
Will Private Credit Returns Surpass Private Equity, Even as Risk Declines?



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KEY TAKEAWAYS

- Rising rates and widening spreads have lifted private credit returns to about 12%, which can be boosted further by buying new issuance at a small discount and by deploying moderate leverage at the fund level.
- The resulting 14% to 15% gross IRR compares with an 18% mean net return for buyout funds from 2008-2018.
- Improved returns are not coming at the expense of increased risk, since many parameters, including leverage levels, covenants, capital structure seniority, and equity contributions are moving in lenders' favor.
- As traditional sources continue to step away from providing debt capital, private credit managers continue to take share in an expanding market.

We believe returns in private credit are approaching levels typically seen by buyout investors, while lenders are also enjoying increased protections and improving deal terms. In combination, these forces may create a compelling era for the private credit asset class, says Jeff Diehl, Managing Partner and Head of Investments at Chicago-based Adams Street Partners, a private markets specialist with more than \$50 billion in assets under management.

Over the past year or so, private credit has shed its reputation as private equity's boring sibling. Because for perhaps the first time, returns for private credit could rival the median return produced by the buyout industry.

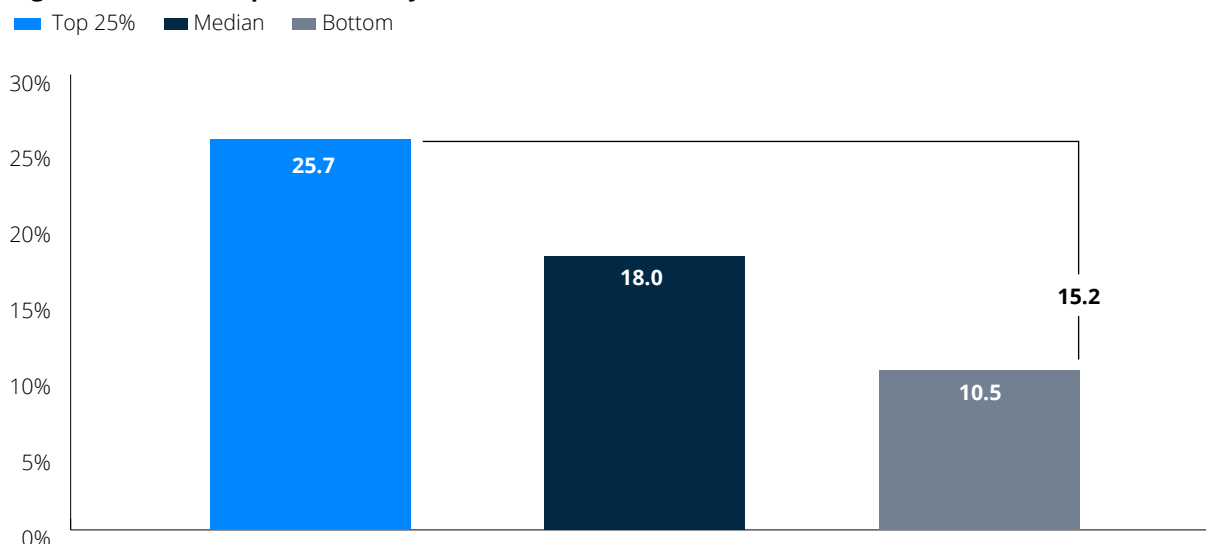
Back in mid-2021, a senior secured loan to a middle market buyout deal was expected to produce a cash yield of about 5-6%.

But rising interest rates and widening credit spreads have lifted that to around 12% today. In addition, private credit lenders can purchase new issues at a slight discount, boosting cash yield by another 100 basis points or so. Adding some modest leverage at the fund level can provide another 1-2% boost to the Internal Rate of Return (IRR).

In the current climate, a high-quality private credit fund has the potential to produce a 14-15% gross IRR, mostly realized through quarterly cash distributions.

That compares quite favorably with liquid credit alternatives and also starts to look compelling relative to private equity, since the median net return of buyout funds from the 2008-18 vintage is 18% (see Figure 1).

