AMERICAN INVESTMENT COUNCIL

Data provided by PitchBook

Partners to Private Companies

How private credit strengthens the American economy

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A message from Drew Maloney

Over the past decade, private credit lenders have proven themselves as reliable, smart, and dedicated partners to private companies across the country. Thanks to their ability to take on more risk and get closer to each company they lend to, private credit firms have dramatically increased the chances for struggling companies to get back on their feet. And because private credit firms work hand-in-hand with private companies, they can develop sturdy, reliable relationships with their management teams and stick by them through thick and thin.

Most importantly, private credit firms have helped stabilize the American economy. They provide an additional source of capital that expands access to credit for businesses throughout the country. The Federal Reserve (the Fed) Board of Governors conducted a study on private credit's impact on the financial system. Their risk, according to the Fed's economists, "are likely limited."[1] The decrease in risk is because these loans originate in closed-ended funds, where capital flight isn't possible because the funding is "locked in." That also means that private credit managers can make prudent decisions for their portfolio companies, including sticking by them until they improve.

According to Gary Creem, an attorney at Proskauer Rose and an expert on the private credit industry, "The theory of the regulators back in 2008-2009 has kind of played out. They wanted to remove risk from banks and put it with private credit managers. So the risk went where it should go."[2]

Private credit managers work behind the scenes, and their contributions to the American economy go largely unnoticed. That shouldn't be the case—private credit managers deserve praise and recognition for their contributions to companies, investors, and the American financial system itself.

Drew Maloney

Drew Maloney
President & CEO,
American Investment Council

1: "Financial Stability Report," Board of Governors of The Federal Reserve System, May 2023.
2: "Axios Markets," Axios, Emily Peck and Matt Phillips, August 14, 2023.

What is private credit?

Private credit firms raise independent funds that are used to loan capital to private companies. That may not seem like a big deal, but it is. Private companies work with investment banks and other financial institutions for financing. Today, private credit has added an additional source of financing to private companies. Today's private equity market is different, and private credit firms are a big part of that change. Private credit firms raise independent funds that are used to loan capital to private companies. By lending out of dedicated funds, private credit investors: help stabilize the American financial system; increase access to capital for struggling or unprofitable companies that often have a difficult time convincing traditional lenders to work with them; and provide peace of mind to private equity firms, regulators, and the companies themselves, since private credit firms keep a very close eye on their loans and will not sell them off in small pieces to the highest bidders.

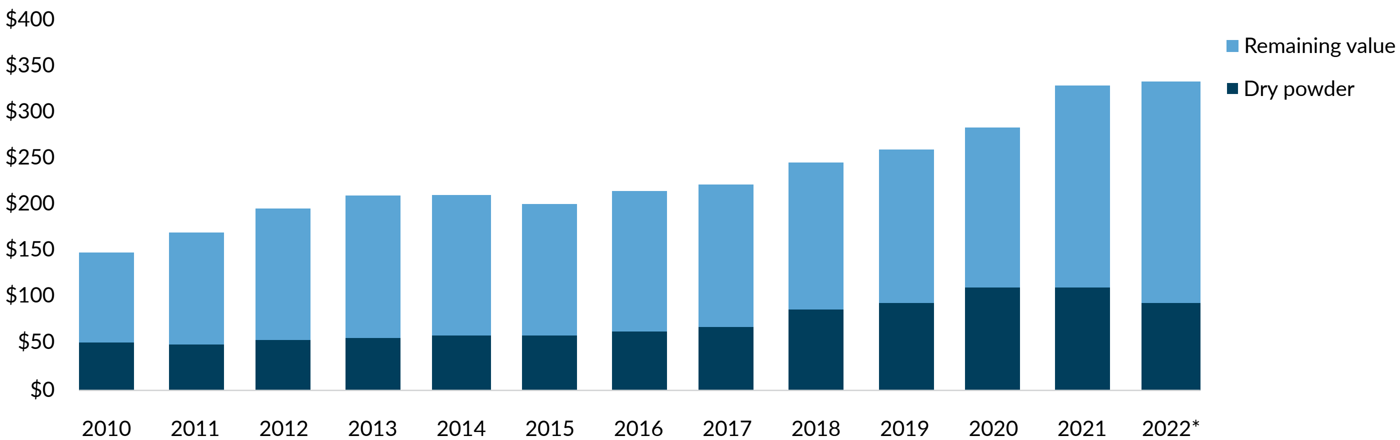
Not all private credit is the same. Different lenders have different areas of expertise, risk tolerance, and transaction experience.

