Research @ Citi Podcast, Episode 54: Private Credit’s Trillion-Dollar Takeover — Growth, AI, & the Future

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Transcript:

Rob Rowe (0:00)

Hi, everyone. Welcome to the Research @ Citi podcast. I'm Rob Rowe, U.S. Regional Director of Research at Citi. And it's thrilling to have our Head of Credit Strategy, Mike Anderson, with us on the podcast today. We're going to be discussing private credit. It's an extremely hot topic. Mike, thanks for being on the podcast today.

Mike Anderson (0:21)

Thanks for having me, Rob.

Rob Rowe (0:22)

Great. So maybe we can start off in regard to private credit, talk a little bit about some of the latest developments we've seen in the space, because this has really proliferated. You know, it's a much larger market than I can recall, and you can correct me if I'm wrong. We're beginning to see how this market is being distributed into the retail markets. We're probably seeing more secondary trading.

Maybe you can share with us how this has grown? You've been in the business for a while, right? How has this market grown and how has it developed, and why is it developing so much right now?

Mike Anderson (0:59)

I think the best way to start this is to discuss or just level-set on what we mean by private credit. Private credit's been around for decades. It was something that historically was focused at middle-market companies. It filled the gap between what banks would do and in terms of deals that banks would finance and what public markets would finance. And you had some of these companies that were in the middle, and private credit catered to those sorts of transactions and filled a very important role.

In recent years, as you mentioned, it definitely has proliferated, and it's getting more and more difficult to refer to private credit just by that term, because it is encompassing so many different things.

The direct-lending category remains very large. It is continuing to grow. It has encroached increasingly upon the public markets, and maybe as we discuss a little bit later, how those markets are actually working together on the direct-lending side. But you've also seen significant growth in securitized, in IG. Private credit has been an important source of capital for companies that are looking to grow AI and just an extreme need for capital in that region of our economy. So the proliferation I think is a very, very important.

Also, we're seeing the retailization, as you mentioned. There have been some ETFs that have been launched that have private-credit assets in them, or at least eventually will be dominated by private credit. Maybe those will be a little bit more IG-focused, but clearly there are vehicles and wrappers that these assets are going to be placed in that will then be marketed to Main Street and through retail channels.

So if you're going to have these daily liquidity instruments, you're going to need some trading — and secondary trading is still pretty light, but some of the private-credit shops have set up broker-type efforts and units that operate separately from their asset-management side. And so, they facilitate trading when the companies want to get more access or if they want to lighten up access on existing loans. So there's a lot going on under the surface. And it's a very interesting time, but it's also a time with a lot of nuance and the need for distinguishing between various segments.

Rob Rowe (3:24)

And Mike, it's funny because in some respects, the private market feels like it's mimicking the public market. If it's going to have more developed secondary trading, different structures, distribution to retail, that sounds a lot like the public market. So how do we distinguish between them?

I would think in the past, private credit was the domain of companies that were, one, private; and two, could not source funding in the public markets for whatever reason. In some instances, those strategies may have been distress strategies or trying to focus on different aspects. Now, today, we're more aware of that market. So how are these strategies deployed by various entities?

Mike Anderson (4:12)

It's a great question and it's a great observation because anytime I talk to a private credit manager — and as this has developed in recent years — you definitely see a parallel to the public markets. You have your trading desk to help trade the liquidity options for fundamental view changes to facilitate portfolio moves to collect those changes. Then you have your syndicate, your sourcing desk, which is important. Obviously, you're going to have your credit-analyst team. You're going to have your portfolio manager that's putting together the portfolio. So, you have all of those different disciplines and all those different roles that are being filled on the private-credit side, just like you would have on the public-credit side.

I think the question comes down to, one of the reasons why private credit was able to grow so quickly is because of the customization and what some people might call innovation. And being able to deliver a solution to a borrower that the public markets can. If you're in the public markets, you need to appeal to a wide audience, to a broad audience of investors, of buyers. And so, therefore, the terms of the documents are going to have to appeal to what the public, the mass wants.

In private credit, you can do a little bit more customization. You can include maybe some equity interest, some equity options or warrants in there, you can have pick optionality. You can also have different maturities, whereas the public-loan market, generally new-issue loans are going to come at six or seven years. Generally, they come at seven years. Sometimes you might deviate a little bit from that. That's an important component too. Private credit allows companies to be able to execute that.

Now, you also mentioned private companies, and private companies like privacy. One of the reasons why they're private is so that they can have an earnings call and not have a competitor on, and it allows them to execute their business plan with a little bit more discretion. And they're really only talking to their lenders as opposed to talking to the broader public. Now, these private companies may issue in broadly syndicated loans as well, kind of what we consider the public market. So, they may issue in broadly syndicated loans and still be private and do a private name and only lenders get access to their fundamental numbers and their commentary on the call. So there is a little bit, and private credit has definitely encroached a bit more on the broadly syndicated market.

One of the things that we've seen over the last few years is the size of the deal that private credit can do has grown tremendously. And so now there's significant overlap between the markets to the extent that we see deals in public markets getting refinanced with a private solution, sometimes deals in the private-credit markets that get refinanced with a public solution. So there is a healthy two-way street that goes between those two markets.

