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# Private Credit Outlook

## J.P. Morgan Alternative Credit Solutions

Authors

**Brian Coleman**
Head of Private Credit
J.P. Morgan Alternative Credit Solutions

**Andrew Carter**
Head of Private Credit Secondaries
J.P. Morgan Alternative Credit Solutions

**Lyn Ngooi**
Investment Specialist
Hedge Fund and Alternative Credit Solutions

**James Williams**
Investment Specialist
Hedge Fund and Alternative Credit Solutions

**Michael Vida**
Investment Specialist
Hedge Fund and Alternative Credit Solutions

Contributors

**Jamie Kramer**
Head of Alternatives Solutions, Hedge Fund and Alternative Credit Solutions

**In brief**

Private credit has been a major beneficiary of the fastest rate hikes in decades, an unexpectedly resilient economy and limited default activity. So despite an inflationary and uncertain growth environment, private credit fundraising has done well as investors can see better relative value compared to private equity and public credit. In sharp contrast to the decades prior, private credit investors have been able to make equity-like returns with credit-like safety.

With inflation normalizing in many parts of the world and the latest Fed meeting signaling that rate cuts are imminent – could this all reverse?

No, and in fact, we think that private credit will remain one of the most attractive investments for 2024.

Firstly, there are many reasons why rates should stay moderately high for longer, including long-term mega trends such as deglobalization and decarbonization. In the intermediate term, it is simply too early to call an end to inflation knowing that geopolitics can disrupt global supply chains overnight.

The demand-supply dynamic in credit has shifted structurally in favor of private lenders. To conserve regulatory capital (in anticipation of the updated global Basel III), banks have and will continue to be stringent on new loans and refinancings -- and are less borrower-friendly overall.

Reduced capital availability is obvious across sectors, allowing private funds to step in and originate new loans or buy loans off banks; and in some cases to go “up market” to better and larger borrowers.

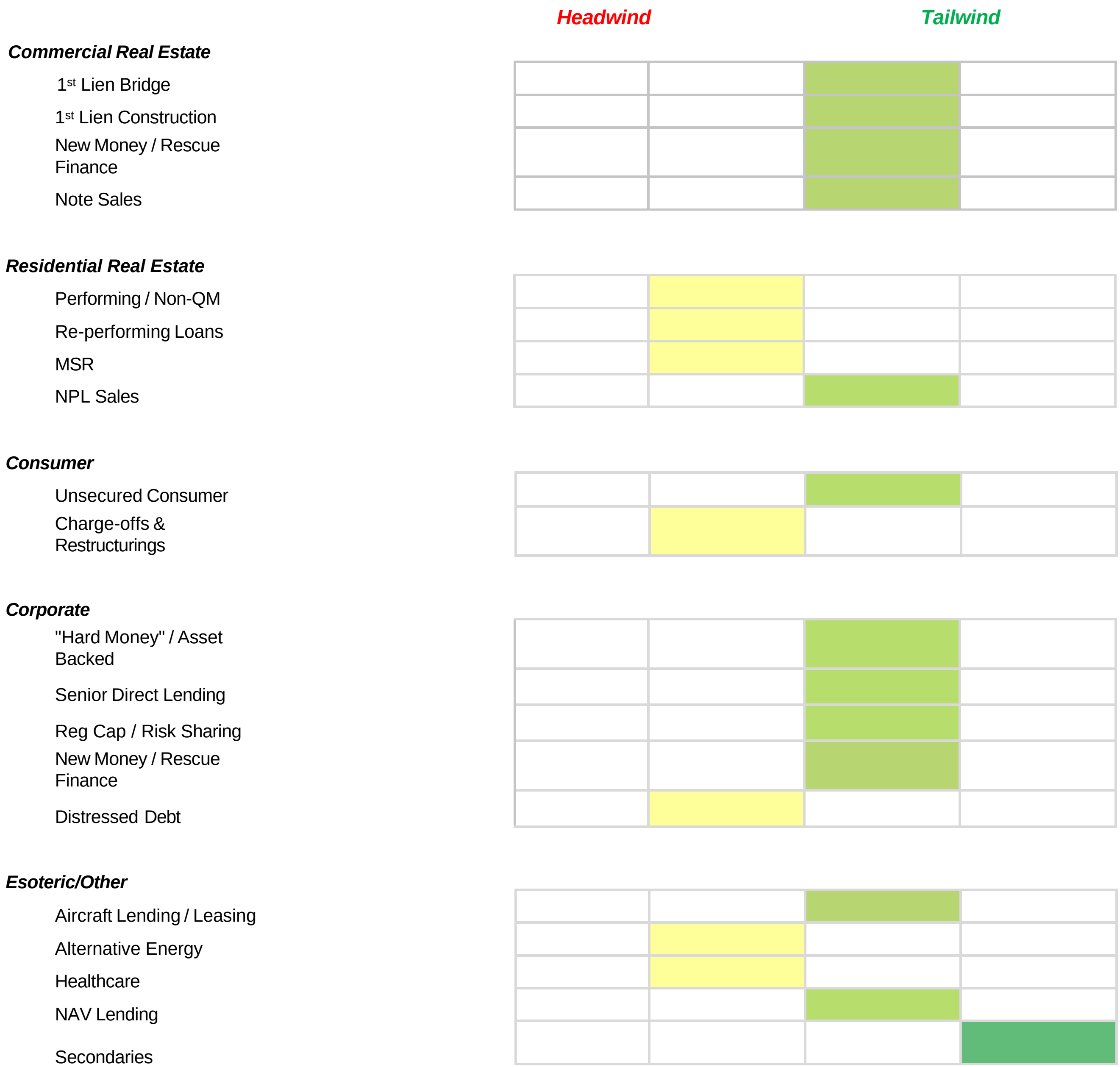
As a result, many private funds have been able to achieve higher returns with stronger protective covenants as compared to the pre-COVID era.

