December 2024

HMC CAPITAL

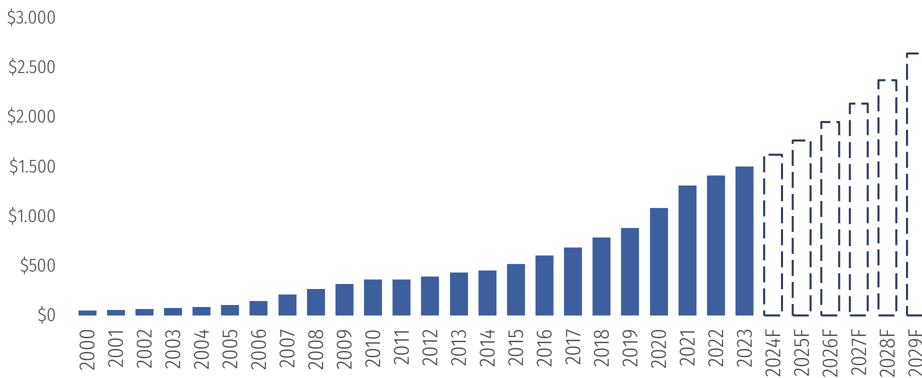
Asset Allocation Report – Private Debt

Context

The private debt market has expanded significantly since the 2008 financial crisis, driven by regulatory changes that tightened bank lending standards. This shift led many companies and private equity funds to turn to private debt as a more flexible and efficient source of financing. Today, the asset class boasts an AUM of USD 1.5 trillion, a 1.7x increase since 2019, with a compound annual growth rate (CAGR) of 16% over the past 23 years—outpacing the 11% CAGR of alternative investments overall. Preqin's projections indicate it will surpass USD 2.6 trillion by 2029, driven by an annual growth rate of 15%.

Several structural shifts in the credit market underpin this growth. The contraction of the banking sector and the migration of syndicated loans to larger borrowers have reshaped the lending landscape, with banks' share of the syndicated loan market falling from 62% a decade ago to just 10-15% today. In response, private debt has stepped in as a dominant force, now facilitating nearly five times the transaction volume of traditional bank loans.

AUM Private Debt (USD billions)



Source: Preqin Pro.

North America Focus

Private debt, as an asset class, is influenced more by macroeconomic conditions, regulatory frameworks, and industry-specific dynamics than by the actions of any particular administration. However, the policies introduced by the new U.S. government could shape specific conditions affecting credit availability, borrower quality, and investor demand.

On one hand, a **pro-business** and **deregulation** agenda could stimulate economic activity, increasing demand for private debt as companies seek financing for expansion. Reduced regulation may also open opportunities for private debt to fill gaps left by banks in mid-market and high-yield lending. Additionally, **corporate tax cuts** or **incentives** could strengthen borrower credit profiles, lowering default risks and enhancing the appeal of private debt for lenders.

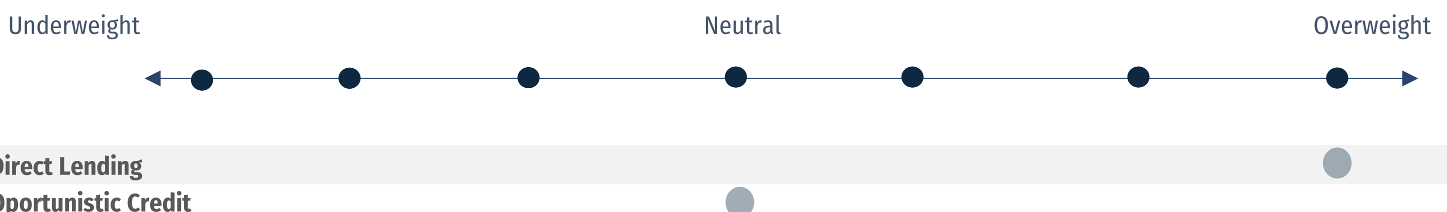
However, policies such as tax cuts, tariffs, and reduced immigration could drive inflation, leading to higher interest rates and wider credit spreads. While this environment might raise borrowing costs, private debt strategies focused on floating-rate instruments are well-positioned to benefit from rising rates. That said, prolonged periods of elevated rates could put pressure on borrowers, necessitating more rigorous underwriting and ongoing monitoring to mitigate potential defaults.

A key strength of private debt lies in the close relationships it fosters between borrowers and lenders. These connections enable early detection of potential financial issues and the development of tailored solutions, which help lower default risks and enhance financial stability. Furthermore, private debt's ability to offer customized terms and structures allows it to address the specific financing needs of companies, making it an attractive option in an evolving credit environment.

