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How Healthy is Today's Private Credit Market?

BARINGS CONVERSATIONS

This piece was adapted from an interview with Jon Bock. The full audio podcast can be found here.

Barings' Jon Bock weighs in on the dynamics shaping private credit today—from deal activity, to leverage metrics, to spread levels—and discusses how investors can access the opportunity.

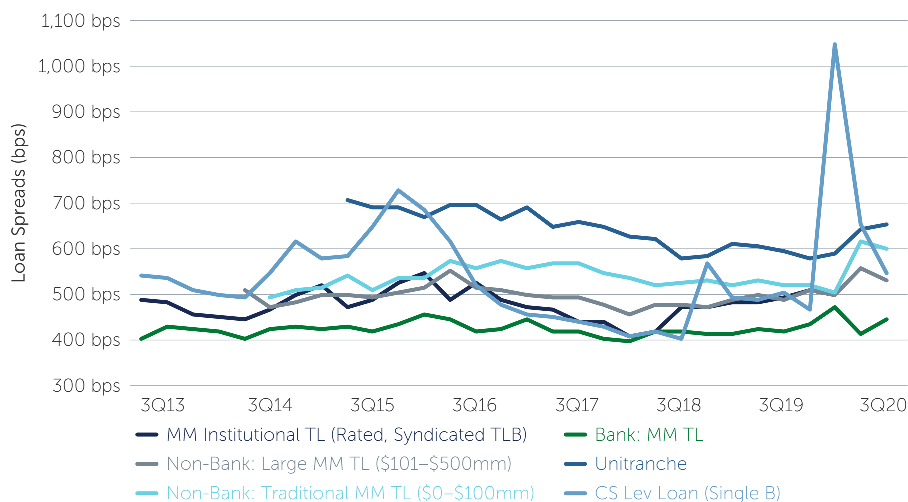
Almost a year ago, you raised some concerns about whether or not investors were being adequately compensated for the risks they were taking in private credit, particularly relative to more liquid asset classes. How has the market changed since then—is that still a concern?

Before the onset of COVID-19, we were certainly witnessing some riskier behavior in parts of the middle market—in particular, we started to see a degree of late-cycle style drift. As more managers raised larger and larger funds, there was more capital chasing deals in the space. And so one of my main concerns was that the more challenged businesses with weaker structures were able to secure attractive financing terms for themselves in the private credit market. In some transactions, leverage levels had risen to the point that they were beginning to resemble those for larger, broadly syndicated corporates. Spreads, too, were narrowing—inching closer to those in certain liquid markets, meaning the illiquidity premium was beginning to vanish. At the same time, covenants and structural protections, which are a critical part of managing losses in the illiquid private lending markets, were being diluted. As a result, many transactions in the private credit market were being priced and structured in a way that, in our view, did not adequately compensate investors for the illiquidity of the asset class.

That lack of liquidity premium coupled with the risks—whether structural or industry-specific risks, such as those posed by heavily cyclical businesses like restaurants and retail—presented concerns. And when COVID hit, and company revenues in some cases fell to zero almost overnight, many of these concerns came to fruition. However, lenders that chose to be more conservative and disciplined, maintaining a focus on the more traditional or true middle market—in essence, 'boring is beautiful' type businesses—were better able to withstand that initial shock, and are now finding themselves in a position to drive strong long-term returns for investors.

Today, these are the businesses that have been able to attract capital. As a result, the quality of deals coming through appears to be higher, with many deals exhibiting lower leverage levels, tighter documentation and better pricing. The spread dynamic has also improved slightly, with spreads widening by roughly 50 to 100 basis points (bps), depending on the business **(FIGURE 1)**.

FIGURE 1: All-In Senior Investment Spreads



SOURCE: Refinitiv LPC. As of September 30, 2019.

What is your sense of activity levels in the market? Is it difficult for managers like Barings to source new transactions today?

