M Capital Group

Private Credit

Private Taking Over Public

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M Capital Group

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Our Word is Our Bond

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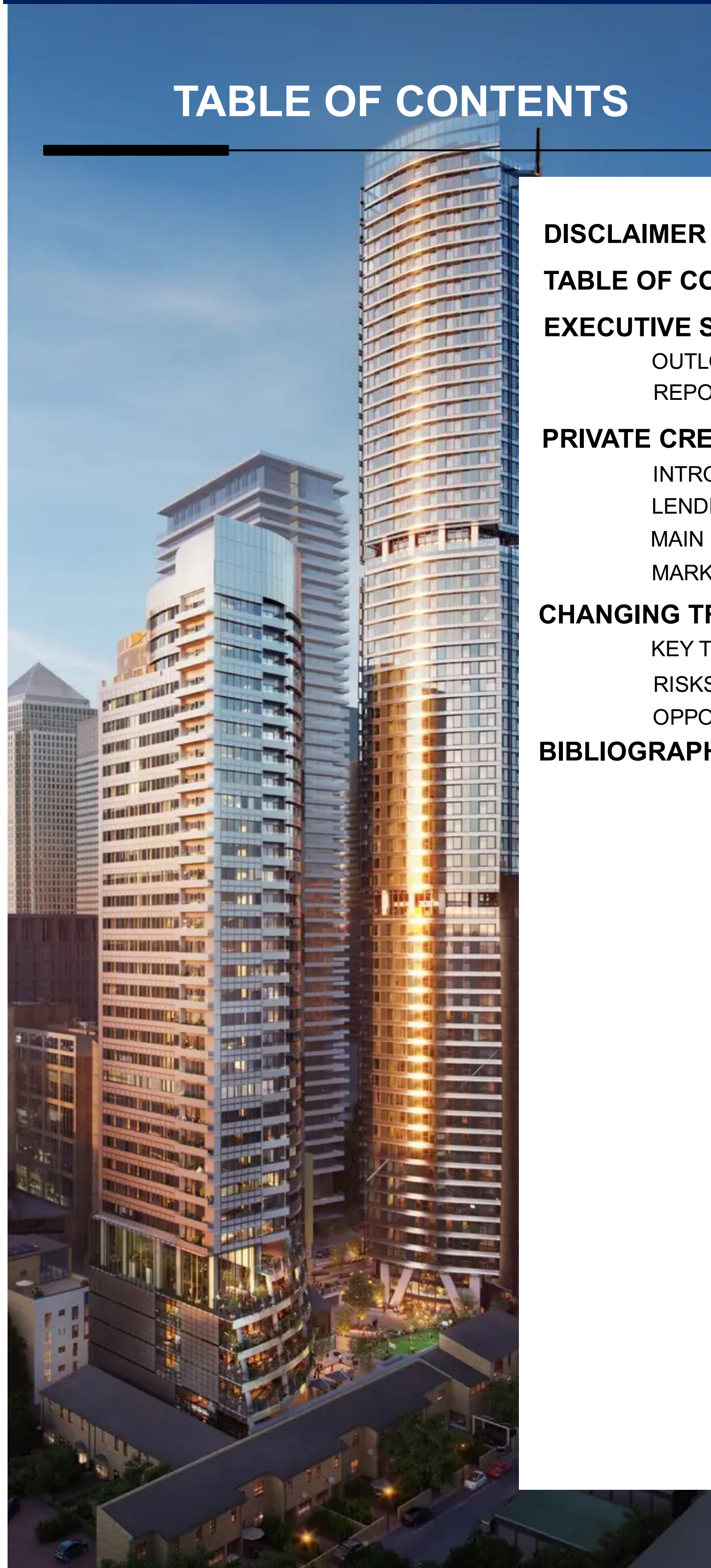


EXECUTIVE SUMMARY

OUTLOOK

Private credit has emerged as a resilient investment mechanism and viable financing option, against all market conditions for investors, lenders, and borrowers alike. With an estimated market value of US$1.7 trillion in 2024, private credit is expected to reach US$2.8 trillion by 2028. The flexibility, customizability, and attractive investor risk-returns, possibly exceeding 10% annually, are key drivers of this growth.

The sector has emerged as a leading force in leveraged buyouts, funding 85% globally, up from 60% five years ago. Private credit achieved a record US$5.3 billion in loans in 2023, where the U.S. Business Development Companies (“BDCs”) are contributing to this expansion by offering publicly tradable investment options with tax benefits. Insurance companies are also increasing their private credit allocations, with 89% prioritizing higher investments in private markets. In addition to Ultra High Net Worth Individuals entering the investor fray.

Underwriting fundamentals have evolved with only 20% of direct lending deals being classified as “covenant-lite,” compared to 90% in syndicated loans, indicating stronger soft protections for lenders in direct lending. Recent interest rate dislocation, stricter regulations, and balance-sheet pressures on banks have also reduced the issuance of commercial and syndicated loans, allowing private credit to fill the resulting gap.

Family offices and high-net-worth individuals have crucially boosted their private credit investments by 45% since July 2019, surpassing the 25% growth in traditional bank credit. Recent U.S. regulatory scrutiny, including the rejection of SEC rules, also affects the market dynamics, influencing market practices and investor strategies.

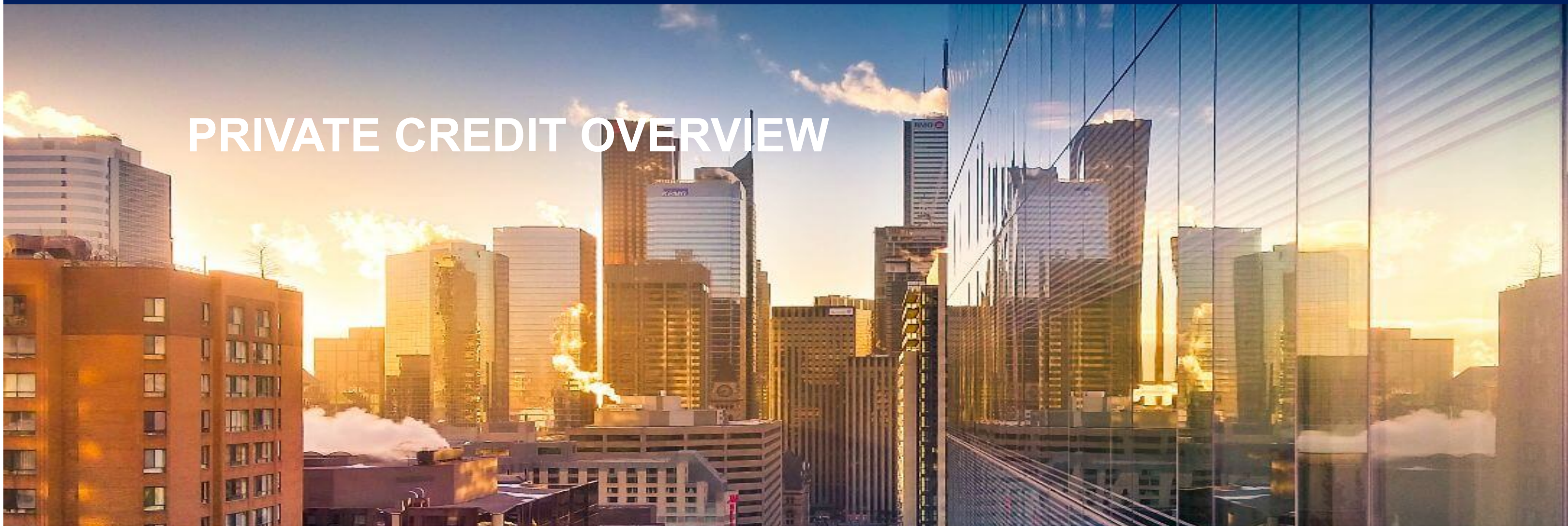
Certain main trends in the private credit markets, such as the rise of Payment-in-Kind (“PIK”) structures, limited lender commitments, lower default recovery rates, and transparency issues could pose challenges to growth and stability.

Despite these challenges, prevailing trends and favorable market conditions, private credit is striving, as a viable financial solution for both investors and borrowers.

REPORT ROADMAP

The report delves into the evolving trends in the private credit markets, providing an analysis on leading markets, including the U.S., Europe, and Asia-Pacific, with a focus on key trends, risks, and opportunities related to rapid market expansion.

With the global private credit markets expected to reach approximately US$1.7 trillion in 2024, up from an estimated US$1 trillion four years ago, the trends and tailwinds present opportunities for investors, lenders, and attractive solutions for borrowers seeking financings.



INTRODUCTION

Private credit has emerged as a significant alternative financing option for businesses, offering direct loans outside traditional bank lending.

The global financial crisis led to stricter regulations that constrained traditional bank lending. Strong market demand, favorable spreads, and attractive returns in the "higher-for-longer" interest rate environment created an opportunity for private credit to emerge as a significant alternative to traditional lending, capturing a growing share of the loan issuance market.