So private credit, I think that component is really more about customization of the credit agreement. And then number two is your loan is not trading on a regular basis, not being marked. The broadly syndicated markets, loans get marked every single day. It's a $1.5 trillion market. You may have $2 or $3 billion of loans being traded daily across the Street. So, there's significant price discovery that goes on a day-to-day basis. Well, if you're a borrower, you may not want the valuation of your loan to be subject to the volatility of markets. For example, in Liberation Day, if the market trades off a few points and your loan trades off a few points or maybe trades off five points, that's not really your fault. But the last thing you want is some borrowers may prefer just to have a relatively illiquid instrument that is going to move more around the fundamentals of the company rather than the macro volatility that affect the broader markets.

Rob Rowe (8:04)

And so let's pretend for a second that I'm a very, very large publicly traded company, and I have the option to issue in the public markets and issue in the private markets. Now, from an investor standpoint, you can probably help explain the motivations for buying the private debt instead of the public debt. What's the motivation also for the publicly traded company to issue private debt under these circumstances?

As you said, there's contract things, but if they're going to get much lower yields or much better treatment in the public markets, why would they be motivated to go in the private market?

Mike Anderson (8:40)

They're paying for that privacy. So, there may be a deal that gets done, achieves a single-A rating from one of the agencies. It might have a 30-year maturity or something like a 30-year maturity. And that might price at 200 over Treasuries or something like that. And it might price like what you might see a well-performing double-B credit price, but they're able to do that off of the balance sheet.

There may be some separation between the assumption of risk, so the deal that's done off balance sheet, the company doesn't necessarily have to talk about it on their public earnings call each quarter. If things go wrong, that deal is backed by the project that it is financing. So from a credit-risk perspective, there may also be a little bit of a split.

We'll also see whether or not valuations between the private assets and the public assets converge. We definitely saw that in direct lending. A couple of years ago, the typical direct-lending loan might price a couple of hundred basis points behind the public markets. And now that's maybe more like 100 or 125 basis points. So, I'd say on the public IG side, we're still early stages. And maybe there's a little bit extra spread in some of these newer deals, just because it's a newer market. Is it going to trade? How well is it going to perform? How well will it be adopted by other investors? Am I the only investor that wants to get involved? So, ultimately for the borrower, it's about the privacy and it's about the separation between their primary business and the public entity and maybe an off-balance-sheet entity that this project is being financed and operated out of.

Rob Rowe (10:18)

To what degree has the private markets or the private-credit markets crowded out some of the public markets? Or what's the size of the two right now? How would you look at that?

Mike Anderson (10:29)

You see estimates of a trillion and a half, maybe a bit more very, very broadly. Direct lending is going to be a fraction of that, like a third or so of those numbers. As far as crowding out, that's another thing that has evolved in the dynamic between public and private. Early on, it was very much that they were competing with each other, and they still do to some extent, but there's definitely been more joint ventures happening between banks and private credit.

And at this point, at least on the direct lending, low-investment-grade spectrum, what you see when deals are being entertained is a private and a public financing solution that are maintained in parallel. And then at the end, if the transaction goes through, then the borrower can decide: Do they want to go to the private-credit market and all the advantages to the private-credit markets, or do they want to go public markets? And you mentioned one of the important advantages of public markets is that they tend to be cheaper, no doubt.

However, if you're a company that eventually wants to IPO, let's say it's a sponsor that buys a company and their exit in three to five years is an IPO. If you do a broadly syndicated loan or broadly syndicated bond, you're more likely to stay in the news flows. I've heard people refer to it as a debt IPO, where your equity team, when they're looking at the IPO a few years from now, may go talk to the debt team and say, “Hey, what do you think of the management team? What do you think of this business? How have they operated?” They can share information.

So there's that option as well. And by the way, one other thing I should mention on private credit is the certainty. Private credit will deliver certainty. So, if private credit comes in and says, “We will finance this LBO at SOFR plus 425,” that's where it gets done. When a bank does it, they're going to leave a little space up to a cap. They may say they're going to do it at SOFR plus 325, but they may need a cap that goes beyond SOFR plus 400, maybe 425 or 450. So there's a lot of considerations that go into that.

Rob Rowe (12:24)

I think when it was mostly private companies that were issuing private credit — in other words, no public companies doing that — I imagine that there was a lot of concentration risk in certain industries. Does that exist today? Is that still the same issue? Are you seeing most of the private credit coming from concentrated industries or specific industries?

Mike Anderson (12:46)

On the IG side, it definitely seems very tech-, very AI-focused. In the LBO below investment grade, it's going to be similar industries that are LBOs being financed in the public market. So software and services. And one of the concerns around private credit right now is the concentration in sectors that might be exposed to AI.

Now, software and services, very generic terms, there's a wide range of companies, wide range of potential exposures to AI. From maybe good, positive implications to negative implications and potentially being pushed out of business to some extent, or losing some business due to the AI disruption.

