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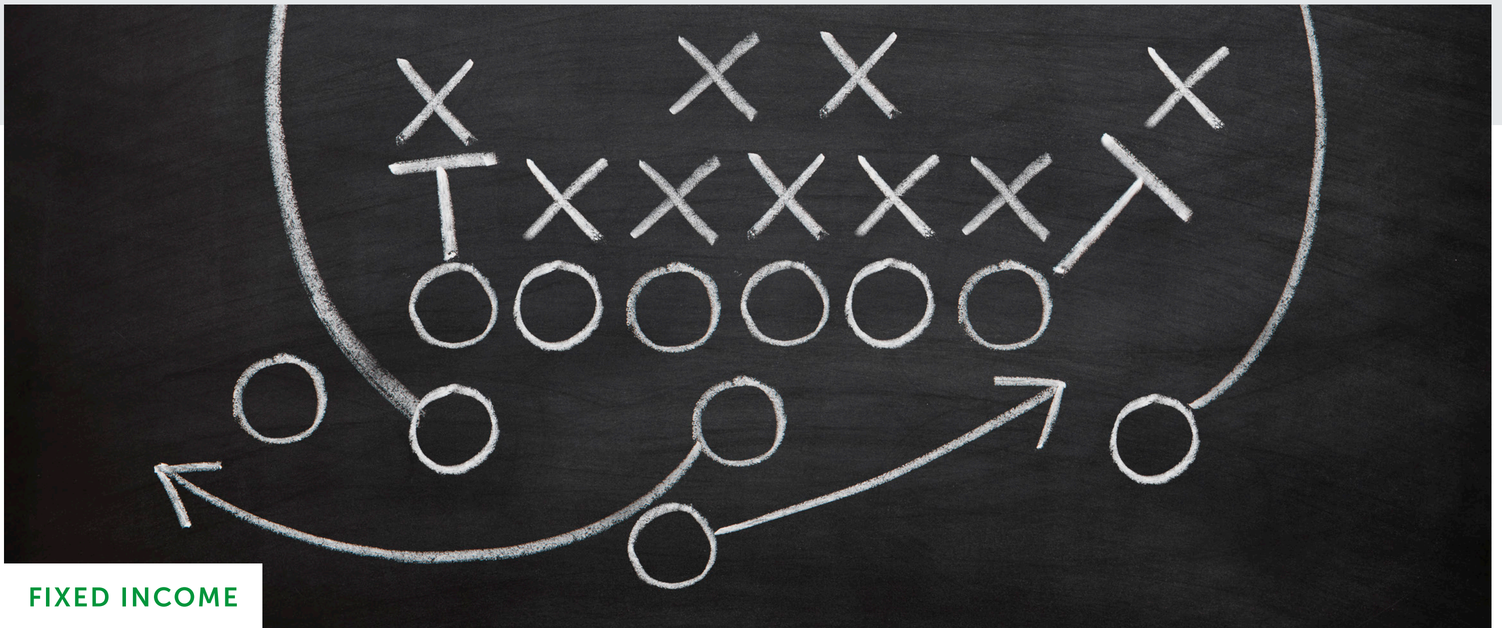

FIXED INCOME

BARINGS INSIGHTS

Four Mistakes Investors Make in Private Credit (And How to Avoid Them)

Why Last Cycle's Playbook Won't Work this Time Around

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It's human nature to overweight proximity. Think about your to-do list today. How many tasks center on reaction to current news, new perspectives, or whatever you've seen on your LinkedIn or Instagram feed? If you're intellectually honest, the answer is probably a lot. Be it life or investing, it's important to understand how proximity to the information of the day influences our attitudes—and ultimately—our decisions.

The same is true when it comes to investing in private credit, an industry where credit asset managers (non-banks) provide loans to corporate borrowers with the goal of delivering attractive rates of return to clients. This industry takes on many different names: direct lending, non-bank lending, private credit, middle market lending and sponsored lending among the most common.

