Private equity challenges and the surge of private credit: Capital opportunities for non-traditional risk profiles

Research Pulse

Private equity is facing challenges in exits and fundraising amidst economic uncertainty, while private credit has seen significant growth. Firms like Ares and Goldman Sachs have raised billions, driven by strong investor demand. Private credit offers diverse strategies, such as junior capital, growth financing, and rescue financing, making it a dominant asset class with capital opportunities for mid-sized and large companies with higher risk profiles.

Stall in private equity transaction are limiting fundraising and impacting management fees

Over the past two years, private equity firms have faced significant challenges in exiting their investments. Traditional exit strategies, such as initial public offerings (IPOs) and industry transactions, have been constrained by elevated interest rates, valuation disputes, and broader economic uncertainty. Consequently, many buyout groups have struggled to meet their fundraising goals for core private equity funds, while holding unsold assets valued at a record $3.2tn (Heal, 2024).

Management fees have dropped to their lowest levels since 2005, as fund managers contend with a challenging fundraising environment and strive to attract investors. According to industry data from Preqin, the average management fee for buyout funds either closed this year or actively fundraising as of June stood at 1.74% of investors' committed capital, down from the previous low of 1.85% recorded in 2023 (Heal, 2024).

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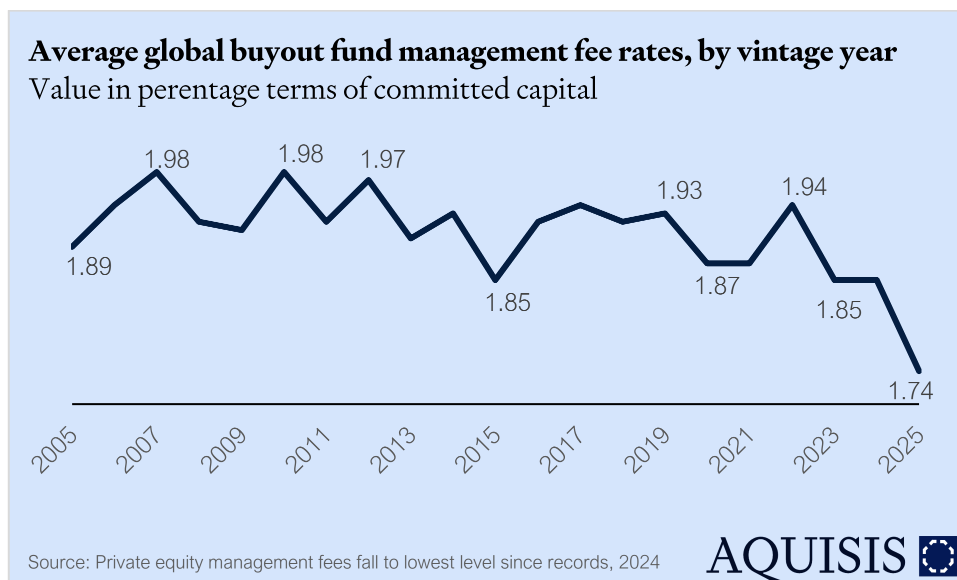

The private credit market has tripled in size since 2013, offering an alternative to bank lending for riskier businesses

In contrast, investor interest in private debt investment has surged significantly. In July, Ares Management achieved a record-breaking milestone, closing a $34bn private credit fund. The firm announced it had secured $15bn in commitments for its third senior direct lending fund, far exceeding its $10bn target. This success is part of a broader trend of strong capital raising within the private credit sector in recent months, driven by growing investor demand for exposure to the asset class and reaching record-breaking $1.6tn in asset under management in 2023, from just $0.5tn compared to 2013. In October, rival HPS Investment Partners raised $14bn for a new loan fund, with the total reaching $21 billion when factoring in bank leverage. Similarly, Goldman Sachs announced in May that it had surpassed $20 billion for its latest private credit fund (Platt, 2024).

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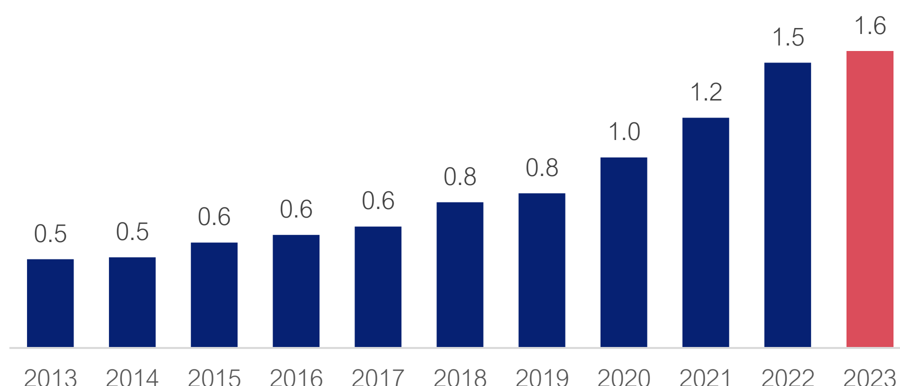
10-year evolution of private credit AUM
Data in $tn



Source : Preqin

The series of successful capital raises highlights the growing allocation of capital by pensions, endowments, and sovereign wealth funds to new funds. Private credit firms have emerged as dominant players on Wall Street, progressively assuming roles traditionally held by banks since the global financial crisis over a decade ago. In response to higher capital requirements and post-crisis regulatory changes, banks have scaled back from certain business lines and curtailed riskier lending activities. Private investment firms have stepped in to fill this void, becoming key purchasers of bank loan portfolios and playing an expanding role in direct lending to companies.

