

# A New Era for Private Credit

Disruptive Forces in Investing

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**Anu Rajakumar:** Private credit markets have been growing rapidly for over a decade, but recent events have added even more fuel to the growth of an already attractive segment of the investment market. With a significant retrenchment in traditional lending, the opportunity ahead for private credit seems significant. But with increased demand from investors and a potential recession on the horizon, what opportunities and risks lie in store for private credit?

My name is Anu Rajakumar, and today I'm welcoming Nikhil Krishnan, managing director of Neuberger Berman Capital Solutions, to discuss the growing significance of private credit in the financial market. Nikhil, thanks for joining me today.

**Nikhil Krishnan:** Thank you for having me.

**Anu:** Now, Nikhil, private credit is an asset class that has been one of the fastest-growing segments for well over a decade. Why don't you tell us a little bit about the evolution of this space and how and why it's disrupted traditional lending?

**Nikhil:** Sure. Well, Anu, thank you for having me. Private credit or direct lending describes the market where lenders, typically institutional investors, are directly interfacing with borrowers. These are typically private equity-backed companies without an intermediary bank. The universe for sponsors and lenders are relatively small. There's a couple of hundred sponsors, couple of hundred lenders. And as private equity has matured, they realized maybe we can directly work with each other to originate these loans and disintermediate the banks.

Initially, direct lending was a product for companies that couldn't get access to banks. It was on the outskirts and the niches of finance. But now, over time, as the market has evolved, more and more companies that used to go to the syndicated loan markets are going to direct lenders. The direct lending market by some estimates is actually larger than the syndicated loan market.

Over the last couple of years, over 90% of new sponsor buyouts have been done by direct lenders. 10 years ago, it was maybe 10%. So I agree with you. It's been this massive growth market, and I think it's ultimately a good thing, right? It's where you have the holders of risk directly interfacing with the borrowers and acting as principles who are long-term incentivized with the right fund structures and is ultimately the result of kind of efficient markets.

**Anu:** Perfect. And, you know, as this area has become more mainstream, we've seen more and more investors become interested in the space, and certainly a lot of the conversations that me and my team, the multi-asset team, are having with CIOs and allocators. They're all interested in private credit. It's like the hot topic, which is why we're so glad to have you here. But, you know, the yields are attractive, the leverage levels are declining, there's good deal flow. With so many investors looking to allocate here, the big question everyone's asking is, is there risk of a bubble forming? What do you say to that, Nikhil?

**Nikhil:** I feel like every week I see a different article that is kind of calling the end to the cycle. But I think if you look at the facts, it's not a bubble as much as a market share shift. Direct lending has taken market share away from the banks. The banks in the end of 2021 underwrote a number of risky loans, that as a result of market volatility and the war on Ukraine, they ended up taking significant losses. These were loans in Citrix, Twitter, and a number of others. As a result of that, banks retrenched. They stopped issuing new paper.

Direct lenders came into this void. Their market share in issuing new debt went from less than 50% to now north of 90%. So they've taken market share. However, the market, which is the actual volume of new loans issued, is down 50% from end of 2021. I would argue it's not a bubble, it's a market share shift. I mean, you don't see dynamics like that.

A couple of facts on kind of why I think there's less of a bubble risk in direct lending. First thing, I think there's much better structures in direct lending than in previous risky credit vehicles. Direct lending fund structures are long-term structures that do not have an asset-liability mismatch and are never forced to sell. They also have a lot less leverage, so typically direct lenders are levered maybe one-to-one. You contrast that with a collateralized loan obligation that's levered 8 to 10 to 1, or in

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the GFC, there were banks that were levered 100 to 1 with overnight repo. That is what causes a bubble. When you have long-term stable structures, you can navigate exogenous shocks a lot better.

I think the second thing that's important is actual leverage is a lot lower today than it was 10 years ago. So loan-to-value today is in the 40s for direct lending transactions versus 70% plus in the GFC, so there's less leverage, more stable fund structures. Investors that are long-term aligned investors, so they're principals, not agents. So all of this shows me a market that's a lot more stable. Will there be defaults? Yes, it's inevitable in risky credit that there will be defaults, but I would argue that the market is a lot better set up to manage through default cycles and I think it's an asset that's here to stay.

**Anu:** Absolutely makes sense. Thank you. You know, Nikhil, you talked about resilience and structural changes that make this asset class potentially more sound. I think that will come to some comfort to folks who are curious about how private credit will do in a recession. Could you speak to that please?

**Nikhil:** I think direct lenders are ultimately the long-term patient investors that have the fund structures to navigate through economic recessions. However, if you look at what's happening to companies right now when you have base rates move from 0% to 5%, a lot of companies are paying 12%, 13% interest on their debt. That's difficult to kind of swallow, so you're gonna see pressures and kind of interest coverage.

You're gonna likely have a lot of companies that require equity infusions or some mechanism to reduce the amount of debt. But I think the big difference in direct lending versus kind of syndicated markets is the borrowers and lenders are in constant communication with each other. They can communicate with each other and work through these cycles. And you also have third-party capital providers that can come in that can help right-size some of these capital structures.

So will there be restructurings in private credit? Like all risky credit, there will be. Yes, inevitably, in cycles, there's restructurings, but I think it'll be in a lot more of a coordinated fashion. There'll be less free-for-all bankruptcies. And everyone in this industry is aligned. They're all rational actors and your behavior and how you behave through a tough time will impact your future viability in this business.

So institutional investors, especially direct lenders, are a lot more collaborative in times of stress. I think that a good example is kind of how direct lenders behaved in COVID, when you had the massive exogenous shock of March and April of 2020. Direct lenders worked collaboratively with companies, providing additional liquidity, waiving covenants, and helping the companies navigate a once-in-a-generation event.

