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CREDIT

A new balance between private credit and syndicated loans is coming

By Michal Katz | August 6, 2024

Increased bank regulation, public market dislocation and investors' search for yield have propelled private credit funds to grow beyond their middle market roots. Private credit, private debt and direct lending are used interchangeably but all refer to loans extended by an asset manager rather than a traditional bank, to corporate borrowers or financial sponsor-backed companies. These lenders stepped in to fund companies viewed to be too risky or too small to raise debt in public markets but have since broadened out to support borrowers that were previously served by banks.

The rise of private credit is, in part, an offshoot of a well-functioning market, born out of legitimate market-fueled demand. During periods of market dislocation, whether the global financial crisis, regional banking meltdown or fast-paced Federal Reserve rate hike cycle, the private debt market has filled a financing gap left open by traditional banks. The asset class has grown to an estimated $1.7 trillion, having taken share in recent years from both the leveraged loan and high-yield debt markets, which, respectively, sit at $1.4 trillion and $1.6 trillion. Private credit brings certainty of execution, flexibility and speed of close compared to the syndicated market, though often at a higher cost and with more restrictive covenants. For its part, the syndicated market where banks play offers less restrictive terms and more competitive pricing.

Innovation in the capital markets is healthy, yet the shift to private credit has led to disequilibrium in the markets. According to LCD and Preqin, private credit constituted roughly a quarter of the leveraged finance market in 2022, up from mid-single digits in the early aughts. This evolution, intended to transfer risk from banks, has come at their (our) expense.

Rapid growth of private credit as an asset class has recently raised concerns, chief among them misjudgment of risk and reward by investors (quality of credit, high leverage) driven by competition for new deals amid a tepid deal environment. Specifically, private credit has yet to go through a cycle where companies in their portfolio may struggle to meet obligations (covenants) in a higher rate environment (notwithstanding expected Fed rate cuts) and underperform in an economic slowdown with higher debt service.

To be sure, some cracks in the market have started to show in the form of equity write-downs, covenant relief and workouts. According to a recent report from the IMF, immediate financial stability risks from private credit appear to be confined. However, the limited oversight and opaque and intertwined nature of its ecosystems may mask vulnerabilities.

In the meantime, the syndicated market has regained its footing this year. In the leveraged loan market, borrowers have outperformed expectations despite the weight of the Fed's aggressive monetary policy. While default rates have risen to 4.7% as of June 2024, according to Moody's, they did so from extremely low levels. As recession fears and corresponding loan defaults have diminished, public market credit spreads (a factor which represents implied default risk) have dropped to historically low levels.

The resurgence of the syndicated loan market signals a pendulum swing back to greater reliance by debt issuers on traditional bank financing, writes Michal Katz.

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According to Mizuho data, high-yield spreads are trading at or near their all-time tightest levels. New LBO activity is still lagging, but the markets have absorbed refinancings and dividend recaps. While still off 2021 high water marks, leveraged loan volumes stand at $300 billion, up nearly 150% compared to the same period last year, and high-yield bond volumes are $170 billion, up 75% year over year.

Investors remain "risk on" awaiting the Fed to lower rates and the appetite for yield remains strong in a resilient macro backdrop. This has led banks to lean in and, once again, be more competitive on recent large transactions such as Advent's take-private of Nuvei for $6.3 billion, Thoma Bravo's $5.3 billion acquisition of Darktrace and KKR's $4.7 billion acquisition of Varsity Brands, all sizeable leveraged buyouts that priced at tight levels.

With the return of the syndicated loan market, I would contend that we should start to see the pendulum swing back to a more balanced distribution across markets. The scarcity of M&A deal flow makes it an issuer's market, and they will decide which alternative solves their need — it's an "and, not or" market.

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