Is This the Golden Age of Private Credit?

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Banks have increasingly been encouraged by regulators to curtail their lending activities, creating a vacuum that is being filled by non-bank lenders. Reacting to waves of risky loan underperformance, bank regulators have encouraged US banks to limit their lending to their largest, lowest-risk, commercial borrowers. As banks have increasingly pulled back from lending to small and medium-sized enterprises (SMEs), non-bank lenders have stepped in to fill this gap, offering flexible credit options to these underfunded companies. Non-bank lenders charge high rates to borrowers that reflect the lenders' higher cost of capital and the perceived higher risk of lending to SME borrowers. The non-bank lending market has grown tremendously over the last 10 years and has generated strong absolute yields of 7.8-10.6% on average with historically low loss rates.[1]

Many pundits and lenders have coined today's market as a "Golden Age of Private Credit," due to the large demand for private loans, the growth of the largest players in the private credit market, and the potential to generate strong LP returns. According to Blackrock, the private credit market is expected to grow from $1.6 trillion to $3.5 trillion in assets under management from 2023 to 2028, propelled by increasing institutional interest in alternative investments. [2] This demand has been met with enthusiasm from the largest institutional limited partners whose appetite is focused on the largest private capital lenders.

"The Golden Age of Private Credit" has benefitted primarily the largest lenders. Many limited partner investors have shown a preference for large funds managed by established firms such as Blackstone, Ares, Apollo, KKR, and HPS Investments. In fact, the top 10 private credit fund managers accounted for 40% of private credit fundraising in 2022 and 2023.[3] Additionally, many of these funds raise capital from their insurance affiliates, which means these funds tend to focus on lower-risk lending, leaving riskier borrowers to be served by the small and medium-sized credit providers.[4] However, there appears to be less near-term enthusiasm from the LP community for these smaller lenders.

Smaller and emerging private credit lenders have struggled to secure additional LP capital. While some limited partners have made substantial commitments to the largest funds, many potential limited partner investors are not yet convinced that making further capital commitments to private credit funds makes sense at this time. This is, in part, due to the denominator effect, as outlined by McKinsey: limited partners are over-exposed to other illiquid assets, which has become even more pronounced due to slowdowns in exits fueled by M&A and IPOs.[5] While credit funds like their market conditions and see opportunities to deploy capital at advantaged rates, limited partners are not responding so enthusiastically. Smaller established funds and new private credit funds are challenged to secure fresh capital to take advantage of market demand for private loans. New private credit fund launches have suffered as LP capital has migrated to the largest lenders. Only 81 new funds were formed in 2023 as compared with 112 in 2022.[6] The "flight to scale" in private credit has left many smaller private credit funds needing to demonstrate above-market performance prior to securing new capital commitments from LPs, and new funds have found today's market less than welcoming.

[1] T. Rowe Price, 09/2023: https://www.troweprice.com/content/dam/trp-sites/cobrand/oha/files/Intro_to_Private_Credit_White_Paper.pdf#:~:text=URL%3A%20https%3A%2F%2Fwww.troweprice.com%2Fcontent%2Fdam%2Ftrp
[2] Blackrock, 09/04/2024: https://www.blackrock.com/us/financial-professionals/insights/private-credit-opportunity
[3] Oliver Wyman, 28/11/2023: https://www.oliverwyman.com/our-expertise/insights/2023/nov/navigating-private-credit-boom.html
[4] Private Debt Investor, 1/12/2023: https://www.privatedebtinvestor.com/pdi-200/
[5] McKinsey, 28/03/2024: https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review
[6] Pitchbook, 01/08/2023: https://pitchbook.com/news/articles/private-debt-fundraising-largest-funds-2023

To succeed, smaller funds must focus on identifying strong borrowers with the potential to generate high returns with a low risk of loss. Smaller firms need to carefully select investments that will perform well immediately, produce strong returns, and demonstrate an ability to achieve scale in order to successfully raise more capital. Shorter term loans will enable lenders to quickly generate returns for their LPs. Higher-yielding loans will draw investor attention, but funds need to be careful about absorbing too much volatility in their returns due to underperformance of higher-risk loans. Furthermore, smaller funds need to showcase their ability to support high-growth companies, highlighting their expertise in nurturing and scaling businesses. These abilities will instill confidence in potential LP investors.

Lower middle-market borrowers must come to market with compelling rationales for loans, demonstrate strong growth prospects, and regularly report key performance indicators to secure more capital. In a crowded debt market where smaller debt funds are capital-constrained, lower middle-market borrowers may only get one chance to make a good impression on private credit providers. These borrowers need to show a clear path to growth and profitability, an ability to satisfy covenants, and bring a data-driven approach to managing their growth and their performance. Demonstrating these qualities will increase their chances of securing the capital necessary for borrowers to succeed.

With deep expertise in the private credit market and strong relationships with both borrowers and lenders, Middlemarch Partners is positioned to surface strong borrowers for lenders and secure capital commitments from leading private capital providers for clients. As a merchant bank focused on obtaining private capital for high-growth clients globally, Middlemarch Partners helps its clients prepare themselves to go to market. Middlemarch advises clients as they craft compelling rationales for the use of private capital. Clients are prepped for the scrutiny that comes from private credit funds seeking to make new investments. Middlemarch connects lenders with the right companies—those with strong growth, proven performance, and an ability to deliver the targeted returns sought by lenders.

To take advantage of today's "Golden Opportunity" in private credit, investors and borrowers have to demonstrate that they are up to the task. Lenders need to convince potential limited partners that they have a winning formula to generate above-market returns. Borrowers need to clearly deliver strong performance to convince private credit lenders that they can generate the results that can support private loans. Middlemarch is here to help both lenders and borrowers find the right relationships to unlock value.

About Middlemarch Partners:

Middlemarch Partners is a New York-based merchant bank.

Middlemarch Securities LLC is the firm's FINRA-registered broker dealer. It assists companies with capital raises and M&A advisory services and is focused on alternative finance, payments, financial technology, business services and impact investing sectors where companies require sophisticated equity and debt investment solutions ranging from $25 - $500 million.

Middlemarch Capital Partners is the firm's registered investment advisor. It designs special purpose investment vehicles that deploy investment capital in venture and growth capital transactions ranging from $5 to $20 million. The firm sources capital from institutional investors, family offices, and accredited high net worth individuals. Middlemarch can serve as an independent sponsor of transactions but frequently co-invests alongside blue-chip lead sponsors that are sourced by Middlemarch Securities.

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