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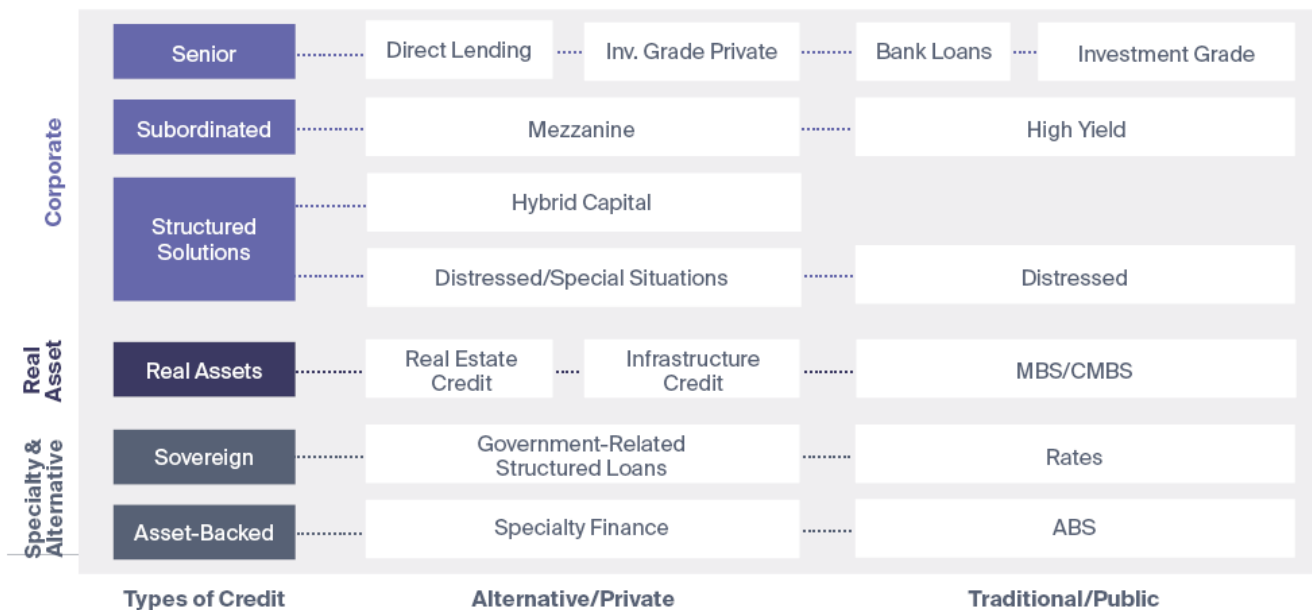
Private Credit Unveiled: Opportunities, Risks, & Why We Steer Clear

Private credit has received significant attention in recent years, with investment managers touting the asset class as a lucrative opportunity. While private credit has existed for decades, market changes, an extended low interest rate environment driving investors to seek higher-yield products, and increased accessibility over the last several years have spurred a surge in popularity. The initial boom in fundraising started after the Global Financial Crisis (“GFC”) as bank regulations and lending standards were tightened, prompting businesses to seek alternative sources of debt financing. Since then, the asset class has thrived in a favorable economic climate characterized by low default rates and growing demand for higher yielding fixed income alternatives amid a prolonged low interest rate environment. As investors have enjoyed consistent results, the amount of capital raised by private credit managers has exploded. Gresham’s admittedly contrarian view has been to avoid jumping on the bandwagon, and here’s why.

But First, What Exactly is Private Credit?

“Private Credit” is a generic term often used to describe a wide range of different debt instruments. Generally, when businesses need to raise debt, they have several options: traditional bank loans, the issuance of bonds, or private market solutions. Private credit asset managers raise funds backed by institutional and retail investors to make floating-rate loans to private businesses. This asset class encompasses a wide array of investment strategies across different risk and seniority levels, offering exposures ranging from pure credit to hybrid credit/equity solutions. These loans are collateralized by a variety of underlying assets and borrowers, as illustrated in **Chart 1**. In this article, we will focus mainly on corporate debt as it represents the largest segment of the private credit market by volume.

Chart 1. Credit Overview



Source: Goldman Sachs Asset Management

The Rise in Popularity

Historically, the corporate debt market was dominated by traditional banks. However, the GFC had a meaningful impact on the market due to the banking system’s stress and failures, and the subsequent regulatory response, which curtailed banks’ willingness and ability to make loans.

