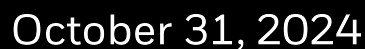

Global Credit Weekly:

Private Debt: A market in motion

BlackRock

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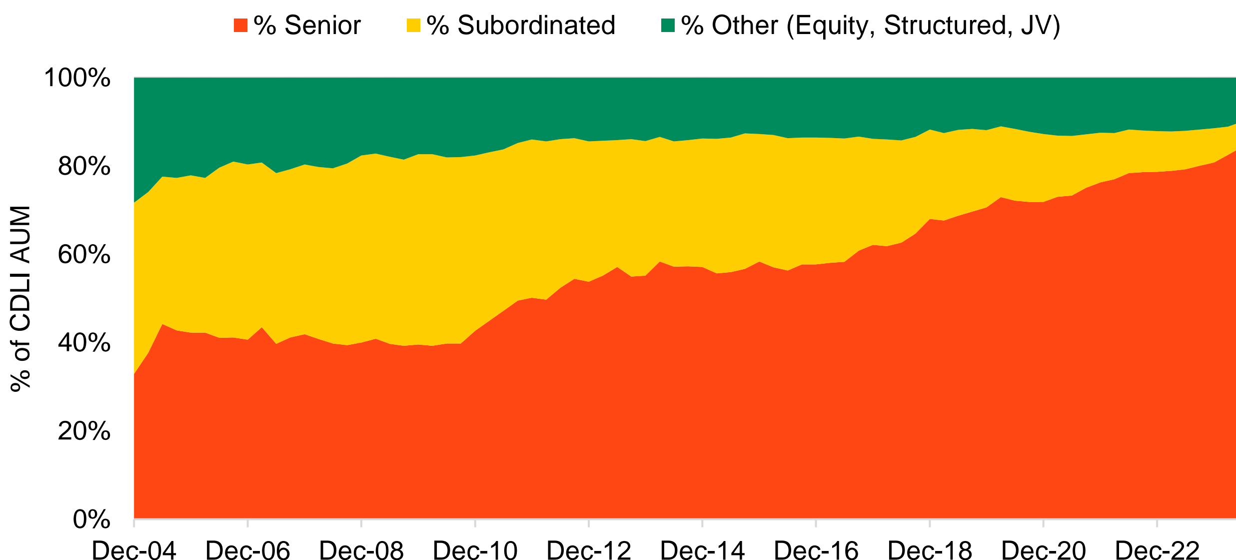
Key takeaways

- In recent weeks, we have discussed some of the fundamental and technical shifts in the USD high yield (HY) corporate bond market, which we believe have contributed to the resilience of spreads. In this *Global Credit Weekly*, we extend a similar analysis to the private debt market, unpacking how the asset class has evolved over the past several years. As we discuss within, the private debt market has shifted in a myriad of ways – contributing to an expanding addressable market of borrowers *and* investors.
- For example, private debt has shifted towards senior positions in capital structures (Exhibit 1) – a trend also visible in fundraising patterns. And in recent years, established managers have captured the majority of fundraising (at the expense of new entrants). Meanwhile, larger fund sizes have allowed private debt to expand its addressable market of borrowers – sometimes lending to firms who have demonstrated access to public debt markets. And similar to public debt markets, risk premiums have fluctuated, and sector weights have varied.
- The growth of business development companies (BDCs) has allowed a wider range of investors to access the private debt asset class. And the insurance sector has also turned towards private debt investments for capital efficient investment income – a trend we expect to continue.
- More recently (since the March 2023 U.S. regional banking disruption), the definition of "private debt" has also evolved, in our view. Previously, the term mainly referred to directly-negotiated lending to middle market corporates. Now, it is frequently used by market participants to refer to a wider universe of financing opportunities: those that can be originated, structured, and held by a lender. For this reason, we see scope for significant growth in private asset-based finance (see our May 2024 report for more) alongside the more "traditional" private debt market.

Exhibit 1: Senior loans represent 84% of the Cliffwater Direct Lending Index

Cliffwater Direct Lending Index (CDLI) assets under management, by seniority



Source: Cliffwater Direct Lending Index (CDLI), BlackRock. As of 2Q2024 (most recent available). Launched in 2015, the CDLI was reconstructed back to 2004 using publicly available quarterly SEC filings required of business development companies.

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Private Debt: A market in motion

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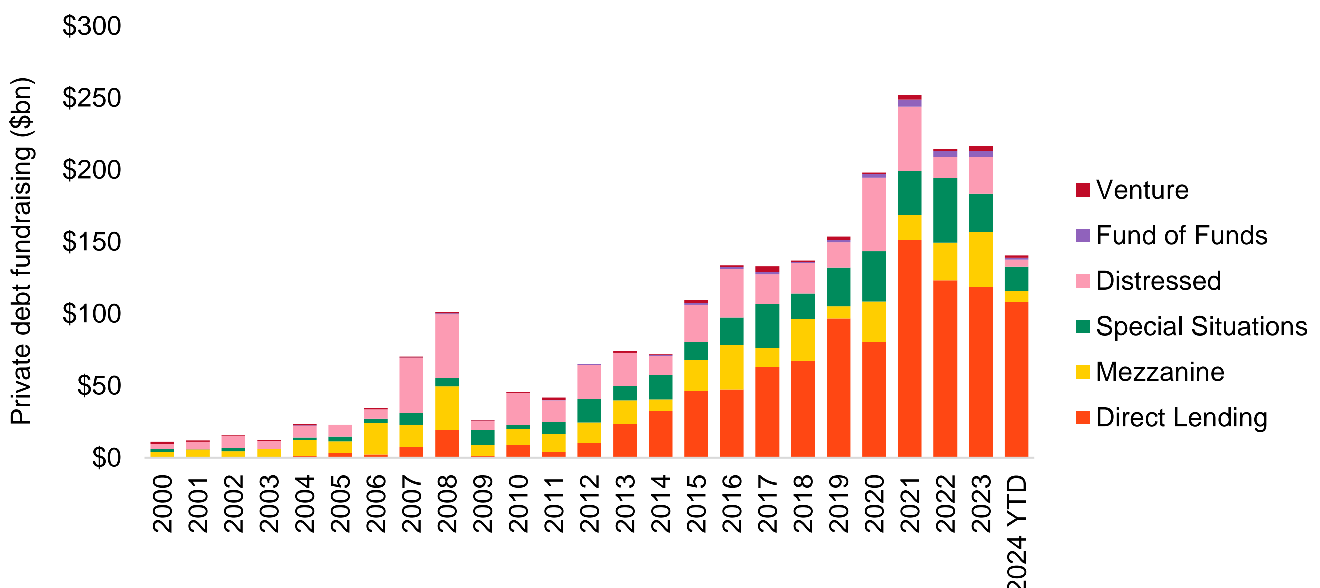
Fundraising has evolved to emphasize seniority

We first start with the longer-term trends around fundraising. Prior to the financial crisis, private debt focused on niche (or more complex) financings involving distressed and special situations opportunities (Exhibit 2). Over time, however, direct lending – which is a strategy that often involves being in a senior, secured position in a company's capital structure – became a more meaningful share of both fundraising and assets under management (AUM). As of March 2024, direct lending accounted for 50% of global private debt AUM, according to Preqin.

