CIO believes private credit can provide a strategic source of income in a portfolio context while diversifying and potentially smoothing returns. (UBS)

How private credit can play a role in portfolios

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Private credit has been in the headlines recently, with prominent financial industry executives highlighting the illiquidity and other risks associated with the asset class.

In addition to more aggressive financing terms due to increasing competition, signs of financial stress from borrowers are also worth monitoring, particularly in the lower middle-market segment, where businesses with weaker balance sheets feel the pressure of current higher rates more strongly. Notably, the default rate on loans to smaller companies—those with an EBITDA of less than USD 25mn—picked up to 2% in the first quarter of this year , up from 1% in the prior quarter, based on data from Proskauer.

However, we continue to see a place for private credit and direct lending strategies in well-diversified portfolios, provided that investors understand and have the means to manage risks inherent to private markets, such as illiquidity, long lock-up periods, and leverage.

Return prospects for the asset class are attractive. Driven by high income and only moderate realized losses, private loans delivered 12.1% total returns in 2023 (as measured by the Cliffwater Direct Lending Index), following a 6.3% return in 2022. With around 2–3% returns estimated to have been achieved in the first quarter, we anticipate high-single to low-double-digit returns for 2024. Longer term, we expect private debt to return around 9% per year over a full business cycle.

Lender protection remains strong. While the negotiating power of borrowers is increasing amid heightened competition, private loans generally have stricter covenants and are senior in the capital structure. According to JPMorgan data, over the past 12 months, only 20% of completed direct lending deals had fewer restrictions on borrowers, compared to 90% in the broadly syndicated loan market. Meanwhile, leverage levels are still low by historical standards, and sponsors' high equity contributions provide a meaningful cushion in case of defaults.

Both fundraising and transaction activities point to a growing market. While total capital raised for private debt last year fell further from the 2021 level, we believe fundraising volumes should find support this year amid a growing use of private debt funding by private equity sponsors. Investor demand for attractive carry with lower sensitivity to broad public market price movements as well as a pickup in M&A and refinancing activities should also be helpful.

So we believe private credit can provide a strategic source of income in a portfolio context while diversifying and potentially smoothing returns. We stress the importance of selectivity when investing in private credit, and recommend senior, upper-middle market, and sponsor-backed loans focused on sectors less susceptible to cyclical downturns.

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