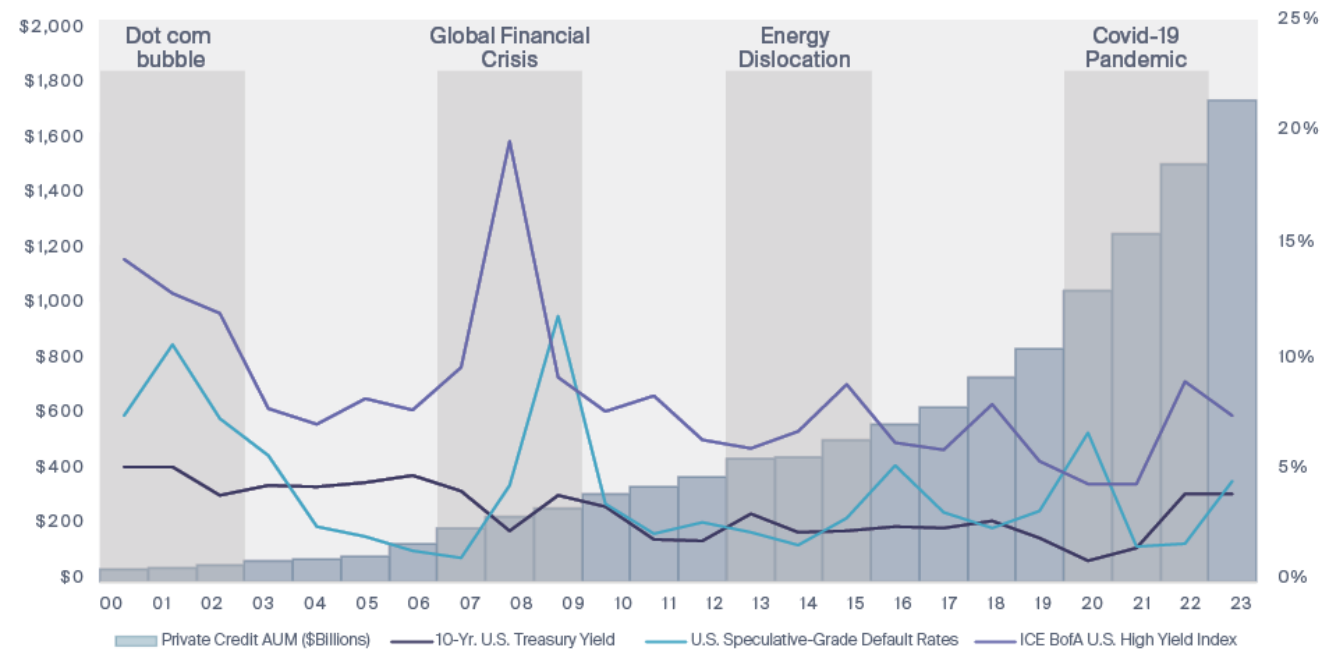
The GFC led to a credit crunch for banks and traditional lenders, who incurred significant losses following the collapse of the housing market. As banks absorbed the severe consequences of their risky lending practices, their appetite for risk waned. Relatedly, governments introduced more stringent regulations such as Dodd-Frank and Basel III. These rules similarly discouraged banks from taking excessive risk and tightened both their capital and liquidity requirements.

As a result, banks began to favor lending to safer and more mature businesses, making it harder for smaller companies to obtain financing. As traditional lenders pulled back, private credit lenders stepped in to fill this funding gap. Operating with more flexibility and fewer restrictions, private credit lenders could offer customized loans to riskier businesses while charging a healthy premium over traditional debt.

Simultaneously, in an effort to stimulate the economy out of the GFC-induced recession, global central banks cut interest rates to historically low levels. This led investors on a frantic search for yield that was no longer satisfied by traditional, high-quality debt investments. The combination of exploding private credit capital and investor demand for income in a low-yield world drove demand for higher-yielding private credit. As shown in **Chart 2**, private credit assets under management have exploded during the post-GFC period as interest

rates and junk bond yields experienced a sustained period of record-low levels.

Chart 2. AUM of Private Credit has surged, while interest rates and default rates have remained low



Source: The Federal Reserve, Bloomberg and SP Global

As shown above, contributing to the historical attractiveness of private credit, loan defaults have remained extremely low over this same period except for momentary blips. Post-GFC, the default rate has averaged ~3.1%, peaking at only 6.7% in 2020 due to Covid-induced business interruptions, which is well below both the tech bubble unwind and GFC periods of stress. These low default rates were driven by the readily available supply of private credit that allowed fundamentally weaker companies to “extend and pretend” by refinancing their outstanding debt and avoiding bankruptcy. Ironically, the ability of low-quality companies to access abundant financing helped perpetuate low default rates and the seeming attractiveness of this asset class for investors.

