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Private Debt: Few Facts Behind the Fears

Despite a rising tide of negative media coverage, we believe that private debt still has tremendous potential to deliver attractive risk-adjusted returns for investors.

In this piece, we aim to separate fact from fear when sizing up the private debt market, thereby potentially helping investors and allocators capture the opportunities that lie within it.

Boil and Bubble?

The market for private debt gained momentum in the wake of the 2008 Great Financial Crisis as regulatory pressures forced banks to tighten their lending criteria, leading many businesses and private equity sponsors to seek alternative financing solutions. As a source of funding, private debt offers borrowers and private equity sponsors flexible customization, fast execution and the opportunity to collaborate with lenders; as an asset class, it can provide investors with access to consistent cash flows via contractual cash coupons paid by borrowers, as well as the opportunity to generate attractive cash yields with historically low volatility and default rates.

Yet, as the roughly $1.4 trillion U.S. private debt market continues to swell, so has chatter about a potential private debt "bubble". In the first half of 2024, concerns grew over the potential threat of rising loan default rates, renewed competition from leading investment banks in the broadly syndicated loan market, and significant capital accumulation by private debt managers (see figure 1).

FIGURE 1: AS THE PRIVATE DEBT MARKET HAS GROWN, NEGATIVE SENTIMENT HAS RISEN

Note: For illustrative purposes only.

In our view, many of these fears have been overblown relative to the market's underlying fundamentals, as we plan to demonstrate over the remainder of this paper.

Dispelling the Doubt

Defaults

In examining the trajectory of U.S. loan defaults between 2022 and 2024, it would be reasonable to anticipate an upward trend, given the pressures of inflation and interest rate hikes. To gain a better understanding of the current default landscape, we feel it is prudent to dig deep into the numbers.

While loan defaults have increased, we do not believe they have met worrisome projections: Default rates in the U.S. broadly syndicated loan market were expected to reach 4% in 2024, up from 1.8% in 2022, but peaked in the first quarter of 2024 at only 3.6%;[1] meanwhile, U.S. private debt defaults have been *de minimis*, at just 0.4% in the same time period, a figure well below its 2020 peak of 2.3%.[2]

Recognizing that defaults are backward-looking figures and may not be fully indicative of what's to come, it is logical to ask: "Could potential problems be hiding in other places?"

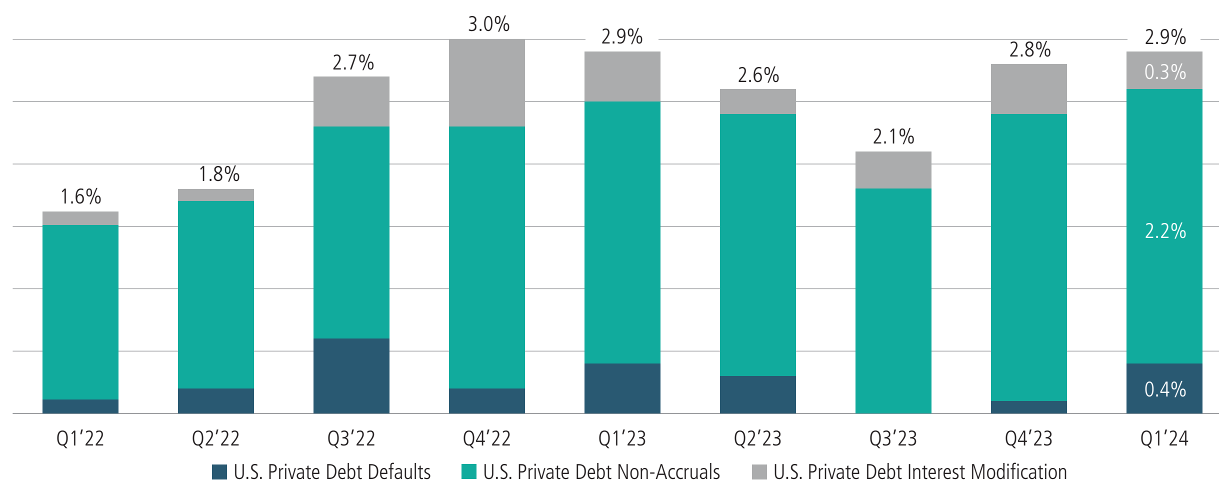
For a clearer picture, let's stack two additional measures of loan underperformance—loans on nonaccrual and loans with interest modifications—onto the aforementioned default figures. The numbers, in our view, are quite encouraging.

First, consider loans on nonaccrual, which are loans that have not gone into default but have been identified by debt managers as potentially vulnerable. As shown in figure 2, the nonaccrual rate for U.S. private debt is 2.2%.

[1] Source: JPM Default Monitor, October 2023. Note: There can be no assurance historical trends will continue or lead to profitable outcomes.
[2] Source: Proskauer Private Credit Default Index.

Next, add interest modifications, where companies may be struggling to service their debt and need some extra breathing room. It is possible that these modifications—such as replacing cash coupon payments with Payment-In-Kind options—partially attributed to the absence of higher defaults. As also shown in figure 2, the rate of loan modifications is 0.3%.

