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Private credit is the better private equity

By Patrick Eisele

When investors are offered double-digit returns with security backing, private lending is an attractive proposition. How much that security will ultimately prove to be worth, however, remains to be seen. The market's rapid growth is another potential source of risk. As a visit to SuperReturn in Berlin showed, sentiment in private credit markets is currently, comparatively speaking, upbeat.

Investors continue to place considerable confidence in private credit funds. Moody's forecasts that global private credit assets under management will reach $3 trillion by 2028. That would represent a doubling from 2023 and a further acceleration in the pace of growth. "Private credit has seen fascinating growth. The asset class is now on a par with private equity and infrastructure," said lending veteran Ted Koenig, founder and CEO of Monroe Capital, at this year's SuperReturn conference. Monroe manages $21 billion in US middle-market credit. For investors, corporate lending offers attractive returns, particularly on a risk-adjusted basis, often close to double digits. Contractually agreed and rapidly recurring cash flows have also become increasingly valuable in an environment where private equity and real estate managers are struggling to make distributions. Investors have also benefited from the rise in base rates since 2022. Diversification is, of course, another argument in favour of private credit.

So, has a golden age arrived for private credit? Yes, if sentiment among private credit and private equity practitioners at SuperReturn is anything to go by. No, if you listen to Robin Doumar, founder of Park Square Capital and another veteran of the lending industry. "Over the past two years, spreads have compressed from 6.5 to 5.5 per cent. Direct lending nevertheless remains attractive." In Doumar's view, private credit is therefore at least still enjoying a silver age. "We are certainly no longer in the private credit Stone Age, when at a conference like this we would have spoken to seven people and four of them would have wandered into the room by mistake." This year's SuperReturn was expected to attract more than 5,500 attendees, with private credit one of the key themes. Like Monroe, asset manager Park Square, which has more than $17 billion in AuM, was founded in 2004.

For most investors, a silver age would be more than sufficient. Whether today's commitments can continue to deliver will depend on the market and on its participants. "This is not the time to increase exposure. Beta in private credit is very unattractive," warned Robin Doumar. He explicitly advised against credit ETFs. "Now is the time to be selective and to focus particularly closely on credit quality." Doumar may well have had Apollo and State Street in mind, which expanded the industry's range of innovations earlier this year with the first private credit ETF. Ted Koenig takes a similar view. "What matters even more now is alpha." Selectivity, he said, is crucial. The industry veteran evidently expects defaults to increase. That expectation also appears to underpin Koenig's more specific advice: "You need to focus on recovery rates. Recoveries depend on collateral and documentation."

Managers lending growth capital to mid-market companies are particularly keen to emphasise their covenants and documentation. "It is not unreasonable to expect higher default rates, if only because that would represent a return to normality," said Matt Harvey, Head of Private Lending at PGIM Private Capital. Harvey puts the current default rate at two per cent a year, below the levels the industry has experienced in previous credit cycles. He agrees with Koenig that security packages and documentation will become more important. These tend to be stronger in the middle market. “In the mid-market, terms and lender protections are more investor-friendly than for larger borrowers, which often demand more issuer-friendly conditions. That also increases the potential for higher recoveries,” said Harvey. He added that as market size declines, alpha potential increases because markets become less efficient.

The case for the mid-market

The private credit market is dominated by sponsored deals. Here, lenders source transactions through private equity funds seeking leverage for M&A activity. The incumbent lender is generally in pole position for new business because it already knows the company, shortening the due diligence process. If the parties agree, the existing capital structure is replaced by a new one. Lenders negotiating directly with borrowers have particularly significant flexibility when agreeing security packages. Deutsche Credit and M&G are examples of lenders that primarily approach mid-market borrowers directly. “Bilateral direct lending transactions in the mid-market require more work in origination and structuring, a regional presence and local expertise, and more intensive credit analysis. In return, competition is significantly lower and both margins and security packages are more attractive,” explained Dr Nicolaus Loos, founder, CEO and CIO of Deutsche Credit. Arrangement fees are therefore charged at the outset, above typical bank fees, to compensate for the additional work. In non-sponsored private debt, Loos can also draw on the contacts he built as Head of Sales at IKB. Deutsche Credit may also benefit from the fact that many German mid-market companies remain reluctant to accept a private equity owner and therefore prefer alternative forms of financing. Conversely, as PGIM’s Matt Harvey puts it: “Family-owned companies are open to private debt.” One other asset manager, however, has withdrawn from non-sponsored deals. His experience: “Entrepreneurs may have substantial wealth, but they also have substantial egos and limited cash reserves.”