Figure 1: Return Dispersion in Buyouts¹



But those returns were produced in a climate of low rates, inexpensive fund lines of credit, and rising valuation multiples, factors that have reversed course in the current climate. While top-performing buyout funds are likely to produce well-above median returns, we believe that the median buyout fund will be challenged to replicate 18% in today's market.

Improving Terms

Perhaps just as surprising, private credit's return potential does not appear to be coming at the expense of increasing risk. Indeed, we believe the opposite – that the pendulum on a whole range of deal metrics has swung in favor of the lender (see Figure 2).

Figure 2: Example Buyout Deal²

	January 2022	Today
EV/EBITDA	12.5x	12.5x
Debt/EBITDA	6.5x	5.0x
Equity/EBITDA	6.0x	7.5x
Debt Cost	5.0%	11.5%

Take leverage. Back in 2021, when that senior secured loan had a cash yield of about 5-6%, a typical middle market buyout deal had leverage of about six to seven times earnings before interest, taxes, depreciation, and amortization (EBITDA). That is now closer to 5.5 times EBITDA and, based on our market observations, is likely to drop to five times EBITDA or lower, since rising interest rates are acting as a governor on companies' ability to service additional debt.

In addition to the lower leverage levels, lender protections have also been bolstered by a return of traditional maintenance-based covenants. These covenants provide lenders with material negotiating rights if company performance begins to lag, not to mention seniority in the event of severe trouble that causes equity value to materially erode.

With debt contributions down, equity contributions have climbed, to typically about 60% of buyout deal value. That's about 10 percentage points higher than 12-15 months ago, which implies that the enterprise value of a portfolio company would need to contract by half to risk impairment in the underlying loan.



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Cardinal Rule

So, while average returns in private credit are significantly higher, risk has simultaneously declined. We believe this dynamic seems likely to continue given that rate hikes do not appear to have peaked, and demand for private debt continues to exceed its supply.

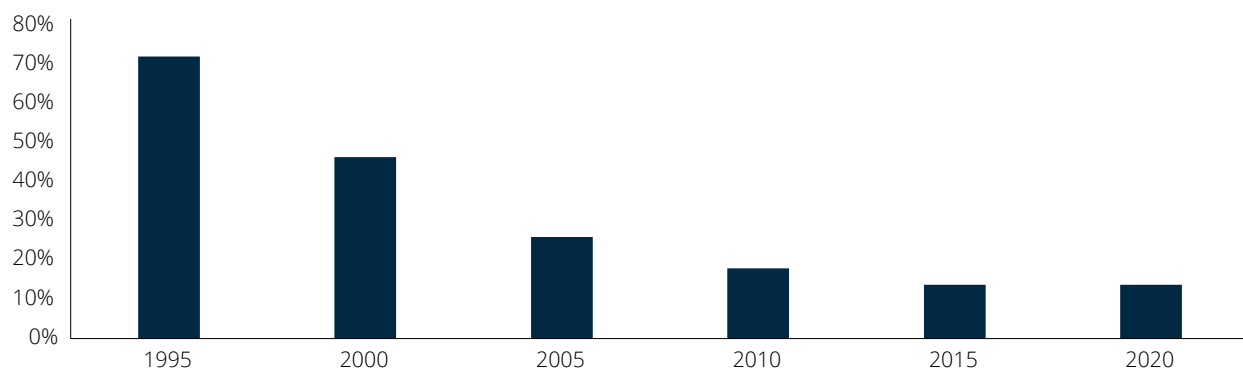
In our view, these dynamics should bode well for managers who adhere to the cardinal rule of private credit – loss avoidance. Private credit funds lack outsized winners than can offset losses (like private equity), so we believe lenders should select borrowers with the business fundamentals and enterprise value to support steady interest payments and principal recovery. In our view, to be successful, private credit providers must make money-good loans.

We have observed that successful private credit investing means backing fund managers with four critical characteristics: meticulous underwriting that leads to solid credit selection; a track record of loss avoidance across market cycles; a large enough deal funnel to support their fund size; and the ability to win deals of their choosing.

Loss avoidance is easier said than done in a climate where company fundamentals are challenged. Historically, private credit return dispersion has been lower than private equity. But we believe recent data has been skewed by benign market conditions and we anticipate private credit return dispersion will rise.