Like the proximity point mentioned above, the torrential news cycle in private credit remains almost as volatile as the revenues of the news industry itself, and investors, if not careful, can quickly get caught in a routine of reacting rather than investing. On one extreme, there is a view that this asset class is akin to James Milton's Shangri-La—offering utopian risk-adjusted returns from lending to middle market borrowers who can smartly handle their debt. Such a view, unsurprisingly, leads to new capital being raised by managers happy to grow assets under management (AUM). The other extreme, of course, is dystopia—the view that substantial industry competition will lead to an eventual loosening of terms and a flood of future losses. This view, also unsurprisingly, tends to be widely reported in the investment press because—let's face it—fear sells.

Whether your view falls at one extreme or somewhere in the middle, it's hard to ignore the drama captured in headlines like: "High Yield was Oxy. Private Credit is Fentanyl" or "There is No End in Sight for the Private Credit Boom." Imagine the influence on private credit investor decision-making when considering those titles.

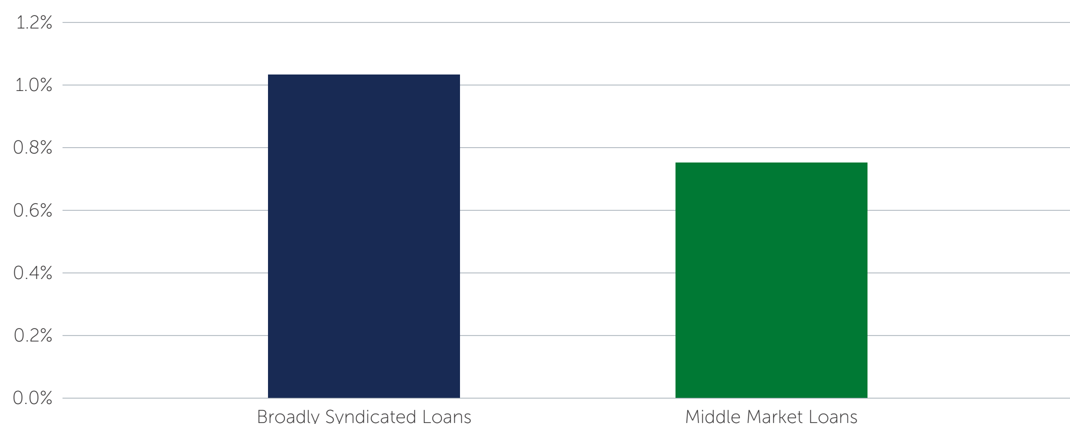
Aside from the inherent hyperbole, one big concern with these headlines is that they tend to focus on the "fruit" issues rather than the "root" issues. Akin to treating symptoms as opposed to the actual sickness, too much time spent on the issues of the present day (the fruit) diverts investors' focus away from the issues that drive market movements (the root).

This article, with (admittedly) a bit of dramatic flair, focuses on the root. It does so through a discussion of common investor mistakes—made by top institutional investors down to the smallest RIA. These mistakes are thematic, and our perspectives here are designed to offend both extreme views on private credit.

MISTAKE #1: PAST IS PROLOGUE

Ask any large institutional investor, and they will likely tell you that the primary reason they invest in private credit is their expectation that the asset class will offer attractive risk-adjusted returns in the future—like it's done in the past. Investors and credit managers alike point to middle market loans' low implied annual loss rates relative to their broadly syndicated counterparts **(FIGURE 1)**.

FIGURE 1: Low Relative Loss Rates Over Time—*Implied Annual Loss Rate (2007–2017)*



SOURCES: Fitch Ratings, Reuters LPC. As of December 31, 2018.

Yet, such a view fails to take into account two important considerations: (1) the root issue that drove superlative returns, and (2) whether or not that root issue is different today than in years past. Looking at Refinitiv data, total leverage during the last cycle peaked at 5.5x for middle market deals, compared to more than 7x for their large corporate counterparts **(FIGURE 2)**.

Looking at M&A as a percentage of 2007 peak volumes **(FIGURE 3)**, notice that middle market deals—a proxy for private credit—experienced a rapid resurgence in M&A on the back of the financial crisis, as a number of these companies refinanced and paid back debt owed. Notice too that their larger counterparts took roughly two additional years to return to that level. The reason? Middle market deals operated under a lower leverage profile in years past, making it easier for companies to refinance their debt burden—which allowed loans to be repaid and kept losses low.

