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PRIVATE CAPITAL

December 2023

Resilient private credit fills a growing need across U.S. and Europe

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SUMMARY

- Direct lenders continue to take market share from banks.
- The evolution of the private credit market favors the largest managers.
- Deal volumes are benefiting from a structural change in the direct lending and liquid markets.
- There is material runway for growth in private credit in the years to come.
- Private credit has delivered attractive returns over the long term.

INTRODUCTION

The U.S. and European private credit markets have been a significant success-story of asset management for the last decade. Commencing as a source of financing for mid-market companies unable to raise funds elsewhere, private credit has grown into a serious and credible competitor to both traditional, liquid markets (i.e., broadly syndicated loans and high yield corporate bonds), something seemingly fanciful only a few years ago. Now, private credit players are regularly financing the entirety of multi-billion-dollar debt structures.[1]

The Global Financial Crisis helped turbo-charge the private credit industry as regulated lenders were discouraged from holding senior bank loans. Each subsequent crisis served to underline the attractiveness of the asset class. The European Sovereign Debt Crisis, the U.S. Taper Tantrum, and COVID all helped place private credit on a steady upward trajectory.[2] Driven by the fundamental supply-demand imbalance for credit on both sides of the Atlantic, private lenders offered increased capacity, greater efficiency, and non-dependence on third-party ratings agencies.

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The most recent wave of macro troubles — inflationary pressure and war in Ukraine — are no exception to the trend. As liquid-market activity fell significantly, private credit was able to step up and step in. The combination of locked-up capital and experienced managers able to access attractive credit opportunities has allowed private credit to take increased share from banks and liquid bond markets.[3]

Even as private credit enters this new phase of "liquid market substitution," the risk-return profile of the asset class remains materially more favourable than that of the liquid markets.[4] Private credit managers tend to also extract better terms and pricing with more diligence than their liquid market counterparties.

In our view, the benefits of these trends accrue to the scaled, established managers in both regions. To be a counterparty to top-tier private equity, a private credit manager needs an established track record of providing finance combined with significant fund sizes. Therefore, we see the mid-to-upper end of the private credit market as being the most attractive place to be — it typically gives access to better investment opportunities with reduced competition.

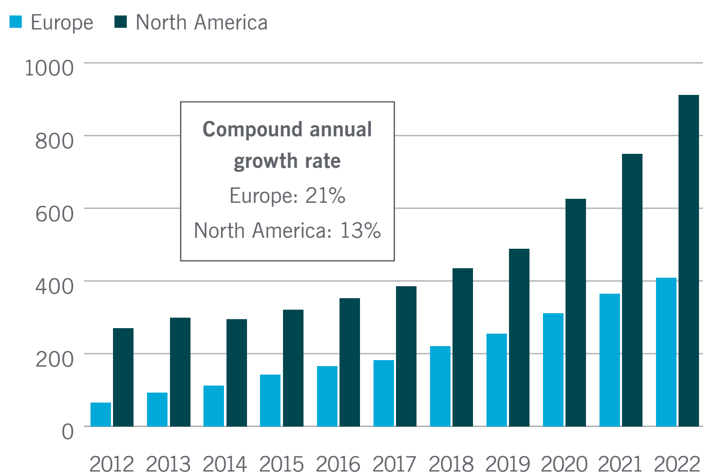
Undoubtedly, there are challenges facing the industry. While some macro worries have subsided, the global economy is not out of the woods yet. Notably, it is clear that interest rates may remain elevated for at least another year or two, putting stress on borrowers whose interest costs are suddenly ballooning. There will certainly be difficult conversations between lenders and borrowers as to how the capital structure can be made sustainable. Ultimately, the quality of the underlying credit will determine fund performance as capital structure issues are easier to fix when business performance is strong. We take comfort that private credit is exposed to materially more defensive industries than the market at large,[5] has stronger structural protections than the liquid markets,[6] and its managers can often take action more decisively than a large club of disparate lenders ever can.

The U.S. and European markets share a large number of similarities, structure, and outlook. Differences do remain, such as the multi-jurisdictional nature of Europe, compared to the more homogeneous U.S. legal system. As such, success in the market requires the manager to be well-versed in the idiosyncrasies of each system.

