Private Debt Study
Summary

(To the whole Study)

Corporate private debt has experienced a significant upswing in the portfolios of German institutional investors. However, in the wake of high inflation and rising interest rates since 2022, there have been shifts in the financial markets that have also affected corporate private debt. To understand these effects, BAI surveyed 109 German institutional investors about planned changes to their corporate private debt allocation and market sentiment. In additional expert interviews, the sell-side also has its say. Asset managers and consultants provide an overview of the opportunities and challenges of corporate private debt in the current market environment.

According to the latest data from the “BAI Investor Survey”, corporate private debt continues to be an important component in the portfolios of institutional investors in Germany. The BAI Alternative Investments Sentiment Barometer underlines that corporate private debt currently offers good opportunities for investors. Private debt is considered to be one of the most attractive alternative asset classes. Compared to the previous year, the share of allocating investors grew from 56% to 66%. **An additional 9% of the investors surveyed plan to enter the asset class in the next few years.**

Momentum in the market also continues to increase among investors already allocating, **with 56% planning to further increase their allocation, 48% last year, as long-term positive drivers are still seen intact.** The current market environment for corporate private debt is also perceived as very attractive by most asset managers. For example, the asset class is benefiting directly from rising interest rates and therefore has historically attractive yield levels for investors. Furthermore, it can be observed that banks are withdrawing from financing the SME sector, which opens up new investment opportunities for private debt investors. The gradual withdrawal of banks from the leveraged loan business, as well as the slowdown in high-yield bond issuance, reinforce this trend. Asset managers perceive rising bond yields as a challenge for the asset class.

Despite interesting investment opportunities in bonds, they do not see traditional fixed income as a significant competitor for corporate private debt. One reason given by asset managers for this is that the liquid market currently cannot be regarded as liquid. In addition, the yield pick-up from private debt to fixed-income debt is greater than it has been for a long time. Also, the advantage of bonds over private debt only applies to nominal yield targets, but not to real ones. In order to compensate for inflation-related real yield losses, investors must continue to rely on alternative risk premiums.

According to the unanimous opinion of the asset managers interviewed, the currently very attractive corporate private debt yields play a decisive role. However, it can be seen as a challenge that some investors have not yet adjusted their nominal return targets to the increased interest rate and inflation level.

At present, the denominator effect is only mentioned by 26% of investors still as a challenge. Due to (regulatory) mechanisms, this can lead to investors possibly not being able to benefit sufficiently from attractive opportunities. However, the effect tends to be only short-term. In addition, the stability of the asset class, which also triggers the denominator effect, is a major advantage for institutional investors, especially in the current volatile market phase.

Increasing default risks due to the current heightened economic risks represent a further potential challenge.

Accordingly, the focus in the lending business is on protection against default risks. This involves a thorough due diligence of the business model, the financial health and the future earnings power of the company, with the involvement of consultants and auditors, as well as determining the appropriate loan amount for the company in question, ideally with a substantial equity buffer. Consequently, the capital structure of borrowing companies plays a crucial role. Likewise, the focus of asset managers in containing default risks is on various protective mechanisms in the contractual framework, including so-called covenants.

Other topics considered include trends regarding subasset classes and industries. Following the opinions of the interviewed asset managers, senior direct lending can be seen as the winner of the current environment. This private debt segment is benefiting from the withdrawal of banks and increasing demand for financing. In addition, margins are widening. Furthermore, in the current volatile market environment, with distortions in the capital market, some managers see the time for opportunistic credit strategies and hybrid capital strategies as having come, with mezzanine strategies being described as more challenging.

In contrast, there is no consensus among the asset managers surveyed, which market segments are currently benefiting the most. Various arguments are put forward in favor of the lower mid-market, upper mid-market and the large-cap segment. We can draw the conclusion that an exposure to all three markets is still appropriate, especially from a diversification and market opportunity perspective. In terms of different industries for private debt, the focus of the asset managers surveyed currently tends to be on defensive industries.