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A Loan for All Seasons (First of a Series)

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When we began our career in the middle market four decades ago, we could not have anticipated its transformation to private debt, the hottest asset class in capital markets.

Back then being a lowly vice-president dedicated to smaller, non-public, non-rated, non-traded loans on the global syndicated finance desk at the great JP Morgan (then Chase Securities) was like being a short-order cook on the QE2.

We have been privileged to see those “little loans” transformed into a $1.3 trillion private debt universe rivaling both broadly syndicated loans and high-yield bonds in size. It is estimated that market will double to $2.7 trillion by 2027.

The vast majority of leveraged buyouts are now being underwritten and held by direct loan managers, with banks struggling to stay relevant. Those managers have raised enormous sums of capital from investors around the world. Private debt is now poised to become a core asset in any alternatives portfolio.

What has contributed to the popularity of this extraordinary financing tool? After all, at its essence private debt is commercial lending, a business that dates back to 2000 BC Mesopotamia.

In two words, flexibility and resilience. For issuers, private debt provides bespoke financings for buyouts and growth with structures able to withstand any economic cycle. For investors, private debt generates consistent income streams at yields above liquid investments and at valuations resistant to deterioration in any market or economic headwinds.

The first impetus to private debt growth was the development of the unitranche during the GFC. While banks were sidelined, direct lenders offered the single-tranche solution that mimicked a senior/junior capital structure. Investors received a blended return higher than first-lien senior debt while retaining a first-out security interest.

During the decade that followed, as the Fed kept interest rates at rockbottom, senior loans generated 7% unlevered returns. This was 3% above both BSLs and HY bonds, a premium sustained through a series of market shocks including debt ceiling crises, taper tantrums and sovereign rating downgrades.

When Covid hit in early 2020 direct lending, after a brief pause, motored along while banks again were sidelined. As the Fed hiked rates two years later, the floating rate loans provided enhanced returns and more conservative structures to investors.

Over the decades, through a multitude of economic, rate, and market headwinds, private debt has proved its worth. Yet to skeptics, there remain three unanswered questions for the future before they jump on board. Next week we’ll answer them.