DIRECT LENDERS CONTINUE TO TAKE MARKET SHARE

The disintermediation of regulated bank lenders by non-banks is a more mature trend in the U.S. than in Europe. As such, the annual growth rate of European private credit AUM since 2012 has been 21% versus 13% in North America.[7] Non-bank alternatives were not available in Europe until the advent of private credit after the Global Financial Crisis, while upper-mid-market U.S. companies have long been able to access debt through bonds, private placements, and BDCs.

Figure 1: Private credit AUM growth ($bn)



Data source: Preqin, September 2023.

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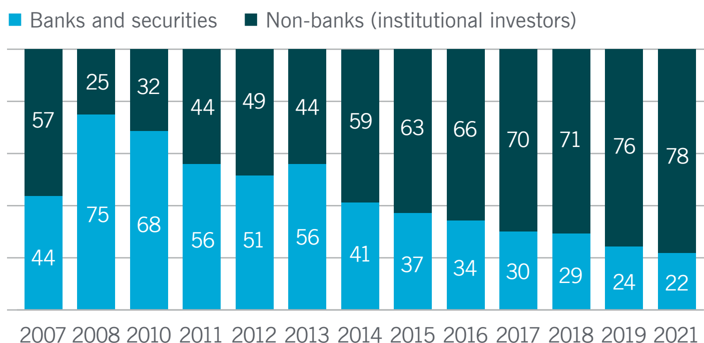
The overriding trend over the period has been a one-way displacement of banks in favour of other institutional investors, including private credit. Relative market shares flipped since 2008 — banks now account for less than 25% of all financing across Europe and the U.S. (Figure 2).

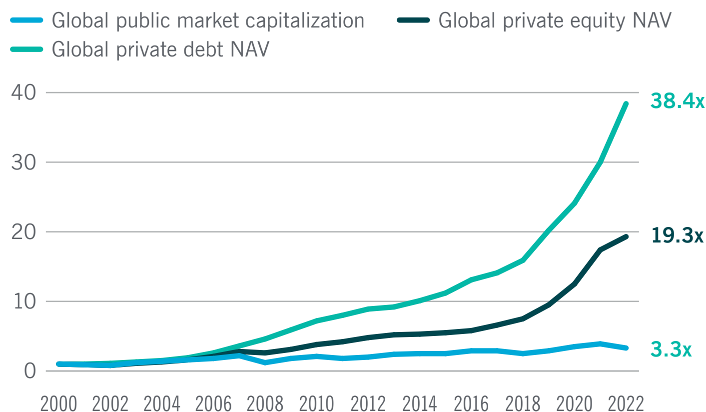
Figure 2: Non-bank lenders continue to take market share from global banks[2] (%)



Data source: PitchBook LCD, Given the lack of primary issuance, LCD did not track enough observations to compile a meaningful sample for 2009, 2020, 2022 and YTD 2023. Note this refers to loans issued by banks and held by for term, i.e., not the syndicated loan market.

The private credit story should be viewed in the context of a broader megatrend — the continued outperformance of private versus public markets. Even in this context, private credit stands out — AUM increased by 38.4x since 2000, versus an equivalent figure of just 3.3x for the public markets at large (Figure 3).

Figure 3: Private vs public market growth

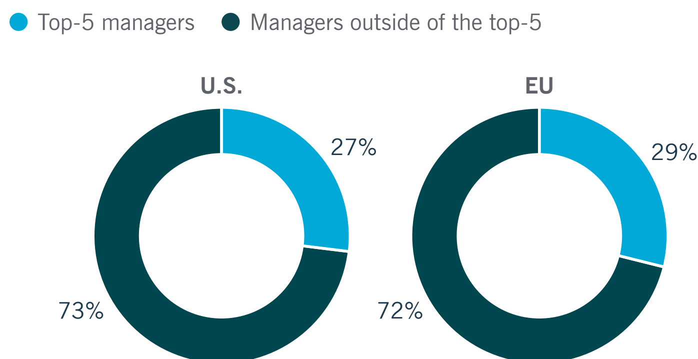


Data source: World Federation of Exchanges (WFE), Preqin, as of December 2022. Notes: Net asset value (NAV) = AUM less dry powder

PRIVATE CREDIT MARKET EVOLUTION FAVORS THE LARGEST MANAGERS

As the market has matured, the benefits of growth have accrued to the scaled providers of capital. Over the last 10 years, the top-5 fund managers in both the U.S. and Europe raised more than 25% of private credit capital.

