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CLIENT ALERT

Seven Key Takeaways from The Fourth Annual U.S. Private Credit Industry Conference on Direct Lending

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This week Willkie Farr & Gallagher LLP attended the fourth annual U.S. Private Credit Industry Conference on Direct Lending hosted by the Loan Syndication and Trading Association and Deal Catalyst. Seven key takeaways from a vast array of conference panels, private meetings and industry discussions with a diverse set of fund sponsors, institutional investors, allocators, originators, rating agencies, wealth managers and many other industry participants are outlined below.

Private Credit Growth Continues

Private credit continues to expand as a core allocation for institutional investors who are increasingly shifting allocations from traditional fixed income securities and broadly syndicated loans to private credit assets due, in part, to its attractive risk-adjusted, lower-correlated and less volatile, return profile, diversification benefits, relational-driven components and solution-oriented protections for stressed and distressed scenarios. Uncertainty surrounding U.S. trade policy, geopolitics and the broader macroeconomic environment has many sponsors taking a more measured approach to underwriting. However, well-diversified asset managers with broad sourcing funnels and scaled execution capabilities continue to see and capitalize on high-quality opportunities, despite a slowdown in M&A deal activity. Managers with narrower skill sets, particularly those operating in sectors with higher U.S. trade policy sensitivities, may be somewhat tested to the extent M&A deal activity remains slow. In such cases, some sponsors cautioned against the potential for heightened risk for overextension on less attractive terms by less experienced managers in an effort by those seeking to achieve absolute returns.

On the demand side, company borrowers, including large cap corporate borrowers with broad capital markets access and stable cash flows, continue to recognize the benefits of private debt funding sources as a tool, and one which carries a vast array of benefits beyond traditional relief use cases. In fact, many sponsor-backed companies have begun to solicit dual-track financing options simultaneously from traditional and non-traditional lending sources, in an effort to leverage and market-test both channels for optimal financing packages, after taking into account a vast array of financial and non-financial factors. The shift by companies to seek private sources of capital is consistent with the continued trend towards privatization of markets generally over the past few decades.

Trends in Asset-Based Lending and Other Lower EBITDA-Correlated Strategies Continue to Build Momentum

Growth areas beyond traditional direct lending include asset-based finance, real estate, infrastructure debt, securitizations and other structured products. On the demand side, bank retrenchment, coupled with the recent challenges faced by regional banks, has created a financing gap for small-and medium-sized businesses, which gap continues to be filled by non-traditional lending sources. A higher interest rate environment has, in some cases, also created more LTV cushion for those specialty finance lenders operating in spaces less susceptible to fee compression by way of lender competition. However, specialty finance providers underwriting to equipment, inventory or other non-financial consumer goods are exercising caution on downside case modeling, particularly to the extent collateral valuations become affected through increased supply chain volatility. Consumer financial assets such as credit card loans, residential mortgages, student loans, auto leases and online lending, in addition to entertainment and media financings, continue to attract high demand. Global trends like energy transition, digitalization, and AI expansion have created a global funding gap for infrastructure projects, resulting in significant demand for alternative financing sources. An approaching maturity wall for commercial real estate loans is also top of mind for many industry participants.

On the supply side, non-corporate credit strategies have become increasingly attractive to investors seeking exposure to assets which are lower-correlated with corporate valuation risk, and which carry downside protection often structured in the form of tangible, bankruptcy-remote, self-liquidating collateral. Self-liquidating assets also typically produce more stable cash flows, which can be attractive for DPI construction in a lower distribution environment by traditional private equity funds, and can also be helpful for incorporating liquidity features in fund product design. More structurally complex financing solutions can also justify higher pricing, while being less replicable by nonspecialized lenders, and may thus be somewhat less susceptible to price compression.

Insurance Companies, Investment Banks and Retail Investors Likely to Play Pivotal Roles

The intersection between insurance companies and asset managers continues to expand, as insurance companies seek higher risk-adjusted returns and asset managers seek additional sources of capital. Acquisitions of insurance business lines and allocation arrangements between insurance companies and asset managers continue to materialize as insurance companies seek access to a stable flow of private debt assets and managers seek AUM growth. Access to end-investors through insurance channels is also factoring into such strategic partnerships.