Exhibit 1 demonstrates the shift towards seniority using the AUM of the Cliffwater Direct Lending Index (CDLI). (*Note: the CDLI is an index of over 16,200 directly originated U.S. middle market loans totaling $358 billion in value as of 2Q2024. Launched in 2015, the CDLI was reconstructed back to 2004 using publicly available quarterly SEC filings required of business development companies*). Cliffwater attributes the shift to an evolving investor base. In the early years of the asset class, investors sought yield and capital appreciation; hence, fundraising favored mezzanine and distressed strategies (again, Exhibit 2). Over time, however, the investor base broadened, and direct lending represented a larger portion of fundraising. Investor return expectations also shifted to focus on high interest income and complete recovery of loan principal.

That said, we still see a meaningful role for private debt strategies focused on opportunistic situations, which provide financing for firms in need of specialized financing solutions.

Exhibit 2: In recent years, direct lending generated the largest share of fundraising
Aggregate global private debt annual fundraising, by strategy



Source: Preqin, BlackRock. As of October 29, 2024.

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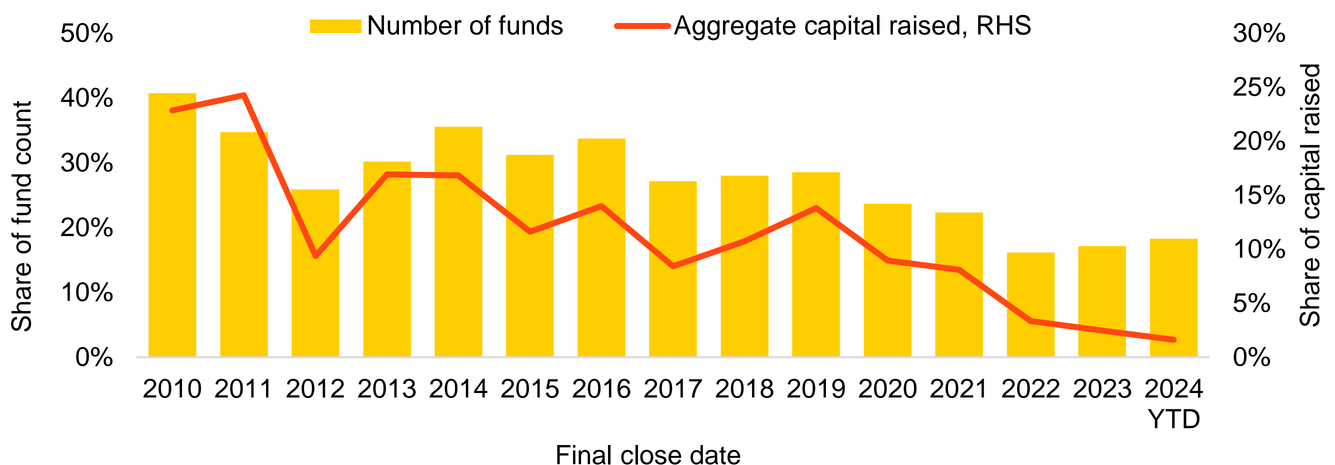
More experienced managers, larger fund sizes

The market has also been discerning regarding where it is allocating capital – a trend we highlighted in September. For example, private debt fundraising data shows that capital allocators have become more selective in the higher interest rate regime of the past few years, favoring more experienced managers, who typically benefit from having restructuring and workout expertise. Exhibit 3 shows that first-time private debt funds have captured, on average, 2.5% of total capital (per year) since 2022, well below the 2019-2021 run rate of 10.3%. Similarly, as shown in Exhibit 4, established private debt managers (i.e., those raising their fourth fund or later) have raised 85% of capital, on average, since 2022, compared to an average of 72% from 2019-2021.

Preqin notes that a higher concentration in private capital fundraising is common as an asset class matures and relationships with limited partner (LP) investors become more entrenched. Further, Preqin broadly expects this trend to continue as private wealth becomes a larger share of fundraising because larger GPs are generally more equipped to build out private wealth distribution channels.

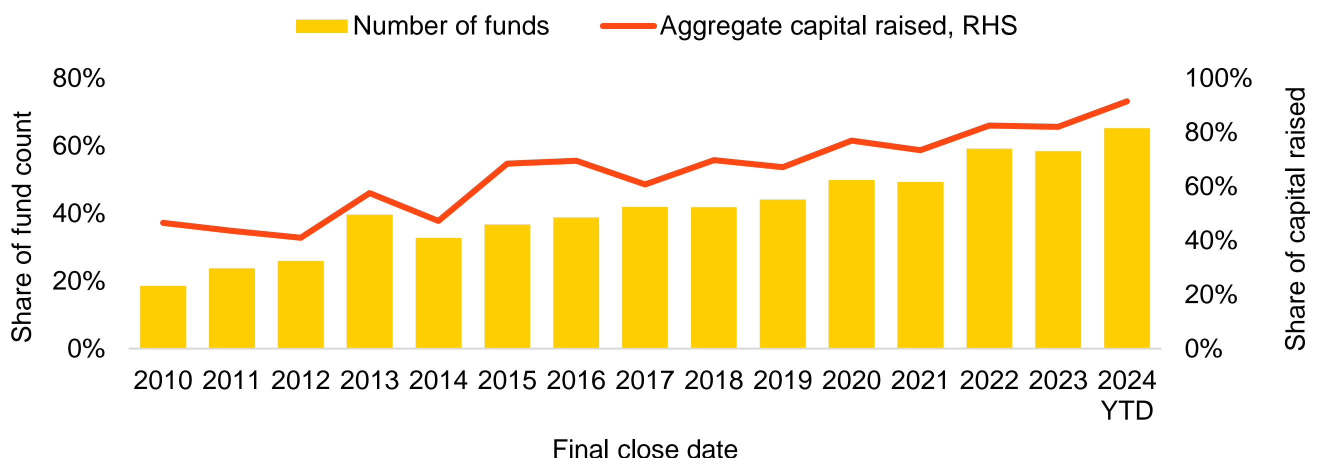
This shift to favor more experienced managers has coincided with larger private debt fund sizes. According to Preqin, the average fund size across all private debt funds closed so far in 2024 is $1.2 billion, compared to $820 million in 2021. Importantly, larger fund sizes allow private debt lenders to compete directly with the syndicated (public) debt markets and finance larger deals without compromising portfolio company diversification.

Exhibit 3: First-time private debt funds have raised minimal amounts of capital
First-time private debt fundraising as a share of total funds and aggregate capital raised, RHS



Source: Preqin, BlackRock. Captures data as of September 20, 2024. Captures closed-ended private debt funds.

Exhibit 4: Experienced managers have raised most of the capital since 2022
Fourth fund or later private debt fundraising as a share of total funds and aggregate capital raised, RHS



Source: Preqin, BlackRock. Captures data as of September 20, 2024. Captures closed-ended private debt funds.

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Growing into upper-middle market lending

The aforementioned structural shifts – direct lending's larger share of total fundraising, a skew towards more experienced managers, and larger fund sizes – have acted as tailwinds in developing the upper-middle market private debt segment. Indeed, private debt is now a third and viable funding option for a wide range of larger borrowers, alongside bank lending and the public debt markets.