Figure 4: U.S. and European funds raised in last 10 years



Data source: Preqin, September 2023.

The size of the average fund raised has also spiked recently in both regions. In Europe, the average fund raised in 2022 was 1.7x that of the last 10-year average, while in North America the equivalent figure was 1.6x, rising to 2.4x in the YTD period.[8]

In our view, there is a clear positive, self-reinforcing cycle that benefits this trend of bifurcation and the continued outpacing at the upper end of the markets. Larger fund sizes allow access to better, larger deals with top-tier sponsors, which in turn attracts LPs who see value in having access to these sorts of transactions.

Private credit managers can offer (i) speed in underwriting, (ii) flexibility with respect to structuring for bespoke business requirements, (iii) the ability to provide follow-on capital to facilitate future inorganic growth, and (iv) greater certainty of execution — particularly when liquid markets are volatile or practically closed. In the face of inflation and macroeconomic volatility, private credit may provide certainty where the other markets might be in flux.

Further, as the private credit market becomes more sophisticated in terms of breadth of products and geographic diversification, the increased requirements for significant infrastructure favours larger firms with the financial resources to support this added complexity.

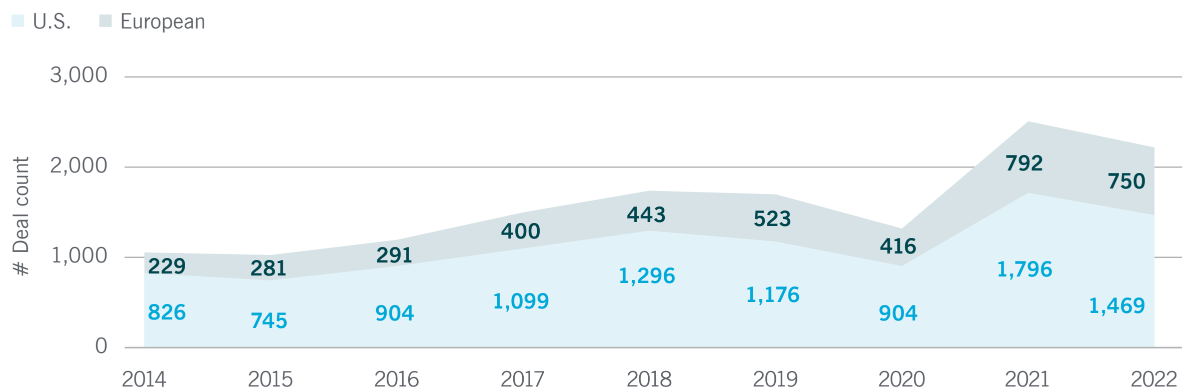
Overall, these are signs of a growing market and positive trends for managers that are able to take advantage of this bifurcation. There are now significant barriers to entry into becoming one of the largest managers.

DEAL VOLUMES — BENEFITTING FROM A STRUCTURAL CHANGE

On the back of the trends described above, deal volumes are generally on a constant upward trajectory in both European and U.S. private credit, while liquid market primary issuance has been variable over the period.[9]

