Private Debt: What Next?

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A transformational decade

In 2012 private debt Assets under Management were US$370 billion. At the end of 2022, that figure had risen to US$1.4 trillion.[1] The asset class has been on an extraordinary growth trajectory since the Global Financial Crisis (GFC). Regulatory legislation, such as the roll outs of Basel 3 and IFRS 9, has been the underlying driver. Balance sheet efficiency has become the primary focus for banks across the globe who have retrenched from specific lending areas as a result, exiting activities or geographies deemed subscale or non-core. Alternative asset managers have been all too happy to fill the void. Faced with a client base desperate for yield in a low interest rate environment, private debt has been put forward as one possible fixed income replacement solution and institutional investors have bought into the asset class. According to one recent study, US public pension plans representing a combined US$3.2 trillion in assets have increased their private debt allocations to an asset-weighted average of 3.6% in 2022 against 2.1% five years earlier.[2] And to date, these investors have been well rewarded. Consistent high single-digit returns have been achieved, well in excess of public fixed income returns (see Figure 1).

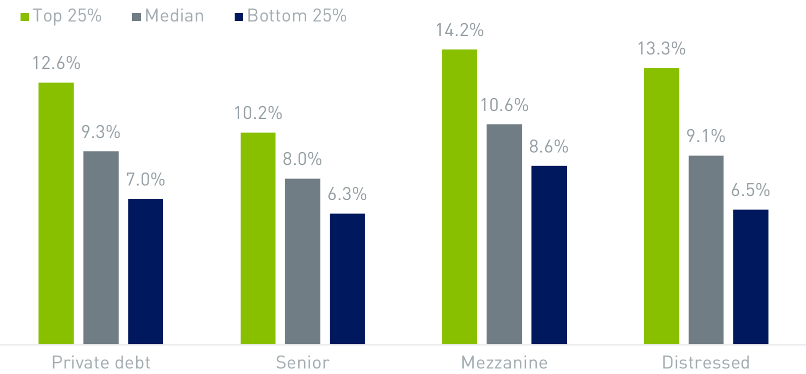
A new landscape

Much has changed in the last 18 months though. 14 consecutive interest rate increases in the UK; 11 consecutive interest rate increases in the USA; two-year US Treasury yields have hit levels last seen in 2006, nudging above 5%. Asset owners are now re-evaluating their asset allocations accordingly. At the same time, 2022's denominator effect has brought investors' approach to private markets into sharper focus after the asset class's relative outperformance resulted in many institutions getting close to or exceeding their allocation targets on a percentage basis. Whilst still a strong year with more than US$200 billion of capital raised, 2022 was also only the third time in the last 12 years that private debt didn't set a fundraising record.

But some things have not changed

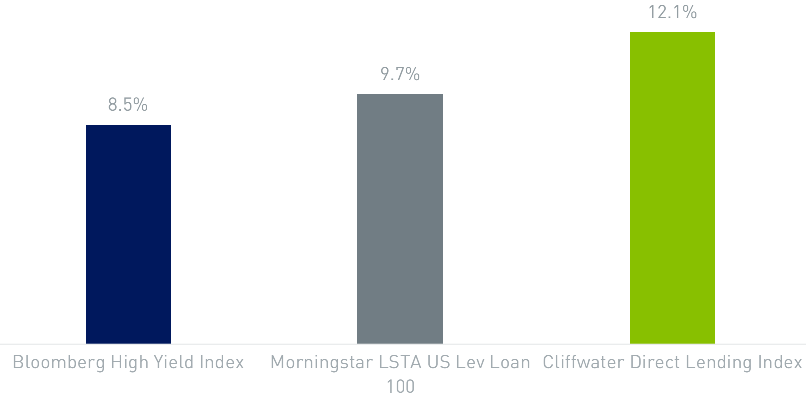
While there is much for investors to ponder today, some longer-term themes endure. If Benjamin Franklin were alive today, he could have added increased financial regulation to his list of certainties. Much has been done to sure up the global banking system since the GFC but arguably the final Basel 3 revised standards for bank capital requirements are some of the most significant changes to date. Implementation is scheduled to start from 2025 with the European Banking Authority (EBA) forecasting Tier 1 Minimum Required Capital inflation of 10.7% by the end of the transition period. Meanwhile, US bank executives have been particularly vocal about their opposition to the latest Federal Reserve implementation proposals in recent weeks. Irrespective of whether they are successful in watering down the legislation, what is clear is that bank lending activity is going to be further curtailed.

Figure 1: Global private debt performance by strategy
Net IRR through Sept 30, 2022 for vintage 2009 – 19 funds



Source: Burgiss

Figure 2: High yield bond, leveraged loan and direct lending yield to maturity comparison, June 2023



Source: Cliffwater LLC

So what's next for private debt?

On the one hand, there are concerns. Will performance hold up in a higher interest rate environment and in the event of a macroeconomic downturn? Can private debt continue to generate a sufficient illiquidity premium over returns available from public securities? On the other hand, many market participants believe today's opportunity set is as good as at any point since the GFC. As is often the case, the most likely outcome is probably somewhere in the middle, with a greater dispersion to be expected in manager performance in the coming years.

Undoubtedly the private debt fundraising environment will be more challenging in the immediate future. Aside from the base effect that comes with a maturing asset class, the search for yield has diminished with many more institutions able to meet their return objectives via a greater weighting to publicly available securities. But private debt's success over the last decade is also its greatest strength today. For those that have embraced the asset class, there is a good understanding of its merits; highly cash generative investments delivering uncorrelated returns with little volatility while at the same time often acting as a hedge against inflation via floating interest rates plus offering downside protection in the form of a senior position in the capital structure. Indeed, with rising interest rates direct lenders have seen available returns rise well into double digits, still comfortably above those available from public markets (see Figure 2).

Along with this, as private debt has matured it has also innovated and large sophisticated limited partners have built out well-diversified private debt portfolios that include more niche strategies. Arguably, the supply and demand dynamics in some of these more specialist areas of the market are even more attractive. We see this in our own space. At LCM we have been an ever-present operator in the European consumer and SME loan market for 24 years, acquiring performing and non-performing loans (NPLs). Our largest competitors are typically highly leveraged corporate balance sheet buyers who are currently being forced to preserve capital in advance of refinancing events at a time when NPL volumes are increasing. As well as providing more favourable pricing conditions, in turn it is fuelling an active secondary market; never before have so many of our competitors approached us about acquiring some of their assets.

Conclusions

Regulation has been the catalyst for private debt growth over the last decade and we expect implementation of the Basel 3 endgame reforms to be supportive for the asset class in the years ahead. There will be greater competition for limited partner commitments and, in the event of any sort of macroeconomic downturn, greater dispersion in manager performance will lead to clear winners and losers. As Warren Buffett famously said, "only when the tide goes out do you discover who's been swimming naked". For those managers that keep their discipline, we think private debt will continue to complement other portfolio holdings and generate compelling risk-adjusted returns for investors across a range of core and niche strategies.

FOOTNOTES
1 Preqin
2 Cliffwater LLC

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