Growth and Change: Locking in certainty in an uncertain world

Exploring the rapid growth of private credit and where future opportunities may lie

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A Golden Era for Private Credit?

Gary Adams
Senior Investment Content Specialist
Savvy Investor

The most rudimentary study of how private credit has evolved and performed over the last 10-15 years will convince anybody that its role has changed significantly. It has moved far beyond its beginnings as a source of financing for mid-market companies struggling to raise funds elsewhere.

This can be partially put down to a series of shocks to the world's financial system and wider society, including the Global Financial Crisis, Covid, rapidly rising inflation, and most recently, the war in Ukraine. Each of these factors has played a part in both making it more difficult for traditional lenders to extend credit and in highlighting the advantages inherent to private credit as an asset class and tool.

As a result, the appetite for private credit has strengthened considerably across the U.S. and Europe, driving it to become a genuine competitor to traditional, liquid markets.

In this Special Report, Nuveen's private capital investment specialists, Churchill Asset Management and Arcmont Asset Management, explain why they believe this to be a growth story likely to continue in earnest. They also detail some of the challenges and opportunities that lie on the horizon for the asset class.

Meanwhile, our "Ask the Expert" section finds the paper's authors engaged in a more detailed discussion of some of the critical points covered, arming readers with cutting-edge insight into this exciting asset class.

Report Sponsor

About Nuveen

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Nuveen® is a premier global investment manager that has been helping clients meet their goals for more than 120 years. The company brings together two great legacies of service: Our parent, Teachers Insurance and Annuity Association of America® (TIAA®), pioneered retirement plans for teachers and non-profit organizations, while Nuveen helped build America's infrastructure through municipal finance. Nuveen today has more than $1.1 trillion in assets under management as of 30 Sept 2023 and operations in 27 countries.

Nuveen offers a comprehensive range of public and private investment capabilities across income, equity, real estate, real assets and multi-asset solutions. Our differentiated approach is informed by a history of investing by example. And we often invest alongside our clients, helping to ensure an alignment of interests.

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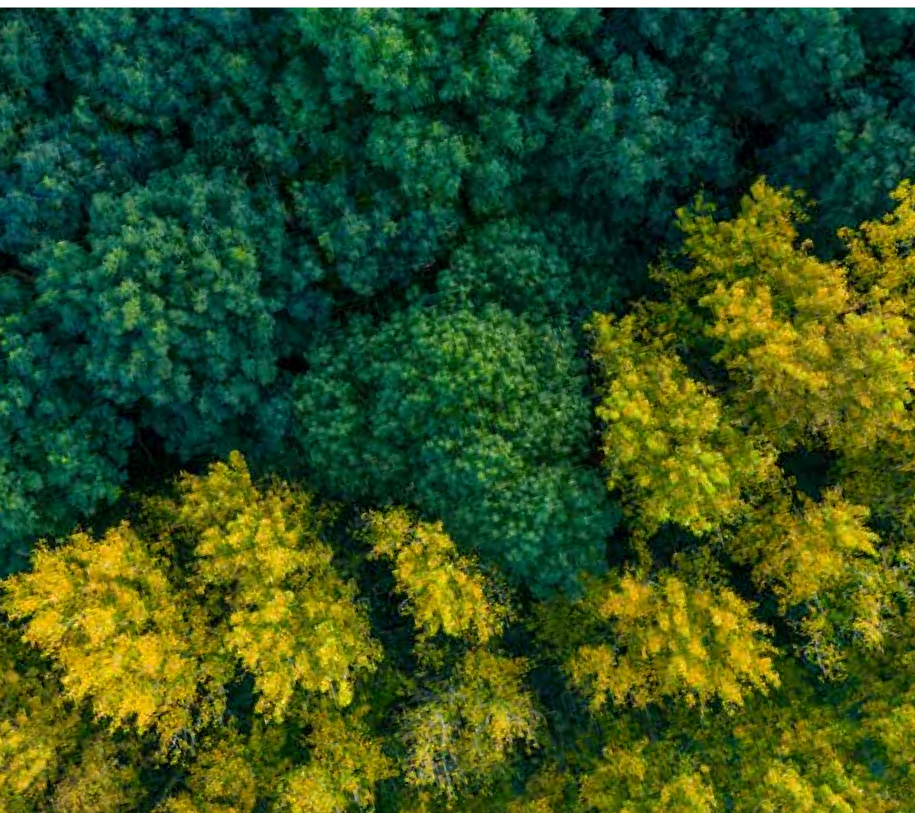

