Private Market Insights

A NEWSLETTER BY FAST

Private Debt Dominance: What drives private credit's outsized yield and lower risk, and is it sustainable?

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Based on recent headlines, it seems the financial news media has finally picked up on private credit.

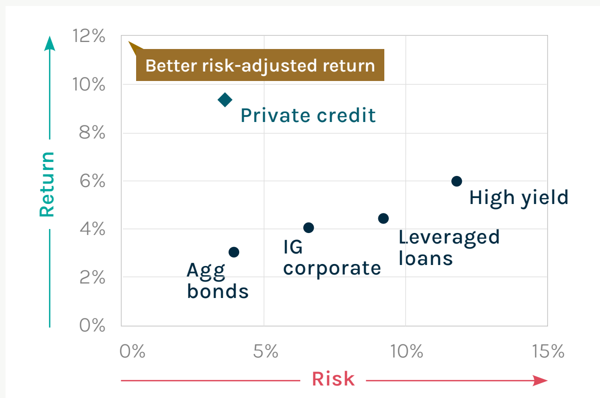
Private credit's allure, quite simply, is its return-for-risk profile. In today's markets, it has one of the highest Sharpe ratios, particularly when compared to other liquid credit alternatives.

Current returns[1,2] are in the low double digits (~10–12%) with lower risk—as defined either by volatility (~5%) or loss rates (~1%)—than more liquid bank loans and high-yield bonds, which have volatility of 9–12% and loss rates of 1.0–1.5%).

Drawn in by these fundamentals, many advisors have begun investing in private credit and been rewarded with an experience consistent with history: yields 200-400bps higher than public debt, with lower volatility.[2]

Others have been more skeptical. "Too good to be true" is a phrase we hear a lot.

Historical Risk and Return[2]



While awareness of these investment results is growing, there remains a lack of understanding of what truly drives them. With this paper, we help fill that knowledge gap by answering the following question:

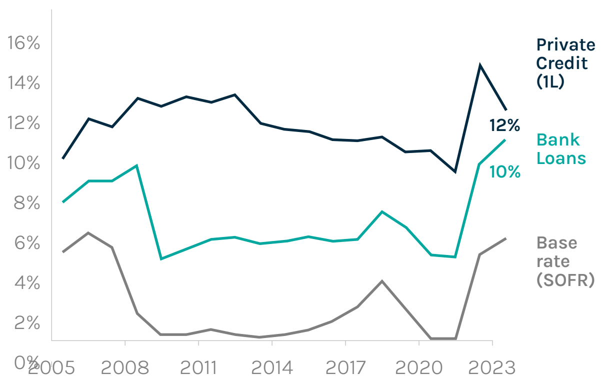
What drives private credit's historically attractive yield and lower risk, and is it sustainable?

1. Based on index information below.
2. All data 9/30/2004 – 3/31/2023. "Private credit" is represented by the CDLI Index. "Leveraged loans" is represented by Credit Suisse Leveraged Loan Index. "Agg bonds" is represented by Bloomberg Barclays US Agg Total Return Index. "IG corporate" is represented by Bloomberg U.S. Corporate Bond Index. "High yield" is represented by Bloomberg Barclays U.S. Corporate HY Bond Index.

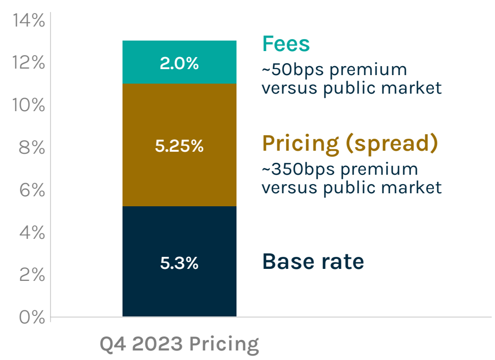
The basics of private debt

Private debt's yield premium to public debt has persisted since the beginning of the asset class. It is driven by a pricing spread (premium) and fees.

~400bps average premium over public loans[3]...



