

# Private debt misconceptions

SEPTEMBER 2024

# Introduction

Although private debt first emerged as an asset class in the 1990s, it did not gain momentum until after the Global Financial Crisis (GFC) at which point it began capturing market share from traditional banks and public markets. Initially regarded as a return enhancer for fixed-income portfolios in low interest rate environments, private debt has since evolved into a core component of institutional portfolios.

However, as more capital flows into private debt, some worry that its growing popularity might be masking risks that could destabilize the broader economy. These concerns largely stem from the perceived opacity associated with private markets. While that is true, private debt has become more transparent: Business development companies (BDCs) and interval funds now offer regular reporting on holdings and performance.

The rise of private debt is the result of an organic growth fueled by private lenders capitalizing on favorable market conditions. Unlike traditional banks, which have historically been the primary financing sources for middle-market companies, private debt funds are generally less vulnerable to market fluctuations. As a result, they do not pose the same level of systemic risk to the economy.

In this white paper, we explore five misconceptions often brought up when discussing private debt's rise. By doing so, we highlight private debt's potential as a valuable addition to traditional portfolios and the broader economy.

# Misconception 1: Private debt grew too much too quickly

## Which factors led to the private debt market growth?

### BANK DISINTERMEDIATION

Among other things, the GFC revealed deficiencies in the established Basel regulations. In particular, it exposed their inability to prevent banks from amassing excessive leverage as well as insufficient liquidity buffers.

In response, Basel III imposed more stringent capital requirements, which necessitated higher capital reserves for “riskier” loans such as private loans. It also established new liquidity ratios to ensure banks could withstand liquidity stress. This prompted banks to reorganize their balance sheets toward less risky and more liquid assets to avoid higher capital charges. Finally, Basel III implemented a leverage ratio to curb excessive leverage in the banking sector. These changes collectively limited banks’ capacity to extend loans as freely as they once had.

Ultimately, the new Basel Framework made banks more financially stable. But the retrenchment in private lending left a void, which private debt managers happily filled.

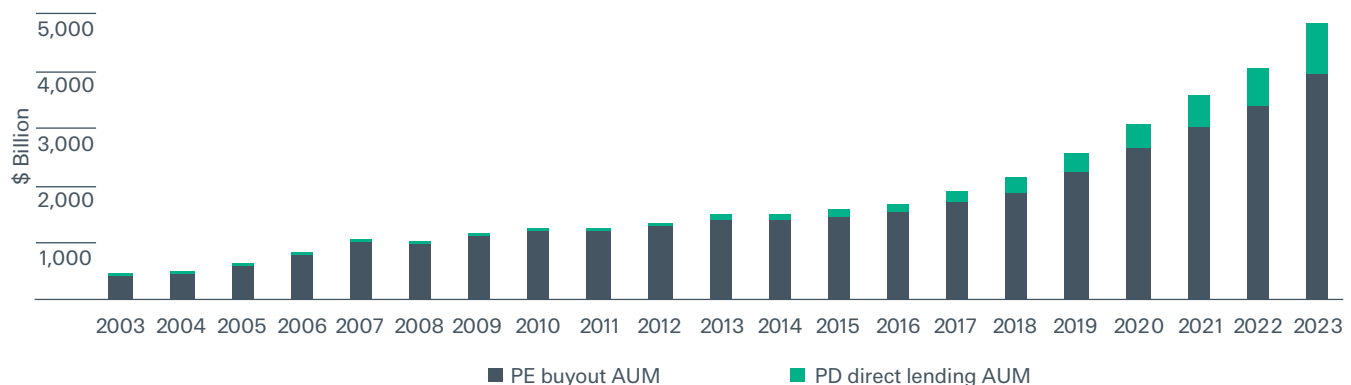
### PRIVATE EQUITY GROWTH

The expansion of private debt markets over recent years also correlates with the growth of private equity (PE) sponsors, which use borrowed funds to acquire companies. The low interest rates that followed the GFC plus the boom in private lending made debt-financed acquisitions more attractive and led to a surge in leveraged buyouts (LBOs).

The growth of private debt, in this context, can be interpreted as a simple narrative of supply and demand demonstrated by the increase in private debt dry powder as private equity grew (**Figure 1**).

- PE sponsors sought additional sources of capital to finance their expanding activities—especially in a market where timely and flexible financing options were prized.
- Private lenders emerged as vital players, offering the required capital with more flexible and tailored terms compared with traditional bank lending.

FIGURE 1: GLOBAL PRIVATE EQUITY AND PRIVATE DEBT DRY POWDER



Sources: Preqin, Credit Suisse, PitchBook LCD, Bloomberg, StepStone Group, as of June 2024.

## Is private debt too big?

### SIZE OF PRIVATE DEBT RELATIVE TO SYNDICATED LOANS AND HIGH-YIELD BOND MARKETS

In the early 2000s, private debt had a relatively modest asset base, possessing around \$28 billion in invested capital, which made it smaller than both the high-yield and leveraged-loan markets (i.e., the closest equivalent in the sub-investment grade lending space). It was not until after the GFC that private debt achieved a scale comparable to that of the high-yield market, which measured \$1.2 trillion by 2023. While most sources report a size of \$1.7 trillion, this number reflects dry powder, which does not represent the actual capital deployed.