One of the biggest types of private credit is "direct lending." These types of lenders work directly with thousands of private companies and give them tailored financing to help them grow.

Another type of private credit is "distressed debt," which is often synonymous with "special situations debt." These lenders also partner with PE firms, but the companies they work with are usually unprofitable, struggling, or too complex for traditional lenders to loan to them. These types of lenders are vital to a wide swath of the American economy. Not every company performs at its best every single year. Distressed lenders are comfortable working with these companies and offering lifelines to give them another chance at success. Because of the risk involved, distressed lenders are often the last resort to obtain financing. Not only are distressed lenders willing to lend to them, they're also very good at it and keep a close eye on their performance and can adjust their terms if needed.

There are also industry-specific lenders that have expertise in complicated sectors, including real estate, venture capital, infrastructure projects, transportation, insurance agriculture, and consumer. They fill roles that other lenders can't, and they play an integral part in making sure projects and specialized companies fulfill their potential.

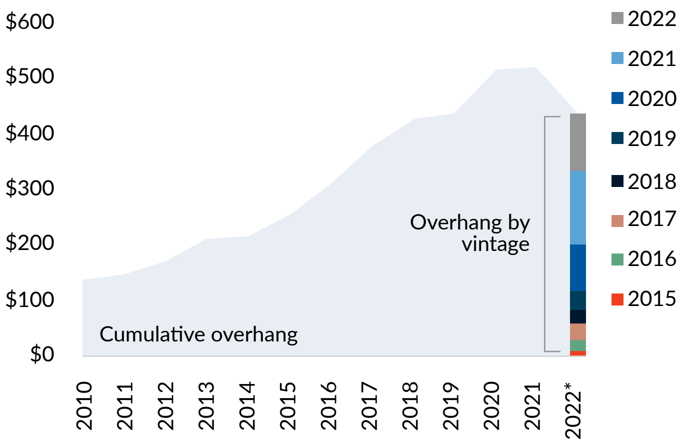
Private credit AUM ($B)



Source: PitchBook • Geography: US
*Data through December 31, 2022

Today's private credit industry

Private credit dry powder ($B) by vintage



Source: PitchBook • Geography: US
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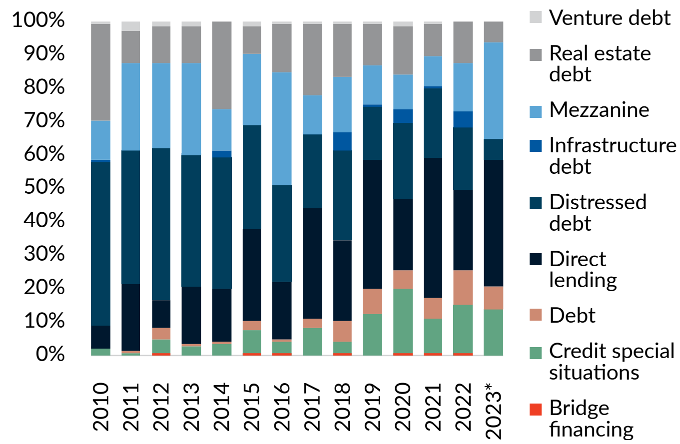
Share of private credit capital raised by strategy



