Private Debt: Resilience Despite Interest Rate Rise

Karen Simeone, Managing Partner, HarbourVest, Boston
Martina Schliemann, Principal, HarbourVest, Frankfurt

In recent years, institutional investors from Germany – including insurance companies - have come to appreciate the merits of private debt. Stable cash flows, low volatility, adequate returns in times of negative real yields in the public markets have made the private markets particularly attractive. Additional regulatory developments have opened the door to loan funds and direct lending strategies for insurance companies. But has the case for private debt diminished in the face of higher inflation and rising interest rates?

Institutional investors have generally been very satisfied with the returns of their private debt portfolios over the last ten years as the asset class has meaningfully outperformed the public bond markets. Private debt has proven to be much less volatile than public fixed income alternatives and similar to the comparison of private equity to equity markets, private markets are generally much more resilient and less volatile given their illiquid nature and lack of price discovery on the secondary market. Additionally, the floating rate nature of the private debt asset class insulates these securities from the sharp price declines that have been realized by the public bond market which are fixed rate in nature.

In the face of heightened macroeconomic uncertainty and coordinated interest rate hikes by central banks around the world, investors may now be asking themselves whether the private credit market is more or less attractive than public fixed income. We believe that private credit, especially in the US, provides superior risk-adjusted returns, offering investors the chance to obtain yields in excess of 10% in an asset class that continues to take market share from the high yield and broadly syndicated loan market while demonstrating low volatility, low default rates, and high recovery rates in the event that a default occurs.

Floating rates offer protection against rising interest rates

One of the key structural features of private debt is its floating rate nature. This compares to the public high yield which is typically comprised of fixed rate securities which leaves them susceptible to meaningful price changes as interest rates change. Most private debt is priced as a spread over the short-term, risk-free rate like three-month term SOFR (Secured Overnight Financing Rate) in the USA or EURIBOR (Euro Interbank Offered Rate) in the euro area. The total yield rate on a loan is comprised of upfront fees, the base rate (e.g., SOFR), and a fixed spread on it - depending on the market situation and the risk rating of the

debtor company. Given recent interest rate hikes by the Fed, since early 2022, three month term SOFR has risen from less than the 0.75% floors found in most private credit deals to 4.26% as of 10 November 2022[1]. Over a similar period, we have observed that the average spread on the most common private debt structures has widened by approximately 100 bps, from 550-575 bps to 650-675 bps, and upfront fees have increased by approximately 1.0%.

Private debt investments can therefore serve as a hedge against rising interest rates. This gives them an advantage not only over fixed-rate bonds with a fixed nominal interest rate, which make up the bulk of the bond market, but also over most assets in the equity markets, where rising interest rates can translate to lower valuations. Private debt with floating rates, on the other hand, adjusts to the rise in interest rates to deliver higher returns in tandem.

Private credit first emerged in the US as a niche industry approximately 20 years ago, followed by gaining popularity in Europe since the GFC. Market volume is currently almost one trillion US dollars. In this short time, private credit has weathered a number of economic downturns, including the bursting of the dotcom bubble, the global financial crisis, and the COVID pandemic, and we believe it has emerged as a larger, resilient, and attractive asset class.

Financing US SMEs with private debt

Private debt is the preferred financing vehicle for the middle market in the USA, especially for portfolio companies of private equity firms. The "Mittelstand" is not an exclusively German anomaly: In the USA, around 200,000 companies are classified as middle market; which in represent approximately 1/3 of US GDP and, if disaggregated from the US, would represent the fifth largest economy in the world[2]. Over 25% of these companies are private equity-owned. In recent years, and especially in 2022, private equity owners have increasingly turned to private credit to finance their portfolio companies owing to the flexibility, reliability, and confidentiality that private credit offers vs. public fixed income- even for companies that may be large enough to tap the high yield or syndicated loan market. Over the course of the last twenty years, the direct lending market has continued to take market share from these more public markets as well as banks- with banks now representing approximately 10% of financings for US middle market companies[3].

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[1] https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html
[2] https://www.sbia.org/wp-content/uploads/2021/02/GR-Fact-Sheet-Middle-Market-1.pdf and https://hbr.org/2021/03/the-middle-market-is-stressed-but-resilient
[3] Source: Refinitiv

Private credit loans generally offer greater structural protections than bonds or even broadly syndicated loans. Generally speaking, borrowers in the private credit market typically have loan to values of 40% or said another way borrowers are often supported by a 60% equity cushion. In addition, private-debt creditors have many more opportunities to intervene at an early stage since the loans are closely held by a relatively small group of lenders who have similar objective. And last but not least, the private debt market tends to focus on less cyclical industries, with stable cash flows and resilient business models that have shown very stable development, such as business-related services, healthcare, software and technology, which has contributed to the resiliency of the asset class over time.

Private equity as a door opener for private debt

The role of private equity is very important to the development of the private debt market. Private equity general partners in the USA prefer to use private debt as a source of leverage for their portfolio companies. This is partly due to the adaptability of the loans, but also to the speed of execution and anonymity in the marketplace. A good network in the private equity segment is the ideal way for private debt investors and their fund managers to source deals. If you consider that the "dry powder" of private equity investors is currently still four times as large as the existing private debt market, it suggests that the private credit market needs to grow substantially to meet the financing needs of private equity sponsors.

However, demand for private debt remains strong not only on the borrower side but also on the investor side. Institutional investors in the USA have multiplied their allocation to private debt from one to two percent to around 15 percent in the past ten years alone - in search of adequate cash flows to meet yield objectives. In addition to commanding a significant yield premium, private credit funds generate contractual cash flows by way of regular coupon payments and generally charge fees on invested capital only, which helps to mitigate the J curve. As a result of these structural benefits, numerous investors in search of yield and stability, are increasingly discovering this asset class for themselves.

Despite the significant growth in the asset class over the last twenty years, the private credit markets are expected to see continued growth as it solidifies itself as the preferred method of financing for private equity general partners. We believe that investor demand will remain robust as the asset class offers a meaningful yield premium to the public markets, in addition to stability and diversification to other risk assets that has been difficult to find in the public markets in recent years.