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The New Order: Leverage Finance in an Asset Management World (Second of a Series)

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To understand the dynamics of buyout finance today, you need to appreciate the difference in what drives the public credit markets versus private credit. The biggest change since the GFC has been the shift away from the investment banking model.

For both corporates and private equity-backed deals, borrowers often relied on investment banks to advise on, and propose financing terms for, transactions – the so-called "one-stop shop." Banks extended underwritten commitments based on expectations of buyer appetite, with buyers being CLOs, retail funds, and insurance companies. Terms held only to the extent the market didn't move substantially, otherwise underwriters could "flex" them.

It feels as if some media outlets, rating agencies, and bank research teams are stuck in the early 2000's. They report as if banks are "lending" and that non-banks operate on the same playing field. That leads to mistaken pattern recognition where dynamics such as default and valuation data in publics arise from a very different context than what actually occurs in privates.

Increasingly, leading private credit managers with capacity to speak comfortably for $1 billion or more are committing to financings with the ability to hold the entire loan among controlled funds. As a result, terms don't change regardless of market conditions. There's also no syndication process and more efficient negotiation among lenders (and with the borrower), shrinking the timing to close.

This combined with the drain of liquidity from public credit over the past two years has made financing decisions easier; the ratio of private-to-public deals has been tilted to privates for a while. With expectations for higher rates softening, CLOs are finding the equity arbitrage to be (in the words of one leading manager) "attractive both on an absolute and relative basis." Such a development leads naturally to new vehicle formation (see our *Chart of the Week)*.

Armed with fresh cash, CLOs have appetite for single-B paper. It's this appetite that drives BSL lending, not (as some would have it) banks deciding to "fight back" to take share. Banks don't "lend" in the same sense as direct lenders. They underwrite to distribute, and if buyers aren't there, they don't underwrite. And since the Fed's hike regime, buyers haven't been there.

Systemic illiquidity has led to a fascinating role reversal. As one of our market friends noted, before the GFC broadly syndicated loans and high-yield bonds represented the organized, institutionalized, efficient and disciplined markets. The middle market was considered spotty, niche-y, and less well-organized. That's changed. With the influx of institutional investors over the past decade, the private credit universe is larger than either loans or bonds. Its leading managers can speak with confidence for the largest financings, regardless of cycle, rates, or complexity.

The battle for buyouts is over: privates have won. Yes, the pendulum swings back from extremes. Having buyers with dry powder, banks are pitching cheaper refinancings to private credit borrowers. All’s fair in love, war, and capital markets. But the tide won’t come back as far as it has in the past. Private credit fundraising has changed that narrative for good.