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Private Credit: An Enduring Opportunity in Dynamic Market Cycles

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KEY TAKEAWAYS

- We continue to see increasing demand for large-scale direct lending, highlighting the enduring nature of private credit. The opportunity to lend to larger businesses on a first-lien, senior-secured basis at attractive yields continues to grow as corporate borrowers seek bespoke solutions and diverse funding sources.
- Despite the Federal Reserve's shift to easing monetary policy, we expect interest rates to stay higher for longer on a relative basis. An environment of sustained higher interest rates can enhance opportunities in direct lending, which are often floating rate instruments. Additionally, private credit continues to generate incremental spread over public credit, and we expect that to remain the case for the foreseeable future.
- We believe that the opportunity to provide private capital to borrowers may be enhanced as dealmaking activity picks up further in light of potentially less-stringent regulatory policies from the incoming US administration.
- Even as public debt markets have seen a resurgence, we believe both the public and private debt markets will continue to grow and coexist. We do not see it as an either/or opportunity. Rather, the key benefits private credit can offer—e.g., customization, speed, and certainty of execution—have become an integral part of the menu of credit solutions available to large borrowers.
- In our view, private credit is not inherently more risky compared with public debt markets. Private transactions are generally negotiated on a bilateral basis and allow lenders to secure stronger legal and contractual protections.

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One of the questions we're most frequently asked is why large borrowers would look for solutions in private credit as opposed to the public market. Some find it even more perplexing in the context of monetary easing, or as syndicated-loan markets are open and regaining steam, or when these companies and sponsors are already big issuers in the public markets.

The answer to that question, in our view, is simple: We firmly believe in the enduring power of private credit throughout dynamic market cycles. In fact, we continue to see growing demand for large-scale lending by borrowers seeking multiple types of capital solutions and we attribute this to the key benefits private credit can offer—i.e., customization, speed, and certainty of execution—which are not available in the syndicated market. Private credit has become an integral part of the menu of credit options available to large borrowers.

Further, we continue to focus on lending to bigger, more established, and diversified businesses on a first-lien, senior-secured basis versus those investors that focus on smaller (more risky) corporate borrowers or subordinated risk. We believe the opportunity set in large-cap lending should further benefit from a more active M&A market, with many advisors predicting increased deal activity in the year ahead and a potential boost from the incoming US administration.

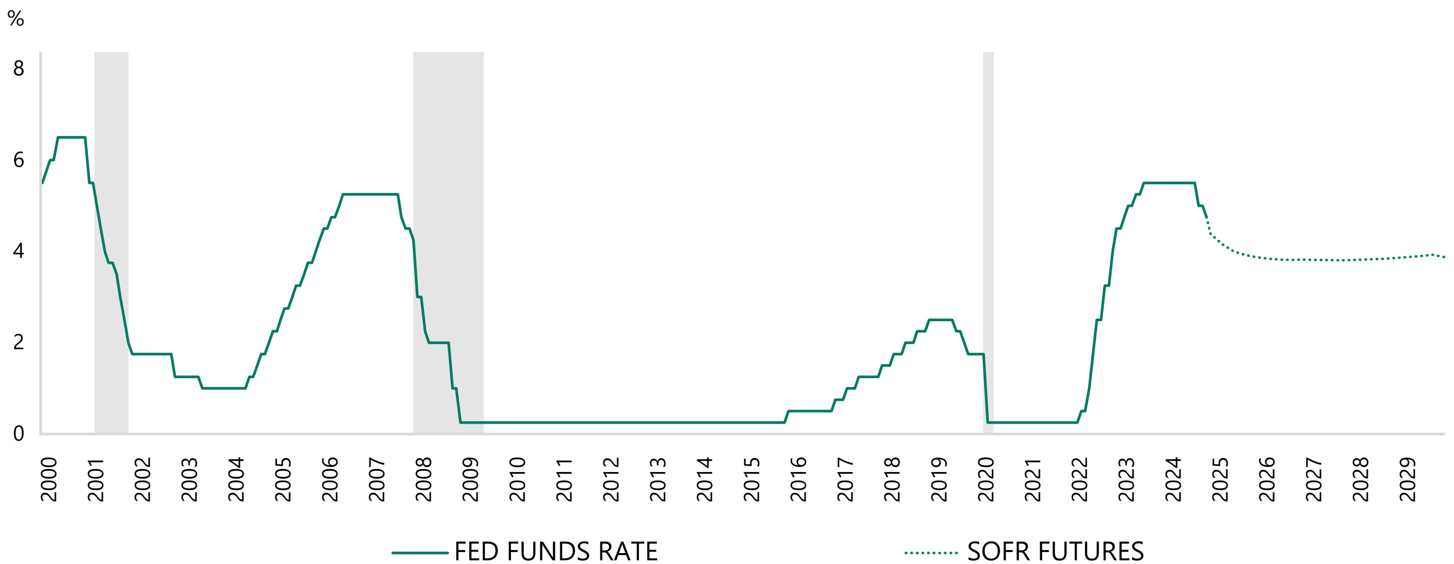
With that in mind, the remainder of this paper discusses some key top-of-mind topics when considering an allocation to private credit in this stage of cycle, namely a) what Fed cuts can mean for direct lending; b) what a recent increase in syndicated-loan market activity can mean to borrowers seeking private solutions; and c) a comparative analysis of the risks of investing in private vs. public credit today. Additionally, we will briefly explore the landscape for providing capital to companies and outline where we see the strongest opportunities today.