Outside of commercial real estate, lenders and borrowers have navigated a tumultuous 2023 rather well and portfolio valuations have proven resilient.

In 2024, we expect institutional capital to flow into private credit at a strong pace. Competition for deals is growing and spreads in some segments will narrow further. Like others, we are very optimistic about this vintage, but our experience tells us that the more optimistic the market is, the more important it is to be selective and proactive.

## Strategy Heatmap

The strategy heatmap is integral to our portfolio construction process. It guides our portfolio allocations and represents our conviction in different strategies over the year.

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## Corporate Direct Lending

Comprising more than half of the total $2tn private credit universe, allocations to corporate direct lending from pensions and insurers globally are projected to increase further, and new and/or bigger funds are coming to market. That said, we expect demand for such private capital to remain robust.

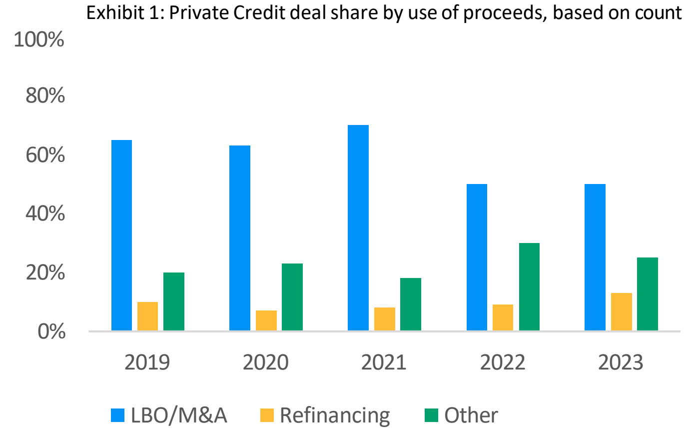
When LBO activity was more muted in 2023, borrowers were turning to private credit funds to refinance their debt. A gradual recovery of LBO / M&A deal volumes (which started in 3Q '23 as markets became more convinced of a soft landing) spells new lending opportunities for private credit funds. On a risk adjusted basis, we continue to like sponsored direct lending focused on senior secured first lien loans. Over the years, we have seen sponsors step in to write equity checks and offer strategic support to help their portfolio companies get back on their feet which ultimately protects loan principal. While we expect debt coverage ratios to improve as inflation and rates ease, downside protection is always on our minds especially given the complex macro environment.

