Private Credit: Poised for Growth in 2025

A conversation with Armen Panossian, Oaktree's Co-Chief Executive Officer and Head of Performing Credit.

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We sat down with Armen Panossian, Oaktree's Co-Chief Executive Officer and Head of Performing Credit, to get his views on the state of the private credit market and the outlook for 2025.

Highlights:

- Private credit investing has seen enormous growth over the last decade, a result of strong yields outpacing traditional fixed income and the fact that private credit is generally a stable asset class with a lower default rate than public credit.
- Although interest rates are trending lower, the appetite for private credit continues to look favorable into the new year.
- Direct lending comes in a variety of shapes and sizes, with each form carrying its own risks and rewards.
- We believe experienced managers capable of originating non-sponsored loans while maintaining a disciplined approach to risk management can deliver strong results for investors.

Q: Before we turn to the outlook for private credit over the coming year, could you please walk us through the evolution of the private credit market over the past several years, and what that looks like today?

Panossian: Private credit has seen enormous growth in the years since the Global Financial Crisis. Following the enactment of Dodd-Frank regulations, banks began to step away from lending, particularly to the middle market and even some of the upper middle or large-cap markets. Direct lending stepped in and filled the gap. The asset class was yielding around 6 to 8%, and we began to see some strong growth, which really took off after the Federal Reserve ("Fed") increased interest rates beginning in 2022 to rein in inflation. When that happened, and SOFR (Secured Overnight Financing Rate) rose alongside the federal funds rate, yields suddenly were around 12%.

At that point, a lot of institutional and high-net-worth investors became interested in the asset class, realizing that direct lending had been a very stable asset class for 10 years, generating steady income without much movement in the price of the assets, and with a lower default rate than public credit. And this coincided with the growth in availability of private BDCs (business development companies), making it easier for investors to access the asset class.

When rates rose in the back half of 2022 and into 2023, banks stepped away again from the broadly syndicated loan market because of concerns around the economy and inflation. There was a selloff of bonds, and in the first six months of 2022, high yield fell by 7%, and senior loans were down about 4%. Bonds were trading at pretty steep discounts, and the banks exited that market for about a year. With a base rate of over 5%, you were now getting yields of about 12% in private credit.

Since late 2023, the banks have returned, and they are now competing in the upper middle and large-cap markets with loans that are about 100-150 basis points (bps) tighter than the direct lending market and with more borrower-friendly terms. That has resulted in a compression of direct lending spreads back to 500-550 bps. As spreads have come down, we are seeing more merger and acquisition (M&A) deal activity in the last three to six months than we did in all of 2023.

While direct lending yields have come down over the last year from 13% to closer to 10%, we are still happy with the relative value of direct lending versus the publicly traded markets. High yield spreads have tightened and are now under 300 bps – which is within the normal range of 300-450 bps – but total return is still reasonably good.

Q: With the banks coming back to market, why would a company want to work with a private lender if there are wider spreads and more covenants on a private loan?

Panossian: The banks are most aggressive in loans that are easiest to understand by rating agencies. A majority of publicly traded bank loans are owned through CLOs (collateralized loan obligations), which are rating-sensitive buyers of broadly syndicated loans. If there's a company that will either rate poorly or the rating agencies just won't be able to rate it, then the sponsor buying that business would rather pay that extra 100-200 bps and give up on a covenant. Those types of businesses may include corporate carve-outs where there isn't a clean set of financials that has been audited for five or more years, so it's more difficult to secure a bank loan; in such cases the borrower may turn to direct lending. For example, a lot of technology companies (such as those involved in software) often turn to direct lending. The reason for this is that technology companies often have very high debt loads relative to their cash flows, even though the balance of the debt may be lower than most other businesses on a loan-to-value basis. Because of uncertainty as to how these companies could get rated, a direct lender that gets comfortable with relatively low loan-to-values, high potential growth rates, and the ability of these companies to generate cash if they were required to pay down debt may be a better provider of debt financing than the broadly syndicated loan market.

