Private Credit: No Longer Just For Institutional Investors

Q&A with Scott McCabe, Head of Private Wealth Distribution

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- Private credit is a growing asset class that is attractive to investors because it potentially offers consistent income, low volatility, and diversifications benefits
- Individual investors now have more access to private credit than ever before, thanks to the proliferation of user-friendly investor structures like BDCs

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Private credit is having a renaissance of sorts.

If you follow financial business media, you've likely read how private credit has become the "darling" of the alts industry, delivering double-digit returns typically associated with private equity, but with a level of risk usually reserved for fixed income. What's not to like?

Institutional investors have long understood the appeal of private credit, with its potential for consistent income, low volatility profile, and diversification benefits. Up until the 2008 Global Financial Crisis ("GFC") and the subsequent upheaval in the lending industry, institutional investors dominated the private credit market.

That is no longer the case. For a variety of compelling reasons, private credit has attracted the attention (and billions of dollars) of individual investors in a big way. And we believe that the trend shows no signs of slowing down.

Below, **Scott McCabe**, Managing Director and Head of Private Wealth Distribution with PennantPark, shares his perspective on what's driving the surge in interest in private credit, why the core middle market presents a particularly unique opportunity for individual investors, and what the outlook for private credit is in this dynamic economic environment.

Scott, can you provide more background on how and why the private credit market has grown so much?

We believe the **growth of private credit** has been nothing short of amazing, and that growth reflects an "aligning of the stars" for the asset class in a variety of ways. First is the notable expansion of private equity as private companies, eschewing the costs and complexity of going public, are staying private longer. Since the early 2000s, there has been a 30% decline in the number of U.S publicly traded companies. Over that same time period, we've observed a 60-fold increase in the number of private equity-backed businesses[1]. In other words, private equity is filling the capital void left by the decline in publicly traded companies. This has led to a dramatic increase in demand for debt capital, as private equity investors use debt in their acquisition, recapitalization, and growth transactions.

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[1] *World Federation of Exchanges, World Bank. As of December 2023.*

However, post GFC, regulators essentially forced banks to step back from the private lending business. Because privately held businesses, which again have been proliferating, still needed the infusion of credit capital, the pullback from traditional banks triggered an opportunity for private credit managers to fill that gap. Many asset managers jumped on this opportunity and launched private credit funds as a way to significantly grow their assets under management. And they did, raising billions of dollars through private credit funds, with private equity firms an eager recipient.

This was all happening at a time when the Fed cut interest rates to zero and investors were hungry for yield in their portfolios. Private credit funds are typically comprised of floating-rate loans, loans that generate yields above the risk-free rate. As such, investors were investing in private credit seeking to generate yield (current income) in their portfolios. Fast forward to today and our higher interest rate environment, private credit, specifically direct lending funds, are potentially generating double-digit yields, with potentially strong structural down-side protections.

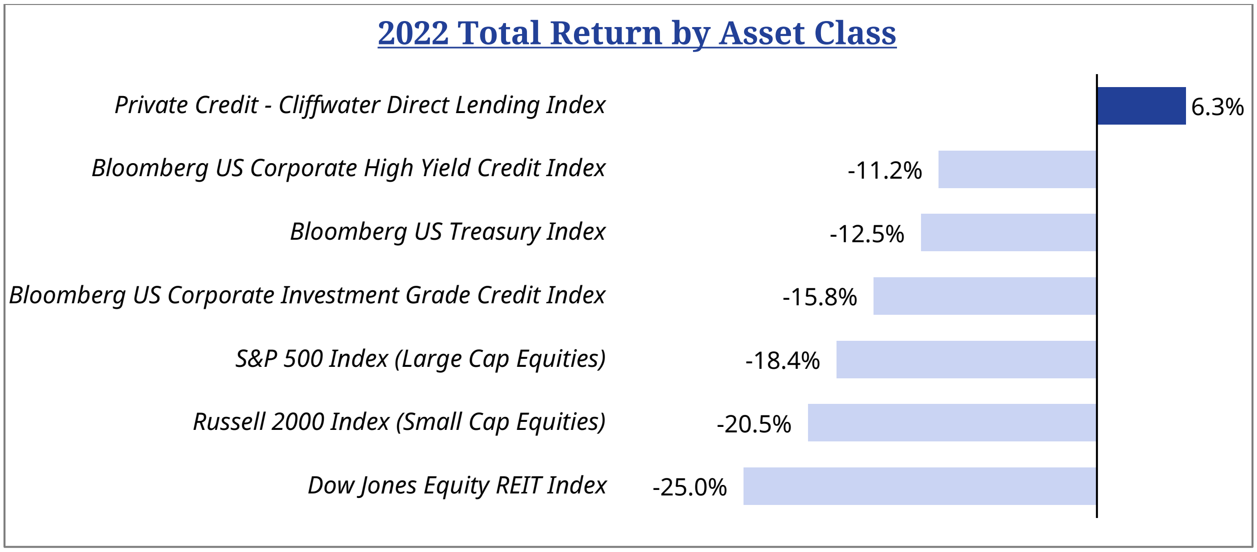
Overall, the private credit market has grown to $1.5 trillion today, from $70 billion in 2005[2]. BlackRock estimates that private credit will grow to $3.5 trillion by 2028[3]. Not surprisingly, we remain very bullish on the private credit market.