**Figure 2** illustrates the sustained growth of private debt over the past decade, a trend that parallels the expansion of the leveraged-loan market. The high-yield bond market, on the other hand, appears to have stalled since the mid-2010s.

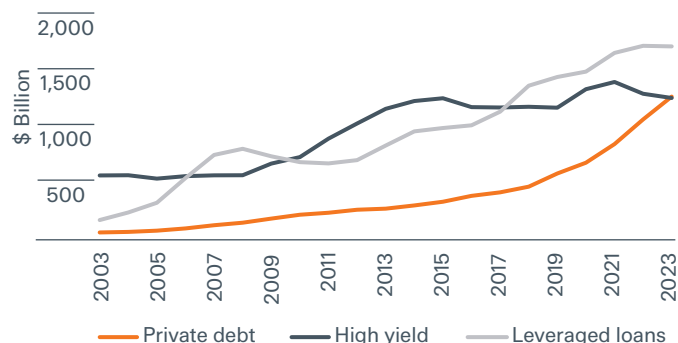
Although it grew quickly, the private debt market is not necessarily overinflated; in many ways it has simply caught up to the other sub-investment grade markets. Moreover, private debt does not usually target the same borrowers as the high-yield and leveraged-loan markets, which cater to large-cap firms and the higher end of the upper-middle market. Private lenders, on the other hand, typically serve middle-market companies.<sup>1</sup> As a result, the strong growth of private debt did not entail a stark increase in competition that could have led to a “race to the bottom” in terms of underwriting standards.

### SIZE OF PRIVATE DEBT RELATIVE TO BANK LENDING

Historically, banks served as the main financing source for middle-market firms. But owing to post-GFC banking reforms, banks scaled back their activities in this market, creating a void. Private lenders filled this gap, offering tailored financing solutions to those companies. This development has been one of the main drivers of the recent growth in private debt AUM. Nonetheless, despite its growth, the private debt market remains relatively small in both the United States and Europe when compared with traditional bank corporate lending (**Figure 3**).

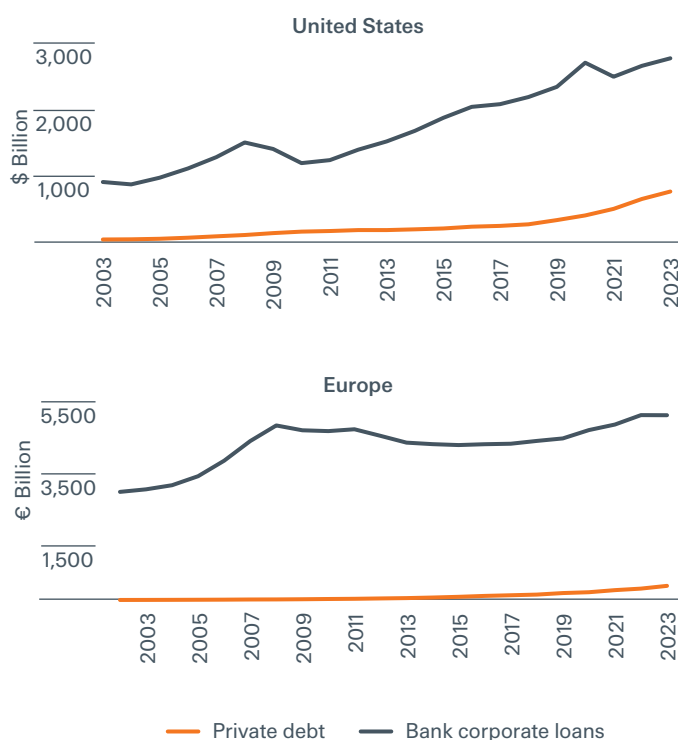
<sup>1</sup> The middle market has various definitions based on revenue, EBITDA or headcount. The National Center for the Middle Market (NCMM) definition of a middle-market firm is a company with annual revenues between \$10 million and \$1 billion. Following the NCMM definition, the US middle market represents 33% of the US private-sector GDP, 48 million jobs and around 200,000 US companies in total. The vast majority of the middle market is privately owned, usually by the founders or a private equity firm.

FIGURE 2: GLOBAL CREDIT MARKET SIZES



Sources: Preqin, Credit Suisse, PitchBook LCD, Bloomberg, StepStone Group, as of June 2024. \*Refers to United States and Europe combined.

FIGURE 3: PRIVATE DEBT RELATIVE TO BANK CORPORATE LENDING ACROSS REGIONS



Sources: Preqin, Federal Reserve Board, ECB, as of July 2024.  
Note: In the US, bank corporate loans refer to “commercial and industrial loans” per the Federal Reserve Board. In Europe, they refer to “loans vis-à-vis euro-area NFCs reported by MFIs excluding ESCB in the euro area,” as defined by the European Central bank.

