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Private Credit in a Post-Rate World (First of a Series)

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When you're successful, everyone wants a piece of you. That's the challenge private credit faces today. Its grown from a small, largely ignored corner of leveraged loans called the middle market two decades ago to an asset class rivaling both broadly syndicated loans and high-yield bonds. And now private credit is drawing attention from sophisticated global institutional as well as retail investors for being an astonishingly helpful way to produce consistent income streams at attractive risk-weighted premiums.

The limelight has also brought it criticism for being, among other things, an asset bubble waiting to pop, a hiding place for loans of dubious valuations, worse in defaults and losses than public credit, crowded with too many managers doing the same thing, and conspirators with banks in weakening terms and structures at the upper end of the loan market.

Our forty-five years of direct lending experience and being on the management team of one of the most successful practitioners in the industry (not to mention our weekly Lead Left publications since March, 2008), has given us a unique perspective to separate fact from fiction for investors and observers. Not that the line between the two is always easy to recognize. Particularly when the future upside in the wealth space could make private credit's unprecedented growth to date pale by comparison.

It was one thing when direct lenders providing financings to private equity sponsors competitive with banks who couldn't keep leveraged loans on their books. But now the largest of asset managers are holding loans regardless of size and allocating to investors of all stripes, and also providing the firms themselves with capital solutions at a GP and LP level.

In making private credit appealing to retail, managers are increasingly looking for ways to make illiquid assets look more liquid, like stocks or bonds. The term "semi-liquid" suggests the direction product marketing is taking. One CEO has predicted in the future, when it comes to liquidity, it will be hard to tell the difference between publics and privates.

But even if possible, is it desirable to make a loan to a middle market company owned by a private equity sponsor easily traded on some open exchange? If investors could do so, as with a mutual fund, what would that mean for the valuations of those hitherto non-traded loans? And during periods of market unrest, would not those loans take on undesirable volatility? Would that inevitably lead to the kind of value agitation that alternatives were designed to avoid?

Product innovation is one of the hallmarks of the US credit markets. It has allowed us to lead the world in leveraged buyouts and M&A for over fifty years. The mid-decade advances in private asset technology will no doubt benefit an incredible range of capital users and providers for years to come. But we think it's important to distinguish those participants in terms of size in order to appropriately understand the risks and rewards.

Next week we see how different manager origins change the direction private credit has taken.