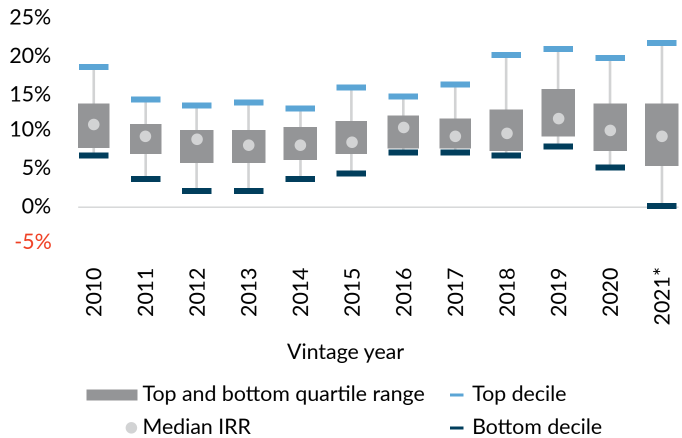
Source: PitchBook • Geography: US
*Data through August 1, 2023

Note: Venture debt refers to debt earmarked for venture-backed companies and other startup situations. Mezzanine debt refers to more junior debt with higher risks (i.e., subordinated debt), which usually has higher interest rates in return. Distressed debt is intended for usage by companies with significant pressures or those facing bankruptcy. Direct lending refers to financing for borrowers without the use of an investment bank or other third party. Credit special situations refers to specialist or rare occurrences that call for particular kinds of terms and types of debt. Bridge financing is usually a shorter-term type of debt used by companies while they work through longer-term options.

As an asset class, private credit has grown significantly in a short amount of time. In 2005, there was a little over $100 billion under management in the US. By 2022, that figure had grown to $1.5 trillion, and private credit is taking a larger role in financing private companies around the country.

That's good news for the American economy. Even though its growing at a rapid pace, the private credit industry has room to get bigger, and lenders will get even better and more sophisticated as time goes on. With $1.5 trillion under management, private credit managers are becoming a bigger aspect of PE investing. As more portfolio companies get support from private credit managers, their financial performance will be more carefully scrutinized, their overall health and performance will improve, and the American financial system will benefit from sturdier, healthier companies in every sector of the economy.

