

Is private debt worth the fees?

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- Private equity and venture capital are the most significant asset classes in the private markets universe, but private debt complements them as an essential pillar of the ecosystem.
- Specialized funds promise higher returns than are achievable in the syndicated high-yield and leveraged loan market with lower volatility.
- However, due to the opaque nature of the ecosystem, it can be challenging to develop a clear idea of the risk/return profile of the asset class.
- We have therefore taken a closer look at some of the literature and data available on this topic in order to at least roughly categorise the asset class and derive expected returns that can be integrated into our capital market assumptions.

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P rivate debt, also called private credit, has become a booming asset class driven by the fast growth and increasing differentiation of the private equity industry. The rise in interest rates has further fueled the appeal of the typically floating rate debt, in particular, compared to longer duration high yield bonds. On the other hand, private debt comes with intransparency, illiquidity and significantly higher fees. What should we make of the risk/return profile of this relatively new asset class and what returns can investors reasonably expect?

1 Cutting through the jumble of terms

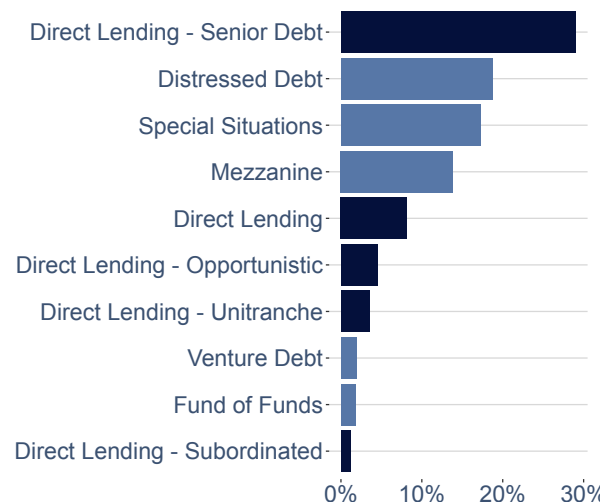
In principle, Private debt describes any lending that occurs outside the banking system and public syndicated debt markets. The category, therefore, spans a wide array of strategies, ranging from peer-to-peer lending platforms to hedge-fund-like strategies such as the secondary-market acquisition of debt of struggling companies at steep discounts. Having grown at double-digit rates post 2006 [6], the asset class represented a whopping USD 1.6tr by November 2023 [2].

In practice, when investors talk about private debt, it mainly refers to direct lending, which, as Figure 1 shows, represents 46% of global AuM. Direct lending describes a practice where a loan, typically to a small- or mid-sized corporation with elevated default risk, is negotiated directly between the borrower and one or a few lenders. These loans generally are originated and held by specialized private debt funds or non-bank financial institutions such as family offices. Furthermore, loans are given by these institutions with