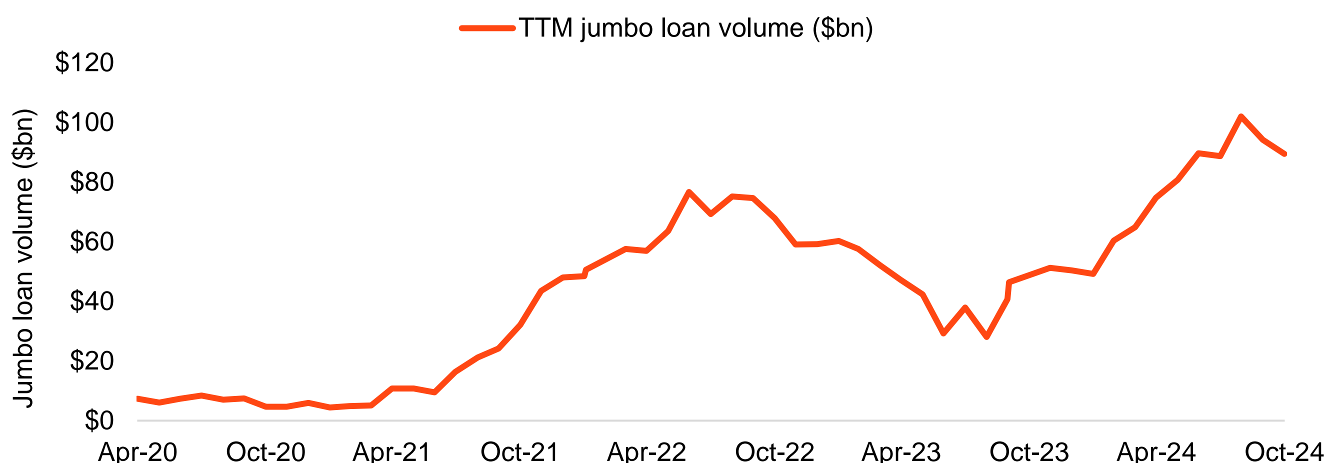
Data from KBRA DLD, a third-party data provider, demonstrates this increasing exposure to larger financings by tracking "jumbo" loan volume in the private debt market (jumbo loans are defined as loans of $1 billion or more). In practice, these jumbo loans often mean a deal would be large enough to be relatively liquid and index-eligible in the syndicated leveraged loan and HY bond markets. They also tend to be issued by larger borrowers – some of which have *demonstrated* access to the public debt markets.

Per KBRA DLD, private jumbo loan issuance has climbed to all-time highs, with year-to-date volume reaching $77 billion and surpassing the full-year record of $59 billion in 2022 (Exhibit 5). The average jumbo loan size has also grown this year, reaching an average of $1.4 billion, up from an average of $1.0 billion over the same period in 2023.

Private debt's growth is further evidenced by the decline in middle market leveraged loan issuance (defined by LCD as firms with less than $50 million in annual EBITDA; Exhibit 6) over the past several years. We expect that the expanded addressable market of borrowers will act as a tailwind to private debt's growth (a larger opportunity set should warrant more opportunities for capital deployment).

Exhibit 5: "Jumbo" private debt loan volume has grown

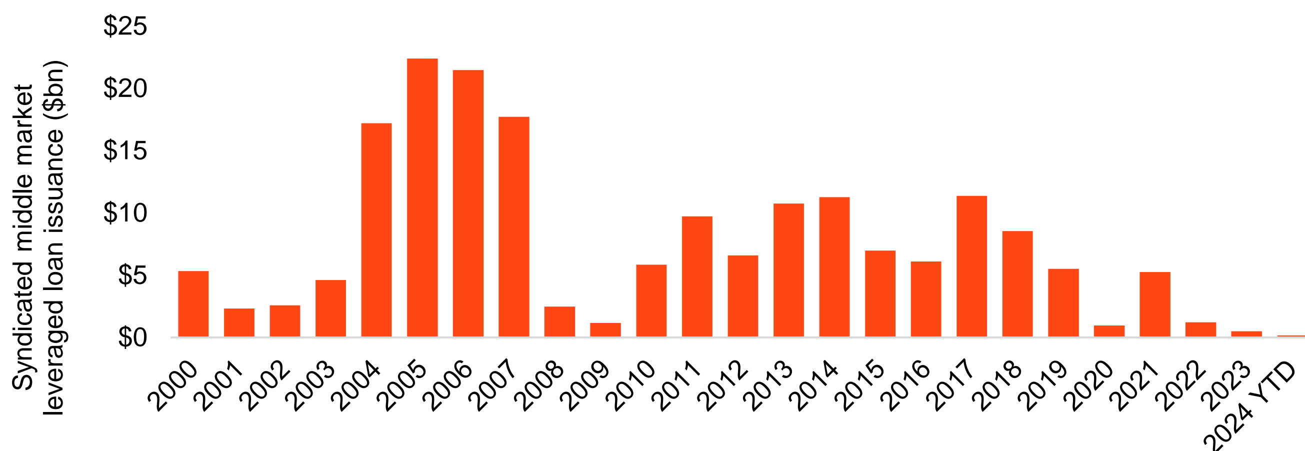
Trailing twelve-month (TTM) private debt jumbo loan (defined as loans $1 billion or larger) volume



Source: KBRA DLD News, BlackRock. KBRA DLD defines jumbo deals as loans $1 billion or larger. As of October 29, 2024.

Exhibit 6: Syndicated middle market leveraged loan issuance has stagnated

USD syndicated middle market leveraged loan issuance



Source: BlackRock, Pitchbook LCD. As of October 29, 2024. LCD defines middle market as firms with less than $50 million in annual EBITDA.

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BDCs have broadened investor access to private debt

Another structural shift relates to business development companies (BDCs), which are a common structure for retail investors to access private debt. BDCs are companies created to provide capital to small and medium businesses. There are three types of BDCs with varying liquidity requirements. Public BDCs are liquid and traded on an exchange. That said, they do not exhibit the same liquidity as a large-cap stock, for example, and often trade at a discount to their net asset value to reflect the fact that they own underlying assets that are illiquid. Unlisted BDCs – including private BDCs and continuously offered, evergreen (or perpetual) BDCs – are less liquid and do not trade. For this reason, unlisted BDCs are typically less volatile than their public BDC peers. Most private BDCs have defined, longer-term lockup periods, whereas continuously offered, evergreen (or perpetual) BDCs allow limited (and conditional) redemptions, generally available quarterly.

For much of the last decade, public BDCs dominated BDC AUM. However, in 2021, this shifted as evergreen / perpetual BDCs gained popularity, growing from $0 at year-end 2020 to $151 billion in 2Q2024 (Exhibit 7). Today, evergreen / perpetual BDCs represent 43% of total BDC AUM, according to Cliffwater. While relatively new, evergreen / perpetual BDCs have been attractive to retail investors – and some segments of the institutional market – because of their structure. Indeed, evergreen / perpetual BDCs allow investors limited volatility (vs. public BDCs), the opportunity to become immediately invested in an existing pool of private loans (vs. a drawdown structure, for example), and recurring redemption opportunities (vs. private BDCs, for example).

