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Private Debt Funds: What They Are and Trends under Interest Rate Hikes

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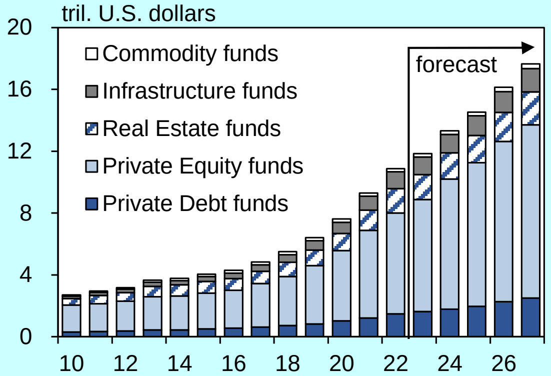
Private Debt (PD) funds are those that specialize in providing loans mainly to middle-market firms with low creditworthiness. Their assets under management (AUM) have expanded mainly in the U.S., as their borrower-investor bases have broadened, against the background of growing investment needs in the low interest rate environment and the strengthening of financial regulations after the global financial crisis. However, with the recent interest rate hikes in the U.S. and Europe, both the average time required to raise new funds and concentration in major PD funds have increased, and the amount of fundraising for new funds has declined. In Japan the market size of PD funds is extremely limited relative to the U.S. and Europe. Potential risks of PD funds include opacity due to lack of disclosed information, the interconnectedness within the financial system, the accumulation of vulnerabilities associated with rapid credit growth, and the liquidity risk of open-end funds. It is necessary to pay close attention to these developments, including their impact on the efficient allocation of resources for sustainable economic growth in the longer run.

Introduction

Private funds are those that raise capital from limited investors. Among private funds, those that invest in firms are known as Private Equity (PE) funds and those that provide loans to firms are known as Private Debt (PD) funds.[1,2] The AUM of private funds has expanded, reflecting the growing investment needs of investors seeking high yields and risk diversification in alternative assets under the prolonged low interest rate environment after the global financial crisis (GFC). This expansion is forecast to continue (Chart 1).

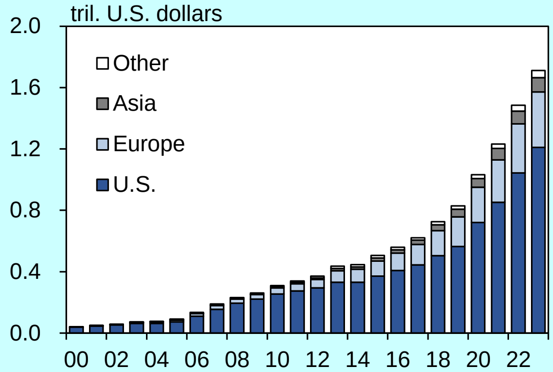
The expansion of the private fund market has been driven by PE funds so far, but in recent years, the contribution of PD funds, which provide loans mainly to middle-market firms with low creditworthiness, has increased. Although the AUM of PD funds is only about one-fifth the size of PE funds at about $1.7 trillion as of end-June 2023, their AUM has nearly quadrupled over the past decade, and their presence has grown, especially in the U.S. (Chart 2).

[Chart 1] AUM of Private Funds



Note: AUM of Commodity funds from 2022 onward are estimated by Preqin. Note that Private Equity funds exclude RMB-denominated funds.
Source: Preqin.

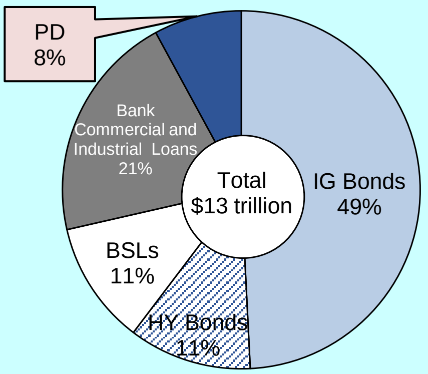
[Chart 2] AUM of PD Funds by Region



Notes: 1. The data are classified based on fund managers' location.
2. Latest data as of end-June 2023.
Source: Preqin.