Furthermore, in the current high-interest rate environment, private debt continues to demonstrate its adaptability, offering compelling opportunities for investors while maintaining its relevance as a preferred financing option. Although the market may face some compression in spreads and original issue discounts, yields are expected to remain attractive due to persistently elevated interest rates by historical standards.

In this context, private debt continues to demonstrate its relevance and resilience, offering significant benefits to both borrowers and investors in a rapidly evolving financial landscape.

Private Debt Outlook



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Direct Lending

Direct lending continues to stand out as a compelling asset class, demonstrating its adaptability to evolving economic and monetary conditions.

The 2025 outlook is highly optimistic, fueled by macroeconomic tailwinds, a revival in the M&A market, and an uptick in capital deployment. A more moderate inflationary environment and the potential for a "soft landing" further improve the outlook for corporate borrowers, enhancing financial performance and credit conditions.

The asset class remains robust, bolstered by strong loan documentation, prudent leverage levels, and disciplined asset selection. Structural advantages, including floating-rate loan structures and shorter durations, add to its flexibility, ensuring resilience across economic cycles.

Tailwinds

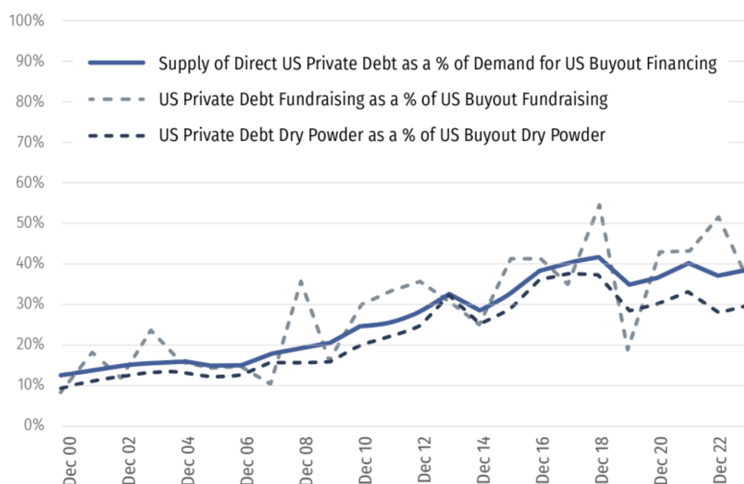
Stabilizing Economic and Credit Conditions:

- Lower rates create a favorable environment for private debt by reducing interest expenses, which, in turn, mitigate default risks and strengthen borrower credit profiles, leading to stronger debt service coverage and healthier loan-to-value ratios. These dynamics support stable income generation and enhance direct lending valuations.
- A smoother economic adjustment (soft landing) reduces the risk of widespread defaults and supports borrower repayment capacity, enhancing the attractiveness of lending opportunities with improved risk-adjusted returns.

Rising Demand for Alternative Financing:

- **Bank Retrenchment:** Traditional banks face tighter regulatory constraints, reducing their ability to lend to mid-market businesses. This trend is amplified by the culmination of the Basel III endgame, with stricter rules for large U.S. banks starting in 2025 followed by a three-year transition period. These changes further limit bank participation in private credit, creating opportunities for private lenders to fill the gap. Lower interest rates also unlock opportunities in mid-market lending by enabling businesses to assume additional leverage. This opens opportunities for private credit lenders to step in as primary financing sources.
- **Corporate flexibility**: Direct lending has experienced rapid growth among corporations due to its unique borrower advantages, including faster execution, more streamlined disclosure requirements compared to traditional markets, no need for credit ratings, and customizable loan structures that provide management with greater flexibility. These benefits make private lending an attractive option despite its higher yields.
- **M&A activity**: The resurgence of M&A activity is expected to drive significant financing opportunities. Private equity firms, under increasing pressure to deliver liquidity to their limited partners, are likely to spur transaction volumes after a prolonged slowdown. Improved visibility into economic conditions and moderating financing costs will further bolster deal flow, increasing demand for direct lending solutions.
- **Private Equity Growth:** A strong pipeline of private equity buyouts, with funds holding record levels of dry powder, is driving demand for direct lending, as PE firms increasingly depend on this financing for leveraged acquisitions and portfolio expansion. According to Preqin, private debt now accounts for 40% of total buyout financing, underscoring its growing prominence as a vital alternative to traditional funding sources in the US buyout market. The steady market share of private debt indicates that it has coexisted alongside other financing sources, highlighting a balanced market without signs of a bubble.

