Private credit market still attractive despite spread contraction

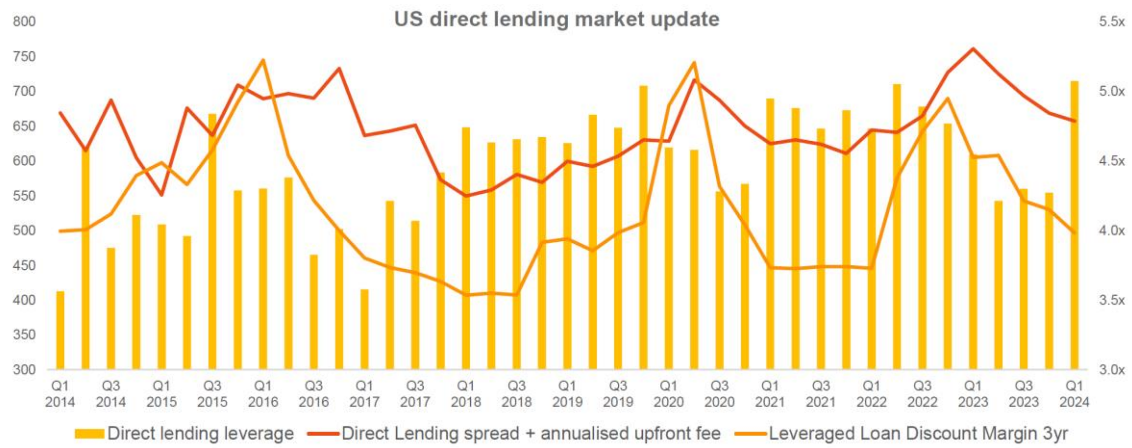
Private credit remains an attractive investment that can play a strategic role in portfolios despite the recent spread contraction, according to Frontier.

The private credit asset class, which has been driven by increased regulation that drove many US banks out of the lending market, consists of corporate credit (or direct lending), infrastructure debt, or private placements across a variety of securities.

Nam Tran, Senior Consultant, Frontier Advisors, said private credit continued to perform in a new investing environment with higher interest rates and within a slowing economy.

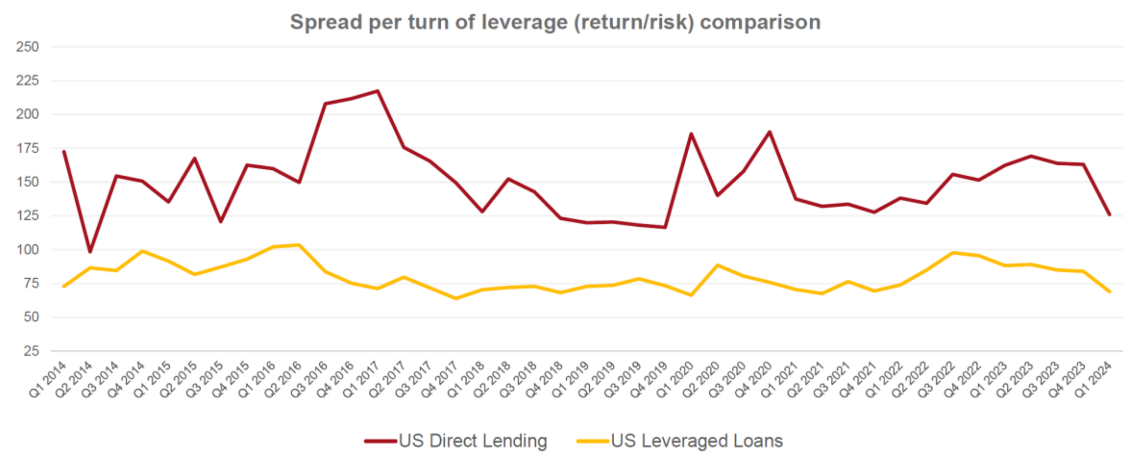
Frontier's latest senior direct lending market survey showed leverage remained consistent at about 4-5 times and, while spreads had contracted, they remained attractive.

"The contraction is coming from a historical high that you saw in 2023 and right now it's at more normalised levels" he said.



Source: Frontier Advisors' direct lending survey, Credit Suisse

The direct lending market is still offering about double the spread per turn of leverage over the liquid leveraged loans market (150 basis points versus 75), according to the survey.



Source: Frontier Advisors' direct lending survey, S&P LCD

Brett Lauber, Managing Director, Northleaf, said the ongoing rise in private equity-backed companies was adding to a deep and growing investable universe in the middle market. Market activity was also starting to rebound as the operating and interest rate environment stabilised.

“We continue to see very strong borrower demand for private credit, not just investor demand, and again, after 18 months of pretty slow M&A activity, we're actually starting to see an uptick in M&A volumes,” according to Lauber.

Northleaf is focused on the core middle market (companies with EBITDA $US10-$US75 million), which continues to produce stronger risk-adjusted returns than the upper middle market where strong investor inflows are leading to tighter pricing. Middle market loans have also historically outperformed broadly syndicated loans, partly due to lower leverage levels, maintenance covenants and direct access to management and sponsor.

“Mid-market is able to achieve outsized returns in the current environment,” Lauber said.

The US middle market (companies with annual revenue $US10 million to $ US1 billion) includes nearly 200,000 companies and is responsible for roughly one-third of private US GDP.

Brianne Ptacek, Managing Director, North America Private Credit, Barings, said its portfolio companies’ performance remained resilient with more than two-thirds generated growing or flat EBITDA in 2023.

“That stabilisation really began in late 2022 and we've continued to see trends improve,” she said. “The one trend that we have seen is as the supply chain has normalised, we've seen companies who've purchased excess inventory levels… we've seen a little bit of a destocking trend occur in early-2024.”

More than half of companies surveyed expected the biggest challenge over next 12 months to be a recession, while liquidity and inflationary concerns had subsided.

Frontier will issue a direct lending paper shortly with insights on the current market conditions. While the asset class remains attractive, accessing it can be a challenge due to difficulty in obtaining and analysing data. Frontier can offer advice on portfolio construction and implementation ideas. Please contact Nam Tran, Senior Consultant, Frontier Advisors, on ntran@frontieradvisors.com.au for more information.