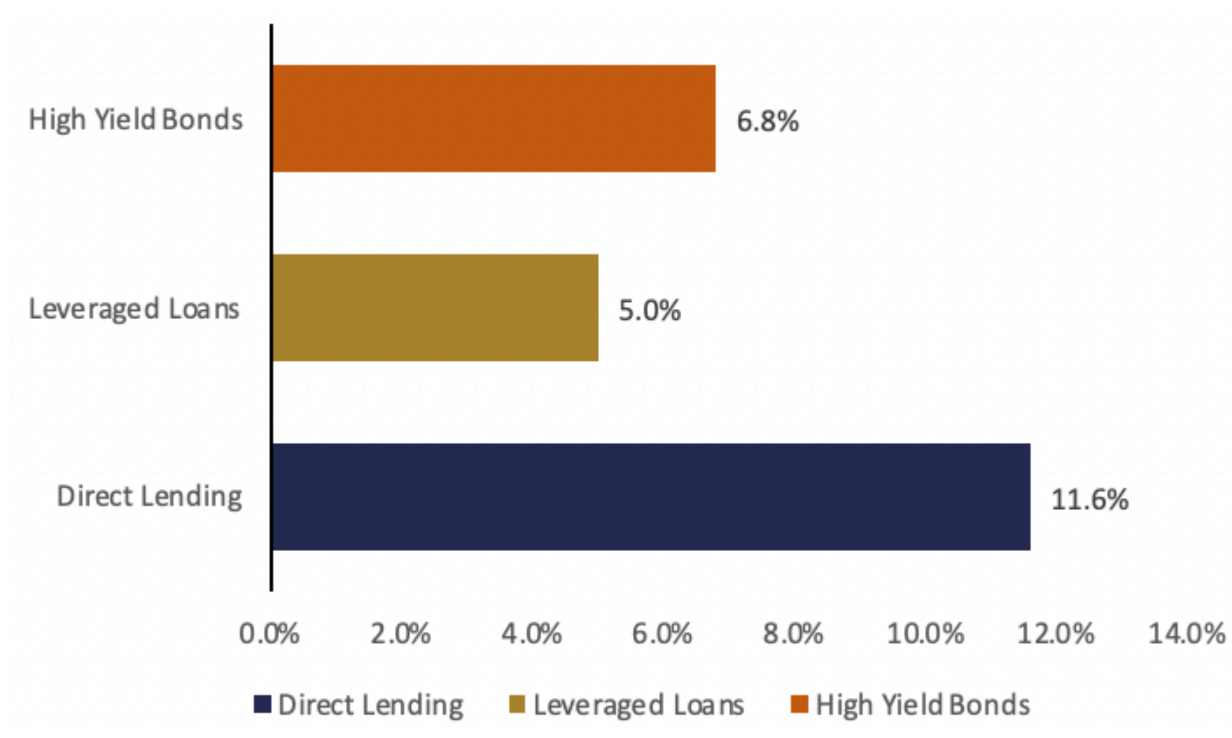
Traditionally, private credit catered to the small and middle market, targeting firms with annual revenues between US$10 million and US$1 billion. However, it has expanded significantly to include larger corporations previously financed through leveraged loans. Estimates suggest a shift in leveraged buyout financing, with private credit currently estimated to fund 85% of global leveraged buyouts compared to 60% five years ago. This growth reflects the perceived advantages of private credit in terms of flexibility, simplicity, and speed in negotiating loan terms that the syndicated lending market struggles to match.

Investors view the current environment as a "golden age of private credit" due to its potential for strong performance. Private credit's market share is likely at a cyclical high, benefiting from the current high interest rate environment, in addition to the consequences of the COVID-19 pandemic, Russia's invasion of Ukraine, conflicts in the Middle East, and labor shortage. In certain cases, private credit utilizes floating-rate structures that adjust with prevailing interest rates, protecting investors from rising-rate environments.

Direct lending in the middle market has delivered attractive returns compared to traditional options, such as leveraged loans and fixed-income high-yield bonds, especially in today's markets where banks have constrained lending capacity.

Recent economic developments, including persistently high interest rates, have highlighted the competitive advantage of private credit markets in customizing solutions to meet borrowers' unique capital needs. This advantage has become particularly pronounced due to tighter public market regulations, including the Federal Reserve's Leveraged Lending Guidance and Basel III Capital Requirement. These strict regulations have discouraged banks from providing higher-risk middle-market loans, allowing private credit providers to fill the gap with tailored financial solutions, thereby capturing an increasing share of the loan issuance market.

Global Direct Lending's Performance
Q1 2008 – Q3 2024



Source: MCG, Morgan Stanley, 2024

LENDING STRUCTURES

There are mainly five common types of private credit investments: senior direct lending, junior capital, distressed debt, specialty finance, and collateralized loan obligations.

Senior Direct Lending

Providing loans directly to middle-market companies, senior direct lending offers investors a steady income, a structured risk and potential additional upside.

Junior Capital

Junior capital, mezzanine, second lien debt, and preferred equity offer borrowers subordinated financing that ranks below senior debt but above equity in the capital structure. These forms of financing typically provide higher yields to compensate for the increased credit risk associated with their lower priority in the repayment hierarchy.

Distressed Debt

Investors focus on loans or bonds issued by companies or governments facing financial difficulties. It provides opportunities during economic downturns or periods of limited credit availability, where investors accept higher risk for the potential to acquire assets at discounted prices and achieve higher returns.

Specialty Finance

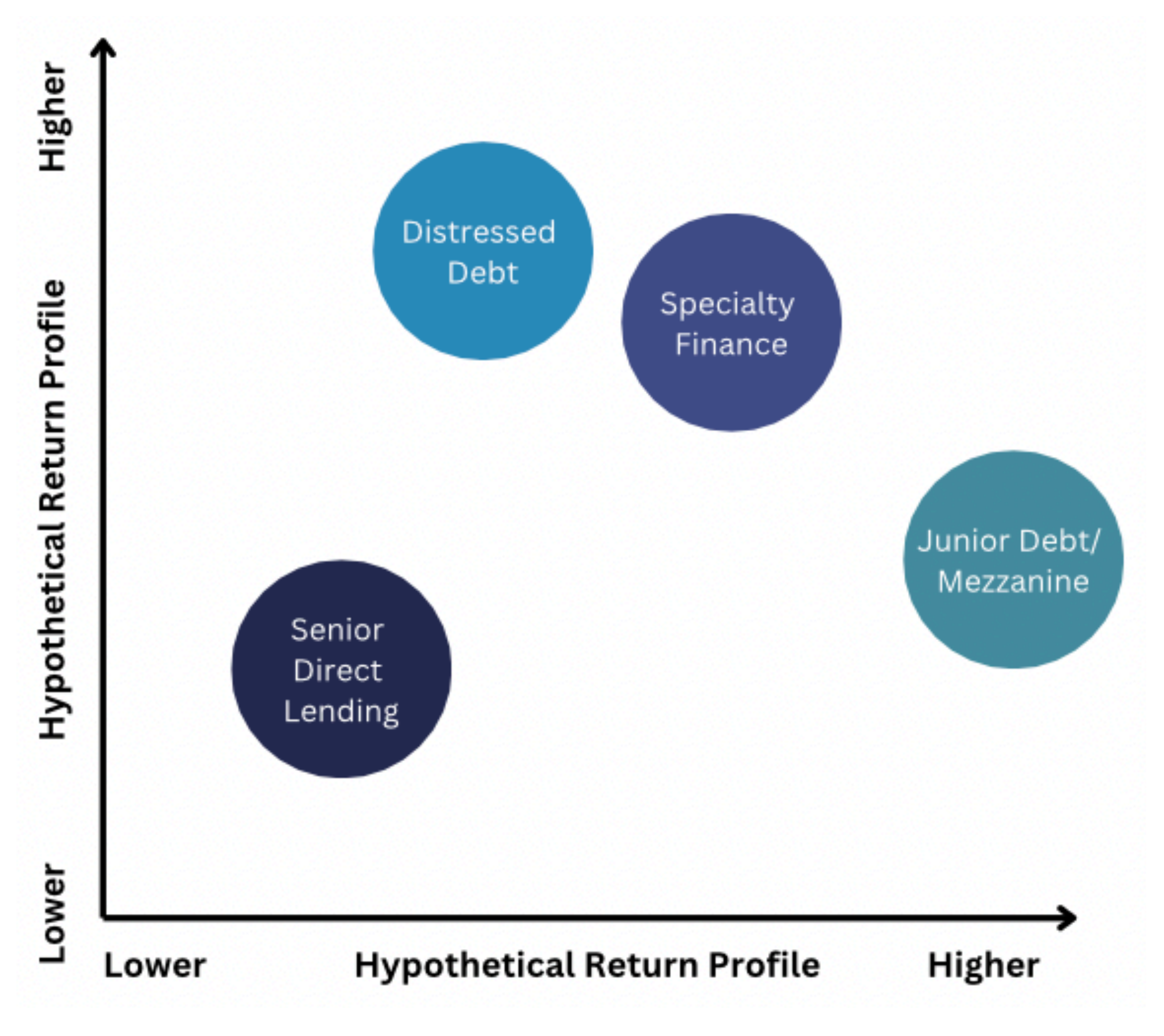
Catering to non-corporate lending in unique situations, specialty finance covers areas outside the traditional banking system that require a high degree of customization and complexity including turnaround financing, recapitalizations, M&A transactions, spinoffs, and other capital needs.

Collateralized Loan Obligations ("CLOs")

Actively managed securitized products, known as collateralized loan obligations or CLOs, are backed by a highly diversified pool of loans. CLOs free up capacity on the balance sheet, serving as an additional funding source. The prevalence of private credit CLOs has risen in recent years, accounting for 20% of new CLO issuance volume in 2023 and is projected to exceed 30% of total issuance in 2024.

Within private credit, each investment type carries a unique risk-return profile. While senior direct lending typically offers the lowest risk, it is also associated with lower returns. Conversely, junior debt generally provides the potential for higher returns, with correspondingly higher risk. The chart below illustrates this risk-return tradeoff among different private credit types.