Reflecting this expansion, PD now accounts for a little less than 10% of the U.S. corporate debt market, compared with about 60% for corporate bonds (sum of Investment Grade (IG) and High Yield (HY) bonds) and 30% for bank loans (sum of bilateral loans and syndicated loans) (Chart 3).

[Chart 3] Size of U.S. Corporate Debt Market



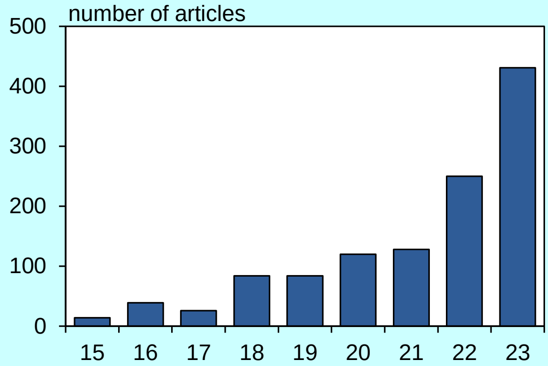
Note: As of end-March 2022.
Source: Nesbitt, S. L., 2023, *Private Debt: Yield, Safety and the Emergence of Alternative Lending*, Wiley.

PD funds have expanded against the background of growing investment needs under the prolonged low interest rate environment. In addition, the reasons behind the expansion include (i) PD funds' role as supplementing financial intermediation to firms, especially in the U.S., amid the strengthening of financial regulations on banks after the GFC, (ii) a recent broadening in borrower-investor bases, and (iii) a tightening in banks' lending standards in response to the recent rise in interest rates and the bankruptcy of U.S. regional banks.

In this connection, the market size of PD funds in Japan is extremely limited relative to the U.S. and Europe. This is because the Japanese debt market is dominated by domestic banks, and the loan interest rates are not commensurate with the PD funds' expected risk and return as they are lower than those in the U.S. and Europe.

Under these circumstances, there has recently been an increasing interest in PD funds as they have been mentioned many times by the media and featured in numerous reports by major central banks and international organizations (Chart 4). In February 2022, this BOJ Review Series also covered PD funds by focusing on the characteristics of their lending methods and performance.[3] In light of changes in the environment since then, this report focuses on recent characteristics of entities that are involved in PD funds, trends during the recent interest rate hikes, and potential risks of PD funds.

[Chart 4] Number of Articles on PD



Note: 1. Number of articles including the word "private debt" or "private credit" in headlines and bodies of newspapers, magazines, and news articles, published in English and Japanese.
2. The data was acquired on March 4, 2024.
Source: Nikkei Telecom.

What are PD Funds?

To begin with, we provide the definition of PD funds and summarize their loan schemes, the characteristics of their loan terms, and their performance.

Definition of PD funds

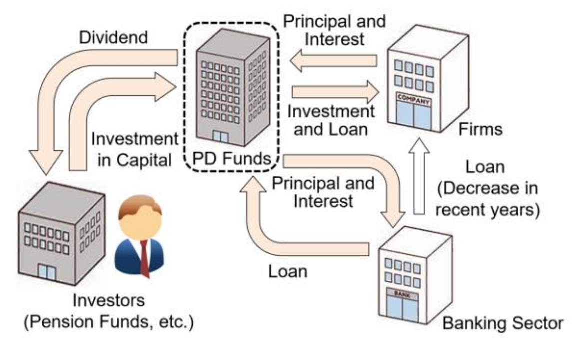
Although there is no unified definition of PD funds, they are generally regarded as "funds that specialize in loans to middle-market firms with low creditworthiness and relatively high risk, such as those with little disclosed information and no borrowing records." In this definition, "middle-market firms" means those in the U.S. and Europe, and thus their size differs from that in Japan. "Middle-market firms" in the U.S. and Europe correspond to Japanese firms that include not only middle-market firms but also some large firms. It is estimated that there are 30,000 to 60,000 middle-market firms in the U.S. and Europe, which means that there are many potential borrowers for PD funds.[4]

Loan schemes

PD funds provide corporate loans, which are financed by equity raised from investors, such as pension funds etc., and borrowing from banks, and distribute the interest to investors and banks (Chart 5).[5] PD funds also receive a part of the interest as management fees.