This Goldilocks period is widely recognized by many market participants, particularly by asset managers, who have built extraordinary businesses offering private credit to their clients. Recently, Blackstone, an industry behemoth, referred to the current environment as a “golden moment for private credit”.

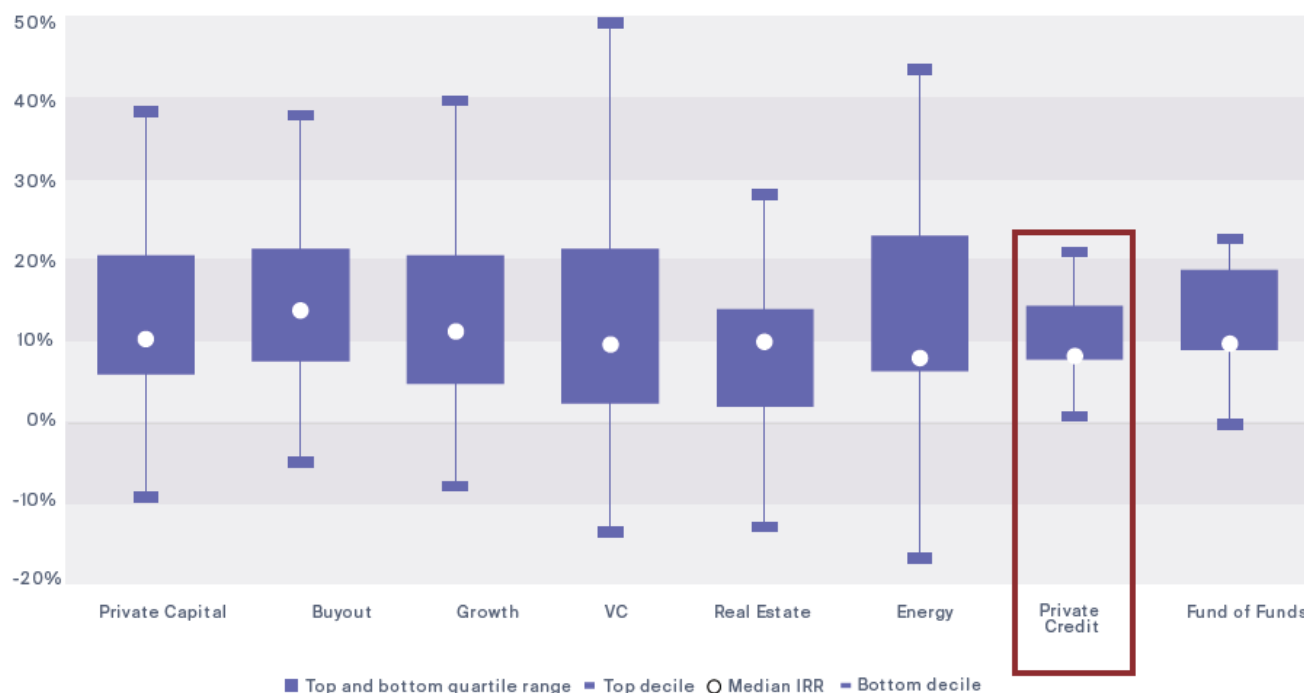
The Allure for Investors

From a performance perspective, it’s easy to see why private credit looks attractive, as returns have been good over the past three decades. According to Cambridge Associates, the median private credit fund has generated an 8.9% IRR since inception^[1]. Importantly, these returns have been consistent, with the median IRR ranging from 4.0% to 16.8%, for vintages between 1993 and 2020.

Compared to other asset classes, investors may also be drawn to what appears to be solid downside protection. The bottom quartile of private credit managers, on average, has still generated positive returns, while all other asset types have seen losses (**Chart 3**)^[2]. While skeptics might point out that top-quartile private credit managers generate the lowest returns among these investment categories, for investors who prioritize principal protection, this could be an acceptable trade-off.

Chart 3. IRR Fund Performance Dispersion By Strategy (Vintage Years 1993 – 2020)

Private Credit has had consistently good performance with limited downside.



Source: Cambridge Associates, Gresham Partners

A further benefit to investors is that private credit managers have, on average, returned capital to investors at a faster rate than many other private strategies. During this same period, private credit investors received their full invested capital back within an average of seven years, which is two years faster than the average buyout manager and five years faster than the average venture capital manager^[3].

Hidden Pitfalls?

Despite the aforementioned benefits, Gresham remains cautious about private credit investments. Our concerns arise from issues that may not be readily apparent to investors: tax inefficiency, a negatively skewed risk-return profile, a lack of liquidity and inefficient use of our clients' liquidity budget.