Risk & Return Profile by Fund Type
Historical Risk and Return Analysis



Source: MCG, 2024

MAIN MARKETS

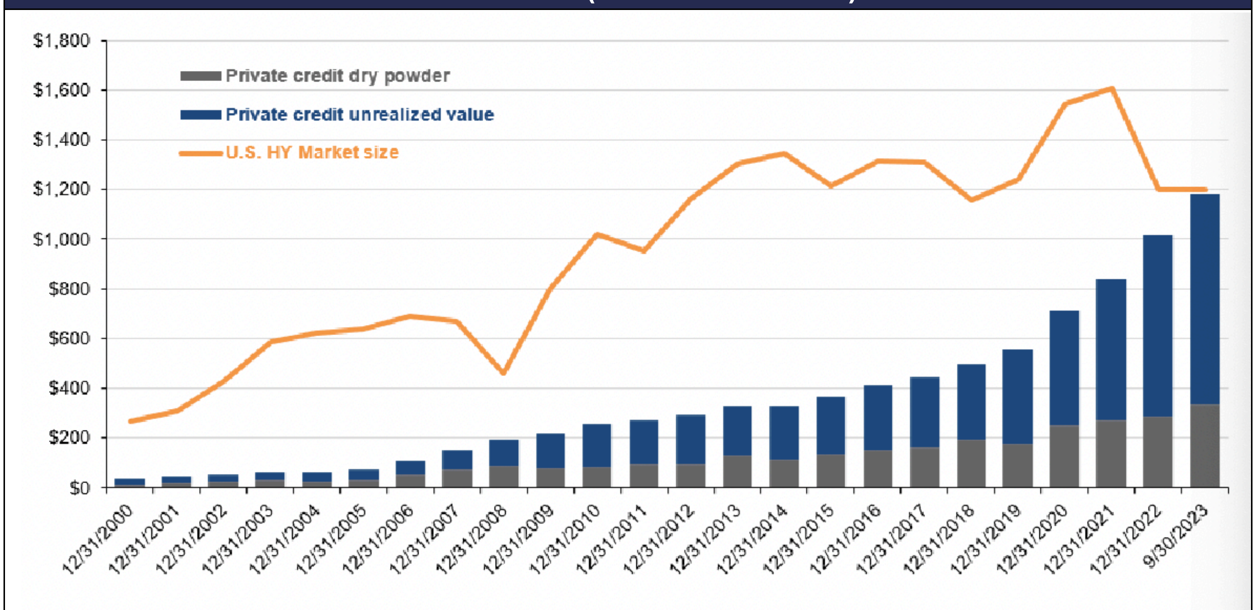
The United States

The expansion of private credit in the United States has been notable. Since 2000, assets under management ("AUM") in U.S. private credit have surged from approximately US$40 billion to US$1.2 trillion as of 2024, more than doubling since 2019. Although nearly 30% of these AUMs remain as "dry powder"—capital raised but not yet deployed—the growth and its implications for the credit markets are substantial.

The contraction of the U.S. public high yield ("HY") markets by nearly 25% since 2021 has led investors to turn to private capital as an alternative funding source for companies that would typically access public markets.

This shrinking of the high-yield markets is driven by the migration of high-quality credits, or "rising stars," to investment grade, significantly outpacing the "fallen angels"—investment grade credits downgraded to junk status. Since 2021, nearly US$300 billion of high-yield credits have been upgraded to investment grade, compared to US$40 billion downgraded. Despite this trend towards higher credit quality, with over 50% of the U.S. HY market rated BB or higher, it highlights a broader movement toward higher-quality credits within the high-yield sector.

U.S. Private Credit vs U.S. High Yield
2000 – 2023 ("in US$ billions")



Source: MCG, Preqin, 2024

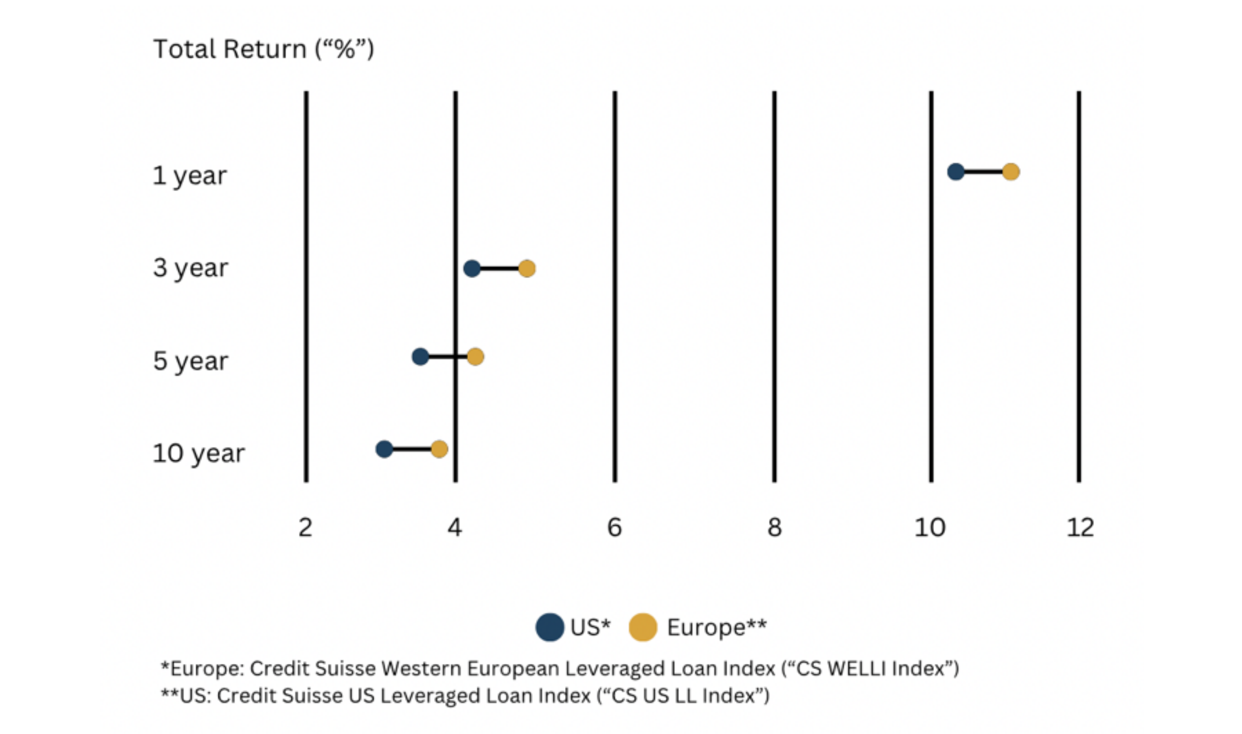
Europe

Europe's private credit markets offer attractive returns due to wider loan spreads, making senior secured lending an appealing choice for portfolio diversification and potentially superior risk-adjusted returns.

The introduction of regulated frameworks, such as the European Long-Term Investment Funds ("ELTIFs"), has broadened access to private credit, increasing investment opportunities, and enhancing market accessibility for a wider range of investors across the region.

Beyond wider spreads, the European market is generally characterized by lower risk compared to the U.S. This is evidenced by higher interest coverage ratios indicating a borrower's ability to service debt and lower default rates in Europe. Additionally, European companies have traditionally maintained more conservative equity cushions, further mitigating risk.

Loan Returns – Europe vs US
2024



Source: MCG, Credit Suisse, 2024

Loan Characteristics – Europe vs US Markets 2024		
Characteristics	**Europe**	**United States**
Interest Cover	4.0 – 4.5 x	3.5 – 4.0 x
Default Rates	1.1%	1.6%
Recovery Rates ("3 year average")	75%	67%
Source: MCG, 2024		

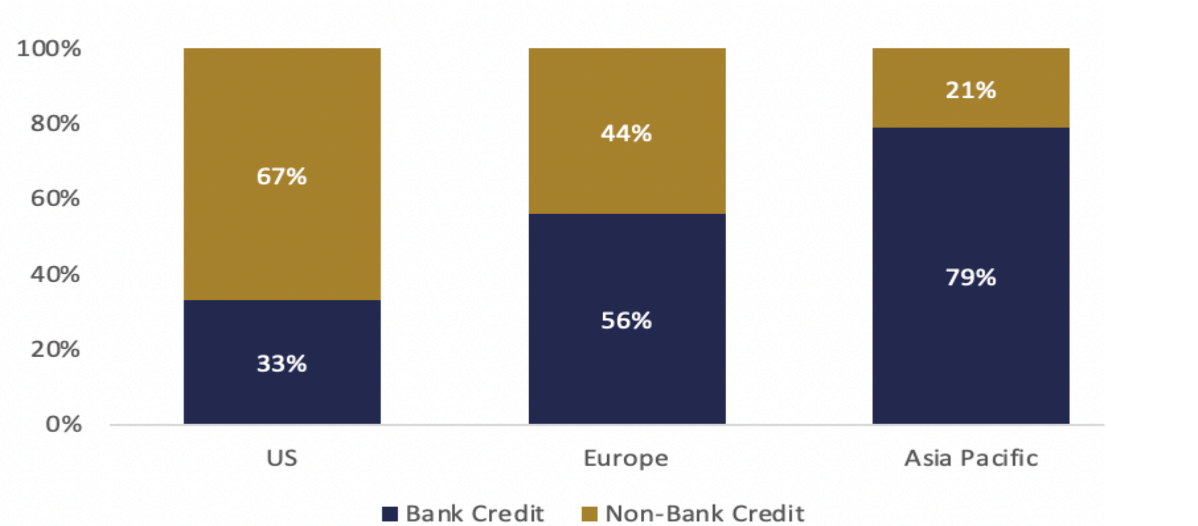
For non-European investors, the fewer tax and structuring restrictions in Europe lead to greater tax efficiency, enhancing the appeal of European senior secured lending for global diversification and investment.

