Private Markets

February 2024

Private debt:

Exploring the nuances

BlackRock

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Key Takeaways

In our recent Private Debt Primer, we outlined the multi-faceted growth tailwinds behind the global private debt market, which collectively underpin our year-end 2028 assets under management (AUM) forecast of $3.5 trillion (vs. $1.7 trillion as of June 2023, per Preqin). That said, the term "private debt" is incredibly broad and encompasses a wide range of investing strategies – often with varying risk/return profiles.

For example, direct lending, which represents 46% of global AUM according to Preqin, is the largest private debt strategy. But other strategies such as distressed, special situations, and mezzanine are also sizable (Exhibit 1). Historically, fundraising patterns have varied across strategies, as investors respond to the broader macro environment (and opportunity set) at any given point in time.

In 2024, we expect some modest relief in monetary policy rates (in the U.S. and Euro Area), but nonetheless expect the high cost of capital environment will persist over (at least) the medium term. Against that backdrop, we believe dispersion across the broader private debt market will continue to play an important role. As we outline within, we see three main elements of dispersion:

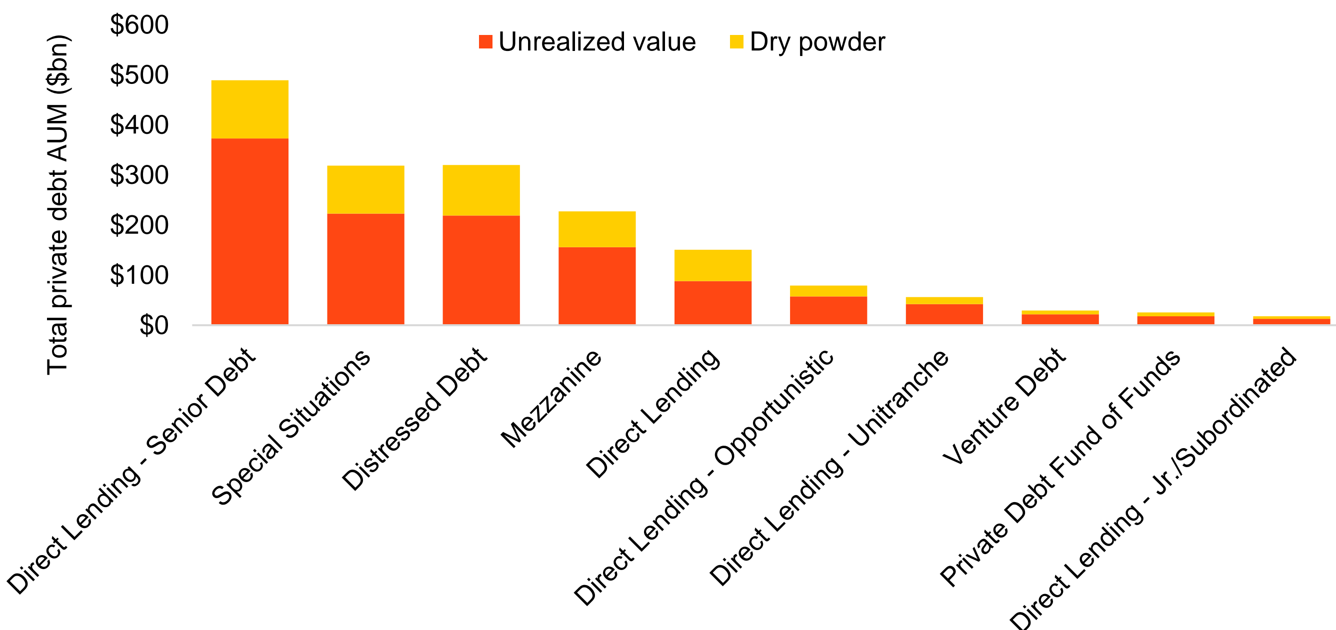
(1) Strategy: capital structure seniority, investment goals and situational complexity

(2) Portfolio: areas of lending focus, including sector selection and company size

(3) Vintage: broader macroeconomic environment, risk asset valuations, and overall opportunity set

We also expect ongoing evolution in terms and conditions. The global private debt market is now a sizable and scalable asset class, on a stand-alone basis. This has led to an expansion of the addressable market of potential borrowers and an increase in direct competition with the public financing markets.

Exhibit 1: The term "private debt" encompasses a wide range of investing strategies
Total private debt AUM, by strategy



Source: BlackRock, Preqin. 2023 is as of June 2023 (most recent available). Excludes Real Estate and Infrastructure lending.

"Private debt" encompasses a range of regions and strategies

The global private debt market stood at $1.7 trillion in AUM as of June 2023, according to data from Preqin. Roughly two-thirds of this amount has a primary region of focus of North America. But as Exhibit 2 illustrates, regions outside of North America have been experiencing significant growth (a trend we also highlighted in our 1Q2024 Global Credit Outlook).

The four largest private debt strategies – direct lending, distressed, mezzanine, and special situations – accounted for 97% of total AUM. Below is an overview of each. That said, the lines between strategies can often blur, especially for more complex financing situations.

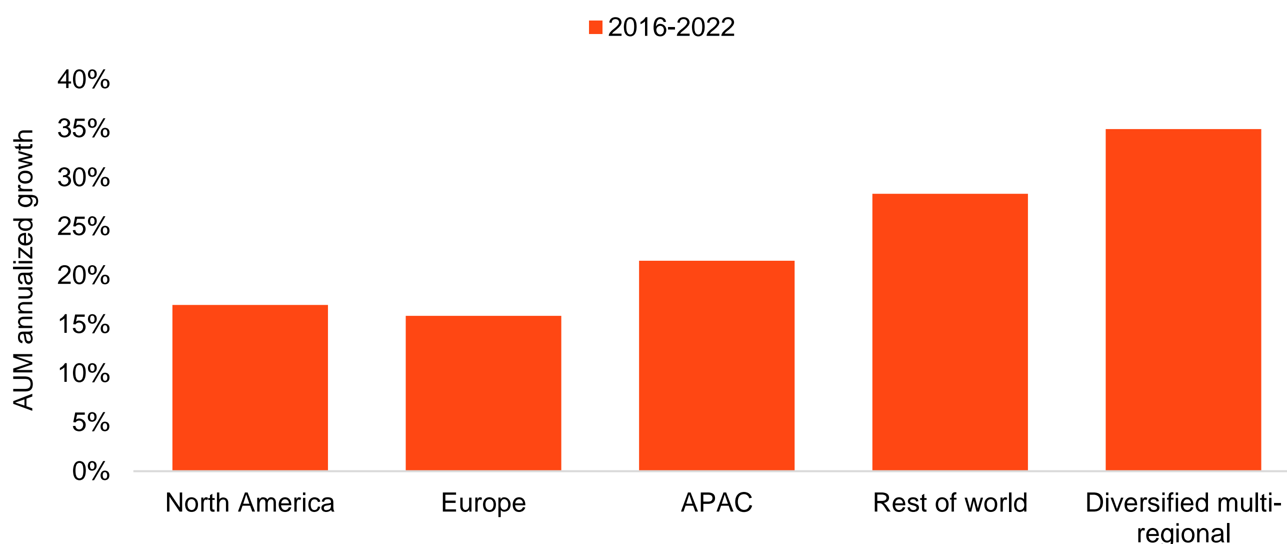
(1) **Direct lending:** Non-bank lending, directly to small and medium enterprises. Debt can be senior (i.e., repaid first in a restructuring) or subordinated (i.e., repaid after senior holders), depending on the fund's strategy. The size of the borrowers can vary significantly, from lower middle market (loosely defined as annual EBITDA of less than $25 million) to upper middle market (loosely defined as annual EBITDA of $75 to $150 million). Preqin, for example, includes four sub-strategies in direct lending: senior debt, blended/opportunistic debt, unitranche debt, and junior/subordinated debt.

(2) **Distressed:** Purchasing debt of companies (usually at a significant discount, in the secondary market) that are in bankruptcy, or likely to enter bankruptcy. Debt tends to be senior, given the high likelihood of liquidation. These strategies will also typically identify a "fulcrum" security, which is the most subordinated part of the capital structure likely to be paid back in a restructuring.

(3) **Mezzanine:** Subordinated debt, but still senior to equity positions. Can be a mix of debt and equity financing. Debt has conversion rights to equity (embedded equity option).

(4) **Special situations:** Category can span other lending types such as distressed and mezzanine. Funding in response to a specific event, such as a merger or spin-off, often with the intent of gaining control of a company in financial distress.