Private credit IRR dispersion by vintage

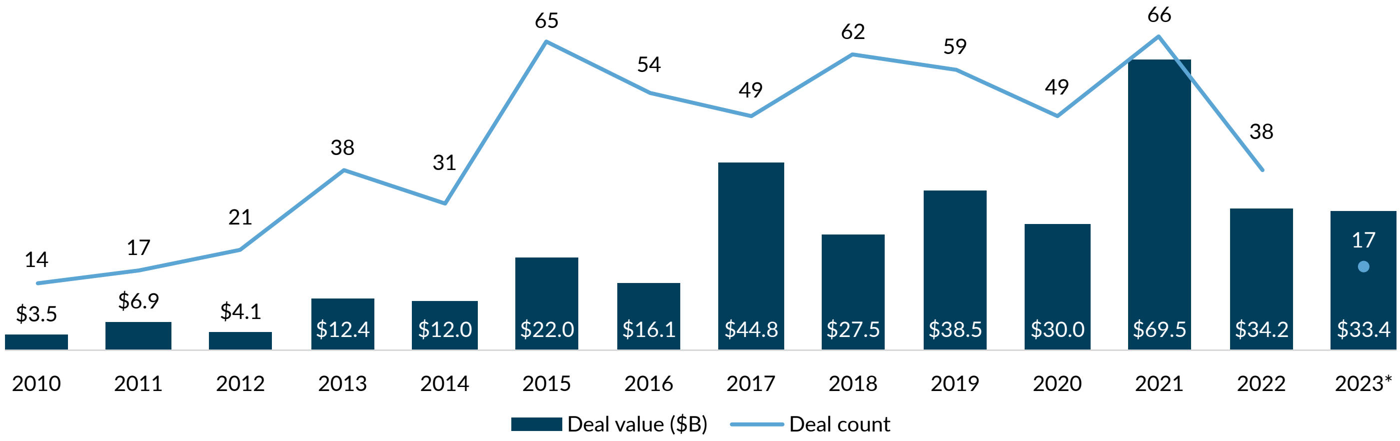


Source: PitchBook • Geography: US
*Data through August 1, 2023

PitchBook returns data shows strong performance for private credit managers. Top quartile performers have not dipped below 11% returns in almost a decade. By comparison, PitchBook's latest Global Fund Performance Report showed that the S&P 500 suffered an 18.1% loss in 2022 alongside a 15.7% loss for high-grade corporate bonds, while Morningstar's LTSA US Leveraged Loan Index declined less than 1%. Private debt returned a positive gain of 4.0% across all funds and strategies in 2022.

Spotlight on direct lending

Direct lending fundraising activity



Source: PitchBook • Geography: US
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Direct lenders have become a prominent partner to American companies, big and small.

Most often these relationships are in the middle market and lower middle market—including many main street companies with small revenues. Not only are many of these companies small, but many of them are unrated. Unrated companies have a difficult time getting loans from traditional lenders, especially newer companies that don't have long credit histories. So, the ability to get financing from direct lenders is a huge bonus to those companies and the American economy.

Importantly, direct lenders are careful with their investments; they get to know the companies they lend to and keep a close eye on their performance after the investment is made.

One reason why the COVID-19 pandemic was manageable for private equity is thanks to the knowledge and preparation that lenders made before loaning their capital. That preparation also means that direct lenders are careful with their paperwork, and direct lenders are willing to include terms and conditions that lower the risk of default if market conditions change.[3]

Today's portfolio companies are closely watched and cared for. Their sponsors and creditors know everything about these businesses and are willing to do what it takes to keep them healthy and profitable. As a result, private credit-backed companies are often the safest and strongest companies operating today. The efforts made behind the scenes, by both sponsors and lenders, is a major benefit to the broader American economy.

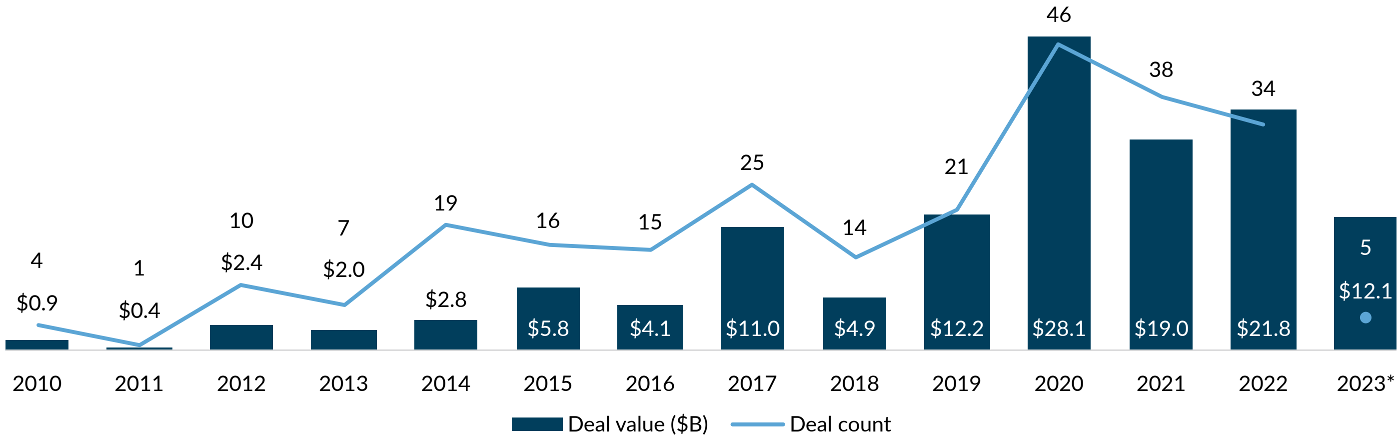
3: "The Role of Private Credit in U.S. Capital Markets," Proskauer, n.d., accessed September 27, 2023.