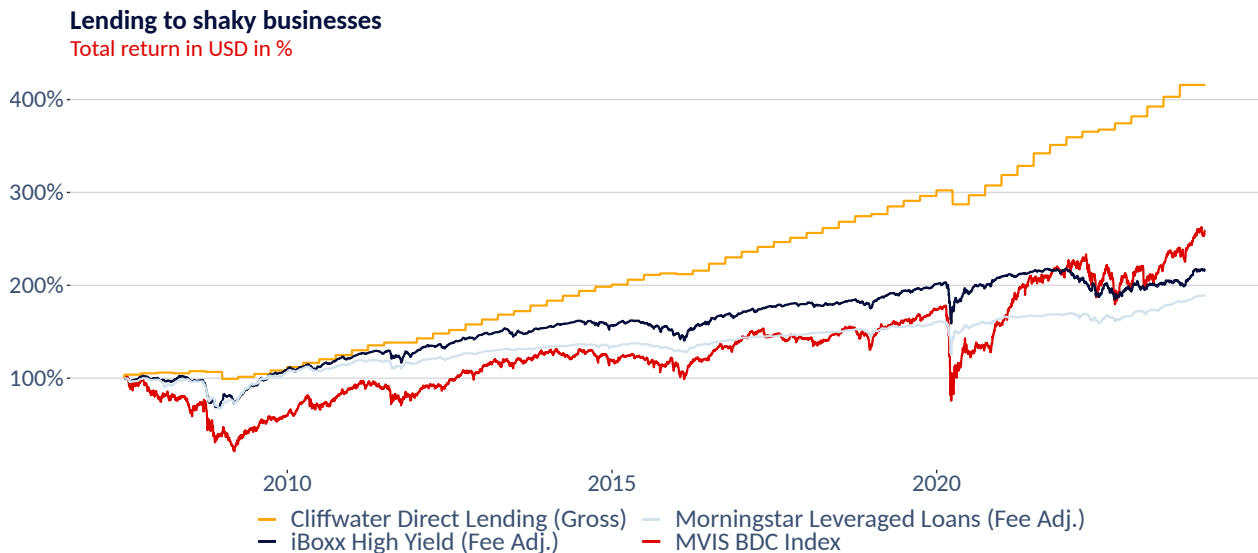
the intention to be held to maturity and not syndicated or traded afterwards. This clearly differentiates direct lending from other forms of lending to riskier borrowers like high-yield (junk) bonds or syndicated leveraged loans (also often called senior loans or senior bank loans). Direct lending, therefore, forms part of the private markets investment universe. More importantly, private debt and other private asset classes, such as private equity, real estate and private

Private debt investment universe

% of unrealized value and committed capital



Source: Source: Bloomberg, Amadeus Capital
Figure 1: Private debt is often synonymous with direct lending, which is the dominating sub-asset class in the >USD 1.6tr ecosystem, as found by BlackRock based on Preqin data.



Source: Bloomberg, Cliffwater, Amadeus Capital

Figure 2: High-yield bonds and syndicated leveraged loans are available relatively cheaply via exchange-traded funds with cost ratios of around 50 basis points. Private debt in general and direct loans in particular, on the other hand, are an exclusive business. In most cases, end investors have to subscribe to special closed-end private debt funds. So-called business development companies (BDCs) also make direct loans and may be listed, but investors who choose to invest in their equity as an alternative route to private debt are in for a very rough ride (as the maximum drawdown of 80% of the red line above shows). The underlying loan performance (orange line) has been spectacular and explains the attractiveness of private debt as an asset class.

infrastructure, are closely intertwined. High-yield bonds are typically issued by larger corporations, have a longer tenure and usually pay a fixed-rate coupon. Furthermore, as securities, they are subject to certain regulatory disclosure requirements [11]. Syndicated leveraged loans, on the other hand, share some common characteristics with direct lending, as they are not subject to securities laws and generally have similar maturities and variable interest rates. However, due to the origination and syndication process led by the bank, leveraged loans are usually granted to companies with a credit rating and generally have conforming features and terms.

In private debt, no such standardization and harmonization is required. As borrowers negotiate terms and conditions outside of any regulatory requirements and at arm's length with often only one counterparty, agreements can be highly customized and consider particular circumstances. Furthermore, as the complicated syndication process is omitted, this kind of bilateral setup can enable fast and reliable execution.