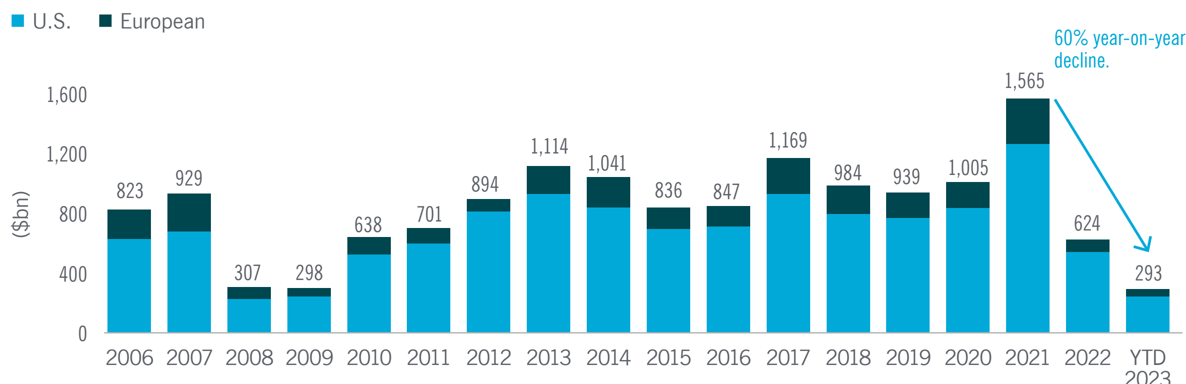
The acceleration of liquid market substitution is exemplified by the experience of 2022. Liquid market volumes fell by a staggering 60% in the face of macro uncertainty and investors pulling back,[9] while overall private credit deal count fell by only 9%. This speaks to the power of locked-up capital, and managers ability to navigate choppier climates with more certainty.

Figure 5: Private credit deal volume has materially increased across geographies



Data source: EU: Deloitte Alternative Lender Deal Tracker Q4 2022; US: Refinitiv LPC's Sponsored Middle Market Private Deals Analysis Q2 2023

Figure 6: U.S. and European primary liquid market activity has fallen significantly since 2021



Data source: Includes high-yield and leveraged-loan issuance. LCD Quarterly European & U.S. Leveraged Lending Review: Q2 2023

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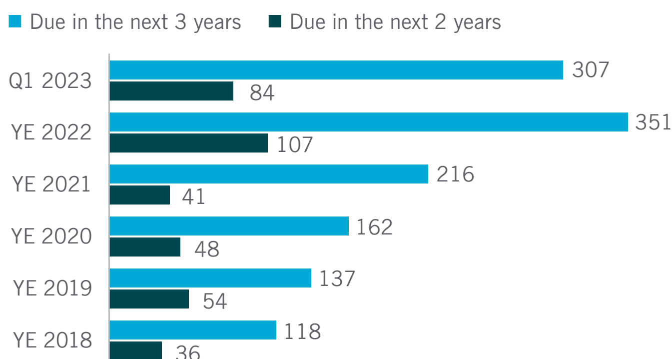
MATERIAL RUNWAY FOR GROWTH

As private credit markets mature, we do believe there is material runway for continued growth. Fundamentally, we believe that private equity firms will continue to see private credit as a flexible and reliable source of capital to meet their financing needs. In our experience this trend is becoming increasingly visible in non-sponsored deal flow, representing a structural change in the overall lending markets in Europe and the U.S.

Figure 7: Maturity wall provides material pipeline for private credit ($bn)

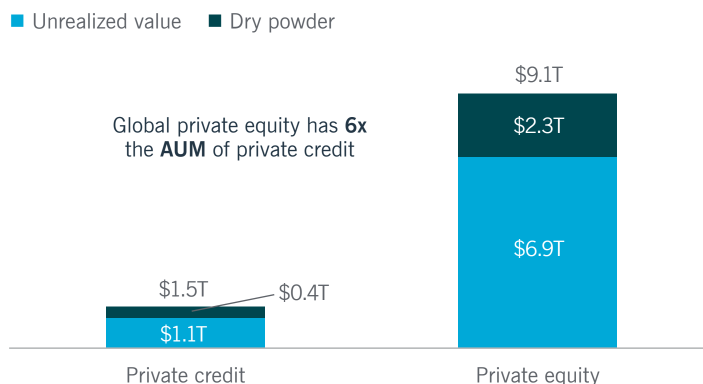


Data source: PitchBook LCD, as of Q1 2022.

In the near term, we see a significant opportunity in the $370bn maturity wall that will be seeking refinance from the liquid markets over the next several years — and given the market dynamics discussed above, we believe private credit is well-positioned to take a very material share of this.