Exhibit 2: Regions outside the U.S. have seen significant growth in private debt AUM
Annualized growth rates of private debt AUM, by region (2016 to 2022)



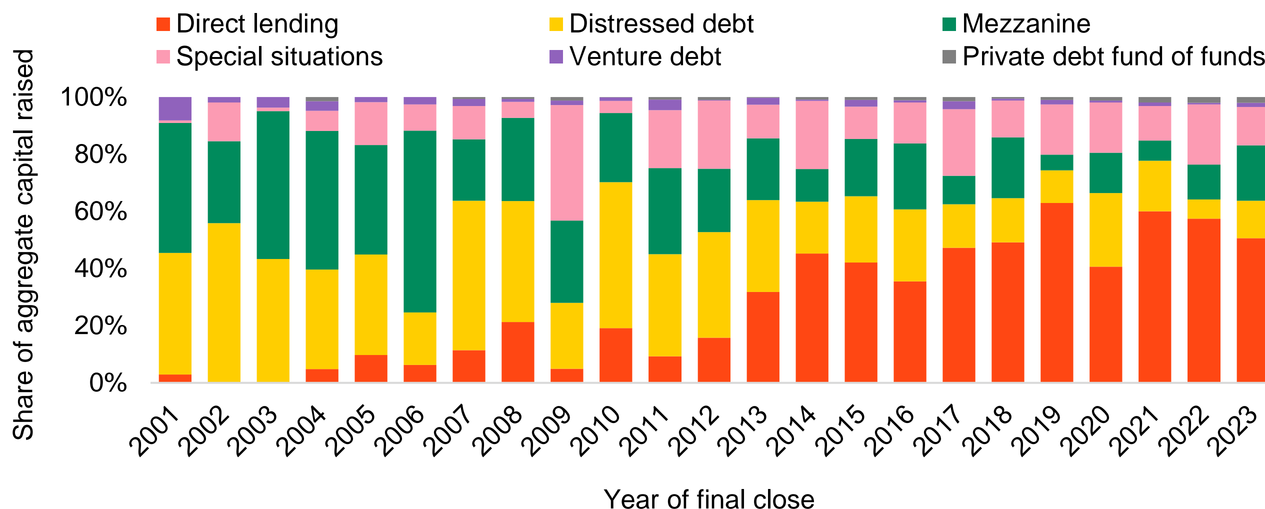
Source: BlackRock, Preqin. Captures growth rates from calendar year-end 2016 to calendar year-end 2022.

Fundraising patterns often respond to the macroeconomic backdrop

The "mix shift" of private debt fundraising can vary from year to year (Exhibit 3), due in part to the macroeconomic backdrop. For example, in the years prior to and immediately following the global financial crisis (2007 – 2010) and the onset of the pandemic (2020), distressed and mezzanine (and, to a lesser extent, special situations) represented a larger share of overall fundraising.

In 2023, according to Preqin data, mezzanine debt accounted for 21% of total private debt capital raised, compared to 12% in 2022 and 7% in 2021 (again, Exhibit 3). Mezzanine strategies can often be favored when investors have a positive outlook on the performance of risk assets, such as debt and equity. Some of the increase in 2023 also reflected the timing of fund closes (i.e., funds launched in 2022 which closed in early 2023).

Exhibit 3: The share of mezzanine fundraising increased notably in 2023
Share of aggregate capital raised by private debt fund type

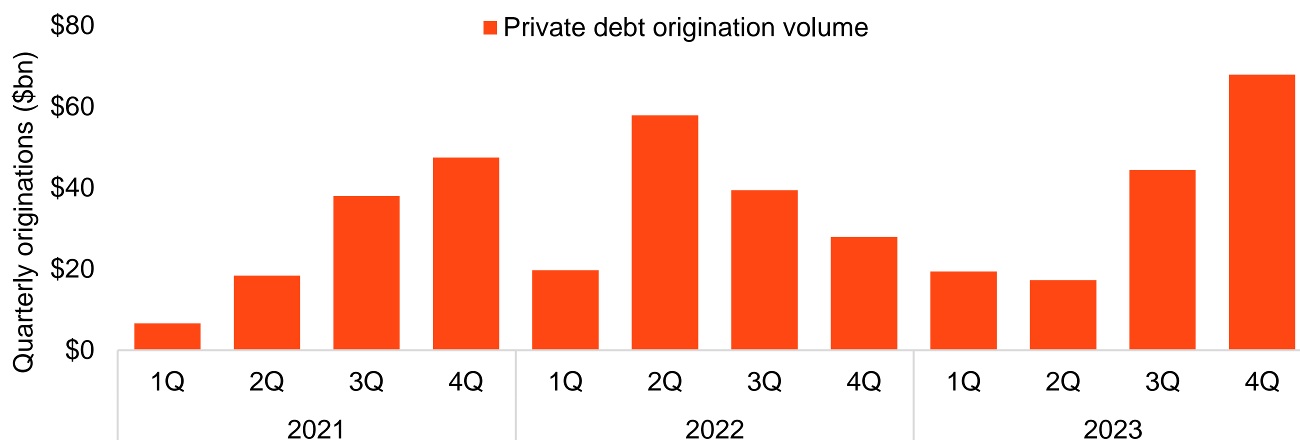


Source: BlackRock, Preqin. As of December 31, 2023.

2023 private debt originations outpaced 2022 and 2021

In addition to fundraising, another way to track activity in the private debt market is through originations, which are defined by research provider KBRA DLD as new money, senior debt transactions. Private debt origination volume hit $149 billion in 2023, surpassing both 2022 and 2021 volumes, according to KBRA DLD, which tracks senior U.S. direct lending activity. 2H2023 was busier than 1H2023, representing 76% of total annual volume according to KBRA DLD. Indeed, 4Q2023 marked the highest quarterly issuance since KBRA DLD began tracking the data in 2021 (Exhibit 4). Notably, the rebound in private lending activity in 2H2023 corresponded with the (presumed) end of the Federal Reserve's rate hiking cycle (the last hike was in July 2023) and increased optimism among market participants regarding the potential for a "soft landing."

Exhibit 4: 4Q2023 generated a rebound in private debt origination volumes
Quarterly private debt deal origination volume



Source: BlackRock, KBRA DLD Private Data as of December 31, 2023.

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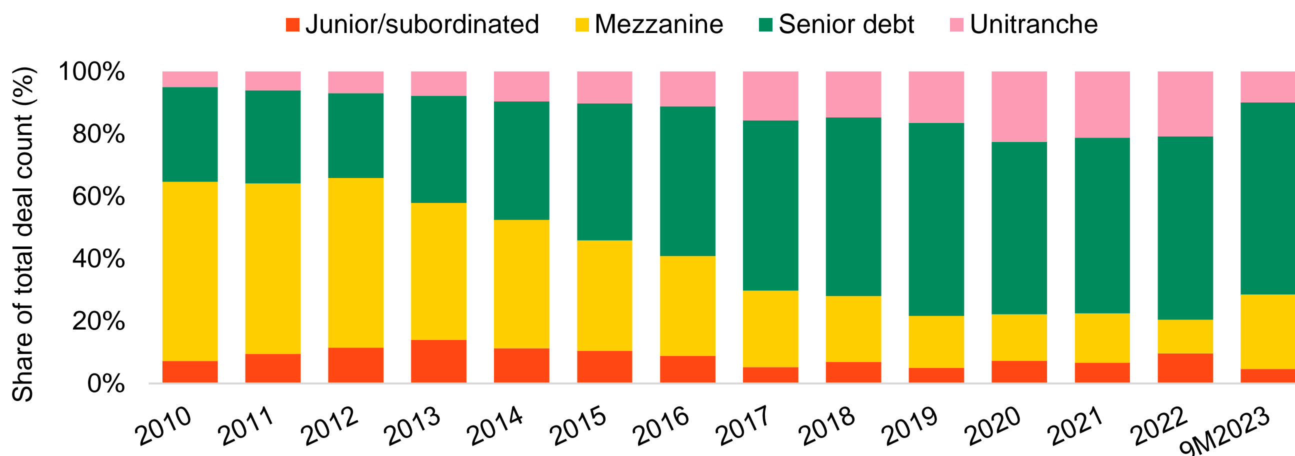
Demand for mezzanine has grown recently

The macro environment can influence what debt instruments are most interesting to borrowers. For example, higher interest rates made mezzanine a popular solution in 2023 because it can often provide additional financial optionality for companies. In the first nine months of 2023, mezzanine deals accounted for 24% of total private debt deals (by deal count), the largest share since 2017, according to data by Preqin (Exhibit 5).

