The future of private debt in uncertain times

Should investors be worried about rapid private debt AUM growth in the face of rising recession risks?

Vivek Mathew
Head of Asset Management
Antares Capital

Growing for good reason…
To start, there is good reason for private debt's, and notably direct lending's, rapid growth and appeal. From an investor's perspective, private debt offers more favorable risk-adjusted returns than most other asset classes, as well as an embedded inflation and interest rate hedge via floating LIBOR or SOFR base rates, with floors protecting on the downside against rate declines. This is likely why nearly half of the institutional investors surveyed by Preqin are looking to increase allocations, while less than 10% claim they are decreasing allocations.

Importantly, demand for private debt has also seen rapid secular demand growth from the issuer side. This reflects its appealing attributes of speed, simplicity, certainty of execution, better control of confidentiality, and the preference for dealing with only a few trusted lenders in an amendment process. These attributes are viewed by issuers as particularly favorable in today's uncertain environment.

…and with plenty of runway
Next, private debt AUM still appears to have plenty of room to grow. According to Preqin data, private debt AUM is less than $800bn for North American-focused funds (e.g. less than Tesla's market cap for perspective). Globally, private debt AUM is only about $1.4tn, which is just a fraction of the combined outstandings of the high yield and syndicated leveraged loan markets, and only around 1% of global fixed income assets.

When looking at private equity, the main driver of private debt demand, AUM is over $2.5tn in North America and more than $4.5tn globally, putting the ratio of private debt to private equity AUM at only about 0.3 to 1. Likewise, when looking specifically at the North American-focused direct lending only dry powder of $114bn as of August 2022, it is only about 21% of the North America-focused PE buyout only dry powder of $550bn. Assuming a typical leveraged buyout debt to equity ratio of close to 45/55, one might expect a significantly higher level of direct lending dry powder.

Admittedly, one reason the private debt to PE dry powder ratio seems so low is the fact that private debt historically has been focused only on middle market PE deals and not larger PE deals, but this is changing. According to Direct Lending Deals, there have been 46 jumbo, unitranche deals ($1bn+ in size) since mid-2019 totaling $87bn, with $70bn underwritten in just the past 12 months. Likewise, Refinitiv LPC data now shows large corporate segment (i.e. revenue or deal size >$500mn) unitranche volume of $26bn in Q2 2022. Remarkably, this was double the level of middle market unitranche. It wasn't until last year that large corporate unitranche volume began to exceed middle market volume.

In assessing the market opportunity ahead, note that total "large corporate" syndicated U.S. sponsored volume was near $680bn in 2021, the bulk of which included deals in the $1bn-to-$5bn range. This implies plenty of runway for U.S. sponsored direct lending volume growth from a base of an estimated $217bn in 2021 per Refinitiv LPC. Meanwhile, in the middle market segment where direct lending already dominates, companies are seeing an average revenue growth rate of 12%+ year-on-year.[1]

But how will private debt fare in a recession?
This year has seen its fair share of challenges, including inflation and a hawkish Fed. Rate hike expectations have soared since the beginning of the year, driving up the odds of a recession. Higher rates mean higher yields for floating rate loans, which can benefit private debt returns, but also add worry that defaults and losses will also rise if rates increase too much.

As of this writing, there are signs that inflation has peaked. Commodity prices are rolling over and inflation expectations embedded in five-year TIPS are back down closer to their target levels. Thus far, base case default rates are forecast to remain relatively benign. For example, the S&P/LCD Leveraged loan index default rate is forecast to rise from a low of 0.43% in July 2022 to 2.0% by June 2023 according to S&P Global Ratings base case. But this is still slightly below the long-term average default rate for

[1] National Center for the Middle Markets' mid-year 2022 survey

leveraged loans of 2.1% since 2007. Even S&P's "pessimistic" case forecast of 4.25% in 2023 remains below the peak COVID-19 period rate of 4.6% (September 2020), when direct lending proved its resilience with low losses on average.

Meanwhile, private debt spreads have begun to rise, albeit with a lag versus dislocated syndicated markets, and loan terms are improving. Indeed, looking at historical Preqin vintage year average IRR data, vintages during and just coming out of the last two recessions generated among the best returns.

"Nobody goes there anymore, it's too crowded" – Yogi Berra

The success and recognition of direct lending, private debt's largest segment, has driven investors to hunt for alpha in less-trafficked, niche-specialty finance subsegments. Recession worries have also prompted renewed interest in distressed funds. While these segments offer their own distinct set of potentially attractive attributes and diversification benefits, they also have their own set of challenges. This includes issues such as complexity, volatility, low valuation confidence, high potential principal risk, small market size, and limited liquidity. As such, return dispersions can also be high.

The future is bright, but performance will vary

We believe private debt's and, in particular direct lending's, long-term prospects continue to look bright, but the next year or two will bring its challenges. With inflation and economic uncertainty currently slowing M&A/LBO activity and driving dispersion in company results, performance is likely to vary significantly among lenders. Indeed, the National Center for the Middle Market's most recent survey shows middle market companies split on the impact of inflation with 39% reporting negative effects and the same percentage claiming a positive impact.

For direct lending, we believe four factors will be critical to favorable outcomes: 1) strong originations and a large, diversified portfolio of lead managed incumbent opportunities that allows for selectivity among the best credits, 2) a first lien focus with strong PE sponsor support, 3) strong credit discipline, portfolios management and experience through multiple cycles, and 4) a dedicated and experienced workout team to maximize recoveries.

Vivek Mathew joined Antares Capital in 2016 as head of Structured Products. Previously, he was a managing director at J.P. Morgan, where he led the global primary CLO business. He also served as a vice president of structured finance at Deutsche Bank. Vivek graduated with a bachelor's degree from Harvard University.

With more than $55bn of capital under management and administration, **Antares** is a private debt credit manager and a leading provider of financing and investment solutions for middle-market private equity-backed borrowers and investors. Since its founding in 1996, Antares has built one of the industry's largest and longest-tenured portfolios of middle market companies and has been recognized by industry organizations as a leading provider of middle market private debt. Through its Asset Management & Funding team, Antares offers investors the opportunity to invest in collateralized loan obligations, funds and separately managed accounts.