Some have referred to this as the “golden age” for private credit. Why is that and what should investors expect going forward, particularly as interest rates decline?

For all the reasons stated above, this is may indeed be a “golden” period for private credit. As interest rates have risen, so, too, have private credit returns. That is what is in large part driving the double-digit private credit returns we’ve been seeing. With that said, we believe private credit is an all-weather asset class that is designed to generate consistent, attractive income in any market environment, with high levels of principal protection. When interest rates do start to drop, private credit is expected to still provide a return premium relative to newly issued liquid credit investments, as floating-rate loan yields sit above the risk-free rates. Additionally, as interest rates go down, the cost of capital for companies will also go down, which may provide a greater level of downside cushion for investors.

Finally, we believe private credit has proven resilient even during severe market volatility. Per the graph below titled 2022 Total Return by Asset Class, public market indices, both equities and fixed income, experienced significant drawdowns (for example, Bloomberg US Corporate High Yield Credit Index -11.2%), while private credit generated positive returns (Cliffwater Direct Lending Index +6.3%). These results demonstrate the diversification benefits of allocating to private credit in a well-diversified investment portfolio.

[2] *Source: Preqin as of December 12, 2023. Private credit market size based on assets under management.*
[3] *Source: The Definitive History of Private Credit, February 2024 and Markets Media: BlackRock Says Private Debt Will Reach $3.5tr by 2028.*



Source: Cliffwater Direct Lending Index. All other performance figures from Bloomberg.

Why do you like the core middle market when it comes to private credit?

We believe that the core middle market truly is the "Goldilocks" of private credit. We define the core middle market as private companies with earnings of $10 million to $50 million. In the U.S. there are approximately 200,000 core middle market companies that generate in aggregate $10 trillion in revenue and represent one third of the U.S. economy.[4] Needless to say, it's a large addressable market.

In addition, this core middle market segment is historically underbanked, which allows private credit managers to negotiate lender-friendly terms in their loans. The core middle market has also provided investors with higher return premiums, lower leverage (risk measure), and tighter financial protections compared to the upper middle market and broadly syndicated loans.

Lucky for us, large asset managers have raised significant amounts of capital for their private credit funds. Because they've raised so much capital, they've been forced to "move up market" and focus on making deals with ever-larger companies to efficiently deploy their massive amounts of capital. The core middle market deals simply do not move the needle for these large asset managers. Those large asset managers and their private credit funds have essentially moved out of the core middle market. That means less competition for those of us focused on the core middle market. It's a great place to be as a savvy private credit investor.

As the headline of this article implies, private credit has been moving from being primarily an asset class for institutional investors to more individual investors and families of wealth. Why is that?

We believe this shift is certainly happening, which is fantastic news for individual investors. I attribute this to the proliferation of more user-friendly investor structures within private credit. For example, the **Business Development Company** (BDC) structure allows individual investors to enjoy benefits of

[4] *National Center for the Middle Market, 4Q 2022 Middle Market Indicator Report.*

high-quality private credit investing with the added benefits of monthly cash distributions, quarterly redemptions, 1099 tax reporting, and lower investment minimums.

Basically, we are in an environment where individual investors have a level of access to private credit that largely didn't exist before. Gone are the days when a $25 million check was required to gain access to private credit funds. Today, access has been democratized for many more investors.

What should investors look for in a private credit manager?

First, you want a fund manager with a proven track record and deep experience investing through various economic cycles. In down markets, the manager should have a proven ability to restructure investments that have gone sideways. In particular, pay special attention to a manager's loss and recovery rates.

Additionally, a stable leadership team that has worked together for a long time is critical in selecting a private credit fund manager, as is ensuring a strong alignment of interests between the fund's leadership team and its investors. For example, do the fund's general partners invest alongside the fund's investors? Look for that. And does the fund structure provide for a reasonable return to investors before the general partners of the fund take their share of the profits? If so, that's a promising sign.

We welcome a conversation; please contact invest@pennantpark.com or the professionals listed below.

Contact Us

About PennantPark:

PennantPark is an independent middle market credit platform founded in 2007 by private credit industry veteran Art Penn (most recently Managing Partner at Apollo Credit). Our clients include some of the world's largest and most sophisticated institutional investors. The Firm is headquartered in Miami with additional offices in New York, Chicago, Houston, Los Angeles, and Amsterdam. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. In addition to middle market CLOs, the firm offers its investment strategies through a range of public and private fund structures.

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