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# 2024 US Private Credit Outlook: PE sponsors, investors eye busier year, along with defaults

**By Abby Latour, Olivia Fishlow and Zack Miller**

Private credit investors, looking ahead to next year, can expect a resurgence of deal activity, steady-to-tighter spreads, and a renewed focus on private debt recovery levels as defaults rise.

It was tough sledding when interest rates rose at their fastest clip in decades, slashing new origination volume in the first half of 2023.

Borrower companies and private equity sponsors have since adjusted to the higher-for-longer interest rate environment. Deal activity began picking up in the third quarter, raising hopes for more robust origination volume to continue in 2024.

“We’ve skied down the first part of the mountain,” said Ted Denniston, co-head of NXT Capital, referring to the challenges posed by interest rate hikes for new issuance over the past year. NXT focuses on the lower middle market. “We’ve seen deal flow get back to our historical average. We think we’ll see good deal flow in the first half of 2024.”

Market participants have spent much of 2023 postponing expectations for renewed deal activity. Buyers and sellers appear to be aligning better on price expectations, even if deal levels in 2024 don’t break records.

“In the first part of this year a lot of sponsors were focused on add-on acquisitions. Now that M&A activity is slowly picking up, they’re reloading DDTLs and acquisition lines to get ready to go back into the market,” said Greg Cashman, co-head of direct lending at Golub Capital.

“A lot of investment banks are also saying they’ve got a Santa’s bag of deals that they’re ready to launch next year, but whether those deals come to fruition is still to be seen,” Cashman said.

Antares Capital said that a rise in deal screening activity in recent months points to improved deal volume in 2024.

“That’s a leading indicator of what’s to come. The wind is blowing toward a good level of activity that wasn’t happening in 2023,” said Doug Cannaliato, co-head of originations at Antares Capital.

There’s no doubt that private equity sponsors have stores of dry powder to deploy and are eager for exit opportunities after a difficult year.

“While I wouldn’t necessarily describe the mood a year later as upbeat, there generally seems to be less anxiety among sponsors. That alone gives us reason to think that new deal volume may pick up alongside the release of pent-up M&A activity,” said Michelle Handy, senior managing director and deputy CIO of direct lending for First Eagle.

But geopolitical uncertainty and the US election still cast a pall over the deal environment in 2024.

“Broadly speaking, none of the consensus predictions made so far [about M&A] have come true. Some sponsors expect it to continue to be slower, whereas others see different factors driving this — the uncertainty around the election year being just one of them,” Cashman said.

**Long lines**

Although conditions on the slopes might be improving, lenders still anticipate long lines at the chair lift as new lenders emerge. The reasons why are clear, as juicy yields make private credit hard for would-be lenders to ignore. The trend is expected to continue.

"In 2024, we think the conditions are ripe among the most attractive new vintages and opportunities in some time across the credit spectrum, including private and publicly traded credit. Lenders should continue to benefit from relatively scarce capital conditions to reach high-quality borrowers on attractive terms," said KKR Credit in a December report.

Lenders have once again turned to hold size as a way to compete for deals. A late 2023 deal, IntegriChain, highlighted that the financing was executed via a single lender.

"I don't need more deals. What I really want to see is less folks looking at those deals. People think that you're in a better spot if you see more deals, but that's not the case," said Milwood Hobbs Jr., head of origination and sourcing for Oaktree Capital.

"We focus on the relationship which drives the first and last call on these deals," said Hobbs.

If a rebound remains elusive, near-term maturities in the syndicated loan market are bound to remain a source of activity in 2024 for private credit providers.

The number of leveraged loans maturing in the next two years in the $1.4 trillion broadly syndicated universe is higher than ever, with nearly half the loans rated B-minus or lower. Private credit, as evidenced from jumbo deals in 2023, such as PetVet, Hyland Software, and Finastra, expects to refinance many of these loans.

"We expect to see a portion of the $130 billion of leveraged loans maturing by the end of 2025 to come to private credit, creating opportunities to put capital to work, when interesting opportunities arise," said Bo Stanley, president at Sixth Street Specialty Lending (NYSE: TSLX), on a Nov. 3 earnings call.

Private equity sponsors are routinely dual-tracking loans in private credit and the syndicated market to see where the best terms and pricing are available, with many credit platforms able to offer both options.

Another maturity wall — one that few people are discussing — comes from direct loans themselves. This will provide another path for origination opportunities.

"Demand for refinancings is likely to grow significantly in the coming years, as an estimated 40% of the direct lending market is maturing in 2024-25. Only about 15% of both the high-yield bond and leveraged loan markets are expected to mature in 2024-25," said Oaktree in a market commentary on Oct. 26.

**Spreads: Past peak**

Most agree private credit yields have moved past post-pandemic peaks. Spreads in private credit began to compress in the third quarter, as competition heated up anew.

At the start of 2022, a typical spread on a high-quality middle market buyout could be S+675-750, with three points of OID, according to market sources. At the end of 2023, a typical spread is closer to 525-575 bps, with two points of OID.

"Direct lending spreads have tightened somewhat, although they are still above pre-Fed hike levels. For a middle of the road, traditional middle market sponsored unitranche financing, we are seeing S+550 (vs. 600 six months ago). OIDs are averaging 98, slightly tighter than earlier in the year. The

same dynamics hold true for first-lien term loans, with spreads about 25 bps lower. For investors, senior debt yields remain in the 11-12% range," said Randy Schwimmer, co-head of senior lending at Churchill Asset Management.

