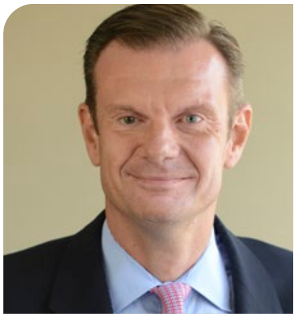
Advertised returns may not pan out, but private credit isn't a bubble



Thomas Majewski
Founder & managing partner
Eagle Point Credit Management

Private credit funds are more stable, lower levered and more regulated than you might think

The private credit market's steady and impressive growth has caused some pundits to voice concerns about an eventual bubble. While we expect there to be more dispersion in private credit funds' performance in the coming years, we don't see signs that a bubble is about to burst.

In our view, the increase in private credit assets over the past decade represents a solution that the industry did not realise it needed until it arrived. This asset class continues to benefit borrowers and investors: it provides borrowers with a source of capital they need to run their businesses, while generating a premium return to broadly syndicated loans for investors.

We also believe private credit contributes to the financial system's overall stability. Structurally, most private credit lenders — for example, business development companies (BDCs), private funds and private credit CLOs — are more stable than the banks they are stepping in for. Most private credit assets are in 'locked-up' funds, which don't suffer from asset-liability mismatches and can see investments through to their final outcomes.

The myth of under-regulation

The notion that these private credit pools are somehow unregulated or less regulated than banks is also without merit. In many cases, the opposite is true. A prime example would be BDCs. As pools of direct loans, they are governed under the Investment Company Act of 1940, making them regulated by a highly protective asset coverage ratio. This means that, by law, BDCs cannot be levered more than two times, compared to banks, which are generally levered as much as 10 times.

Private credit funds, along with the investment advisers of these funds, are also tightly regulated by the SEC. This additional layer of scrutiny has led private credit institutions to implement governance processes — for example, legal, compliance, operational and valuation oversight — to meet the SEC's requirements. The idea that private credit is under-regulated or unregulated is unfounded and, in reality, the sector has multiple levels of regulatory review.

For most investors, the idea of an illiquid asset class might seem like a significant risk. But in situations of declining asset valuations, whether due to economic conditions, the industry or specific borrower deterioration, private credit investors enjoy various protections. The lack of a secondary market for private credit collateral limits distressed debt investors from swooping in to bid troubled loans lower or buy them at heavily discounted levels, hoping to earn a premium return in the workout. Furthermore, direct lenders, private credit sponsors and borrowers have a direct relationship. All sides are incentivised to come to the table to renegotiate terms if a covenant is breached.

Banks are playing catch-up

Although some leaders in the banking industry shunned the private credit market at the outset, many are now playing catch-up as they try to create private credit lending arms to complement their broadly syndicated loan businesses. Perhaps part of the urgency may stem from the relative decline of total banking assets when compared with the strong growth in private credit dry powder.

Meanwhile, according to multiple estimates, the now USD 1.7trn private credit market is expected to grow by another USD 1trn in the coming years. The trend reflects a transfer of assets from banks — the traditional lenders — to private credit lenders.

Since 2008, when bank lending dried up for all but the most credit-worthy borrowers, private credit has filled in. This dynamic played out again following the turmoil in regional banking last year, once again positioning non-bank lenders as the go-to source of capital for many businesses and private market participants. But with so much capital raised in a short time, private credit lenders have had to sacrifice returns and relax covenants in order to deploy capital. As a result, advertised returns in the low double digits may not pan out after the inclusion of credit expense. But we hardly think this means private credit is a bubble.