In private credit, which is really dominated by the LBOs and sponsor-backed companies, that could be up to 40 % from some estimates I've seen. In broadly syndicated markets, it's probably closer to 15% to 20%. And in loans and in high yields, even smaller — it might be mid- to high single digits. So there's definitely a good concentration of that.

So it's funding AI, more in IG, and then it's AI-exposed sectors in below-investment-grade.

Rob Rowe (13:55)

And when you say AI disruption for certain firms, are you suggesting that there's more private issuance coming out of those firms or firms that may be seen as being disrupted by AI?

Mike Anderson (14:10)

Well, so these are companies that historically were very attracted to sponsors. They had a good degree of revenue and cash-flow visibility. So you were able to lever up those cash flows. But if they are providing software, they're providing, say, legal services that AI could potentially replace, the concern is that your revenue and cash-flow visibility isn't as good as it used to be. So I'm talking about the disruption. I'm just talking about AI replacing the products that they have, or at least commoditizing the products that they have, and they'll have less pricing power.

Again, there's a wide range of implications here because there's a wide range of companies in terms of what they do, what their place is, what sort of moat they have in their industry. So it's a very, very wide range. But when you're a lender, you're always worried about risks. You're always worried about potential threats to you getting paid back because you don't have the upside that equity does. So that's what lenders worry about. And AI is a potential threat to some of the companies that private credit has financed that sponsors have bought.

Rob Rowe (15:12)

Lastly, a couple of things. Maybe you can look in your crystal ball a little bit and tell me over the next couple of years, do you think we will see continued real large growth in private-credit markets?

And also, we've seen recently a couple of defaults that were in the headlines. How do you anticipate that? Do you think that the state of the credit is still very good now? Do you think that there are factors that could contribute to an increased set of defaults? How are you seeing it over, say, the next two years?

Mike Anderson (15:44)

I think first on the growth side, it's much easier to see a clear path to growth for the IG space and securitizing. Clearly, there's a lot of demand. There's a lot of capital need for AI build-out. I mean, there's just a wide range of things that need to be built out. And certainly, we've seen a lot of companies tapping the public markets and the private markets to the tune of $20, $30, $40 billion at a pop.

The direct lending, I think, is a little bit closer to being in a state of equilibrium. Relative to a couple years ago, the public markets are presenting a much more attractive opportunity for sponsors. So I think that the growth at the expense of public markets has probably largely played out on that front.

And the other question you ask, which really is the million-dollar question, is where are we in this credit cycle? Are we expanding? Are we contracting? Because I think, especially as you head into a new year and you start considering what you're going to write for your outlook for the new year, that's always a good place to start. And this cycle has been very unusual. For example, the Fed is cutting rates with equities at all-time highs. NASDAQ, Russell, S&P have been at their all-time highs very, very recently. You could talk about a lot of other things that just show unusual this cycle is.

So the factors that you'll normally see early, late in the cycle are kind of jumbled up a little bit. So, if you want to make an argument that you're late in the cycle, you would say valuations are very rich, and they've been rich for quite a while. You're starting to see a pickup in these idiosyncratic stories, as you mentioned. So that's a feather in the cap of it being later in the credit cycle.

The arguments that we’re earlier in the credit cycle, though, are also very numerous. I mean, the Fed’s cutting rates. That usually eases financial conditions. You have deregulation and you've seen how bank stocks have performed, and bank spreads performed. Clearly banks are much more on the front foot heading into 2026 than they've been in the past. And you look at the commentary from alternative asset-manager earnings calls, they're expecting 2026 to be a really good year to deploy capital and to harvest their existing portfolio.

So the deregulation has certainly helped on that side. I think enthusiasm around AI can certainly help this credit cycle continue to move forth. But I think it's very hard to ignore the fact that it's been about five years since we've had a big default cycle right around the pandemic.

I might say that this isn't the normal cycle because … as a fellow baseball fan, Rob, you hear, "What inning are we in?" I look at the Fed hiking rates as being somewhat of a rain delay, right? That there really wasn't aggressive risk-taking at that time. Now the deals that were done in '21, that may be a little bit more aggressive, those continue to season. So I don't know if it's necessarily five years deep into the typical cycle, but we are getting deeper into the credit cycle.

So you would imagine that some of these deals, as they season, as a sponsor doesn't sell the company off, they're not able to refinance it, some of these are going to be in need of restructuring. So, you would imagine that that's going to be a common theme.

The real question is just how large that's going to be. And a lot of that's just going to be determined based on how the economy evolves and how the industry dynamics around software and AI evolve. But it's not hard to see a lingering and nagging default rate being higher than what you would normally expect in an easy financial-condition environment.

Rob Rowe (19:08)

Great, Mike. Well, we've run out of time. Thanks so much. Been very insightful.

Mike Anderson (19:12)

Thanks for having me.

Rob Rowe (19:14)

This podcast was recorded on Oct. 31, 2025. Be sure to join us for our next Research @ Citi podcast, which will feature Thomas Chauvet, the Citi luxury-goods analyst, who will provide a preview of the holiday shopping season.

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Thanks so much, everyone.

Disclaimer (19:52)