More broadly, looking at the relative AUM of private credit versus private equity, we see that there remains a material gap. It is not unreasonable to expect that the vast majority of private equity deals can be backed by private credit. Assuming a loan-to-value of 50%, this would suggest that private credit AUM should equalize to that of private equity. With private equity having approximately 6x the amount of dry powder as private credit, the demand for private credit solutions should continue. According to a Preqin forecast, private credit AUM will grow at a compound annual growth rate (CAGR) of 11.1% between 2022 and 2028 to reach an all-time high of $2.8tn — almost doubling the 2022 figure of $1.5tn.

Figure 8: Global private credit AUM is only a fraction of private equity

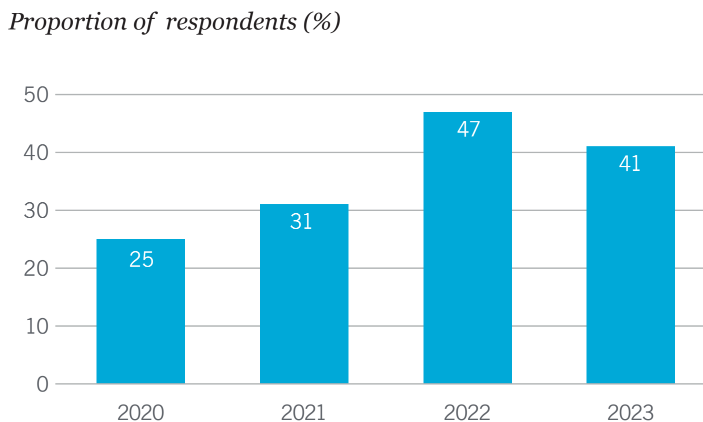


Data source: Preqin as of December 2022.

Underlying investor sentiment for private credit also remains strong. According to Nuveen's annual EQuilibrium survey, the percent of institutional investors looking to increase allocations to private credit climbed to 47% in 2022, and in 2023 private credit tied with private equity at 41%.

Figure 9: Institutional investors planning to increase allocations to private credit

Proportion of respondents (%)

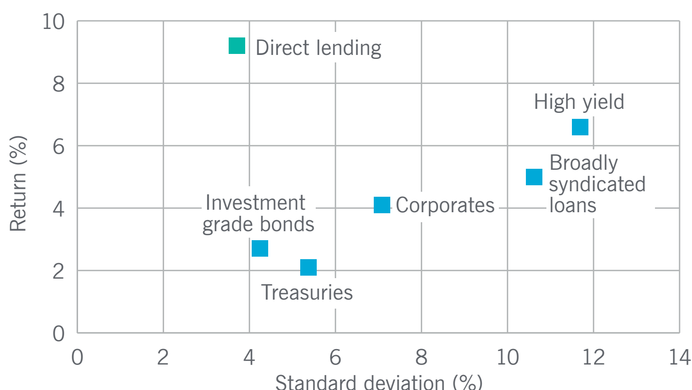


Data source: Nuveen's 2024 annual EQuilibrium survey. Final survey to be released in March 2024.

PRIVATE CREDIT HAS DELIVERED ATTRACTIVE RETURNS OVER THE LONG TERM

On a risk-adjusted basis, direct lending is a particular stand-out performer, with materially lower risk and higher returns than its liquid market counterparts (Figure 10).

Figure 10: Direct lending risk / return analysis (10 years)