Private Credit at Work

$25 million in senior secured capital facilities: In order to add on two water treatment companies, PumpTech worked with O2 Finance to obtain $25 million in senior secured credit. PumpTech is currently backed by Pike Street Capital. Such a deal speaks to the current PE buying environment, wherein add-ons remain the most popular buyout strategy, but also to the benefit of existing relationships across credit for PE portfolio companies.

Spotlight on special situations

Special situations debt fundraising activity



Source: PitchBook • Geography: US
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Running a company often means running into hardship. Even Apple, one of the world's most successful companies, struggled mightily at one point. One of PE's best strengths is resuscitating those types of companies and returning them to health. That process requires know-how for PE sponsors and for the lenders who help finance their comebacks.

That's where special situations lenders come in. Staffed by some of the smartest lenders, special situations lenders are not scared away by unprofitable or struggling companies or complex situations. While there is more risk involved, special situations lenders take a close look at each struggling company that comes their way. When they do decide to loan capital, they feel comfortable about the company, its situation, and its path forward, even if it might take several years. For these companies, special situations lenders are a necessary lifeline to their survival since traditional lenders wouldn't consider lending to them at all. Over the past decade, $126.2 billion has been raised by special situations lenders, according to PitchBook. That money has helped finance thousands of struggling companies, with many making recoveries and continuing to add firepower to the American economy.

Private Credit at Work

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$125.0 million facility: On the other end of the size spectrum, Victory Park Capital provided a $125 million facility to financing firm Novo Funding, with the proceeds intended for working capital. Novo's business banking platform seeks to provide multiple financing solutions, as well as tools, to small business owners, startups, freelancers, and more. Partnered with Middlesex Federal Savings in a typical fintech-traditional bank partnership, Novo targets growing enterprises to support their critical capital needs.

Weathering storms

The private credit industry came of age following the global financial crisis. But the private credit has been tested twice in the past three years—first by the COVID-19 pandemic and then by the collapse of Silicon Valley Bank (SVB).

The pandemic was a massive test for private credit managers, and they passed with flying colors. In 2020, when thousands of companies were upended by a health crisis and social distancing, the private credit default rate was less than 2% for the year—lower than the default rates of the high-yield bond market and the leveraged loan markets. A major advantage for private credit managers was their industry expertise, as well as the industry expertise of the PE firms they partnered with. Because private credit managers work directly with borrowers, they were able to make sure that private companies had ample access to capital and flexibility given the unpredictability of the pandemic. Today's private credit managers are experts in every sector, including consumer, manufacturing, healthcare, and real estate. Being backed by knowledgeable and patient lenders made all the difference for thousands of portfolio companies, and many are stronger than ever today thanks to their backers.

The private credit industry has proven itself as a reliable, safe source of financing to the American economy, which continues to this day. Proskauer's Private Credit Default Index decreased again in late 2023 and is now down to 1.4%. The default rate for the smallest companies backed by private credit firms is even lower, at 0.7%. In fact, the default rates for every company size tracked by Proskauer's index were lower than the comparable default rates from Fitch Ratings for two quarters in a row.[4] With two tests passed, the industry's reputation has improved greatly, which is a good thing for American companies and their employees in the years ahead.

4: "Proskauer's Q3 2023 Private Credit Default Index Highlights the Resilience of Private Credit in a Turbulent Economy," Proskauer, October 24, 2023.

About AIC

The American Investment Council (AIC) is the leading advocacy and resource organization established to develop and provide information about the private investment industry and its contributions to the long-term growth of the U.S. economy and the retirement security of American workers. Member firms of the AIC consist of the country's leading private equity, private credit, and growth capital firms united by their successful partnerships with limited partners and American businesses. More information about the AIC can be found at www.investmentcouncil.org.