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Private Credit is Poised for a Multi-Trillion-Dollar Boom, But It Could Get Ugly Soon

Fidelity International and T Rowe Price are among firms making moves; Apollo says private credit will replace other fixed income.

Wall Street's Favorite New Buzzword: Private Credit

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June 5, 2023 at 1:25 AM EDT
Updated on June 5, 2023 at 8:53 AM EDT

First came the debt specialists and the private equity firms. Then, hedge funds and wealth managers saw an opening. Now everyone from sovereign wealth funds to venture capitalists are spouting Wall Street’s favorite buzzword: private credit.

Higher rates, banks’ lending retreat and strong fees are bringing a raft of newcomers to the product that has quickly turned from a niche to a must-have. Amid the proclamations of an industry poised for a multi-trillion-dollar boom, a few voices are warning that it may all get ugly very soon.

DWS Group, Fidelity International, PGIM and T Rowe Price are among the investing stalwarts that are buying or building a private credit franchise. Even SoftBank and Qatar’s sovereign wealth fund are wading in. But if the last decade was marked by low rates and even

lower defaults, the next era will be one of higher upside and more pitfalls.

"Years ago everyone was expecting consolidation as the market grew, but the opposite has happened," Faisal Ramzan, a partner at Proskauer Rose, said in an interview. "We're seeing more first-time funds trying to raise cash and that we think will be tough, at least in the current climate."

The private credit market — which began by catering to private equity businesses and grew rapidly as banks pulled back after the global financial crisis — has roughly tripled in size since 2015 to $1.5 trillion. Apollo Global Management, the biggest alternative credit manager, says the industry could grow to replace as much as $40 trillion of the debt markets.

What's in the Pipeline?

Funds raising money and taking private credit market share
Source: Bloomberg reporting

Like private equity funds, private debt companies raise capital from investors but instead of using that money to take ownership of companies, they lend to them instead.

The relationship between private equity and private credit persists, with many of the biggest PE firms having large private credit businesses they use to finance their acquisitions. Now, while established veterans such as Oaktree Capital Management and BlackRock Inc. continue to raise cash for their mammoth strategies, traditional asset managers including Allianz Global Investors and PGIM are also making moves on what's become a sought-after

option for investors targeting net returns in the high single digits to as much as the high teens.

Private Credit Becomes Mainstream Asset Class

The mix between specialists and broader funds broadens
Source: Preqin
Data as of Q1 2023

The private credit market has increasingly become a catch-all concept that incorporates everything from traditional direct lending to smaller companies, buyout financing and even real estate and infrastructure debt. In short, it's a way for fund managers to capitalize on strategies they say shields them from the volatility of mark-to-market losses in public markets.

Fees for running these strategies are lucrative, and in some instances managers can expect to net around 1%-1.5% on assets under management, and a 15% cut of gains provided they hit an 8% hurdle rate, according to people with knowledge of the matter.

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Laura Benitez On Private Credit Boom (Audio)

Sona Asset Management and Marathon Asset Management are among hedge funds expanding or moving into the sector. Sona is planning to raise at least $500 million for a private credit strategy and will target returns in the mid-to-high teens, its Chief Investment Officer John Aylward said in an interview.

Risk strategies across the array of funds piling in or expanding into the sector differ vastly. From providing credit to back private equity buyout deals, to offering so-called senior secured debt to mid-size

companies with relatively low leverage. Others are also offering higher risk mezzanine financing, which sits between debt and equity, to firms that are struggling. Almost all of the funds that are expanding their presence in the market are hiring experts to help fund raise.

Marathon Chief Executive Officer Bruce Richards said earlier last month that the firm is looking at private asset-based lending and expanding credit facilities to mid-market companies, including those with stressed balance sheets.

Read More: Marathon CEO Sees ‘Golden Time’ in Private Credit Market Boom

Ares Management Corp.’s latest European direct lending fund has raised $8.7 billion so far, as the alternative asset manager seeks to build the largest investment vehicle of its kind.

The investment arm of Deutsche Bank AG, DWS, has increased emphasis on private credit as it continues to invest in its alternatives business. It recently hired industry veteran and former Blackstone executive Paul Kelly to help grow the franchise. Its Chief Executive Officer Stefan Hoops said in an telephone interview that it’s been tough to fund raise for firms without a strong track record in the sector.

Indeed, fundraising is proving a trickier proposition than in previous rounds.

Assets under management in the industry, which have swelled from $500 billion in 2015 to $1.5 trillion, were expected to reach $2 trillion

in 2025. That forecast has since been revised down to $1.8 trillion by Preqin, in a sign of cooling demand.

