Private Debt: The Appeal, The Fears & The Facts

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Anu Rajakumar: With its rapid growth over the past 15 years, Private Debt has evolved into a $1.4 trillion asset class becoming a significant part of the investment opportunity set. However, the current environment presents unique challenges for this asset class. Investors are wondering how private debt will fare in an environment of slowing growth and lower rates. Why is it becoming an increasingly attractive option for investors, despite some negative headlines? Finally, what are the trends shaping the future of private debt? My name is Anu Rajakumar, and I'm excited to welcome Parrish Smith, Vice President at Neuberger Berman, and a member of the private debt team to help us explore these questions and more. Parrish, welcome to the show.

Parrish Smith: Thanks, Anu. Happy to be here.

Anu: So Parrish, let's start with some of the basics. Can you explain what private debt is and how it's evolved over the last number of years?

Parrish: Sure. Private debt, and for purposes of today's conversation, when we say private debt, we're referring to US direct lending. It involves the sourcing, underwriting, structuring, and holding of private negotiated loans. As you mentioned, the market's at about $1.4 trillion today. Our senior secured loans are extended to businesses owned by private equity sponsors, and they're funded using privately raised capital from investors. The asset class propelled following the great financial crisis when we saw increased regulation on banks that led to stricter and tighter lending standards, which left companies and sponsors to explore alternative financing options.

Then in 2022, we saw banks drastically reduce their lending practices as they had underwritten a series of loans that became difficult to syndicate due to heightened risk aversion by investors, and so borrowers were in a position where they really had no choice but to turn to the private debt markets for financing, and that acted as a real tailwind for the asset class.

Today, we've seen banks resume activity at more normalized levels. The exciting thing is that private debt actually maintained a meaningful portion of the market share that was captured in 2022. To put some numbers on that, in the fourth quarter of 2021, private debt held about 35% of the market share, compared to 65% that was held by the broadly syndicated loan market. Today, those numbers look more like private debt holding 60% of the market compared to 40% held by the broadly syndicated loan market. Again, that comes as banks are back to normal.

Anu: That's great. You went from 35% market share to about 60% market share, which is a huge shift. As the asset class has attracted more and more attention, there are some negative headlines that we've seen a little bit more recently. I highlight that a recent allocator raised concern and suggested that we might be heading towards and I quote "A reckoning moment for private debt, potentially reminiscent of 2008." Parrish, what are your reactions to those sentiments, and how is your team preparing for it?

Parrish: Sure. We're definitely seeing private debt and private credit in the headlines. Some articles are positive, others are not so positive. I'd say from our seat, we've noticed the three common themes being discussed are fundraising and capital accumulation. Then there's default and loan underperformance, and then there's a resurgence of and competition with the banks. We actually put together a market commentary piece back in August titled *Private Debt: Few Facts Behind the Fears*. I'd invite all of our listeners to head to nb.com where we actually take a deep dive into these themes using a ton of data and charts and graphs.

To summarize our views on fundraising and capital accumulation, look, fundraising has definitely been strong. We've seen it slowing this year. I think if you look on an annual basis at the amount of capital that's been raised on a year-by-year basis, the amount of capital that's been raised isn't quite staggering, and there's also been a lot of private equity capital raised. Today, there's more than two times the amount of US Private Equity dry powder relative to US private debt dry powder. If you look at the ratio of that private equity buyout dry powder relative to private debt dry powder, it's actually in line with where historic levels have been so we find that data quite encouraging.

On loans and defaults, I'd say that default rates in the US broadly syndicated loan markets remain below forecasted figures for 2024. Default rates in the US private debt market remain well below those of the broadly syndicated loan market. If you want to take a conservative view, and you stack on current US private debt non-accrual rates and US private debt interest modification rates on top of those US private debt default rates, while the numbers are trending up, they're still relatively modest. Then on competition with banks, I mentioned earlier, despite banks resuming their lending practices, private debt still holds a meaningful portion of the market share. There we believe that borrowers are continuing to see the benefits that private debt has to offer. While there is some skepticism, and some of that skepticism is fair and warranted, we're optimistic about investors being able to continue securing attractive risk-adjusted returns from private debt.