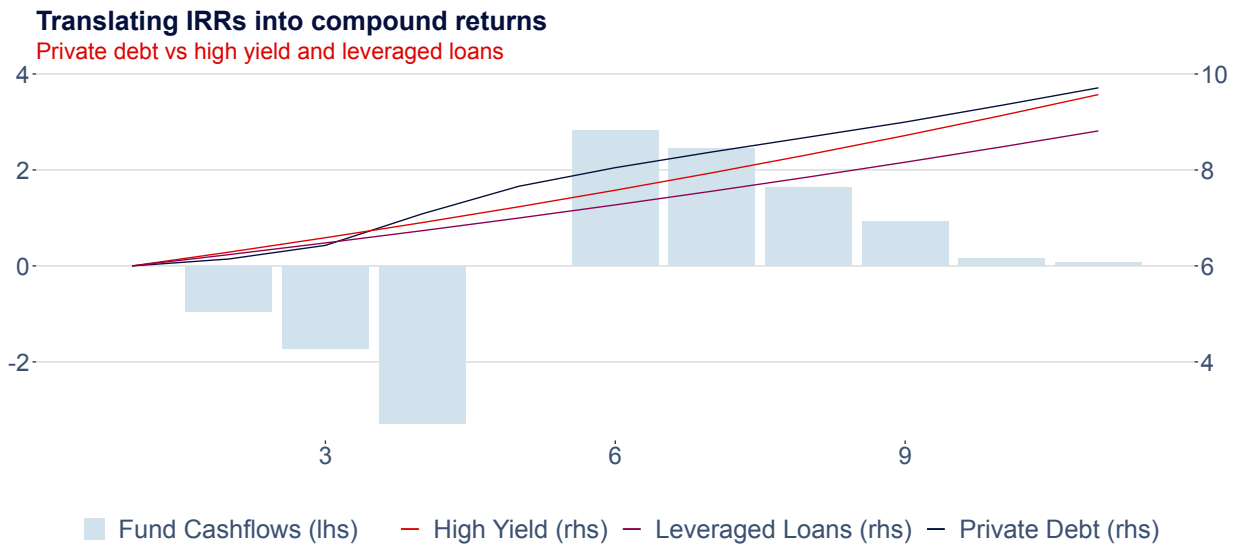
This makes direct lending the perfect source of financing for private equity sponsors seeking to obtain loans for transactions with limited holding periods and high IRR targets and who are, therefore, willing to pay a premium in return for speed of execution, flexibility and light covenants. For investors, on the other hand, private debt offers the possibility of exposure to small and medium-sized and often private equity-run companies in a comparably

less risky way. Investors in the most typical form of private debt forego the high payout promised by private equity or venture capital on exit in return for a higher position in the capital structure, regular cash flows and a predetermined maturity date.

2 Realized and expected returns in private debt

Investors usually gain access to private debt via closed-end vehicles such as alternative investment funds or so-called business development companies (BDCs). Private debt funds are similar to other private market funds and can be organised as RAIFs, for example. The BDC, on the other hand, a purely American phenomenon, must be organized under the Investment Company Act of 1940, which obligates it to get actively involved in the management and operations of certain qualifying investments. Interestingly, BDCs can be listed, offering investors a route into private debt with daily liquidity and regulatory oversight (which we nevertheless would not recommend).

Setting publicly traded BDCs aside, the transparency of the sector and the broad range of strategies that can differ significantly in terms of risk make it challenging to pigeonhole the risk and return of private debt. Even though primarily senior debt, direct lending also includes unitranche (hybrid tranche combining senior and subordinated debt into one instrument) and



Source: Bloomberg, Amadeus Capital

Figure 3: Assuming a typical private debt fund's net cashflow profile, we have constructed a bridge from IRR to compound returns assuming a relatively simple commitment strategy that overcommits by the factor 1.67x, invests cash during the investing phase into money-market instruments and reinvests into high-yield bonds (example shown in the graphic) or syndicated leveraged loans (slightly lower returns). Money market, high yield and leveraged loan returns are based on historical averages between 2007 and 2024. The IRR estimate corresponds to the median IRR of direct lending funds net of fees between 2008 and 2022 reported by Pitchbook.

mezzanine debt (subordinated debt bridging the gap between debt and equity financing). Furthermore, private debt funds and BDCs often take leverage at the fund level to seek higher returns (AQR estimates an average of 20% of NAV [1]), which results in further variation of the risk profile. Such NAV lending to private debt funds but also to private equity or secondary funds has become an asset class in private debt itself.