This illustrates that while private debt is becoming an important component in the financial landscape, it still operates on a smaller scale. If further sustained, the shift to nonbank lending could divert even more companies away from traditional bank financing, thus reflecting a growing preference for the bespoke solutions offered by private lenders.<sup>2</sup>

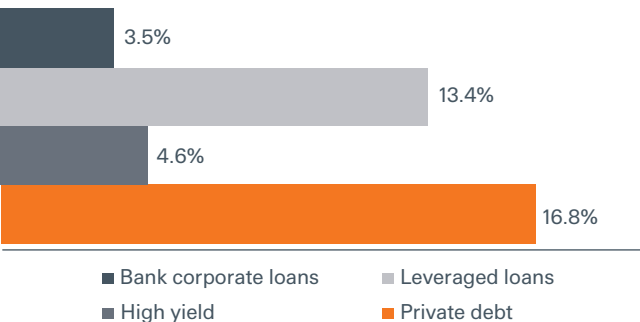
## Key take away

The changes in the regulatory framework following the GFC prompted banks to pull back from the middle market. This retrenchment created the conditions for private debt to grow.

The expansion of private debt has been further supported by the private equity market and the increasing funding demands of PE-backed companies. Notably, the growth rate of the private debt market has paralleled that of the syndicated loan market (**Figure 4**). In terms of market size, private debt is now comparable to the high-yield market, yet it remains significantly smaller than traditional corporate bank lending. This adjustment in the financial landscape underscores the shifting dynamics in lending and the rising importance of alternative financing solutions.

Overall, the recent development in private debt is the result of an organic growth fueled by an increasing demand for the services offered by private lenders and a retrenchment by banks.

FIGURE 4: PRIVATE DEBT GROWTH RELATIVE TO OTHER CREDIT ASSET CLASSES



Sources: StepStone Group, Federal Reserve, FDIC, Bloomberg, as of March 31, 2024. CAGR for the period 2002–2023.

## Regulators' views on private debt's growth

"The availability of private credit can be beneficial for economic activity and innovation. By providing finance where traditional means fall short, it can support investment and growth opportunities. And to the extent that private credit substitutes for bank financing, it can contribute to the diversification of financing sources. In many ways lending via private markets is likely to be lower risk from a financial stability perspective than had the lending been undertaken by the pre-GFC banking system." *BoE, Lee Foulger Speech at AFME, Jan 2024*

"Private markets provide benefits to the economy. They offer an alternative source of funding, with often faster and more reliable execution. For investors, they provide a portfolio diversification option and constant income streams. For the wider economy, private markets often finance the kind of smaller, riskier and innovative firms that are important for future economic growth. Nonetheless, the opaqueness and strong growth of private markets may give rise to financial stability risks." *ECB, FSR, May 2024*

"Private credit creates significant economic benefits by providing long-term financing to firms too large or risky for banks and too small for public markets. However, credit migrating from regulated banks and relatively transparent public markets to the more opaque world of private credit creates potential risks." *IMF, FSR, Apr 2024*

"Both credit demand and supply contributed to the rapid growth of private credit over the past decade. On the demand side, unrated firms, including highly indebted companies or small and medium-sized enterprises, which may struggle or be reluctant to borrow from banks or to issue debt in public markets, have been able to borrow from private credit funds. On the supply side, high rates of return and portfolio diversification motives have made private credit an attractive asset class for long-term investors." *BIS, Annual Economic Report, Jun 2024*

<sup>2</sup> It is important to emphasize that the "business model" of corporate lending remains more or less the same; the primary distinction lies in who is providing the loans.

# Misconception 2:

## Private debt funds face material liquidity risks

### Limited duration mismatch in closed-ended private debt funds

Most private debt funds are closed-ended and lock investors' capital for the duration of the fund's life. This long tenor inherently facilitates the alignment of the maturity profiles of assets and liabilities, as private lenders do not need to meet unexpected redemption requests. Private debt loans are also normally held to maturity and rarely traded. This limits the risk of forced sales at unfavorable prices.

In addition, according to SPI by StepStone data, the average fund life from inception to the end of the harvesting period is 6 to 7 years. In comparison, the average effective loan life is closer to 2.5 or 3 years. Even if a loan reaches its usual contractual maturity of 7 years, or its maturity is extended, this typically does not represent a significant issue. Most funds also include options to extend the fund's life by 1 or 2 years, further reducing the risk of a forced sale.

Altogether, the risk of duration mismatch in private debt funds is low compared with traditional banks. Banks are more vulnerable to asset-liability mismatches because they typically rely on short-term deposits to make long-term loans, commonly known as maturity transformation. This business model can lead to severe solvency risk in the event of a bank run, which usually results from a sharp and sudden drop in the depositors' trust in the bank's ability to meet its obligations. In contrast, the closed-ended structure typical of most private debt funds offers a more stable setup: Funds are not obliged to meet unexpected redemption demands (such as deposit withdrawals in banks). This setup minimizes the risk of forced liquidations under unfavorable market conditions.