Private credit has grown in part by taking share from the leveraged loan market, e.g. to fund LBOs. Over the next several years, we also expect to see a share of the refinancing activity in leveraged loans to go to private credit fund managers. According to LCD, the 2025-2026 maturity wall is roughly $277 billion,[1] with $96 billion of that due in 2025 and $181 billion in 2026.

According to the Proskauer Private Credit Default Index for senior-secured and unitranche loans, overall default rates were 1.41% for the third quarter of 2023. However, we have seen elevated loan amendment and modification activity since the sharp rise in interest rates. Based on a back of the envelope estimate from our portfolios, we estimate that roughly 10-15% of all private loans have had an amendment of some kind in the last year as lenders show flexibility towards borrowers in a high-rate environment.

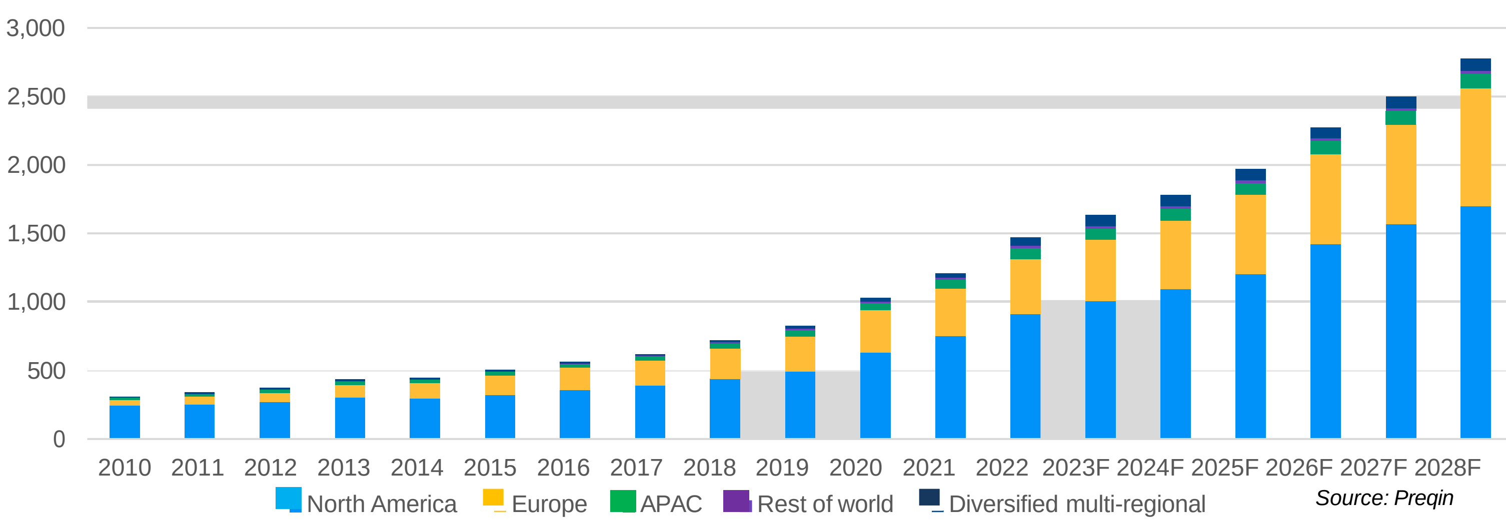
Looking ahead, we expect to see lenders continue to benefit from capital-scarce conditions to make loans on attractive terms. Compared to 3 years ago for example, 2023 loan originations were done at spreads that were 100-150bps wider, Debt to EBITDA levels 50% lower and LTVs that were 10-15 percentage points lower.