3 Does private debt deliver higher returns

For those who do not want to rely on the glossy presentations and the promise of top-quartile performance from private debt funds, we have taken a closer look at risk/return profile estimations for an average investment into an average strategy. Figure 2 compares two measures of broad private debt performance with the performance of liquid leveraged loans and high-yield bonds.

The **MVIS US Business Development Companies Index** (MVIS BDC Index [10]) Index tracks the performance of the most liquid business development companies listed on the stock exchange, while the **Cliffwater Direct Lending Index** summarizes the underlying performance of debt held by BDCs [3]. Unfortunately, both indices, therefore, come with important caveats. The MVIS index shows the performance of the **equity** of the companies tracked, which may be indicative of private debt performance in the long run but naturally is much more sensitive to investor expectations and

has, therefore, experienced high volatility and brutal drawdowns (-80% during the Great Financial Crisis). On the other hand, the Cliffwater Direct Lending Index is constructed based on SEC filings and evidently not investable. Generally, it assumes a pull-to-par over a 3-year horizon regardless of the actual maturity date, which may be unrealistic during times of distress when loans are extended. The (quarterly) time series looks unnaturally smooth and excludes the impact of fees, cash drag and leverage at the fund level.

While there are ETFs tracking the Leveraged Loan and High Yield Index, they, however, have a shorter history than the indices. We, therefore, calculated the average performance differential between the reference index and the ETF and adjusted the respective time series shown in Figure 2 for fees and costs. As the exact figures can vary depending on the fund chosen we simply assumed 0.5%, which is roughly in line with the annualized underperformance of the iShares iBoxx High Yield Bond ETF and the First Trust Senior Loan ETF against their respective high yield and leveraged loan benchmark index. These two time series can thus be considered a realistic representation of an investable benchmark.

In terms of their risk profile, syndicated leveraged loans and high-yield bonds seem to be relatively comparable with differences in volatility, average return and behaviour, especially since 2021, attributable primarily to the longer duration of fixed-coupon high-yield bonds (it is noteworthy, though, that credit loss rates in high yield have been slightly higher too). Over the cycle, high yield has outperformed leveraged loans by

1.3% p.a. while the MVIS BDC Index delivered a 1.09% higher performance than the fee-adjusted high yield bond series. The performance differential between the synthetic Cliffwater Direct Lending Index (5.9% p.a.) and the listed BDCs owning (some of) the loans has been 3% per year (8.9%), which probably provides a relatively accurate estimate of the costs and cash drags involved in originating and holding private loans. Notably, the universe of Cliffwater is increasingly dominated by senior loans as opposed to subordinated debt (80% today vs 40% in 2010). Unsurprisingly, it is more difficult to find proper reference data for private debt funds. Pitchbook publishes benchmark returns for a global private debt universe (avg. IRR of 8.67% between 2007 and 2022), and sub-categories like direct lending (8.3%), mezzanine (10.32%), distressed (8.4%) and venture debt (many gaps in the data) [7]. While the data is reported net of fees and carry and includes fund-level leverage, it unfortunately suffers from a very small sample size. A more comprehensive assessment of private debt fund returns was compiled by Munday et al. in 2018 and updated in 2020 based on sample cashflow data covering over 500 funds from the Burgiss database. For the period from 2007 to 2016, their analysis reports an average pooled IRR of 9.3% across all verticals, slightly higher than the 8.7% shown by Pitchbook for the same period. Interestingly, the universe covered by the Burgiss sample skews much more towards distressed (45% of committed capital) and mezzanine funds compared to the Blackrock statistic in Figure 1 or the Cliffwater index, which may also

