Private Credit 2021 Outlook: A Steady Ship in Choppy Waters

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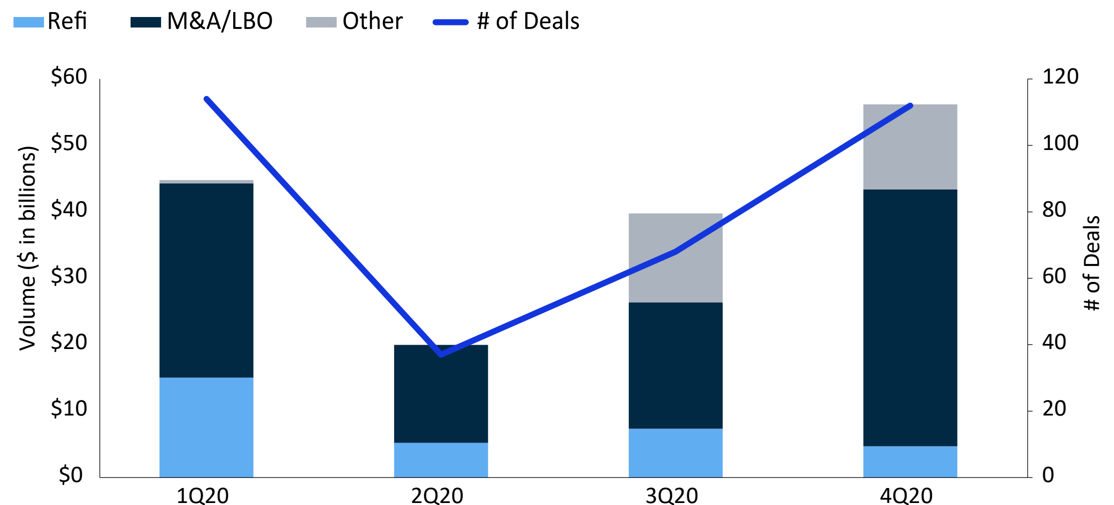
In a climate of increasing uncertainty, institutional investors are trusting private credit to provide high-yield, stable solutions compared to other asset classes. While 2020 was a turbulent and devastating year for many across the globe, it was an interesting case study on the strengths of the private credit market compared to other debt and credit investments, and provided insights into how private credit can continue to play an important role in a private markets portfolio in 2021.

A Port in the Storm

In a year that was marked by extreme volatility – especially evidenced by the dramatic swings experienced by the liquid markets – private credit lived up to its reputation and provided much-needed consistency and a steady cash flow. Following the coronavirus-induced shutdown in the second quarter, conditions in the private credit market were quite favorable in the third and fourth quarters, allowing well-positioned investment managers to take advantage of numerous opportunities.

Private Equity Loan Volume and Deal Count[1]



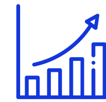
Between April and the end of the summer, the balance of power had unmistakably shifted in favor of private credit lenders, creating an unusually attractive investment environment for much of the year. For lenders with few credit problems and some dry powder, that period likely served as one of the best windows of opportunity seen in almost a decade.

The fourth quarter in particular saw an explosion of deal activity that represented the highest volume seen in a long time. In fact, the number of deals that occurred in the fourth quarter were above pre-pandemic levels, while consensus estimates for GDP growth for full year 2020 were 3.8%.[2] While certainly bolstered by fiscal and monetary stimulus plans, this was still high by historical standards, and particularly interesting when contrasted with market activity earlier in 2020.

Many of the lenders that had been previously sidelined were able to return to the market in Q4, leading to an increasingly competitive private credit environment. But while competition did intensify, the remarkably high volume of deal flow was more than able to maintain favorable conditions.

Despite everything, 2020 clearly bolstered private credit's credentials as a reliable alternative in such an unpredictable environment. So, what makes private credit so uniquely suited to withstand turmoil and volatility?