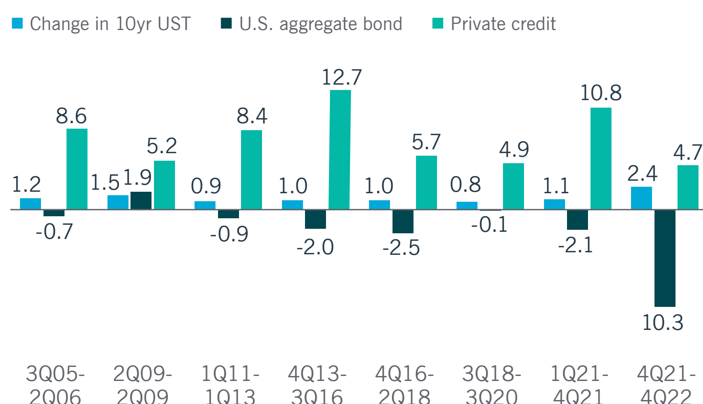


Data source: "Direct Lending" is represented by the Cliffwater Direct Lending Index. "Broadly Syndicated" is represented by the Morningstar LSTA US Leveraged Loan 100 Index. "High Yield" is represented by the Bloomberg US Corporate High Yield Total Return Index. "Corporates" is represented by the Bloomberg US Corporate Bond Index. "Investment Grade Bonds" is represented by the Bloomberg US Aggregate Bond Index. "Treasuries" is represented by the Bloomberg US Treasury Index. Data presented is as of 1Q 2023. Past performance does not guarantee future results.

Performance in rising rate environments is more attractive

The floating rate nature of direct lending loans (which accounts for the majority of private credit) provides material protection in increasing base-rate environments. This is in stark contrast to the majority of the fixed-rate bond market, which exhibits value decline in periods of rising rates. In a falling rate environment, direct lending loans benefit from interest rate floors that provide a minimum yield.

Figure 11: Private credit returns in rising rate environments (%)

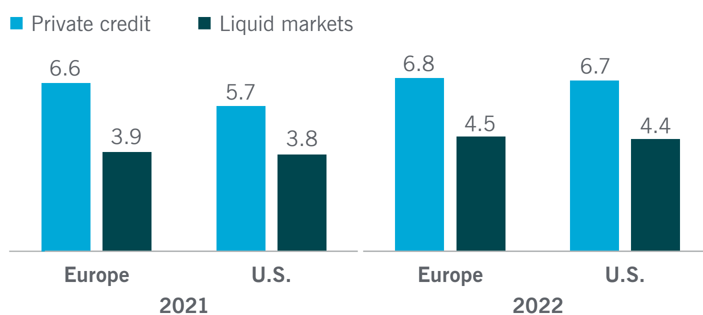


Data source: Factset, Morningstar Direct, Cliffwater Direct Lending Index. As of 31 Mar 2023. Past performance does not guarantee future results.

Pricing continues to be strong compared to the liquid markets

Both in Europe and the U.S., private credit margins continue to be materially strong to those of the liquid markets, running at a 200-300bps premium across the board.[10]

Figure 12: New issue margins in European / U.S. private credit and liquid markets (%)

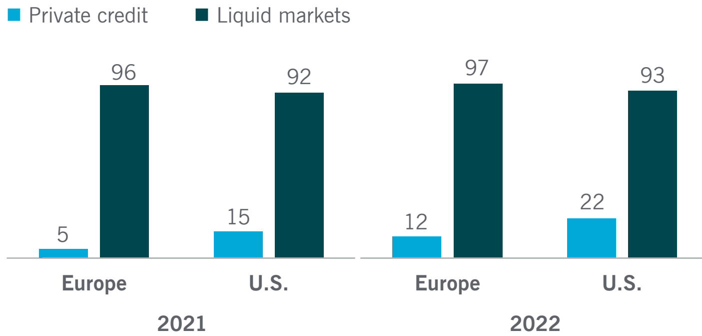


Data source: S&P Comps September 2023, Proskauer private credit Insights 2022.

Better protections in private credit

Private credit remains an overwhelmingly covenanted market in both regions, in stark contrast to the liquid markets. This fundamental advantage affords private credit managers the right to step in where there is underperformance

Figure 13: Covenant-lite new issuance (%)