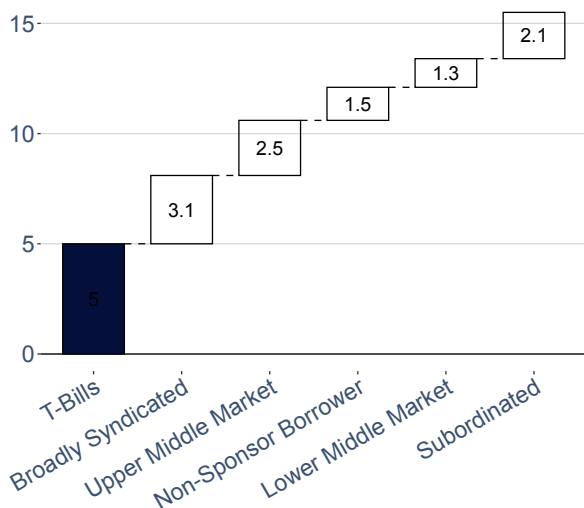
explain the higher volatility compared to the Pitchbook IRRs [7].

4 From IRR to compound return

While these IRRs are net of fees, we all know only too well that, as the saying goes, "you can't eat IRRs". By definition, the Internal Rate of Return (IRR) assumes that cashflows are reinvested at the IRR, which is a reasonable assumption when investing for instance in an ETF tracking the S&P 500. Still, it is clearly problematic in the case of closed-end funds. Calculating Public Market Equivalents (PMEs) is one way of adequately benchmarking IRRs across liquid and illiquid asset classes. Still, PME's are not exactly intuitive either and do not account for the challenges investors in private assets face in practice when making commitments to closed-end vehicles.

Figure 3 therefore shows the compounded returns resulting from an IRR of 8.3% (pitchbook), given the typical drawdown and distribution schedule of a closed-end private debt fund and a relatively simple commitment strategy that invests all cash in risk-free money market instruments until all capital has been drawn down and reinvests the proceeds in high-yield bonds (the liquid debt instrument with the next highest yield). In our example, the Private Debt Fund never deploys more than 60% of committed capital on a net basis, as distributions are naturally made early and offset some capital calls.

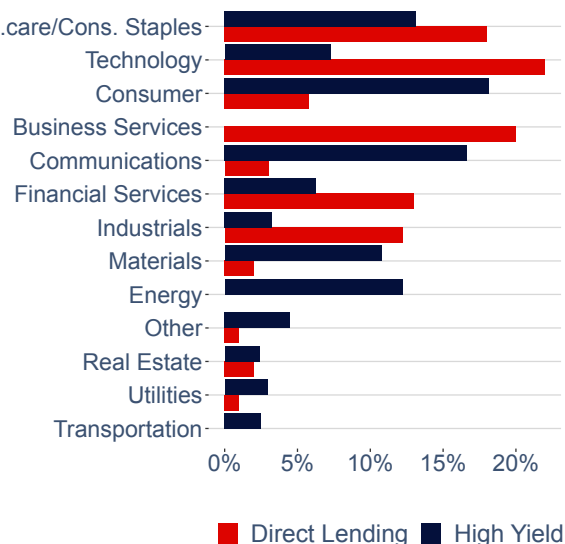
Risk premium by credit segment
in % for U.S. loans