In addition, PD funds generally invest in deals as investors (known as General Partner, GP), being responsible for managing the fund, in order to gain investors' trust by assuming the same risks as the investors.[6]

[Chart 5] Scheme of PD Funds



Source: Created by the authors based on Kanaguchi, T., Kawakami, T., Hasebe, A., and Ogawa, Y., "The Overview and Risks of Fund Finance" (Bank of Japan Review 2023-E-5, 2023).

Typically, PD funds do not disclose much information, including details of their portfolios, the percentage of their investments as GP investors, and the status of their borrowing from banks, etc.

Characteristics of loan terms

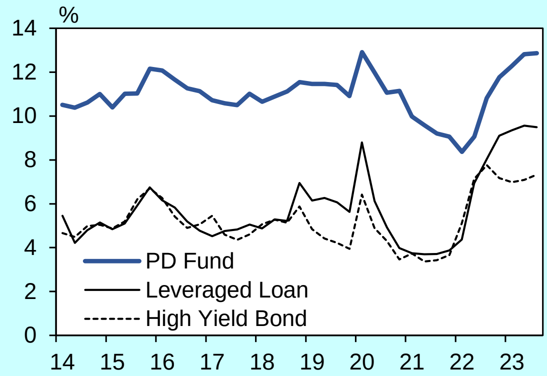
Most loans issued by PD funds are bilateral loans with floating interest rates and loan terms of 7 to 10 years. Compared with bank loans, PD fund loans have longer loan terms and higher risk of borrower firms in many cases; for this reason, PD's interest rates on loans have a wider spread.

Compared with bank loans and HY bonds, PD fund loans are characterized by low liquidity and strict covenants (Chart 6). Regarding liquidity, most PDs are closed-end, with limited cancellation by investors, and there is no secondary market and liquidity is extremely poor since PD funds are supposed to hold the loans from their issuance to redemption. Regarding covenants, PDs often set their own strong restrictions on borrower firms to reduce the default rates and increase the recovery rates in the case of default.

Performance

PD funds are not traded in financial markets, making them less susceptible to market fluctuations than other debt assets, and have so far delivered consistently stable and high returns (Chart 7). In addition, PD funds have benefited from the recent rise in interest rates in the U.S. and Europe with higher returns because their loan rates are floating. The high performance of PD funds is one of the reasons for the expansion of their market size. However, it should be noted that the sample period of this return is limited, and the return reflects the high risks of the borrowers and compensation for the investor's provision of funds for a long period of time.

[Chart 7] Performance of PD Funds



Notes: 1. The data of "PD Fund" indicate performance in the Cliffwater Direct Lending Index (CDLI).
2. Latest data as of end-September 2023.
Sources: S&P Global; Cliffwater Direct Lending Index.

Characteristics of Fund Managers, Borrowers, and Investors

Next, we overview the characteristics of and the recent changes in the entities that are involved in PD funds, i.e., fund managers, borrowers, and investors.

Fund managers

Many of the PD fund managers are major U.S. funds that also operate PE funds and Real Estate funds. Some of these fund managers have strived to expand PD funds, as they can expect stable and high returns even under interest rate hikes. This shift is partly due to the decline in the performance of PE funds, which used to generate high returns, against the backdrop of high interest rates in recent years.

[Chart 6] Characteristics of PD

	PD	Bank Loan	HY Bond
Lending Form	**Bilateral Loan**	Bilateral or Syndicated Loan	Corporate Bond
Interest Rate	**Floating Rate**	Floating or Fixed Rate	Fixed Rate
Liquidity	**Extremely Low (Hold to Maturity)**	Middle	High
Loan Term	**approx. 7-10 years**	approx. 1-7 years	approx. 1-10 years
Covenants	**Strong Restrictions**	Weak Restrictions	No
Collateral	**Yes**	Yes	No

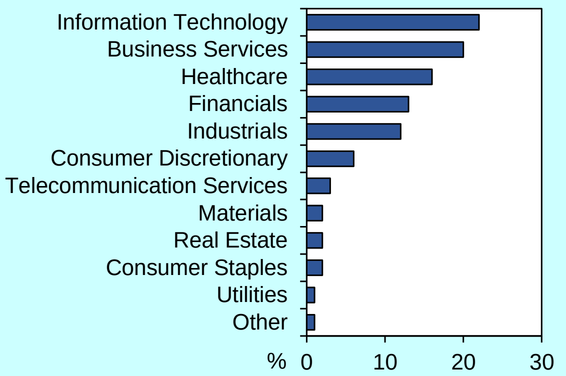
Source: Created by the authors based on Mitsubishi UFJ Trust and Banking Corporation, etc.