Anu: Now, when you talk about the banks re-entering and resuming activities in this space, is it full on as it was before? Is it more reduced, or is that the direction that you think the bank activity is going in?

Parrish: No, I think the banks are definitely back in action, and they're also hungry. They're definitely looking to transact. Again, as we see these figures and that we've been able to maintain a portion of that market share when the bankers are hungry, it's quite encouraging for us.

Anu: Absolutely. With that said, you said that you're still quite optimistic about the market, the opportunities ahead. What are some of the key aspects that make private debt attractive?

Parrish: I think to that question, you have to think of it through two lenses. First, there's the investor, and then there's the borrower. Let's start with the investor. For investors, private debt has historically offered less volatility when compared to other asset classes. Then within credit, it's offered low default and loss rates. That's really attractive for investors. There's the consistent cash flows that the asset class kicks off and so returns for us are driven primarily by contractual cash coupon payments, which provide investors with cash flow certainty.

Then there's where we sit within a company's capital structure. Our senior secured loans place us at the very top of the capital structure that ensures priority in event of a bankruptcy, and places us senior in right of payment. This is really important when an investor comes to you seeking capital preservation. Then on the borrower side, it's helpful here to make comparisons with the broadly syndicated loan market. While private debt may be more expensive, we're not going to deny that, we do think that borrowers see the benefits it offers and are willing to pay a premium to secure those benefits.

Those benefits include speed of execution. Deals can be completed quite quickly, sometimes in as little as two weeks. There's a simplicity aspect. With private debt, there's a one-step process, generally with a few lenders, unlike the complex two-step process you see with the banks, which could involve many investors. There within the broadly syndicated loan market, first, the borrower negotiates the debt with the bank, and then the bank has to go out and syndicate the debt.

There's price certainty. Within the broadly syndicated loan market, pricing can change between negotiation and syndication in that two-step process I just described. We saw that happen in 2022. Then there's a flexibility aspect, so you can structure the debt within private debt to meet the specific needs of a business.

Let's say you have a borrower that is looking for capital but doesn't need all that capital upfront, private debt can structure the credit with financing options such as a delayed draw term loan to accommodate the capital need that may not require full funding upfront.

Anu: Terrific. We talked about senior secured loans where you're at the top of the capital structure. Then on the borrower side, speed of execution, lack of complexity, price certainty, et cetera, all very helpful. Earlier you mentioned that defaults seem to have been lower than forecasted figures for 2024. I imagine that's probably one of the key risks that folks are concerned about. Maybe speak a little bit more about that or other key risks that your team is focused on.

Parrish: Yes, so I think the biggest risk that we face is losing money, issuing a bad loan. I'd say one of the most important, if not the most important, key performance indicator for us as managers is our default and loss rate. To that, I'd say that risk management really starts at the beginning of the underwriting process. It's extremely important for managers to maintain a disciplined and selective approach when deploying capital.

It's also important to remember that external factors can lead to business challenges as well. It can be something completely out of the business's control, out of the manager's control. Let's say a recession. You have a potential global pandemic. We

weren't expecting that in 2020 or some sort of geopolitical conflict, and these types of circumstances may lead a business to struggle unexpectedly.

To that, we say you want to construct a portfolio where even in the face of an unforeseen challenge, the cash flows of the business that you lend to can withstand the impacts of the challenge, ensuring that your portfolio company can continue to meet their cash coupon payment and on time.

Anu: Absolutely. Parrish, you mentioned recession risks. Obviously, the global economy is starting to slow and beyond that, your interest rates have been a factor driving private debt returns. As rates start to come down, how do you see all of this affecting private debt performance?

Parrish: Why don't I spend some time talking about what we're seeing from a terms perspective, and then I can dive in on how we think about rate cuts?

Anu: Yes, sure. Thank you.