European companies, facing significant refinancing needs and sluggish economic conditions, may experience heightened restructuring activity. This environment could present opportunities for distressed acquisition financing, loan modifications, debt-for-equity swaps, and creditor takeovers, enabling private credit investors to acquire debt at a discount and potentially achieve substantial returns.

Asia-Pacific

Holding nearly 80% of global bank credit, Asia-Pacific provides major private credit growth opportunities.

Global Bank Funded and Non-Bank Funded Credit Split
2024



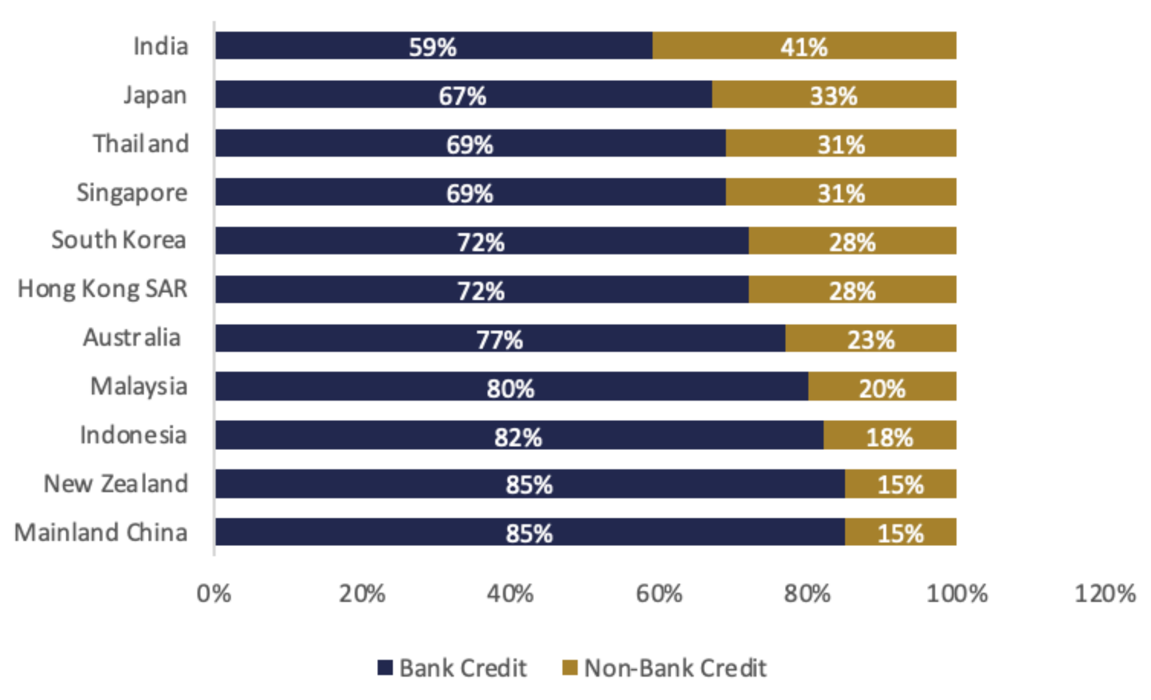
Source: MCG, Bank for International Settlements, PwC, 2023

In emerging markets ("EMs"), banks provide approximately 90% of corporate funding, compared to 20-40% in the U.S. and 50-60% in Europe. Shallow local capital markets in EMs and limited alternative funding sources, such as insurance capital, highlight the sector's heavy reliance on traditional banking.

Recent trends suggest a potential shift, as Asian banks may be reducing their appetite for new credit and seeking to offload distressed assets, presenting opportunities for alternative lenders to capture market share.

The rapid economic growth in the Asia-Pacific, especially within the Association of Southeast Asian Nations ("ASEAN"), drives a need for capital and cross-border financing. Limited domestic capital pools in these expanding economies create a favorable environment for alternative lenders. India, in particular, has seen a 41% increase in non-bank credit in 2023, with 108 deals valued at US$7.8 billion, up from 77 deals worth US$5.3 billion the previous year, driven by heightened activity in real estate private credit and larger transactions.

Asia-Pacific Bank-Funded vs Non-Bank-Funded Credit Split 2024



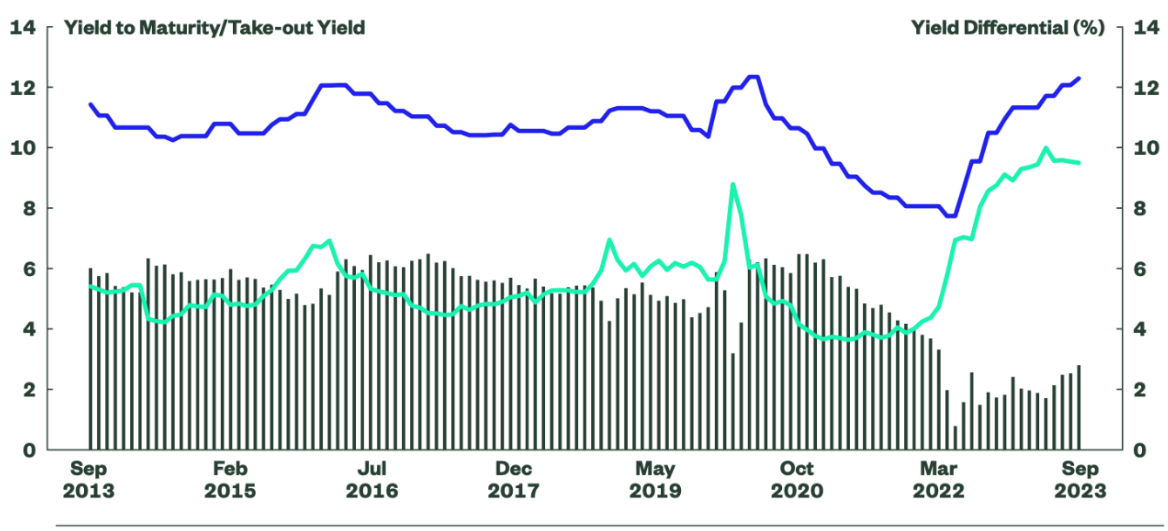
Source: MCG, Bank for International Settlements, 2023

The SME sector in Asia is also of importance, with SMEs comprising 96.6% of all businesses and employing 55.8% of the workforce. These enterprises are crucial to the region's economic growth.

MARKET SIZE & GROWTH

The private credit markets have experienced remarkable global expansion, reaching US$1.7 trillion in 2023, a rise from an estimated US$1 trillion just four years ago. In the current high-interest-rate environment, private credit offers attractive yields of around 12% or more. The "Illiquidity Premium" in the private market has allowed private credit to maintain a spread of approximately 200 to 300 basis points above leveraged loans and high-yield bonds.

Yield Premium Direct Lending vs Leveraged Loans 2013 – 2023

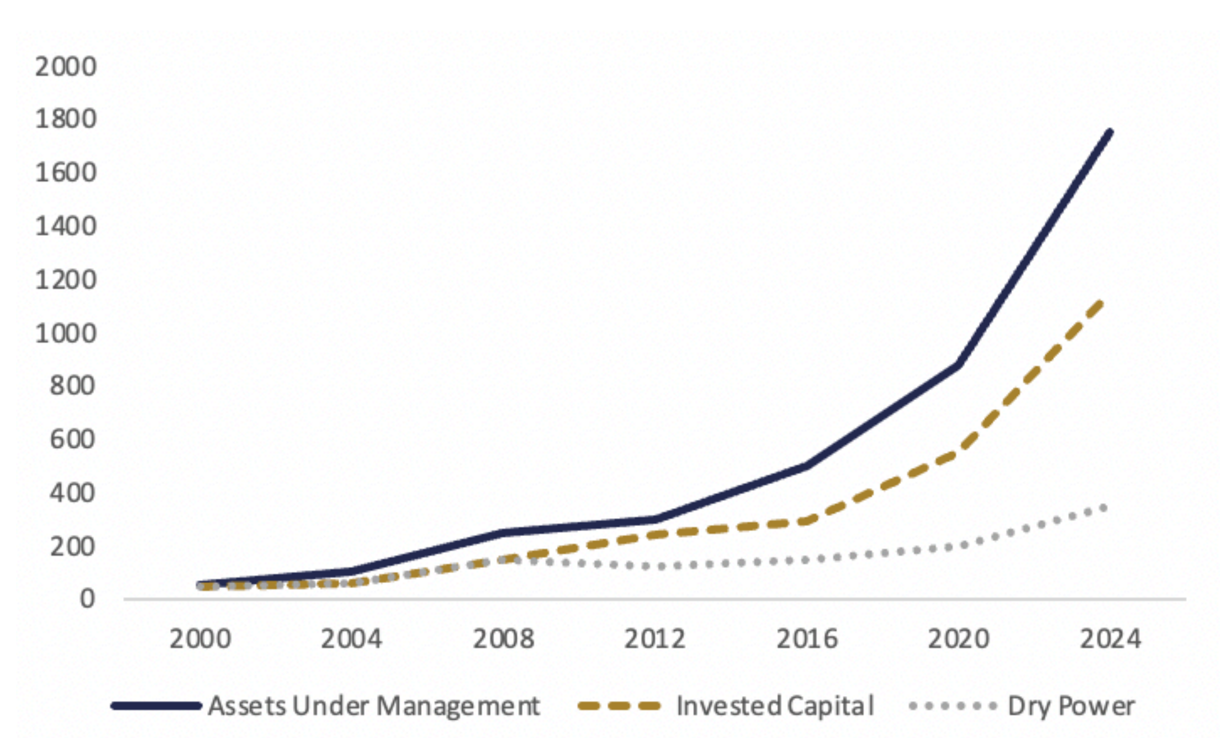


Source: MCG, State Street Global Advisors, 2024

The maturity schedules for leveraged loans and high-yield bonds suggest that a significant portion of this debt will be due within the next three to five years. This anticipated repayment schedule is expected to drive continued growth in the private credit markets, increasingly recognized as a viable alternative financing source for companies. The private credit market is projected to expand to US$2.8 trillion by 2028 from US$1.7 trillion in 2024. Direct lending remains the dominant strategy, accounting for roughly half of the market at an estimated US$800 billion.

