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LOUAY MIKDASHI
Head of Multi-Sector Private Credit

JONATHAN SHAHRABANI
Chief Operating Officer, Global Research Strategies
Senior Research Analyst, Financials

Private Credit Is Gaining Steam—Where Do We Go From Here?

A vast menu of private credit arrangements now finance nearly every aspect of the real economy.

As traditional lenders retrenched in the wake of the Great Financial Crisis and, more recently, a spate of regional bank failures, suppliers of private credit have increasingly filled the vacuum. Today, private credit—in its myriad forms—is no longer just an intriguing alternative asset class, but arguably a foundational pillar of the financial system.

This paper discusses the remarkable rise of private credit; the factors that, in our view, will shape its evolution; and its potential to continue delivering attractive risk-adjusted returns for selective investors.

Executive Summary

- Private credit has moved well beyond the borders of traditional corporate lending—a market now in excess of $2 trillion—into myriad forms of asset-backed and opportunistic financing.
- Tightening banking standards, such as the Basel III Endgame, are forcing banks to meet stricter regulatory capital requirements and spur partnerships with private credit providers.
- As the market for private credit continues to expand at a rapid pace, some investors have wondered whether a bubble has begun to inflate. While we acknowledge a crop of new entrants in the private credit arena, we believe this is more indicative of shifts in market share rather than evidence of a widespread bubble.

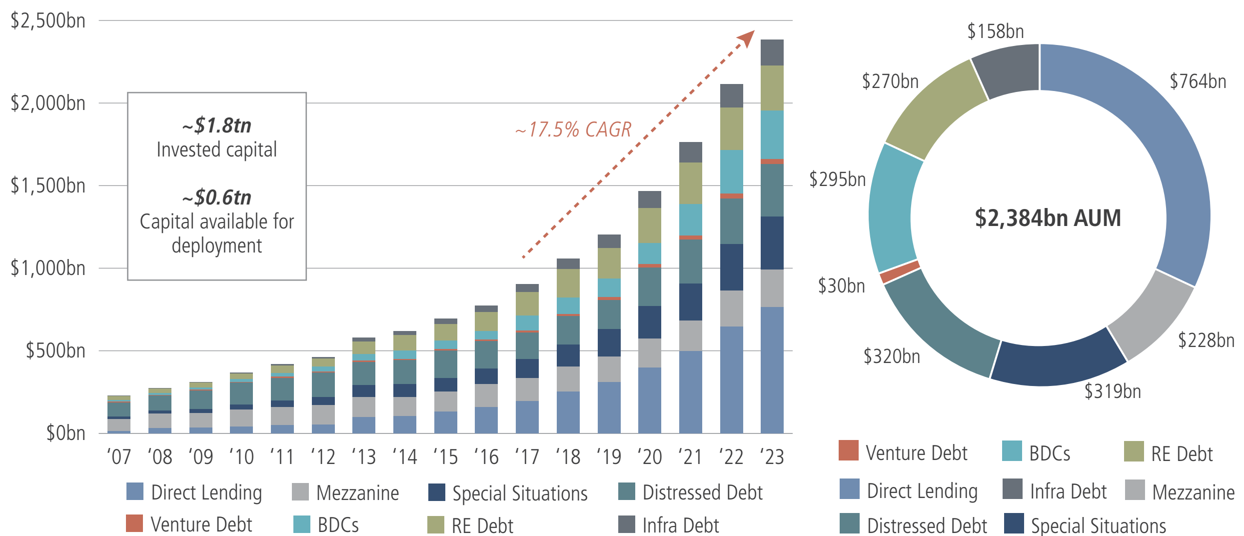
A Vast Menu of Credit

In 1899, the American Telephone and Telegraph Company issued what may have been the first "private placement memorandum." The modern private credit market was born.

But private placements were just the beginning. Today, a vast menu of private credit arrangements now finance nearly every aspect of the real economy. On the heels of the 2008 Global Financial Crisis, the global private credit market had grown to $230 billion; at last count, it had reached north of $2 trillion (see figure 1).