Tax Inefficiency:

Without considering any other risk factors, tax inefficiency poses a significant hurdle for taxable investors and may be singularly disqualifying. Taxable investors face a substantial

headwind when investing in almost any income-producing investment, and private credit is no exception. In private credit, interest income – rather than price appreciation – is the primary driver of return unlike most of Gresham’s private investment strategies. Consequently, the majority of returns from private credit investments are taxed at higher ordinary income rates rather than preferential capital gains tax rates, significantly reducing investors’ after-tax return and the overall attractiveness of the asset class. Many of our clients will lose 50% or more of their returns from these investments to taxes, turning the 8.9% median return into something less than 5%.

Negatively Skewed Risk-Reward:

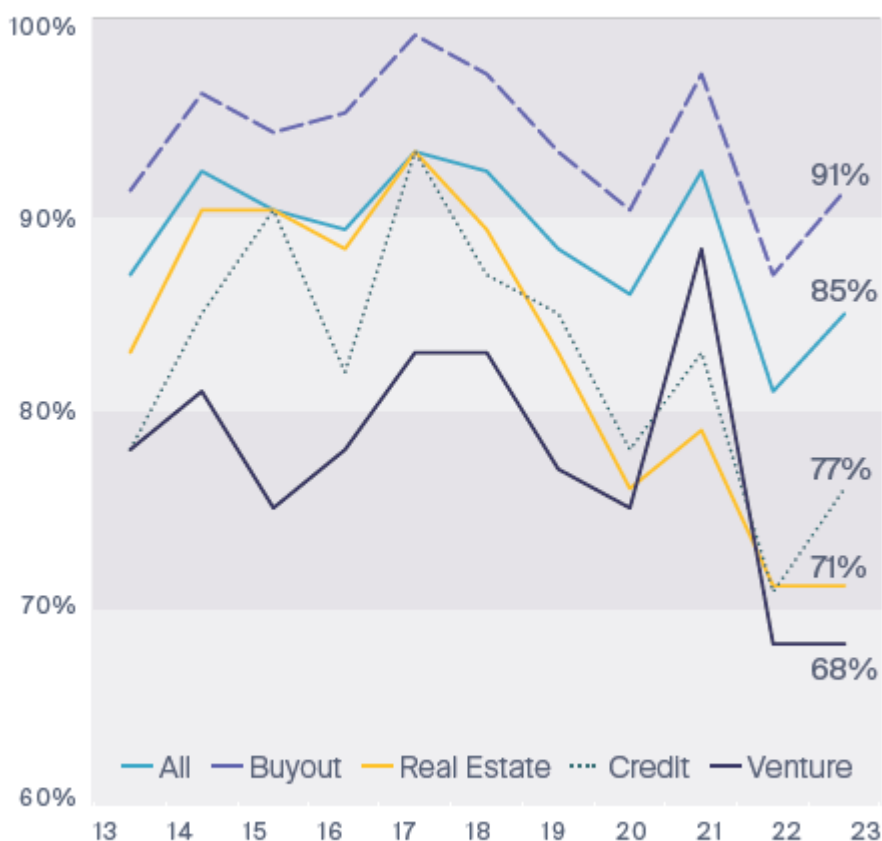
Private credit investments have exhibited low volatility, as measured by dispersion of returns, in the recent benign environment. However, low apparent volatility is not the same as low risk. In a less favorable environment, the downside risk increases significantly, as more companies struggle to refinance debt obligations and default rates rise. While this is true of nearly every asset class, the downside risk must be measured against the potential upside. In the case of credit investments, the downside could be multiples of the limited upside. We believe this negative skew or asymmetric risk-return profile makes private credit investments less attractive for our clients.

Lack of Liquidity:

Private credit is illiquid by nature. The standard vehicle for private credit strategies is a closed-end fund, similar to a private equity fund. Investors should expect their capital to be inaccessible for several years, becoming available only as interest income is generated or loans are re-paid by the borrower and then distributed by the manager to their investors. Those that unexpectedly need capital might explore the nascent private credit secondary market where fund stakes trade at a significant discount to par (**Chart 4**), forcing investors to take a loss on their investment in exchange for liquidity.

Chart 4. Private Credit Secondary Sales

Price to NTM Earnings



Source: J.P.Morgan Asset Management

Portfolio Liquidity Budgets:

Relatedly, when building portfolios for our clients, we are acutely aware of liquidity limitations, whether functional or simply based on personal comfort. How we optimize the use of a client's limited liquidity budget is an important consideration in maximizing long-term outcomes. Generally, the excess return captured from investing in private equity is a powerful driver of an investor's outperformance. Sacrificing this upside for lower-returning and less tax-efficient strategies, such as private credit, is a sub-optimal decision for most of our client portfolios.