Exhibit 1: Private Credit deal share by use of proceeds, based on count




*Source: PitchBook | LCD, November 2023*[2]

Exhibit 2: Private Debt assets set to hit all-time highs




*Source: Preqin*

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## Private Credit Secondaries

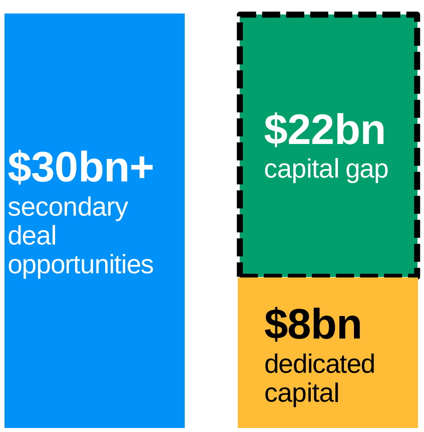
Secondary opportunities across the private credit spectrum remain strong with average discounts steadily in the mid-teens over the past 18 months. These discounts are a function of the consistent shortage in capital available to absorb deals in the market. In Q4 2023 there were over $6bn in deals coming to market and volumes in Q1 2024 look potentially as strong.

A significant part of deal flow over the past 6 months has been due to the slow-down in the primary markets – as refinancings (via M&A or the capital markets) has slowed, both GP's and LPs have searched for liquidity alternatives via the secondary market. We think this trend will ease going into the second half of 2024, though as it does, we expect cash flow generation to meaningfully pick-up on seasoned portfolios in the coming months, leading to higher IRRs on secondary transactions.

On the underlying assets, several tailwinds exist with yields being higher than historical averages. Markets are expecting a pause in rate hikes and more than likely several cuts, this reduces our default expectations in the near-term are beginning to decrease as much of the default activity to date has been due to high interest expense burdens.

We are especially excited about the opportunities here as unlike other markets, a large portion of secondaries deal flow is proprietorially sourced, which gives buyers with primary relationships like ourselves distinct advantages

*Liquidity providers to the market have not kept pace with the supply of actionable secondary deal opportunities*



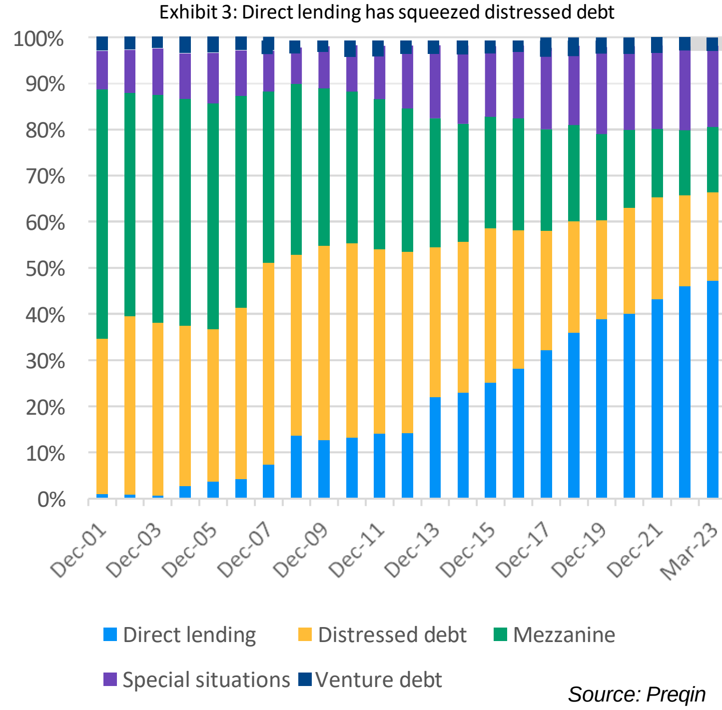

Source: JPMAAM

## Corporate Distressed Debt

With a slowing economy and a high cost of debt, we expect to see further credit deterioration in 2024. Widespread corporate distress looks very unlikely but diminished interest coverage across the board points to more opportunities, especially in lower quality companies. The lending pull back by US regional banks after deposit outflows and mark to market losses on assets in 2023 could also mean that the pain is unevenly borne by smaller, lower-middle market companies.