The US private credit markets represented nearly 20% of market share for non-real estate loans in 2023, up from just 2.5% in 2018. Despite this growth, substantial expansion opportunities remain. Outstanding direct loans are projected to total US$475 billion in 2024, excluding dry powder. In comparison, domestic high-yield bonds amount to US$925 billion, and U.S. leveraged loans are expected to reach US$1.4 trillion, emphasizing private credit as a promising growth sector.

Global Growth in Private Debt Allocation
2024



Source: MCG, The Fed, 2024

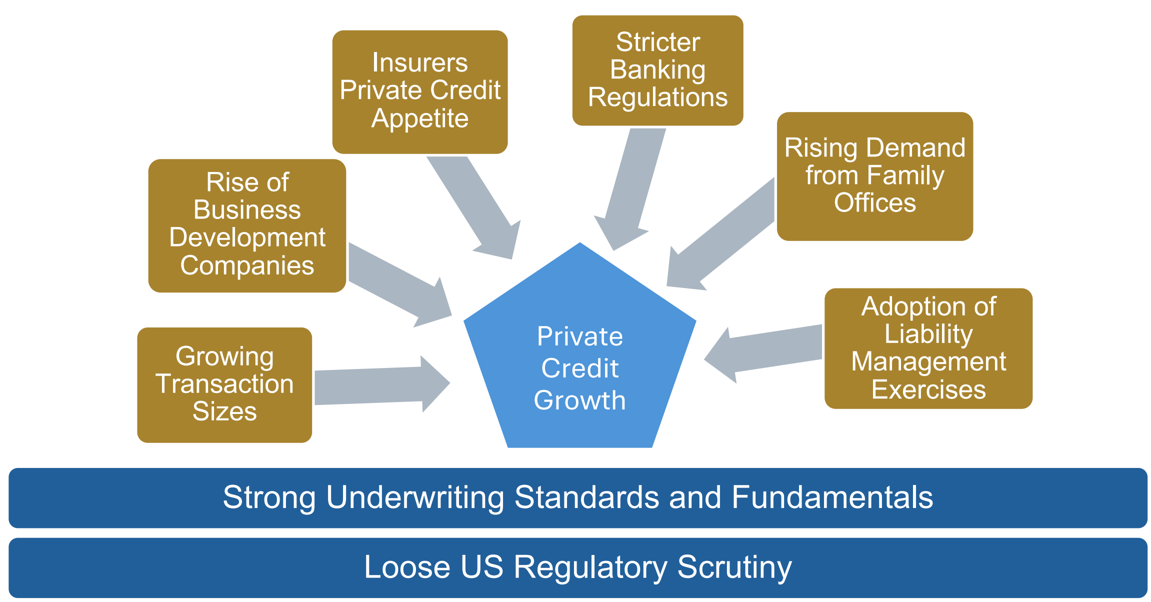
Meanwhile, the growth potential of the private credit markets is even greater in Europe. As of June 2023, with a market size of US$459 billion, the share of transactions financed by private credit more than doubled, rising from 27% in 2020 to 56% in 2024.

CHANGING TRENDS: INDUSTRY EVOLUTION

KEY TRENDS

As markets evolve, several trends are driving the growth of private credit. The increase in larger transactions, exemplified by multiple recent deals exceeding US$1 billion, signals greater investor and borrower confidence in private credit. The rise of business development companies is providing borrowers with enhanced liquidity and additional options. Insurers also continue to lead their preference for private credit investing, with many planning to boost their allocations. Other trends – consistently strong underwriting standards and recent rejections of US regulatory scrutiny – indicate that this growth could continue unabated.

Private Credit Key Trends
2024



Source: MCG, 2024

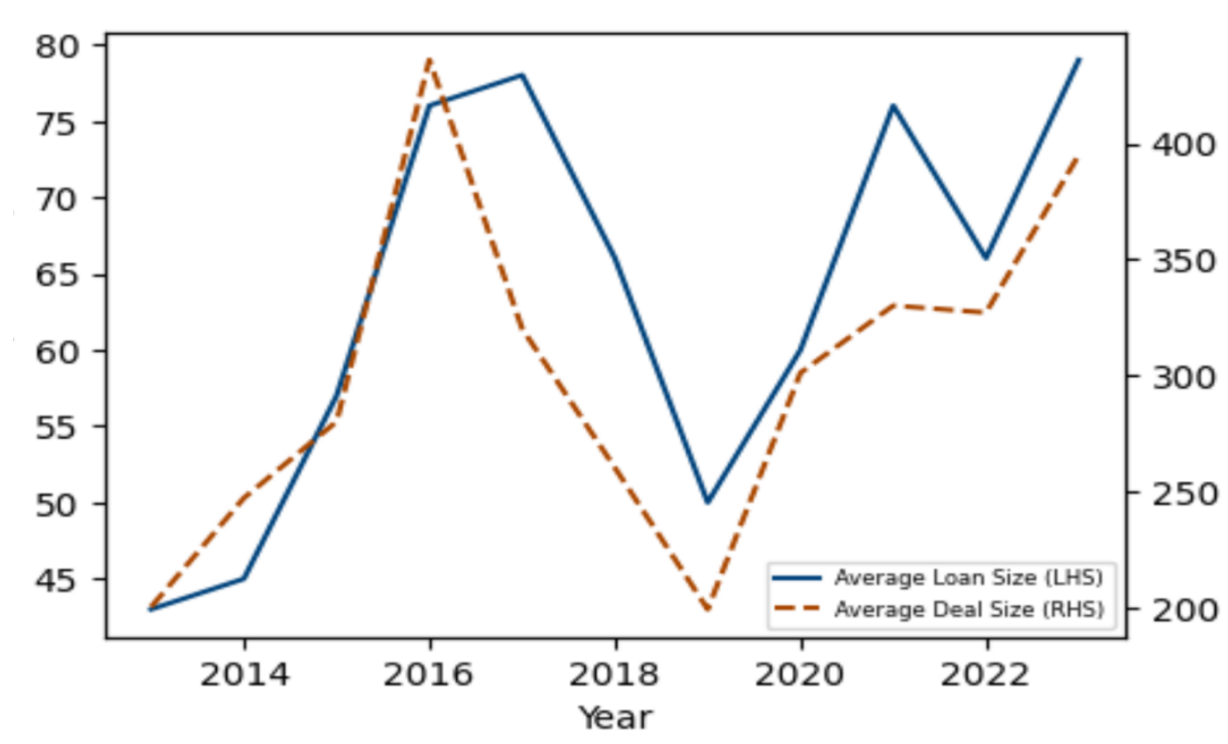
Growing Deal Size

Traditionally, private credit has focused on lending to lower and middle-market firms, defined as those with revenues between US$10 million and US$1 billion. As financing conditions tighten and debt market volatility increases, borrowers are increasingly turning to private credit for certainty and predictability. For investors, this shift allows more capital to be deployed quickly while maintaining higher returns.

For example, Finastra, a FinTech company owned by Vista Equity Partners, secured the largest US private credit loan on record at US$5.3 billion in August of 2023 from lenders Oak Hill Advisors, Blue Owl Capital, and HPS Investment Partners. The financing replaced previous debt from the leveraged loans sector.

The trend towards larger private credit deals highlights a growing preference in the leveraged finance markets for private credit solutions over traditional syndicated markets.

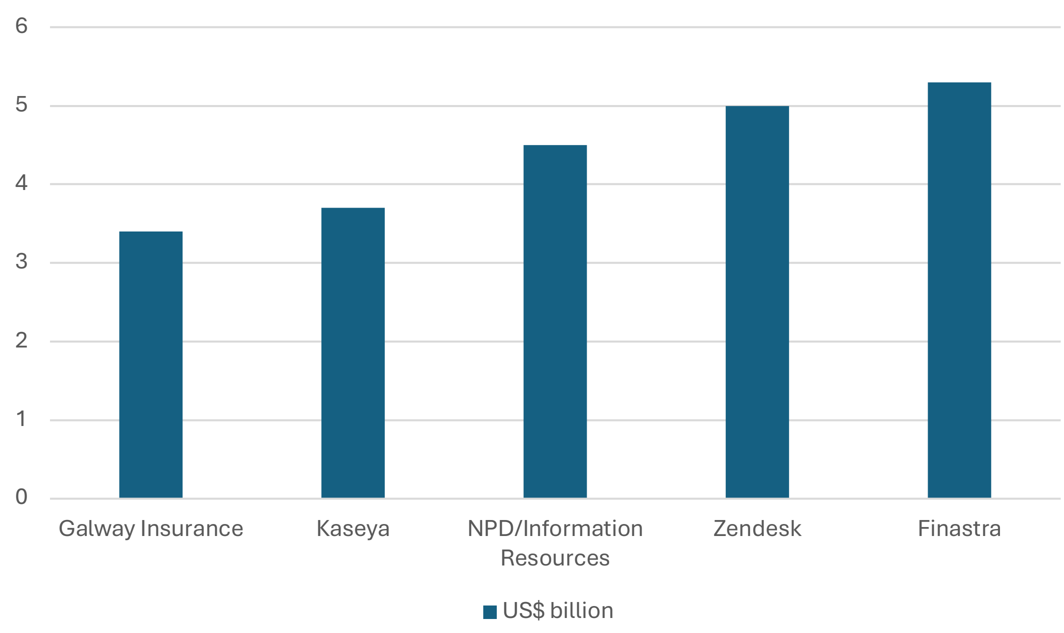
Private Credit Average Loans Deal Size
2014 – 2022 ("US$ Million")



Source: MCG, The Fed, 2023

While Finastra currently holds the record for the largest private credit loan, it is not the only notable deal. The previous record was a US$5 billion private debt loan provided for a take private of Zendesk in 2023, with lenders including Apollo Global Management, Blue Owl Capital, and HPS Investment Partners. The chart below illustrates the largest U.S. private credit loans to date.

