



Private Credit: Reaching Equilibrium

Q3 2024 Overview & Outlook

Reaching Equilibrium

Private credit's tighter pricing will persist until M&A returns...

Credit spreads are tight. Like 500 bps or under. DC Advisory and LevFin Insights review some of the borrowers in Q3 that lowered their interest rates.

Galway Insurance and Higginbotham each lowered the pricing on their debt to S+450, while CorroHealth reduced its interest rate from S+600 to S+500. In addition, quarterly fillings from business development companies (BDC) – a specific type of private credit fund – disclosed a refinancing of Pye-Barker Fire & Safety cleared at S+450 in Q2.¹

Directionally, pricing has come in about 200 bps, depending on the credit. For some issuers the reduction has been even further. Using SEC filings, LevFin Insights tracked borrowers that reduced their interest rate in the Q2, the most recent data available. Based off those BDC filings, we saw a plethora of repricings in Q2, including one that shaved 400 bps off its loan. ReliaQuest repriced from S+1075 to S+675.²

Prices in the syndicated market have largely priced tight recently and this competition will likely lead to continued competitive pricing in the private credit market.

Just in Q3, eight borrowers launched processes that resulted in the companies leaving the broadly syndicated market. Borrower World Choice Investments generated the biggest savings by reducing its interest cost by about 325 bps.

That competition will likely keep pricing cost effective for private credit borrowers. Until the M&A market is humming again, giving lenders more chances to pass on deals, we believe that these tight spreads are here to stay.

But Federal Reserve rate cuts may limit how low private credit can go on spreads

The open question is if the Federal Reserve's 50 bps rate cut will scramble the balance of power between the syndicated and private markets.

Private credit managers' ability to be competitive with banks may become more limited as rates fall further. These managers have specified returns to meet for LPs, which are delivered partially via an illiquidity premium. Note this is particularly the case for companies with \$50mn of EBITDA or more, the inflection point where banks and private credit firms compete for the same deals.

We believe that borrowers must decide if the speed and certainty provided by private credit will be worth the premium. The private credit market can allow for more tailored financing packages that can include the option to PIK a portion of interest payments and the availability of delayed-drawn term loans, which are often reserved for future M&A.

Private credit is likely to face competing tasks. They must remain competitive with the syndicated market's lower cost of capital but also protect LP returns.

PIK optionality usage has become strategic for borrowers, easing its stigma, and helping differentiate private credit from syndicated markets

We expect that some private credit borrowers who tapped the direct lending market in recent quarters have turned to PIK in what appears to be a proactive usage of

the tool, which was once considered a harbinger of tight liquidity. Making coupon payments in kind in the opening quarters of a loan's issuance shows it has become more of a strategy and lessened its negative stereotype.

This option is not available in the syndicated market; the appeal to borrowers is that they can use it to manage cashflow. Less cash out the door immediately can facilitate M&A or other growth investments, but of course that interest will come due upon repayment or maturity of the loan.

For example, in Q2, the most recently disclosed pricing data, CentralSquare Technologies and Parts Town both used PIK options after refinancing debt in that time frame. The former paid 300 bps of its S+650 pricing in kind, while the latter PIK'd 175 bps of its S+500 pricing according to BDC quarterly reports.^{3,4}

ReliaQuest landed a new unitranche, refinancing an October 2026 maturity, that also paid a portion of its interest in PIK, according to BDC quarterly reports. Similar documents showed Baxter Planning Systems also utilized PIK in its first interest payment for a loan that funded Marlin Equity Partners buyout of the company in May.⁵

Private-syndicated market push and pull reaches equilibrium as borrowers navigate the two markets

There has been a raft of borrowers that left the leveraged finance market through the year but particularly in Q3. But there has been a cohort of borrowers that moved the opposite way.

USIC refinanced an originally \$1.005bn first-lien term loan and \$285mn second-lien loan, both syndicated, with a \$1.4bn private credit loan. CLEAResult left the syndicated market in September when Kohlberg & Co.'s acquisition of the company was funded with an \$850mn private credit loan.

Yet Geosyntec Consultants is among those that have moved from the direct loan market to the syndicated loan market and saved some money in the process. It obtained a \$440mn syndicated loan that cleared at S+375 to refinance an S+525 private credit loan. CIRCOR International is doing the same; it decreased its interest rate by 250 bps, from S+600 to S+350, which

wrapped post Q3 and ended up at 25 bps lower than anticipated.

Gone are the days of one market dominating another. Private credit has asserted itself in recent years so much so that many deals are dual tracked, meaning the private equity sponsor will weigh both private and syndicated options. We have likely reached a point where the push and pull between the two markets shows they can co-exist, even with a little friendly competition.

Partnerships with private credit firms provide side-door entrance into asset class for banks

Banks - both large and small - are partnering with private credit firms to gain access to the asset class after a period in which many banks lost credits to direct lenders.

The latest example is a \$25bn partnership between Citi and Apollo Global Management, which will target North American direct lending investments. This follows a slew of other partnerships, and more are likely to follow.

This alters the dynamic between banks and private credit firms. Previously, they mainly competed on deals; now they can also collaborate in what may be a win-win for borrowers.

What may be key to whether these prove fruitful is the structure of the tie-up. Those factors include financial incentives for originators in both the bank and private credit firm, as well as which party has the final say on whether an investment will be made.

Summary



- In a reversal from last year, we expect both the private and syndicated loan markets to remain open this year



- While competition has driven pricing increasingly tighter to the benefit of borrowers, the start of the Federal Reserve's rate-cutting campaign should restart the M&A engine for both lenders and sponsors

References

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