E X P E R T Q & A

Barings' heads of North American and European private finance Ian Fowler and Adam Wheeler discuss the trends – as well as the key differences – shaping their respective markets

From covid to ESG: Navigating the private debt market

Q How has covid-19 affected North America and European private credit?

Ian Fowler: There are certain things that have surprised us in North America. For instance, given how important relationships are to transacting in this space, there was a view at the onset of the crisis that activity would stall and it would be challenging to get deals done. But it has been quite the opposite. Whether it is sponsors, management teams or lenders, everyone seems to have figured out a way to navigate this period of physical separation. Indeed, activity rebounded strongly in the third and fourth quarters of last year, and has remained elevated in early 2021.

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This crisis has also been much more targeted than past recessions, when nearly all businesses and industries were affected. This time around, consumer-facing businesses, particularly fad industries like restaurants and retail – areas where we do not invest – have been disproportionately impacted. As follows, lenders with exposure to restaurants and retail have had to spend more effort dealing with trouble spots in their portfolio, whereas lenders with less or no exposure to those sectors have been able to concentrate on deploying capital and taking advantage of attractive post-covid deal terms.

Adam Wheeler: While there are many similarities in how the pandemic impacted European private credit, there are also a couple of key differences. For one, Europe went into lockdown much sooner than the US and also came out a little earlier in terms of dealflow. Unlike the US, Europe is a sole lender market – so as dealflow has resumed, market share growth has become increasingly bifurcated among direct lenders. In essence, we have seen a flight to quality, as tends to happen in times of uncertainty, with private equity sponsors gravitating toward managers with whom they

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have strong partnerships – as well as those with execution skills, significant hold capacity and flexible capital structure solutions. This has amplified the market's already high barriers to entry and, as a result, we are seeing a number of smaller players in the market facing adverse selection – or basically having their investment universe curtailed to the transactions top-tier managers have turned down.

Q Where are you seeing the most interest?

AW: In Europe, we have historically seen the most interest from pensions and insurance companies. More recently, however, large sovereign wealth funds have turned to the asset class as well. Increasingly, these investors are looking to form strategic relationships with managers of scale in pursuit of consistent, through-the-cycle returns and potentially attractive yields. At a higher level, for many investors, European private credit is becoming more of a core allocation, which wasn't necessarily the case a few years ago. We are also seeing more North American investors expand their private credit allocations to include Europe – similar to what they've been doing in high-yield and broadly syndicated loans for the last decade plus.

IF: In North America, many large, institutional investors view private credit as a core allocation and have been invested consistently for a number of years. In addition to the potential benefits Adam mentioned, private credit is a floating rate asset class, typically with a floor in mid-market deals. So regardless of whether rates rise or fall, all-in yields tend to stay in the same range – although the components can shift between the spread from LIBOR and the credit spread based on market conditions. We've seen some investors who are newer to the asset class adopt more of a 'wait-and-see' approach through this period of uncertainty. But that is more the exception, particularly given that we're in a world where the majority of sovereign and corporate credit is trading below 2 percent. Relatively speaking, an investment in senior debt that has historically offered yields in the 6-8% range looks fairly compelling.

Q What is your outlook over the next 12-24 months?

IF: In North America, we're optimistic that activity levels will remain elevated—particularly given expectations around leveraged buyouts on the back of the capital infusions we've seen over the last year. Even with the potential for headwinds going forward, we feel confident that there will be opportunities to invest in high-quality companies.

In the North American mid-market, we haven't seen many distressed opportunities emerge. We know they exist, and that there are managers with exposure to industries and businesses that have been impaired and may not recover anytime soon. But one of the things that can happen in an illiquid asset class like private credit is that managers can kick the can down the road, so to speak.

For this reason, it is critical for investors to closely examine their managers to see if there are any pain points in the portfolio. This means drilling down into deal-level statistics, valuation policies and other factors to try and gauge the durability of the platform. It all comes down to discipline, ultimately, and ensuring managers have deployed capital in a prudent and efficient way while avoiding significant style drift.

AW: I would echo Ian's cautious optimism. In Europe, given the high number of covid cases and extended lockdown, we are looking to deploy capital with the understanding that the economy could move into a deeper recession going forward.

For this reason, while we avoid fad industries as Ian mentioned earlier, we also go beyond that – looking to invest in businesses that we think will be resilient and able to weather a broader economic downturn.

On the positive side, the deal pipeline in Europe is also very strong, helped by continued M&A activity.

Additionally, many of the transactions we're seeing in the market today are showing decreased leverage levels, stronger documentation and improvements in pricing versus what we were seeing immediately preceding the crises – suggesting a rebasing of the market from where it's been for the past several years.

With the vaccine being rolled out across Europe, we could see a bounce-back in economic activity in the second half of this year, which would be further supportive of the asset class.

The last thing I would mention is that in Europe, in particular, environmental, social and governance considerations have remained at the forefront. Although debt holders by definition do not own companies – and therefore cannot directly influence company behavior – the market is increasingly recognising the ability of lenders to influence ESG practices through the terms and conditions, and ultimately the pricing, of debt structures.

In fact, we were recently involved in one of the first European mid-market transactions with ESG criteria embedded into the terms of the loan in a way that directly influenced the overall price.

As more lenders consider the ways they can encourage borrowers to adhere to certain ESG standards, ESG criteria may very well become a mainstay in these transactions. ■