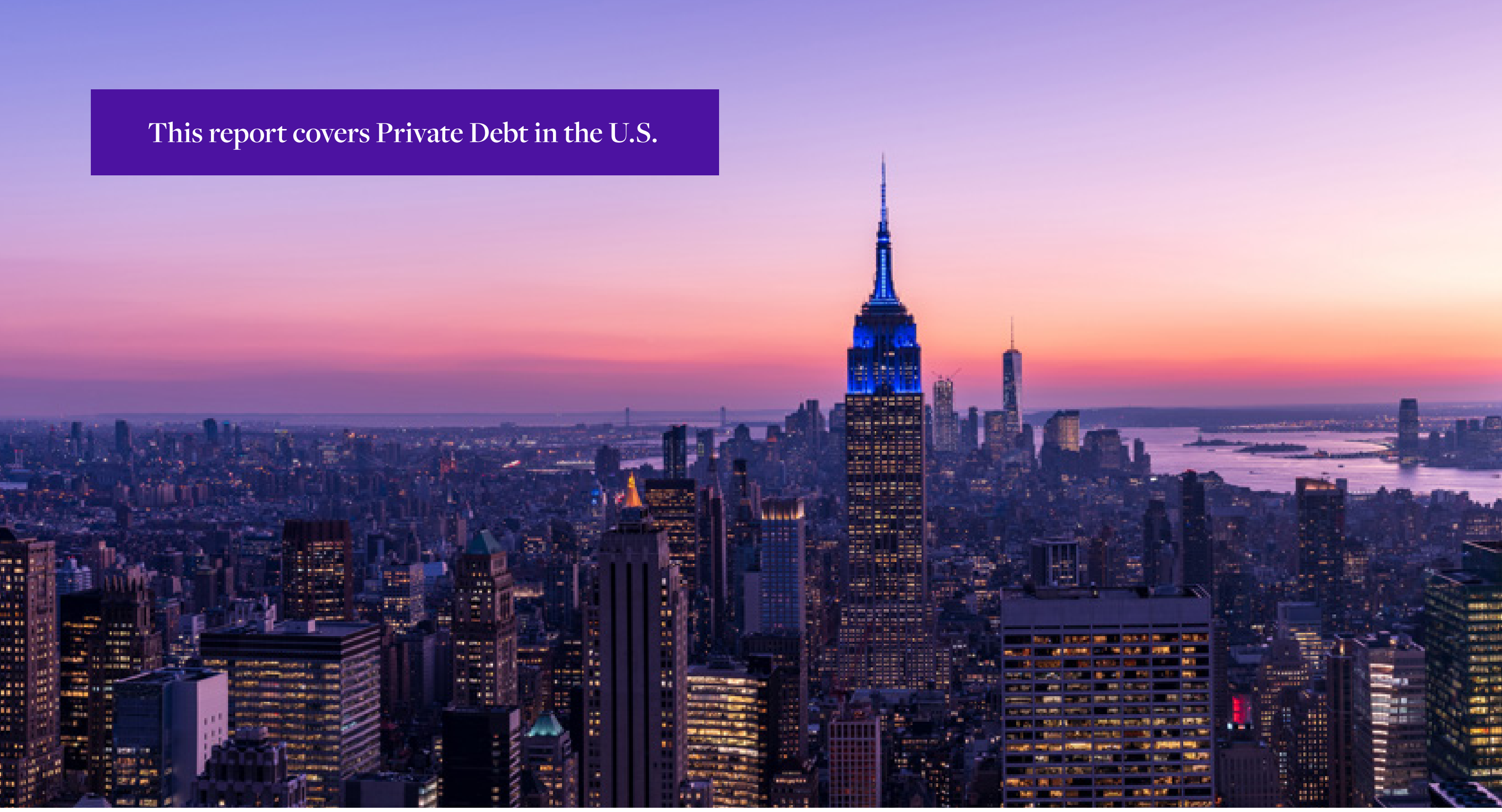
Private Debt in the U.S.

June 2024



Introduction

We've witnessed notable macroeconomic shifts, including record-high inflation rates and an aggressive monetary policy tightening campaign across advanced economies over the last 12 months.

Such headwinds have precipitated a global downturn, injecting a considerable degree of uncertainty into markets. Private markets, in turn, have borne significant pressure in light of such headwinds in 2023, albeit with some notable exceptions across strategies and regions.

In 2024, a more optimistic landscape emerges, fueled by expectations of major central banks implementing rate cuts and inflation stabilizing at levels close to target. This optimism sets the stage for a potential resurgence in private market activity. Nevertheless, a broader sense of uncertainty is still expected to linger, driven in part by geopolitical tensions, the prospect of a significant shift in the global political order amid the numerous elections slated for 2024, and persistent macroeconomic challenges.