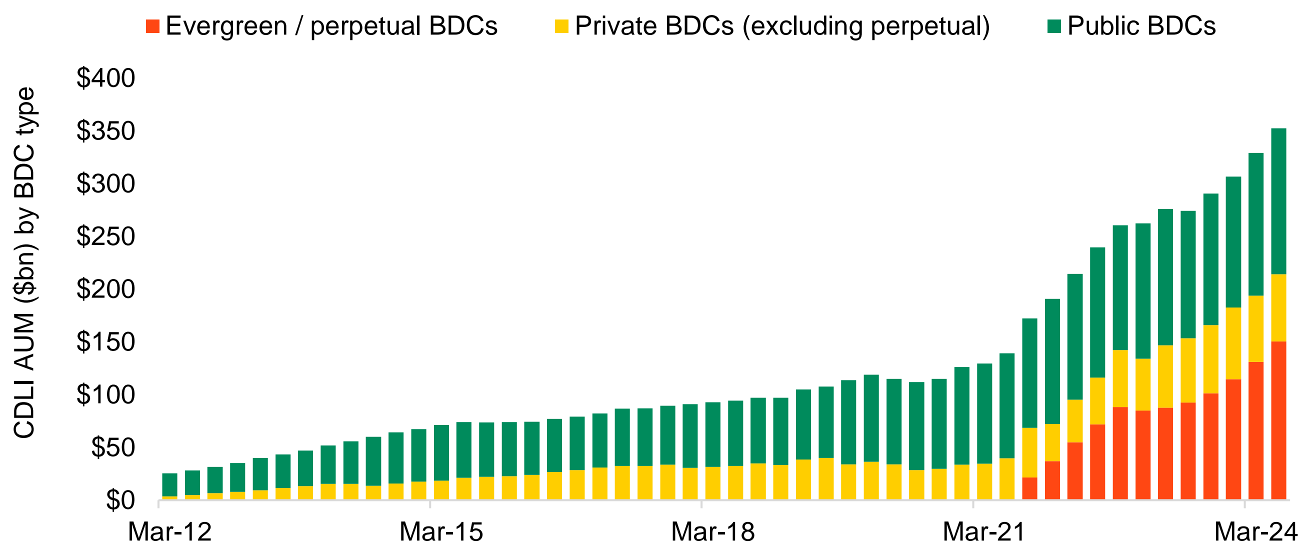
An October 2024 analysis by Moody's highlighted generally resilient performance (albeit with dispersion, as would be expected) among a sample of 33 BDCs in various downside scenarios (modeled after the 2008-2009 Global Financial Crisis) as "a consequence of their mostly secured asset composition and strong capital [equity] cushions."

Further, evergreen / perpetual BDCs tend to have more attractive fees and expenses than traded BDCs (inclusive of management and other incentive fees). For example, Cliffwater notes that fees and costs for evergreen / perpetual BDCs have averaged 3.21% of net asset value (NAV) over the last 2.5 years (as of 1Q2024) vs. 4.50% of NAV for all BDCs within the CDLI.

We anticipate that BDCs will remain a key avenue for retail and private wealth investors to access private debt, likely supporting further expansion of the addressable market of investors over time. Additionally, the rise of evergreen / perpetual BDCs signifies the growth of semi-permanent capital in private debt. The innovation of evergreen / perpetual vehicles for retail and institutional investors may influence how investors commit capital to the asset class.

Exhibit 7: Evergreen / perpetual BDCs have grown rapidly since 2021

Cliffwater Direct Lending Index assets under management, by BDC type



Source: Cliffwater Direct Lending Index, BlackRock. As of 2Q2024 (the most recent available data). Evergreen / perpetual BDCs are referred to as "Perpetually Private BDCs" per Cliffwater data.

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Private debt risk premiums vary over time

Another interesting shift in the private debt market has been the evolution – and varying contribution – of the multiple risk premium factors, due to dynamics such as the macroeconomic backdrop, investor risk appetite, and portfolio composition. The current yield across private debt strategies remains somewhat elevated relative to history, supported in part (but not exclusively) by a higher risk-free rate.

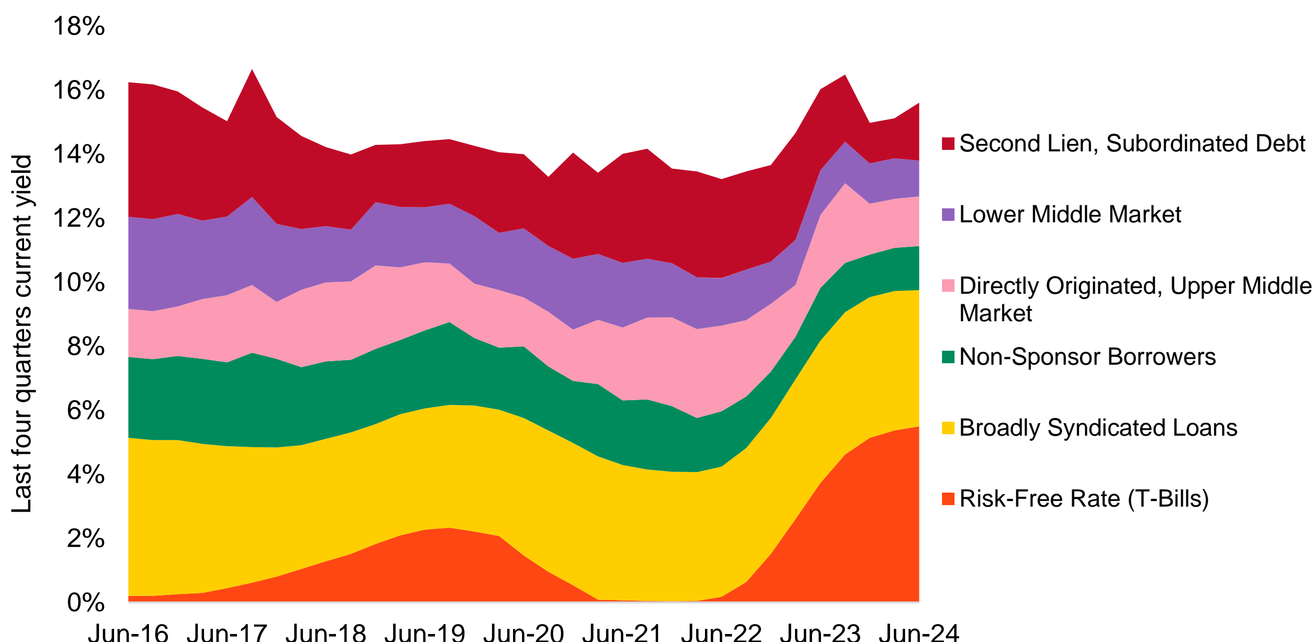
This is illustrated in Exhibit 8, again using the Cliffwater Direct Lending Index as a proxy for U.S. middle market lending. *Note: the risk premiums shown in Exhibit 8 are meant to be illustrative for each risk premium in the aggregate, and higher values represent higher expected risk. The risk premium values do not sum to the CDLI yield (which was 11.8% as of 2Q2024), as not all risk premiums will be captured at once.*

Risk appetite and the receptivity of the syndicated leveraged loan market to lower-rated borrowers is also important to monitor related to private debt risk premiums and activity, in our view. We see syndicated leveraged loans as the closest asset class proxy to direct lending, given its floating rate structure and universe of borrowers. But the syndicated leveraged loan market is rather technical, as its largest buyer – collateralized loan obligations (CLOs), which have historically purchased nearly two-thirds of leveraged loans, per estimates from Pitchbook LCD – is rating sensitive. Most CLO structures have limits (typically 7.5%, per industry wide data) on the amount of CCC-rated loans that can be held. As a result, in periods of elevated recession risk (in late 2022 and 2023, for example), CLOs tend to avoid not only CCC loans *but also B-rated loans* for fear of downgrade risk. As was the case during that time, many of these B-rated borrowers accessed the private debt market for funding, instead.

