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What's Next for Private Credit?

BARINGS INSIGHTS

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Now that the proverbial rubber has met the road, many investors are questioning what's in store for private credit in the months (and years) ahead. In many ways, the current volatility is setting the stage for significant opportunity—but managing the downside is critical.

COVID-19 and the fallout from the prolonged global shutdown have certainly brought challenges to private credit. Relative to past events like the global financial crisis, the effects on many companies have been swift and severe—companies that performed well in January and February saw revenues decline to almost zero in the following months as demand dropped off. There is no way to know when this event and the related economic slowdown will ease, though it is looking increasingly likely that many companies face a long, slow road to full recovery, particularly those in industries more affected by shelter-in-place orders.

There are bright spots, to be sure. As an asset class, private credit can offer an opportunity to invest in high-quality companies through private investments that offer a potential yield premium relative to the broadly syndicated loan markets—with greater downside protection in the form of covenants. But some strategies and segments of the market are better positioned to deliver attractive risk-adjusted returns than others, and the key going forward will be to differentiate those capable of effectively managing the downside.

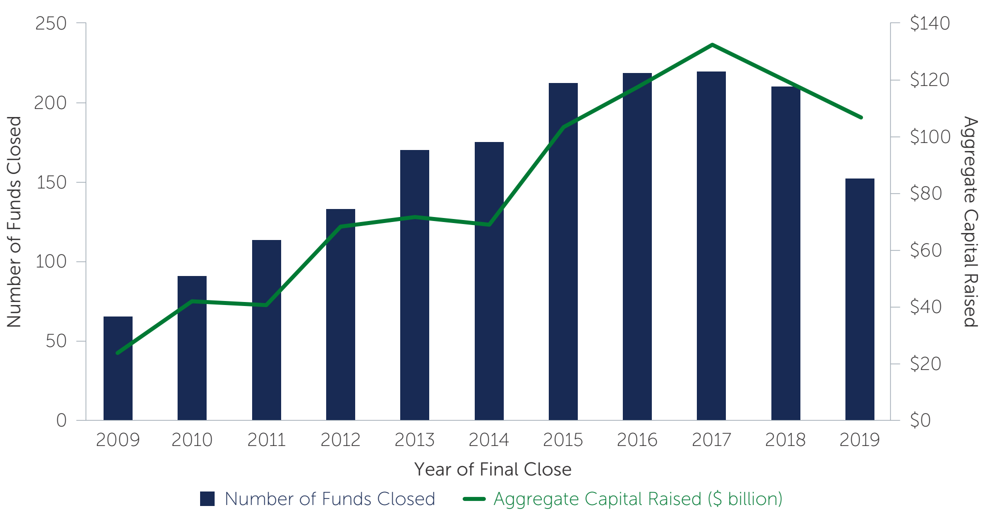
For the last several years, we have continued to see the most attractive value in what we consider the traditional or true middle market—companies with EBITDA between $15 and $50 million. Within this space, as we mentioned here and here, we see particular value in the more conservative parts of the capital structure, namely first lien senior debt, with a specific focus on industries that are truly suitable for illiquid investments, avoiding spaces such as retail, restaurants and oil & gas.

Realizing the Consequences of Late-cycle Style Drift

Today, traditional middle market companies have a potential advantage over their smaller and larger counterparts. On the one hand, they have greater enterprise value than the lower part of the middle market[1], where loss potential in the event of default tends to be higher as smaller companies typically have fewer "levers to pull" in the event of financial difficulties. On the other hand, relative to the upper end of the market[2], mid-middle market companies are likely to require less financing to bridge themselves through shorter-term shocks and periods of deteriorating economic growth.

This sweet spot has also been more insulated in recent years from some of the riskier behavior exhibited in other parts of the middle market. Over the last several years in particular, we started to see a degree of late-cycle style drift across private credit more broadly. As more managers raised larger and larger funds, there was more capital chasing deals in the space **(FIGURE 1)**. Because capital needs to be deployed over a set time period, typically two to three years, it can be more efficient to ramp large funds with larger investments in upper middle market companies than to try and find smaller, more traditional middle market opportunities.