Mattis Poetter
Partner and Co-CIO
Arcmont Asset
Management

Mattis Poetter is a Partner and Co-CIO of Arcmont Asset Management, an affiliate of Nuveen. He was previously a Partner at BlueBay's Private Debt group where he worked from 2018-2019. Prior, Mattis was a Director in the Private Credit team of HPS Investment Partners and spent seven years in the European Leveraged Finance team of J.P. Morgan.

Randy Schwimmer
Co-Head of Senior Lending
Churchill Asset Management

Randy Schwimmer is co-head of senior lending and oversees senior lending origination and capital markets for Churchill Asset Management, an investment specialist of Nuveen. Previously, Randy was a senior managing director and head of capital markets and indirect origination at Churchill Financial. Before that, he worked as managing director and head of leveraged finance syndication for BNP Paribas, and spent 15 years at JP Morgan Chase in corporate banking and loan syndications.

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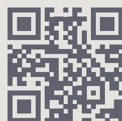

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1 As of 30 Sep 2023. Nuveen assets under management (AUM) is inclusive of underlying investment specialists.
2 Pensions & Investments, 06 Jun 2022. Rankings based on total worldwide assets as of 31 Dec 2021 reported by each responding asset manager, with 444 firms responding; updated annually.
3 As of 31 Dec 2022; updated annually.
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Featured Paper from Nuveen:

A Fast-Growing Challenge to Traditional Finance

nuveen
PRIVATE CAPITAL

December 2023

Resilient private credit fills a growing need across U.S. and Europe

Randy Schwimmer
Co-Head of Senior Lending, Churchill Asset Management

Mattis Poetter
Partner, Co-CIO, Arcmont Asset Management

SUMMARY

- Direct lenders continue to take market share from banks.
- The evolution of the private credit market favors the largest managers.
- Deal volumes are benefiting from a structural change in the direct lending and liquid markets.
- There is material runway for growth in private credit in the years to come.
- Private credit has delivered attractive returns over the long term.

INTRODUCTION

The U.S. and European private credit markets have been a significant success-story of asset management for the last decade. Commencing as a source of financing for mid-market companies unable to raise funds elsewhere, private credit has grown into a serious and credible competitor to both traditional, liquid markets (i.e., broadly syndicated loans and high yield corporate bonds), something seemingly fanciful only a few years ago. Now, private credit players are regularly financing the entirety of multi-billion-dollar debt structures.[1]

The Global Financial Crisis helped turbo-charge the private credit industry as regulated lenders were discouraged from holding senior bank loans. Each subsequent crisis served to underline the attractiveness of the asset class. The European Sovereign Debt Crisis, the U.S. Taper Tantrum, and COVID all helped place private credit on a steady upward trajectory.[2] Driven by the fundamental supply-demand imbalance for credit on both sides of the Atlantic, private lenders offered increased capacity, greater efficiency, and non-dependence on third-party ratings agencies.

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.
NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

Click to view the full paper

The private credit market is growing. And according to Nuveen's latest paper on the subject, there is little reason to believe this expansion will slow down any time soon. In fact, the next few years will likely see growth occur at even faster rates.

One key reason for this is the European appetite for private credit. With non-bank alternatives only gaining meaningful traction in the region after the Global Financial Crisis, it took some time for European markets to become comfortable with the asset class.

However, since 2012, the private credit assets under management (AUM) compound annual growth rate in Europe has increased by 21% compared to 13% in North America. This increase occurred most sharply after 2019. Private credit has quickly become a familiar form of issuing and borrowing in European markets.