Outside of the risk-free rate, private debt risk premiums are relatively tight compared to historical levels. This reflects, in our view, a strong risk appetite across corporate credit markets, broadly – liquid and private (as discussed in our *4Q2024 Global Credit Outlook*). This has been further supported by resilient growth in the U.S. economy. For example, 3Q2024 U.S. real GDP growth, based on advanced estimates, was an above-trend 2.8% per the Bureau of Economic Analysis, as of October 30th.

Exhibit 8: A combination of factors influence private debt risk premiums

Current yield illustrated by historical risk premiums and the risk-free rate for the Cliffwater Direct Lending Index



Source: Cliffwater Direct Lending Index (CDLI), Morningstar LSTA U.S. Leveraged Loan Index, BlackRock. As of 2Q2024 (the most recent available for CDLI). **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index. Uses weekly return data. Risk premiums are estimates and use a cross-sectional three-factor regression of public and private BDCs' four-quarter gross yields against Cliffwater's best estimates of each manager's loan seniority, expected/actual portfolio company size by average EBITDA and expected/actual share of sponsor vs. non-sponsor lending. Broadly syndicated loan yield is as reported by the interest return of the Morningstar LSTA U.S. Leveraged Loan Index.

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Sector shifts, PIK flexibility

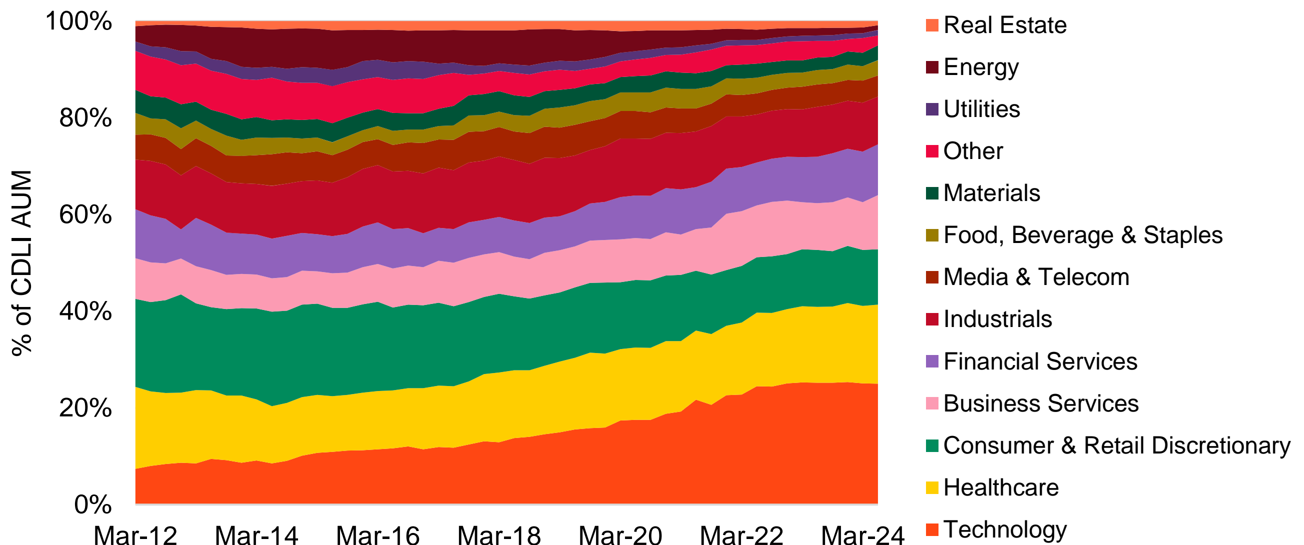
The private debt market's industry composition has also evolved over time. For example, Technology's share of the CDLI has increased over the past decade and now represents 25% of AUM (Exhibit 9) – a larger share than in the syndicated leveraged loan market (18.4%) and the USD HY bond market (7.5%). By contrast, the exposure to Consumer & Retail Discretionary and Energy has declined.

The flexibility that private debt markets can provide to borrowers (vs. syndicated markets) can position private lenders as preferred partners. For example, annual recurring revenue loans have allowed scaled technology companies to access financing from private debt lenders while still focusing on growth and continued investment into the business. Additionally, we expect that private debt will play a prominent role in the ongoing, long-term, and multi-phased buildout of artificial intelligence capabilities.

Another recent evolution in the market is an increase in "payment-in-kind" (PIK) income as a share of total income. Private lenders at times offer PIK, or the ability to forgo cash interest payments in exchange for increasing the principal owed on the loan. A PIK option allows borrowers to temporarily reallocate cash for interest payments to other business needs, such as financing growth. Exhibit 10 illustrates how PIK income as a share of total income has grown over time, reaching 8.4% in 2Q2024. This trend will likely persist while the cost of capital remains elevated and markets remain somewhat issuer-friendly.

Exhibit 9: Technology has grown to 25% of the CDLI AUM

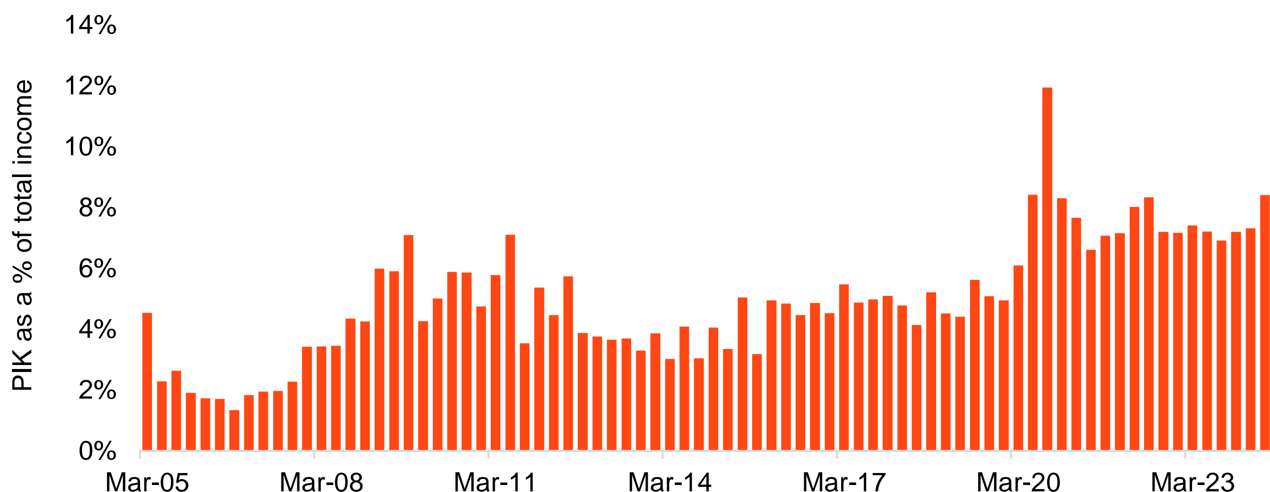
Cliffwater Direct Lending Index assets under management by industry



Source: Cliffwater Direct Lending Index, BlackRock. As of 2Q2024 (most recent available).