Largest US Private Credit Loans to Date
2023



Source: MCG, 2024

The trend of larger deal sizes shows no signs of abating. In Q1 2024, there were over three deals with transaction sizes exceeding US$1 billion, including MB2 Dental, Aptean, and Equinox. The ten largest private credit transactions for Q1 2024 are listed below:

Largest US Private Credit Loans to Date		
Company Name	**Date**	**Deal Size ("US$")**
MB2 Dental	Feb 2024	2.34 billion
Aptean	Jan 2024	2.11 billion
Equinox	Mar 2024	1.80 billion
Oral Surgery Partners	Jan 2024	0.40 billion
Artivion	Jan 2024	0.35 billion
Nassau Financial Group	Feb 2024	0.25 billion
Xeris Pharmaceuticals	Mar 2024	0.20 billion
LendingTree	Mar 2024	0.13 billion
Altus Power	Jan 2024	0.10 billion
DecisionsRx	Jan 2024	0.10 billion
Source: MCG, AIC, 2024		

Rise of Business Development Companies

These closed-end alternative investment vehicle companies offer tax advantages and provide a liquid alternative to private credit. Established by Congress in 1980, BDCs are considered specialty finance companies and are exempt from federal entity-level taxes upon meeting certain requirements, such as distributing at least 90% of taxable income to shareholders. BDCs are required to invest in lower to middle-market firms with market capitalizations under US$250 million. Like other private credit funds, BDCs can be publicly traded on exchanges. While BDC portfolios are not restricted to credit and generally include equity, loans account for more than 80% of a BDC's portfolio.

BDCs have experienced an eightfold increase in AUM from 2012 to 2023. In 2023, multiple asset managers, including Oak Hill Advisors, Fidelity Investments, Jefferies Financial Group, Churchill Asset Management, and Vista Equity Partners, launched their first non-traded/private BDCs. Amid a "higher-for-longer" interest rate environment with no near-term rate cuts expected, small businesses are increasingly turning to BDCs to refinance floating-rate debt on their balance sheets, given the limited accessibility of bank loans. As a result, BDCs' AUM has surged from US$134 billion in 2020 to US$271 billion in 2023.

While traditional private credit funds remain illiquid for several years, BDCs can offer comparable investor returns while being publicly tradable, providing valuable liquidity in uncertain markets and providing retail investors access to private credit opportunities typically unavailable to them. These advantages have increased investor appetite and contributed to the private credit industry's expansion.

Growing Insurer Appetite for Private Credit

Although investors in private credit range from pension funds and sovereign wealth funds to high-net-worth individuals, insurance companies have emerged as the main investors. Growing numbers of US insurers are developing close relationships with US private credit fund managers, where these markets are most mature. Private credit constitutes only 6% of insurers' investments in Asia Pacific but accounts for 36% in the US.

Insurance companies are drawn to private credit for its flexibility, risk profile, and returns. The high customizability allows insurers to select investment types that best match their desired duration, seniority, credit quality, or collateral type. Stronger covenant protections and seniority in direct lending provide risk mitigation. In the case of corrections or restructuring, fewer players in private credit make negotiations easier.

The risks involved are also well compensated with premiums, in addition to an illiquidity premium. Since private credit funds are typically committed for several years, returns are generally higher. A 2024 survey by Goldman Sachs Asset Management revealed that 53% of insurance company executives considered private credit one of the top five asset classes for returns in the next 12 months. Insurers are attracted to the higher returns of private credit without assuming significantly more risk than traditional bond investments.

To emphasize insurance companies' interest in private credit, a recent Moody's analysis of US insurers found that nearly 80% were planning to increase their holdings of at least one class of private credit over the long term. This analysis is supported by BlackRock's 12th annual Global Insurance Report published in late 2023 showed that increasing allocations to private markets was the top priority for 89% of insurers, with 60% focusing on direct lending.

With the headwinds pointed toward the continued performance of private credit markets, insurers seem poised to double down on their private market investments.

Strong Underwriting Standards and Fundamentals

Larger transaction sizes do not necessarily indicate that private credit funds have become oversaturated. In fact, the good news for investors in private credit in 2024 is that lenders continue to maintain strong underwriting standards and fundamentals, thereby limiting risk. For example, average net leverage, a metric comparing net debt to EBITDA, for borrowers remains well below the levels seen in 2021 and 2022.

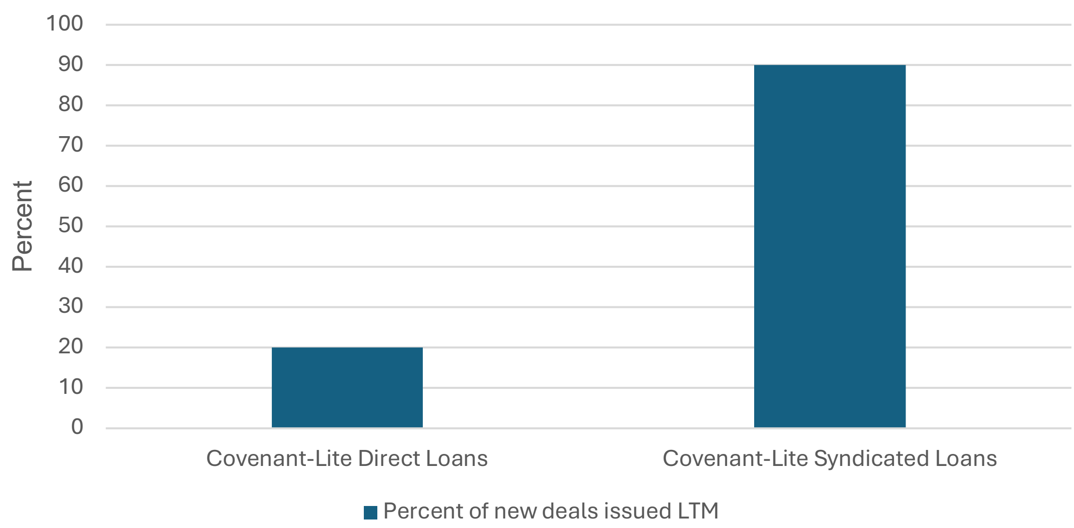
The following table shows the average net debt to EBITDA of new direct loan transactions, revealing the steady maintenance of lending standards by lenders and providing investors with confidence in current investments.

Net Debt to EBITDA Private Credits Financing 2021 – 2024

Source: MCG, 2024

Over the past 12 months, only 20% of direct lending transactions were also classified as "covenant-lite" loans, compared to 90% of syndicated loans, suggesting that private credit remains committed to limiting risk and providing lender protection.

Covenant-Lite Loans
Last Twelve Months



Source: MCG, 2024

US Attempts to Regulate Private Credit Rejected

While the rapid expansion of the private credit industry has drawn interest from investors and borrowers, it has also attracted increased scrutiny from regulatory authorities such as the U.S. Securities and Exchange Commission ("SEC"). In August 2023, the SEC proposed new rules to enhance disclosure requirements for private funds. However, these proposed regulations were overturned by the courts in June 2024.

Private credit funds face looser regulatory requirements compared to banks that has allowed fund managers greater operational flexibility and reduced reporting and administrative costs.

Despite this, regulators have expressed concerns about the sector's growth, viewing it as a potential risk to overall economic stability. The International Monetary Fund ("IMF"), issued a 2024 report calling for greater oversight of the private credit markets, citing the opaqueness and growing interconnectedness of the industry as a source of financial stability risks. The IMF also noted that the smaller nature of private credit borrowers, infrequent fund valuations available, and the potential for hidden layers of leverage within funds contribute to their concerns.

In response to these concerns, the SEC proposed new rules in 2023 to improve transparency regarding fees, expenses, and performance. The SEC stated that “the rules are designed to protect investors” by “increasing visibility into certain practices involving compensation schemes, sales practices and conflicts of interest through disclosure; establishing requirements to address such practices that have the potential to lead to investor harm”.

Nevertheless, in June 2024, the US Fifth Circuit Court of Appeals invalidated these new rules, holding that they were beyond the SEC’s authority. According to Moody’s Investors Service, for investors, lenders, and borrowers in the private credit industry, this suggests that there will be limited prospects for increased regulatory or financial oversight of the private credit industry in the short term.

Private credit participants will need to continue self-monitoring their risks, while the sector is likely to continue its growth unabated on the regulatory front, at least for the time being.