...coming from wider spreads and higher fees[4]

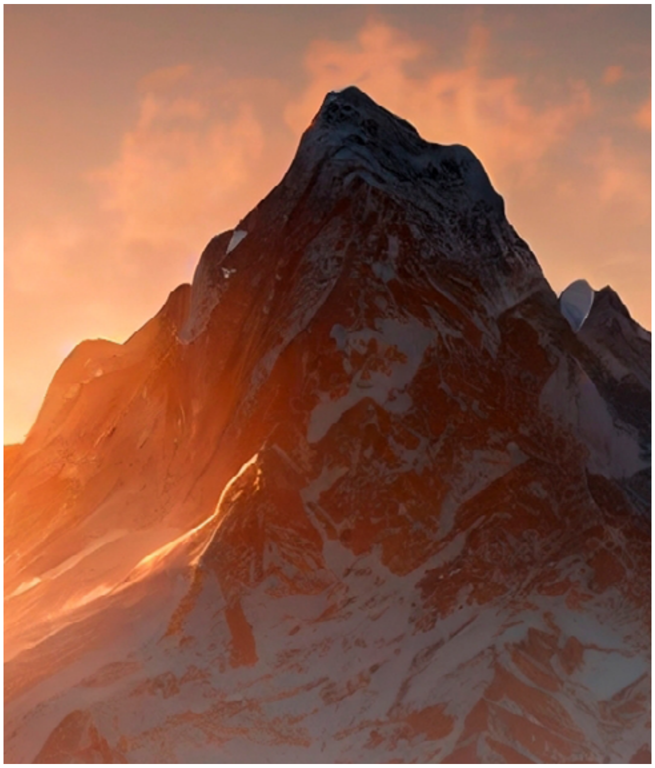


Private credit is a broad term, and its largest segment is direct lending, which refers to corporate loans issued by lenders that are not banks ("non-banks"). Such loans are based on future expected EBITDA of the borrowers.

Private loans are predominantly floating rate, meaning the yield "floats" with market interest rates. As short-term interest rates move up or down, so, too, will the yield of private credit. The short-term market rate on which this "float" is based is called the "base rate" and is synonymous with SOFR (formerly LIBOR). This rate is closely tied to the Fed Funds rate.

This floating-rate dynamic is no different than what we see in corporate loans issued by public banks, which also have floating rates. But there are meaningful differences between public bank loans and private direct lending in three key areas: **discretion**, **speed and certainty of execution**, and **customization and flexibility**.

These differentiators drive the higher yield and returns of private loans.



3. Data as of June 30, 2023. Private Debt is represented by the Cliffwater Direct Lending Index annualized current yield. Leveraged Loans are represented as Credit Suisse Leveraged Loan Index yield to maturity. Risk free rate represented by 3M LIBOR 2005 – Q1 2018 and SOFR thereafter.
4. Pricing data source is Ares estimates.

A bank by any other name… seems to smell sweeter

Discretion: Private loans are (mostly) issued to private companies, who prefer to keep their financials private.

Speed and certainty of execution: Private loans are issued in about half the time that public loans take, and borrowers pay a premium for quickness. Bank loan pricing is based on supply/demand dynamics, and market conditions for issuing public debt can change quickly. Direct lenders are able to offer certainty of execution.

Buy and hold: Banks are nothing more than brokers, and they typically hold direct loans on their balance sheets for less than 12 months. In contrast, non-banks hold loans directly and to maturity.

DISCRETION

Private loans are (mostly) issued to private companies, who prefer to keep their financials private.

Before entering into a direct lending contract, the first thing any lender needs to do is assess the credit worthiness of the borrower. As stated earlier, the loan is made based on expected future EBITDA, which means the issuer needs to be confident in underwriting those expected future cash flows. If the borrower is public, the underwriting process is fairly straightforward. But in the direct lending market, most loans are issued to middle-market companies—which are, for the most part, private.

The borrowers may be private, but lenders still need to access and analyze their sensitive financial data. Private companies are wary of having their private information leaked to competitors. They're often more comfortable sharing it with one or a small handful of private lenders versus a large syndicate of banks bidding on their loan.