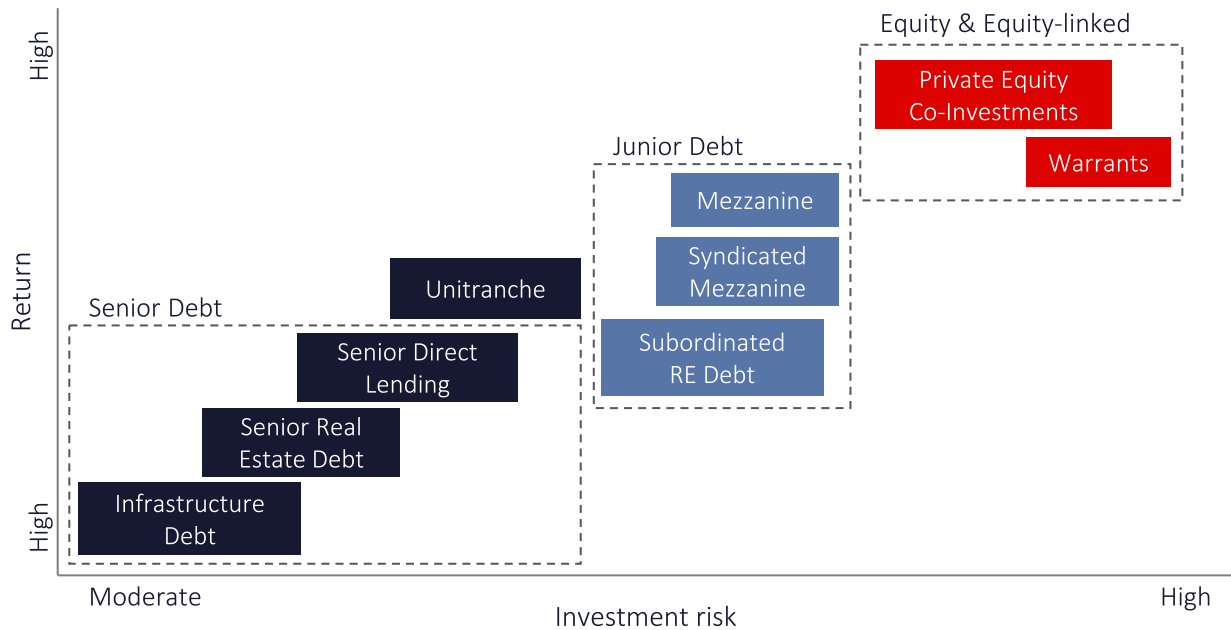
Source: Source: Cliffwater, Amadeus Capital
Figure 4: A cross-sectional regression run by Cliffwater across gross yields across loans held by business development companies suggests that borrower size, private equity sponsors' involvement, and the capital structure position are the most influential risk factors in U.S. direct lending.

Sector allocation

Cliffwater Direct Lending vs iBoxx High Yield



Source: Source: Cliffwater; iShares, Amadeus Capital
Figure 5: We have looked into the sector exposure of the iBoxx High Yield Index and compared it to that reported by the Cliffwater Direct Lending Index. As both indices use different classification systems, our comparison will not be 100% accurate, but some tendencies are obvious enough.



Source: Source: Principles for Responsible Investment [8], Amadeus Capital
Figure 6

We, therefore, assume that the investor, being aware of this, overcommits by 67% (commits 10m when 6m are supposed to be deployed). In the given example, we assume a money market rate of just over 1%, which was the historical average between 2007 and today and thus corresponds to the returns shown in Figure 2. The reinvestment into high-yield bonds is assumed to yield 4.8%. In the given example, the 8.3% net IRR would consequently yield a compound return of 5.3% per year, a roughly 50bp premium to high-yield bonds (a beta of 1.1x). This premium drops to 4.9% (1.03x high yield) under the assumption that returns were reinvested at average returns generated by the syndicated leveraged loan market. As the risk return profile of leveraged loans more closely corresponds to that of private debt this assumption may in fact make more sense.

Obviously, the relative level of risk-free short-term interest rates and reinvestment returns matters a lot in this context. In the given example, the 10-year compound return of our strategy increases to almost 6% when excess cash during the first years is invested at current 1-year and 2-year Treasury rates. Similarly, a lower gap between the assumed private debt IRR and reinvestment returns in liquid credit instruments would reduce the drag stemming from the need to invest excess cash in the closed-end scenario.

Certainly, larger investors and institutions can follow more sophisticated commitment strategies and potentially generate higher returns through more frequent reinvestments into new private debt funds or secondary market investments. In any case, it indicates that investors in private debt have historically been able to

generate slightly higher returns but should hardly expect miracles.

Another approach to deriving expected returns for the asset class has been taken by the specialists at AQR, who model private debt as high yield adjusted for the duration component and fund level leverage [1]. The resulting relative return estimate of 1.06 times the assumed return for high-yield bonds aligns with our estimate derived above.