Stricter Banking Regulations

Rising interest rates and volatility in public markets have significantly contributed to the growth of private credit markets since 2023.

Stricter banking regulations, deposit losses, and balance-sheet pressures have led banks to reduce their issuance of commercial and broadly syndicated loans, with private credit increasingly filling the void through the origination of loans for both sponsor and non-sponsor-backed middle markets.

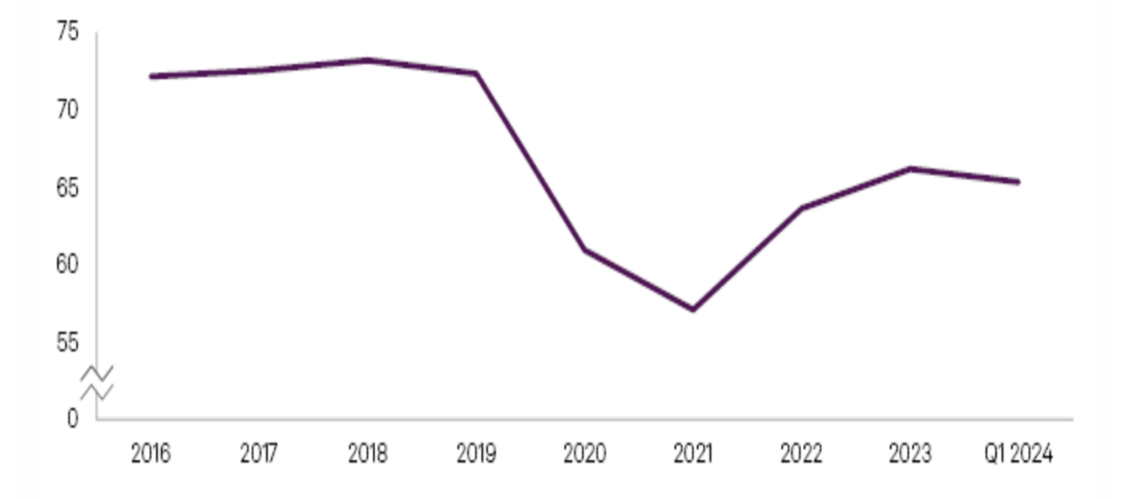
The collapse of Silicon Valley Bank and the US banking crisis in March 2023 prompted banks to reduce risk exposure, removing competition in corporate and real estate lending.

Under the July 2023 Basel III proposal for tighter bank capital requirements, the largest US banks would face about a 19% increase in required capital buffers against losses Meanwhile, smaller regional banks would need to declare unrealized losses on fixed-income investments, necessitating more cash reserves and reducing their lending capacity.

Simultaneously, over US$1 trillion in household deposits have exited the US banking system since 2022, with deposits at domestically chartered US commercial banks declining by 0.6% during the second quarter of 2024. The Loan-to-Deposit ratio has decreased from pre-pandemic levels with a limited indication of short-term rebound.

Currently, non-bank lenders hold a 75% share of US leveraged lending markets, compared to banks that accounted for the same 75% thirty years ago. With constrained lending capacity likely to persist into the second half of 2024 and the potential implementation of even stricter capital regulations, there are increasing opportunities for investors in private credit and direct lending strategies.

Total Loans and Leases/Total Deposits - US Banking Industry 2016 – Q1 2024



Source: MCG, S&P Global, 2024

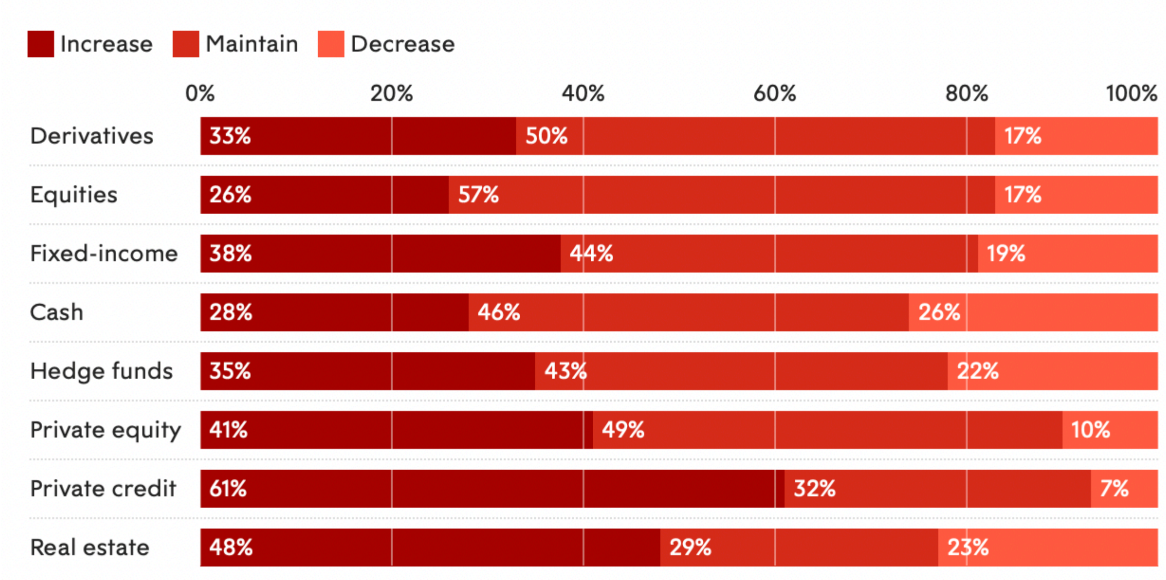
Rising Demand from Family Offices

Family offices and high-net-worth individuals are increasingly driving demand for private credit. According to Citi estimates, this segment of private credit, excluding warehouse financing, has surged approximately 45% since July 2019, significantly outpacing the 25% growth observed in traditional bank credit over the same period.

The 2023 Family Office Report reveals that family offices are planning to increase their allocation to alternative investments over the next 12 months driven by diversification benefits and returns in a higher-rate environment. Among these alternatives, private credit is emerging as the most popular asset class, while cash is out of favor.

Preqin data indicates that Asia leads in alternative investments, with 74% of family offices reporting exposure, followed by Europe at 69% and North America at 57%.

Allocation Plans for Family Offices
2024



Source: MCG, Hedgeweek Family Office Survey, 2024

Adoption of Liability Management Exercises ("LMEs")

In recent years, borrowers and their sponsors have increasingly leveraged the flexibility in their loan documents to undertake LMEs that enhance or protect equity value, often at the expense of existing creditors. Historically, LMEs have typically involved transferring assets to unrestricted or non-guarantor subsidiaries to secure senior financing or converting certain debts into more senior priming debt. The latest innovations, such as "double dips," "pari plus," and other hybrid structures, present new challenges, and opportunities for lenders.

Looking ahead, with high interest rates likely to persist and debt maturities approaching, U.S. private companies are expected to continue utilizing LMEs at elevated levels. These flexible instruments will be crucial in managing liquidity issues and addressing financial distress. In contrast, European companies have been slower to adopt LMEs due to differing regulatory frameworks, inter-creditor agreements, and market culture. Nevertheless, European firms are expected to increasingly recognize these tools, potentially influencing lender behavior and negotiation dynamics. Meanwhile, in Asia, LME usage remains less common, though notable instances, such as Vedanta Resources' restructuring of approximately US$3.8 billion in late 2023, highlight emerging trends in the region.

RISKS

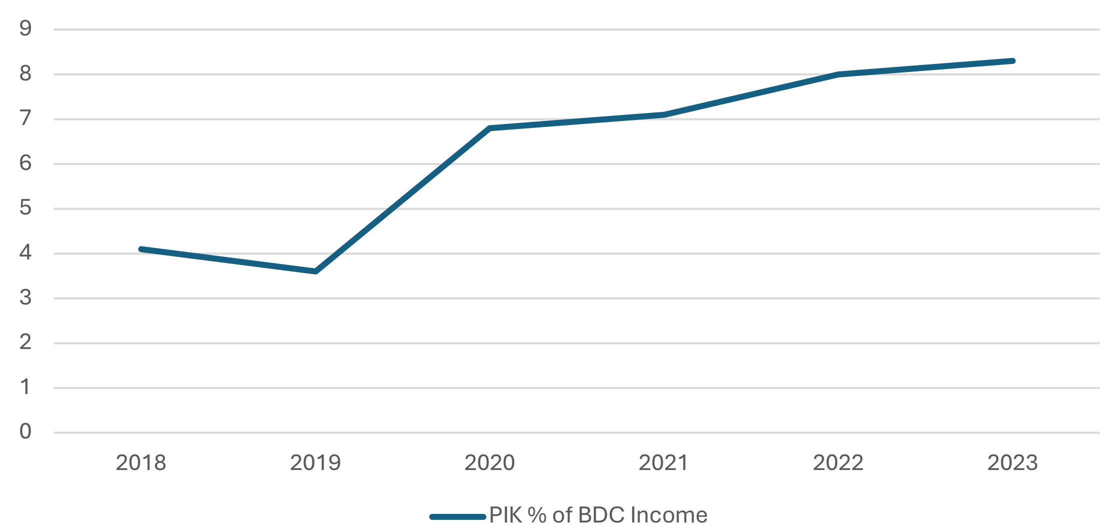
Despite the strong momentum in the private credit markets, risks for investors and the overall economy persist. Alongside the potential for tighter regulatory scrutiny previously discussed, concerns may arise from the increased use of PIK, insufficient alignment of interests for fund managers, and lower default recovery rates.