SPEED AND CERTAINTY OF EXECUTION

Private loans are issued in about half the time that public loans take, and borrowers pay a premium for quickness. Bank loan pricing is based on supply/demand dynamics, and market conditions for issuing public debt can change quickly. Direct lenders are able to offer certainty of execution.

Banks conduct due diligence on their borrowers to understand the risk of default. But at the end of the day, a bank is nothing more than a broker that packages the loan, collects a fee for doing so, and subsequently sells the loan off to interested third parties, most of which are CLOs. This means a lending bank must also identify a set of buyers, and this process takes time. When that's done, they also must conduct due diligence on those buyers. More time. Sometimes, buyers pull out at the last minute, and the bank has to scramble to find another. More time. Finally, bank-financed loans must be rated—a long and drawn-out process that also takes time and resources.

All in all, bank loans are issued in about six weeks. In contrast, private loans can be completed in two or three weeks.

Furthermore, most bank loans include "flex provisions." These provisions vary but, in general, are designed to give the bank flexibility as to the terms of the loan—usually with the intention of helping them successfully syndicate. The wording is typically such that the bank can change certain key terms to make the loan more attractive to potential lenders.

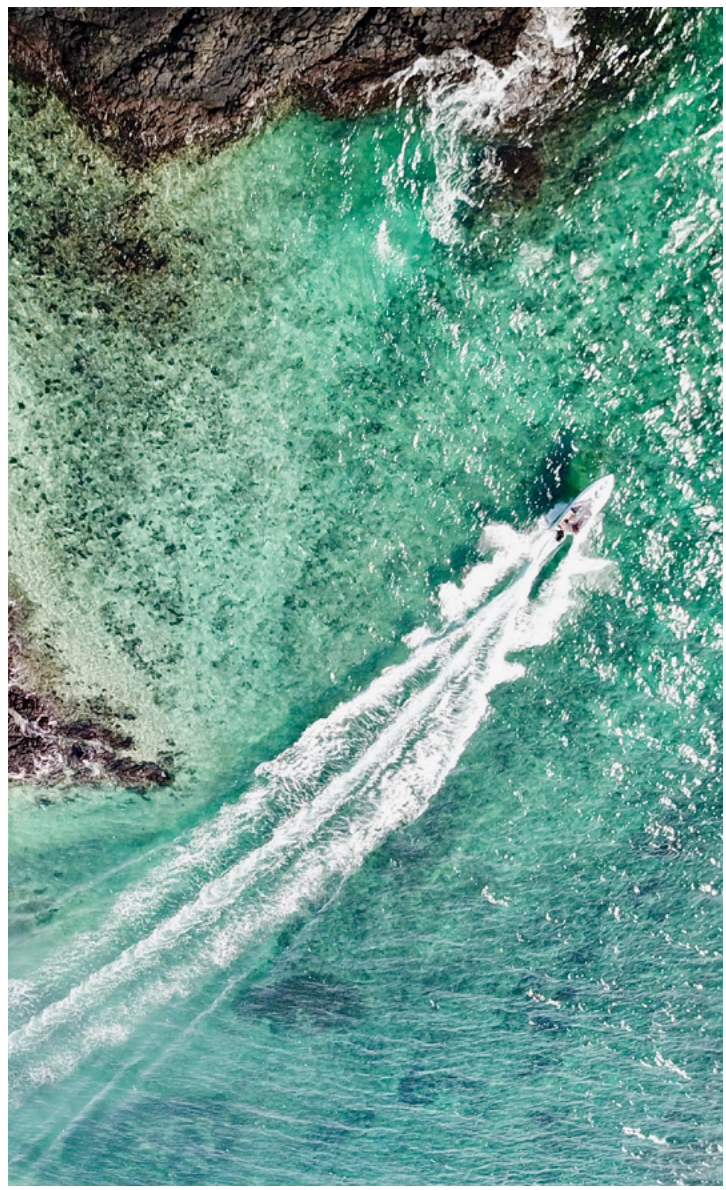
By contrast, direct lenders provide borrowers with:

- Fully committed financing with no flex language
- A single or small club of like-minded lenders holding the entire tranche
- A privately placed solution that eliminates the need for rating agencies and the cost and administrative burden associated with public registrants
- Ease of execution

Especially during times of market uncertainty and dislocation, the capital available to middle-market companies is generally less stable, less reliable, or non-existent—making private credit particularly relevant and valuable.