5 Does private debt bear higher or lower risk?

Due to the industry’s rather short history and opacity, it is not exactly straightforward to analyze private debt’s historical returns or derive expected returns. Similarly, as Munday et al. put it, in 2018 with "just one full cycle and a limited number of funds, it is empirically difficult to identify precise risk characteristics". As mentioned earlier, those evidently depend on the respective sub-strategy, fund level leverage and the manager’s deal sourcing and underwriting skills and thus can’t be determined top-down. Especially the importance of the last point can’t be underscored too much. Naturally, given the overall lack of data and a continuous market, price discovery in direct lending is more prone to severe inefficiencies than public debt markets. These inefficiencies may offer opportunities but also be potentially hazardous for inexperienced investors pulled into the space by the strong boom.

For the asset class as a whole, a lot of sources point to

some paradox. On the one hand, statistics as in Figure 4 indicate that there exists a **risk premium** in direct lending; on the other hand, historical price volatility and default rates suggest **lower** risk, at least compared to high yield bonds. Naturally, we are suspicious of the smoothed time series that report substantially lower drawdowns in loan prices in direct lending compared to high yield and leveraged loans (less than 20% vs 40% during the Great Financial Crisis). Instead, we find the data on realised credit default rates much more revealing. According to Cliffwater, these have equated to 0.9% for direct SME bond lending over the last ten years. This means that they were lower than the loss rates of high-yield bonds (1.47%) and commercial and industrial bank loans (1.19%), but slightly higher than those of syndicated senior loans (0.81%). Similarly, the recovery rates for direct loans (46%) were between those of high-yield bonds (40%) and senior loans (70%).

Looking at senior direct lending only, Cliffwater sees the recovery rate at roughly the same level as for the broadly syndicated senior loans (70%). This challenges one of the assumptions often put forward by proponents of private credit, namely the theory that private credit funds or business development companies are better placed to recover value in the event of default because they have specialised restructuring teams and a turnaround is easier to structure when the complicated process of coordinating the interests of many small creditors is omitted. There is also conflicting evidence concerning the impact of sponsor-backing. Recent survey data suggests that American investors are more likely to believe that sponsored deals performed better during Covid than their European peers who see little difference [5].

A potentially more reliable mitigating factor may instead be the significantly different sector and industry exposure in direct lending (and leveraged loans [9]) compared to high-yield bonds. Lending to sponsor-backed companies naturally skews towards the industries typically hailed by private equity groups (technology, healthcare, business services, etc.) due to their low cyclicality, secular growth prospects and solid cash-generating capabilities. The Cliffwater data suggests a similar overweight among business development companies [3]. High yield, on the other hand, tends to be exposed to cyclical sectors with consumer cyclical, energy and capital goods representing over 40% of the iBoxx High Yield index today [4]. Admittedly, an exact mapping of the sector composition is complicated due to the different classification systems used, but we have tried to approximate a direct comparison in Figure 6.

6 Conclusion

In the rising interest rate environment and on the back of the general trend towards private market allocations, private debt, often equated with direct lending, has become the flavour of the day. Our article attempts to shun some light on the asset class's risk profile and the kind of returns end investors can realistically expect relative to other riskier credit investments, such as high-yield bonds and syndicated leveraged loans. Industry data and academic research suggest that the risk profile of direct lending as an asset class lies between that of syndicated leveraged loans and high yield bonds. The risk profile of direct senior loans seems to be in line with that of broadly syndicated senior loans.

Historical return patterns in private debt most closely match those of syndicated leveraged loans, which is not surprising as comparisons with high yield are distorted by the duration component (fixed vs floating coupon). All in all, we find hints that, on average, the asset class has historically been able to deliver slightly higher risk-adjusted returns after fees than the syndicated loan or high-yield bond market. Under the assumption of a typical cash flow profile and a simple commitment strategy, private debt may allow investors to generate high-yield-like returns with a leveraged loan-like risk profile. Just as in other areas of the private market universe, the long-term return premium after fees is likely to be low and a sound underwriting strategy is therefore absolutely critical.