Against this intricate backdrop, we delve into the examination of how these conditions will influence the outlook for private markets in 2024. Our comprehensive series of reports will scrutinize the prospects for three specific asset classes—private debt, private equity, and real estate—across diverse geographical regions, in light of developments in each region. Accordingly, we provide insights into how investors across various segments can navigate current market dynamics, leveraging opportunities strategically to their advantage.

Macroeconomic overview

In the first half of 2023, inflation represented a key macroeconomic concern, while the second half of the year saw the Federal Reserve's (the Fed) efforts to curb inflationary pressures without severely hindering growth prospects coming to fruition.

Looking ahead to 2024, inflationary pressures are expected to be less pronounced but still significant. The Fed expects inflation on their preferred personal consumption expenditure (PCE) measure to amount to 2.4% in 2024, based on their latest quarterly projections at the time of writing.

Yet, despite the Fed's aggressive monetary tightening campaign, recent data suggest that the U.S. economy is on course for a soft landing, not least due to a still robust labor market and resilient consumer spending. However, these same factors also pose upside risks to inflation.

Consequently, the Fed will likely be prudent with the timing and magnitude of interest rate cuts. Even when cuts are implemented, interest rates will likely stay in restrictive territory for some time, and significantly above pre-pandemic lows.

As a result, borrowing costs and debt service payments are expected to remain elevated. Further concerns about rising default rates and downside risks to the banking sector increase the uncertainty for the financial sector.

Additionally, 2024 is an election year that introduces further uncertainties regarding overall policy and regulatory frameworks. Meanwhile, ongoing geopolitical tensions, notably the Russia-Ukraine conflict and conflicts in the Middle East, present further challenges for the U.S. economy, with potential implications for the overall economic outlook.

Overview of private credit market

The aftermath of the global financial crisis (GFC) heightened regulations on the banking sector, propelling the expansion of the private credit market.

This market, operating beyond strict banking regulations, emerged as a vital alternative credit source, particularly for risky firms shunned by traditional banks.

The sector's growth is notably underscored by its rapid assets under management (AUM) growth to $1.7 trillion as of mid-2023, from $231 billion in 2008.[1] This surge, despite a general slowdown in fundraising activities across private market asset classes, illustrates the sector's solid foundation and readiness to navigate economic complexities. Indeed, while overall fundraising across private market asset classes saw a 22% decline in 2023, private debt saw a much more modest 13% decrease.[2] Notably, the accumulation of over $500 billion in dry powder globally signifies a potent war chest, ready to be deployed, enabling private debt funds to seize opportunities even in times of high inflation and interest rates.[3]

Navigating fundraising and exit strategies in the U.S. amidst prevailing macroeconomic conditions

The U.S., as the largest market for private credit, commands around 40% of global private credit funds.[4]

The strategic advantages of private debt, particularly in the context of higher interest rates, offer a dual benefit: the potential for increased returns through floating interest rates and the capacity to bridge financing gaps left by traditional banking's cautious lending approaches.

This unique positioning is further amplified by substantial dry powder and increased allocations from limited partners (LPs), indicating a robust growth outlook for 2024 despite inherent liquidity and exit strategy challenges.

Industry trends are increasingly leaning towards a recalibration of financing strategies, with investors favoring the use of more equity and less debt.[5] This shift, primarily driven by the heightened cost of borrowing, presents a nuanced downside risk to private credit markets.

Indeed, rising interest rates and lingering inflationary pressure have not only made leveraging more challenging but have also led to debt multiples descending to a decade low and interest coverage ratios falling.[6] This scenario underscores the mounting difficulties in piling on leverage amidst an environment of increasing borrowing costs.

This has had knock-on effects on fundraising efforts, as private debt fundraising in the U.S. saw a decrease to $144 billion in 2023, marking a 20% reduction from its peak in 2021.[7] Despite this downturn, fundraising levels have remained historically high, even in a less favorable environment.

Indeed, the retreat of banks from traditional financing roles has paradoxically opened new avenues for private lenders. These entities have seized the opportunity to broaden their footprint in financing middle-market deals, effectively expanding their share and influence in the market.[8]

Moreover, there has also been an increase in club deals in the U.S., with the average number of lenders in a single loan facility reaching 2.5 in 2023, enabling the private credit market to have larger and more diverse borrowers.[9] Considering the ample dry powder, this bodes as a positive signal to the sector's growth prospects in the foreseeable future, with this increase driven by limited partners' (LP) growing allocations to private credit funds, which in turn provide financing for new investment opportunities.