This matches with the broader trend of lending activity moving away from regulated bank lenders. In its paper, Nuveen points out that in 2007, 44% of all financing across the U.S. and Europe came from banks and securities. As of 2021, this comes to a mere 22%. Further, since 2000, private credit AUM has multiplied by over 38 times, whereas public markets have seen an increase of just over three times.

A multitude of benefits

Moving away from larger trends, the composition of private credit offerings, and changes in the structure of the deals being made, are also driving growth.

At a basic level, the benefits of private credit have become clearer as the macroeconomic backdrop has grown more volatile. Private credit boasts a floating rate as a feature, perfectly adapted to a rising rate environment. Private credit also tends to be covenanted, meaning that managers can take an active part in addressing underperformance of firms it has issued credit to. Private credit also tends to be active in industries that stay relevant throughout different market cycles—think software, healthcare and business services. Based on Arcmont and Churchill's recent deal activity and active investment pipeline, investors can expect new issue margins of between 200-300 basis points above the liquid markets across both Europe and the U.S.

The certainty this engenders, paired with features such as speed of execution, bespoke structuring options, and the ability to provide more capital as a business grows, makes private credit an enticing investment amid more chaotic liquid options.

Nuveen's paper notes that the top five fund managers in the U.S. and Europe have created a virtuous circle. Combined, they have raised more than 25% of all private credit capital over the last 10 years, which has in turn seen the size of the average fund increase significantly – and critically

has enabled these managers to challenge for ever larger deals. Larger fund sizes mean access to higher quality deals, which then brings in more limited partners. Regarding the changing nature of deal structures, the paper contains data showing that in 2022, liquid market volumes fell by 60%, while private credit deal count dropped 9%—a testament to the benefits of capital being locked up.

The financing needs of private equity is marked as one of the bigger engines of future growth in private markets, with Nuveen's paper stating this is a trend that becomes more evident when looking at non-sponsored deal flow. Additionally, it provides evidence that, under specific assumptions regarding the $370 billion maturity wall that will need refinancing over the next two to three years, global private credit will likely play a vital role. AUM could well hit $3.5 trillion by 2028 (as of 2022, total AUM comprised $1.5 trillion).

"At a basic level, the benefits of private credit have become clearer as the macroeconomic backdrop has grown more volatile"

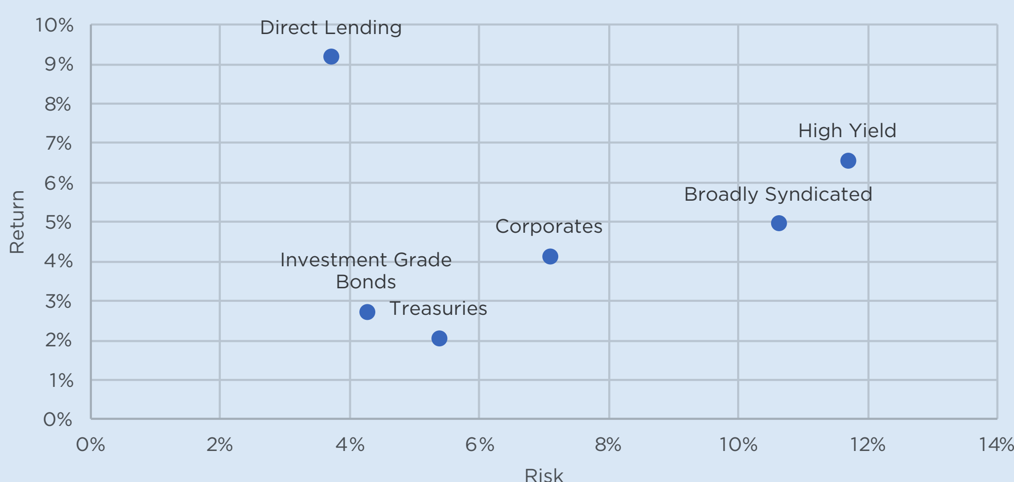
Attractive returns in a rising rate environment

The risk-return profile of private credit is another argument in its favor. As can be seen in Figure 1, the asset class boasts of having lower risk and higher returns than liquid market alternatives.

And as Figure 2 shows, private credit has a clear history of posting attractive returns in rising rate environments.