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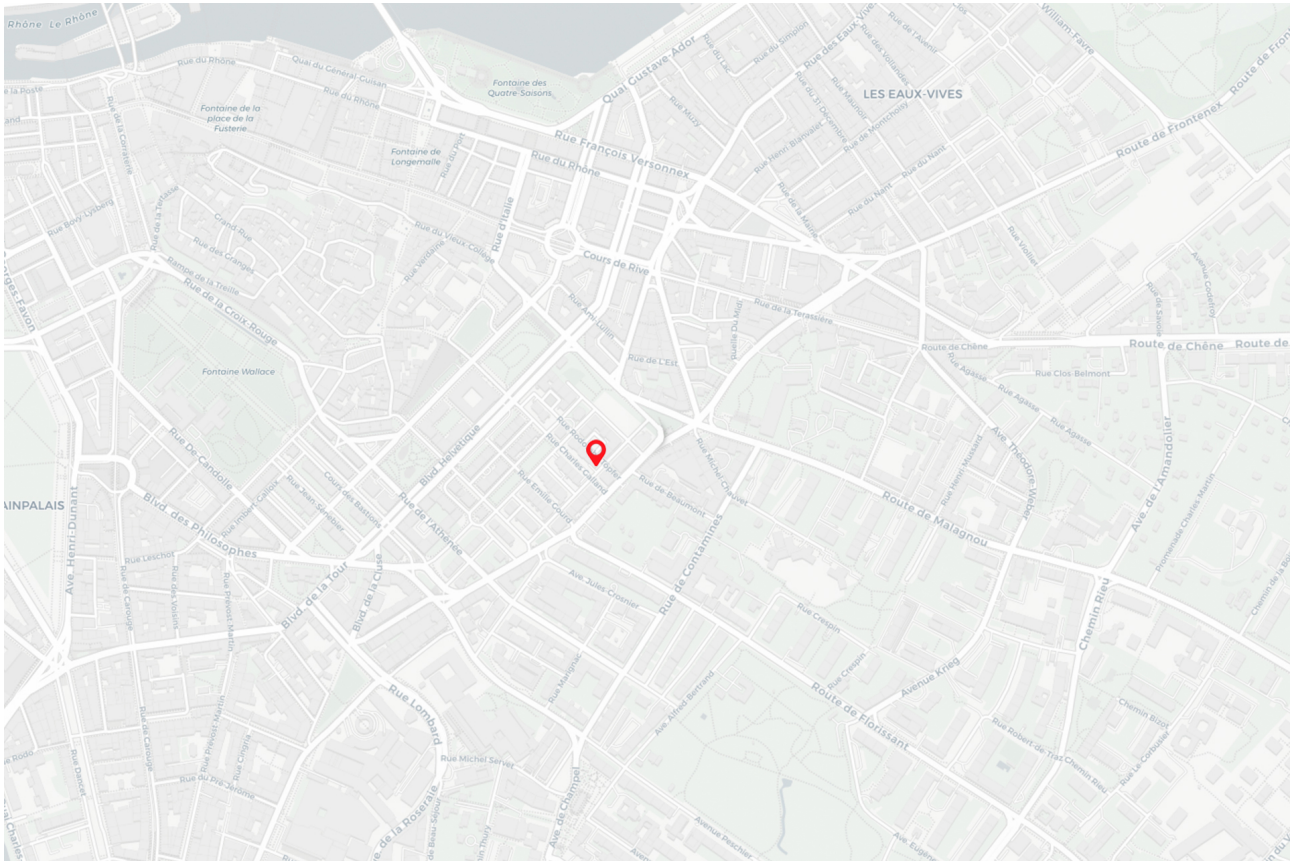
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