### Regulators' views on liquidity risk

"Although currently low, liquidity risks could rise with the growth of retail funds. The great majority of private credit funds poses little maturity transformation risk, yet the growth of semiliquid funds could increase first-mover advantages and run risks." *IMF, FSR, Apr 2024*

"Most private credit funds have a closed-end fund structure and typically lock up the capital of their investors (that is, limited partners) for 5 to 10 years. Those funds that are structured as hedge funds routinely restrict share redemptions of their investors through redemption notice periods, lockups, and gates. Thus, private credit funds engage in limited liquidity and maturity transformation." *Federal Reserve, FSR, May 2023*

"With regard to liquidity transformation, most funds active in private finance have closed-end structures or lock-up periods, which limits their liquidity transformation. However, liquidity shortages can arise from committed but not yet invested capital, "dry powder", if investors are not able or willing to fulfil their funding commitment." *FSB, Global Monitoring Report on NBFIs, Dec 2023*

# Liquidity in private debt open-ended funds

The rising popularity of evergreen funds, such as business development companies (BDCs) and interval funds, introduces a different dynamic. Because these funds have embedded liquidity features, they are somewhat more vulnerable to market volatility and investor sentiment. That said, outflows from such funds are inherently limited by design.

For instance, BDCs typically permit redemptions only every quarter—and within certain percentage limits of the fund’s NAV (usually 5% per quarter). These mechanisms prevent large-scale withdrawals akin to bank runs and mitigate the risk of a liquidity-induced collapse, thus ensuring that while investor liquidity is somewhat accommodated, it does not jeopardize the overall stability of the fund. Importantly, even with such liquidity features embedded in their funds, so far not a single private debt manager has had to limit redemptions in their BDCs.

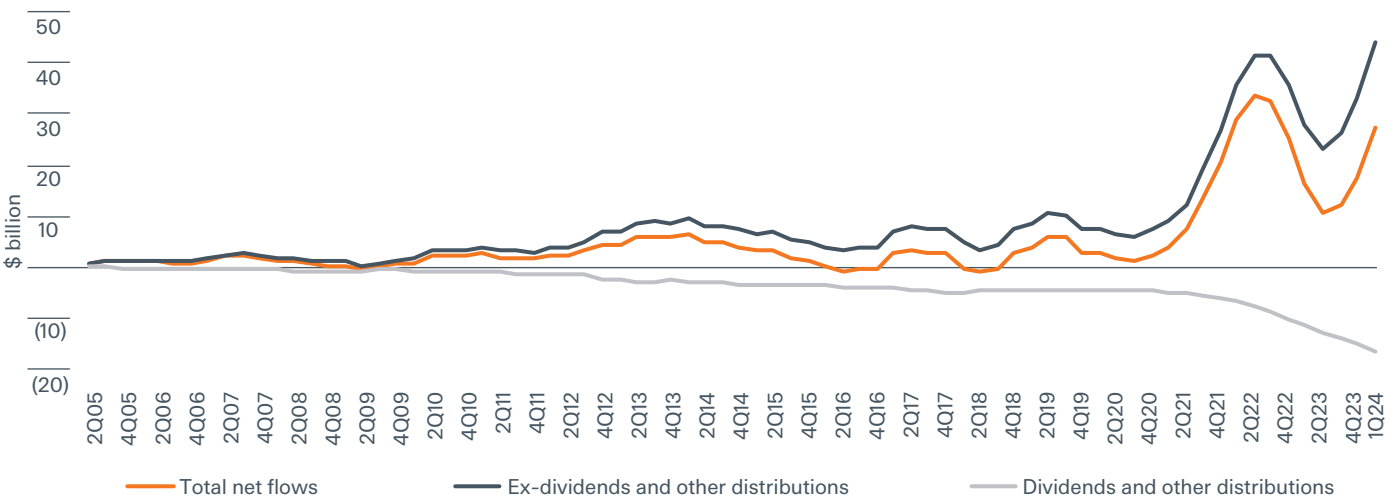
“BDCs” net flows have remained positive over the past five years (**Figure 5**)—weathering both the pandemic and central banks’ recent tightening cycle.

Moreover, BDC managers have several tools at their disposal to manage liquidity in their funds effectively. Repayments are one of the main sources of liquidity in private debt funds. On average, repayments within direct lending portfolios account for about 30% of NAV within a given year. However, this figure can vary significantly depending on market conditions. In more stressed environments, repayments can slow to approximately 15%. Conversely, in years characterized by strong market activity, repayments can surge to 40–45% per Cliffwater.

The practice of matching subscriptions and redemptions is pivotal to managing the inflow and outflow of capital. This balancing act ensures that the fund can accommodate new investments while meeting the redemption requests of existing investors.

Secondary transactions represent a growing opportunity to generate liquidity as the private debt market grows. However, secondary deals might necessitate discounts on the NAV in order to find buyers during periods of financial stress, making their appeal dependent on market conditions.

FIGURE 5: BDCs’ NET ASSET INFLOWS/OUTFLOWS



Source: Cliffwater, as of March 31, 2024. Outflows = Total distributions to investors + Dollar amount of shares repurchased. Inflows = Proceeds from shares purchased by investors.



Another crucial aspect is the use of leverage, particularly in the context of evergreen funds. These funds often utilize borrowing facilities to enhance returns or as a credit line, which managers can draw from to meet short-term liquidity needs. They can then repay the line once cash starts building up to avoid cash drag. This enables evergreen funds to remain flexible and responsive to short-term cash requirements. However, leverage magnifies both gains and losses. Managers should approach leverage with caution.