Supply versus Demand for Direct Lending



Source: Preqin, Cliffwater

Headwinds

Declining Rate Environment: As interest rates decline, floating-rate private debt instruments may produce lower interest income. However, looking ahead, direct lending all-in yields are expected to remain above historical averages, bolstered by elevated base rates and robust loan margins. Furthermore, private debt yields benefit from SOFR floors, a mechanism that sets a minimum rate for loans, thus protecting lender returns when rates decline. For contracts including these floors, if rates fall below the established threshold, borrowers continue to pay interest based on that minimum level.

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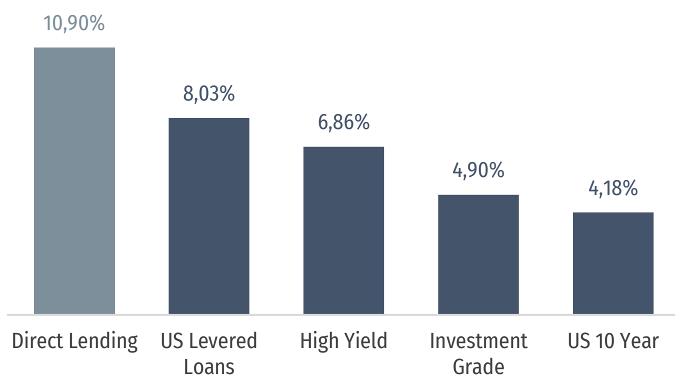
Historically, private debt has demonstrated competitive performance, as highlighted by the Cliffwater Direct Lending Index, which posted a 10.4% average annual return from 2009 to 2021—a period of near-zero interest rates—outperforming 5-year Treasury bonds by almost 9%. Projections for 2025 indicate that 5-year Treasury yields will remain within the range of 4.15% to 4.2%, aligning with the current rate. This stability underscores the resilience of private debt as a reliable investment amid evolving economic conditions.

Fixed Income yields



Source: HMC Construction. All yields as of November 30, 2024. Direct Lending: CCLFX Corporate Lending Fund, US Levered Loans: Morningstar LSTA US Leveraged Loan 100 Index (Wtd Average Yield), High Yield: ICE BofA US High Yield Index Effective Yield, Investment Grade: LBUSTRUU Index, US 10-Year: U.S. 10-Year Treasury.

Competitive Deployment: High levels of dry powder amplify competition among lenders, leading to tighter spreads, lower yields, and more borrower-friendly terms. This dynamic can compress risk-adjusted returns for investors and pose challenges in deploying capital efficiently. Increasing capital inflows into private debt further exacerbate competition, putting additional pressure on returns and lending conditions .

Despite this, private debt activity is expected to remain robust in 2025, driven by increased event-driven issuance, including LBOs and M&As. According to Preqin, private equity dry powder reached USD 2.5 trillion as of December 2024, which could further fuel demand for private credit as investment activity recovers.

At the same time, private credit providers have been increasingly successful in capturing a segment of borrowers traditionally served by the broadly syndicated loan market. With the median loan size in the BSL market now standing at USD 860 million, a 40% increase from pre-pandemic levels, the market has shifted its focus to larger loans. As a result, smaller borrowers who no longer meet the BSL market's larger loan thresholds are turning to private credit providers, who are more willing to offer tailored solutions for smaller or middle-market companies. Notably, spreads in the lower middle market have also shown more resilience, providing additional opportunities for private credit lenders to deliver competitive returns.

Opportunistic Credit

The outlook for opportunistic credit in 2025 is balanced, with opportunities and challenges shaping the landscape. While the market may offer areas of value, evolving economic conditions could influence returns and complicate deployment strategies. A thoughtful and disciplined approach will be essential to navigating opportunities in a constrained and competitive environment.

Tailwinds

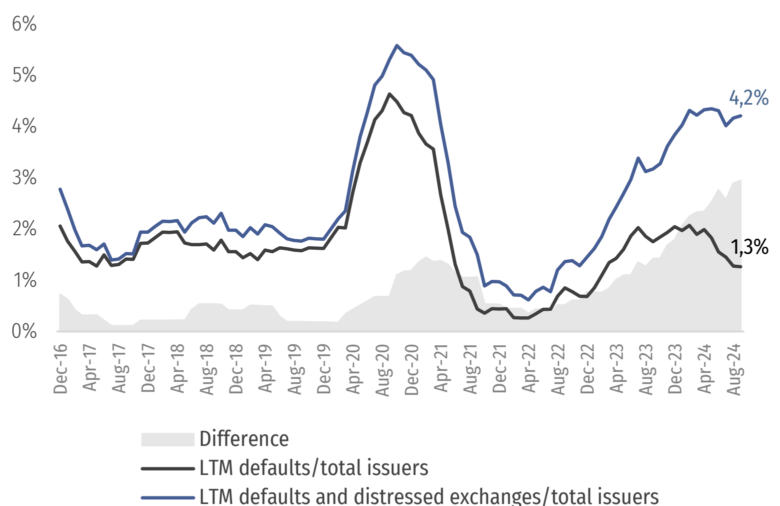
Opportunistic credit shares several tailwinds with direct lending, particularly the rising demand for flexible financing solutions as borrowers facing financial strain or unique challenges increasingly seek tailored capital options like rescue financing, structured debt, or turnaround investments.