Exhibit 5: The first nine months of 2023 highlighted an increase in mezzanine deals
Share of private debt deals, by strategy

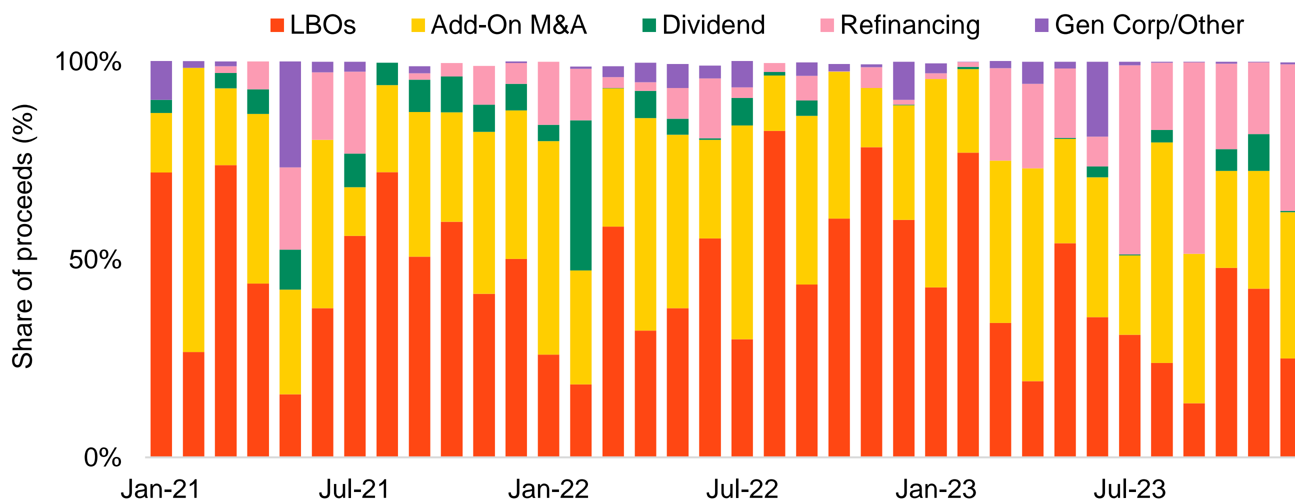


Source: BlackRock, Preqin. As of September 30, 2023 (most recent).

Refinancing activity increased sharply in 2023

Similar to the structure of debt instruments, the use of proceeds for transactions (i.e., leveraged buy out (LBO), refinancing, etc.) can also exhibit variation from year to year – again, likely influenced in part by the macroeconomic backdrop and opportunity set. LBOs represented 36% of total proceeds in 2023, down from 50% in 2022 and 51% in 2021, according to KBRA DLD (Exhibit 6). By contrast, refinancing activity increased to account for 26% of volume in 2023 (vs. 7% in 2022 and 8% in 2021), according to KBRA DLD. Add-on M&A volume held steady year-over-year, at around 33% in 2023.

Exhibit 6: Refinancing activity increased in 2023
Share of monthly proceeds by activity type



Source: BlackRock, KBRA DLD Private Data as of December 31, 2023. Data submissions reconcile quarterly.

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Drivers behind persistent dispersion in 2024

In 2024, we expect some modest relief in monetary policy rates (in the U.S. and Euro Area), but nonetheless expect the high cost of capital environment will persist over (at least) the medium term. Against that backdrop, we believe dispersion across the broader private debt market will continue to play an important role. We see three main elements of dispersion:

1) Strategy: capital structure seniority, investment goals and situational complexity
2) Portfolio: areas of lending focus, including sector selection and company size
3) Vintage: broader macroeconomic environment, risk asset valuations, and overall opportunity set

Strategy dispersion: A range of risk / return profiles

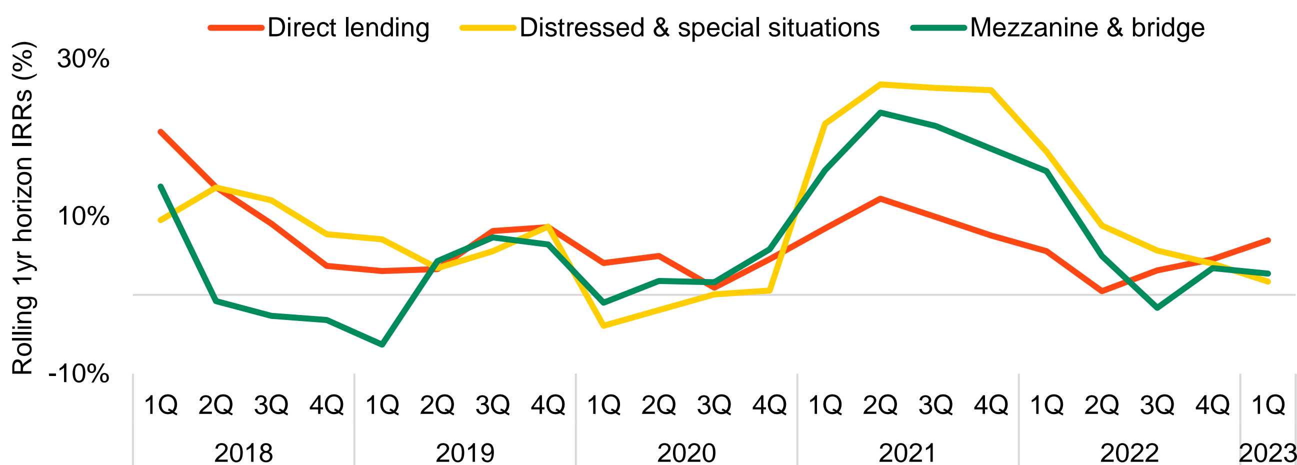
The global private debt market includes a wide range of strategies which vary in terms of structure, seniority, and investing approach. These range from senior secured direct lending for relatively mature companies to early-stage venture lending.

Direct lending – the largest strategy by AUM – has historically maintained a different risk/reward profile than other private debt strategies. The strategy generally delivers steadier returns throughout economic cycles because it does not seek to capitalize on disruptions in the economic cycle, or underperformance of a business. Direct lending strategies can also involve structural seniority in terms of the lender position, although this is not always the case. This is evident in the widely tracked Cliffwater Direct Lending Index (CDLI), which is an asset-weighted index of approximately 14,000 directly originated U.S. middle market loans totaling $295 billion as of September 30, 2023. 80% of the underlying assets of the individual business development companies (BDCs) included CDLI (as of September 2023) were senior. The balance was largely split across subordinated debt and equity.

Other strategies such as distressed, special situations, and mezzanine generally seek to finance more complex situations. The situations and return outcomes vary depending on the strategy and the macro environment. For example, a distressed lender may engage when a company is nearing bankruptcy, whereas a mezzanine lender may engage when a company has near-term growth goals and would like to finance it with pay-in-kind (PIK) instruments.

Since 2018, rolling one-year internal rates of return (IRRs) for direct lending have been less volatile than distressed/special situations and mezzanine (Exhibit 7), using data complied by Pitchbook LCD.

Exhibit 7: Direct lending has delivered the most stable returns vs other strategies since 2018
Private debt funds rolling one-year horizon IRRs by type, for funds included in Pitchbook's global fund performance report



Source: BlackRock, Pitchbook LCD. As of March 31, 2023 (most recent). Horizon IRR is a capital-weighted pooled calculation that shows the IRR from a certain point in time. For example, the one-year horizon IRR figures for 1Q2018 show the IRR performance for the one-year period beginning in 1Q2017 through the end of 1Q2018. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

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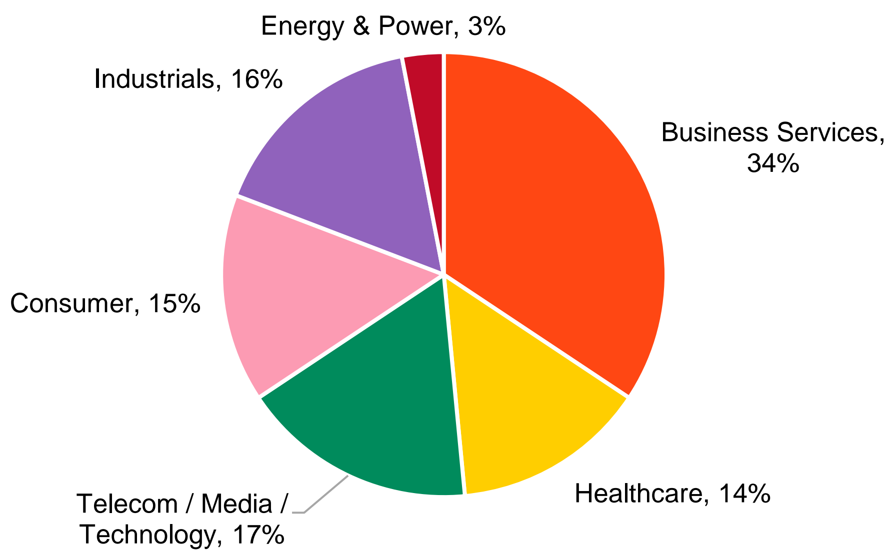
Portfolio dispersion: Sector selection, company sizing

Focus areas for lending – in terms of regional focus, sector selection and company size, as a few examples – can also vary significantly across the private debt market. Exhibits 8 and 9 zoom in on the sector weights for two private debt universes: the previously referenced CDLI, and the Lincoln International Proprietary Private Markets Database.

For context, Lincoln International is an independent valuation advisor specializing in illiquid alternative investments. Lincoln's Valuations and Opinions Group Proprietary Private Markets Database included approximately 5,000 U.S. operating companies as of 4Q2023, representing over $175 billion of privately held principal and invested capital (primarily by private equity sponsors).