FIGURE 2: DESPITE NEGATIVE SENTIMENT, POTENTIAL DEFAULT RATES STILL APPEAR LOW



Source: Proskauer Private Credit Default Index (defaults include distressed exchanges); KBW equity research. There can be no assurance historical trends will continue or lead to profitable outcomes.

If we aggregate loan defaults, loans on nonaccrual and loans with interest modifications for U.S. private debt, we find the total remains below 3%—a figure we view as relatively modest, and one that *still* outperforms the U.S. broadly syndicated loan market.

In light of this analysis based on the available information, we believe the concern over potentially rising default rates—understandable, perhaps, given uncertainty within the market—is not as magnified as portrayed by headlines.

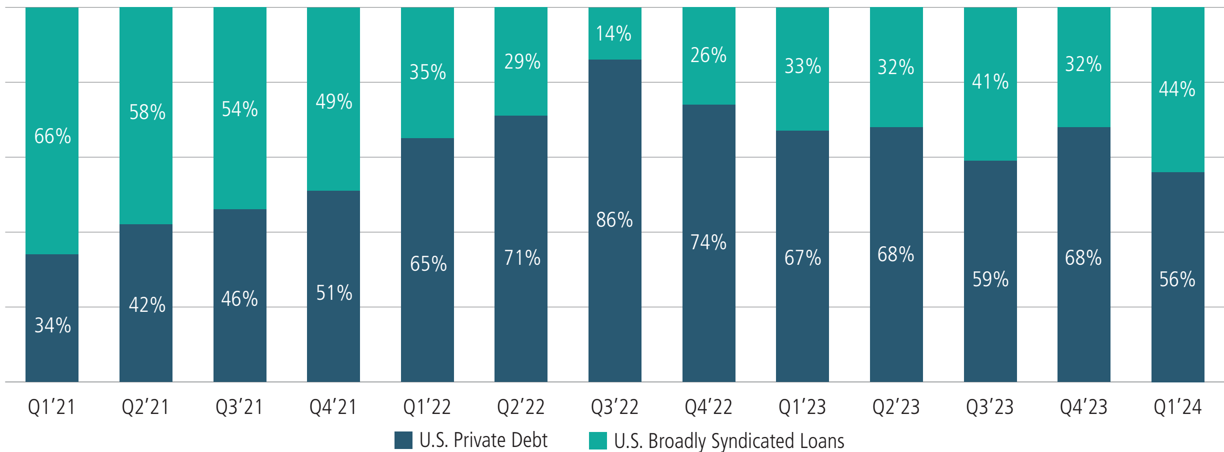
Increasing Competition

Demand for U.S. private debt appears to be holding up to resurgent competition as investment banks have waded back into the broadly syndicated loan market.

In early 2021, we saw record deployment by private equity sponsors who leaned heavily on U.S. banks and broadly syndicated loans to finance their deals (see figure 3). That trend shifted in 2022 as banks grappled with poorly performing loans that became difficult to syndicate. As a result, banks pulled back from lending, igniting demand for private debt throughout 2022 and 2023.

Worth noting in figure 3, however, is that even with the U.S. broadly syndicated loan market's revival in 2024, *U.S. private debt continues to retain market share at or above 2021 levels*. In our view, this is a sign that borrowers and private equity sponsors—some who prior to 2022 had not considered private debt when financing deals—recognize it as a reliable partner in volatile times.

FIGURE 3: PRIVATE DEBT IS TAKING SHARE FROM BROADLY SYNDICATED LOANS



Source: S&P LCD. There can be no assurance historical trends will continue.

We believe private debt's steadfast performance in the face of renewed investment banking competition represents a *sustainable structural shift*. A bubble, in our view, this is not.

Oversupply of Capital

As the U.S. private debt market began to heat up in 2022, it drew investors eager to diversify their portfolios with a historically less volatile asset class offering attractive cash yields. Today, some observers wonder whether the market has amassed too much capital to continue delivering attractive risk-adjusted returns.

While capital flows into private debt have indeed risen in recent years, the increase is by no means alarming, in our view: According to data from Preqin, total dry powder across U.S. private debt managers reached $271 billion in Q1 2024, up modestly from $236 billion in 2020.[3]

Furthermore, we observe a notable supply-demand imbalance between U.S. private equity sponsors and U.S. private debt lenders: Preqin data shows that available dry powder among sponsors is *more than double* the amount among private debt managers[4]—and we expect those sponsors will continue to tap the private debt market to finance their transactions.

Conclusion

Despite recently challenging headlines, we believe private debt has made significant progress in solidifying its reputation as a reliable financing ally amid market instability. As banking regulations continue to evolve, we remain confident that private debt will sustain its value proposition for both borrowers and investors, and we foresee further growth for the asset class. Lastly, we believe that as the landscape of the private debt asset class continues to develop, manager selectivity and highly disciplined investment approaches will be crucial to deliver attractive risk-adjusted returns for investors.

[3] Preqin data, as of the end of Q1 2024.
[4] Ibid.

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