As with every asset class, there are risks for any prudent investor to consider. In private credit specifically, the most obvious is that, despite recent remarks from the Federal Reserve regarding possible rate cuts throughout 2024, nobody really knows what will happen. It is worth remembering that, up until the end of November 2023, market participants were almost certain that rates would have stayed put until the end of 2024. In the case that rates do dip as suggested during 2024,

Figure 1. Direct lending risk / return analysis (10 years)



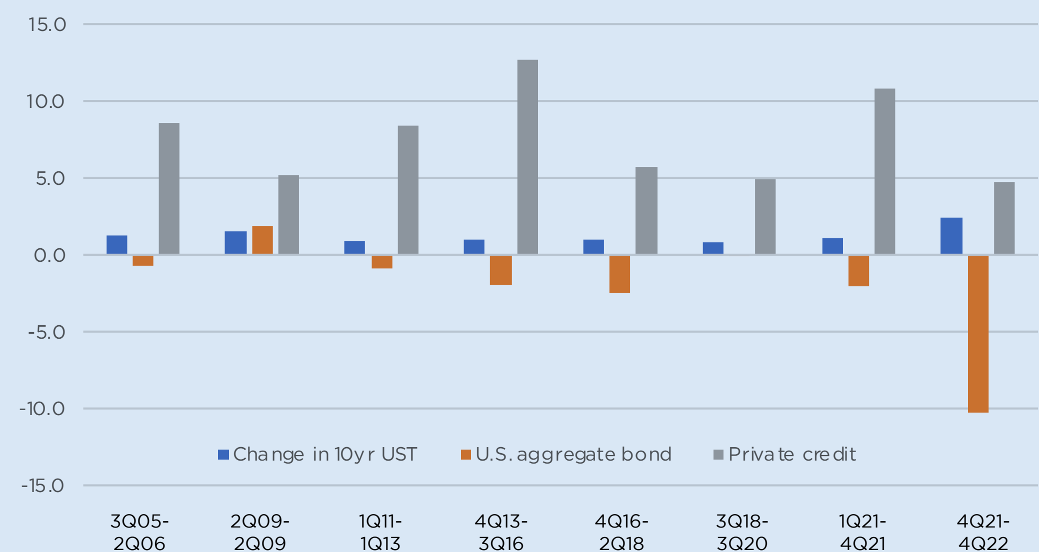
Sources: "Direct Lending" is represented by the Cliffwater Direct Lending Index. "Broadly Syndicated" is represented by the Morningstar LSTA US Leveraged Loan 100 Index . "High Yield" is represented by the Bloomberg US Corporate High Yield Total Return Index. "Corporates" is represented by the Bloomberg US Corporate Bond Index. "Investment Grade Bonds" is represented by the Bloomberg US Aggregate Bond Index. "Treasuries" is represented by the Bloomberg US Treasury Index. Data presented is as of 1Q 2023.

“In the case that rates dip as suggested during 2024, they are likely to remain at elevated levels relative to the last two decades.”

they are likely to remain at elevated levels relative to the last two decades. Some issuers and borrowers may need to renegotiate their capital structure deals in the years ahead. However, the bi-lateral, relationship-driven nature of private debt lending should largely curtail the potential for particularly thorny discussions.

Regardless, investors are continuing to increase their allocations to private credit, and reading Nuveen’s paper, it is easy to see why. For a more detailed discussion on this compelling and fast-growing asset class from the paper’s authors, dig into our “Ask the Expert” interview with Randy Schwimmer, Co-Head of Senior Lending at Churchill Asset Management, and Mattis Poetter, Partner and Co-CIO at Arcmont Asset Management.

Figure 2. Private credit returns in rising rate environments (%)



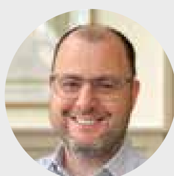
Data source: Factset, Morningstar Direct, Cliffwater Direct Lending Index. As of 31 Mar 2023. Past performance does not guarantee future results.