FIGURE 1: Global Private Debt Fundraising Nearly Quadrupled in the Last Decade



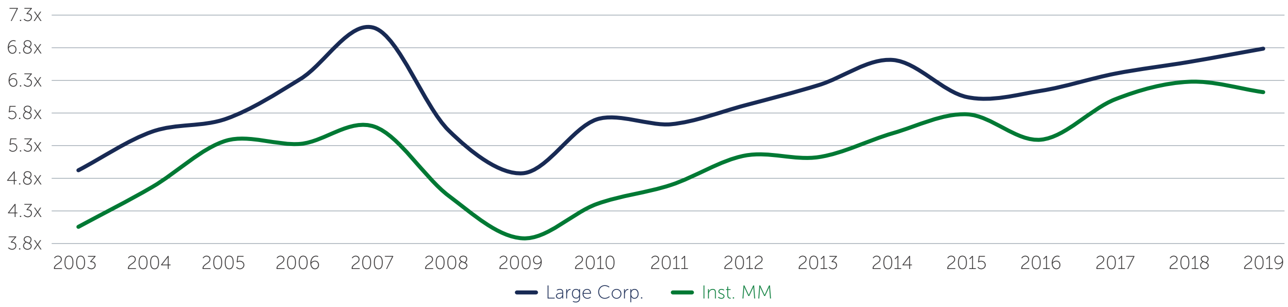
SOURCE: Preqin. As of December 31, 2019.

1. Companies with $15 million or less of EBITDA.
2. Companies with EBITDA over $40 million and up to $75–$100 million.

HIGHER LEVERAGE

In some cases, the lines with the broadly syndicated market started to blur. Specifically, leverage levels in some transactions were beginning to resemble those for larger, broadly syndicated corporates. In fact, total leverage during the last cycle peaked at 5.5x for U.S. middle market deals, compared to more than 7x for their broadly syndicated counterparts. Heading into this crisis, middle market leverage, on average, was close to 6.2x, versus roughly 6.8x for large corporates **(FIGURE 2)**. For comparison, leverage on more traditional first lien senior debt has remained closer to 4.5x. Even at the lower end of the middle market, while leverage remained low at an absolute level, it was much higher relative to history.

FIGURE 2: Leverage Levels Over Time



SOURCE: Reuters LPC. As of December 31, 2019.

Additionally, as the popularity of unitranche debt—essentially a hybrid between senior and mezzanine debt—increased, and competition intensified, leverage continued to rise as a means of maintaining anticipated returns. This resulted in deep first-lien debt that had a much higher risk profile than is typical of traditional senior debt. In some cases, these highly leveraged first lien deals, often marketed as more conservative senior debt, were actually quite aggressively structured—and investors weren't necessarily being compensated for the increased risk they were taking. In essence, many of these deals looked more akin to "mequity" risk—or mezzanine/equity risk—given the high leverage and often significant level of execution risk in converting adjustments to cash.

Ultimately, this can result in very real liquidity issues—and, in fact, already has. We noted here that the next downturn could very likely be driven by liquidity challenges, and COVID has not only turned that into reality but also exacerbated it, with companies across the market experiencing significant cash flow problems. While measures like the Paycheck Protection Program (PPP) in the U.S. have provided near-term support that many companies in this space have been able to take advantage of, the longer-term outlook is far less certain and depends largely on the longevity and severity of the pandemic.

WEAKER DOCUMENTATION

Compounding this, covenants and structural protections have been diluted in recent years, meaning that if or when companies encounter liquidity issues, they may not be well-telegraphed. While covenant-lite transactions aren't necessarily troubling in the more liquid broadly syndicated market—as investors have the ability to sell out of assets more readily—they are a critical part of managing losses in the illiquid private lending markets. At the most basic level, maintenance covenants give managers the ability to track the performance of a company to help ensure it is in compliance with certain performance metrics. They also give lenders a seat at the negotiating table if a company runs into trouble.

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In this capacity, the lack of robust covenant packages can have a material impact on the severity of defaults and the ultimate recovery values. While weakening documentation has been widespread across the middle market, it has been most pronounced in the upper part of the market, where almost 50% of transactions in recent years were cov-lite, versus 20% in the traditional middle market.[3] This, combined with increased leveraged levels, essentially resulted in liquid assets in an illiquid wrapper—transactions that were priced and structured in a way that were not adequately compensating investors for the illiquidity of the private credit market.