Borrowers

Many borrowers rely on PD funds either because they have difficulty in borrowing from banks due to opacity resulting from lack of disclosed information or sluggish business conditions, or because they are sponsored by PE funds and are introduced to PD funds.[7]

Borrowers of PD funds by industry show that they are mostly in the information technology, business services (law firms, IT consulting services, etc.), and healthcare industries (Chart 8). It appears that firms in these industries find it relatively difficult to obtain loans from banks due to the peculiarity and uniqueness of their businesses.

[Chart 8] Borrowers of PD Funds

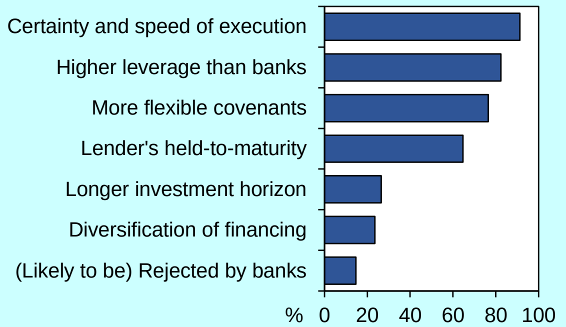


Note: Breakdown by industry for 14,000 loans recorded in the Cliffwater Direct Lending Index (CDLI) as of end-September 2023.

Source: Cliffwater Direct Lending Index.

For borrowers, despite interest rates on PD loans being higher than those of bank loans, the advantages of using PD funds include the short loan-approval period, fast and reliable financing, and flexibility to provide large credit facilities and long-term loans that would be difficult under banking regulations (Chart 9).

[Chart 9] Why Firms Choose PD Funds



Note: The data are based on the survey for PD funds conducted by the University of Chicago.

Source: Becker Friedman Institute.

Recently, the range of borrowers has expanded as some large firms have chosen major PD funds as a new source of financing, while banks have tightened their lending standards in response to the recent rise in interest rates.

Investors

Institutional investors such as pension funds and asset management firms, which can make long-term investments, account for nearly 90% of the investors in PD funds. The main reasons for investing in PD funds are portfolio diversification and stable income gain.[8]

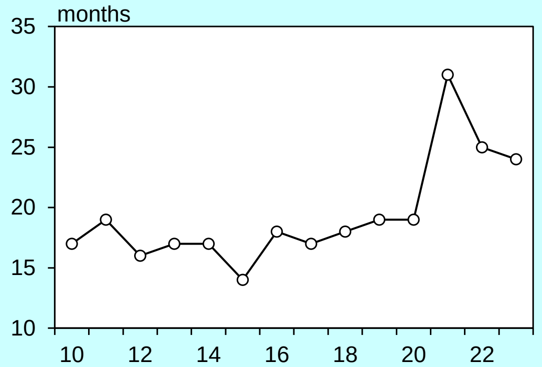
Recently, the range of investors has broadened as major funds have targeted individual investors, mainly high-net-worth investors, by launching open-end private fund products that accept monthly or quarterly purchases and cancellations to facilitate investments from individuals.[9]

Trends under Interest Rate Hikes

Given the overview of PD funds and the characteristics of related entities provided above, in the following, we point out some notable trends of PD funds during the recent interest rate hikes in the U.S. and Europe.

First, the impact of rising interest rates has been seen as an increase in the fundraising period for new funds during which investors are invited to invest in (Chart 10). With the present value of acquired companies declining due to higher discount rates, the M&A market has been sluggish, and the exit of investment capital through company sales has been delayed in buyout deals. Similar developments have been observed not only in PE funds but also in PD funds that have financed deals undertaken by PE funds. Since investors usually use the return from previous investments for next deals, the sluggish flow of funds between investors and fund managers has made it difficult for PD funds to attract new investments.