FIGURE 1: THE GLOBAL PRIVATE CREDIT MARKET HAS GROWN DRAMATICALLY SINCE THE GREAT RECESSION

Global Private Lending AUM



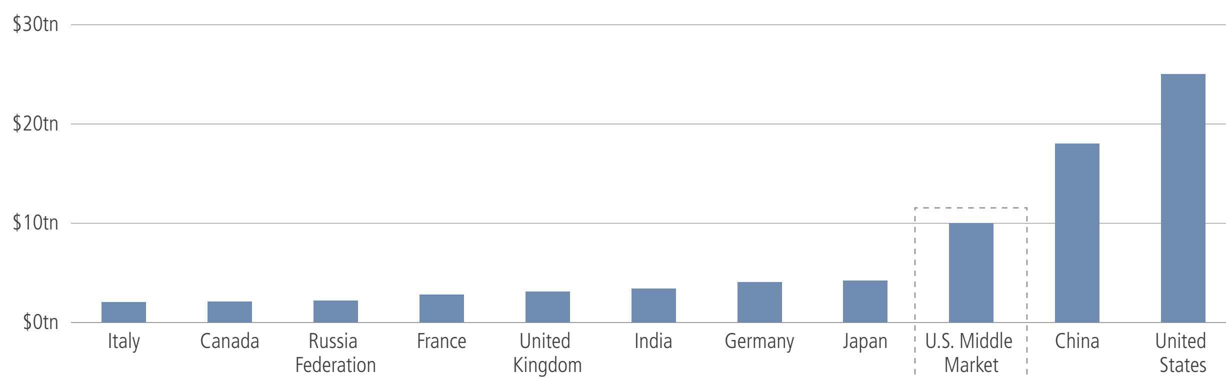
Source: Preqin, Goldman Sachs Global Investment Research, as of December 31, 2023.

The charts in Figure 1 primarily capture the most established segment of the private credit market—corporate lending—which mainly focuses on financing acquisitions led by private equity (PE) sponsors. But with stunning growth came increased specialization beyond the borders of corporate lending, including various forms of asset-backed and opportunistic financing.

Asset-backed lending covers a range of strategies, such as consumer credit, commercial and residential mortgages, equipment leasing, project finance and fund finance. Opportunistic lending covers all other niche segments, from insurance-linked securities to litigation funding. Taken together, the total addressable market for private credit could reach $5.4 trillion in 2027.[1]

In particular, we think the large U.S. middle market (see figure 2) will continue to yield attractive opportunities for selective private credit providers. Thus far, direct lenders have primarily targeted PE-sponsored companies, yet some are increasingly turning to non-sponsored borrowers as well.

FIGURE 2: THE MASSIVE U.S. MIDDLE MARKET REPRESENTS A SIGNIFICANT PRIVATE CREDIT OPPORTUNITY
GDP by Country



Note: Middle-market companies are defined as those with between $10 million and $1 billion in revenue.
Source: National Center of the Middle Market, "Middle Market Update," August 9, 2023; The World Bank, 2022.

Evolving Regulatory Regime

We believe the emergence of private credit has been driven in part by bank regulation intended to strengthen the stability of the financial system.

This shift—underway well before the sudden downfall of Silicon Valley Bank (SVB) and others in the spring of 2023—has gained further momentum in the wake of the "Basel III Endgame," a regulatory standard (likely set to phase in over the next few years) that seeks to establish stricter capital requirements for banks.

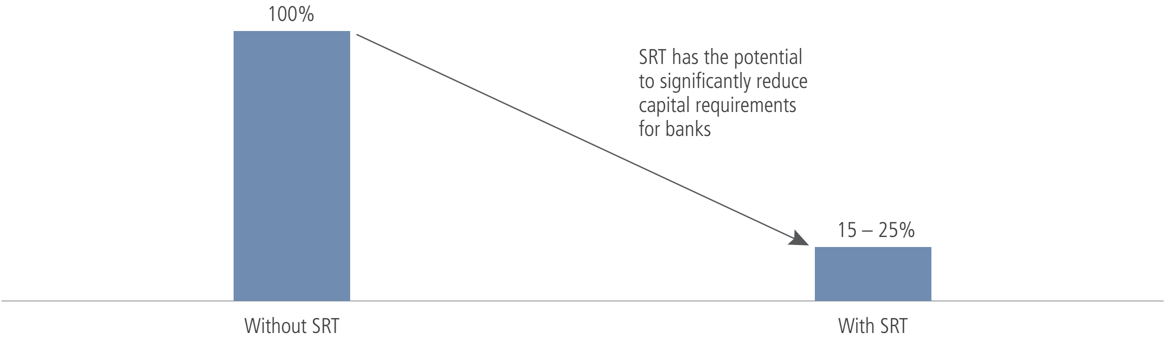
If implemented in its current proposed form, the Basel III Endgame would compel large U.S. banks to increase common equity capital requirements against risk-weighted assets (RWAs) by upwards of 20%.[2] While we expect the final rule will be softened, its ultimate impact is still likely to be material—and indeed many banks have since gone on "RWA diets" that have implications for both sides of their balance sheets.

