rated tranche. This area of private credit is beginning to get more active as it expands into ABF. It could be a significant source of capital for private credit managers, provided they get the senior tranche properly valued and rated for insurance companies to hold on their balance sheets.”

More collaboration

At Union Banque Privée, Roth anticipates even further collaboration between banks and credit managers as IG capital solutions become more prevalent: “The emergence of non-bank lenders in that segment will enable issuers to access financing facilities that are a departure from traditional IG issuance, in the sense that they might offer longer duration and other features.

“If the certainty of execution at pre-defined cost can be transposed to the IG world, it is possible non-bank lenders could make a place for themselves.”

"Creditor-on-creditor violence, particularly up-tiering, has become a notable trend within private credit and will likely persist."

Jason Colodne, Colbeck Capital Management

The Risks Remain Real

While big growth drivers are shaping private credit — from tapping into the trillion dollar asset-backed lending market to partnering more closely with banks in the large-cap market — there are also risks. One aspect of this is the rise of creditor-on-creditor violence in the U.S., which has the potential to cause significant losses to senior debt lenders who have underwritten covenant-lite loans in the last few years. This is simply a byproduct of too much capital chasing too few deals, pushing lenders to accept more flexible terms. "Creditor-on-creditor violence, particularly up-tiering, has become a notable trend within private credit and will likely persist."

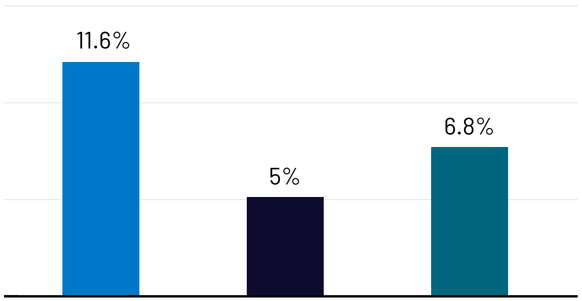
The interest rate environment is another prevailing risk factor. While the U.S. Federal Reserve has made two rate cuts, bringing the benchmark borrowing rate down to between 4.5 percent and 4.75 percent, Chairman Powell has already intimated that the central bank will not need to be "in a hurry" to lower rates.

High rates favor direct lending strategies given the floating rate nature of the loans. (See Figure 4.)

However, investors need to keep their eyes wide open to potential distress in companies struggling to grow their bottom line and efficiently service their debt. Three years ago, the interest coverage ratio was 3.3 to 3.5 percent. Before the Fed's recent interest rate cuts, however, this had dropped on average to one to 1.5 percent, according to Ma.

"Companies are still able to cover interest costs, but the amount of cushioning has definitely narrowed. Still, while private credit has its share of defaults, this has not been widespread. The default rate remains relatively stable," she says.

Figure 4: Direct lending's outperformance in high interest rate environments



Source: Morgan Stanley

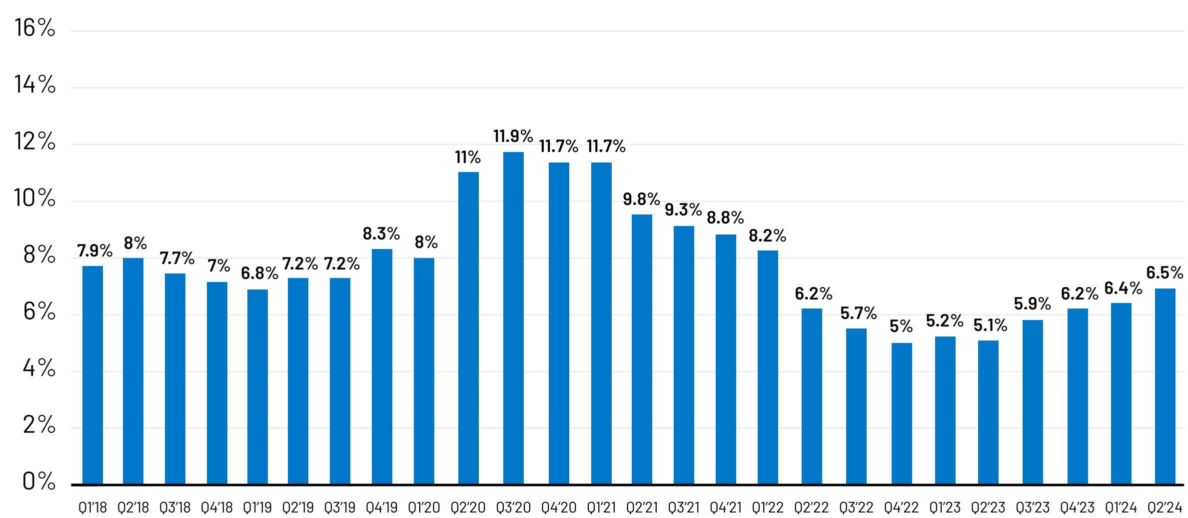
What will be interesting to observe is how PE sponsors navigate their exit strategy in this rate environment, given that there remains, according to Eurazeo's Nedelec, a massive backlog of deals. High quality, top-tier assets are being exited without too much problem. Lower quality tier two assets, where bid/ask prices are not being met, could struggle to find favorable lending terms.

"The clock is ticking and those sponsors will need to do something. If they don't sell, then these companies will need refinancing, which will be quite expensive," says Nedelec. "Generally speaking, we have more deal flow than we can serve. So if there's anything we don't feel comfortable with, we will often pass on the opportunity and move on to something else, even if we can extract better pricing out of it."

Unlike banks, direct lenders have far more flexibility to find workaround solutions with companies that may be struggling to hit their growth targets. Part of that solution might involve capitalizing a percentage of the loan interest with payment in kind (PIK).

PIK is essentially another form of leverage where companies defer cash payment of interest, which accrues until the loan matures. Although PIK as a percentage of total interest income is still relatively flat compared to 2023 and remains in line with or lower than historical averages, it has been steadily increasing quarter on quarter since Q2 2023, as companies feel the interest rate pinch. (See Figure 5.) "Investors must set clear expectations of what an allocation into private credit can

Figure 5: PIK as a percentage of total interest income Q1 2018 - Q2 2024



Source: *Houlihan Lokey Direct Lending Update, Fall 2024* provide to their portfolio and be cognizant that there is a form of correlation to the economic cycle.

“From litigation funding to consumer finance origination, trade finance and more, private credit has a lot to offer. Investors can create uncorrelated streams of cash flows and exposure to strategies that can’t be replicated using liquid instruments if they start considering the full spectrum of private credit,” concludes Roth.

As the private credit universe continues to expand, fund managers have plenty of opportunities to prove their star quality.

This is a moment for private credit managers to seize the opportunity as the asset class enters its next stage of evolution. However, to do so with confidence and conviction, will require even greater focus on credit underwriting and risk identification, especially as firms begin to broaden their activities in asset-backed lending.

Those able to take a disciplined approach will find that the combination of strong credit underwriting and sophisticated risk management will translate into more successful fundraising at a time when access to capital remains the main bottleneck for most managers.

Utilizing best-in-class technology solutions to handle data aggregation and management, and provide sophisticated LP reporting, will further burnish the credentials of those harboring ambitions to grow their influence in this important asset class.

Going forward, this will help:

- Stress test and model credit events under a wide range of scenarios
- Respond faster to limited partner (LP) requests for greater portfolio transparency
- Monitor financial maintenance covenants for early warning of deteriorating borrower performance
- Integrate environmental, social and corporate governance (ESG) and climate-related risks
- Build cross-asset valuation policies to support a wider set of credit investment opportunities