Q&A

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Private Credit Mid-Year Check-In: Is it still a good time to invest?

The reopening of the broadly syndicated loan market and related spread compression has grabbed headlines of late and left some investors questioning if now is still a good time to be allocating to private credit and direct lending in particular.

Q1: What has been driving the resurgence of the broadly syndicated loan market and related spread compression?

The recent resurgence in the syndicated market reflects an improving outlook for the creditworthiness of most borrowers and banks' desire to win back lost share. The resiliency of the U.S. economy and related expectations of "higher for longer" interest rates have driven robust investor demand for leveraged loans, with new CLO issuance up 57% YTD-April, and with net funds flow on the rise. This improved loan demand coupled with a lagging supply of "new money" M&A related loan issuance and reduced odds of a "bad case" scenario default cycle emerging have led to about 100 bps of spread compression for B-rated leveraged loan issuers from October 2023 to April 2024.[1] This spread compression has led to a surge in loans trading above par and a repricing wave, with institutional refinancing volume of $57 billion YTD-April up 106% YoY.

Q2: What has been the impact on the direct lending market?

Direct lending markets have been impacted primarily in the large corporate and upper middle market segments which compete most directly with the broadly syndicated loan (BSL) market, and to a lesser degree in the core and lower middle market. We don't believe there are definitive lines on where the size cut off here is exactly, but most of the competition with the syndicated market tends to be for companies over $100 million of EBITDA. As company size shrinks, trading liquidity tends to become thinner and less attractive to BSL CLOs which we believe is a competitive moat of sorts for the "core" direct lending middle market.

According to Pitchbook LCD, over $13 billion of direct loans have been refinanced into the syndicated market YTD-April, with most of these companies having EBITDA of over $150 million. Some of these borrowers have reduced their interest costs by 200-300 bps in the syndicated market. As a result, price talk on spreads for new issue "jumbo" unitranche loans ($1 billion+ deal size) has fallen ~75-100 bps YTD April 2024.[2] In contrast, "core" middle market direct lending which is more insulated from the syndicated market has seen spreads hold up better - falling by a lesser ~50 bps as of mid-May vs. 4Q 2023.[3]

Cyclical swings in the risk appetite of the public syndicated markets are nothing new. We have been competing with the bank dominated syndicated market since our founding almost three decades ago and view the syndicated markets as an important part of the lending ecosystem. As a lender of choice servicing sponsors and borrowers, we believe it is important to have the capacity to offer best in class execution, be it direct or syndicated. As a best in class General Partner (GP) managing assets on behalf of our investors, we believe scale is critical in enabling a flexible strategy that allows us to reap a consistent yield premium in the core middle market where we remain focused while also allowing us to lead on the underwriting of very large transactions and/or trade in the BSL market when we see good relative value (e.g. during periods of syndicated market dislocation).

Finally, it is worth noting that the pro-cyclicality of banks in the syndicated capital markets actually underscores one aspect of the appeal of direct lending executions for many borrowers – namely the ability to work constructively with a few direct lenders when times are not pro-cyclical and syndicated markets are closed. Even in today's market, YTD-April, borrowers have elected to move about $5 billion from syndicated to direct loan facilities reflecting direct lending's appeal regardless of its pricing premium.[4] While syndicated markets are enjoying a cyclical reprieve in the near term, we continue to believe secular trends will favor market share growth for direct lending over the longer term, with direct lending assets under management (AUM) expected to see double digit CAGR over the next several years.[5]

Q3: Do you see spread compression continuing?

The answer to that question hinges largely on the outlook for M&A activity. In theory, rising M&A related issuance should improve the loan supply/demand balance and lead to spread stabilization or even possibly some spread widening.

So far in 2024, PE M&A investment activity has recovered some YoY but remains relatively depressed. Looking forward, we continue to expect at least modest improvement in M&A volume in 2024 with a boom potentially in 2025-26. Drivers include record levels of PE dry powder, rising pressure for GPs to return capital to their LPs, a very high backlog of M&A transactions and eventually lower interest rates.

Q4: Does capital allocation to direct lending still make sense in light of spread compression?

First, we would argue that private credit and direct lending should be a core allocation for most portfolios and that practically speaking, if a portfolio is under-allocated, holding back and trying to time future allocation to the best vintages is probably not a well-advised strategy. Funds typically deploy over multiple vintages and lost opportunity costs will typically outweigh uncertain prospects of successful market timing. The topic is well covered in a research paper published on January 8, 2024 by Cliffwater LLC titled "Vintage Voodoo." (see: **https://caia.org/blog/2024/05/09/vintage-voodoo**)

Having said that, we do believe the current direct lending market continues to provide attractive risk adjusted returns – particularly on a relative basis. While the absolute level of yield on sponsored middle market direct loans has declined, so has leverage and the tail risk of sharply higher default rates. Meanwhile, the absolute level of yield is still quite attractive and the yield premium of direct sponsored middle market loans vs. broadly syndicated loans remains well above the average of 1.8% since 2013 when LSEG LPC began collecting surveyed private deal data.[6]

Of course, even granted a goldilocks scenario where interest rates are higher-for-longer but EBITDA is growing and default rates are manageable, performance dispersion among GPs may widen. In fact, this is already evident in the dispersion of non-accrual rates of publicly traded BDCs as of 1Q24.[7]

Q5: If performance dispersion is likely to rise, what attributes do you think will be key to outperformance in the period ahead.

There are over 1,300 private debt fund managers in North America of which about 750 are direct lending focused according to Preqin's database. Most do not have scale (e.g. $50 billion+ of AUM), and many if not most, do not directly lead originate loans or have dedicated, experienced workout teams. We believe these attributes will likely prove to be critical to creating alpha in an increasingly competitive and less forgiving credit environment relative to the past 15-year period of mostly ultra-low interest rates and default rates. Having strong originations and incumbency advantage will likely be particularly important in a lower spread environment by enabling selection of the most attractive credits. Likewise, although we do not expect default rates to increase sharply, they appear likely to climb modestly over the course of 2024 as some borrowers struggle in a higher for longer interest rate environment.

In summary, we believe the direct lending market continues to offer attractive risk adjusted returns (e.g. estimated by Cliffwater to be 7.7% unlevered and 9.6% levered over the next 10 years as of April 2024[8]), but GP selection is likely to become increasingly important.

Visit antares.com/market-insights for more views and analysis of the private credit market.

Source footnotes:

1) Pitchbook LCD LoanStats as of April 2024
2) Direct Lending Deals Insights & Outlook Report December 2023 and April 2024
3) Lincoln International Private Credit Fundamentals Webinar May 14, 2024
4) Pitchbook LCD US Private Credit & Middle Market Weekly Wrap May 2, 2024
5) Preqin Future of Alternatives 2028
6) LSEG LPC Private Deal Analysis 1Q24
7) 1Q24 public BDC SEC filings
8) Cliffwater Asset Allocation Outlook 2Q 2024

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