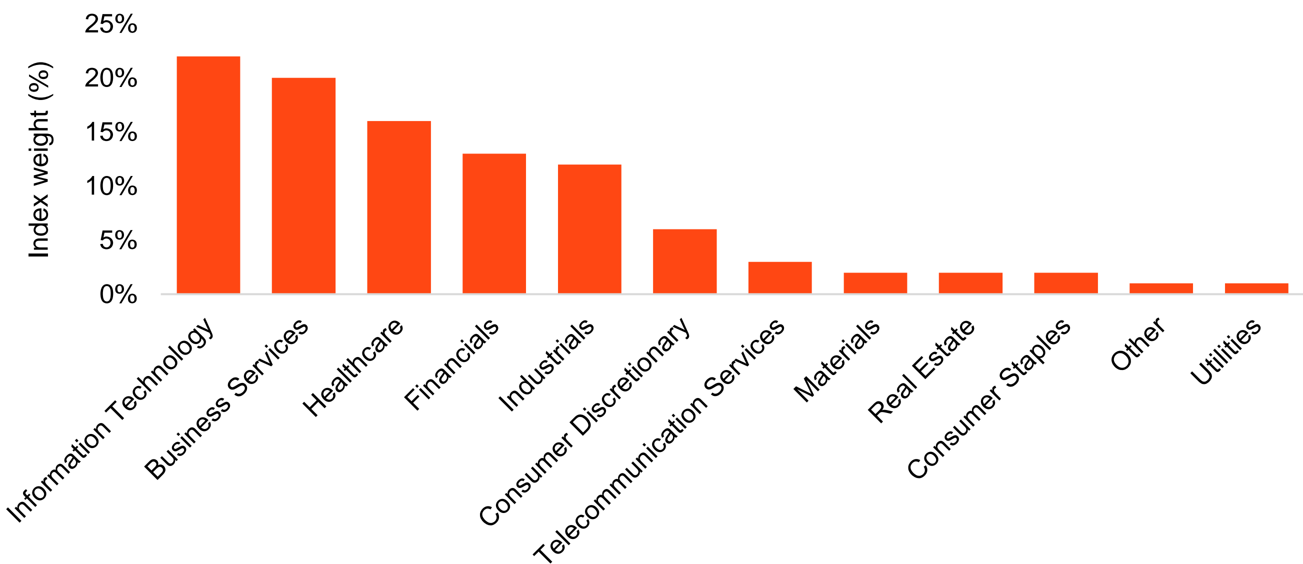
As shown below, for both indices, sectors such as Business Services, Technology / Telecommunications, Healthcare and Industrials are sizable weights. Similarly, commodities-related sectors represent a small share of each.

Exhibit 8: Business Services represent one-third of the Lincoln International Database
Portfolio companies in the Lincoln International Proprietary Private Markets Database, by industry



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of December 31, 2023.

Exhibit 9: Technology, Business Services and Healthcare are the CDLI's largest sectors
Industry weights (based on fair value) of the Cliffwater Direct Lending Index



Source: BlackRock, Cliffwater. As of September 30, 2023. Indices are unmanaged and one cannot invest directly in an index.

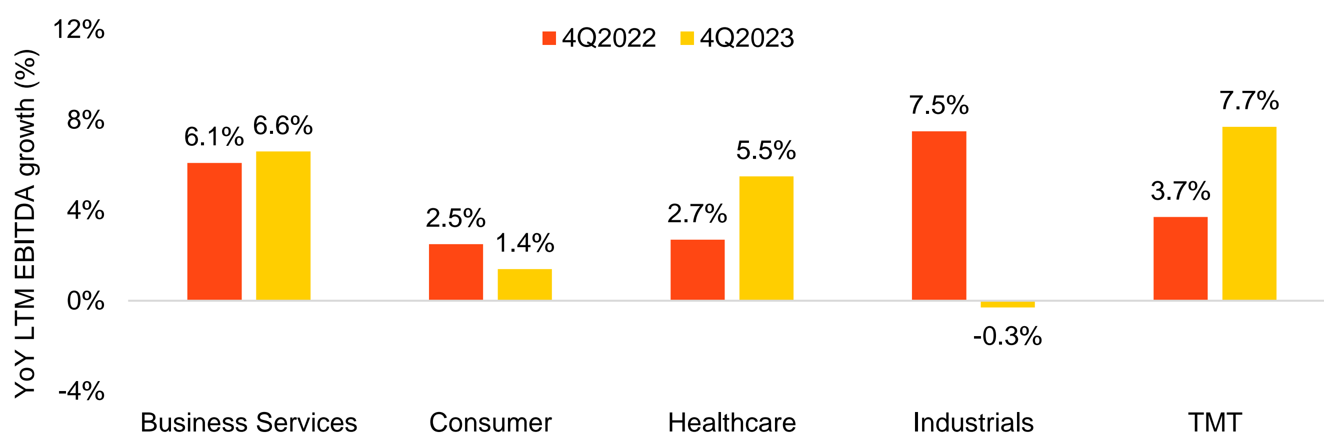
Sector variation is evident EBITDA performance, covenant defaults

For all companies in the Lincoln International Database, last twelve-month (LTM) EBITDA increased 4.8% (on average) in 4Q2023. This compares to a 4.7% increase in LTM EBITDA in 4Q2022. Under the surface, however, there was significant dispersion – driven, in our view, by varying degrees of cyclicality, pricing power, operational agility and financial flexibility across these sectors.

As shown in Exhibit 10, three of the five borrower industries experienced higher year-over-year (YoY) LTM EBITDA growth in 4Q2023 than in 4Q2022. Two borrower industries, consumer and industrial, experienced a decline in YoY LTM EBITDA growth, versus 4Q2022.

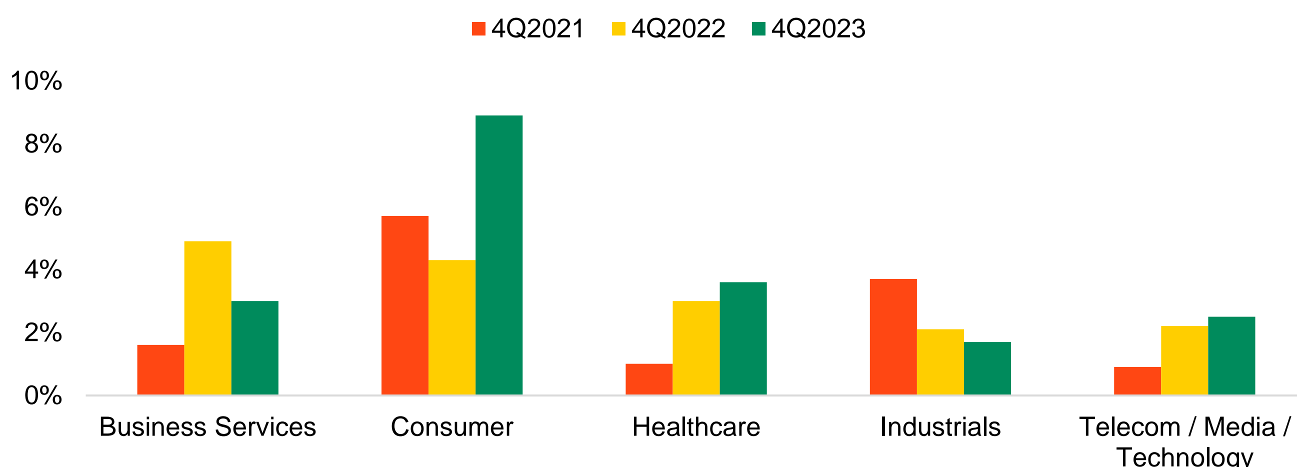
The dispersion at the sector level is also evident when focusing on covenant default activity, as shown in Exhibit 11. That said, covenant defaults for the broader company universe in the Lincoln International Database have *declined* for three consecutive quarters (Exhibit 12). Another important caveat is that defaulting on a covenant in private debt does not necessarily mean lenders will incur losses. Rather, it often provides lenders the time and legal position to address issues in advance of a payment default.

Exhibit 10: YoY LTM EBITDA growth declined for consumer and industrial sectors in 4Q2023
YoY LTM EBITDA growth by industry, for companies in the Lincoln International Proprietary Private Markets Database



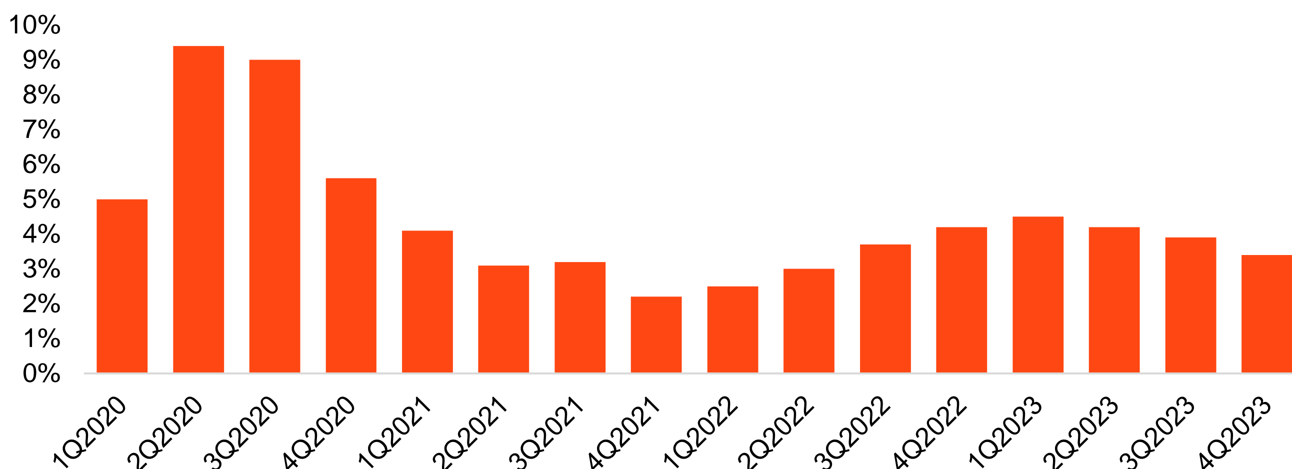
Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of December 31, 2023.