On the asset side, we have seen banks reduce their exposure to certain loans, or exit some sectors altogether. We are also seeing increasing origination partnership where banks seek private capital providers to take a portion of their non-investment grade risk.

On the liability side, banks are increasingly embracing "significant risk transfer" (SRT) arrangements, which are designed to shift first losses on risk-bearing loans to SRT buyers. These strategies allow banks to slim down their RWAs and reduce the amount of capital they are required to hold, thereby unlocking resources for other endeavors. As illustrated in figure 3, SRTs can significantly lower the risk-weighting assigned to a group of loans—say, a capital call facility—to 20% from 100%.

[1] Goldman Sachs Global Investment Research, as of December 31, 2023.
[2] The U.S. Federal Reserve, July 18, 2023.

FIGURE 3: OPTIMIZING RISK – THE POWER OF "SIGNIFICANT RISK TRANSFER" (SRT) ARRANGEMENTS
Risk Weight on Assets (%)



Source: Neuberger Berman.

Redrawing the Financial Map—Safely and Transparently

Amid the tightening regulatory regime, *we believe traditional lenders and non-bank private credit providers are forging an increasingly symbiotic relationship* across both sides of the balance sheet.

At the same time, some observers have expressed concerns over the perceived opacity and light regulation of private credit markets. While we acknowledge that some areas of the market may face stiffer competition as capital formation increases, we believe on the whole that selective private capital providers not only court reasonable levels of risk, but also help bolster the overall stability of the financial system.

First, unlike most banks, which rely on funding from deposits (which can be short-term in nature), most private credit strategies are match-funded, meaning that their assets and liabilities have similar duration profiles. We believe this reduced asset-liability mismatch makes private capital providers logical holders of longer-duration assets.

Second, we find that private credit funds often take on less balance sheet risk by employing either modest leverage (up to 1-times equity capital) or none at all. Banks, by comparison, tend to be levered 10 to 1.

Third, we believe private credit arrangements can be more transparent than critics suggest.

Take Business Development Companies (BDCs), an approximately $300bn sector that invests primarily in direct loans.[3] As regulated investment companies, BDCs must disclose, via quarterly public filings, not just the composition of their portfolios, but also their valuation methods and investment performance. Although banks must adhere to rules set by the Federal Reserve and other banking regulators, their disclosures tend to address the broader health and credit quality of their balance sheets rather than specific details about individual loans.

Is a Private Credit Bubble Brewing?

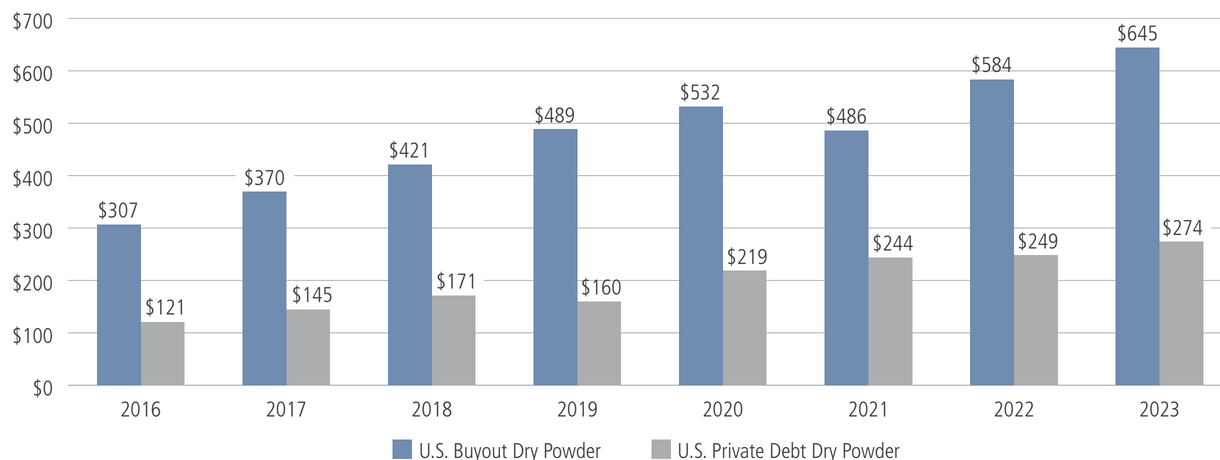
As the market for private credit continues to expand at a rapid pace, some investors have wondered whether a bubble has begun to inflate. While we acknowledge a crop of new entrants in the private credit arena, we believe this is more indicative of shifts in market share rather than evidence of a widespread bubble.