What the Fed's rate cuts mean for direct lending

While the Federal Reserve has embarked on a monetary-policy easing cycle—having lowered the federal funds rate since September by 75 basis points (bps) to a range of 4.50% to 4.75% as of this writing—we believe interest rates will stay relatively higher compared to historical standards for longer **(Exhibit 1),** enhancing the opportunity to deploy capital in direct lending strategies.

Even if the Fed's December meeting results in an additional cut of 25 bps, short-term rates would be around 4.5% at the end of 2024—the highest since 2007 (excluding the most recent rate-hike cycle). We see this as a normalization of base rates to historical levels. In fact, we believe that the period that preceded this cycle—when interest rates spent almost 15 years close to zero—was the true anomaly. In other words, we don't expect base rates to return to rock-bottom lows any time soon.

Exhibit 1: Interest rates expected to remain permanently higher despite Fed easing



Data as of November 2024.
Sources: Bloomberg, Apollo Chief Economist

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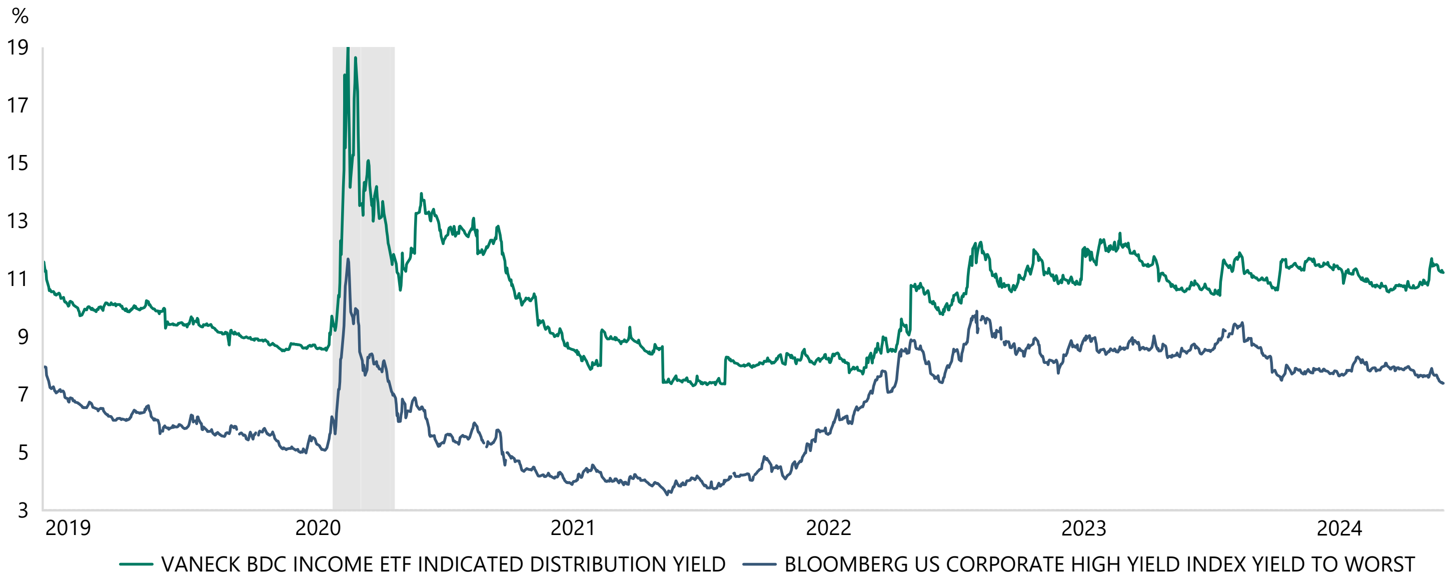
We view this higher-for-longer environment as particularly positive for direct lending given the floating rate aspect of the asset class tends to benefit from higher rates. In addition, private credit continues to offer wider credit spreads than public markets, contributing to higher overall yields **(Exhibit 2)**. We expect this delta to remain intact for the foreseeable future, as demand for credit stays robust, in line with strong economic activity.