Exhibit 11: 4Q2023 included an increase in defaults in the consumer sector
Covenant default rates by industry (size-weighted), for companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of December 31, 2023. Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Exhibit 12: The private debt covenant default rate has declined for the last three quarters
Covenant default rate (size-weighted) for the companies in the Lincoln International Proprietary Private Markets Database



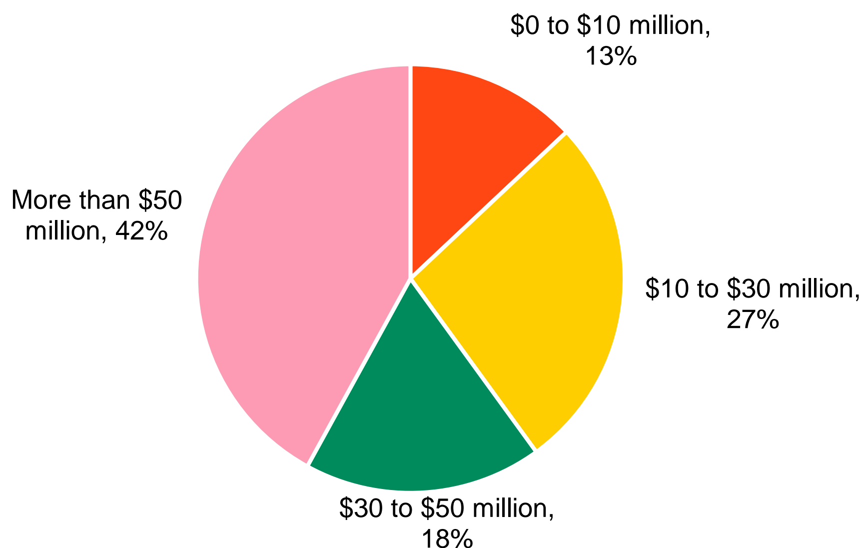
Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of 4Q2023. Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Company sizing can also drive dispersion

The private debt lending landscape also includes a range of companies of various sizes. Exhibit 13 again captures the Lincoln International Proprietary Private Markets Database, this time split by company size (defined as annual EBITDA).

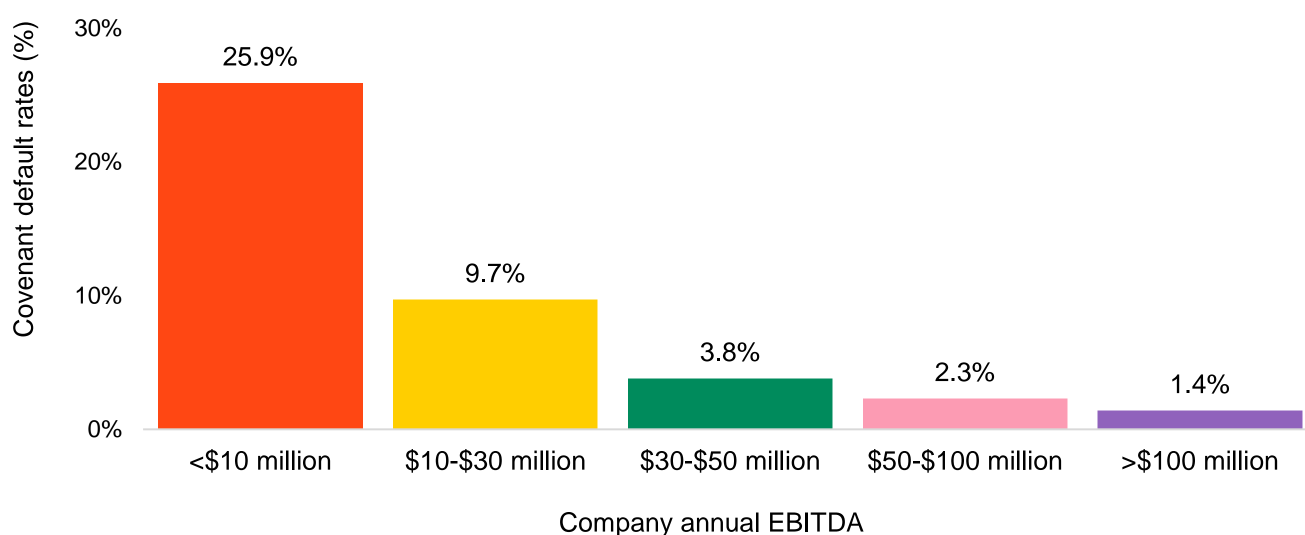
Further, data tracked by Lincoln International suggests an inverse relationship between borrower size and default rate (Exhibit 14). This is especially true for smaller borrowers (less than $10 million and $10-$30 million in annual EBITDA), which have experienced meaningfully higher default rates than larger peer groups. We believe this underscores the importance of manager workout experience, especially for lenders focused on lower middle market borrowers.

Exhibit 13: Company sizing also varies across the private debt market
Share of portfolio companies in the Lincoln International Proprietary Private Markets Database by LTM EBITDA



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database. As of 4Q2023.

Exhibit 14: One in four companies with less than $10 million in EBITDA defaulted in 4Q2023
Covenant default rates (size-weighted by annual EBITDA) for companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Valuations & Opinions Group Proprietary Private Markets Database, as of December 31, 2023. Note: A default is defined as a covenant default and not a monetary default. The analysis was performed based on a size-weighted approach, which considered the total net debt balance for each of the portfolio companies that had a defaulting security in the respective quarter.

Vintage Dispersion: Macroeconomic backdrop, interest rates

Beyond diversification in fund strategies and portfolio construction, we expect the macroeconomic backdrop to contribute to variation in fund performance across vintages – a theme we outlined in our 1Q2024 Global Credit Outlook.

Based on data provided by Pitchbook LCD, vintages investing during major economic disruptions have higher performance dispersion. These include vintages such as 2008 and 2009, which invested through the global financial crisis, and 2018, which invested during the COVID-19 pandemic (Exhibit 15). This emphasizes the importance of manager selection as a compliment to vintage selection.

Two other important indicators which may gauge the financial strength of a vintage are 1) health of interest coverage metrics and 2) number of amendments. Exhibit 16 illustrates the dispersion in the fixed charge coverage (FCC) ratio across vintages, again using the companies in Lincoln International's Proprietary Private Markets Database.

For example, the average FCC ratio for deals done in 4Q2021 – prior to the start of the Federal Reserve's rate hiking cycle (which began in March 2022) – is 1.10x. And 35.2% of these deals have a FCC ratio below 1.0x. By contrast, the average FCC ratio for deals done in 4Q2023 is 1.20x. And 16.8% of these deals have a FCC ratio below 1.0x.

Vintage dispersion can also be seen in loan amendment activity, which typically involves a borrower seeking additional financial flexibility from its lender. In 2023, approximately 18% of the companies tracked by Lincoln International had executed at least one amendment. Of those companies that completed amendments in 2023, two themes stand out to us:

- The majority of amendments were for deals originated in the low interest rate environment of 2021 (again, prior to the start of rate hikes).
- 12% of companies completed multiple amendments over 2023, and 33% of these firms were in the Business Services sector.