Calm Before the Storm?

Conditions for private credit funds have been optimal for the past decade, characterized by a generally positive economic environment with low default rates. However, the industry as it's constituted today has never been truly tested. Further, the massive influx of capital into this asset class has created an imbalance between supply and demand, compressing the premiums that were readily available over a decade ago. While predicting the future is impossible, it's safe to say it would be difficult to reproduce the perfect environment of the

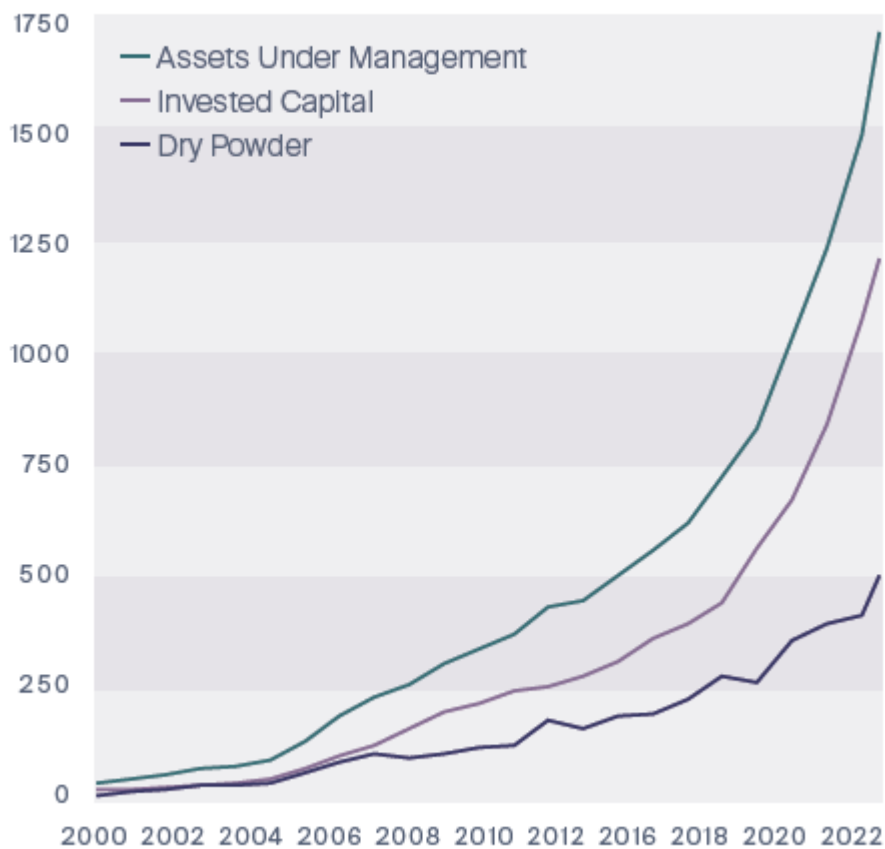
prior 15 years, and a less supportive period going forward is quite possible.

Oversupply of Capital:

The growth of private credit funds has been exponential in recent years. As indicated in **Chart 5**, the total assets under management (“AUM”) for private credit fund managers has reached \$1.7 trillion, making it nearly the size of the leveraged loan and high-yield bond markets, as shown in **Chart 6**. Relatedly, there is a rapidly growing amount of committed but uninvested capital (“dry powder”) for managers in the industry, suggesting the supply of private credit funding is outstripping the demand for private loans.