**Anu:** Well, that's great to hear. And, you know, one sort of additional question then would be how do you capitalize on that distress?

**Nikhil:** This is a question we get a lot. And I would say markets have changed dramatically over the last 15 years. The previous playbook used to be when you had a recession, risky credit trades down. Smart hedge funds or opportunistic credit funds buy the debt at pennies in the dollar and work them through a bankruptcy process and buy companies cheap.

That playbook does not work in direct lending. When the market has become increasingly private, you don't have direct lending funds indiscriminately selling their loans. Instead, it's a very different playbook. You need to work collaboratively with the companies, with the sponsors to provide capital to right-size these structures.

So you're seeing this massive growth on capital solutions funds or hybrid capital funds. They're all playing this theme of there is a need for capital that is between first lien unitranche and regular weight common equity that is set up to be flexible in nature that can be used to right-size some of these structures in a recession, but the people that are gonna be successful are the ones that have relationships, that have a reputation of being collaborative and helpful. And I think that there's gonna be a pretty interesting time in the market for the next couple of years for these type of strategies.

**Anu:** Yeah, that makes a lot of sense. And I think all your comments so far really underscore why private credit has been on the minds of so many investors, both institutional and retail as well. Could you talk about the appeal of this asset class to different types of investors?

**Nikhil:** Having 12% first lien in this market is attractive.

**Anu:** [chuckles]

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**Nikhil:** I-it's, uh--

**Anu:** Period, is it?

**Nikhil:** Period. I think that's been the biggest difference right over the last couple of years. The move in base rates has made a lot of investors, institutional as well as retail, really focus in on this asset class and saying, "Wait, I can get double-digit returns for first lien debt in good companies with lots and lots of sponsor equity value?" And this has resulted in, I think, institutional investors saying private credit should be a core asset allocation. That maybe I can expand my private markets allocations beyond just private equity, create a separate allocation sleeve just for direct lending and adjacent strategies, and maybe reduce my allocation to liquid credit.

And some investors that you speak to would actually argue that some liquid credit that's higher rated is arguably more risky 'cause you're taking significant duration risk. And in direct lending, maybe you can trade off some duration risk for illiquidity, but take higher nominal rates. So you're definitely seeing that shift where institutional investors are moving away from kind of selling down their IG or high yield exposure and moving into a private credit allocation.

But I think the big thing you've seen over the last couple of years is almost the democratization of direct lending. You're seeing this demand from retail investors saying that, "I want access to this type of return. I can partner with the best-of-class asset managers who are directly originating these loans and are aligned with me, and I'm getting double-digit returns." That's pretty attractive to a lot of people.

**Anu:** Yeah, absolutely. You know, we've heard from more and more investors, particularly institutional investors, who are blurring the spectrum between liquid and less liquid fixed-income strategies and really thinking about how private credit coexists with their traditional fixed-income allocations. Nikhil, as we wrap up here, I'd love to ask you about your outlook for private credit over the next several years. What are some of your final thoughts you'd like to share with our listeners?

**Nikhil:** Sure. I think private credit as an asset class is large enough that it's sort of an established asset class. However, I think banks are gonna reenter the market. Banks are not gonna be left in the sidelines forever, so you're gonna start seeing more competition from banks as well as direct lenders for the same deals. It's gonna directly result in spreads compressing. It'll create more competition. And ultimately that's good for the economy. That's good for capital markets to have more competition and allow sponsors more flexibility.

I think the second thing you'll start seeing is more adjacent strategies. Direct lending initially was only providing first lien debt, was first lien and unitranche debt. You're gonna start seeing extensions of that. You're gonna start seeing junior capital funds that have flexible mandates, that can do hybrid capital, increase in market share.

I think a big part of this is all tied to kind of the growth of private equity, the maturation of private equity, is people are ultimately gonna think creatively about how they wanna finance their companies, and institutional investors are gonna be more prudent on how they think of risk-return and create more dynamic portfolios that can weather private equity volatility and do that through having direct lending allocations, having capital solutions allocations, and create a more diversified private equity portfolio.

**Anu:** Great. Well, that was all very helpful. Thank you very much for sharing your comments there. Nikhil, I can't let you go without quickly asking you a bonus question.

**Nikhil:** Sure.

**Anu:** So, you know, we're solidly in winter in New York where we finally got snow after two plus years. So, Nikhil, my bonus question for you is, what is your favorite winter sport or winter activity?

**Nikhil:** Um, I shoveled snow for the first time in my life yesterday.

**Anu:** [chuckles] First time?

**Nikhil:** So first time--

**Anu:** How did you manage to, uh, escape that for--?

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**Nikhil:** Uh, I grew up in Dubai.

**Anu:** Okay. That'll do it. [chuckles]

**Nikhil:** We did not have snow. I lived in the city for a long time and I finally moved to the suburbs. So I'm not gonna say that's my favorite.

**Anu:** [chuckles]

**Nikhil:** I like skiing a lot. I really do. I have not been skiing for the last handful of years 'cause my son is just too young, but I think he's gonna hit that age where I can take him skiing this season, so looking forward to that.

**Anu:** Well, that's great. Well, hopefully, there's more skiing and less shoveling snow in your future. That's a great place to end. Nikhil, thank you so much for coming on the show to talk about this asset class, which is so critical for so many investors. You know, you spoke about the evolution of the market, why you don't think this is a bubble, it's more of a shift of the market.

You talked about the resilience of the asset class, the more stable structure to navigate, slower growth as we are in the late stage of the economic cycle. And you talked about the democratization of direct lending and this increased demand from, you know, not just institutional investors, but also retail investors too. So a lot of great content. Again, thank you for coming on here, for sharing your insights, and for joining me today.

**Nikhil:** Well, thank you for having me.

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