Market View

by Sergio Grasso

Private debt: not always a backward-looking figure

The private debt market has expanded exponentially over the past decade, driven primarily by funds focused on direct lending. This growth has been fueled by tighter bank capital regulations and, to a significant extent, by institutional investors' ongoing search for higher yields — particularly among life insurance companies and pension funds.

Today, the financial market is dealing, on average, with the third generation of private debt funds (the ones with reinvestment periods that started in 2022-2023).

While the first two generations delivered strong performance, the third has encountered significant headwinds: underperforming credits, rising interest rates, and increased tail risks within portfolios.

Several indicators underscore these challenges (answering the question: how do we know?). First, middle-market CLOs (MM CLOs) in the U.S. have compelled, due to their structures, the portfolio managers to enhance disclosure, providing investors with greater visibility into portfolios' performance and manager' style. Second, the migration of borrowers between public and private markets (from 2022 up until now) has offered a more transparent view of credit quality, exposing weaknesses and complicated credits in some private debt portfolios. Third, a growing number of limited partners (LPs) have begun to voice concerns over disappointing portfolios and internal rates of return (IRRs). I speak with LPs and I see portfolios.

Currently (with obvious dispersion), the performance of third-generation private debt funds closely resembles that of the public high-yield (HY) market, though important structural and crucial differences remain.

Many private loans carry-from the beginning or amended later- PIK features (more than a third of the market), which create ballooning repayment obligations at maturity, increasing refinancing risk. Additionally, companies that accessed private markets in the period 2021-2024 have been more highly leveraged than those issuing in the public space and now show uneven profitability.

As I often note, everything ultimately hinges on returns. This brings us to critical questions:

1. If performance is assumed to be equivalent, does the current spread between public and private debt markets (around 115 bps in the US favoring the private sector) sufficiently compensate investors for the investment illiquidity and limited transparency inherent in private credit?
2. Is the tail event risk upon maturity embedded in the private debt portfolios — though not yet realized — effectively eroding the entire existing premium?
3. Moreover, if the fears around rising default rates in private debt are overstated (or underestimated), as someone suggests, why isn't more portfolio-level transparency being provided to validate this view? (especially in Europe where we do not have Private or MM CLOs?).

Fees and performance-related charges are outside the scope of this text.

The private debt has a solid reputation, and it is an important asset class in capital markets. It would be great to remain confident that it will be able to sustain its value proposition for both borrowers and investors.