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Private credit's abundant dry powder is great news for CLOs as well as borrowers

The recent rapid growth in private credit funds has garnered much attention from market participants and media pundits. While naysayers warn that this "shadow banking" channel could be a bubble waiting to burst in the higher-for-longer environment, issuers and investors continue to flock to the asset class.

Once a niche corner of fixed income, the now $1.6 trillion market is expected to grow by another $1 trillion+ over the next five years, according to multiple estimates. Borrowers are drawn to the certainty of execution and the likelihood of bespoke lending agreements, while investors are attracted to the seemingly consistent return potential and lender-friendly terms. But now it seems private credit managers might have too much capital and too few investment opportunities.

Broadly syndicated loans prepaid at par

To address this issue, private credit funds have started looking to the broadly syndicated loan market. We have observed some loans being prepaid at par — well above their discounted market prices — and refinanced into new facilities from private credit funds. While private credit is no stranger to the buyout market, regularly taking out challenged and discounted syndicated loans around par is relatively new.

A recent example would be private credit providing the capital for Misys (Finastra) to refinance nearly $5bn of its CCC-rated loan. This was the largest takeout of an institutional term loan by private credit on record, according to Pitchbook LCD. Notably, CLOs owned billions of dollars of this paper — and were happy to be repaid at par. The Misys first lien loan was trading in the low 90s, and the second lien at around 80, before both were taken out at par.

Not long after, Hyland Software refinanced its senior secured term loans with a nearly $3.5bn private credit facility, and PetVet Care Centers refinanced into a $2.3bn private credit loan. These are just a handful of examples of private credit funds bringing CLOs par pay-offs.

While it is still early days for these deals, we believe they are likely to develop into a long-term trend that could improve the overall risk profile of BSL CLOs for years to come. In many cases, these businesses have new money needs or are under credit stress. Private credit solutions in these instances not only provide a buoy to the business they are financing, but also to the CLOs holding the pre-refinanced stressed asset in the form of an unexpected pull to par.

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Private credit flourished out of necessity

To understand why we think these deals are likely to become a trend, it's important to consider how private credit grew into what it is today, and its expanding role in the non-bank lending arena.

Today's private credit market didn't suddenly find itself awash with cash following the recent turmoil in regional banking, although that is a factor. Rather, it began its significant growth in the wake of the 2008 global financial crisis, when new regulation brought bank lending to all but the most creditworthy borrowers to a halt, fostering non-bank lenders as the go-to source of capital for many businesses and private markets participants.

After more than decade of turning to non-bank lenders for a growing number of capital needs, private credit has evolved into a permanent asset class for issuers and investors, and a legitimate lending competitor for banks.

For example, private credit sponsors have recently tapped private credit funds for financing terms and then taken those terms back to banks and the broadly syndicated lenders to negotiate. In most cases, sponsors prefer to find a solution with their broadly syndicated counterparts due to the potential for better non-call and tighter pricing. However, the volume of capital prepared to disintermediate the process, at a cost, does provide borrower CFOs with some leverage in negotiations.

Overall, we believe the growth of the private credit market is positive for the financial system, as these vehicles tend to be stable, especially when compared to banks. We have even begun to hear of private credit fund backstops replacing those of arranging banks in syndication processes.

As with CLO investing, there can be a substantial differentiation in the performance and experience of private credit management teams. Nonetheless, we only expect private credit to continue to grow in the coming years, making room for many differently aligned interests.