Portfolio composition also plays a role, particularly in terms of liquid assets. Some GPs might allocate a larger portion of the portfolio to liquid assets, such as syndicated loans, than what they would typically do in a closed-ended fund. This approach can enhance the liquidity profile of the portfolio, providing additional flexibility to meet unexpected demands. However,

while it might be more liquid, it also creates more volatility and liquidity might evaporate when needed (i.e., in a period of market stress).

## Key take away

Overall, closed-ended funds are optimally structured to align with the maturities of the underlying loans, limiting duration risk and bypassing the possibility of a run on the fund thanks to locked-up capital. On the other hand, open-ended funds incorporate several features designed to mitigate liquidity risks. These funds offer limited liquidity, supported by various tools, such as credit lines or repayments, that managers can use to ensure that liquidity requirements are consistently met.



# Misconception 3: Private debt funds could lead to contagion

## Source of funding in private debt funds

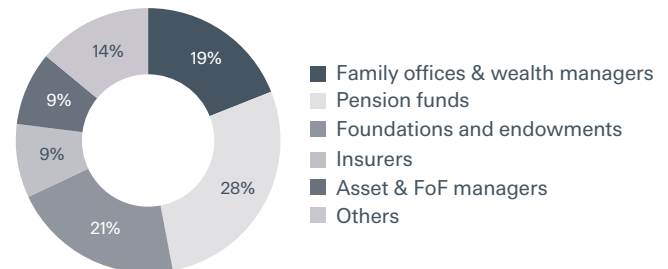
Private debt funds primarily draw capital from institutional investors (**Figure 6**), such as pension funds and insurance companies, which are considered sophisticated enough to assess and bear the risks associated with such investments. This reliance on institutional capital means that the funds are utilizing resources from investors who are appropriately informed about the potential for both returns and losses.

In contrast, banks primarily source their capital from the deposits of the general public (**Figure 7**). While these deposits are often guaranteed by government insurance programs, such as the FDIC in the United States, a bank failure could still force a government bailout and put taxpayer money at risk.

This structure necessitates a higher level of regulatory oversight and intervention to protect the financial system and prevent significant economic repercussions that could arise from bank runs or failures. That private debt funds operate largely with capital from institutional investors reduces the potential need for government bailouts.

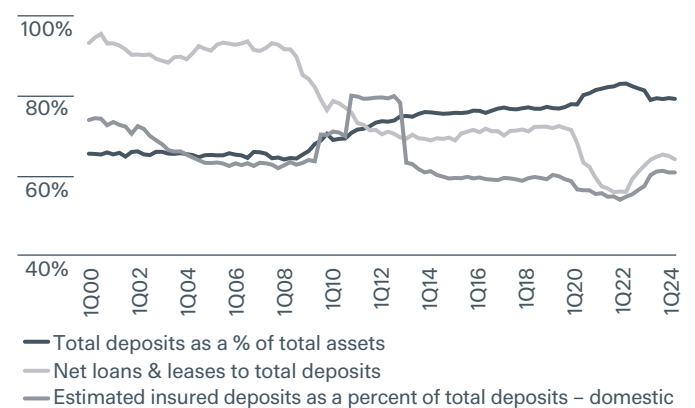
Nonetheless, some may argue that because pension funds and insurance companies are among the main investors in private debt, it represents a vulnerability in itself. If private debt suffered from a downturn, it could drag down returns and potentially stress their balance sheets. However, historical data suggests a different interpretation. In down markets, direct lending tended to have materially lower maximum drawdowns than other asset classes (**Figure 8**).

FIGURE 6: SHARE OF PRIVATE DEBT INVESTOR BASE



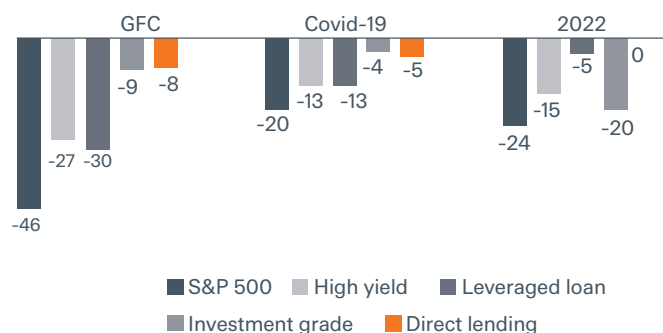
Source: IMF Financial Stability Report 2023.

FIGURE 7: US BANKS' FUNDING



Source: FDIC, as of March 31, 2024.

FIGURE 8: MAX DRAWDOWNS BY ASSET CLASS (%)



Sources: Bloomberg, PitchBook LCD and Cliffwater.

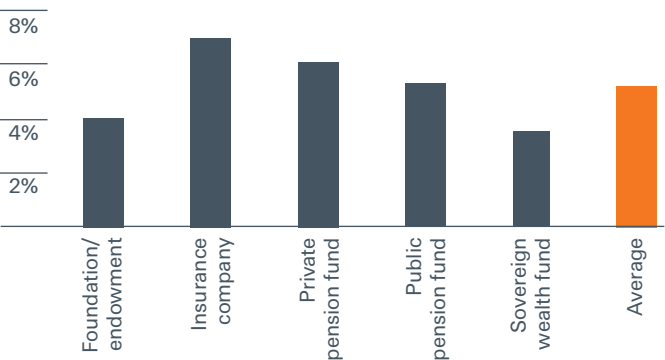
As seen in **Figure 9**, private debt makes up only about 5% of institutions' portfolios on average. At this level, it would appear that institutions' exposure to private debt is not significant enough to pose substantial risk. This, together with private debt's lower historical volatility, suggests that the systemic risk from potential contagion due to private debt underperformance seems to be limited.