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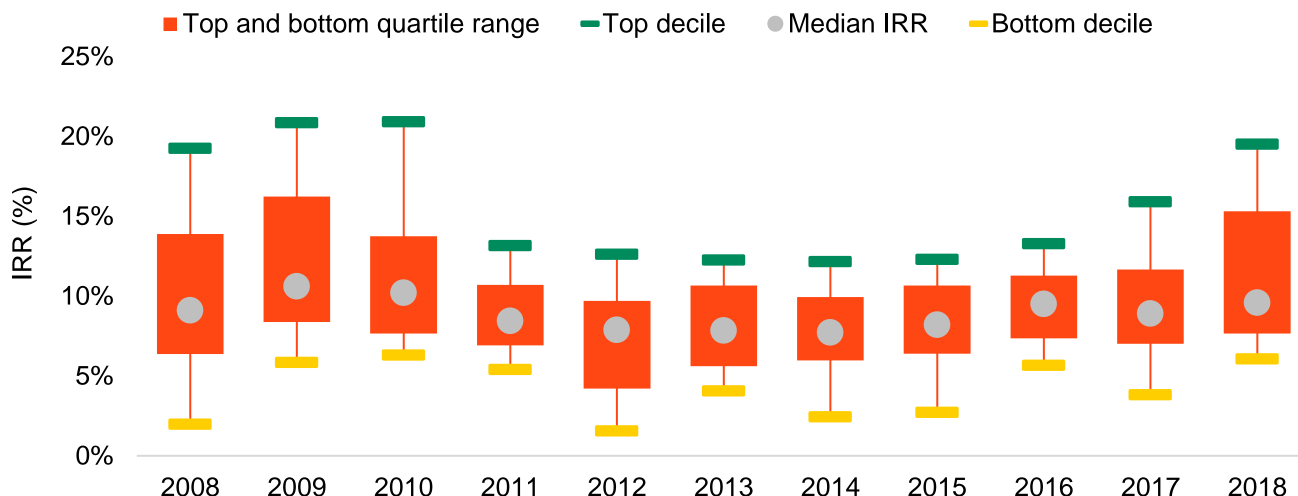
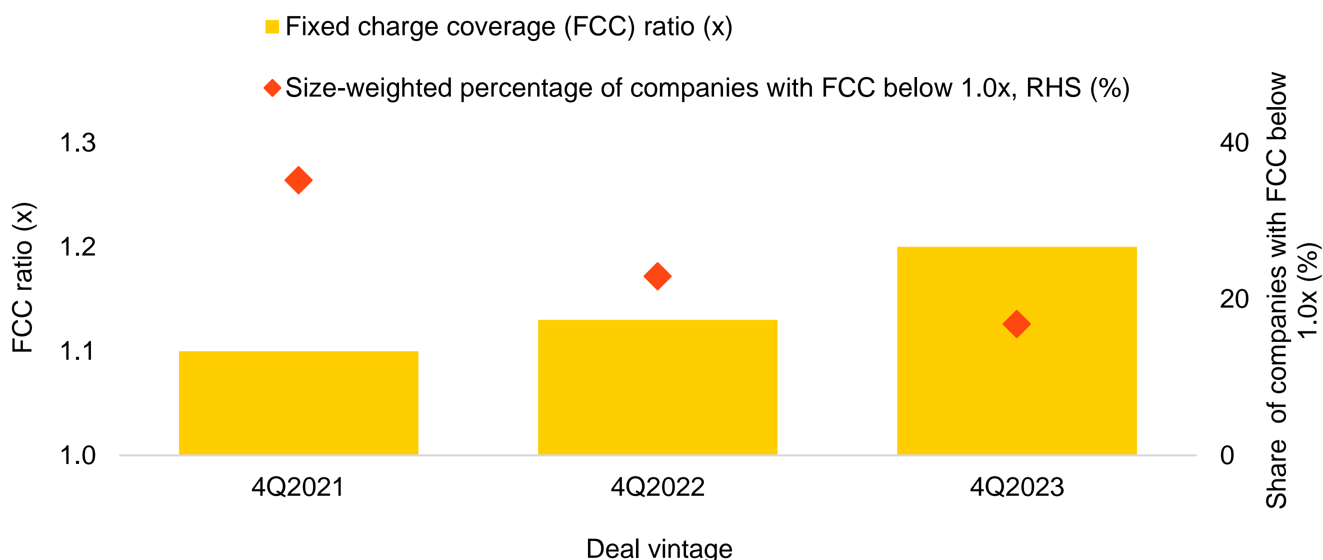
While we believe we have reached peak monetary policy rates for this cycle, we expect headwinds related to debt service costs to remain a key issue in 2024 and 2025, especially for older vintages underwritten in a more benign rate regime (which ultimately proved to be short-lived). In our view, this underscores the importance of credit and sector selection (i.e., avoiding borrowers that cannot grow in a capital efficient way, outside of ultra-low interest rate regimes, as well as avoiding sectors which may not have strong margins and pricing power).

Exhibit 15: Vintage dispersion is higher in times of economic disruption
Private debt funds' IRR dispersion by vintage, for 2008 – 2018 vintages, for funds included in Pitchbook's global fund performance report



Source: BlackRock, Pitchbook LCD. As of March 31, 2023 (most recent). Vintage year is based on the managing firm's classification. If not available, classification is based on the year of first investment, or the year of final close. IRR represents the rate at which cashflows are discounted so the net present value of cashflows equals zero. For fund-level IRRs, any remaining value in the fund is treated as a distribution in the most recent reporting period. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

Exhibit 16: Fundamental dispersion across interest rate regimes
Fixed charge coverage ratios, by deal vintage, for the operating companies in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln Valuations & Opinions Group Proprietary Private Markets Database. As of December 31, 2023. Calculations: Fixed Charge Coverage Ratio = (LTM EBITDA - Taxes – Capex) / (LTM Interest Expense + (1% * Total Debt)).

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Structural shifts are underway as private debt matures

Beyond the well documented growth in the size of the private debt asset class, there have also been shifts in the market structure and composition. One of the most notable developments has been the increased "overlap" with the syndicated markets, which has resulted in more direct competition with public financing markets. This has caused deal terms for large private loans to evolve (in terms of pricing and flexibility).

Beyond the overlap in the funding markets (which has given borrowers more optionality), other recent dynamics include the announcement of new partnerships between banks and non-banks, and the growth of unlisted BDCs.

An expanding (and overlapping) addressable market

One key development in recent years has been private debt's expanding universe of borrowers. A decade ago, private debt was generally reserved for financing niche pockets of the market. Now, the asset class is regularly competing with the syndicated markets – including lending to firms that have demonstrated access to public debt financing.

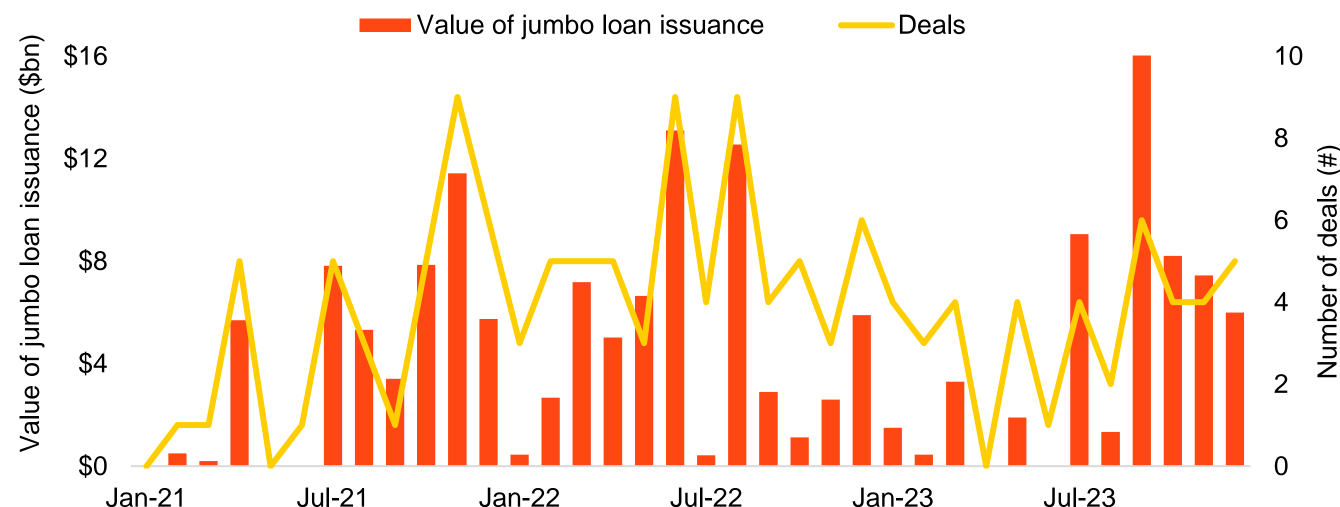
The process of borrowing is substantially different in private markets than in public markets. Direct negotiations and underwritings generally eliminate the need for lengthy investor roadshows and rating agency reviews, which are more common in the syndicated market. Private lenders can also typically offer more customized funding solutions and more certainty of execution because deals are not reliant on syndication to many investors. Finally, the ability to keep proprietary information out of the public domain may be appealing to some borrowers. Private debt, in exchange for these advantages, is usually priced at a higher yield relative to public markets (although this can vary).

The growing size and scale of private debt funds has been a key driver in allowing private lenders to compete with public debt markets. According to Preqin, the average fund size for experienced managers (defined as those who have four or more funds) closing funds between 1Q and 3Q2023 stood at $1.4 billion, roughly double the size of funds closed by experienced managers in 2019.

Importantly, an increase in fund size allows lenders to scale commitments without compromising on diversification in funds. According to KBRA DLD, private debt has financed approximately 140 "jumbo financings" (loans exceeding $1 billion) from 2021 to 2023, totaling $164 billion in issuance (Exhibit 17). During the same period, $66 billion of syndicated loans were refinanced into private debt. 84% of these loans (by volume) were over $1 billion, according to data compiled by KBRA DLD.