“Fundraising has been slower and that’s mainly been driven by investors being more cautious, having more questions and wanting to do more due diligence on their fund managers,” Stephan Caron, head of European middle market debt for BlackRock’s private credit business, said in an phone interview.

In the first three months of 2023, the amount raised fell by about 10% to $31.9 billion raised from 33 funds from the same period a year earlier, according to a report by Preqin. The number of funds closings in the first quarter of this year marks the lowest since at least 2017, the data shows.

Fundraising Cools Off

The number of fund closes hits a low
Source: Preqin

For example, almost six months after starting a fund targeting Europe’s wealthy, Blackstone Inc. own figures show it’s attracted €240 million ($258 million) to its new private credit fund, dubbed ECRED. That’s a fraction of the $12 billion raised for BCRED, an equivalent US fund, at the half-year point of its fundraising about two years ago.

Read more: Blackstone’s New Credit Fund Struggles to Lure Europe’s Rich

For the new managers trying to access an already saturated market, it’s turning out to be even more difficult, data from Preqin shows.

Investors Flock To Experienced Managers

The average fund size has grown, but first-time managers not getting more money

Source: Preqin

The figures show the average size of private credit funds.

“Raising capital now is tough for everyone whether you’re big or small,” said Marc Chowrimootoo, managing director at €35 billion alternatives manager Hayfin Capital Management. “What we’ve found recently is that LPs are favoring managers that have an established track record in investing even in tricky markets.”

The saturation of new entrants hasn’t deterred the rolling flurry of asset managers announcing their new strategies or expansions. Allianz Global Investors is stepping up its presence in Asia’s private markets, and SoftBank is looking at deploying as much as $1 billion privately for tech firms.

That’s happened just as the market is set to face another strain. Most private credit funds arrange loans on a floating-rate basis. That boosts returns for the funds as rates rise and protects their holdings from interest-rate risk. But the structure is coming under pressure after central banks around the world embarked on a series of rate hikes to combat spiraling inflation.

Since the start of 2022, the Federal Reserve has raised its benchmark rate 10 times to 5.25% from 0.25%, the Bank of England has hiked its key rate 11 times to 4.5% from 0.25% and the European Central Bank increased its seven times to 3.75% from 0%.

The terms of the majority of private credit investments outstanding today would have been agreed at least 18 months ago, assuming a three-year average life, according to James Keenan, who runs BlackRock's private credit unit. Higher interest payments will stress borrowers' balance sheets and are likely to lead to defaults, he said.

"Those investments were made against a very different economic backdrop from today's," Keenan wrote in a November report for the asset manager. "Subsequent developments have the potential to significantly affect the performance of those companies, their debt and the funds that invested in them."

Canyon Partners co-founder Josh Friedman warned last month about the impact of leverage levels on borrowers.

"There has been an absolute explosion in balance sheets that are no longer tenable if you refinance them in today's interest rate environment," Friedman said during a panel discussion at the Milken Institute Global Conference in Beverly Hills last month. "You've got balance sheets with generally speaking five, six or seven turns of leverage where every dime of cash flow and then some will get consumed by interest."

Market participants also point to risks including the practice of the funds using leverage to juice returns and that several firms are increasingly targeting retail investors. Ares Management Corp., Blackstone, Carlyle Group Inc., CVC and Goldman Sachs Asset Management are all offering access to private credit money pools that require a lower minimum investment.

Defaults for loans in the US have increased for two consecutive quarters, according to data compiled by law firm Proskauer Rose. And they are likely to rise further this year, Michael Mezzacappa, partner and co-head of the firm's private credit group, said in an interview.

So far this year, the volume of defaults in the direct-lending market has reached $1.7 billion, according to data compiled by KBRA Analytics. Some 75% of private credit executives surveyed by Proskauer Rose expect defaults in their portfolios to rise over the next year.

Defaults On the Rise

Signs of stress emerge again in private credit
Source: The Proskauer Private Credit Default Index
Proskauer's Private Credit Default Index tracks senior-secured and unitranche loans in the US

In anticipation of borrower stress, firms including Barings, Blackstone and Bain Capital have been hiring in-house restructuring experts and workout specialists, who have expertise in managing investments during a downturn, Bloomberg reported earlier this month.

Patrick Marshall, head of private debt at Federated Hermes, said he expects to see the number of restructurings across private debt rise and he is only hiring those with 10 years or more of experience and only those who have previously handled workouts.

"There are a lot of people in private credit markets who have never experienced a downturn," Marshall said. "All they know is how to be bullish."

Hermes opened its first private credit fund in 2007 and expects to raise a fourth after adding more staff, with plans to appoint more as needed over the year, said Marshall who helped oversee the wind down of Lehman Brothers' loans and real estate in 2008.

"There's going to be a lot of pain for some direct lenders at at some point in the future," Marshall added.