Today, it's a different story, with middle market leverage currently at levels comparable to larger, broadly syndicated corporates. Even at the lower end of the middle market, leverage levels have gone up—while still low at an absolute level, they are higher than they have been in the past and perhaps higher than they should be.

Another consideration: covenants and structural protections in both large corporate *and* middle market deals have been diluted compared to the prior cycle. Covenants are critical in managing losses, and the current covenant packages (or lack thereof) will have a material impact on severity of defaults and ultimate recovery values, particularly as liquidity issues may arise before covenant defaults in many situations.

Markets adapt, so to assume that past is prologue—or (worse) that what worked for managers in the last recession will also work in today's environment—is a mistake. But this mistake gets made time and time again (no matter how sophisticated the investor).

FIGURE 2: Low Leverage Over Time—*LBO Leverage By Market Segment*

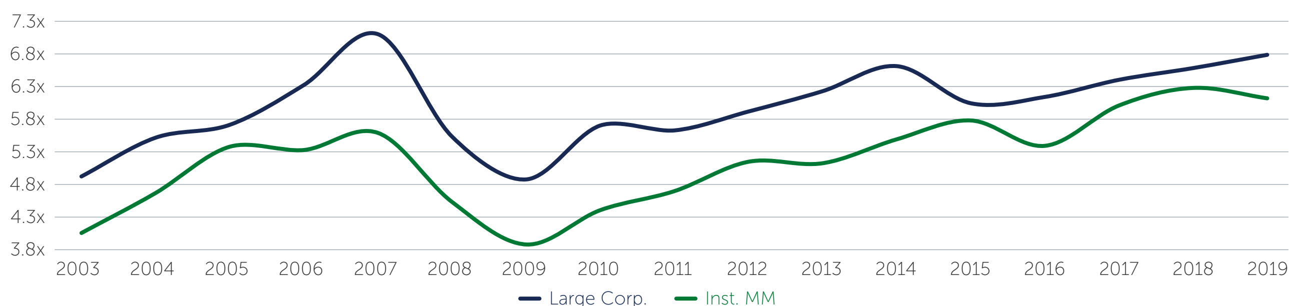
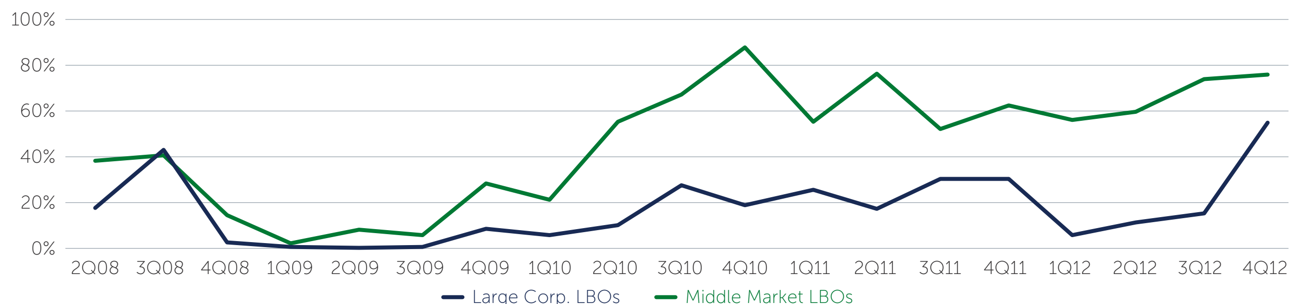


FIGURE 3: MM M&A Rebounded Faster Than Their Larger Counterparts—*M&A Volume as % of 2007 Peak*



SOURCE: Reuters LPC. Figure 2 as of December 31, 2019.