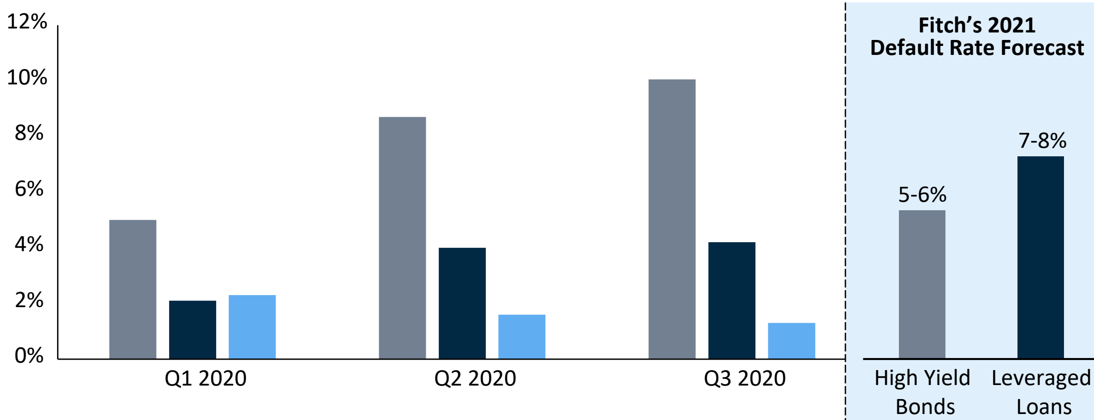
A key facet of private credit's success is its ability to remain relatively stable amidst times of uncertainty. Liquid credit, for example, tends to be significantly more affected by market technicals, especially during periods of severe disruption. These technical forces can, for a time, overwhelm the fundamental changes in the underlying credits, magnifying both high and low pricing swings. Private credit, on the other hand, is more fundamentally driven and generally less affected by market technicals, because it is typically held in lock-up vehicles that are not actively traded. Additionally, private credit deals also tend to employ less leverage and possess more equity, which helps contribute to their overall stability.



As of the end of Q4 2020, the leveraged loan default rate was 4.22%

Default Rates by Fixed Income Asset Type

High Yield Bonds[3] Leveraged Loans[3] Private Credit[4]



The above graphic illustrates another advantage of private credit: low default rates. Leveraged loan default rates in the second and third quarters were as high as the levels seen during the Great Financial Crisis, and at the end of the fourth quarter, the leveraged loan default rate remained high at 4.22%. By contrast, the private credit default levels never rose above 2% throughout 2020.

Fitch Ratings projects that leveraged loans and high yield bonds will experience default rates of mid-to-high single digits in 2021, which is still unusually high by historic standards. Although private credit could experience a slight uptick as well this year, due to the stabilizing factors inherent in private credit, it is likely that the market will still fare much better than leveraged loans and high yield bonds.

Positive Outlook for 2021

As we enter 2021, there are several reasons to be optimistic about the private credit market.

The bolstered vaccine rollout and preliminary plans for further stimulus are certainly positive indicators – we expect to see many businesses successfully adapt to this environment. Additionally, as we approach the second year of the coronavirus pandemic, we have been inspired by some businesses' remarkably successful attempts at adapting to new, changing circumstances. There also exists a high level of dry powder in private equity funds, which will serve as a source for supporting existing portfolio investments, as well as help drive robust deal flow.

At the same time, there are some obvious challenges that we face in this new year. The economic recovery has lagged considerably, with unemployment still high and perhaps more importantly, in a slowing rate of decline.[5] Additionally, Covid-19 and new variants appear to be worsening in several parts of the country, which could lead to further shutdowns and local restrictions. And finally, as we discussed earlier, default rates could rise in 2021.

Despite these very real challenges, we believe the outlook for a robust economic recovery in 2021 is positive. And given the overall situation that the US finds itself in, we think that the private credit space is particularly well-positioned for the current market environment.

The Federal Reserve's unprecedented actions – which include pushing interest rates to near-historic lows, exacerbating the demand for needed yield – have made private credit yields popular and will likely continue to do so in 2021.

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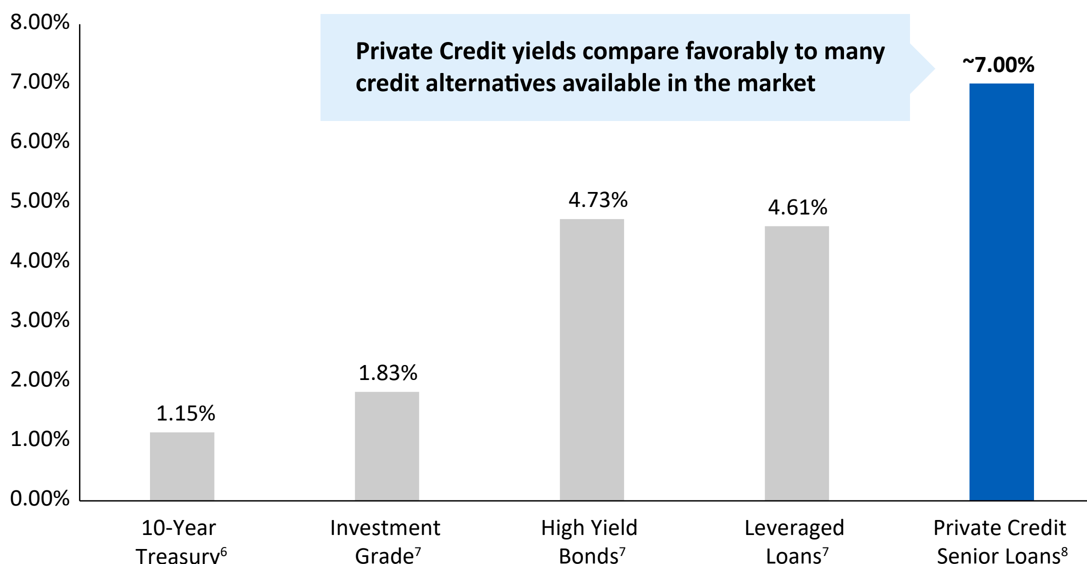
Private Credit Leads the Way in Yields