Defaults in senior secured and unitranche private credit have been low and fell in Q2 and Q3 of 2023[3]. In the public markets however, defaults are above historical averages, and S&P Global[4] forecasts that speculative-grade default rates will reach 5% and 3.75% in the U.S. and Europe respectively. We expect some of the defaults to come from the leveraged loan market, where around half of the 2025 maturity wall is from issuers with a B-minus rating. Tight credit conditions and elevated rates mean that some lenders will simply be unable to "amend and extend" and some borrowers will have to default on their obligations.

Exhibit 3: Direct lending has squeezed distressed debt




Source: Preqin

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## Commercial Real Estate Debt

The relatively high levels of leverage required in real estate has made it the biggest loser in the rising rate regime. Office has been the most publicly challenged given the seemingly permanent shift to hybrid work-from-home, but activity in the whole sector has suffered from limited liquidity and deal flow. In such an environment, investors willing to provide “rescue capital” to struggling property owners may be able to get very favorable terms and thus attractive returns.

There are two key issues facing CRE today. Firstly, compared to pre-2022, the cost of real estate financing is now 3-4x higher - from a 2-3% cost of financing to 9% for the highest quality assets.

Secondly, post COVID tenant demands have fundamentally changed, and some of the existing property stock has simply become obsolete. This transition is hard to quantify but the flight to quality and towards new builds, should continue to accelerate in 2024.

On the supply side, capital is simply less available - traditional lenders are “limit long” commercial real estate (e.g. banks own some 45% of outstanding office debt[5]). The credit crunch is made worse by the hundreds of millions in existing loans that come due in 2024/ 2025.

While we expect some “pretend and extend” behavior from existing lenders, this happens less often in a high-rate environment. There will consequently be a lot of pressure on the system and an opportunity for private credit managers to close the debt funding gap.

This is potentially a good entry point for investors. The combination of higher rates and lower leverage levels, against an asset that has already fallen in value means better safety margins and likely, an attractive absolute level of returns. At the same time, in a more stable rate environment, buyer interest (and valuations) should recover, at least in areas like industrial and multifamily where one can point to relatively strong fundamentals.