## Limited leverage in private debt funds

Private debt funds and traditional banks operate with markedly different levels of leverage, which significantly affects the risk they represent for the broader economy.

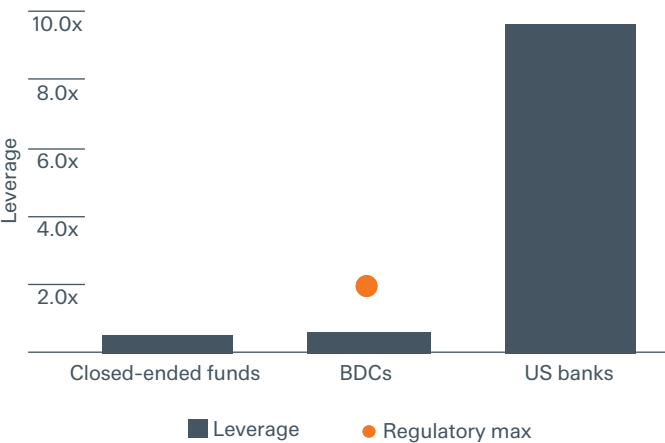
Private debt funds, particularly those that are closed-ended, typically operate with little to no leverage (**Figure 10**). This conservatism ensures that these funds provide a stable investment platform. BDCs employ a higher but still modest degree of leverage, usually around 1.0x to 1.25x as a target. Notably, BDCs' leverage levels are well below the regulatory maximum, which stands at 2x. In contrast, traditional banks frequently operate with leverage ratios closer to 10.0x. The higher leverage ratio in banks is an important factor in their potential to trigger financial contagion; problems within the banking sector can quickly spread to other parts of the economy.

FIGURE 9: 2023 AVERAGE PRIVATE DEBT ALLOCATION BY INSTITUTIONS



Source: Private Debt Investor, as of December 31, 2023.

FIGURE 10: LEVERAGE IN PRIVATE DEBT FUNDS



Sources: StepStone Group, Goldman Sachs, BDCs' Fact sheets and FDIC.

## Key take away

Most private debt investors are sophisticated institutional investors with a relatively small exposure to private debt in their portfolio. This limited exposure, combined with the low volatility of the asset class, reduces the likelihood that underperformance in private debt would create systemic issues.

In addition, the relatively lower leverage employed by private debt funds, especially closed-ended funds, which represent the majority of the offerings in the asset class, inherently limits their potential for causing systemic contagion. Since these funds are less dependent on borrowed money, they are more insulated from risks that can lead to rapid and widespread financial destabilization. Open-ended funds already face higher regulations regarding leverage. For example, BDCs are limited to a maximum of 2.0x leverage.

## How do regulators perceive the risk of contagion from private debt?

“On the investor side, large institutional investors such as pension funds and insurance companies are dominant players in both private finance investments and in public debt markets, such as corporate bond markets. Clients of banks are also significant investors in private finance. Greater-than-expected losses could also have significant implications for these investors, amplified by asset liability matching.” *IOSCO, Emerging Risks in Private Finance, Sep 2023*

“Risks to financial stability from leverage at private credit funds appear low. Indeed, most private credit funds are unlevered, with no borrowings or derivative exposures. A minority of funds, however, use modest amounts of financial or synthetic leverage. Risks to lenders of private credit funds, typically banks, appear moderate due to the relatively modest amount of borrowings of private credit funds and their secured nature.” *Federal Reserve, FSR, May 2023*

“Significant cross-sectoral and cross-border linkages in private finance provide channels for contagion within jurisdictions and globally. Such interlinkages can lead to the spreading of credit and liquidity risk across institutions and markets, should the underlying risks materialize. Although systemic risks to the financial system are generally assessed to be low, underlying vulnerabilities from leverage and liquidity risk could lead to a procyclical contraction of investments during a market downturn, with implications for the availability and cost of funding of target companies.” *FSB, Global Monitoring Report on NBFIs, Dec 2023*

# Misconception 4:

## There are significant conflicts of interest among private lenders

### Originate and hold vs syndicate

A key aspect of private debt managers that differentiates them from banks is the retention of loans within their flagship funds. Private lenders often hold the loans they originate, a practice that directly aligns the interests of the fund managers with those of their investors. This ensures that fund managers are directly affected by the performance of the loans and incentivizes them to conduct thorough due diligence and maintain high underwriting standards. By retaining a stake in the loans, private lenders share both the risks and rewards with investors. In addition, GPs typically invest a certain percentage of their own capital in the fund, further aligning their interests with investors.

In contrast, the syndicated loan market operates very differently. In this market, banks frequently originate loans only to syndicate them out to other investors and financial institutions. This means that the originating banks may not retain a significant stake in the loans on their balance sheets. Consequently, their exposure to the risk of default is minimized since the originating bank's financial well-being is less tied to the borrower's ability to repay the loan.