Exhibit 2: BDC yields noticeably higher than high yield bonds



Data as of August 2024.
Sources: Bloomberg, Apollo Chief Economist

Further, we believe that private credit can offer an interesting alternative for market participants worried about lofty valuations in the public equity markets today. As our Chief Economist Torsten Sløk wrote recently, public stocks at current valuations can imply a 3% annualized return over the next three years. If realized, those returns can trail overall returns expected in the private credit space in the same period of time, especially when one factors in original issue discounts with still-elevated base rates, as well as structural protections.

A key structural protection in private credit is that it's typically senior in the capital structure. Senior debt holds a higher priority of claims on a company's assets in the event of bankruptcy or liquidation, compared to subordinated debt or equity holders. This seniority can provide greater security and stability for lenders, particularly in volatile economic environments.

Additionally, the incoming Republican administration in the US may result in a less-stringent regulatory environment, which will likely increase dealmaking and financing activity. Mergers and acquisitions (M&A) activity has already seen a comeback in recent quarters amid a strong economy, robust corporate earnings, and lower cost of financing. In the third quarter of 2024, global dealmaking volume totaled $922 billion, the highest in two years (**Exhibit 3).**

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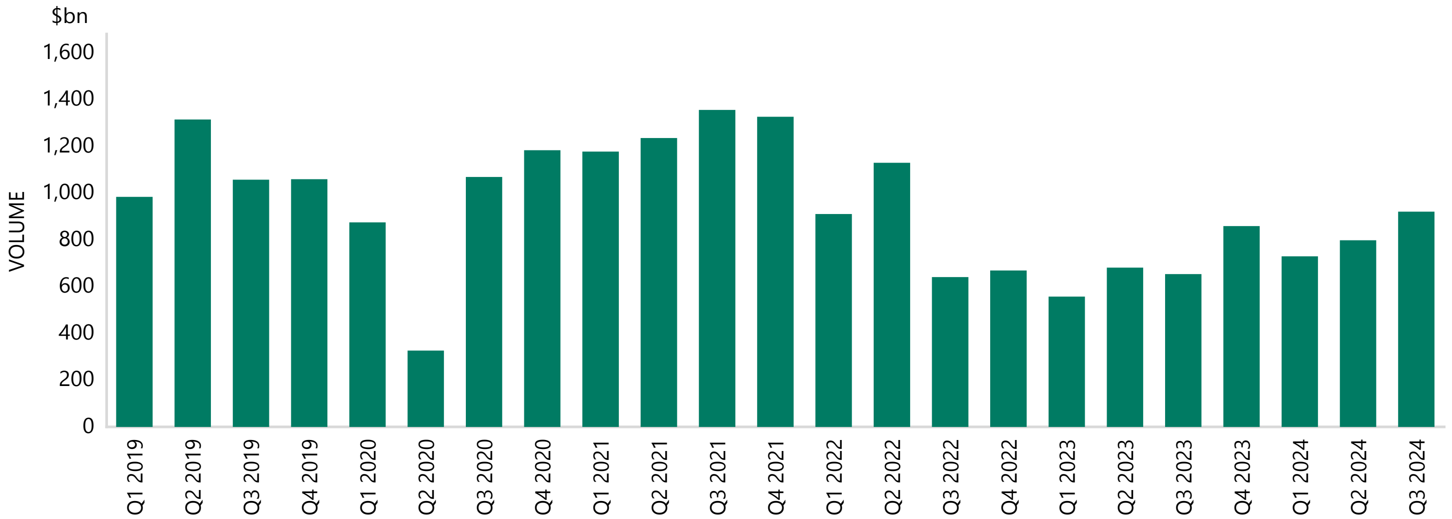
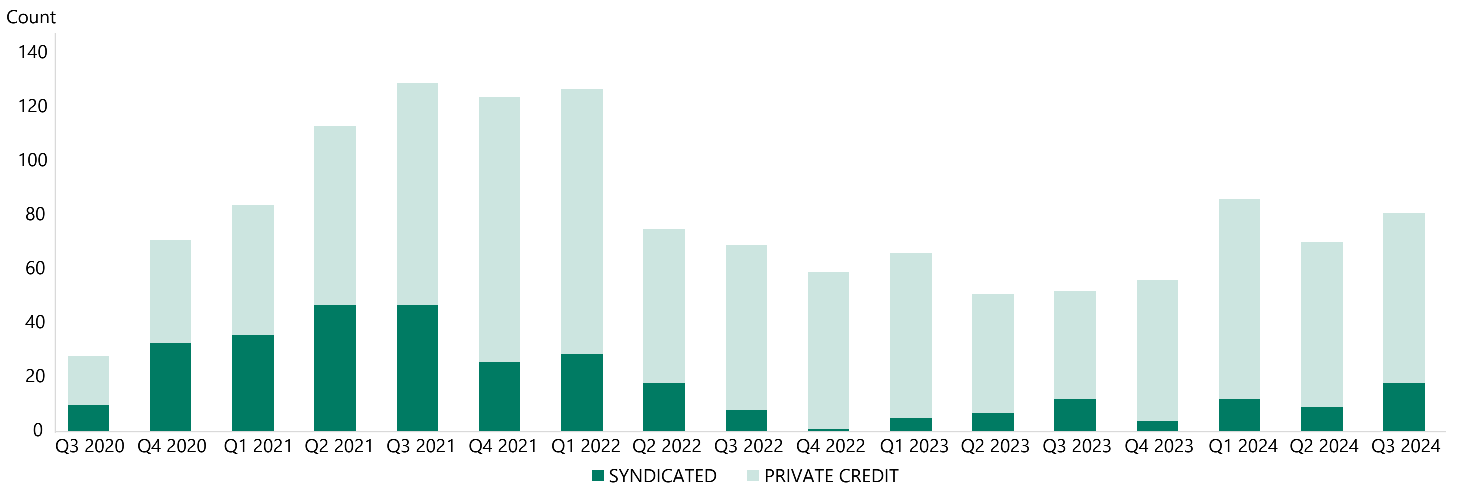
Exhibit 3: M&A activity picking up in recent quarters