Accessing the Opportunity

Traditional first lien senior debt has been relatively insulated from some of the riskier behavior in the space, and—for lenders with the ability and willingness to meet the financing needs of middle market companies—continues to offer attractive value and the potential for strong risk-adjusted returns over time. In the U.S. specifically, the middle market is core to the economy—it represents more than 200,000 companies that collectively employ millions of Americans. Most of these companies rely on private lending as a means of raising capital for investments, given their limited ability to directly access liquid capital markets. All of this is to say, the opportunity for investors in this market—particularly those looking to generate yield in a prolonged low rate environment—is not going to disappear.

As shockwaves continue to reverberate through the leveraged loan market, some companies and industries are inevitably better positioned to withstand the volatility than others. The energy sector, of course, has been particularly hard-hit given the oil price weakness that has run parallel to the pandemic-related shocks. Airlines, restaurants and retail have also suffered notably as countries around the globe have instituted various lockdown measures.

FAD RISK

Prior to the crisis, so-called fad industries like restaurants and retail already posed notable risks, in our view—namely, increased vulnerability to intermediation and disruption over the lifecycle of the investment. The disruption in the retail space from the rise in e-commerce is probably the most well-known example, though restaurants have faced their share of challenges as increased options for food delivery have threatened more traditional dine-in models. Given the high degree of uncertainty around how these industries may evolve or change over the five to seven year life cycle of a typical private credit investment, we believe these areas look less attractive.

3. Source: Reuters. As of December 31, 2018.

In our view, dependable and defensive sectors tend to be better positioned to withstand challenges. Diversification is also critical, as it helps protect the overall performance of a portfolio from weakness in a few sectors or industries. In addition to fad risks, we also don't invest in cyclical businesses like oil and gas, or mining. In fact, 80% of defaults in the leveraged loan market over the last five years were in sectors where we don't invest.[4] When we think about middle market deals, and the illiquidity in the market, we assume that we are holding an investment until maturity.

Additionally, the substantial growth of the private credit market over the last decade will naturally result in more middle market issuers running into stressed situations. And the aforementioned weaker documentation, higher leverage levels and proliferation of new entrants will likely be key factors contributing to the growing distressed opportunity in this space.

What's Next?

The long-term effects of the coronavirus and related economic slowdown are impossible to quantify, and things may get worse before getting better. However, when it comes to private credit, there are also potential upsides to volatility, particularly longer-term. For an asset class that has been characterized in recent years by increasing competition, lack of transparency and a degree of style drift—which as mentioned above has caused market dynamics to become somewhat distorted—this event will almost certainly "lift the curtain" to some degree and differentiate those strategies that are built to last.

Indeed, risk management and experience have come to the forefront as managers and investors alike seek to navigate the challenges facing businesses today—and grapple with the tragic toll the virus has taken around the world. When it comes to investing in this asset class, deploying capital in the good times is one thing; managing investments through the tough times is another. And in this environment of heightened uncertainty, it is critical for investors to partner with managers that have experience managing through the ups and downs of economic cycles.

The big question today is how long this crisis will last, and whether companies have sufficient liquidity to endure it. At Barings, we are re-underwriting and stress testing every company we're invested in to try and gauge whether it can endure a prolonged low-demand environment. As part of that analysis, we are differentiating companies that have an immediate need for liquidity from those that may need cash down the road and/or that ultimately look well-positioned to withstand the crisis.

Despite the current challenges, we believe private credit markets remain attractive, and the asset class has generated solid risk-adjusted returns over time. When deal flow returns and supply/demand dynamics begin to normalize, we believe there is a strong likelihood that the post-crisis environment will be more attractive than that immediately preceding this crisis. Specifically, we think there is a good chance of seeing better pricing, lower overall leverage and more robust structural protections—creating what may be very favorable conditions for deploying capital and generating strong risk-adjusted returns for investors. In our view, managers who have remained focused on the true middle market—and maintained a disciplined approach rather than chasing yield through higher leverage or looser covenant structures—are best positioned to endure this near-term shock and capitalize on the longer-term opportunity.

4. Source: S&P. As of December 31, 2018.

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