### The importance of track record

When launching a new fund in the market, the importance of a solid track record cannot be overstated. Fundraising tends to be easier for large GPs with a long-standing history of strong performance. This, coupled with the fact that most loans are held in their flagship funds, means that the investment returns of the GP will directly affect the current fund's performance as well as its ability to raise future funds. Consequently, private lenders have strong incentives to select and underwrite loans to the best of their abilities, ensuring not only the satisfaction of current investors but also the growth and sustainability of their business moving forward.

### Private debt funds' fees

The compensation that private lenders receive for managing their funds includes both management and performance fees. The performance fee, which is contingent upon achieving a certain performance level or hurdle rate, ensures that private lenders are rewarded based on the fund's long-term performance. It also means that a short-term performance boost followed by losses does not lead to performance fees. This structure provides direct incentives for private lenders to maximize the long-term performance of their funds to increase their revenues, further aligning their interests with those of their investors.

If it continues, the shift to nonbank lending could divert even more companies away from traditional bank financing, thus reflecting a growing preference for the bespoke solutions offered by private lenders.

## Key take away

Private debt managers typically adopt the “originate and hold” model, retaining loans within their flagship funds. This approach aligns their interests with those of their investors, as the managers are directly affected by how the loans perform. This model promotes thorough due diligence and high underwriting standards to produce a good track record.

Track records are crucial: Strong historical performance facilitates easier fundraising and increases investors’ trust in the GP’s abilities. As a result, established GPs with proven success can attract more capital, ensuring the sustainability and growth of their business.

Moreover, the fee structure of private debt funds, which includes incentivizing managers to maximize their fund’s long-term performance rather than short-term gains, further aligns their interests with those of their investors.

## Regulators’ views on conflicts of interest

“Another potential conflict arises from the carried interest or performance fee that private finance managers receive when the fund generates certain returns. This fee is intended to align the manager’s interests with those of the investors, as the manager only receives a fee if the fund generates strong returns. However, investors could be concerned that the manager has an incentive to take excessive risks or pursue short-term gains in order to generate a performance fee, rather than focusing on long-term value creation (though such risks are somewhat mitigated by ‘clawback’ provisions).”

“Conflicts are likely to arise when the private credit fund of a firm finances a portfolio company of the same firm’s private equity fund, or where the portfolio company is otherwise related to the firm. Some industry stakeholders have indicated that conflict of the equity investors’ interests with the debt investors’ interests would be avoided, and generally covered by internal policies that stipulate that fund-sponsoring firms should not favor one set of investors over another. In some cases, regulations place restrictions on transactions.” *IOSCO, Emerging Risks in Private Finance, Sep 2023*

# Misconception 5: Private debt loans' valuations are not reliable

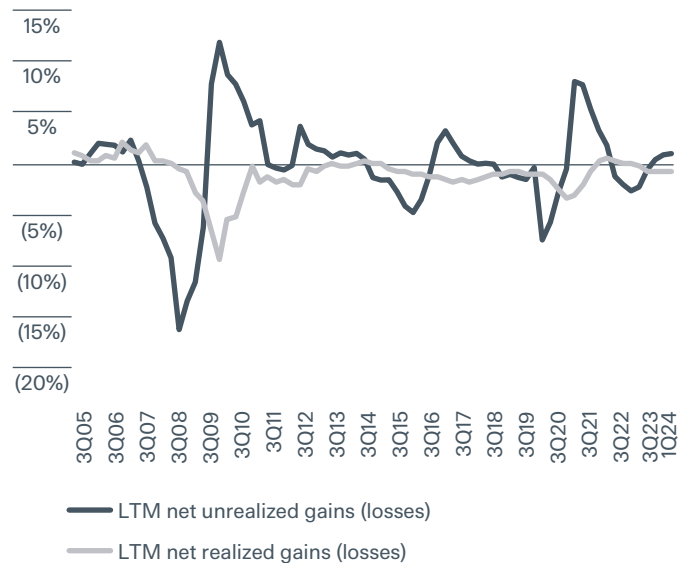
## Markdowns in private debt

Another area of focus recently in private debt revolved around how loans are valued. Some have argued that the loan valuations are stale and do not reflect the risk as accurately as do public markets. However, there are fundamental differences between the private and public markets that need to be considered.

The approach to valuation in private debt funds reflects the fundamental value of assets, as opposed to the often volatile trading dynamics seen in public markets. Private debt funds focus on the intrinsic worth of the underlying loans, which is based on the borrower's financial health and the probability of repayment rather than short-term market fluctuations.

Historically, the provisions (i.e., markdowns) set aside by private debt funds to cover potential losses have typically been more than sufficient to cover the subsequent realized losses. Markdowns typically overshot the ultimate realized losses by 1.7x to 2.5x following periods of financial market stress (**Figure 11**). This conservative approach to loan valuation indicates that direct lenders manage their books effectively and prudently. Moreover, because these loans are usually held to maturity, a GP could argue in favor of holding loans at amortized cost value. But they aren't. By effectively reflecting the credit quality deterioration of their borrowers, GPs demonstrate their willingness to show the appropriate credit risk in the valuation of their loans.