For Loos, operating in the non-private-equity-backed mid-market supports both fund returns and stronger security structures. “In the mid-market, covenants tend to be tighter, documentation is better, and margins are often still around 600 to 750 basis points,” said Loos. Larger companies, particularly those backed by private equity, are more commonly financed on covenant-loose or covenant-lite terms, with fewer binding protections for lenders. Margins in this segment are also generally only around 500 basis points and continue to decline.

Robert Scheer, Co-Head of Private Credit Origination at M&G, likewise confirmed that the mid-market, where the British asset manager operates as a senior direct lender, offers stricter loan documentation, less competitive pressure and higher margins. Those margins, however, have fallen by around 100 basis points. “The golden age ended very abruptly in 2024. Banks are back, and competition from syndicated loans and the high-yield market is increasing. Unitranche loans are now being agreed at spreads below 500 basis points.”

Higher standards of collateral and documentation are not confined to the mid-market. They can also be found when investors turn their focus much further east. Asia offers diversification and stronger market growth. “The Asian private credit market is less scalable, more complex and therefore requires more structuring work. But competition is also lower and credit documentation is stronger,” explained Dr Sebastian Schroff, CIO Private Credit & Private Equity at Allianz GI. According to Schroff, average returns of ten to 15 per cent mean that double-digit returns remain achievable, at least for now. “The market is developing and more investors are moving into Asia.”

The case against the mid-market

Large-cap market participants acknowledge that the mid-market tends to offer tighter documentation, but question how much protection this really provides. “Good documentation does not protect you from a bad loan, and maintenance covenants are primarily a tool that allows lenders to enter into more intensive discussions with a borrower at an earlier stage when problems begin to emerge,” explained Christian Schaefer, Head of Private Credit for Germany, Austria and Switzerland at Goldman Sachs Alternatives. Goldman Sachs is one of the world’s largest private credit providers and, through dedicated funds, which is a comparatively unusual structure for a bank, provides privately placed mezzanine, senior direct lending and hybrid capital primarily to companies with EBITDA of €50 million or more. For Schaefer, this market segment provides access to more diversified companies, often with strong management teams and a need for larger amounts of capital per transaction. “From our perspective, the large-cap market offers attractive risk-adjusted returns throughout the economic cycle because default rates tend to be lower than in the small and mid-cap market,” said Schaefer. He added that despite the larger number of borrowers, the mid-market can in fact be more competitive because more debt funds operate in the segment. Private credit lenders to larger companies, however, compete with syndicated loans and the high-yield bond market.

Sometimes, documentation no longer reflects the borrower’s underlying credit quality. It is rational for a lender not to push a company into insolvency simply because a covenant such as the interest coverage ratio has been breached. Instead, the parties can work flexibly towards a solution. One advantage of private credit is that the private lender is often the sole lender, or at least the largest. That gives the parties room to negotiate covenant holidays, changes to coupons, maturities or repayment amounts and schedules. Maturity extensions, often the only point on which a large group of high-yield lenders can agree, are more difficult for closed-ended funds. A loan-to-own strategy, in other words seeking to acquire equity cheaply through the debt, is meanwhile not an attractive proposition if a lender wants to preserve future origination opportunities. Nevertheless, market participants report an increase in debt-to-equity swaps.

Banks and the bright side of shadow banking

As throughout the fixed-income universe, downside protection has to remain paramount. Some readers may wonder whether the real problem is not covenant-lite structures or a recession, but double-digit interest burdens and the selection of borrowers that apparently are not bankable. The latter issue, however, has more to do with the banking market itself. “Savings banks and cooperative banks generally provide loans of no more than €10 million to €20 million. Our focus is more in the €25 million to €75 million range, which is attractive for growth-oriented mid-market companies,” explained Christian Burkard, Investment Partner at Deutsche Credit. “Commerzbank and the Landesbanken are also active in the upper mid-market. But even these larger banks are becoming increasingly constrained by regulation in terms of the lending volumes they can provide. We therefore see them more as potential partners for co-lending models than as competitors per se.”

Arcmont Asset Management takes a similar view. “Our average loan size is €100 million, although we lend up to €400 million, and our portfolio companies have average EBITDA of

€65 million. That means we operate below the liquid market and above the segment of smaller, riskier companies, where competition from banks and savings banks is greater and governance is often weaker," explained Marcus Maier-Krug, Partner and Co-Head of Portfolio Management.

The question of whether borrowers can sustain their interest burden over the long term is nevertheless a valid one. Hamilton Lane recalls that the rapid rise in interest rates in 2022 raised concerns about a potential default cycle. Consider borrowers that had taken out floating-rate loans in a zero-interest-rate environment. In the US in 2021, a loan priced at 500 basis points with a one per cent SOFR floor would have cost a borrower six per cent a year in interest. Today, the same loan costs 9.3 per cent.

