

Shifts in Private Debt Market, Don't Overshadow the Opportunity Set

By Noiel Brill and Colleen Longobardi

AUDAX PRIVATE DEBT

The fundamental shift in investor allocation towards private debt remains strong, driven by the gravitation of LPs to the middle market. Per the June 2024 Collier Capital survey, among those polled, more than 90% expect to increase or maintain their allocations to the asset class, outpacing all other alternative categories.

According to Preqin, the total AUM across private debt exceeds \$1.7 trillion as of December 31, 2023, while the amount of dry powder is nearly \$500 billion, up 3.5x and 2.6x respectively compared to 2015. Despite the growth, private debt AUM is still only a fifth of private equity AUM, implying substantial runway for growth. However, while there is significant dry powder in private debt, LBO volumes in 2023 and 2024 have lagged historical levels. This has driven increased competition, which has moved spreads down and leverage up, as lenders compete to win opportunities.

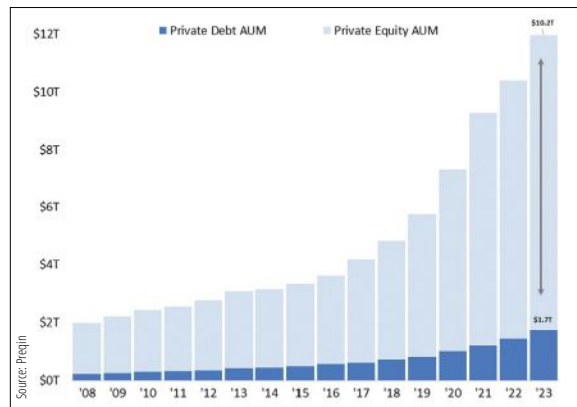
Credit Selection and Underwriting

With increased competition, ongoing inflationary pressures, and economic uncertainty, it's critical to remain disciplined in credit selection. Targeting non-cyclical industries with resilient demand drivers and borrowers with sufficient market share, niche offerings, critical expertise to facilitate pricing power, and ample free cash flow, are important credit characteristics to filter through an investment process. It's important to maintain a strong credit discipline in structuring transactions for appropriate leverage, focused on cash flow at investment and through recession or rate scenarios. Managers with broad origination market coverage and capabilities drive the ability to remain highly selective with a keen focus on credit quality through stable and challenging markets to try to ensure a viable path to a successful exit.

Portfolio Management

Credit discipline at underwriting can be strengthened by broad portfolio diversification, minimizing risk in periods of volatility, with the aim of maximizing returns and preserving capital. Portfolio construction and management entails building diversification by investment, industry, sponsor, and vintage, with careful monitoring to drive potentially attractive long-term returns.

A comprehensive management process is critical to preserving capital. An experienced team with exposure to multiple



economic cycles, coupled with a rigorous credit monitoring process, allows for an active approach that can drive early indication of trends, risks and opportunities. Maintaining a dialogue and reporting structure is critical. Supported by robust analytical tools and ongoing credit reviews, these disciplines support the goal of maximizing positive outcomes.

From a top-down portfolio analytics perspective, firms analyze portfolio and industry trends, benchmarking to peers, and assessing risk. Stress testing borrowers and portfolios can further help to identify early warning signs, including liquidity risks. Good relationships and direct communication with sponsors and management is critical with any sign of weakness or economic turbulence for an individual credit. An experienced manager with the discipline and capabilities to handle all of the above should drive long-term success.

Compelling Opportunity Set Remains

While uncertainty remains around timing of interest and economic cycles, the opportunity in private debt remains robust. Despite yields compressing, they remain high when compared to the prior 20-plus years. Private debt's outlook is positive with continued market share gains from banks, shifting investor allocation into private debt, and continued growth of private equity AUM. However, an experienced manager that deploys a credit-first culture with a disciplined approach to underwriting and portfolio management will distinguish itself from others as the landscape matures. ■

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