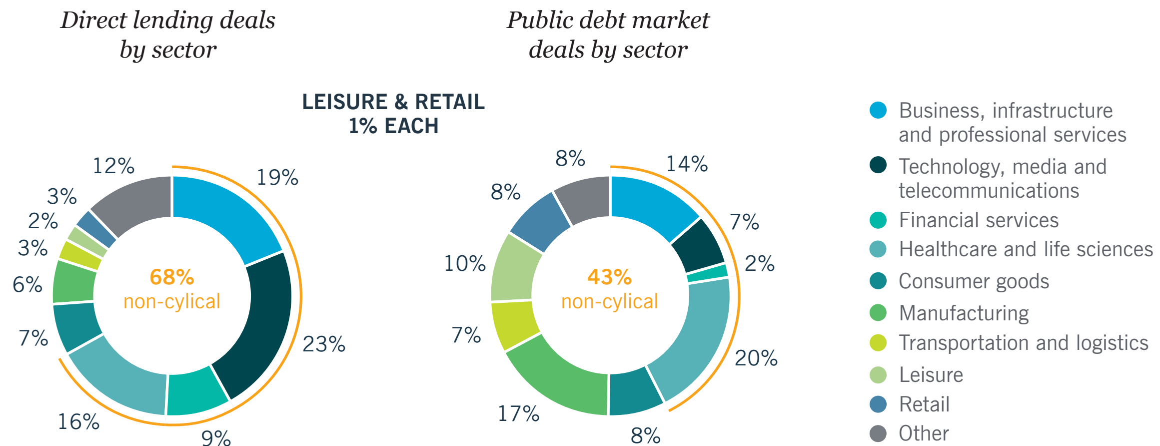


Data source: LCD Comps September 2023, Proskauer private credit Insights 2022.

and take action. Though this does not necessarily lead to the lender taking control, it does mean that the lender is in a far better negotiating position to require deleveraging or de-risking action by the sponsor, at a level where there still remains significant value in the debt. In a cov-lite deal, the lender generally has to wait until a payment default before they have a seat at the table, at which point the business could be damaged to the point where the debt is impaired through various market cycles.

Further, we also take comfort in the fact that historically private credit has focused on non-cyclical industries such as business services, technology, and healthcare. This is in comparison to the liquid markets, where a greater proportion of lending has been in consumer goods, leisure and retail, sectors that typically experience more cyclical variation — 57% of outstanding liquid market debt is in cyclical industries (Figure 14). As such, we believe private credit portfolios are well positioned to demonstrate robust performance through various market cycles.

Figure 14: European private credit aligned to defensive sectors



Data source: LCD Research — S&P Global Market Intelligence, S&P European Leveraged Loan Index components as at 8th September 2023 — sector categorisation through Arcmont internal analysis.

SUMMARY

As discussed in this paper, private credit has been a rapidly growing asset class with attractive investment characteristics.

The growth has been largely driven by the increased demand by borrowers for the reliability and flexibility that private credit offers, particularly in periods of market volatility where banks continue to retrench from their lending activities and the liquid fixed income markets are restricted in their ability to offer new financing solutions.

Similarly, investors have continued to increase allocations to private credit, attracted by the strong absolute returns the asset class generates versus the liquid markets, as well as the lower risk profile due to less cyclical underlying businesses, typically better structural and legal protections and the lower volatility of long-term debt structures.

Private credit has proven its resilience through difficult economic environments, is of a size and scale where it represents a meaningful and attractive financing alternative to the liquid markets, and we believe that the asset class will continue to demonstrate strong growth for many years to come.

For more information, please visit nuveen.com.

Endnotes

1 Barclays - August 2023 Private Credit Newsletter. 2 Preqin, September 2023. 3 PitchBook LCD, Given the lack of primary issuance, LCD did not track enough observations to compile a meaningful sample for 2009, 2020, 2022 and YTD 2023. Note this refers to loans issued by banks and held by for term, i.e. not the syndicated loan market. 4 Cliffwater Direct Lending Index, Morningstar Direct, Cambridge Associates, Pitchbook, as at 31st March 2023. 5 Direct Lending: Deloitte Alternative Lender Deal Tracker; Public Markets: Pitchbook. 6 LCD Comps Sept-23, Proskauer Private Credit Insights 2022. 7 LCD Comps Sept-23, Proskauer Private Credit Insights 2022. 8 Preqin, September 2023. 9 Includes High-Yield and Leveraged Loan Issuance. LCD Quarterly European & U.S. Leveraged Lending Review: Q2 2023. 10 S&P Comps Sept-23, Proskauer Private Credit Insights 2022.

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