Recent Increasing Use of Payment-in-Kind

Higher interest rates and market uncertainty have led to an increased use of PIK in private credit loans, whereby payments are delayed and amortized into the loan's principal, with cash collected only upon final repayment.

Estimating PIK usage is challenging, but Fitch Rating's report for the first quarter of 2024 indicates that approximately 9% of income for 24 BDCs comes from PIK, up from 7% in 2020 and 4% in 2019 when interest rates were lower. Private Debt Investor also reports that mid-market lender Man Varagon, using public BDC filings, estimated that as of June 30, 2023, PIK income represented up to 12% of interest income among top-tier publicly traded BDCs with market capitalizations exceeding US$500 million.

Payment-In-Kind
As a Percent of All-In-Returns



Source: MCG, Fitch Ratings, 2024

Some experts are suggesting the rise in PIK, as a potential warning signal for private credit investors. Christina Padgett, Associate Managing Director with Moody's Private Credit team, notes, "The increasing number of PIK loans and nonaccruals is a red flag because it suggests that LBO borrowers are experiencing weakening cashflows." As borrowers underperform and lack the cash to make interest payments, the demand for PIK loans naturally increases to buy time.

Conversely, the growing use of PIK could simply be a result of lending competition from syndicated loan markets. PIK offers a strategic advantage for private credit by preserving borrower liquidity. When incorporated into a loan at origination, PIK allows a growing company to reinvest in growth rather than allocate funds to cash interest payments. PIK availability also provides a yield premium to compensate for the additional risk and can potentially reduce the need for loan restructuring.

No Skin in the Game

The Bank for International Settlements ("BIS") has raised concerns about a potential conflict of interest within the US$1.7 trillion private credit industry, particularly regarding the limited personal capital invested by many fund managers. The BIS argues that the lack of significant personal financial stake in the funds overseen by managers—referred to as a lack of "skin in the game"—creates a potential misalignment of incentives, as managers might prioritize their own profits over generating strong returns for investors since their wealth is not directly tied to the fund's performance.

Default Recovery Rates

The booming private credit industry is facing scrutiny over potential loan overvaluation, as new data reveals a discrepancy between pre-default optimism and post-default reality for private credit firms.

Direct lenders tend to be much more optimistic about their loan prospects in the months leading up to a default, but this optimism is not always reflected. Data shows that loans from private credit firms recovered less on average, at US$0.48 after default, compared to syndicated loans' US$0.55, where this disparity raises concerns about overvaluation and lower protection in the private credit markets.

Traditionally, leveraged loan providers have expected to recover 70% to 80% of their investments from struggling businesses, but recent examples challenge this expectation. Loans to Jenny Craig, a weight-loss brand that went bankrupt, were priced at US$0.20 on the day of default, despite being valued significantly higher at least US$0.45 more just three months prior. Similarly, Numet Machining Techniques and Williams Industrial Services Group recovered only US$0.105 and US$0.50 on the dollar, respectively, after being valued much higher just before default. These discrepancies highlight the potential issue of overvaluation within the private credit industry.

The syndicated loan market tends to lend to larger companies and might benefit from more "levers to pull" for restructuring and performance improvement during financial difficulties. This could be a contributing factor to their relatively better recovery rates compared to private credit lenders.

Valuation and Transparency

Concerns have expanded to valuation methodologies, as only 40% of private credit funds in the U.S. use independent appraisals when reporting data to the SEC. The lack of transparency makes it challenging to accurately assess the health of underlying assets within private credit portfolios, raising concerns about potential mispricing and risk exposure.

The issue is further exacerbated by the industry's reliance on self-monitoring. According to research by Moody’s Ratings, the private credit industry will maintain this practice, as a recent U.S. legal decision indicates that stricter regulatory oversight is unlikely soon. The absence of increased regulation further complicates efforts to ensure accurate valuations and transparency.

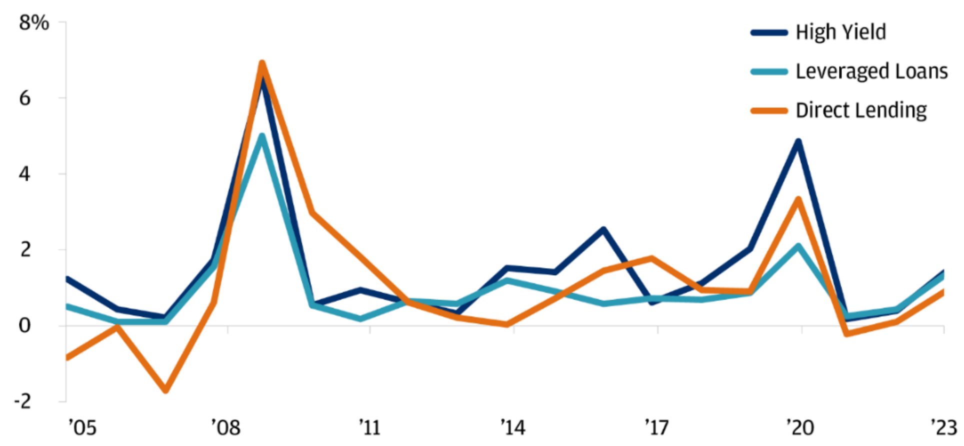
Market discipline reflects these valuation concerns, as evidenced by recent secondary fund trades, where prices fluctuate based on the manager, strategy, and portfolio composition. Secondary fund investors actively scrutinize and challenge valuations.

Risk Mitigation

Despite concerns over transparency, default risks, and fund management in the private credit market, the sector has demonstrated a healthy level of growth, supported by comparatively high returns, strong structures, and a positive outlook for deal activity.

Although default risk remains the primary concern in private credit, it has been shown to be adequately compensated by higher returns, as well as strong underwriting, structuring, and portfolio management, as discussed earlier in the report. Direct lending offers senior-secured loan downside protection, partially offsetting potential increases in losses if borrowers struggle to meet higher debt repayments.

Average Credit Loss by Asset Class ("%")
2005 – 2023



Source: MCG, JPMorgan, 2024

OPPORTUNITIES

The private credit trends covered in this report present unique opportunities for investors, lenders, and borrowers. The following table illustrates some of the benefits offered to different parties.

Private Credit Opportunities for Investors, Lenders, and Borrowers
2024

Investors	Lenders	Borrowers
•Higher Alternative Returns •Strong Fundamentals: Tighter Covenants •Reasonable Leverage Ratios •Insurance Companies Oversight	•Additional Capital Flows •Insurers' Increased Allocations •Ligh Regulation •Few Disclosure Requirements	•Rising Demand for Junior Capital, Bridging Debt Gaps •More Financing Options and Flexibility •Larger Transactions (">US$1 billion") Become Common •Customizable Benefits •Diverse Sector Returns

Source: MCG, 2024

Investors

For investors, the private credit markets remain an attractive option, offering higher returns compared to alternatives such as leveraged finance and high-yield bonds, while maintaining strong fundamentals, including tighter covenants and relatively more conservative leverage ratios. Over the past 12 months, only 20% of direct lending transactions have been “covenant-lite,” compared to 90% of syndicated loans. Net debt-to-EBITDA ratios are significantly lower than those observed in 2021 and 2022. Surveys indicate that insurance companies are increasing their private credit holdings, reflecting continued investor interest and confidence in the asset class. Incorporating private credit into a traditional portfolio of equities and fixed-income securities allows investors to further diversify risk while benefiting from the attractive risk-return profile.

In 2023, firms such as Oak Hill Advisors, Fidelity Investments, Jefferies Financial Group, Churchill Asset Management, and Vista Equity Partners launched their first BDCs. As more firms establish private credit funds, investor options are expected to expand, potentially enhancing opportunities for better and more diverse returns.

Lenders

For lenders and fund managers, the increased availability of capital liquidity, from insurance companies, has facilitated larger transactions. With most insurers planning to allocate more resources to private credits, lenders and fund managers can anticipate growth in fund sizes. BDCs, for example, have more than doubled in AUM, increasing from US$134 billion to US$271 billion over the three years.

The recent rejection of new SEC regulatory scrutiny rules by the US Fifth Circuit Court of Appeals is also favorable for maintaining low costs and offering flexibility to lenders. Private credit lenders are expected to continue to operate with fewer disclosure requirements compared to other funds. While European and international regulators are also concerned about private credits, the SEC’s ruling is expected to postpone comparable regulatory measures in the near term.

Borrowers

The current economic environment, characterized by prolonged high interest rates, is increasing the demand for junior capital solutions. Elevated rates increase the cost of senior debt and limit companies' ability to take on additional senior debt, creating refinancing challenges. Junior capital helps borrowers manage these issues by alleviating fixed obligations and bridging the gap between cash flow and total debt obligations. It complements equity contributions from sponsors, addressing shortfalls due to rising interest rates and enabling companies to pursue growth opportunities.

The expansion of private credit and the increase in transaction sizes provide both large and small companies with greater flexibility and more financing options. Multi-billion-dollar deals are becoming more frequent, with the US$5.0 billion record set in 2022 quickly surpassed by a US$5.3 billion deal with Finastra in 2023. Both large businesses and smaller businesses are recognizing the value of private credit's customizable and bespoke, offering financing solutions otherwise unavailable to them.

Despite macroeconomic headwinds and concerns about overly optimistic markets outlook, the private credit sector is expected to continue delivering strong returns with an attractive risk-adjusted profile. This continued strength is reinforced by favorable conditions in direct lending, liquidity from BDCs and special finance, along with increased investor asset allocation and capital inflows from high-net-worth individuals("HWI") into the private credit markets.

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