It's been a robust market for lenders that have the ability to deploy capital. From an origination perspective, disciplined lenders that were both rational and patient through the initial shock of the crisis—and that had done their work in recognizing the underlying value of the businesses they lent to (i.e. boring is beautiful)—should be fairly well-positioned today, and likely to attract more deal flow. In essence, reputable managers that have strong partnerships with financial sponsors, intermediaries and portfolio companies—as well as execution skills, significant hold capacity and flexible capital structure solutions—are likely to be at an advantage when it comes to securing deals as we move through what are hopefully the final stages of the pandemic.

Despite the volume of deals in the third quarter falling short of what it was in the same period last year, we at Barings have been very busy. This is not only due to an increased market share, but also because we're fortunate to have a stable and well-designed capital base behind us—enabling us to deploy capital at attractively priced opportunities, such as the ones we're seeing today.

Are there any particular areas of the market where you're seeing weakness or distress?

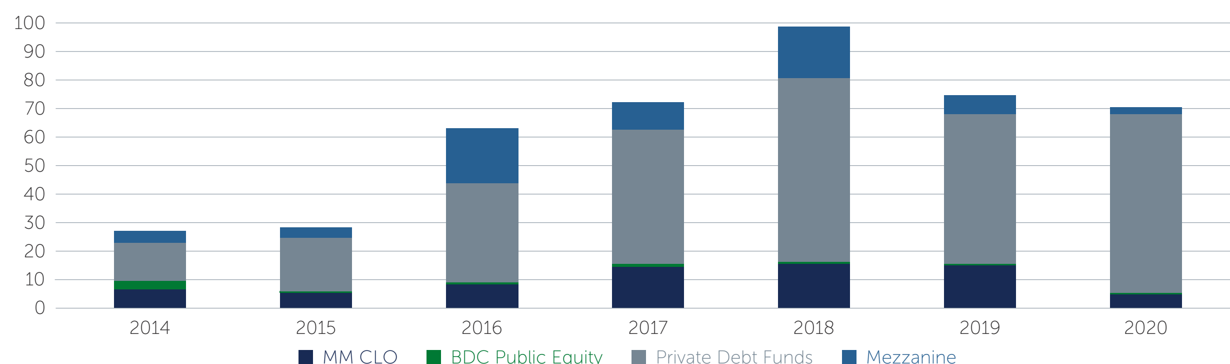
We're seeing market stress exactly where you'd expect it to be, and in the same places as in the public markets—in particular in the retail, travel and leisure industries, which have been directly impacted by government shutdowns across the world. However, even prior to the crisis, we viewed these hyper-cyclical industries as fairly risky, particularly given their 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 a well-known example. Restaurants, too, have faced their share of challenges as increased options for food delivery have threatened more traditional dine-in models.

Another area where we have seen stress is in debt marketed as senior ahead of the crisis, but that in reality had a much higher risk profile than is typical of traditional senior debt. In our view, many of these deals looked more akin to "mequity" risk, or mezzanine/equity risk, given the higher leverage and often significant level of execution risk in converting adjustments to cash. Ultimately, this resulted in very real liquidity issues as companies across the market started to experience cash flow problems.

If you think about the competitive environment, one concern is that there is too much capital chasing the same deals. Can you put that into context?

There has certainly been a lot of capital raised, just north of $70 billion in direct lending strategies in 2020 **(FIGURE 2)**. Often, times of stress, like we've seen with COVID, create technical volatility that can result in attractive opportunities—and smart managers will look to raise capital to try and invest in those opportunities. However, given the stress that the economy has experienced, discipline will be a big differentiator, which means keeping your foot on the brake to the extent that you need to, despite how much you want to push the accelerator. Essentially, you don't want to overcommit to one area that ends up causing a return detriment.

FIGURE 2: Middle Market Direct Lending Capital Raised ($ Billions)



SOURCE: Refinitiv LPC.

Looking across private credit markets, how big is the opportunity today, and what is driving it?

As the stress from the pandemic continues to impact businesses, the need for capital will persist, particularly as the private lending market moves further toward institutional lenders and away from traditional lenders like banks. In addition, and perhaps more importantly, some private companies will continue to stay private for a long time—suggesting there will continue to be a need for financing via private equity sponsor-backed deals.