Why are stability and reliability so important? Because time is money, particularly for the borrower! Remember that when a business owner seeks a loan, they intend to use that capital to fund a growth plan in which the cost of capital needed to finance the plan is a key assumption. Once the plan is written, the business owner then assumes the risk of market movement between the budgeted and actual cost of capital.

A loan with more certainty of execution minimizes the risk that markets will move and render the economics of the growth plan less profitable.



BUY AND HOLD

Banks are nothing more than brokers, and they typically hold direct loans on their balance sheets for less than 12 months. In contrast, non-banks hold loans directly and to maturity.

These different approaches to loan terms represent a significant difference in alignment and motivations between public and private lenders, which affects the structure and risk profile of the loans themselves.

Because a non-bank holds a loan to maturity on its own balance sheet, it also holds the risk of default. This alignment of interest between the lender and borrower may drive non-bank issuers to be more detailed and selective in their due diligence and credit underwriting processes than a traditional bank might be. Furthermore, because the loan is held to maturity, more emphasis is placed on the borrower's medium- and long-term business trajectory, including durability through economic cycles, the competitive landscape, sustainability of margins and cash flows, and the like.

Banks, on the other hand, are most significantly focused on near-term financial projections. For example: Will the company meet investor expectations for next quarter or the upcoming year-end?

Non-banks tend to issue loans with terms and covenants that more holistically and accurately account for the health and trajectory of the borrowing business.

What's underappreciated is the degree to which borrowers prefer these more customized protections, to the extent that they are willing to pay a premium for them. While this may sound counterintuitive, custom covenants are like insurance: protection when and if it's needed most. That's worth paying for.

Businesses are most vulnerable when markets take a turn for the worse, earnings stall, and they can't make interest payments. (The pandemic is the best recent example of such a perfect storm.) In contrast to traditional banks, which don't even keep the loans they issue, non-banks work with borrowers to adjust the terms as needed to avoid default. Remember: the lenders own the risk, too. If a company can't make an interest payment in public markets, they must follow an onerous legal process that involves notifying all the owners of the debt, formally disclosing the details of the default, and so on. Imagine doing all this in the midst of a broader financial crisis. How much is that flexibility worth? It's difficult to quantify, but if history is a guide, it seems to be worth a few hundred basis points!

Banks also receive an underwriting fee for successfully executing a syndicated market transaction, whereas transaction fees in a private credit loan remain with the transaction and accrue to the benefit of investors.

In a syndicated market transaction, the bank generates a fee for all the work associated with underwriting and marketing the loan and placing it with investors. The bank keeps this transaction fee for itself, and the investors simply receive the stated interest on the loan. In a non-bank transaction, the direct lender does all the underwriting work and charges an underwriting fee to the borrower, but these fees generally remain with the actual loan and accrue to the benefit of investors—resulting in the 50bps of premium fees outlined above.

So, is private credit too good to be true?

The more than 20-year track record of private credit speaks to its merits and results. Investors have been rewarded with yields 200–400bps higher than public debt, without taking on more risk. Investors need to understand the drivers of that return difference—we do not view it as some ephemeral "illiquidity premium," nor as an arbitrage that can be easily eroded. Rather, it is the result of real value-add between lenders and borrowers and an alignment of interests that is likely to persist. Over time, as non-banks continue to take market share from traditional banks, we may see banks evolve their business models, and spreads between public and private floating rate corporate debt may converge. But for now, we see private credit as an attractive asset class for any investor.

About the Financial Advisor Solutions Team (FAST)

FAST offers resources and one-on-one support to help navigate the complexities of private markets investing. The team's goal is to empower investors to confidently incorporate private markets investments into portfolios. The educational content, research and analytics that FAST delivers are designed to enhance the understanding of the benefits of private markets investments. FAST is a skilled and knowledgeable team of professionals who can answer questions and foster more informed decisions.

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