Ask the Expert Interview with Nuveen:

A Word in Private:

How we got here and where we're going

We sat down with Randy Schwimmer and Mattis Poetter to discuss a host of topics on private credit, moving from why private credit has become so popular, how the asset class has evolved in recent times, to what it might look like in the months ahead.



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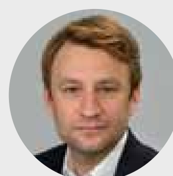


Mattis Poetter
Partner and Co-CIO
Arcmont Asset Management

Has the difficult economic environment over the last few years been a driver of private credit activity, or rather amplified advantages it always had?

Randy Schwimmer: Yes, it has been a driver of activity. But it has also accentuated the benefits inherent in the asset class for both issuers and investors. Private credit has taken on additional significance in the current "higher-for-longer" rate environment that has emerged as the Fed imposed a series of hikes over the last 18 months. That rate regime forced a reordering of the financing markets, disintermediating leveraged buyout activity from the public markets to the private markets.

The fact that private credit managers are supported by long-term capital unaffected by fund flows and collateralized loan obligation formation has given leading managers a significant weapon in providing private equity sponsors with all sorts of flexible credit solutions. For investors, the higher-for-longer environment has provided what some are calling the "golden era" for private credit, where the all-in yields unlevered for senior debt are close to 12%, which is higher than it's ever been.

And at the same time, leverage is lower on a relative basis, creating an optimal vintage for investors. As more capital flows into the market, more is fed back into the investing side of the business. This has resulted in a virtuous cycle that doesn't look as though it will dissipate any time soon.

Do European borrowers have the same appetite for private funding as U.S. borrowers? Are there cultural differences in terms of attitude to risk or expectations of returns?

"For investors, the higher-for-longer [interest rate] environment has provided what some are calling the 'golden era' for private credit"

Mattis Poetter: When I compare what I did when working on financings for American institutions 10-15 years ago to what I do today with European (but primarily German borrowers and German management teams), I would say European markets are much more conservative in their business and capital structure planning.

However, in reality, our industry in the U.S. and in Europe is driven by private equity. And private equity investors want to maximize their returns. Investors in both regions thus look for the best partner to drive those returns.

When private debt didn't exist in Europe, there were of course liquid markets and bank debt, which were driven to offer the best possible terms and rates to generate returns. What private equity has learned over the last decade in Europe—long after the U.S.—is that private debt firms are more expensive for good reasons. The flexibility of capital and the long-term, locked-up nature of private debt structure shows that firms can be long-term partners that can drive the equity story.

I would say that between the U.S. and Europe, appetite for private credit and attitude to risk is very similar, being driven by private equity firms proactively approaching private debt managers.

How do you view the impact of "higher-for-longer" interest rates and how does this affect your default expectations for the industry?

RS: The outlook is improving in general for loans, but because of the higher leverage and weaker structures inherent in the broadly syndicated loan market—and particularly given that those loans don't have financial covenants—the risk dynamic in those loans is believed to be highly visible. In private credit, some people thought that because loans are opaquer, default risk may be higher. In fact, some rating agencies and investment banks recently projected higher default rates for private credit than for their public counterparts.

However, the opposite turns out to be the case. This is because private credit managers are active with regard to the types of industries and companies they're investing in. Second, when they invest into a loan, managers don't have the opportunity to trade—they own that loan until it gets repaid or the company is sold. They therefore take a very different risk profile and underwriting approach.

Additionally, although we haven't gone into a significant recession, we have experienced mini-cycles over the last five to seven years. We've had rates very high. We've had rates very low. We've had Covid, and we've had recessions in specific sectors, such as retail. We've also had supply chain problems. Many quality portfolios are now pretty battle tested.

And defaults for private credit borrowers have been coming down quarter-over-quarter because of much better risk management of illiquid loans than regulators or the media understand.

I expect that as rates have peaked and will likely come down, the pressure on interest coverage and fixed charge coverage on portfolios in general will ease. The outlook for defaults will be even better next year.

Certain features of private credit, such as it being a covenanted market and the loans having floating interest rates, give clear advantages over liquid markets. Why was AUM growth slow until 2019?