In addition, banks are focusing on larger deals, in the $800 million range, and those companies with the cleanest financials available. Middle-market companies who have a competitive reason to keep the business out of the public eye are also often great candidates for direct lending. Of course, lending to riskier companies certainly may involve pricing risk in a manner that is aggressive and reflective of the potentially higher risk.

Q: With current portfolios that many of us have exposure to right now, how would you go about measuring or monitoring the health of a credit portfolio?

Panossian: When we're looking at our portfolio, we're tracking the performance of these businesses on the revenue line, the cost line, and the cash flow line relative to both prior periods and to the budgets that the companies provided us. We're talking with these businesses at least quarterly – sometimes even monthly – and assessing their performance relative to our expectations, and we have a watch list to assess corporate health, especially with the businesses [in industries] that are showing some signs of slowdown.

Q: You talked a little bit about the different markets within private credit. How do you break those down in terms of what the earnings are, as well as the risks associated with each?

Panossian: One way to think about this is that as you get smaller in company size, you have increases in business risk. Smaller companies often have businesses that have some concentration in their supplier or customer base, which means that a smaller business is more likely to experience shocks if there is a decline in revenues, or some tightening of terms by its suppliers. We generally don't engage as much in the lower middle market because we feel that there is substantial business risk. Of course, the compensating factor there is that usually there are some tight covenants in that lower middle market. Meanwhile, the large-cap direct lenders compete against the banks, which offer low spreads and fewer creditor protections. That means the large-cap direct lenders must accept a legal document that does not have a negative financial maintenance covenant tested quarterly – shorthand for how much room the borrower has to strip collateral away from the lenders. In the case of direct lending, those potential loopholes in legal documents are closed fairly well. In core middle market, it's more of a mix. Sometimes you see covenants, sometimes you don't, but pricing can be favorable than large-cap. A fourth category that we didn't talk about yet is sponsored direct lending. That's where the business – sometimes publicly traded, sometimes founder-owned – just needs to take on more debt to accomplish a strategic initiative, but they still want low leverage and are sensitive to their return on investment. In these cases, there usually is a sole lender, unlike large-cap, where there can be many lenders on one deal.

Q: Looking ahead over the next six to 12 months, what is your expectation for private credit returns and where do you think we will see base rates head over the next year?

Panossian: President-elect Trump is likely going to be a big deficit spender – at least in the near term – which probably means that the long end of the curve will be a bit more elevated than what people thought two months ago. But in terms of rates, I don't see the federal funds rate coming down considerably anytime soon without signs of a shock to the economy in the form of a recession or a spike in unemployment. The numbers don't suggest either of those are on the horizon, while inflation is within the range of being under control.

While the new administration might try to convince the Fed to reduce rates, the Fed is more focused on avoiding a recession and avoiding a spike in unemployment. I don't expect to see a meaningful rate reduction at the front end of the curve, although I do think that the Fed will continue to moderate rates and settle in the 3 to 4% range on the front end, with the long end likely to stay elevated above that 4% range. That, combined with a lot of dry powder with private equity firm funds, means a probable pickup in deals over the next year or two, which should have the effect of normalizing spreads. The total return could then come down somewhat, but this largely depends on deal flow.

Q: What do you believe makes your strategy approach and Oaktree different from traditional sponsor-backed lending strategies?

Panossian: We do sponsor-backed lending, so it's not the case at all that we don't favor it, but I would characterize it as the most consistent part of the private credit market in terms of frequency of deal flow, so it is more like the "beta" of private credit. But we also believe in alpha and have been involved in non-traditional private credit strategies (e.g., non-sponsored direct lending, asset-backed finance, and rescue lending) for well over a decade. While deal flow in these areas is harder to source and structure, the investments can offer a lot of potential value. They can add to the very important element of diversification, as well as offer potentially higher returns, with risk under control. We think this is very important, and believe it is where our private credit platform can really add some differentiated value to our clients' portfolios.

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As an asset class, private credit comprises a large variety of different debt instruments. While each has its own risk and return profile, private credit assets generally have increased risk of default, due to their typical opportunistic focus on companies with limited funding options, in comparison to their public equivalents.

Because private credit usually involves lending to below-investment-grade or non-rated issuers, yield on private credit assets is increased in return for taking on increased risk.

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