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

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One of the frequent observations of private credit, usually couched as a complaint, is how many competitors are crowding into the asset class. In part this is due to the increasingly specialized strategies managers are employing that all fit into the PC classification.

A few years back, we received a gift membership for a popular fitness club. On the first visit, we found the parking lot so crowded the only available space was a block away. Won't be using place this much, we thought. But once inside, the activity level seemed surprisingly reasonable, and we easily found a quiet corner for our modest physical exertions. Where was everybody?

Turned out there were a dozen classes going on in the building. Stretching, boxing, cycling, yoga, dance, barre, Pilates, and one windowless room requiring special entry cards. (Still not sure what happens there.) Over time we realized this was a useful metaphor for private credit. From the outside it looks ridiculously crowded. But once inside it's clear many different and useful things are happening without one interfering with the others.

Under the roof of Private Credit, direct lending, special situations, distressed, non-sponsored, venture debt, mezzanine, asset-based lending, and others co-exist happily. Managers came to the asset class via different routes. Some from commercial lending arms of regional and money-center banks focusing on traditional middle market borrowers. Pressured by consolidation and regulatory agencies, banks have mostly abandoned leveraged lending.

At the larger end of the private credit market, companies north of $500 million revenues, bankers with M&A and public credit backgrounds saw the role of the asset manager evolving to one-stop, bond or syndicated loan-replacement strategies. This ranged from regular way mega-corporate financings, with or without private equity backing, and opportunistic acquisitions.

These two manager styles saw private credit through different lenses. Smaller borrowers required (among other things) more conservative structures with lower leverage, higher pricing and financial covenants maintained at all times. Larger borrowers were treated like bond issuers with the ability to incur higher leverage, more accommodative terms, and financial tests only measured when incurring additional debt.

As private credit gained widespread attention, the distinction between styles has been largely lost. Inevitably the media seizes on dramatic mega-deals with permissive terms and cheaper yields to stand in for the asset class as a whole. So all managers have to constantly answer to investors for the most extreme end of the risk spectrum regardless of their own conservative underwriting practices.

That leads us, in this and other *Lead Left* series, to reiterate the foundational risk/reward principles of private credit that lead to so many benefits for issuers and investors regardless of rate movements. And to highlight when the market departs from those principles.