[Chart 10] Average Period to Final Close

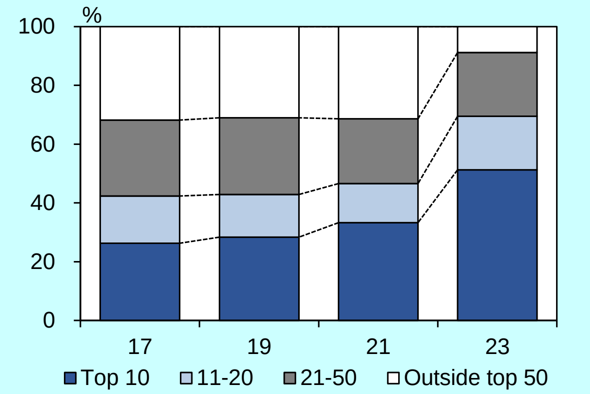


Note: "Final Close" is the timing when the last investors commit to making their investments.

Source: Preqin.

In addition, under interest rate hikes, investment capital has been concentrated in large funds with strong investment performance, making it difficult for non-major funds to attract investment capital (Chart 11). As a result, the size of newly established funds has increased significantly.

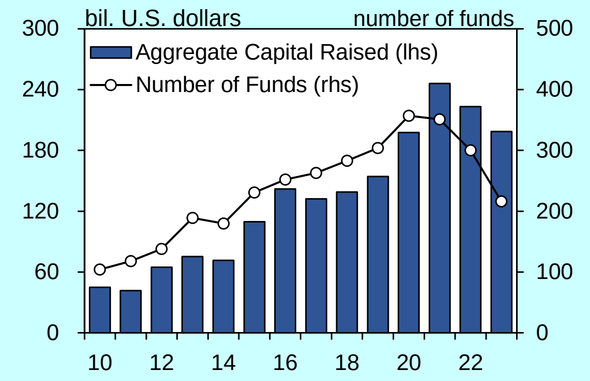
[Chart 11] Distribution of Fundraising by Size



Note: The data are based on the ranking of PD fund managers by annual fundraising amount.
Source: Preqin.

Reflecting these trends, although the AUM of PD funds has continued to expand as noted at the beginning of this report, the aggregate capital raised and the number of newly established funds, which represent additional capital inflows (fundraising), have been on a downward trend in recent years (Chart 12).

[Chart 12] Fundraising of PD Funds



Source: Preqin.

Potential Risks of PD Funds

Finally, we consider the potential risks of PD funds.

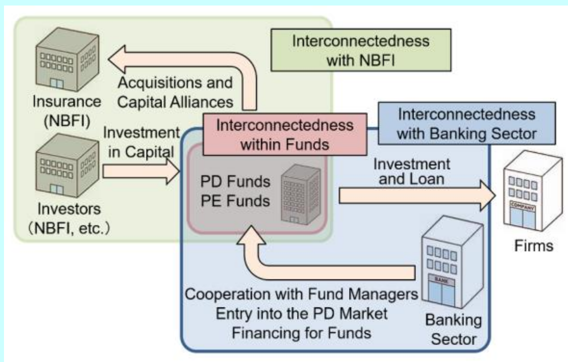
The risk of capital outflows (fund liquidity risk) due to large premature cancellations by investors appears to be low since PD funds are predominantly closed-end funds. In addition, PD funds have so far typically used little leverage. Given these observations, there is a view that the impact of PD funds on the financial system would be limited.

Recently, however, the potential risks of PD funds have been pointed out, and there has been a gradual awareness of the heightened risk surrounding PD funds. Specifically, such risks include (i) opacity due to lack of disclosed information, (ii) the interconnectedness within the financial system, (iii) the accumulation of vulnerabilities associated with rapid credit growth, and (iv) the liquidity risk of open-end funds.

Regarding (i), as already mentioned, there is little disclosed information on PD funds. The lack of comprehensive data on PD funds raises concerns that it is hard to grasp their investment situations and the risks inherent in the assets held.