Funds nevertheless argue that they provide strategic capital to companies pursuing growth. "Paying us three percentage points more than a bank should not be a problem for these companies," is a view heard within the industry. Because of the sponsored model, private credit funds typically operate in growth sectors such as software, healthcare and services. According to market participants, companies accept the higher cost because the financing is flexible, fast and straightforward. "We can provide larger volumes, and the process is leaner because fewer parties are involved. Repayment is generally bullet at maturity, which gives the borrower greater flexibility," said M&G's Robert Scheer. If the business plan delivers, at least the larger funds can demonstrate their flexibility again. "In a buy-and-build strategy where leverage falls from five times to four times as the company grows, we can provide additional capital and ultimately receive a larger repayment," said Arcmont's Maier-Krug. With €34 billion in assets under management, Arcmont considers itself one of the roughly ten larger private credit firms in Europe. "Scale is important for a pan-European approach because regional markets differ considerably. You need dedicated teams for them, and those teams need to be on the ground rather than sitting in London," said Maier-Krug. Credit managers also must live up to their mantra of flexibility when the buy-and-build strategy fails to deliver. "Of course, funds in Europe are flexible, if only because the companies are unable to pay. At present, there are many extensions and payments-in-kind instead of cash payments," said Mihai Florian, Emerging Markets Portfolio Manager at BlueBay Asset Management.

Three critical trends in private credit

Three current trends could become problematic for private credit: the shift from private equity to private debt, the influx of wealth capital and the move towards larger managers. One reason private credit is enjoying increasing popularity is the weakness of private equity. The former perpetual motion machine of capital calls, value appreciation and distributions, which in turn provided capital for new commitments, has stalled because of the lack of exits and M&A activity and because buyers' and sellers' valuation expectations have moved too far apart. The change in interest rates in 2022 brought that process to a halt. Fewer M&A transactions also mean fewer financing opportunities for credit funds, which themselves continue to grow. "A large proportion of our business comes from our relationships with private equity sponsors. When a company is sold, the entire capital structure is typically refinanced. With M&A volumes lower, there is also less new business for private credit," explained Goldman Sachs's Christian Schaefer. He does not regard this as a serious problem. "In previous years, ownership structures often changed every three or four years. Loans generally run for seven years, however, and if private equity sponsors now hold companies for longer, we are happy to remain invested for longer as well. Another aspect of this development is that companies themselves are seeking to grow actively by making more small acquisitions. These add-on acquisition financings for existing portfolio borrowers also create new private debt investment opportunities."

Lenders and their flexible capital are in demand for other purposes too. Speaking about the private equity community of GPs and LPs at SuperReturn, EQT's Bert Janssens said: "DPI, Distributed to Paid-In Capital, is the word of the conference." Many GPs, he said, are sitting on their assets and therefore on their problems, leaving LPs waiting for cash. Janssens argued for realism and a clean-up of portfolios. "Some exits will not be particularly attractive, although on average they will still come in above current valuations." Until an exit can be achieved, private equity funds can, provided their portfolio companies can support the additional debt, raise more borrowing and distribute the proceeds to their investors. "Dividend recaps are highly relevant because they allow private equity funds to make distributions to LPs before selling a portfolio company. These dividend refinancings provide us with additional deal flow," said Christian Schaefer.

Another major theme at the conference in Berlin was the move into wealth and with it the democratisation of private markets, or alternatively the expansion of AuM on comparatively expensive terms. Moody's notes that retail private debt AuM still accounts for less than 20 per cent of total private debt assets but is growing faster than institutional capital. To access this newer source of funding, asset managers are launching evergreen funds, while some have introduced the first exchange-traded private credit ETFs. Capital from wealth and retail investors is generally expected to flow primarily into credit strategies within private markets, particularly evergreen vehicles, because liquidity management is easier than in private equity due to predictable maturities and regular interest payments. That inflow is not necessarily a bad thing. PGIM's Matt Harvey welcomes the expansion into wealth. "Growth for the industry is coming from the wealth segment. Private credit is particularly well suited to this market compared with private equity because of its greater emphasis on capital preservation and current income. The mass-market business is also positive for asset managers because it deepens the capital base and broadens access to different sources of funding." A further large inflow of capital, however, is unlikely to help returns that are already under pressure. Borrowers are already drawing less debt because interest rates have risen. The crucial question will be how wealth vehicles manage liquidity under stress.