Additionally, stabilizing economic and credit conditions can strengthen borrower credit profiles, offering particular benefits for mezzanine financing and special situations strategies. However, opportunistic credit also benefits from specific tailwinds, such as the following:

High Refinancing Needs: Companies facing tight refinancing deadlines often accept higher yields, stricter covenants, or equity-like terms, enabling opportunistic investors to secure enhanced risk-adjusted returns. Additionally, unmet refinancing demands can lead to distressed situations, allowing investors to acquire debt at a discount, participate in restructurings, or gain equity upside.

As shown in the following chart, when the LTM defaults and distressed exchanges/total issuers increases, it signals growing financial stress among borrowers. Opportunistic credit investors can take advantage of this by targeting distressed assets, providing capital to companies in need of restructuring, or purchasing loans at discounted prices.

US leveraged loan dual-track default rates



Source: Pitchbook, As of September 30, 2024

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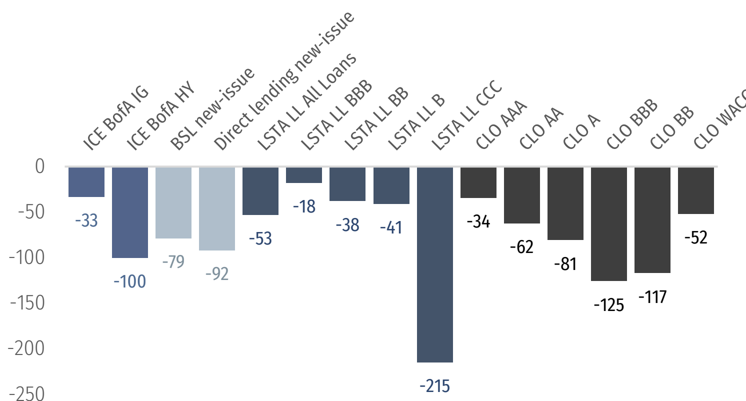
Headwinds

Decreased Market Dislocations: If global markets continue to stabilize, opportunities to capitalize on distressed or dislocated assets may diminish, reducing the availability of high-return opportunities. A successful "soft landing" for major economies could limit the number of distressed situations or credit events that opportunistic investors typically rely on.

Compressed Yields and Narrower Spreads: As economic and credit conditions improve, spreads on higher-risk credit instruments, such as distressed debt, could compress, reducing the potential returns across credit strategies. This dynamic, as shown in the following graph, is not exclusive to opportunistic credit but could have a greater impact on this strategy. Given the inherent risks of opportunistic credit, investors may find the reduced compensation less attractive, prompting them to allocate capital to other opportunities with better risk-adjusted returns.

Furthermore, hybrid spreads have tightened significantly, contracting from 250 basis points over senior debt in 2023 to the current 110 bps. Historically, hybrid spreads rarely tighten below 100 bps over senior debt, signaling limited room for further compression. This is particularly important for opportunistic credit, as hybrids are a key component of this strategy. While tightening spreads benefit issuers by reducing their borrowing costs, they could limit capital gains for investors in hybrid securities, potentially reducing the overall attractiveness of this segment within opportunistic credit strategies.