Regarding (ii), PD funds are highly interconnected with PE funds, which share the same objectives in investment and financing, and with non-bank financial intermediaries (NBFIs) such as institutional investors. In addition, in recent years, more and more U.S. and European banks have entered the PD market in collaboration with private fund firms, and some Japanese banks have actively engaged in fund finance. Thus, the interconnectedness between PD funds and the banking sector has also increased. Should the performance of PD funds deteriorate due to recessions for example, the financial system could come under stress through a sharp decline in capital inflows to funds, rebalancing by NBFIs, and the deterioration of fund finance by the banking sector (Chart 13).

[Chart 13] Interconnectedness of PD Funds



Regarding (iii), history shows that vulnerabilities tend to accumulate during periods of rapid expansion of credit, resulting in many financial crises. Many PD funds that grew rapidly after the GFC are considered to have little experience in managing risks in recessions, such as debt collection. Close attention should be paid to: whether PD funds will further expand the market size and rapidly increase the growth of private-sector credit as a whole, accompanied by intensified lending competition and a loosening of lending standards; and whether a rapid shift to PD funds will occur in the debt market when firms refinance their existing low-interest bank loans.

Regarding (iv), so far, the ratio of open-end funds to the total PD funds does not appear to be high, but in recent years, some major funds have started to launch open-end funds to seek stable income under long-term management. Therefore, the liquidity risk of such funds should be kept in mind.[10]

Concluding Remarks

This paper has provided an overview of PD funds, focusing on their recent characteristics by related entity, trends during the recent interest rate hikes, and potential risks of PD funds. The market size for PD funds has expanded against the backdrop of more active management policies by fund managers, a broadening in the range of investors and borrowers, and tighter lending standards among financial institutions under strengthened financial regulations and interest rate hikes, and it is forecast to continue growing.

With the recent interest rate hikes in the U.S. and Europe, PD funds with stable and high returns have been an attractive option for investors. However, with the high interest rate environment continuing, both the average time required to raise new funds and concentration in major PD funds have increased, and the amount of fundraising for new funds has declined.

The potential risks of PD funds, such as opacity due to lack of disclosed information, the interconnectedness within the financial system, the accumulation of vulnerabilities associated with rapid credit growth, and the liquidity risk of open-end funds, have been pointed out, and there has been a gradual awareness of the heightened risk surrounding PD funds.

In addition to these potential risks, close attention should be paid to whether financial intermediation activities by PD funds will contribute to the efficient allocation of resources for sustainable economic growth from a long-term perspective, including their impact on borrower firms' business operations as well as capital and R&D investment.

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[1] PE funds is a generic term for funds that invest mainly in the shares of unlisted companies. For an overview of PE funds, see Watanabe, K., Igarashi, K., and Inaba, H., "The recent growing momentum of private equity funds" (Bank of Japan Review 2018-E-1, 2018).

[2] Private Debt and Private Credit are often used synonymously, as in this report. In some cases, while Private Credit is used in a broad sense, Private Debt is used in a narrow sense.

[3] This report is available only in Japanese.

[4] This is based on the estimation by Campbell Lutyens.

[5] In general, borrowing from banks often takes the form of a revolving credit facility (RCF), which allows funds to freely draw down and repay their loans within a certain period and limit.

[6] General Partner (GP) is the managing partner who has unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management. GP contribution to the fund is generally at least 1% of the fund's total value.

[7] Direct lending, the main strategy of PD funds, has two types of deals: sponsored deals, in which debt is provided to firms owned by the PE fund, and non-sponsored deals, in which PE funds are not involved.

[8] According to a survey conducted by Preqin as of 2022, the investor share of PD funds is as follows: Pension funds (30%), Asset managers and Family offices (27%), Endowments and University funds (21%), Insurance companies (8%), Banks and Investment banks (5%), and Others (8%).

[9] Open-end fund is a fund that allows investors to withdraw funds (cancellation) or make additional investments at regular intervals, such as monthly or quarterly, and has no redemption period.

[10] Of the 56 PD funds surveyed by the Alternative Investment Management Association, open-end funds accounted for 16%. The market share of these 56 PD funds accounted for approximately 60% of the market.

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