MISTAKE #2: DIFFERENTIATION SOLELY THROUGH SIZE OF CAPITAL BASE

Too often, investors differentiate managers based solely on the size of the manager's underlying platform AUM—the (misguided) assumption being that the larger check one writes, the greater access one receives to large private transactions. While this may seem logical on the surface, root-level issues require a more thorough investigation. On this point, three considerations come to mind:

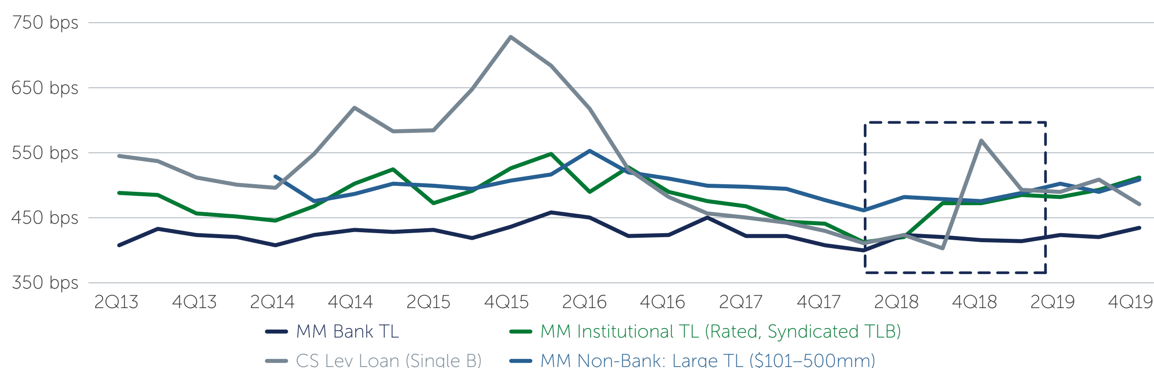
1. While size and scale have advantages, there is a point to which size becomes the enemy of net return.
2. The greater the capital base to "feed" in a deal-making industry like private lending, the greater the probability that a manager underwrites to satiate an asset management business as opposed to a principal investment business (and investors should care about the second more than the first!).
3. If an investor truly differentiates between private credit managers based on size, they are by extension rewarding a manager's ability to raise capital rather than to actually invest it. And many managers have achieved great fundraising success in this space in recent years—today over 37 private credit platforms may write checks of $100 million or more, according to Refinitiv data.

To be discerning means to consider measures beyond size—and while a minimum scale does need to be achieved in private markets, true differentiation is accomplished through diversity of both lender product and private credit asset class. To a hammer everything is a nail—the same logic applies to private credit, in that a monochromatic focus on one product (e.g. unitranche credit to large borrowers) can severely restrict a manager's and end-investor's frame of reference.

There is an additional downside to homogeneity that relates to how assets are priced. In the world of institutional investing, there is a saying along the lines of: *thou shalt never invest at a liquid price, at terms comparable to the liquid structure, but do so in an illiquid wrapper.* Translating that to common English: lenders must price and structure loans to compensate for illiquidity—or the risk of not being able to sell a security. This sounds easy in theory, but in reality—as many managers move away from principal investor (i.e. investing on their own behalf) and into the world of credit asset managers (i.e. investing on behalf of others and collecting management fees)—the illiquid spread premium begins to vanish. A look at loan spreads over the last several years underscores this distinction.

Notice the third quarter of 2018, when liquid loan spreads widened as a result of market fear **(FIGURE 4)**. At that point in time, broadly syndicated loans—despite having EBITDA[1] profiles substantially larger than the middle market borrowers—were offering spreads of close to L+600. Many middle market transactions, for comparison, were priced at L+475 with zero liquidity.