FIGURE 11: 4-QUARTER TRAILING HISTORICAL UNREALIZED AND REALIZED LOSSES IN PRIVATE DEBT BDCs



Sources: StepStone Group, Cliffwater, as of March 31, 2024.

Although it grew quickly, the private debt market is not necessarily overinflated; in many ways it has simply caught up to the other sub-investment grade markets.

# Valuation differences among private lenders

Some may argue that differences in how two managers value the same loan indicates a lack of consensus and too much subjectivity in determining a loan's value. However, an analysis of loan valuations in private debt BDCs, which are required to report their holdings to the SEC quarterly, seems to dispel those concerns.

To illustrate this point, we analyzed 563 US first-lien loans, for which multiple GPs provided valuations for the same loan since the borrower is part of multiple BDCs. As seen in **Figure 12**, on average, the differences are negligible. This suggests that GPs' valuations are generally aligned. Additionally, only nine loans in the sample had a difference greater than 10, most of which were between 10 and 15. Therefore, the fear of large discrepancies between GPs' valuations concerns very few loans, and the difference in valuations between managers remains minimal. This is perhaps most appropriate for distressed loans, where managers may disagree on the borrower's prospects and the GP's restructuring experience and capabilities may play a role in the ultimate expected recovery.

## Key take away

The valuation of loans in private debt has come under scrutiny, with some arguing they are stale compared with public markets. However, private debt funds are not subject to the trading volatility of public markets and prioritize the fundamental value of loans, focusing on borrowers' financial health and repayment likelihood rather than market fluctuations. That private debt markdowns have historically been conservative demonstrates prudent risk management. Although concerns about valuation subjectivity exist, our analysis of US first-lien loans in BDCs shows the discrepancies tend to be minimal. Large valuation differences are rare and mainly occur in distressed loans.

FIGURE 12: DIFFERENCE IN FIRST-LIEN LOAN VALUATIONS ACROSS BDCs

# deals	Med. diff.	Avg. diff.	% with diff. >10	Max diff.	Min diff.
563	0.79	1.69	1.6%	35.54	0.00

Sources: StepStone Group, Cliffwater, as of December 31, 2023. The sample consists of 563 US first-lien loans with a fair value above \$10 million and for which there is an overlap across GPs. The fair-value/cost-value ratio difference across GPs is then computed by taking the highest ratio minus the lowest one from different GPs.

## Regulators' views on loan valuations

"Valuations of private finance investments are subjective because of their illiquid nature and lack of secondary market, with many managers designating such investments as 'buy and hold.' Managers may be incentivized to maintain their (higher) valuations on private finance investments despite falling prices in public markets or use improper valuation methodologies to achieve such a goal." *IOSCO, Emerging Risks in Private Finance, Sep 2023*

"Stale valuations could offer a first-mover advantage and increase runoff risks for private credit funds, but this risk appears significantly mitigated at present. In a downside scenario, stale valuations might overvalue a fund's assets, potentially prompting investors to exit before asset values are marked down. Private credit funds impose substantial obstacles for investors seeking to redeem their investments, thus mitigating this risk." *IMF, FSR, Apr 2024*



# Conclusion

The sustained growth of the private debt market can be attributed to regulatory changes and an increasing demand for private debt, which provides the real economy with an additional source of funding, diversifying risk away from banks.

The structural characteristics of most private credit funds—e.g., closed-ended and relatively low leverage—considerably reduce the likelihood of liquidity crises as well as the risk of contagion during economic downturns. Additionally, the predominance of institutional investors within private credit funds, coupled with their typically conservative allocation to the asset class, also limits the potential for market-wide contagion.

Furthermore, the incentives of private lenders to maintain high underwriting standards ensure alignment of interests between investors and lenders.

Moreover, the conservative and consistent valuation practices across private debt loans, as demonstrated by the markdowns and valuations in private debt BDCs, alleviate concerns about stale valuations, which would misrepresent credit risk in the private debt space.

Collectively, these elements should ease a lot of the recent concerns regarding the soundness and resilience of the private debt market. As a result, the stable and attractive risk-adjusted returns offered by private lenders make private debt a valuable addition to any portfolio. Additionally, its limited potential for systemic risk contributes positively to the broader financial ecosystem by providing companies with another source of financing to draw from.

## Regulators' conclusions on private debt

"Risks to financial stability from private credit warrant close monitoring. Mitigating factors include the still small size, low share in investors' portfolios, low liquidity risks and low fund-level leverage. However, the direct and indirect interconnections with other parts of the financial system, especially banks, could amplify future shocks." *BIS, Annual Economic Report, Jan 2024*

"While private credit funds have grown rapidly since the 2007–09 financial crisis and the assets they hold are mostly illiquid, the funds typically use little leverage, and investor redemption risks appear low. However, the sector remains opaque, and it is difficult to assess the default risk in private credit portfolios." *Federal Reserve, FSR, May 2023*

"While financial stability risks from private markets seem contained in the euro area, some concerns remain. Aggregated exposures, opaqueness and private markets' resilience are all elements that warrant monitoring, especially in an environment of higher interest rates. Given the limited liquidity mismatches of private funds in aggregate, and the long-term investment horizons of their main investors, risks to euro area financial stability from private markets appear limited." *ECB, FSR, May 2024*

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