Distressed capital is attracting the most resources, with performances in line with equity returns

Private credit investments are debt-like instruments that have no readily tradeable market or publicly quoted price. Typically, private debt is provided by non-bank entities to fund middle-market companies, but can include funding for larger companies as well. Private credit has many features similar to traditional credit instruments including variations in seniority, tenor, amortization, collateral provisions and floating or fixed interest rate coupons, among others.

Since there is often limited active trading in the primary or secondary markets for many private credit instruments, lenders tend to structure or purchase the loans with a view towards holding the exposure until maturity or a refinancing event. As a result, the instruments can include features uncommon to traditional loans, such as a structured equity component, high prepayment penalties, customized amortization schedule or a role in oversight or management of the company.

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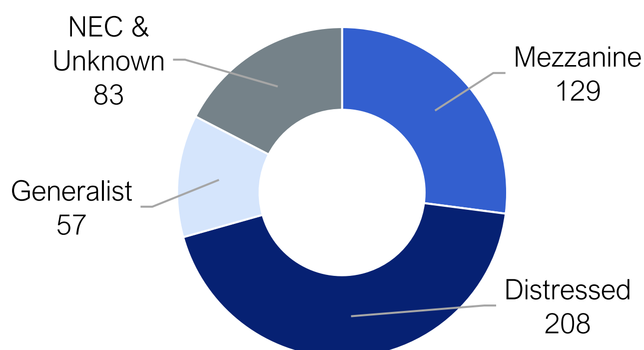
Private credit encompasses a range of investments, including performing loans as well as debt in stressed or distressed companies. When assessed by committed capital, distressed debt funds represent the largest sub-strategy, accounting for 43% of total commitments. Mezzanine funds follow, comprising 27% of committed capital, while generalist strategies and NEC & Unknown collectively make up the remaining 30% (Shawn Munday, 2018).

Committed Capital by global private credit fnuds listed in Burgiss
Vintage Year between 2004 - 2016, data in €tn



Source: Source: Performance of Private Credit Funds: A First Look, 2018

Across all funds, the pooled IRR is positive for every year from 2004 through 2016, varying from 1.2% for 2004 vintage funds to a high of 14.2% for 2011 vintage funds. The pooled IRR for all vintages and strategies is 8.1% which is roughly on par with return expectations for equity. This underscores the strength of the private debt market, which is capable of delivering returns through non-bank loans.

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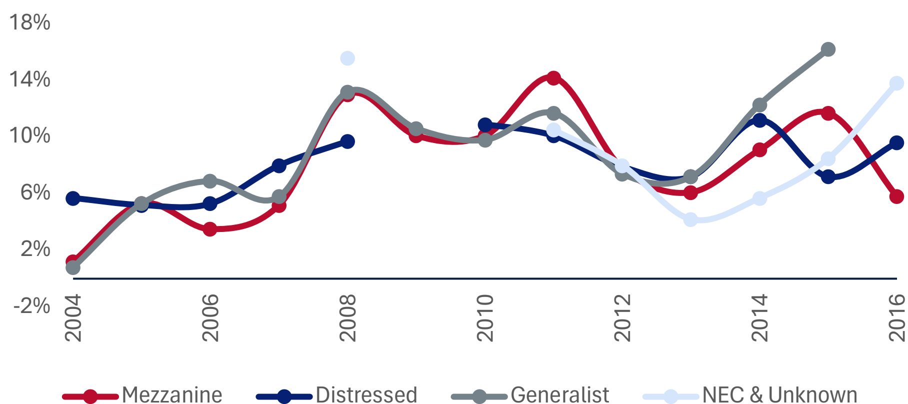
Pooled IRR of private credit funds by vintage year, 2004 - 2016
Data in percentage (%)



Source : Performance of Private Credit Funds: A First Look, 2018

Private credit is an opportunity for mid-sized firms with higher risk profiles, but debt servicing may lead to financial distress

Morgan Stanley's investment management team provides insight into the types of companies private credit funds are targeting and the capital solutions being explored (Stanley, 2024):

- Junior and Hybrid Capital Solutions
  For fundamentally sound businesses that faces high cash debt service obligations and reduced senior debt capacity. Private credit funds can offer junior capital solutions to alleviate these fixed obligations, enabling companies to pursue accretive organic and inorganic growth opportunities
- Growth Financing for High-Quality Companies:
  Rising benchmark rates have shifted equity investor focus from “growth at any cost” to stable, profitable enterprises, limiting the availability of growth capital for high-quality, scalable businesses sound KPIs. Private credit funds can address this gap by providing capital that enables these companies to reinvest earnings at attractive incremental returns, with minimal equity dilution, while delivering strong returns to investors.
- Rescue Financing:
  If the economy enters a recession or a period of elevated defaults, private credit funds are well-positioned to provide rescue-financing capital to stabilize distressed companies.

The IMF delivered a sobering evaluation of the private credit market in its latest report, highlighting growing pressures on midsized firms borrowing at elevated interest rates. Many of these companies are resorting to payment-in-kind (PIK) loans, which defer interest payments while compounding their debt burdens.

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Although PIK loans can be a practical tool for fast-growing businesses prioritizing reinvestment in their core operations, a shift from cash-based interest payments to PIK loans often signals underlying financial difficulties. This concerning trend appears to be gaining traction within the private credit landscape (Wigglesworth, 2024).

Authors

Stefano Buldrini is an Associate

Kristoffer Stapelmann is a Managing Partner.

To learn more, you can reach us via

- Email: info@aquisis.com
- Phone: +39 055 517 0015
- Further contact details available on our website: www.aquisis.com

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