MP: We've had a number of shocks since 2019, such as Covid, high inflation, fears of recessions and, in some countries, actual recessions. Public markets have been extremely volatile as a result. People had a very tough time in 2020 in the public markets. And while 2020-2021 was great, 2022 was a bloodbath across all fixed income—in levered loans and high yield bonds especially.

Against this, investors saw the returns and stability of private credit over the last five-10 years and found that to be very attractive. Many investors want consistent, stable returns and they've only just woken up to how volatile public markets can be, and that's helped our industry hugely.

Additionally, we have the base rate situation. Being floating rate in nature and generating 11% to 12% gross returns on first lien credit, as we are currently seeing, is incredibly enticing.

How much has the form private credit takes changed in the last few years? In what ways, and why?

RS: Historically, revolving credit capacity was one area where banks excelled over private credit. That's one area where we were initially off to a slow start, but today there's been significant improvement in this area.

Other evolutions include the ability to offer a portion of a subordinated debt structure as cash pay and a portion as payment-in-kind, which is particularly attractive in this higher-rate environment. We can also provide significant delayed draw term loan capacity for companies that are making acquisitions, along with the ability to be flexible with regard to covenants and debt incurrence.

Overall, the general trend has been toward custom-made credit solutions. In our case, we have a suite of products up and down the capital structure, enabling us to sit down with a client and identify how to create a financing structure that meets their exact needs. But in my view, the single most important innovation in the last decade of private credit has been the unitranche structure. This gives us the ability to have one senior loan going all the way up to the total leverage affordable by the cash flow capacity of the deal.

Is private credit worth the illiquidity premium and how is investor appetite evolving?

MP: Investor appetite is still incredibly strong for private credit, especially for the larger managers who have a long track record and a big investor base. There is a huge skew toward these managers at the moment because first-time funds have less of a track record and less means to fundraise.

Private credit is very attractive to a potential investor, because they are seeing returns that are—even in euros—almost hitting double digits.

Investors are noting fixed income with interest and that private credit, with a premium of 2%-3% over liquid loans, is exciting. You're getting all that extra return and you're getting the benefit of better companies at the moment because we can access larger borrowers that were previously financed by liquid markets.

Granted, there was a little bit of a scare in the final two quarters of 2022, when everyone was afraid

“Having a strong portfolio allows you to continue to fundraise and continue to invest. And if you’ve been successful in a higher-for-longer regime, you will be even more successful next year.”

of a huge recession. But, since then, in terms of fundraising and investor appetite for the asset class, it’s hardly been better.

Is the market overcrowded? Which managers are best positioned in this environment?

RS: The story I tell concerns a gym in town that my wife got me into about three years ago. It’s very popular.

The first time I drove up there I was a little intimidated because the parking lot was packed, and I thought there was no way I’d be able to get my little workout in. But while it was certainly busy, there weren’t many people in my section. I realized there were about 12 different classes going on—a cycling class, a weightlifting class, a judo class, a boxing class… and that’s how the private credit market is.

When you look at the participants in this industry, in terms of the number of deals completed, after you get past the first five, we don’t see any of these players. They don’t play in our space. They’re in more opportunistic credit, they do small cap deals, or even, in some cases, non-sponsored deals. The asset class umbrella is very wide.

There are a lot of competitors doing different things, but in the space that we are in, which is the traditional middle market, private equity backed companies, the number of players who have the skills that we do and the relationships that we have has actually fallen off. There are fewer competitors today than there were pre-Covid. A lot of folks who had portfolio problems during the pandemic dropped off and were therefore unable to raise more money.

However, just because there is less competition does not mean that what is left is less competitive.

Where do you see the market heading into 2024? With rate hikes slowing down, an upcoming presidential election in the U.S., global turmoil… what are you preparing for in the coming months, and do you foresee any of these issues fundamentally reshaping the credit market in the next year?

MP: No-one expected Ukraine. No-one expected soaring inflation. And no-one ever expected rates going from zero to 5% that quickly. There were so many issues that, frankly, we didn’t foresee. You’ve asked about risks we know are either probably or most likely coming, but there may be many more, right?