Chart 5. All Private Debt Strategies

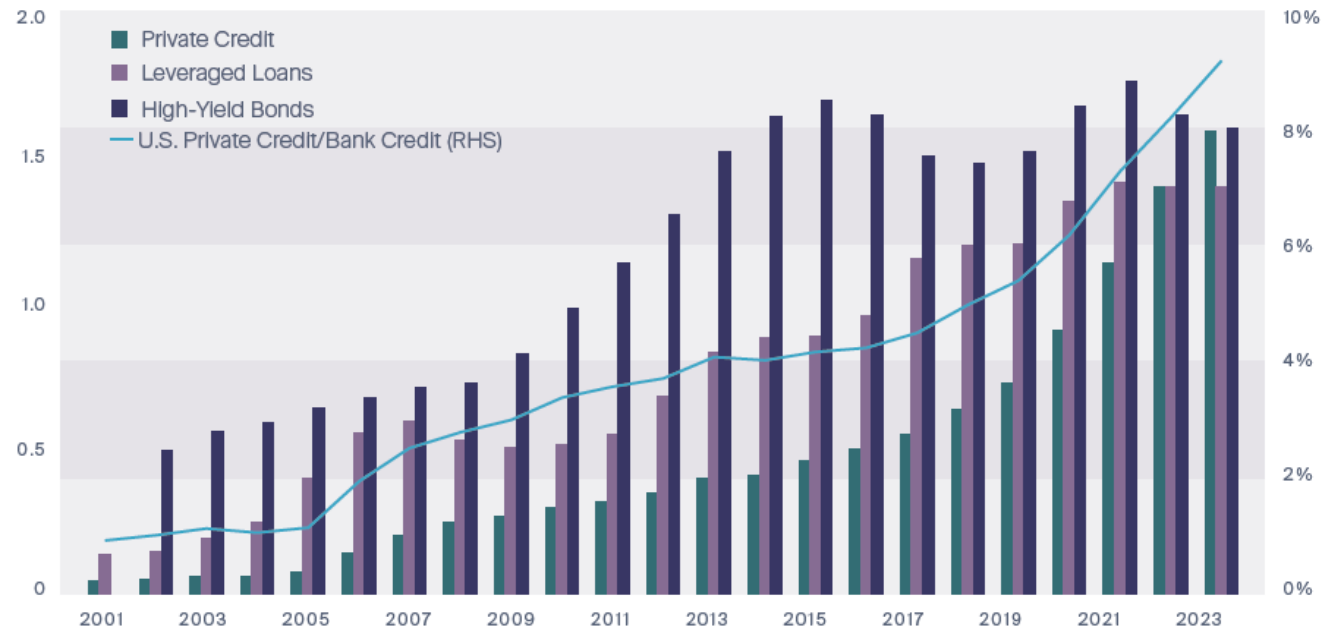
\$ Billions



Source: The Federal Reserve

Chart 6. The Private Credit market size is now comparable to Leveraged Loans and High-Yield Bonds

\$ Billions

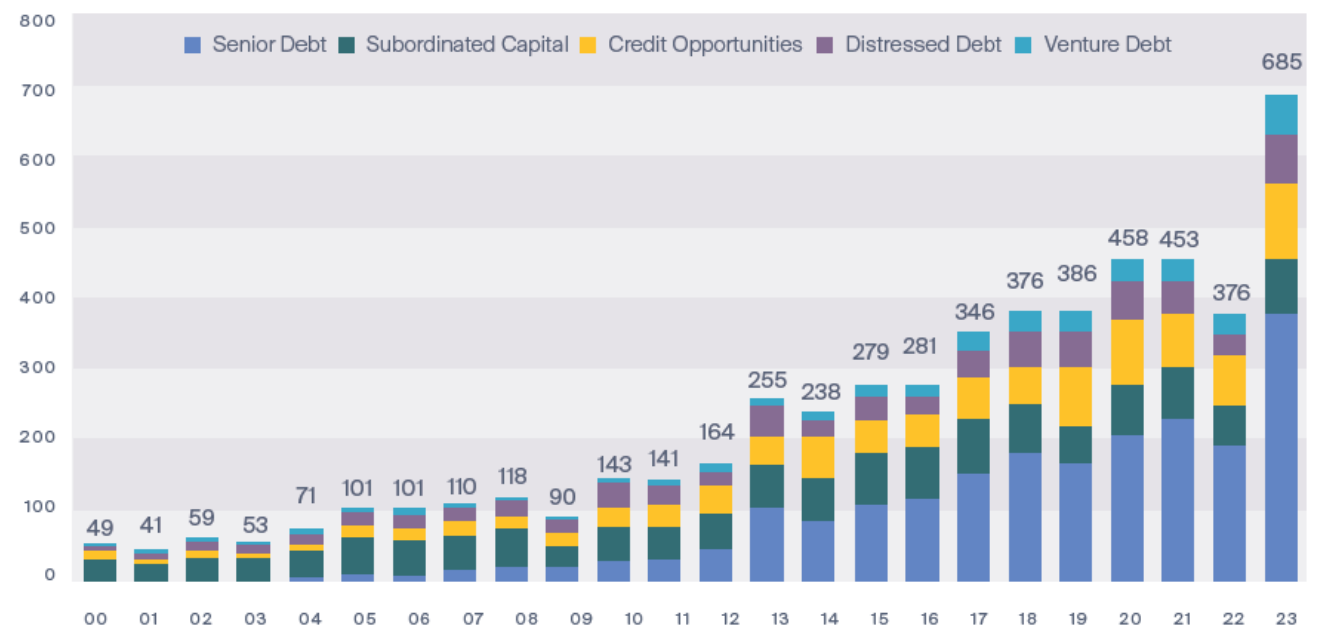


Source: International Monetary Fund

Managers are incentivized to gather AUM, deploy capital swiftly and raise their next fund. As these bloated funds get overrun with loan applications, logic suggests that lending standards will deteriorate as it's unlikely that every manager is selecting only their best deals. Inevitably, some will have looser underwriting standards and we will see "who's swimming naked when the tide goes out". Moreover, as illustrated in **Chart 7**, the vast majority of these managers emerged post-GFC and have never navigated a significant economic downturn.