Speaking of stress, participants at the conference disagreed over whether the still relatively young private credit market has ever been properly tested. Around four fifths of respondents to a live poll said no. Arcmont's Marcus Maier-Krug disagreed, pointing out that the past five years have included a pandemic, wars and inflation. "And the asset class still performed." Most asset managers entered the market only after the financial crisis. At that time, many investors suffered significant losses in mezzanine financing. It is therefore reassuring that private loans today are generally senior secured and rank higher in the capital structure.

[Tabelle: Credit has outperformed equity for three years]

Returns in per cent

Asset class	2022	2023	2024
Global Private Credit Funds	3.8	10.2	6.9
Senior	3.3	12.0	5.7
Mezzanine	5.3	10.8	8.3
Distressed	3.5	9.0	7.0
MSCI USD HY Corporate Bond Index	-11.8	12.8	8.3
Global Private Equity Funds	-8.4	5.9	5.6
Real Estate	2.0	-6.2	-3.0
Infrastructure	9.5	8.6	6.1

Source: MSCI; © portfolio institutionell

Fundraising: size matters

Fundraising provides another reason for a critical assessment. As in private equity, the biblical principle that “whoever has will be given more, and they will have an abundance” also applies to credit managers. According to its own figures, industry heavyweight Ares attracted a total of $64.5 billion over recent months across two strategies, including related vehicles and leverage, further cementing its position as global market leader. At the end of last year, Ares had $546 billion in assets under management, of which $359 billion was in credit. Apollo had $751 billion, including $616 billion in credit. At Blackstone, Carlyle and KKR, all listed firms with roots in private equity, credit accounts for around 40 per cent of total assets under management. Those proportions could rise further. “Large asset managers are large asset gatherers,” said Park Square founder Robin Doumar, adding that the biggest brands are now raising more money for private debt than for private equity.

David Allen, Managing Partner and CIO of AlbaCore, an alternative credit specialist and part of First Sentier Investors Group, highlighted the balancing act facing large listed managers as they seek to satisfy both investors and equity analysts. “The growth opportunities for alternative asset managers in private equity are limited. Private equity funds with more than $25 billion in assets are rare. So the large alternative asset managers are expanding their credit businesses. Credit markets are much larger and continue to shift away from banks towards private credit funds. As a result, we have seen US private credit managers continue to grow and large institutional players emerge in the sector. Europe is still catching up because the shift from bank lending to private lenders began later.” Allen added that, from a regional perspective, he expects the growth potential in Europe to be greater than in the US. Dr Sebastian Schroff of Allianz GI, by contrast, pointed out that the shift from public to private equity would continue. He nevertheless also expects credit funds to grow larger and spreads to narrow. His recommendation: “Stay disciplined and do not limit yourself to the mainstream." Allianz GI has offered a secondary private credit strategy for the past two years and as already noted, also lends in Asia. Tikehau and Coller are among the other managers already active in second-hand private credit fund interests.

Emerging markets are worth considering

Continued spread compression in established markets can also be seen as an argument for emerging markets. BlueBay's Mihai Florian said emerging markets offer attractive inefficiencies, strategic opportunities and returns. As one example, Florian points to Brazilian companies with US dollar revenues. "For these companies, financing themselves at current Brazilian interest rates is too expensive. At the same time, US banks will not lend to them because they are non-US companies. BlueBay lends to these businesses against their US dollar cash flows." Florian also sees opportunities among Mexican companies. In India, by contrast, lenders depend on private equity sponsors or promoters and on the equity market as an exit route, which means they are also dependent on the current capacity of public equity markets. A similar situation applies in South Korea. In both countries, lending is primarily conducted in local currency. The emerging markets deal pipeline is supplied by investment banks and large regional banks, which approach BlueBay in London. In Asia, however, a local office network is also required. For emerging markets illiquid credit, BlueBay targets a double-digit net IRR while lending to companies with lower leverage than comparable borrowers in developed markets and with strong collateral and documentation.

The fact that private credit has delivered higher returns than private equity for three consecutive years is an anomaly that cannot persist indefinitely. Continued spread compression as market volumes grow is foreseeable. On a risk-adjusted basis, however, private credit should remain compelling and continue to perform in at least a silver age. For more risk-averse investors, the asset class remains the better private equity.

[Tabelle: Direct lending strategies and their risk/return profiles]

Strategy	Leverage (Debt/EBITDA)	Pricing
Senior	4.0x	E + 425 to 550 bps
Stretched Senior	4.5x	E + 500 to 600 bps
Unitranche	5.0x	E + 550 to 700 bps

E = Euribor

Source: Deloitte 2023 and M&G, August 2024; © portfolio institutionell

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