"For 2024 we do not expect any significant tightening, perhaps 25-50 bps, for the better borrowers. Where they sit a year from now depends on deal flow," said Schwimmer.

Nevertheless, BeyondTrust Software recently obtained more than $1 billion in unitranche private credit loans to support a refinancing of the company's syndicated loans at S+500, with an OID of 99, potentially among the tightest for the year.

"This might be a tale of two markets: stable spreads in the lower market where private credit's main competitors, regional banks, have largely disappeared, and spread compression in the upper middle market where the alternatives to private credit, high yield bonds and syndicated loans, are staging a real comeback," said Dean D'Angelo, a partner at Stellus Capital.

D'Angelo said that in the lower middle market — generally recognized as borrowers generating $25 million of EBITDA or below — have two real options for credit: regulated banks and private credit providers. The banks are being significantly less aggressive, helping credit spreads remain relatively stable.

**Mission critical, recurring revenue**

An LCD analysis showed, by use of proceeds, private credit LBOs and M&A activity in 2023 was roughly on par with 2022 levels, while the volume of refinancings increased.

For sectors, private credit lenders continue to hunt for a recession-agnostic, or at least recession-resistant, portfolio. The favorites since the pandemic hit have not moved significantly: mission-critical components, healthcare, business services and enterprise software, plus fragmented high-margin businesses like eye care and pet care.

Sectors like industrials, energy and manufacturing, with their constant capital expenditure needs and exposure to macro headwinds, typically join consumer and retail at the out-of-vogue table, according to market participants.

"We're already seeing sponsors laying the groundwork for deals in early 2024," said First Eagle's Handy. "One notable area is healthcare, where many sponsors were waiting for their companies to recover from the impacts of Covid … Other people-heavy sectors like technology may also see an uptick in activity as wages ease."

**Trends ahead**

As the private credit market matures, we are likely to see even more innovation in terms of deal structures and portfolio management.

Holly Etlin, a partner at Alix Partners, said at Beard Group's 2023 Distressed Investing Conference on Nov. 29 that she believes there will be an uptick in club deals, instead of financing provided by a single lender, as well as more rated debt, adding that private credit will "look more like conventional lending groups today."

Private credit has been willing to provide features and structures unavailable in the syndicated loan market. This is expected to continue next year as the two markets compete for transactions.

"Private credit investments are infinitely more customizable than the syndicated loan market. We have a lot of flexibility to continue assisting our portfolio companies while maintaining, or even strengthening, our issuer exposure," said Mark Gatto, co-CEO at CION Investment.

Private credit lenders showed this year they have been willing to structure loans with a portability feature, allowing them to move with a company when the business changes hands.

Guidehouse said it planned to keep in place a first-lien facility that has been upsized to more than $3 billion as the business changes hands via a $5.3 billion purchase by Bain Capital Private Equity. The feature is attractive to sponsors, particularly on the eve of a company's sale, when financing is more difficult or expensive to find.

The private credit market has also been willing to underwrite loans based on recurring revenue, a structure unavailable in the syndicated loan market. Recurring revenue companies, which may have low or no EBITDA, tend to have high upfront costs for infrastructure and customer acquisition, but high retention rates of customers due to high costs of switching enterprise software. The structure has made sense for software as a service (SaaS) borrowers, which have been the main recipients.

**Black diamond**

A year ago, market participants said they expected defaults in private credit to increase. This has so far not materialized. The Proskauer Private Credit Default Index showed defaults of senior secured and unitranche private loans falling in two successive quarters, Q2 and Q3 of 2023, a surprise to many.

One of the core arguments about private credit is that since lender groups are smaller and most loan agreements contain covenants, credit providers are able to keep close tabs on borrower companies. This could be one explanation for lower-than-expected private credit defaults.

The picture is slightly different in the syndicated loan market.

Keen to avoid losses, private credit lenders have been turning to PIK interest and amendments. Sponsors have also been willing to provide equity infusions, blunting defaults.

"Sponsors are getting ahead of the problem and solving it before a default is called," said Christine Tiseo, co-head of Lincoln International's Capital Advisory Group.

Mezzanine debt has also reappeared in the market after a significant absence. MFN or "most favored nation" clauses have made it impossible in some cases for a needful borrower to bring in new senior debt without repricing an entire first-lien facility, an unattractive prospect at this time. This has led to a fundraising avalanche for mezzanine strategies.

But the path is treacherous ahead, with many market participants saying defaults will increase in 2024. Many issuers have turned to the private credit market in recent months for "solutions." Some have walked away emptyhanded, with even private credit unable to help, market sources say.

"Higher for longer rates will make unviable the capital structures built primarily on their ability to borrow at low cost. This is expected to transpire as increasing debt costs and stagnant earnings impact cashflows of low-quality issuers, resulting in greater pressures around cashflows, downgrades and defaults," said BofA Securities said in a recent research report. The bank projects US loan defaults will reach 3.5%.

Recovery levels will come into focus in 2024, with the small (but growing) data set of private credit loan recovery levels offering early clues to how the asset class will hold up in face of higher interest rates. Benefytt Technologies provided a case study when it filed for bankruptcy in May, resulting in Ares Capital Corporation and Blackstone Secured Lending Fund writing down their loans.

It has been said that skiing is the art of catching cold and going broke while rapidly heading nowhere at great personal risk. Clearly, that comparison does not apply to private credit. But as private credit looks to take on more of the leveraged finance mountain in 2024, market participants are no doubt hoping whatever risk that entails comes with ample rewards.