Chart 7. Majority of Private Credit Funds Emerged Post-GFC

Global Private Credit Funds By Vintage Year



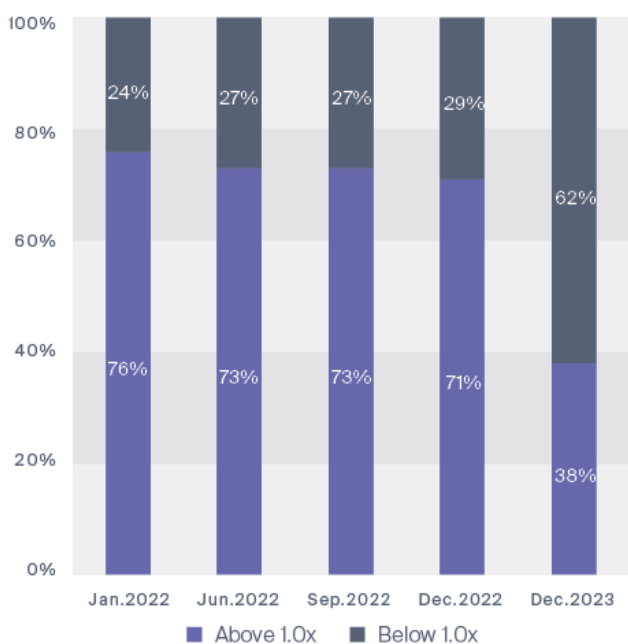
Source: Cambridge Associates, Preqin

Risk of Rising Defaults:

Many investors often extrapolate trends based on the recent past. This recency bias is quite common in all aspects of our lives, and historical default rates are no exception. While we haven't seen a significant uptick in default rates, there are several warning signs suggesting stress is rising. Sharply higher interest rates over the last 18 months have elevated borrowing costs, weakened borrower cash flows and eroded the ability of many companies to pay higher interest costs associated with their debt.

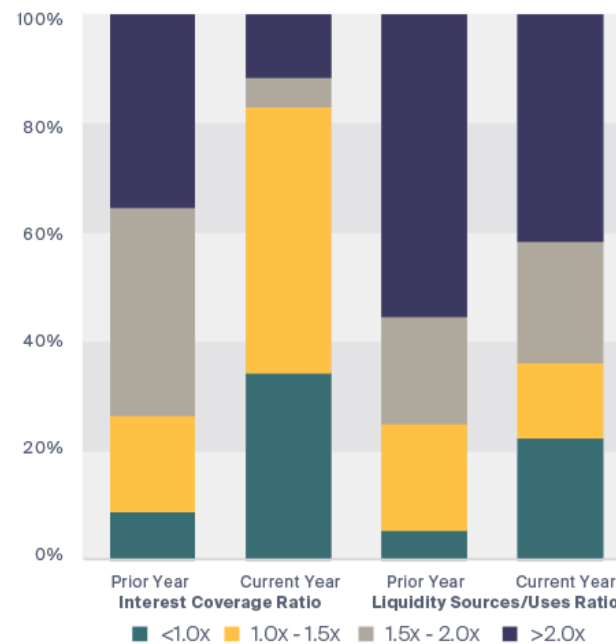
- Interest coverage ratios, a common indicator of borrower stress, have significantly dropped. In December 2023, 62% of “B3” rated (a below investment grade rating common for private borrowers) companies recorded an interest coverage ratio below 1x, versus 29% one year earlier, according to Moody’s data cited by JP Morgan (**Chart 8**).
- Morningstar DBRS said that nearly 10% of actively rated private credit issuers were already operating under covenant waivers or amendments. Relatedly, for those companies requesting covenant relief/amendment, their credit profiles have worsened. As shown in **Chart 9**, the average interest coverage across the waiver group declined 34% year-over-year, and this cohort’s average liquidity ratio declined 15% over the same period.
- Finally, the percentage of interest income being paid in kind rather than in cash remains elevated compared to pre-pandemic levels and is approaching peaks last seen during the GFC (**Chart 10**). This trend suggests more borrowers are experiencing cash flow difficulties.