FIGURE 4: A Wider Frame of Reference Allows for More Efficient Pricing
Quarterly Middle-Market Spreads Across The Capital Structure



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

1. Earnings before interest, taxes, depreciation and amortization.

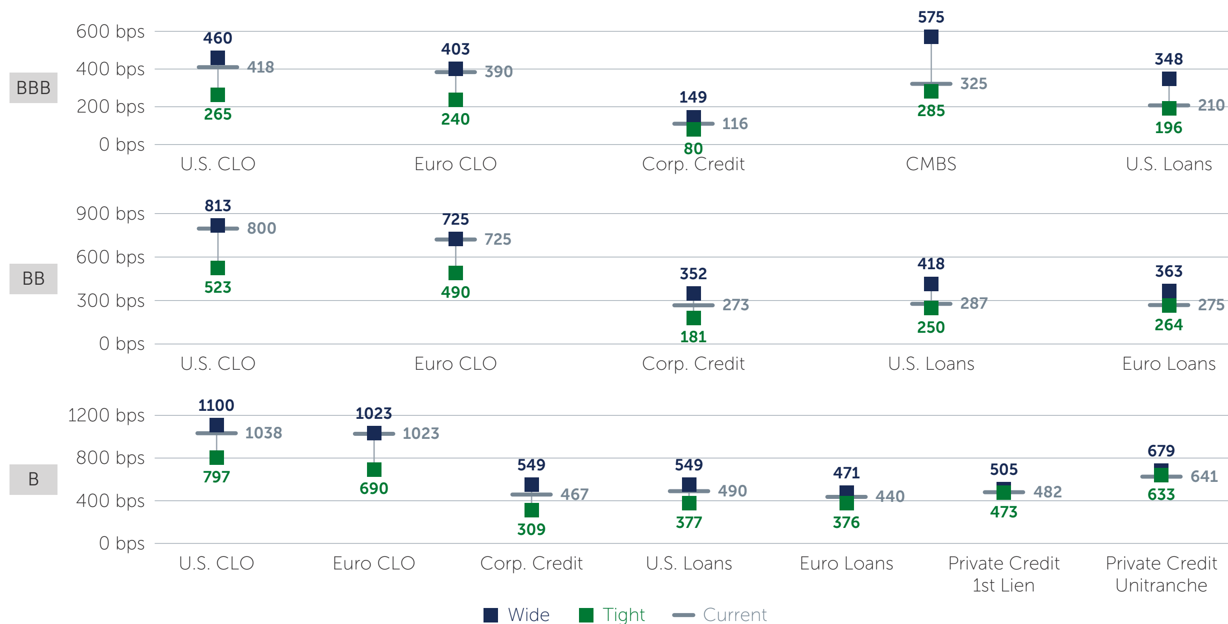
"If a manager is focused only on private credit, as opposed to looking at historical spreads across several liquid and illiquid credit instruments, it is more difficult not only to make the right relative value decisions but also to price loans correctly."

Principal investors often avoid taking illiquidity risk that is not properly priced. Yet there is another important consideration related to differentiation through diversity that ties to pricing. The wider the investment frame of reference in private credit, the better the visibility—and by extension, the ability to price middle market transactions in a way that favors the end investor. In other words, pricing decisions shouldn't be made in a vacuum.

If a manager is focused only on private credit, as opposed to looking at historical spreads across several liquid and illiquid credit instruments, it is more difficult not only to make the right relative value decisions but also to price loans correctly. For example, it is possible that managers may choose to price single-B private credit (first-lien risk) at a tighter spread than a higher-quality BBB CLO with the same liquidity profile **(FIGURE 5)**. Without a wide frame of reference, the monochromatic may miss the potential to price their capital relative to the entire private credit opportunity set, which leads to our last point.

