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The New Paradigm (Third of a Series)

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The confusion around differences between public and private credit dynamics has been compounded by the rapid growth of the illiquid asset class. The middle market was infrequently on investors' radars until it began to rival broadly syndicated loans and high-yield bonds in size.

At $1.5 trillion, private credit has caught up with both, and by some estimates will more than double in the next several years. That kind of popularity attracts an increasing number of investors ("Wow, what's this?") historically in large-cap, liquid strategies. Such a raised profile also has raised eyebrows with regulators and the media ("Wow, should we be worried?").

These reactions are perfectly understandable. Anytime significant dollars are entering any investment category in a seeming hurry there's room for deeper scrutiny. Such was the case with SPACs back in early 2021. Special purpose acquisition companies were the hottest thing back then, as we profiled **here**. And we know what happened to them.

But middle market lending has a long, consistent history of performance through many cycles, across many vehicles, and among many industry sectors. The difference today is that the game has moved away from the banks, an outcome that was widely anticipated – indeed, designed from the outset – by regulatory agencies.

What was less well appreciated was how adaptable private credit would be amid a slew of unexpected market shocks – zero interest rates, COVID, high interest rates, and Ukraine. Or how suitable for investors looking for higher, less-volatile returns with lower risk characteristics.

Nevertheless, the private, illiquid nature of direct lending remains an evolving story. As one panelist at a recent conference noted, "Unfamiliarity with the asset class leads to mistaken pattern recognition." Those more accustomed to actively traded credit with no financial covenants expect certain dynamics when the economy slows, or market conditions tighten.

We've seen that play out in projected default activity or aggressive structures arising from competition with banks. The fact is that the game is over; direct lenders have won. Banks will continue to play a role in some specialized industries and with very large, well-rated issuers CLOs find attractive. But non-banks' hold capabilities provide certainty of execution sponsors need to be successful in increasingly competitive auctions.

The flip side is that more attention will be paid to private credit going forward. Yes, the investors in this debt are more sophisticated. Yes, the asset class has proven its worth through a number of mini-cycles since the GFC. And yes, its popularity with private equity managers is unquestioned. But until we've gone through a full-blown recession, questions will remain.

As we wrap up our series next week, we'll speak with a long-time observer of the credit markets about why private credit's new paradigm has been slow to be understood, and what the outlook is for the fastest-growing sector of the capital markets.