Chart 8. Interest Coverage Ratios of B3 Rated Companies



Source: J.P.Morgan Asset Management

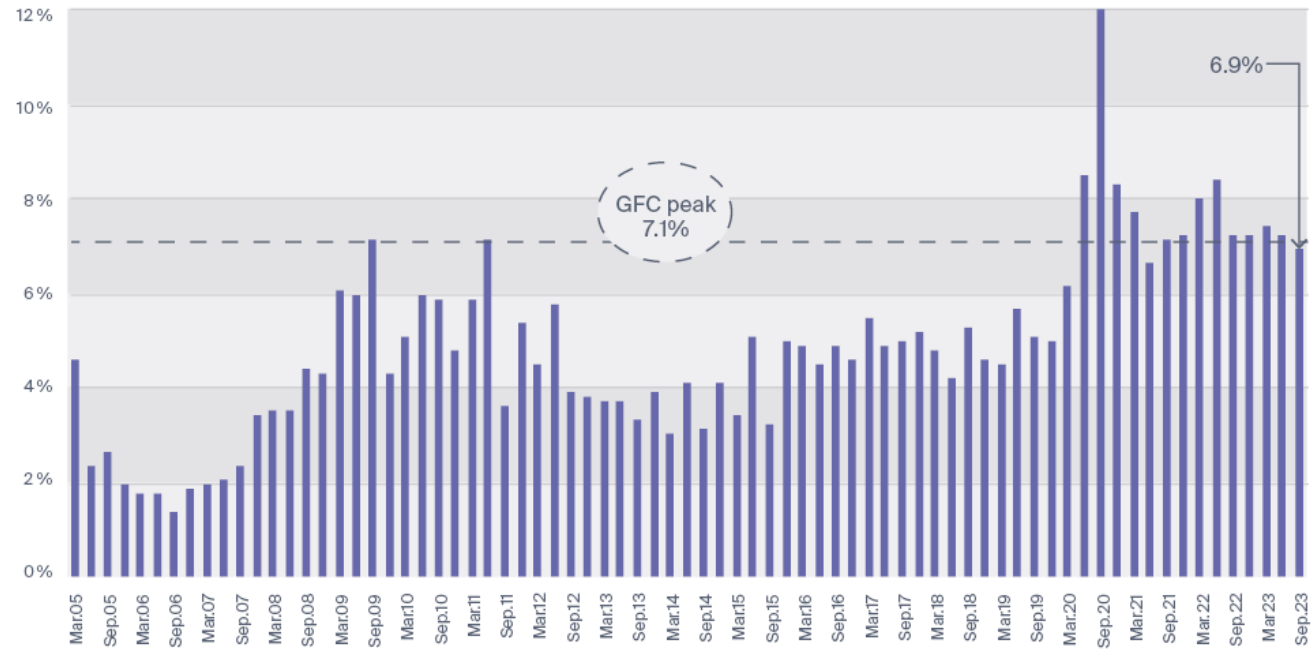
Chart 9. Credit Metrics for Borrowers Requesting Relief Have Deteriorated



Source: Pitchbook

Chart 10. Payment in Kind Income is reaching the GFC peak

As a % of Total Income



Source: J.P.Morgan Asset Management

While outright default rates have risen only modestly since Q1 2022 and remain below levels seen in the stressed periods of 2008 and 2020, the broader mosaic suggests that there is stress building in the market. This may be the “calm before the storm”. If the environment shifts towards an economic downturn, the issues mentioned above could be exacerbated, leading to a sudden increase in defaults.

Conclusion

For taxable investors with limited liquidity budgets including Gresham’s clients, we believe the after-tax, risk-adjusted returns of private credit are less appealing compared to other illiquid investment options such as private equity. Even for non-taxable investors, this asset class warrants caution. Our concerns arise from the over-enthusiasm in capital supply, which often leads to lax lending standards, coupled with the inherent lack of liquidity and transparency, and an increasing degree of risk embedded in these loans. While we are beginning to see signs of strain, the market’s full vulnerabilities have yet to be revealed. Is the risk worth taking right now? We don’t think so.

[1] Cambridge Associates performance data include all managers under Credit Opportunities, Senior Debt, Subordinated Capital for vintages between 1993 and 2020.

[2] Cambridge Associates. Since inception performance.

[3] Cambridge Associates.

The statements made in this article are the opinion of Gresham Partners and were developed

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**Approximate AUM and client families as of 12/31/23*



Gresham Partners LLC

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