With the Fed poised for policy loosening in the second half of this year, the outlook remains cautiously optimistic. Despite an imminent loosening of monetary policy, interest rates are not expected to return to pre-pandemic lows anytime soon. Consequently, yields are expected to remain significantly elevated, though they are expected to moderate slightly.[10] This expected trend offers a silver lining for direct lenders, suggesting an environment ripe with opportunities for those capable of adeptly navigating the nuanced interplay of risk and return.

Despite elevated interest rates, the U.S. economy has remained resilient, fueling confidence that it will achieve a soft landing. Consequently, increased market confidence led to the pricing gap between sponsored and non-sponsored loans narrowing, reflecting a shift towards broader market acceptance of sponsored loans.[11] This change, alongside a decrease in the initial high distress ratios for sponsored loans, suggests a resilient response to economic shocks. Such a trend may boost investment and improve exit strategies, prompting more active fundraising efforts. Investors are now looking to leverage the strong performance of both loan types, highlighting the critical role of portfolio diversification in lending strategies.

In addition, the upcoming refinancing maturity wall in 2024 and 2025 is set to impact the U.S. private debt market significantly.[12]

It is anticipated to drive an increase in fundraising efforts as funds prepare to address these refinancing needs. This situation is also expected to create enhanced exit opportunities for current investments. With a strategic approach and sufficient capital, general partners (GPs) in private debt funds could find advantageous positions for deal-making, especially considering ample dry powder to deploy.

In essence, the U.S. private debt market is navigating through a period of significant transformation and challenge. The interplay of rising borrowing costs, banking sector retreat, and the strategic pivot towards more equity usage frames a market at a crossroads. Yet, within this complexity lies opportunity—especially for those entities poised to leverage their understanding of market dynamics to capture value and drive forward in a landscape marked by fluctuating economic indicators and evolving financing paradigms.

References

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2 *McKinsey & Company. (2024) Private Markets: A slower era*

3 *S&P Global Ratings. (2023) Global Credit Outlook 2024*

4 *Brookings (2024), What is private credit? Does it pose financial stability risks*

5 *Bain (2024), Global Private Equity Report*

6 *ibid*

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8 *ibid*

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11 *S&P Global Ratings (2024), Secondary Markets: Private Credit in the Spotlight*

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Opportunities for new funds/ emerging trends in the U.S.

Degree of opportunity for credit markets posed by macroeconomic conditions

Development	Degree of opportunity for asset class		
	High	Medium	Low
Elevated interest rates	✓		
As the Fed plans to ease monetary policies later this year, interest rates, while expected to decrease, are unlikely to return to pre-pandemic lows. This means yields will likely remain elevated despite an expected moderation, benefiting private credit funds with increased returns. Additionally, the recent relative stability in interest rates is expected to narrow the bid-ask spread among middle market company transactions, potentially boosting deal activities and making the environment more conducive for investments and growth in this sector.			
Retail investing and asset-backed lending strategies	✓		
The robust consumer market in the U.S. offers an avenue for GPs to penetrate the retail sector, with retail investing emerging as a promising trend within the private credit sector. While traditional direct lending remains significant, the rise of asset-backed lending strategies, which involve providing loans secured by receivables, equipment, and inventory, provides investors with an opportunity to diversify their portfolios and access consumer-level credit.			
Increased risk of default and volatile banking sector	✓		
The retreat of banks from traditional financing, due to high borrowing costs, has paved the way for private credit funds to expand their presence, particularly in middle-market transactions. With the U.S. corporate default rate expected to reach 5% by September 2024, the resulting stress and liquidity challenges for certain borrowers present a unique window for private credit funds. They are now positioned to significantly contribute to financing distressed situations and special scenarios, leveraging their innovative and alternative financing solutions to capture a larger share of the market.			
Improved prospects of soft landing in the U.S.		✓	
Improved prospects for the U.S. economy are set to boost investment activities, spurring increased demand for diverse investment opportunities. This optimistic scenario is poised to provide private lenders with a robust platform to navigate and absorb potential external disruptions, ensuring sustained growth and resilience in the evolving financial landscape.			
Intensified regulatory compliance for private credit market	✓		
In September 2023, the U.S. Securities and Exchange Commission (SEC) mandated that private fund advisers registered with the Commission must provide investors with detailed quarterly statements covering fund fees, expenses, and performance metrics. This regulation aims to enhance transparency and protect investors by ensuring comprehensive financial disclosures. Additionally, the SEC requires annual financial audits for all private funds, conducted according to U.S. GAAP standards by PCAOB-registered auditors. Advisers must also obtain independent fairness opinions for adviser-led secondary transactions and are restricted from charging certain fees without proper disclosure and, in some cases, investor consent. These new rules, designed to promote market integrity and protect investors, may impose significant administrative burdens and increase operational costs for private fund advisers, particularly affecting smaller funds and their risk-taking capabilities.			

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