Exhibit 17: Jumbo private loan issuance has increased in recent years

Loans exceeding $1 billion issued by private debt lenders



Source: BlackRock, KBRA DLD. As of December 31, 2023. KBRA DLD defines a deal as new money, senior debt transactions.

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In 2023, both U.S. and European markets set records for the largest private debt loans issued to date, per data compiled by Pitchbook LCD. In the U.S., a group of lenders underwrote a $4.8 billion unitranche loan to Finastra to refinance outstanding syndicated loans. This refinancing is also the largest takeout of a syndicated loan by private debt on record, according to Pitchbook LCD. In Europe, a group of lenders underwrote a record €4.5 billion loan to Adevinta to finance a take-private.

Some large borrowers are using the momentum in public markets to refinance existing private loans into public ones, in search of lower interest expense and fewer covenants. We believe competition between scaled private managers and public lenders will persist through 2024.

"Dual track" processes are becoming more common

Now that private debt has established its potential to finance larger transactions, companies are increasingly assessing their financing options in both private and public debt markets by running so called "dual track" processes.

The competition between private debt and the broadly syndicated loan market has encouraged more competitive terms for larger (i.e., upper middle market - again, loosely defined as annual EBITDA of $75 to $150 million) loans that are eligible for both markets. In practice, this often means a deal would be large enough to be relatively liquid and index-eligible in the syndicated/public debt markets.

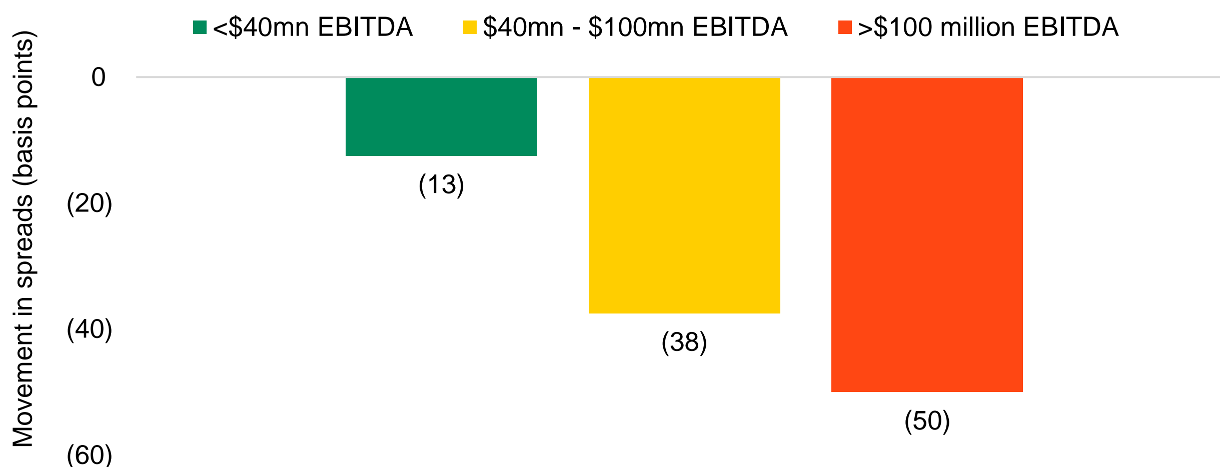
Notably, deal terms for the lower and core middle market – where loan sizes may not reach the point of index-eligibility and thus could be rendered quite illiquid – have remained more stable.

Loan pricing for upper middle market businesses is tightening

According to Lincoln International, private debt spreads for first lien (1L)/unitranche loans to businesses with more than $100 million of annual EBITDA have tightened by 50bp between 2Q2023 and 3Q2023 (Exhibit 18).

The narrowing of spreads among large private loans has led to compression of the private market premium relative to historic levels. As of September 30, 2023, the Lincoln Senior Debt Index yielded 11.8%, while the Morningstar LSTA U.S. Leveraged Loan 100 Index, an index of the 100 largest loan facilities in the U.S. syndicated leveraged loan market, yielded 9.6%, the narrowest differential since 3Q2020. We believe this is reflective, in part, of the more competitive nature of financing large loans. A similar trend of compression vs. public market yields can be seen when using the yield on the CDLI.

Exhibit 18: Upper middle market businesses saw the largest spread tightening in 3Q2023
3Q2023 movement in first lien and unitranche spreads by annual EBITDA size, vs. 2Q2023



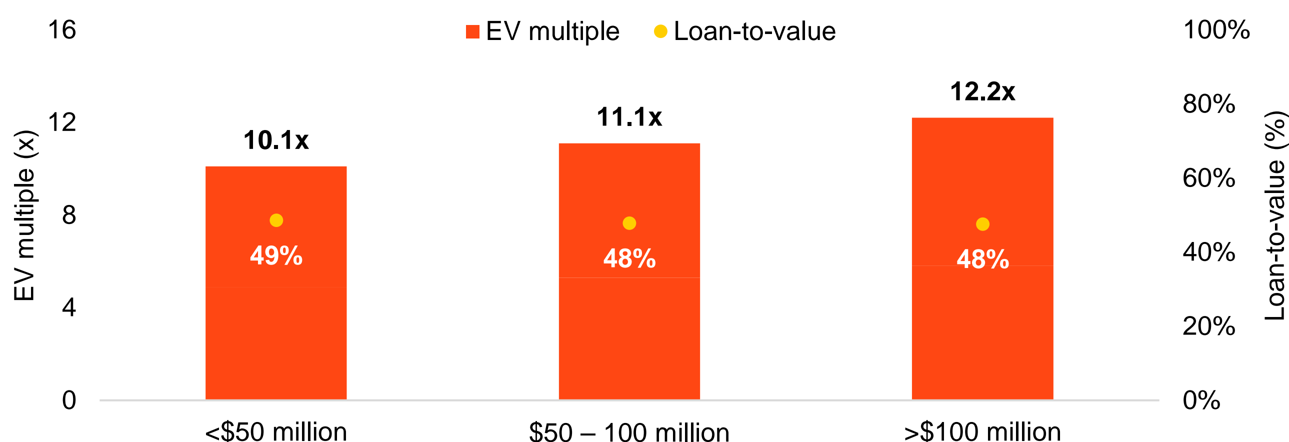
Source: BlackRock, Lincoln International. Spread movement during third quarter. As of September 30, 2023 (most recent).

Loan-to-value is consistent across all size categories

Businesses with more than $100 million of annual EBITDA have seen a 0.4x increase in average enterprise value (EV) multiple (i.e., enterprise value/LTM EBITDA): from 11.8x in 4Q2022, to 12.2x in 4Q2023, according to Lincoln International. Comparatively, EV multiples have declined by 0.2x and increased by 0.1x for businesses with less than $50 million of annual EBITDA and $50-$100 million of annual EBITDA, respectively, over the same period.

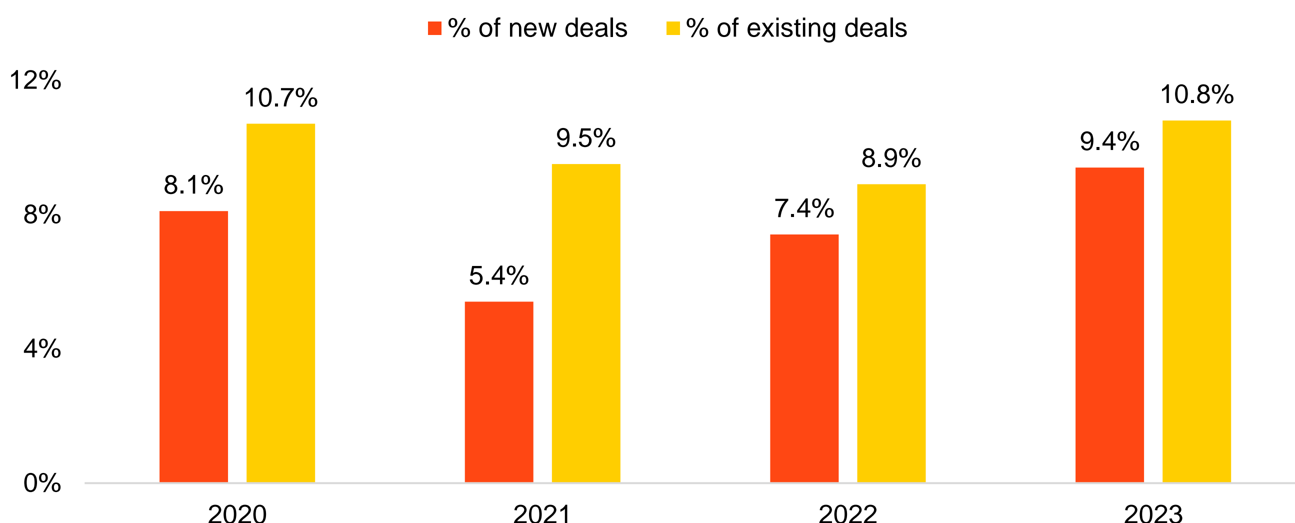
Despite the higher valuations that larger businesses generally attract, loan-to-value ratios across all three size categories are comparable as of 4Q2023 (Exhibit 19), according to Lincoln International. In our view, this demonstrates that regardless of borrower size, debt investors require equity holders to have a meaningful stake in the company (i.e., equity cushion) to protect their debt contribution and ensure incentives are aligned across the capital structure.