Consider, as a start, the pronounced supply-demand imbalance between PE sponsors and private credit providers. As shown in figure 4, the amount of unallocated PE capital is nearly twice that of private debt. We believe this disparity underscores not only the unmet demand for debt financing, but also the ability of private credit markets to absorb additional inflows without unsustainably inflating asset prices.

[3] Source: Keefe, Bruyette & Woods, "Inside the Private Credit and Non-Bank Lending Market: A Comprehensive Examination of the BDCs and Direct Lending Industry", October 2023.

FIGURE 4: DRY POWDER DISPARITIES DON'T SUGGEST A PRIVATE CREDIT BUBBLE

Dry Poweder ($Bn)

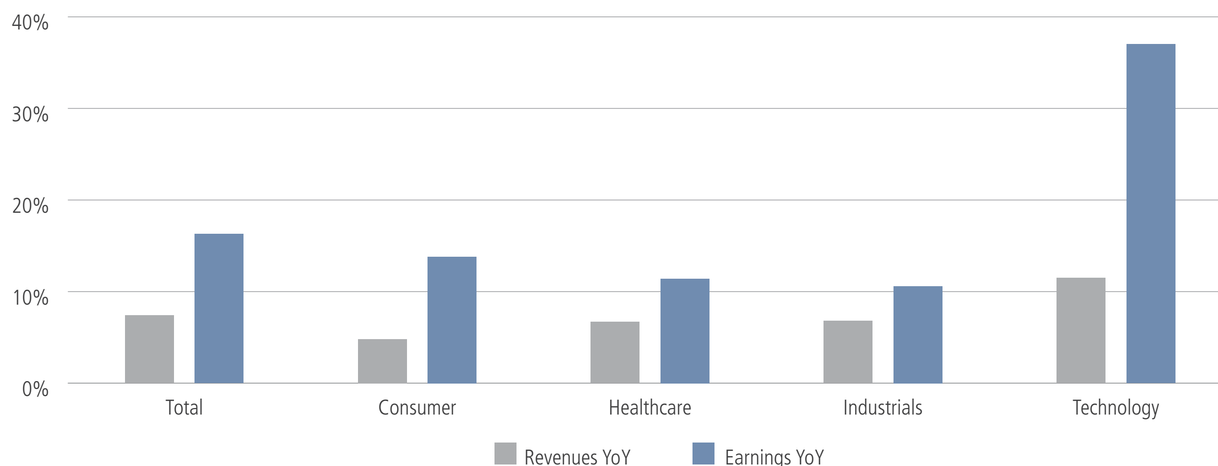


Source: Preqin, as of December 31, 2023.

Next, we think demand for credit could remain strong well into the new year—especially within the middle market, which often relies on private credit—and could continue to offer fertile ground for prudent lending. The National Center for the Middle Market estimates that 65% of these companies expect year-over-year revenue growth—and about 60% expect to expand their workforces—through the second quarter of 2024.[4]

PE-backed middle market firms, in particular, continue to post strong performance. During the first two months of Q4 2023, earnings within this subsector grew by 16% year-over-year, while revenues increased 7% (see figure 5). The technology sector continues to be a standout performer with earnings and revenue growth of 37% and 11%, respectively.

FIGURE 5: PERFORMANCE OF THE MIDDLE MARKET POINTS TO CONTINUED STRENGTH



Source: Golub Capital, data through the first two months of Q4 2023.

[4] National Center for The Middle Market, Mid-Year 2023 Middle Market Indicator.

Furthermore, loan losses in this subsector are historically low and have remained below thresholds observed during the COVID-19 pandemic.[5] We believe this challenging period provided a meaningful (albeit brief) stress test, revealing private credit's potential durability in the face of unprecedented economic volatility. Rising base rates over the last 18 months have further tested that resilience, yet strong performance has generally persisted in the market.

Meanwhile, PE sponsors have played a pivotal role in bolstering the financial stability of their portfolio companies. By injecting additional equity, they have enhanced liquidity and provided a cushion against downturns. We think sponsors' proactive approach is a testament to the strengthening relationship between PE and private credit, wherein both parties have a vested interest in the success and solvency of their investments.

Conclusion

Looking ahead, we expect the burgeoning market for private credit will continue to expand and evolve, driven by shifting regulatory regimes, deepening partnerships with traditional lenders, and the continued potential for attractive risk-adjusted returns. Moreover, we believe the remarkable rise of private credit reflects its increasingly important long-term role within an ever-changing financial landscape.

[5] Proskauer, "Proskauer's Q3 2023 Private Credit Default Index Highlights the Resilience of Private Credit in a Turbulent Economy", October 24, 2023.

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1290 Avenue of the Americas
New York, NY 10104-0001

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