Exhibit 10: PIK as a share of total income is elevated and above long-term averages

Payment-in-Kind (PIK) income as a percentage of total income for the Cliffwater Direct Lending Index



Source: Cliffwater Direct Lending Index, BlackRock. As of 2Q2024 (most recent available).

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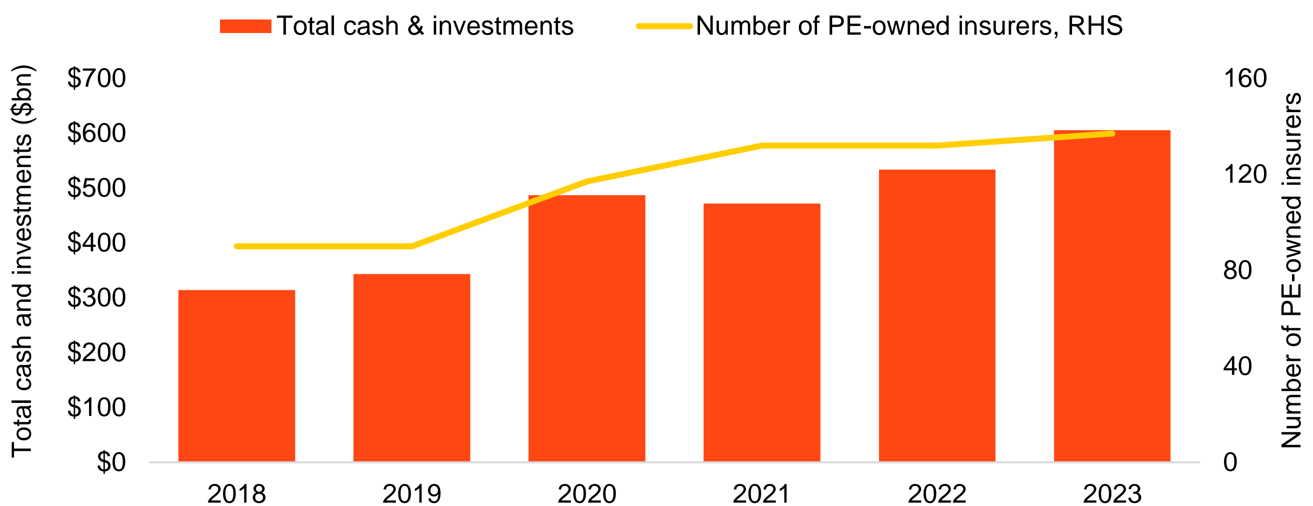
The intersection of private markets and insurance

Another structural shift evident in the private markets over the past several years has been related to its intersection with the insurance sector. This has been a function of insurers' objective of long-term asset-liability matching (as they look to pair long-term investments with long-term liabilities, such as life insurance payouts). It also reflects, in our view, insurers' desire to diversify investment income while generating a capital-efficient yield. In many instances, this has incorporated broadening the investment universe to include investment-grade private, less liquid, and structured investments to improve "yield per unit of capital."

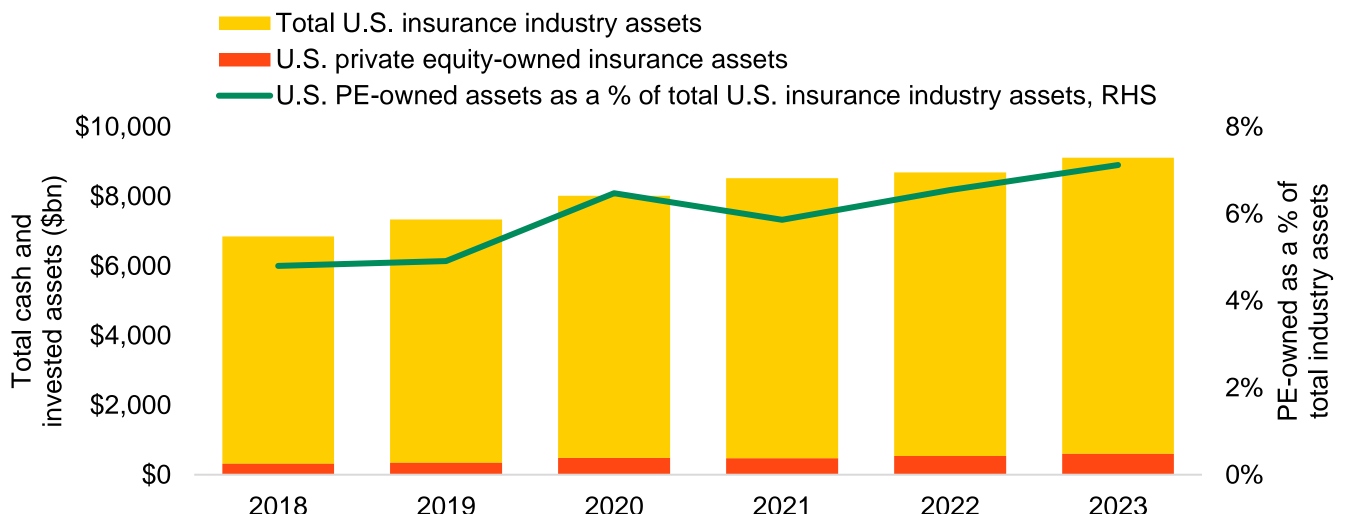
The National Association of Insurance Commissioners (NAIC) estimates there were 137 U.S. insurance companies that were "private equity (PE)-owned" as of July 2024 – a category that includes any reported percentage of ownership. Exhibit 11 further illustrates how the number of insurers – and their total investments – have evolved over the years. As of year-end 2023, PE-owned insurers' total cash and invested assets of $605.7 billion represented 7.1% of the $8.5 trillion U.S. insurance industry – a relatively modest figure in aggregate (Exhibit 12). The vast majority of PE-owned U.S. insurance AUM (95%) is concentrated within the life insurance sector, per NAIC data.

Exhibit 11: PE-owned U.S. insurers' total investments 2018-2023
PE-owned U.S. insurers' total cash and investments, and the number of PE-owned U.S. insurers, RHS



Source: National Association of Insurance Commissioners (NAIC) Capital Markets Bureau, BlackRock. Captures data through year-end 2023 (most recent for invested assets).