Parrish: As a private debt manager, we are focused on capital preservation and current income. We're not focused on capital appreciation. Our job is to ensure that we get our investors their coupons and return their principal at the end of the day. I mentioned earlier, returns are driven primarily by contractual cash coupon payments. Those cash coupon payments are made by borrowers and then, in turn, distributed to investors. They consist of a floating base rate and a fixed spread. That floating base rate fluctuates relative to benchmark interest rates.

Then the fixed spread is agreed to during the negotiation and is paid on top of that base rate. Today, as it relates to terms, compared to 2021, we're seeing higher base rates. Benchmark interest rates are at some of the highest levels we've seen in almost two decades. Spreads are relatively in the same vicinity that they were three years ago. I will note we have seen some tightening from peak levels reached on the back-end of 2022 into 2023. This dynamic came into play when banks reduced their lending practices and so not too surprised to see that tightening given that the banks are now back in the pictures and borrowers have options when it comes to financing.

On the point of interest rates and where things are going, I feel like that right now is front of mind for many folks. Look, everyone knows the Fed cut rates last month by 50 basis points. We're starting to see a lot of questions as it relates to how this could impact what we do. I will preface this by saying we are creditors, not economists. I'm not here to predict the fluctuation of interest rates. But on the topic of rate cuts, lower benchmark interest rates does translate to lower returns for our investors. It's the reality of it. That's the first thing that comes to mind for many.

I think the thing that we should be talking about is that higher base rates are actually a double-edged sword. While investors are achieving higher returns, it comes at the cost of stress put on the portfolio companies that we lend to. While lower rates does equal lower returns, the reduction of obligations to cover interest can actually lead to an improvement in interest coverage ratios for private debt portfolios, which we view as a positive.

By the way, as we progress into what we can call a more normalized environment, we think that basing our assumptions on where we see the rate curve today, private debt will continue to deliver attractive risk-adjusted returns for investors, add a premium to those of the broadly syndicated loan market.

I think one of the things that we need to remember is that private debt has seen a lower rate environment before. It's performed well in zero interest rate environments. It continues to perform well in elevated interest rate environments. That's why we really see it as an all-weather asset class that shows resilience across varying economic climates. We think that that resiliency plays a really important role in a diversified investor portfolio.

Anu: Absolutely. It's a good reminder that lower rates in this situation can actually enhance the deal flow. As companies, as you alluded to, they can be encouraged to borrow at lower rates that could help the overall market. So helpful to hear that perspective. Parrish, looking ahead curious to hear your thoughts, what trends do you see defining the future of private debt? What's in store looking ahead?

Parrish: We think there's a lot of excitement ahead for private debt. As creditors, we tend to think less about what can go right and more about what can go wrong. While we're optimistic about private debt, we do remain focused on potential risks. We are completely cognizant of the fact that increased pressures on portfolio companies due to higher costs of capital is real. We are

completely aware of the fact that the possibility of higher default rates and non-accrual rates is a concern and continues to be a big focus across our industry.

We acknowledge that there's always going to be a possibility of unforeseen events and we can't guess tomorrow. I think to all of those facts, it really underpins the importance of thoughtfulness by managers when it comes to credit selection and investing. As it relates to the positive aspects, we think there's a lot of opportunity out there for capital deployment. Two points I hit on earlier, there's the amount of dry powder within the private equity space and we think that that's exciting as private equity sponsors seek to deploy that capital. They're going to need financing for their transactions.

There's also the market share that we've captured from the broader lending space and so I would expect that that continues to help us perform well. There are some challenges going on right now within the private equity space. We're hearing a lot about DPI issues, distribution volumes are down, LPs want distributions, GPs also have fixed terms as it relates to the life of their funds. There's definitely a need and a desire to transact and we think that this could act as yet another tailwind for private debt.

Then a point that I didn't touch on earlier is actually the prevalence of private companies relative to public companies in the United States. 85% to 90% of US companies with over a hundred million dollars in revenue are private. These companies are staying private for longer and they're likely going to require financing for strategic initiatives. We think that there's going to be a lot of opportunity as we progress.

Anu: That makes a lot of sense. It's an interesting change from years ago where that was always the goal of companies, the IPO, and now that we're seeing that sometimes not always be the eventual outcome. What about on the fundraising side, any comments on that?