Data as of September 30, 2024.
Source: Bloomberg

And importantly, a significant and increasing portion of new LBO activity continues to be financed in the private market as issuers look to the speed, certainty, and sophisticated solutions that private capital can bring **(Exhibit 4).**

Exhibit 4: Most LBO deals continue to be financed with private credit



Data as of September 30, 2024.
Private credit count is based on transactions covered by LCD news.
Source: PitchBook LCD

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The implications for private solutions as syndicated-loan market picks up

While private credit has accounted for the majority of LBO financing since 2021, there has been a pick up in syndicated loan issuance in recent quarters coming off a previous period of low new issuance levels. Reopening of the BSL market doesn't necessarily detract from the opportunity for private credit, in our view. The US leveraged loan market and private credit market have both experienced strong growth in recent years, and we believe they will not only coexist but grow together in their own ways.

Borrowers choose to obtain financing in the public market or seek a private solution based on their particular needs and constraints. While financing in the public market can result in potential cost savings, obtaining funding in the private market can often provide borrowers with bespoke deal structuring and terms, price certainty, and speed of execution. We firmly believe that these traits—which have attracted many companies seeking credit in the past decade—will continue to drive demand for private credit and create opportunities for lenders.

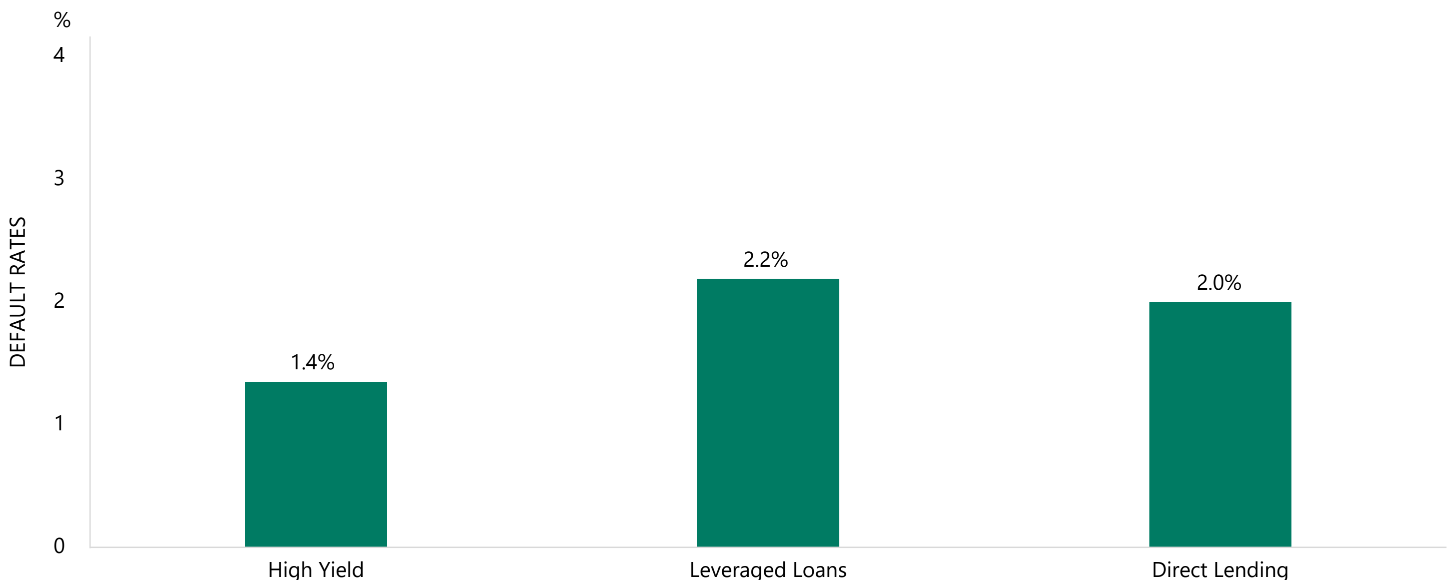
Additionally, while both markets have grown substantially,[1] most of the issuance activity in the US syndicated loan market has been focused on refinancings and repricings, rather than net capital creation, which can support growth and expansion of companies, as well as overall economic growth. Through the first nine months of 2024, 31% of total sub-investment grade private credit origination went towards funding new M&A and leveraged buyout (LBO) activity.[2] In contrast, only 14% of US syndicated loan issuance is expected to result in the creation of new debt capital this year.[3]

Risks in public vs. private credit today

Risk considerations and capital preservation are paramount to successful credit investing. With private credit, transactions are typically negotiated on a bilateral basis, allowing lenders to secure more rigorous legal and contractual protections.