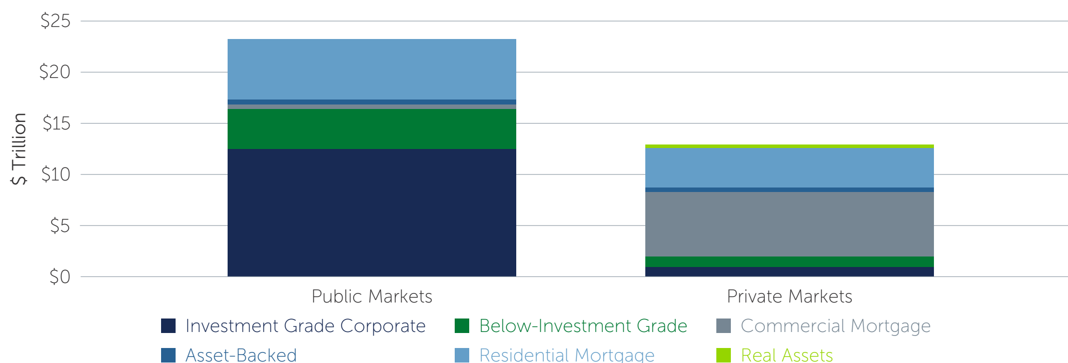
Investors today, in missing the differentiation in diversity, often carry too limited a view of private credit and the risk/returns that exist in private markets as a whole. Today, the vast majority of private credit exposure in institutional accounts is tied to corporate credit (loans to companies), which means many investors are taking the same risks. To expect a different investment result requires the understanding that a corporate credit-only definition of private credit is too narrow. Private markets are roughly 50% the size of the public markets and comprise sub-markets ranging from consumer credit, to private ABS, to mortgage and others—all of which exhibit unique risk/return profiles. In summary, the true definition of private credit moves well past corporate credit beta.

FIGURE 5: Pricing Decisions Shouldn't Be Made in a Vacuum—*3 Year Lookback (Wide/Tight/Current)*



U.S. AND EUROPEAN CLO SPREAD SOURCE: J.P. Morgan. As of October 31, 2019. New issue CLO spreads represent the midpoint of a range of spreads to indicate manager tiering. CMBS, AND SUBPRIME AUTO SPREAD TO SWAP SOURCES: Bank of America, Merrill Lynch. As of November 1, 2019. CORPORATE CREDIT SPREAD TO SWAP SOURCE: Barclays. As of October 31, 2019. U.S.EUROPEANS LOAN SPREAD SOURCE: Credit Suisse. As of October 31, 2019.

FIGURE 6: Private Fixed Income Markets Are Larger Than Most Investors Think
Public Fixed Income Markets vs. Private Fixed Income Markets (2018)*



SOURCES: Bloomberg, Barclays, Credit Suisse, Refinitiv, Cushman & Wakefield, Barings estimates.
*Totals do not include Government bonds or traditional bank lending.

MISTAKE #3: A FOCUS ON THE SIZZLE AND NOT THE STEAK

When investors ask why they should invest with a certain private credit manager, they will likely get a combination of the following answers:

- "We have deep relationships with the PE sponsor community"
- "Our private equity style due diligence is unmatched"
- "We've done this for a long time and know the markets"
- "All of our deal flow is highly proprietary"
- "We have amazing haircuts and sponsors love us"

The last example is made in jest, but the point is that these answers can go on (and on). But notice: none of the examples above allow an investor to tangibly discern quality from one manager to another. In essence, a quantitative phenomenon cannot be supported by qualitative measures—what we like to call the "sizzle," because they sound nice and look good. Rather, when it comes to making discerning investment decisions, investors need to drill down to fundamental math and alignment concepts.

We can talk through the alignment point first. Recall the aforementioned point that many managers today have moved past principal investor and into the world of credit asset management. The highest alignment starts and ends with the assets—whereby the assets owned by a manager are the same as those that sit within their credit manager funds. To the extent a gain or loss is realized, the manager shares in that experience—and, in fact, often has a higher amount of capital invested. In other words, they eat their own cooking.

Another way of quantitatively measuring the "steak" rests in a deep understanding of fee structures and incentives—or in very simplified terms, math. All too often, investors ask for the returns a manager can generate for them in percent terms (i.e. this private credit manager can earn you 9%). This is inherently limiting, as it doesn't give a sense of an investment strategy's underlying risk. It also ignores a key question: What does a manager need to lend at in order to generate the promised 9% return? That question puts the discussion into an entirely different context—as investors can simply use math to determine the underlying risk in achieving the promised rate of return. This required return on assets (ROA) analysis is outlined in the formula below.

$$\text{Req. ROA (\%)} = \left[\frac{\left[\left(\frac{\text{Expected ROE} + \text{Credit Losses}}{1 - \text{Incentive Fee}} \right) + [(\text{Base Fee} + \text{G\&A} + \text{Int Expense}) \times (1 + \text{leverage})] \right]}{1 + \text{leverage}} \right]$$

Let us say a private credit manager (Manager A) is targeting an 8% yield. Say the manager is also charging a 150 basis points (bps) management fee on assets and a 20% incentive fee over a hurdle rate of 6%, subject to a 100% catch up. In that scenario, the manager would need to deploy assets at L+593, at no losses and in perpetuity, to make good on its 8% target. If first lien senior lending rates are today at L+475, it strongly suggests that this manager would need to lend at a higher risk profile to both meet the investor's expectation and pay the required manager fee.