Parrish: Sure. I mentioned earlier fundraising has slowed this year. I think that part of that can actually be attributed to the distribution issue I touched on earlier within the private equity and private market space. Investors have less liquidity to work with which puts them in a position where they're not able to commit to future funds. From what we're seeing, a lot of investors are in the early stages of establishing their private debt allocations and exposure.

There are a lot of investors out there that are increasing their private debt allocations and I'll actually go and say increasing their private credit allocations. The conversation has now been focused more on building out a diversified private credit portfolio which extends beyond private debt and direct lending. I think distress strategies, mezzanine strategies, specialty finance strategies. We're seeing a lot of questions come in on how do I build out that portfolio? It's been really interesting for us at Neuberger to work with our partners who run these strategies as clients are coming to us seeking this broader solution platform.

Anu: Alternative sources of income across the spectrum, yes. Absolutely.

Parrish: Correct. Then I think another exciting thing just happening across the industry is evergreen funds. We're seeing a lot more evergreen funds becoming the norm if you will. They're enhancing the investor experience allowing them to potentially further compound returns over time. It avoids the at times painful manager underwriting process that takes place every few years. I'm sure allocators are thrilled that they can put that behind them should they choose to allocate to an evergreen fund. Then depending on the terms of the fund structure, it offers liquidity and redemption features which I know investors find it quite attractive. With that flexibility, investors can be more thoughtful as it relates to allocating to alternative strategies.

Anu: That's a huge trend that we're seeing in private markets, the emergence of these evergreen funds which is exciting. Parrish, as we wrap up here, any final thoughts?

Parrish: Final thoughts, that's a tough question. I could keep you here for a few hours if you would like.

Anu: We only have a few minutes.

[laughter]

Parrish: No, to wrap up, I'd say, look, we're reading the headlines. We think some are fair, we think that some may be louder than necessary. We're encouraged that investors and borrowers are increasingly seeing and appreciating the value that private debt has to offer. We think that maintaining a disciplined and selective approach is key when managing a strategy where

capital preservation is paramount. Private debt has performed well in various interest rate environments, and we think that the opportunity for attractive risk-adjusted returns regardless of where interest rates stand will still exist. Lastly, we see a lot of growth in runway for private debt and we're really excited to see where things go from here.

Anu: Great. It's an exciting time to be in the asset class. Parrish, before you go I have to ask you a quick bonus question. You've lived in New York City for many years. When you have a friend visiting the city I'm just curious, what's your go-to spot? Where do you like to take friends when they're here to see the sights and the sounds of Manhattan?

Parrish: I am fortunate to live down in the West Village, so whenever I have friends visiting, it usually always involves some sort of restaurant. It's usually me dragging them to a restaurant that I've been dying to try. It's getting a little bit chillier now, but during the summer months, I really enjoy spending time on the West Side Highway. Those are the two things I like to pick.

Anu: Do you have a favorite restaurant or bar that you particularly like?

Parrish: Depends on the day of the week. Right now, Barbuto has been a favorite.

Anu: All right, I'll put that on my list. Excellent. Parrish, we hit on a lot of really critical- -topics today. I appreciate your overview on the asset class, the evolution of private debt, and particularly the notes about the growth of the asset class post-2008 further in 2022 as banks reduced lending activities.

We discussed current macro environment. You highlighted that despite concerns, you're quite optimistic about those attractive risk-adjusted returns that you believe private debt can generate going forward and that you still think the asset class can perform in a lower interest rate environment going forward. Interesting I liked your comments on the outlook and the opportunities for capital deployment due to you talked about private equity dry powder, continued need for financing by private companies, which is still a staggering amount of companies that are staying private.

Lastly, just you wanted to mention that the team did write a paper, which you mentioned earlier on. It's called *Private Debt: Few Facts Behind the Fears*. I hope listeners will go ahead and listen to that. With that recap, I'd like to thank you again for being here and look forward to seeing you again on the show.

Parrish: Thanks for having me, Anu.

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