A race for additional assets has similarly fueled strategic arrangements between asset managers and investment banks, wealth managers and financial advisors, who continue to invest in building out retail channels, distribution networks and investor education initiatives. Industry participants also continue to vie for allocations from target retirement funds and other 401k and long-dated retirement assets.

Product Design Becoming Increasingly Important

On the capital formation side, a diversified offering of well-tailored entry points designed to accommodate a multiplicity of investor needs has become critical for sponsors seeking to capture increased allocations to private credit. Despite, or perhaps in light of, a newly developed principal-based bond definition by the NAIC, nationally recognized rating agencies continue to see an increase in rated private credit assets, and while administratively complex, private fund sponsors are increasingly designing rated-note feeders and other rated or insurance company dedicated structures to accommodate demands of rating-sensitive investors.

Private credit investment strategies have also been at the forefront for sponsors seeking access to the retail channels. Traditional private fund sponsors are increasingly turning to traded and non-traded public and private BDCs, interval funds, and hybrid liquid products in an effort to attract additional inflows from high-net worth investors. Recent steps taken by the Securities and Exchange Commission also reflect a policy shift designed to facilitate increased access, including the streamlining of Rule 506(c) verification requirements, providing “simplified” exemptive relief for co-investments between BDCs and private funds, and enabling multi-share class exemptions. However, the potential for liquidity mismatch is something sponsors are increasingly reckoning with. Structuring BDCs, interval funds, evergreen structures and other semi-liquid products can be challenging for those sponsors that want in on retail inflows but pursue more illiquid investment strategies, and has the potential to create cash flow challenges generally for managers unfamiliar with, or ill-equipped to administer, such products, particularly with exposure to a potentially more fickle retail investor base. This tension in liquidity may increase in times of economic stress.

Increased Attention to Systemic Impact

Since their rapid expansion in the wake of the global financial crises, the nonbank lending markets have come of age during a period of relative sustained growth. Thus far, interest rate hikes have not appeared to have had a material impact on default or recovery rates. However, when/if a deterioration in broader markets occurs, some wonder what systemic effect, if any, potential losses in the non-bank lending sector would have across the broader global economy, particularly should insurance company and retail exposure increase into a more opaque, private lending space. Regulatory bodies such as the FSOC, FSB, OCC, NAIC and others continue to monitor this development. Many market participants believe that non-bank lending alternatives actually reduce systemic risk, as was exemplified following the global financial crises.

Incidents of Lender-on-Lender Violence May Continue

To compete on opportunities during price-compressed, lower-rate environments, many middle-market direct lending sponsors were willing to sacrifice on terms, leaving loopholes customarily utilized by leads in the broadly syndicated market, whereby certain lenders prioritize their interests above other lenders. The bleed of LME maneuvers into the clubby private credit markets has resulted in more attention being paid to loan documentation, and an increased focus on covenants, to ensure productive dialogue ensues and to bring private lender groups around the table when signs of stress first begin to emerge.

Private Credit Fund Secondaries and other Liquidity Solutions Experiencing Growth as an Asset Class

A growth in private credit AUM has also led to a dearth of private credit secondary opportunities. Increased LP-led and GP-led secondary transactions have led to a mature private credit secondaries market, similar to the growth seen for private equity funds, and dedicated private credit secondary funds continue to gain popularity. Given the somewhat less precious nature of diligence materials relative to private equity strategies, private credit managers also seem more willing to accommodate secondary sales to dedicated funds raised by competitors. The structuring of collateralized fund obligations also continues to expand, enabling late entrance to more quickly diversify, and scale their exposure to, potentially rated and higher-yielding, private credit assets and early entrance to achieve early liquidity and more efficiently rebalance their portfolios. Many non-bank lenders also continue to see NAV facility financing as an attractive, non-corporate correlated, investment opportunity. Although non-bank lenders have entered the subscription-backed lending business, price competition amongst traditional lenders on sub-line originations have resulted in price compression and somewhat thin spreads, which, for certain non-bank lenders, are less appealing. However, momentum is building over securitized, and broadly syndicated, sub-line debt, which may be attractive to investors seeking exposure to a rated, structured product, or a more diversified, and tailored, yield, while benefiting lenders who can then underwrite additional financings.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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