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Private debt continues to offer attractive opportunities

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Recent developments in private debt suggest investors need to pay closer attention to borrower stress and choose the right managers. But we believe the asset class can deliver high-single-digit to low-double-digit returns in 2024 and 2025 as lower interest rates and fiercer bank competition moderate returns.

CIO favors senior upper-middle-market and sponsor-backed loans and top-tier managers with experience in stress environments. Investors must be aware of private debt's unique risks.

There are pockets of challenges in private debt.

- Overall default rates rose to 2.7% in the second quarter of 2024, up from 1.8% in the first quarter, according to Proskauer.
- Pockets of vulnerability exist in the lower middle market segment, with weaker interest coverage ratios, higher defaults, and higher non-accrual rates than upper middle market companies.

But we think the asset class offers continued long-term opportunity to diversified investors.

- The Cliffwater Direct Lending Index returned 5.7% in the first half, outperforming US leveraged loans (4.4%) and US high yield (2.6%).
- Private debt managers tend to favor senior secured debt, which is among the most insulated from company losses.
- Current yields for private loans are around 11%, offering a favorable yield pickup compared to US leveraged loans and high yield, at 130bps and 310bps, respectively, as of 30 June 2024.

So, investors who are selective in private debt should be better positioned to navigate a trickier environment.

- Investors should focus on top-tier managers with experience in deploying capital in stress environments that are well diversified and follow strict underwriting principles.
- Investors should consider the risks inherent to private markets before investing, including illiquidity, long lockup periods, leverage, and over-concentration.

Did you know?
European direct lending tends to display more conservative underwriting standards than the US, with higher interest coverage ratios (3.6x versus 2.9x for the US), comparable equity contributions (c. 46% on average between 2019 and 2023), and the same average default rate of 1.8% over 2019-2023 (taking the leveraged loan market as a proxy).

Investment view
Private debt continues to offer attractive opportunities, in our view, particularly in senior upper-middle-market and sponsor-backed loans. Private debt typically exhibits lower volatility than conventional debt with similar ratings, resulting in more moderate reactions to public market volatility and changes in risk sentiment. Private debt and direct lending strategies remain a long-term source of income, diversifier of returns, and potential improver of a portfolio's risk-return characteristics, in our view.

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