Now, let's take another manager (Manager B) who outlines an 8% yield, but charges a 137.5 bps management fee on assets, and a 20% incentive fee over a hurdle rate of 8%, subject to a 100% catch up. This manager, using the math example, would be able to lend at L+497 to generate the same net return as Manager A. Discerning investors may understand that investing at L+497 likely translates to a lower risk profile than investing at L+593—so the question is, why do the two managers have drastically different required returns on assets (ROA)? The answer is fee structures and incentives, which all too often can be contorted into a win/win scenario for a manager (or a lose/lose scenario for an investor). It is beyond the scope of this piece to outline the many potential iterations of this scenario. Suffice it to say, a quantitative, math-based approach gives investors visibility into a steak-level issue.

There's a parting comment that can be applied here. Let's imagine that Manager B above were to experience a 200 bps loss in credit performance. Clearly, such an outcome would be terrible, and a discerning investor would likely ask how much less other managers would need to lose to justify a higher fee structure. And in the case below, it's clear that if manager B lost 200 bps, then Manager A could lose only 103 bps to justify their higher costs as a percent of equity. Interestingly, that manager would need to lose less on higher-risk collateral because the math requires investment at a much higher spread to earn the same return for shareholders. In a world where true differentiation is often so limited, discerning investors may assume that if Manager B were to lose 200 bps, the others would likely lose roughly the same amount. Much like if you ask your peers who in the room is a good driver, and everyone raises a hand (despite the law of numbers saying that isn't possible), the same issue applies here. Not all managers will be good drivers, so it's important to let the steak (i.e. math/incentives) drive investment decision-making—and be wary of the sizzle.

FIGURE 8: Fee Scenarios And Required Credit Alpha to Justify Higher Costs

	Management Fee	Upfront Fee Skim	Incentive Fee	Hurdle Rate	Required Asset Spread* To Meet 8% ROE	Management Fees (% of Fund Equity)	If Manager B loses 200 bps then the other managers can only lose the following to compensate for the higher fee structure
Manager A	1.50%	N	20.%	6%	593	6.1%	103 bps
Manager B	1.38%	N	20%	8%	497	3.8%	—
Manager C	1.38%	Y, 50%	20%	8%	528	4.4%	175 bps
Manager D	0.15%	N	12.5%	LIBOR	426	2.1%	273 bps

SOURCE: Barings.
*Spread also assumes 1.5 pts OID.
For illustrative purposes only. There can be other factors and variables not listed that will affect these outcomes.
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

MISTAKE #4: ASSUMING SENIOR ALWAYS MEANS SENIOR

This last mistake is driven by the math problem outlined previously. As is the case in any market, private credit investors strive to receive the highest return for the lowest possible risk. In this market, investors often equate risk with where one lends in the capital stack—meaning if one lends at the top the stack (i.e. first lien) they stand to be repaid first and hold the lowest risk of loss. Thus, in private credit parlance, investors are seeking high returns on first lien senior secured collateral (i.e. the highest returns on the part of the debt stack with the lowest perceived loss incidence). Historically, first lien loss rates on middle market collateral ranged between 30 and 50 bps throughout the credit cycle, but as investors recall from the first mistake in our discussion—past isn't prologue.