Exhibit 12: PE-owned insurance assets represent 7.1% of total U.S. insurance industry assets
Total cash and invested assets of U.S. insurers at each calendar year-end



Source: National Association of Insurance Commissioners (NAIC) Capital Markets Bureau, BlackRock. Captures data through year-end 2023 (most recent).

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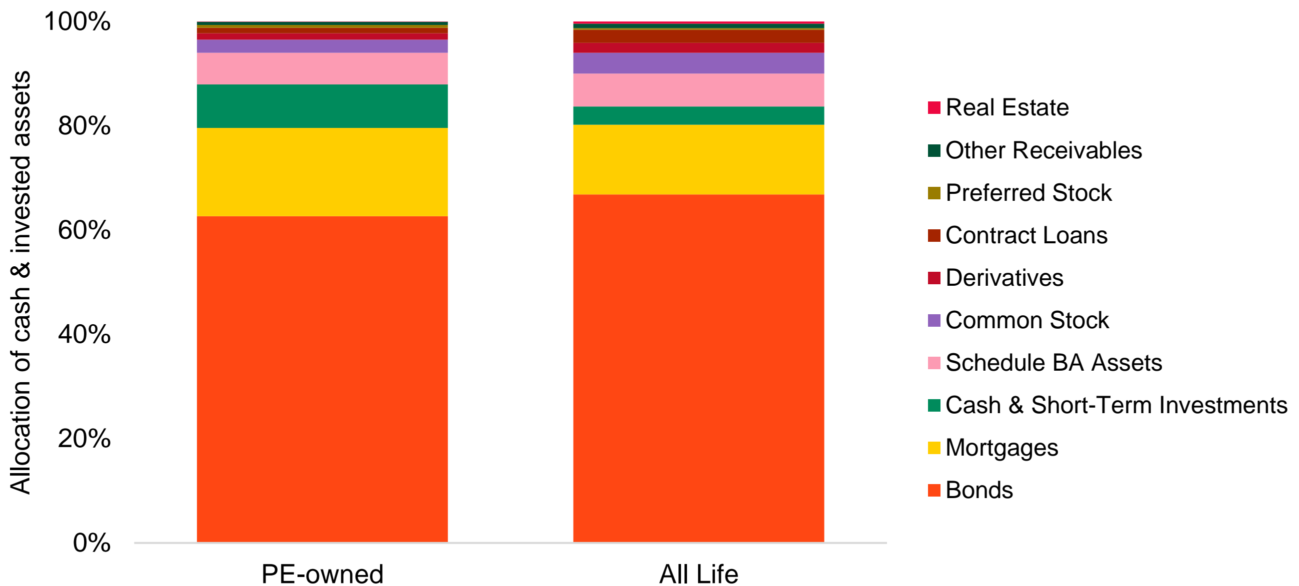
Exhibits 13 and 14 illustrate how the asset allocation patterns among PE-owned U.S. insurers compare to the broader universe of U.S. life insurers. In aggregate, PE-owned U.S. insurers have a larger allocation to mortgages, and smaller allocations to bonds and common stocks. And within the bond allocation, PE-owned insurers have a smaller weight towards corporates and a larger weight toward asset-backed and other structured securities.

However, despite the tendency to allocate to more complex financing opportunities, PE-owned insurers aren't compromising on credit quality. Indeed, the NAIC notes that bonds with high credit quality (designated by an NAIC 1 or 2 rating) comprised 96% of total bond allocations for the subset of PE-owned insurers at year-end 2023.

Exhibit 13: PE-owned insurers had larger allocations to mortgages relative to the U.S. life industry, at year-end 2023

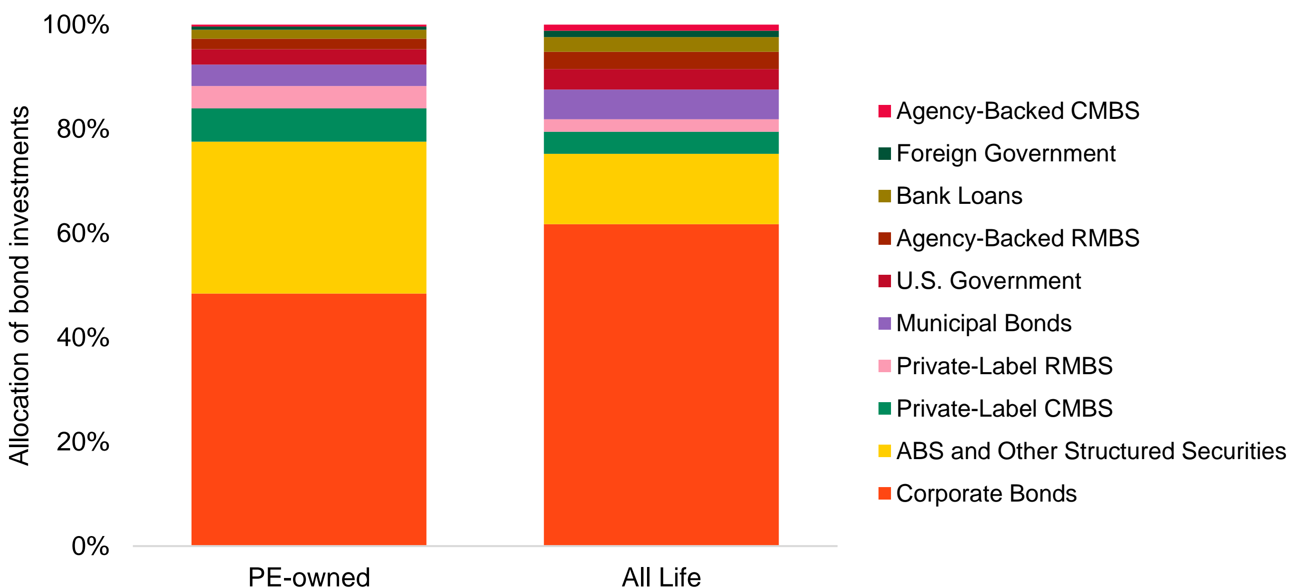
Allocation of cash and invested assets for U.S. insurers (PE-owned and total Life industry)



Source: National Association of Insurance Commissioners (NAIC) Capital Markets Bureau, BlackRock. As of year-end 2023 (most recent).

Exhibit 14: PE-owned insurers had lower allocations to corporate bonds, relative to the broader U.S. life industry, at year-end 2023

Allocation of bond investments for U.S. insurers (PE-owned and total Life industry)



Source: National Association of Insurance Commissioners (NAIC) Capital Markets Bureau, BlackRock. As of year-end 2023 (most recent).

We see scope for insurers to increase their participation in the private debt market. Indeed, the most recent 2024 BlackRock Global Insurance Report[1] (released October 14, 2024) highlights global insurers' plans to increase allocations to private markets.