Additionally, we feel compelled to de-bunk a myth: Private credit is often portrayed in the media as being riskier simply due to its private nature. But recent data suggests private credit not only enjoys stronger documentation and a direct relationship with borrowers, but also that this can lead to lower or comparable credit losses as compared to the leveraged loan and high yield bond markets, respectively. Year-to-date through September 2024, the default rate in private credit was 2%, slightly below the 2.2% rate for leveraged loans, and modestly above the 1.4% rate for high yield bonds **(Exhibit 5)**. In any credit investment, we believe the key focus should be on the quality of the company and its management team, historical performance and feasibility of the capital structure. Ultimately credit selection, origination and structuring can facilitate greater downside protection as well as potential generation of excess spread per unit of risk.

Exhibit 5: Defaults in direct lending mostly in line with syndicated loan market



Data as of September 30, 2024.
Sources: J.P. Morgan, KBRA DLD, Solve

[1] The US syndicated loan market has grown to over $1.4 trillion as of October 2024 from approximately $600 billion in 2008—Source: Morningstar LSTA US Leveraged Loan Index; Private credit has grown to roughly $1.7 trillion as of December 2023 from $300 billion in 2010—Sources: PitchBook LCD, Morgan Stanley Research

[2] Source: PitchBook LCD

[3] Source: J.P. Morgan 2025 High Yield Bond and Leveraged Loan Outlook, November 26, 2024

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Where we see opportunities in private credit now

The cornerstone of private credit is about tending to the evolving needs of company management (and private equity sponsors) seeking bespoke financing solutions. In the current environment, we see most pronounced opportunities in financing providers of essential services such as business and financial services, healthcare, and information technology. But opportunities can exist across other sectors as well.

We believe businesses with stable and predictable revenue models that produce substantial cash flow are prime candidates to provide financing to. These businesses typically have expense structures that are highly flexible and do not require a significant portion of their revenue to be spent on capital expenditures, making them ideal for leveraged borrowing.

In all cases, the ability of a business to generate cash flow regardless of the economic environment is key. This strengthens our confidence about the degree of leverage and the way that the deal is structured.

Conclusion

Demand for private credit remains robust, driven by corporations' need for diverse and flexible capital solutions. Despite the Fed's shift to easing monetary policy, we expect interest rates to stay relatively higher for longer. This, along with a favorable outlook for dealmaking, bodes well for opportunities in direct lending, in our view. While the public credit markets have seen a resurgence in issuance, the private credit market in general—and direct lending in particular—continues to offer attractive risk premiums and all-in yields compared to public markets. We continue to see issuers vying for private solutions as they seek bespoke deals, certainty of execution, speed, and flexibility.

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