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Private Credit Insights
June 2023

Why Private Credit Today

Private credit has always been a reliable arrow in the CIO's quiver to achieve consistent and attractive risk-adjusted returns; a confluence of factors in today's market is bringing newfound attention to the asset class. Turmoil in the banking sector, rising interest rates, recessions fears, and geopolitical events have put the public leveraged loan and high yield bond markets under significant pressure. As banks and traditional lenders retreat from the credit markets, private lenders are filling the void they left.

The secular shift toward private credit is expected to continue as banking regulations increase and balance sheet flexibility decreases for the entire banking sector. But what is driving interest in private credit today extends beyond dislocation in the banking system; private credit is providing a much sought-after solution for both investors and borrowers.

The growing acceptance of private credit as a bulwark in any investor's portfolio is accelerating in tandem with the momentum it is gaining as the preferred financing solution by borrowers.

Why Investors are Choosing Private Credit Today

Private credit offers a compelling combination of features to investors: attractive yields with high current income, better lender protections in more conservative capital structures, lower mark-to-market volatility, and resiliency throughout economic cycles. Although this combination has always existed, today's market environment has accentuated the strengths of these attributes.

The attractive yields and high current income in the asset class cannot be ignored. While private credit has always captured an illiquidity premium compared to the broadly syndicated market, higher base rates and wider spreads today allow investors to reap double digit yields on senior secured debt, an increase of 400-500 basis points or more over prior year. This is due to both private credit's focus on floating-rate debt securities and private credit's ability to capture higher spreads and higher original issue discounts from today's market volatility. It is important to note that robust underwriting and active portfolio management are critical in this high interest rate environment as the underlying borrowers will have to service the higher interest burdens.

This higher yield and return doesn't come at the expense of taking on undue risk or accepting fewer investor protections; in fact, the opposite is true. Private credit managers have the opportunity to conduct disciplined, bottom-up credit underwriting, put in place conservative capital structures, and directly negotiate stronger lender protections in credit agreements. It is difficult to overstate the importance of robust lender protections today. For example, private lenders typically negotiate for important structural protections that prevent the movement of collateral to unrestricted subsidiaries or other liability management transactions; those protections often do not exist in broadly syndicated deals leading to certain company names (e.g., J.Crew, Chewy, Envision, Serta) becoming synonymous with critical legal case studies and required reading for lenders.

Further, as private credit managers are buy-and-hold investors with long investment horizons, marks are typically more insulated from public market price fluctuations and exhibit lower volatility.

Lastly, investors who are worried about an impending hard economic landing and recession are choosing private credit due to its resiliency through cycles. In a recession, private credit benefits from being senior within a borrower's capital structure and having directly negotiated credit agreements with tighter terms and superior covenant protections. In addition, private credit investors often have hands-on monitoring and proactive portfolio management capabilities that can help support borrowers through periods of dislocation.

Why Borrowers are Choosing Private Credit Today

Borrowers and private equity sponsors are increasingly turning to private credit as they value the certainty of execution and ease of use that relationship lenders provide. A private credit financing solution means no market flex, no marketing meetings, no unknown outcomes, and most importantly, choosing exactly who is in your capital structure.

In periods of market dislocation, borrowers are also choosing private credit due to a lack of bona fide alternatives. When the syndicated financing markets are shut due to turmoil in the banking sector, a global pandemic, or market dislocations, private credit remains open for business with its committed capital base.

One key difference today is that private credit can rival the syndicated markets in size and scale in a way that had been recently unfathomable, offering a financing solution to a much broader range of businesses through all types of market conditions.

Current Market Trends and Opportunities

This market is seeing the balance of power continuing to shift in favor of lenders with more attractive structures, pricing, and documentation. Leverage has come down a half to a full turn and spreads have increased by 50-100 bps; this is in addition to the base rate being significantly higher than before thanks to the Federal Reserve's 10-consecutive interest rate hikes. On credit documentation, there are more limits on debt incurrence and restricted payments, tighter baskets, and EBITDA definitions that more accurately represent a company's true operating performance.

Valuation expectations between buyers and sellers have remained apart for much of 2023 thus far, driving a decline in overall M&A volumes. That said, private equity dry powder is at record levels and an increasing number of private companies are looking for an exit, often to private equity. As these valuation expectations converge and buyers and sellers acclimate to the new market environment, M&A volume is expected to pick up. It is important to note that private credit isn't just providing capital for buyouts anymore: demand has grown for private credit in non-buyout financings including incremental financings and refinancings.

How to Capture Today's Market Opportunity

Despite the attractive tailwinds to private credit as an asset class today, how a private credit program is implemented is just as important as ever. Managers with experience investing through cycles (specifically through prior high interest rate environonments and periods of economic weakness), a robust origination franchise with long-standing relationships, time-tested credit underwriting discipline, and hands-on portfolio management expertise will have a higher likelihood of generating superior returns with reduced risk. Periods of economic stress and higher interest rates will introduce a greater dispersion of returns among managers and require managers to prove their mettle. If executed correctly, today's market is an opportunity to capture the outsized returns available in private credit without taking commensurate risk.

In August of 2022, we wrote that "in the world of private credit, these will be remembered as halcyon days" – we believe that remains true today as we did then. Private credit has always had its fervent supporters; if today's market is any indication, its fan base is only going to get larger. Private credit is increasingly seen as indispensable to both investors and borrowers and is taking its place as a core asset class in its own right.

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About Crescent Capital Group

Crescent Capital Group is headquartered in Los Angeles with offices in Boston, Chicago, London, and New York. With more than 100 investment professionals and over 210 employees, the firm invests at all levels of the capital structure, with a significant focus on below investment grade credit through strategies that invest in senior bank loans, unitranche loans, high yield debt, mezzanine debt, and other private debt securities. As of March 31, 2023, Crescent Capital Group managed over $41 billion of privately-originated debt investments as well as marketable securities. For more information about Crescent Capital Group, please visit www.crescentcap.com.

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