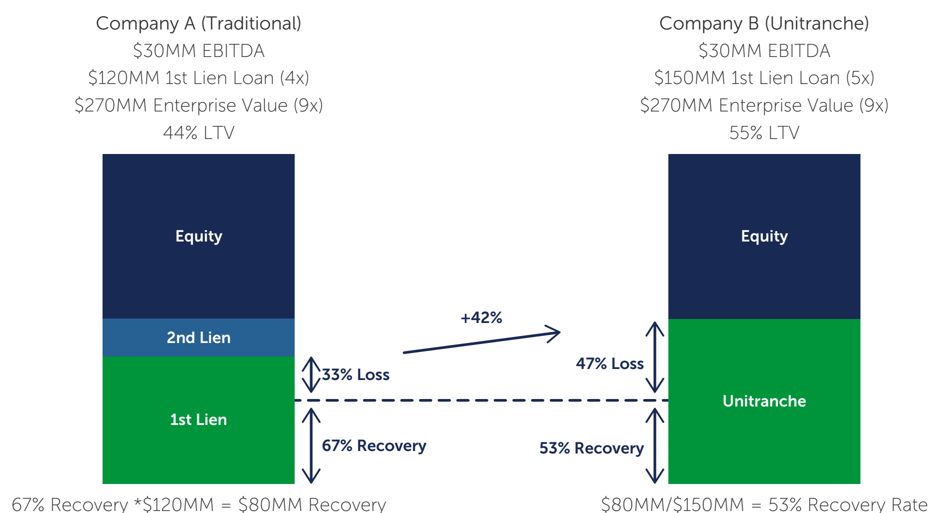
Private credit managers who are improperly incentivized by lack of alignment and poor math may be forced to originate assets at spread levels in excess of L+500 (or even 600) bps to make returns work for their investors. This forces a choice:

1. The manager can begin to focus on more junior collateral and earn higher returns, but at a higher risk profile than the investor understands;
2. The manager can simply cut its management fee to allow it to appropriately price a high-quality senior loan and ensure investors get the same return; or,
3. The manager can redefine what a true senior secured loan is—whereby the loan appears senior at the surface level, but the underlying fundamentals of the loan are vastly different, and more akin to junior debt.

Of the three, certain managers may find it easier to "redefine away" risk rather than ensure proper incentives are in place to allow them to finance the right loan.

In **FIGURE 9**, we outline a true first lien senior investment with a level of junior debt investment behind it (Company A). On average, investors expect 67% recoveries on first lien assets that are properly underwritten. In this case, with a traditional first lien/second lien structure, first lien loan-to-value is roughly 44%. Now, look at Company B. In this case, we still have a senior loan, as the lender provided an all-senior solution to leverage the company (no junior debt). However, the underlying risk profile of that loan is different. In a situation where Company B would need to be liquidated at the same enterprise value, the "senior" lender would end up losing more than the senior lender with Company A as a result of lending more money and structuring the loan differently. This concept often goes unnoticed.

FIGURE 9: Unitranche vs. First/Second Lien Recovery Rates
Expected Recover/Loss Example



SOURCE: Thomson Reuters LPC. For Illustrative Purposes Only.

To mitigate the risk of definitional creep, investors can start with the first line of defense—alignment. It is harder for managers to aggressively redefine senior risk when the loan in question sits on the manager's balance sheet. A second defense would be to look at the amount of freedom being afforded to the manager in the incentive fee structure. Said another way, investors should question whether the math works—can the manager solve for an end return by making the right loan as opposed to redefining risk?

And finally, a discerning investor can look through the underlying loan collateral to try and gauge whether the more "junior like" debt that sits inside the senior debt structure is properly priced. This concept ties to a simple view of spread per turn of leverage—as the leverage level increases inside a transaction, is the manager properly ensuring that the next turns of leverage, beyond a 4.5x traditional senior structure, are carrying higher levels of interest cost?

Suffice it to say, senior isn't always senior.

CONCLUSION

To sum up this discussion, we offer a small smattering of common sense, which is not always easy to come by given our proximity to today's frenetic news cycle. We believe private credit markets are both attractive and dynamic, and the asset class has generated solid risk-adjusted returns over time. But, this is not the market of a decade ago, and it is imperative to partner with a manager that has a proper frame of reference and the right tools in place to avoid the pitfalls of this new environment. The mistakes outlined here are by no means mutually exclusive or all encompassing, but they are the ones we see time and time again.

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