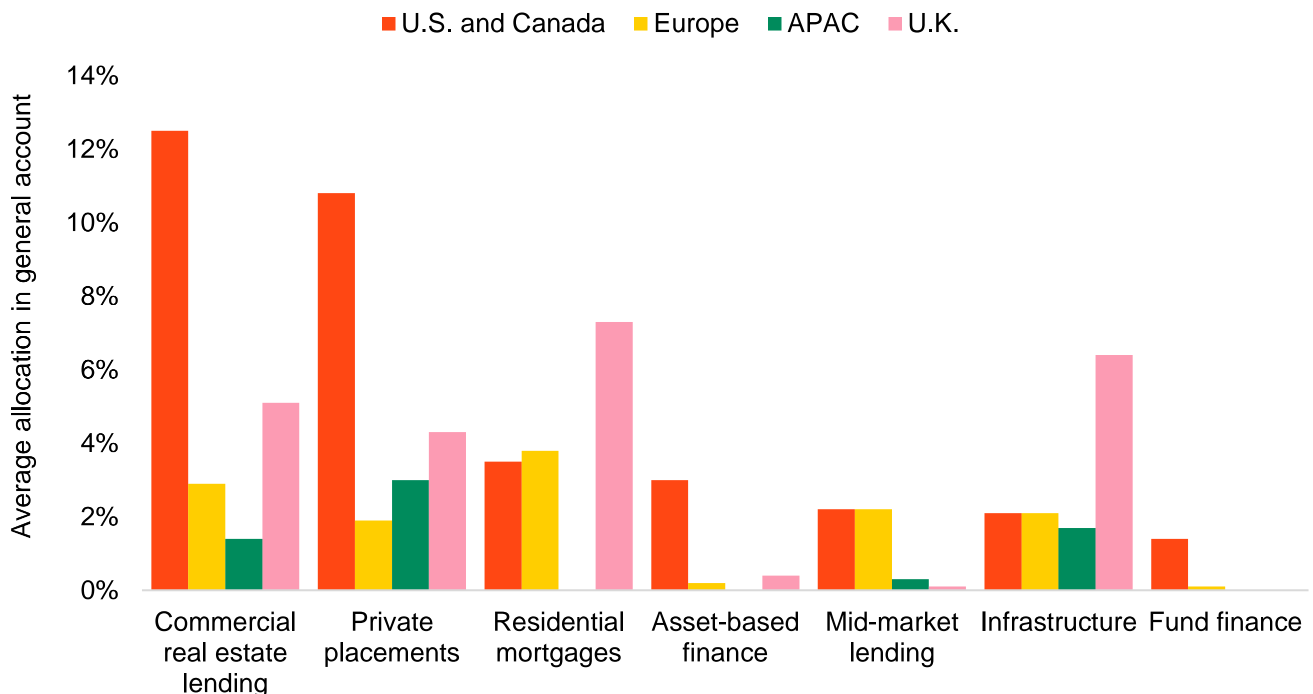
For context, the annual survey (conducted from July to September 2024) captured the views of 410 insurance investors representing $27 trillion in AUM. 91% of respondents intend to increase allocations to private markets over the next two years. And within this cohort, 30% plan to increase exposure to investments in private debt. Diversification, lower volatility, and opportunities to invest in new asset classes were among the most cited motivations for increasing exposure to private markets, per the survey. Increasing income generation, increasing total return, and inflation protection were also cited.

Responding insurers indicated they are looking to increase allocations to private debt across multiple categories, including special situations / opportunistic private debt (41%), private placements (40%), direct lending (39%), and infrastructure debt (34%). In addition, over half of insurers (52%) reported they will increase allocations to multi-alternative investments for greater flexibility and customization.

Similarly, a June 2024 survey conducted by Moody's – which captured responses from 30 of the largest global insurers with combined total investments of $5.3 trillion – found that nearly 80% planned to increase holdings of at least one class of private debt over the long-term. Insurers' interest, per Moody's survey, was most pronounced among asset-based finance (44% of respondents expected to increase allocations) and private placements (44%), followed by middle-market lending (33%), infrastructure lending (33%), and fund finance (28%), which includes subscription lines. Per Moody's, this is reflective of "insurers' growing appetite for diverse segments within the larger private credit ecosystem."

Notably, Moody's indicated that it expects the benefits from growth in private debt "will outweigh risks" for insurers, citing a number of positive credit characteristics for the insurance industry. These include the potential for additional spread earnings (owing to an "illiquidity premium"), an opportunity for detailed due diligence, diversification from other asset classes, and the potential for stronger covenant protections. That said, Moody's also noted that strong asset-liability management is critical.

Exhibit 15: Insurers' exposure to the various categories of private debt varies by region
Per a June 2024 Moody's survey of 30 global insurers: Average allocations as a % general account investments



Source: Moody's ("Insurers' private credit holdings will grow, with benefits outweighing risks," June 4, 2024), BlackRock.

[1] See the BlackRock "2024 Global Insurance Report" for more: https://www.blackrock.com/institutions/en-zz/global-insurance-report-2024.

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As it relates to growing areas such as private asset-based finance, other structural forces should provide opportunities for insurers to deploy capital. For example, a September 2024 analysis by McKinsey & Company[2] estimated that $5 to $6 trillion of assets held by U.S. banks – ranging from corporate / commercial finance, commercial real estate, infrastructure, and consumer finance – "could shift into the nonbank ecosystem over the next decade."

Underpinning this expectation are three assumptions, per McKinsey's analysis: (1) interest rates remain elevated above pandemic-level troughs; (2) yield assets continue to perform in line with their historical range (and do not, for instance, experience accelerating credit losses); and (3) the current regulatory environment for banks persists.

We share a similar view, as we outlined in May (see: "Private debt: Asset-backed finance: Unpacking the structural shifts" for more). While the concept of diversification away from the bank lending channel is not new, over the past several months, market participants have focused on the potential for private credit lenders to play an increased role in private asset-based finance, potentially filling "financing gaps" from some banks' more selective appetite to lend (as they may look to optimize the capital efficiency of their balance sheets).

Indeed, recent news flow over the past year has pointed to increased participation of non-bank lenders in this area, either through some banks' sales of loan exposures, or defined origination/lending partnerships between bank and non-bank lenders.

Exhibit 16: A September 2024 analysis by McKinsey & Company suggests a wide range of lending could migrate to non-banks over the next decade

Propensity to transition to non-banks, based on a variety of factors including but not limited to: duration mismatch with banking deposits, ease of origination for non-banks, and bank regulatory and capital considerations

Corporate and commercial finance	Standard loans	*Medium*
	Structured loans	*High*
	Equipment leasing	*Medium*
	Aircraft and railcar leasing	*High*
	Receivables financing	*Low*
	Trade finance	*Low*
Commercial real estate	Regulatory <80% LTV ratio	*Medium*
	Construction loans and bridge financing	*Low*
	Regulatory >80% LTV ratio	*High*
	Non-regulatory	*High*
Infrastructure	Project finance	*High*
Consumer finance	Auto loans and leases	*Medium*
	Student loans	*Medium*
	Unsecured personal loans	*Low*
	Credit card receivables	*Medium*
	Residential mortgages	*High*

Source: McKinsey and Company analysis (September 2024), BlackRock. LTV = loan to value. The impact on corporate loans will vary based on the type of borrowers. Examples of structured loans include acquisition finance and leveraged finance.

[2] See "The next era of private credit" by McKinsey & Company for more: https://www.mckinsey.com/industries/private-capital/our-insights/the-next-era-of-private-credit.

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