Change in credit spread from a year ago (basis points)



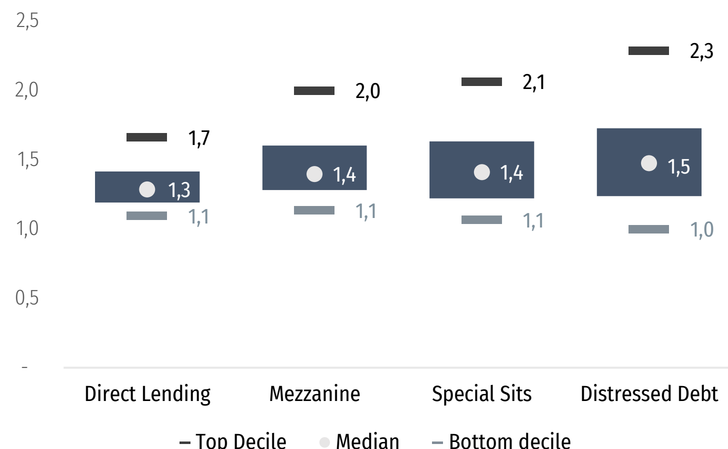
Source: Pitchbook, As of September 30, 2024

Elevated Manager Selection Risks: With fewer clear dislocations, the dispersion in performance among opportunistic credit managers may widen, increasing the importance of selecting skilled managers. The complexity of these strategies requires deep expertise, and missteps in underwriting or restructuring could lead to underperformance.

Area of focus

- **Direct lending** stands out as a key area of focus in private debt for 2025, offering structural protections like guarantees and covenants that safeguard investor capital. Active management by General Partners enables strategic financial restructuring and risk mitigation, while flexible structures, floating rates, and shorter durations provide resilience across economic cycles.
- **Lower middle market (LMM):** The lower middle market (LMM) benefits from a more favorable competitive environment as banks continue to retreat from this segment, while the upper middle market (UMM) faces increased competition from broadly syndicated loans (BSLs). Fewer investors and institutions focus on the LMM, enabling lenders to enforce stricter covenant protections and achieve higher recovery rates. LMM loans also maintain a consistent income advantage over UMM loans.
- **Sponsor-Backed Lending**: Sponsor-backed lending is expanding as private equity activity drives demand for tailored financing. These companies benefit from sponsor support, enhancing resilience and growth potential. Managers focusing on this area can mitigate risks while accessing high-quality borrowers and securing strong, risk-adjusted returns.
- In **opportunistic credit,** focusing on niche markets, alongside disciplined managers who excel in rigorous underwriting and tailored solutions, presents opportunities. This approach enables investors to uncover value in specialized sectors while navigating risks effectively in a competitive and evolving credit environment. Additionally, investors can capitalize on the higher dispersion of returns that this type of debt offers, creating potential for outsized performance through careful manager selection and strategic positioning.

Net TVPI (Vintage 2000-2019)



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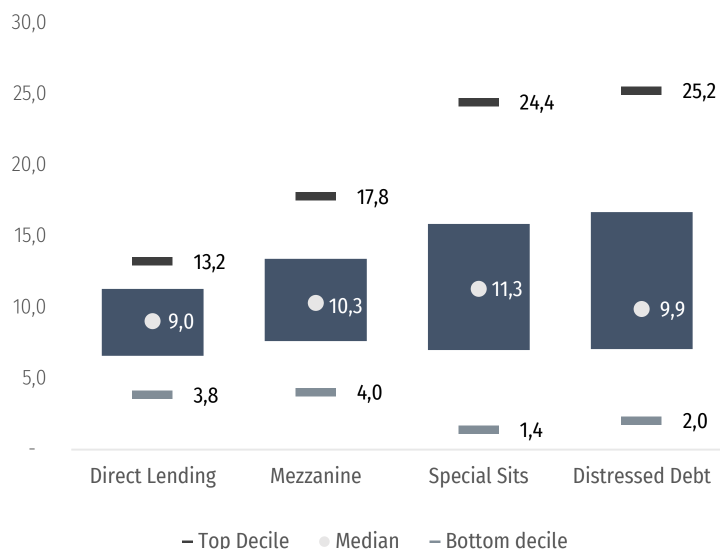
Net IRR (Vintage 2000-2019)



Source: Preqin, based on the most up-to-date data as of December 23, 2024.

- **Evergreen or Interval Funds:**

Investors are increasingly seeking to diversify their public market exposure while capturing the premiums offered by private credit markets, driven by illiquidity and complexity. This trend is fueled by rising demand from both high-net-worth individuals and retail investors. Interval funds—closed-end mutual funds that provide liquidity at set intervals to align with the illiquidity of private markets—have experienced approximately 40% annual growth over the past decade.

In response, fund managers are creating innovative strategies across private credit markets, including private debt funds that invest assets immediately without capital calls, mitigating the J-curve effect, and offering liquidity windows with attractive distributions.

Private debt as an asset class is particularly well-suited to these structures due to its steady generation of cash flows from interest payments and amortizations. Additionally, investment exits are typically tied to loan maturities rather than relying on asset sales, providing a predictable and self-liquidating profile that aligns with the liquidity needs of evergreen or interval funds.