While we can't necessarily quantify how large the opportunity is, there are a few structural drivers that could continue to support the opportunity going forward. For instance, there are indications that pension funds are increasingly considering private credit as a core asset class that they want to devote capital to, driven by the attractive risk-adjusted returns on offer. Currently, pension funds have roughly 2% of their assets in direct lending, suggesting there is scope for material growth in the long term.[1] And as this space continues to professionalize, it will not only continue to attract more companies, but we believe new formation companies will continue to stay private for a longer period.

At a high level, different parts of the private credit market can offer compelling benefits depending on the risk-return profile an investor is trying to generate. For someone looking for lower volatility with a good yield, first lien senior secured debt may be an attractive option. For investors willing to take on slightly more risk in exchange for potentially higher returns, certain junior debt or special situation financings could potentially look compelling. Value can also shift over time—there will be times when mezzanine is more attractive than second-lien and vice versa. Other times, first-lien may look the most attractive. In this regard, a wide frame of reference—as well as visibility across public and private markets up and down the capital structure—is prudent, as it can allow managers to identify the best relative value at any given time.

One final point to mention is that private credit, given its illiquid nature, can offer a potential yield premium relative to the broadly syndicated markets. And in today's lower-for-longer environment, where over 80% of the world's sovereign and corporate debt trades below a 2% yield, investors continue to search for assets that offer an attractive yield.[2] Therefore, it's not surprising that activity levels in the middle market are probably busier than some people may realize.

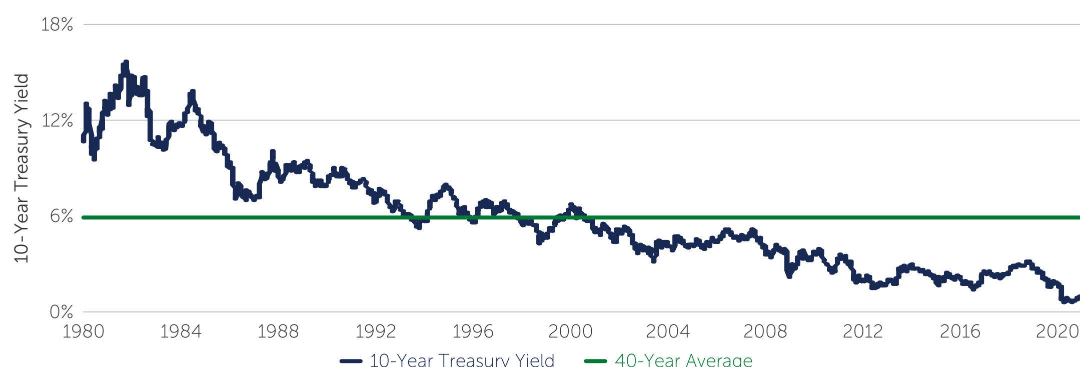
At a high level, for investors looking to access the middle market opportunity, do you have any guidance on the pros and cons for the various investment vehicles available?

From commingled private funds to separately managed accounts to public and private BDCs, there are an increasing number of vehicles for investors to choose from to access the opportunity, all with distinct characteristics. With regard to BDCs specifically, we think demand has actually increased since the onset of the pandemic. There are two types of BDC structures—public and private. In a publicly traded BDC structure, investors have the ability to invest in a publicly traded stock. The key benefits of this vehicle include the simplicity to invest and the liquidity on offer. However, the drawback of this avenue is the potentially higher volatility as markets move.

A private BDC structure does not trade publicly, meaning it is less prone to volatility—the value of the investment is the value of the assets themselves. However, this vehicle does not offer investors the same liquidity as a public BDC. Despite this, we've seen a lot of growth in the private BDC industry in recent years, as investors have been willing to lock up their capital—with a trusted and experienced manager—to potentially receive an attractive outcome over time.

To hear more of the conversation, listen to the full podcast here: https://www.barings.com/viewpoints/private-credit-how-healthy-is-todays-middle-market

FIGURE 3: Interest Rates are Well Below Historical Averages



SOURCE: Refinitiv LPC.

1. Source: Cliffwater. As of June 30, 2019.
2. Source: Bloomberg. As of December 9, 2020.

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