The below chart depicts how the current level of yields compare among the available alternatives, including 10-year treasuries, high yield bonds, leveraged loans, and private credit senior loans. Private credit senior loans – the most basic type of private credit investment – have a yield of about 7%, or approximately 200 basis points above the other fixed income classes. Thus, we believe private credit offers a compelling option compared to other credit alternatives in the market in 2021.

Yields by Fixed Income Class

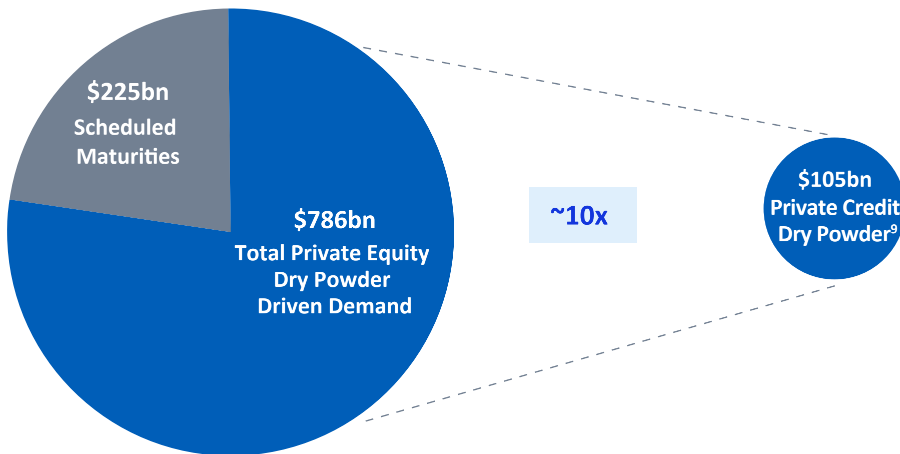


Supply-Demand Imbalance Favors Private Credit Lenders

The confluence of a record amount of private equity dry powder and a strong future pipeline for debt refinancing activity represents a forward debt demand of about a trillion dollars in the next three to five years. Of that amount, there is around $105 billion of private credit dry powder. This creates a 10:1 demand/supply imbalance. While not all of that debt is not guaranteed to be financed in the private market, the middle market represents a substantial amount of that deal activity and so, even if that number is cut in half, there would still be a significant imbalance favoring private credit lenders.

This imbalance has been driving the market and preserving the premium private credit lenders have been able to acquire uninterrupted for almost 25 years.

US Prospective Financing Demand
Over $1 trillion of Debt Financing Demand



In Conclusion

In a year that was marked by extreme volatility, private credit lived up to its reputation as a stable source of reliable cash flow. As investors largely struggled with turbulence in the liquid markets, private credit served as a steady ship in choppy waters, and we believe it will remain a valuable part of an investor's portfolio in 2021. As we look ahead to a sustained period of low federal interest rates and a slow-moving economic recovery, many of the same conditions that helped private credit succeed in 2020 – including a favorable supply/demand imbalance – will likely remain in 2021. ■

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1. Source: LCD Quarterly Commentary and LBO Quarterly, 4Q20
2. "2021 Global Economic Outlook", Morgan Stanley Research dated 12/1/2020
3. High Yield and Leveraged Loan Default Data from Fitch Ratings.
4. Private Credit default index based on data from Proskauer Private Credit Group of observed payment defaults of middle market private credit loans (642 loans included)
5. US Bureau of Labor Statistics, Weekly Update as observed between April 2020 and January 2021
6. Treasury.gov as of 01/14/21
7. From S&P Global relevant indices as of market close 01/14/2021
8. Private Credit Senior Loans calculated on observed senior loans from Lincoln International with average spreads of L+600. Assumes LIBOR floor of 1.0% consistent with observed market trends
9. Preqin, North America focused direct lending and mezzanine funds only, as of January 14, 2021.

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