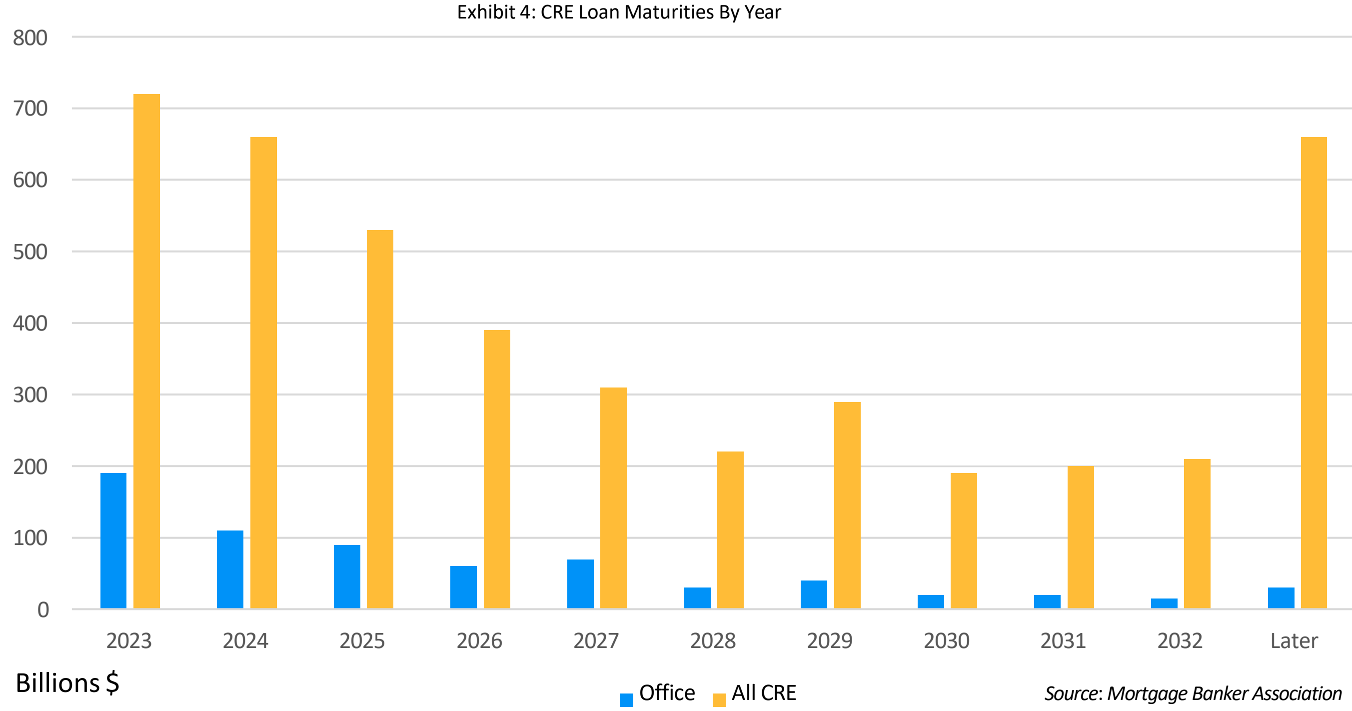
## Residential Real Estate Debt

Residential real estate generally looks attractive considering the overall health of the consumer and the demand supply dynamics of housing. In a high rate environment, we do not see the need to rely on strategies employing an aggregate and securitize model.

We continue to spend most of our time here in “scratch and dent” loans – these are lower coupon performing loans that are acquired at a reasonably large discount to par. They are conforming loans delivered to Fannie Mae and Freddie Mac, where a minor underwriting problem was later discovered meaning that the originators must buy these back (and are thus very motivated sellers).

We also like business purpose residential loans which is typically a form of bridge lending to builders, because of their shorter duration, high coupon and floating rate nature. In that space, however, it is important to be selective.

Exhibit 4: CRE Loan Maturities By Year




*Source: Mortgage Banker Association*

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## Consumer & Small Business Credit

Very selectively, we find compelling opportunities in consumer and small business credit. The dearth of capital combined with the ability to structure protections into deals means that investors can get paid very well for the risks they are taking.

After a very robust 2023, there are some signs of deterioration in U.S. consumer balance sheets including increasing credit card delinquencies. In contrast, consumers in Europe saw real disposable incomes increase in 2023, and sport both excess pandemic savings and reasonably solid household finances.

Lenders in both the US and Europe are being cautious and capital has dried up for many consumer lenders. Private capital providers are thus able to dictate terms – lowering LTVs, reducing concentration limits, increasing cash diversion features and tightening performance triggers – to create considerable downside protection through structuring.

## Other - Clean Energy / Healthcare / Aviation

We have held a positive view on **Clean Energy** for the last several years given the strong structural tail winds. Today, it is important to be highly selective due to more competition and higher costs.

In Europe, we expect declining energy prices, higher costs, and higher rates to put pressure on renewable equities which will in turn create opportunities for custom debt solution providers to step in.

We also expect the demand for battery storage assets alongside wind and solar energy, to be a driver of new renewable energy loans.

In **Healthcare,** the dislocation in equity markets, especially in the biotech space, has created the opportunity for specialized lenders to step in. The lack of equity capital has been broad based, allowing lenders to move up-market in new origination and to focus on borrowers that have a clear pathway to cash flow profitability over the short term.

Much like in healthcare, muted capital markets activity creates an opportunity in **Aviation**. Banks are retreating just as post COVID demand for travel is soaring past pre-pandemic levels. E.g., The International Air Transport Association (IATA) forecassts that 2024 will see 4.7 billion people travel. Our favorable view on the space is reinforced by the fact that aircraft valuations or collateral values, remain well supported given the under supply in the market.

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