Trends in the global economy are likely to continue to make private debt a compelling investment choice in 2024.
2023 was filled with geopolitical uncertainty, inflationary pressures and rising rates. How should investors think about private credit in 2024? Do the opportunities vary by region? What is the competitive dynamic between alternative and traditional financing providers, and what does this mean for investor returns?

We see several potential opportunities to earn meaningful risk-adjusted-returns.

**FIG. 1 - GROWTH OF PRIVATE DEBT**

Source: Prequin, as of 31st October 2023. Latest data used. For illustrative purposes only.

**LOWER MIDDLE MARKET REMAINS UNDERSERVED**

Private debt continues to grow as an asset class (Fig. 1) given continued bank disintermediation. But the lion's share of capital raised is targeting the upper middle market and leaving the lower middle market underserved.
This creates limited supply for alternative capital for lower middle market private debt lenders to charge c.100-200 bps premium (Fig. 2) to upper middle market comparable financings, aiming towards meaningful return enhancement.

Based on our own experience, we also generally see lower leverage levels in lower middle market transactions at around 3.5x Debt to EBITDA as compared to 5x to 7x for transactions for larger companies. Equity cushions are typically higher - more than 50%.

Source: Cliffwater 2023 Q3 Report on US Direct Lending, as of October 2023. For illustrative purposes only.
In the US, high-profile failures of several regional US banks early in 2023 reignited the call for small banks to increase capital requirements and reduce lending, leaving even more room for private lenders to fill the financing gap left by this crisis. The rise in interest rates has led banks to more heavily concentrate on lending to larger companies, thereby reducing the motivation to target smaller companies that come with higher regulatory capital costs, which has become increasingly less compelling.

There are fewer competitors in the lower middle market. With less competition, lenders are better able to structure more conservative debt profiles, thus allowing for better relative value through higher returns and stricter lending terms.

In Europe and the US, private equity sponsors are increasingly looking at buy & build growth strategies as a way of deploying capital in a highly competitive market. Lower middle-market companies are particularly well positioned to benefit from this strategy as there is a large universe of acquisition targets available at potentially attractive enterprise value multiples. This in turn provides opportunities for direct lenders to continue to support and grow with businesses they know and trust.

Within the European and US high yield bond markets, low net supply is likely to benefit private lenders as traditional issuers turn to private sources of financing as their only alternative; the upcoming wall of maturities and banks pulling back from lending to small and medium-sized enterprises (SMEs) could result in even greater demand for private debt. The combined dynamic will allow private debt managers to take market share from banks and drive better return outcomes for investors.

In Asia, the high yield bond market has been shut to all but high-quality issuers for almost two years now while bank financing is primarily focused on larger companies. This presents an opportunity for private debt to be the capital of choice in the current environment.

With China facing headwinds (property crisis and geopolitical tensions), there has been a visible shift on deal flow focus to Southeast Asia and India where economic growth prospects remain compelling. In addition, return prospects in these markets are further enhanced through bank and capital market inefficiencies. Australia also continues to be a key market for private debt deals with its strong legal framework and an open and entrepreneurial mindset towards business.

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1. Source: JP Morgan, Asia Credit Analytics, as of December 29th 2023
LEND TO HIGHER-QUALITY COMPANIES

We believe private credit lenders need to act with prudence as companies who sought financing in a low-rate environment may now struggle to service their debt. The amount of leverage used in a transaction can significantly impact a company’s ability to grow; this was less of a concern in a low interest rate environment but is much more relevant in today’s climate. As such we are focused on less levered companies which are best able to service their debt and have predictable cashflows in sectors such as healthcare and IT / software services. It is important for lenders to ensure their mandates remain flexible and accommodating; if a company has a solid business model, but is struggling with higher rates, it can be helped with short-term cash flow issues.

For investors, higher rates do mean the potential for larger returns as floating rates increase in tandem with higher risk-free rates. This is on top of the illiquidity premium already embedded in the asset class.

DEFAULTS LIKELY TO BE CONTAINED

Not surprisingly, higher interest rates have had an effect on private credit financing. In Europe, defaults have been contained and the market is holding up relatively well. However, we are seeing amendments to debt covenants which means lenders need to be extra vigilant.

The same applies to Asia and the US where companies are beginning to request waivers or revisions to their interest coverage ratios. Covenant breaches and liquidity challenges are becoming more common as the full year impact of high rates has left its mark. Overall, however, we expect default rates to remain relatively muted in 2024 as interest rates stabilize and gradually decrease.
CONCLUSION

Despite headline economic and political uncertainties, private debt in our opinion remains an advantaged asset class in 2024 allowing investors to benefit from lower risk and higher yields, leading to a potentially strong risk-adjusted-return profile.

More specifically, private debt’s lack of volatility and lack of correlation with public markets is likely to prove particularly appealing against this year’s uncertain macroeconomic and potentially volatile backdrop. This, combined with the opportunity for diversification and potential for high returns, should also contribute to heightened interest in the asset class.

From a lenders’ perspective, the lower middle market offers lower leverage and more conservative structures than larger transactions. The relative lack of competition is likely to underpin our ability to maintain stricter deal terms and tight covenants in an environment less susceptible to commercial bank competition.

We are optimistic that the structural tailwinds and attractive returns observed in the current market environment will make lower middle direct lending exceptionally appealing in 2024.

AUTHORS

Andrew Tan
Head of Asia Pacific
Private Debt

Kirsten Bode
Co-Head of Private Debt, Pan Europe

Rafael Torres
Co-Head of Private Debt, Pan Europe

Michael Smith
Co-Head of Private Debt, US

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