Figure 3: Traditional Source of Capital has Declined³

% of US leveraged loans held by banks



Rigorous underwriting and disciplined credit selection are critical as GDP growth slows and companies are forced to absorb higher interest payments and rising input costs due to inflation.

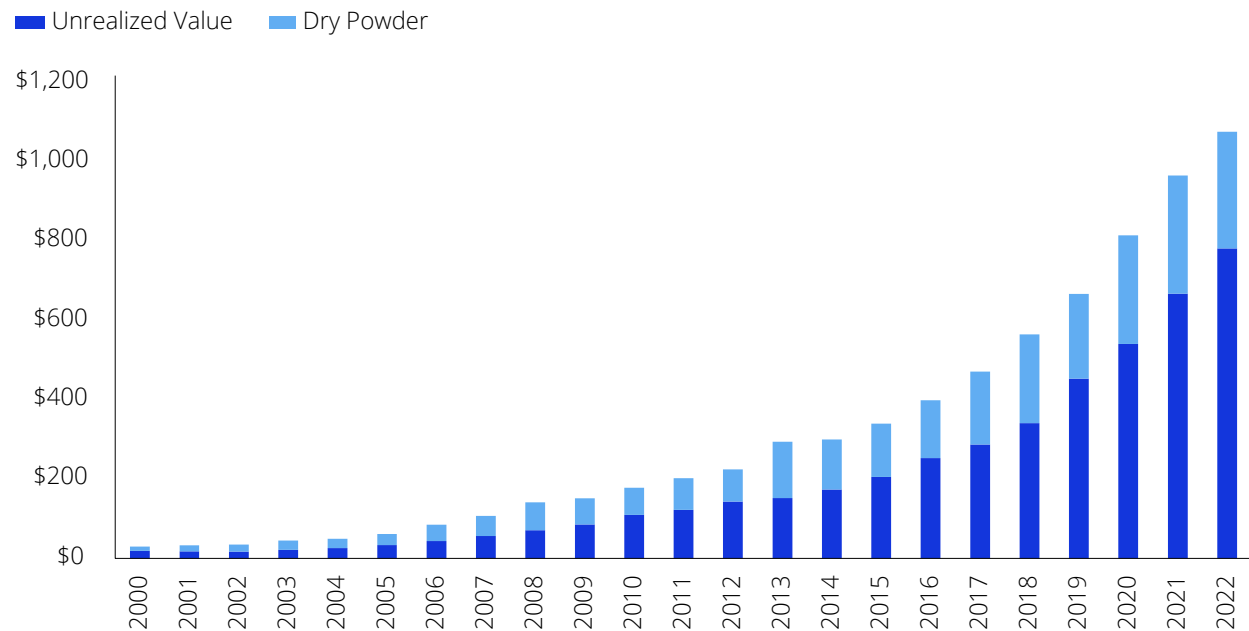
Filling the Funding Void

We believe that the long-term outlook is likely to continue to be positive for the private credit asset class. Private credit has been on a long structural march of taking market share from banks who have concluded that originating and selling loans has a better return on capital than originating and holding loans.

In 1995, banks held 70% of levered buyout debt. By 2020, that figure had declined to less than 15% (see Figure 3). By contrast, in 2007 private credit funds had \$108 billion in assets under management. By year-end 2022, forecasts indicate AUM of about \$1.1 trillion (see Figure 4).

Figure 4: Private Credit AUM Has Grown Significantly⁴

Assets under management, US \$ in billions



Private credit funds are also enjoying market share gains against liquid markets. Private credit funds started by focusing on companies with less than \$100 million in EBITDA. Today, they can fund debt stacks for companies with \$500 million or more in EBITDA, eroding market share of the leveraged loan sector (AKA broadly syndicated loans), which typically serves companies with EBITDA over \$100 million.

And that's anything but boring. ■



1. Source: McKinsey & Company, Private Markets Rally to New Heights, December 2021.
2. Figure 2 is solely an illustration of deal terms observed in Jan '22 vs recently observed deal terms; not representative of any Adams Street Partners investments.
3. Source: S&P Capital IQ, LCD's Leveraged Lending Review, 4Q22.
4. Source: Preqin. Based on Preqin data available in November 2022.

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