All of these issues are short-term shocks that make liquid markets more volatile and difficult to access in size. And shocks and volatility are always good for us because we don’t syndicate, and we hold our risk to maturity.

I think that 2024 will probably be more normalized than 2023, but there will be shocks.

RS: We believe that the environment for both issuance and investing in private credit will be better in 2024 because we don’t believe that rates are going to be coming down with anything close to the speed that they have recently increased.

As a result, we think that rates will be closer to historic averages than was the case in the period from 2010 to 2022—what I call a “zero gravity” environment — which made no sense. The law of gravity has returned and it’s not going away any time soon.

As a result, investors won’t necessarily see the excellent and unprecedented ratio between risk and reward which has benefited the reward side of the equation recently. But having a strong portfolio allows you to continue to fundraise and continue to invest. And if you’ve been successful in a higher-for-longer regime, you will be even more successful next year.

What are you most excited about for 2024?

RS: The thing that I’m most excited about is our competitive position and our partnership with Arcmont – Nuveen’s private capital platform is now one of the largest private debt players globally. Between us, we have just begun to tap the cross-border opportunities from a financing and fundraising perspective. We closed this deal nine months ago, but it feels as though we’ve been working together for much longer.

MP: This goes not just for 2024, but 2025 and 2026, but we have an opportunity that both of us haven’t had before. Certainly, there is a niche private debt part of Europe that, in the past, has often felt left out—especially in capital raising for investors who want global solutions across both continents. We can tackle that now. That is very exciting.

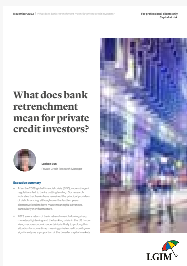
Savvy Investor Top Papers

Our Top Pick of Private Credit Papers

Trends in Private Credit Fund Structuring

26/09/2023 | Dechert

Private credit managers adapt fund structures and terms in order to offer investors customized risks, returns, and retail market access. Learn more about key fund structure trends.



What Does Bank Retrenchment Mean For Private Credit Investors?

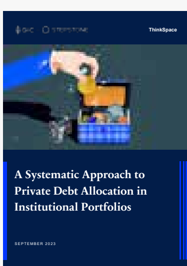
14/11/2023 | LGIM

Post-2008, more stringent regulations saw banks cut lending. Our research indicates that banks have remained the principal providers of debt financing, but over the last ten years, alternative lenders have made meaningful advances.

Fund Financing For Private Credit

15/11/2023 | Macquarie Asset Management

Credit portfolio financing provides institutional investors with a defensive private credit allocation to middle-market lending structured as an investment grade exposure.



A Systematic Approach to Private Debt Allocation in Institutional Portfolios

10/03/2023 | GIC

Private debt has seen rising interest through its potential to enhance risk-adjusted returns and increase resilience. GIC and StepStone offer an analysis of this landscape and a framework for optimizing private debt allocations.

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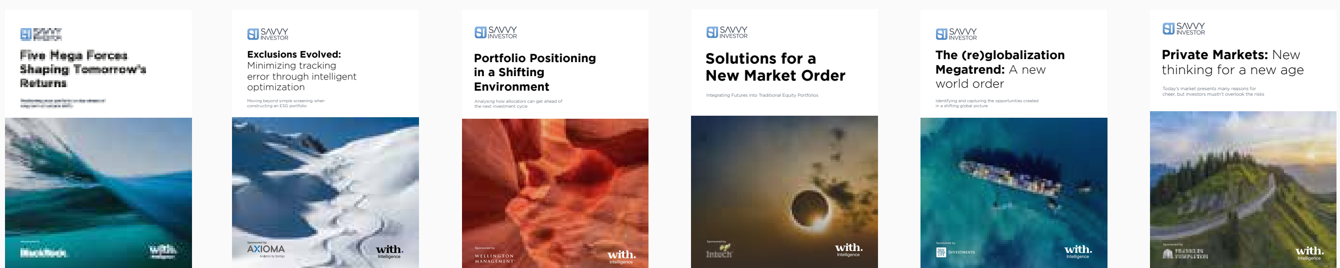

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