Exhibit 19: Loan-to-value is comparable across all size categories
Enterprise value/LTM EBITDA and loan-to-value (RHS) by annual EBITDA size, for the companies included in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Proprietary Private Markets Database. As of December 31, 2023. Loan-to-values are calculated on an enterprise-wide basis (i.e., leverage multiple divided by enterprise value multiple).

Exhibit 20: New and existing deals with PIK pricing pass 2020 peaks
Percentage of new and existing deals with PIK toggles in credit agreement, for the companies included in the Lincoln International Proprietary Private Markets Database



Source: BlackRock, Lincoln International Proprietary Private Markets Database. As of December 31, 2023.

Private lenders are offering borrower-friendly loan features

Private lenders are finding more borrower-friendly loan features to attract large, quality borrowers to private debt. The syndicated nature of public debt markets – where a wide range of investors are involved in a given transaction – can, at times, make offering these sweeteners more challenging.

- **Payment-in-Kind (PIK):** Private lenders are at times offering 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. The PIK feature can be applicable to some, or all, of the outstanding debt, including senior debt. As of November 2, 2023, Bloomberg estimates there were at least $73 billion of outstanding private loans that included PIK options. According to data by Lincoln International, 9.4% of new deals and 10.8% of existing deals in 2023 incorporated PIK toggles into the credit agreement, outpacing prior peaks in 2020. This trend will likely persist while the cost of capital remains elevated, and while markets remain somewhat issuer-friendly (Exhibit 20).
- **Portability:** Private lenders have reintroduced portability, or the option to keep an existing loan in place when company ownership changes, as a loan feature to borrowers. A portability feature can make an asset more attractive to potential buyers by eliminating the need to find new financing for the debt of the business. Portability can also benefit the lender by extending the life of a loan while maintaining previously negotiated terms. To protect lenders, a portability feature is generally conditional and reserved for large, well-performing borrowers.

We expect more industry-wide partnerships involving private lenders

Another shift in the structure of the private debt market is related to banks' participation. Over the past several months, a range of large, global banks have announced plans to further develop their private debt capabilities (directly and indirectly). These have included strategic partnerships with private debt lenders, raising dedicated capital from third parties for direct lending to middle market firms, and participating in private debt lending directly from the capital on their own balance sheets.

As we outlined in our Private Debt Primer in late 2023, with banks approaching lending more selectively, we continue to see an opportunity for private debt to expand its addressable market of borrowers – either through writing new business or acquiring existing business from legacy bank lenders.

To a certain extent, this evolution is similar to another structural shift which has taken place over the past several years: the increased overlap (and partnerships) between private lenders and insurers. This has been facilitated, in our view, by the complementary asset-liability matching profiles between the two groups. Life insurers (and annuity writers) are often investing capital over the long-term (as they match invested assets with the duration of "long-tail" products, such as life insurance policies, which make payments many years in the future). This type of "patient" capital can be attractive for a private debt lender, as it can remain deployed over an extended time horizon.

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Unlisted BDCs are becoming a larger percent of total BDC AUM

The growth of BDCs has also provided another avenue for investors to access the private debt market. BDCs are companies created to provide capital to small and medium businesses. Given that focus, it is perhaps unsurprising that BDCs have been closely linked to the private debt universe for a while. That said, there have been some shifts in the composition of BDC growth in recent years.

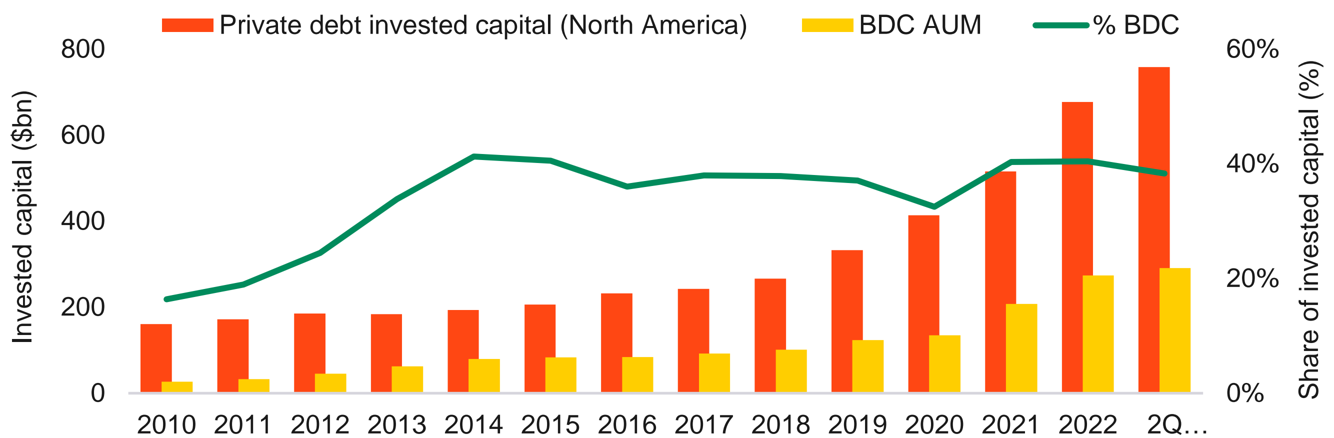
Consistent with the broader trend of increasing private debt fund sizes, BDCs have also become larger in recent years. The average size of BDCs has increased by 11% between 1Q2022 and 1Q2023, to nearly $2.48 billion, according to S&P Global. The average loan size in BDC portfolios has grown in lockstep, increasing by 11%, to $48 million, over the same period according to S&P Global.

In 2Q2023, BDCs had $290 billion in AUM and accounted for ~40% of total North American private debt invested capital, according to Barclays Research (Exhibit 21). There are three types of BDCs with varying liquidity requirements. Public BDCs are liquid and traded on an exchange, while unlisted BDCs (including non-traded and private) are less liquid and do not trade on an exchange.

Data provided by Barclays shows that recent growth has been concentrated in unlisted BDCs, which have grown from 30% of total BDC AUM in 4Q2019, to 57% in 3Q2023 (Exhibit 22). Unlisted BDCs limit liquidity (redemptions) to investors, allowing for a higher concentration of illiquid securities and less observed volatility.

Exhibit 21: BDCs are ~40% of private debt invested capital in North America

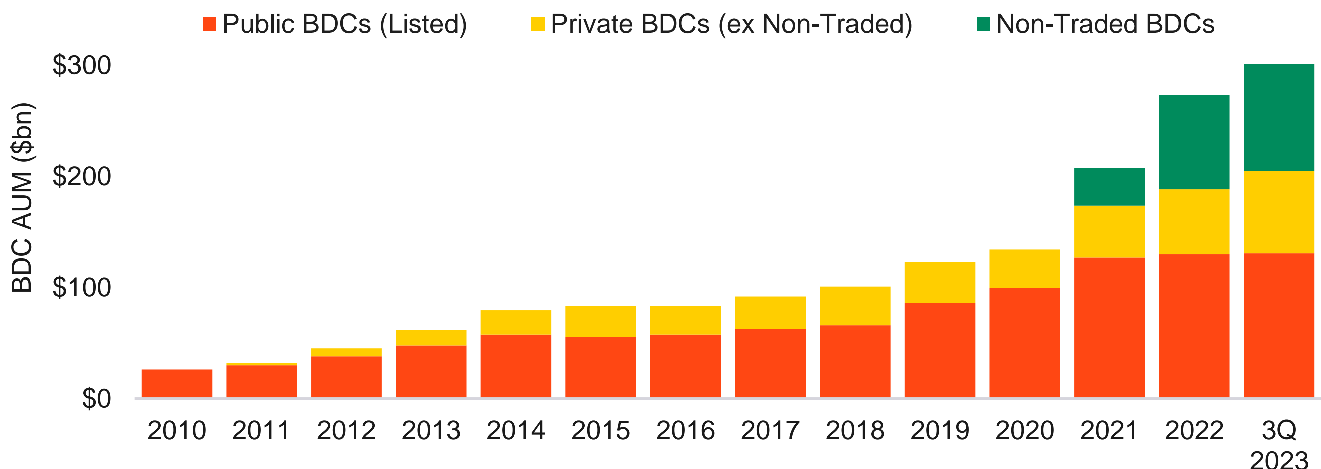
BDC AUM, as a percent of North American private debt invested capital



Source: BlackRock, Preqin, BDC Collateral, Barclays Research. As of June 30, 2023 (most recent).

Exhibit 22: Unlisted BDC AUM has grown since 2020

BDC AUM, by BDC type



Source: BlackRock, Refinitiv's BDC Collateral & Wells Fargo Securities, Barclays Research. As of September 30, 2023 (most recent).

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