PRIVATE CREDIT:
STRONG POCKETS OF OPPORTUNITY

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Institutional investors have poured into the private credit markets over the last decade and continue to find the asset class appealing as a buffer against rising interest rates and public market volatility. Given recent developments, have the underlying drivers of private credit shifted? Should investors be more wary with recessionary concerns on the horizon? According to experts, despite the maturity of the market, there continue to be strong pockets of opportunity across direct lending in the middle market, in specific industry sectors, and in specialty finance. To gain deeper insights into investors' current thinking on the $1.2 trillion private credit market, Pensions & Investments spoke with Ian Fowler, co-head of Barings' global private finance group; Ronald Kantowitz, managing director and head of private debt for Invesco's global private credit platform; and Mary Bates, managing principal and private markets consultant at Meketa Investment Group.

Pensions & Investments: What are the specific characteristics of private credit as an asset class that make it so compelling for investors right now? Where does private credit fit into a multi-asset portfolio?

IAN FOWLER: Private credit has typically fit into one of two buckets: a yield enhancement in a fixed-income bucket or a high-returning strategy and way to diversify in a private equity bucket. Today, we continue to see investors who are looking at private credit to generate yield enhancement on the fixed-income side, especially now that the liquid markets have essentially shut down.

In today's environment, the asset class is compelling given its floating-rate nature, which means all-in-yield increases with rising rates. Additionally, these investments have structural protection through loan documentation and covenants, which help protect investor's capital. If we do enter a recession, we will likely see more private credit vehicles focus on opportunistic situations that are typically higher risk, but that have the potential to generate higher returns.

RONALD KANTOWITZ: Amongst many reasons, direct lending is appealing because of its floating rate nature. So, in an environment of rising rates, as we're in now, investors are insulated against interest rate risk. It's also often a senior secured asset class, meaning that the debt positions sit at the very top of the capital structure. This provides investors added security as they have a priority claim on all of the collateral — hard assets, intellectual property, etc. — of the borrowers.

Additionally, many direct lending opportunities continue to orient around private equity-owned companies. We view the presence of a sponsor as a risk mitigant. From our perspective, if we are partnering with some of the best equity investors in the world, who provide substantial first-loss equity — in our case, generally 50% or more of the value of the business — our debt positions at the top of the capital structure are in a very strong position.

And, finally, consider the current yield dynamic: In today's market, we see opportunities to underwrite new transactions to unlevered returns of upwards of 10+%. These types of returns in first lien assets, with strong sponsors, conservative structures and documentation provide a historically compelling risk-adjusted return.

MARY BATES: One of the benefits of private credit is that it can serve multiple roles for clients. In our experience, many clients have been drawn to it for its income-producing properties and its consistency as well as its upside potential. We have seen investors embrace private credit to meet the need for yield because public fixed-income spreads were tight and rates were low. Since the Global Financial Crisis, we have largely been in a search-for-yield environment, and private credit as an institutional asset class has met that need. The environment, however, has recently changed significantly.

As interest rates rise, private credit will still have a place in investors' portfolios. We are at a very attrac-

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tive entry point for many investors into private credit, for certain strategies. To the extent that we enter a recession or continue experiencing volatility, there likely will be significant opportunity for managers with flexible mandates.

P&I: Private credit has seen significant inflows over the past decade. What is driving the increased interest, and do you expect it to continue?

KANTOWITZ: Based on what we've seen in the market and our discussions with investors, we do believe this asset class will continue grow. There's just so much demand for capital in the middle market, and that's where direct lending comes in.

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Furthermore, from an investor perspective, direct lending tends to demonstrate significantly lower volatility relative to broader debt markets and can offer investors very low correlation to the traditional debt and equity asset classes. This is extremely important in an environment like the one we are now where, almost irrespective of underlying credit risk or fundamentals, you tend to see many assets move in tandem.

FOWLER: If you look at the structural changes to the middle market going back to the Great Recession, the providers of capital changed dramatically from insurance companies and banks to asset management firms. That allowed institutional investors direct access to the asset class. On top of that, the amount of capital raised by private equity firms has fueled further growth.

Prior to the Great Recession, managers were typically financing a company that would either get sold strategically or go public through an initial public offering. But since then, most activity in the buyout market has consisted of sponsor-to-sponsor transactions. And the significant amount of PE capital that has been raised has created more liquidity and a greater need for capital than ever before. With more debt and equity capital entering the market, it has pushed the asset class upward vertically to do larger deals and to compete with and disintermediate the lower end of the broadly syndicated loan market.

Additionally, many private equity firms are pursuing add-on acquisitions as a strategy to create value and reduce the cost basis of their investment by buying add-ons or tuck-in acquisitions at lower multiples. So, essentially, we have both the size of companies expanding in this market and horizontal expansion with add-ons. As a result, the definition of 'middle market' now varies fairly widely from manager to manager.

P&I: The number of participants in the direct-lending market continues to grow. What does it take to be a successful middle-market direct-lending manager?

BATES: Direct lending is a highly competitive space. Managers typically focus either on the sponsored or

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the non-sponsored space, and scale is particularly important in the former. In underwriting managers, we focus not only on a manager's origination capabilities but also on their workout capabilities. What are the asset management capabilities in place to avoid impairment? In the event of an impairment, what are the resources that are in place to manage an impaired credit? We also tend to favor lending strategies that are more diversified, given the asymmetric payout profile of par lending.

KANTOWITZ: There are two areas where you need to have a competitive, differentiated approach to direct lending if you want to be successful: sourcing and diligence. Direct lenders approach these levers in varying ways. At Invesco, our Private Credit Platform has more than $25 billion of capital invested in the portfolio companies of more than 200 private equity firms. Those are long-standing relationships that are very sticky and where we see a lot of repeat business. So that's our differentiator on the sourcing side.

As for diligence, we have a simple philosophy: it is difficult to be a generalist. Transactions have become more complicated and timelines have compressed. If you're looking at an investment opportunity in aerospace, health care, automotive, etc., and you don't have solid grounding in each of these sectors, it's either going to take you too long to get up the learning curve or you're going to cut corners and make mistakes. At Invesco, we maintain one of the largest sector-based private credit research teams in the market. In every one of our deals, we look to include our sector specialist on the diligence team. This is a significant differentiator as it makes our diligence more informed and efficient, and we believe leads to better outcomes for our investors.

P&I: Private credit investments typically have a longer time horizon than other types of credit. How do you address the liquidity concerns of investors?

BATES: In many income-oriented funds, the general partner will recycle the principal during the investment period but distribute the income or a certain percentage of the income. Investors are committed for the life of the fund but receive meaningful distributions during both the investment and harvest periods.

FOWLER: Liquidity concerns are addressed through the structure of the investments. In direct lending, structural protection through the loan documentation, with covenants and a pledge of stock, are designed to provide investors with additional protection albeit without liquidity. We should acknowledge that even liquid markets can experience illiquidity. The broadly-syndicated loan market and high-yield market have essentially been shut down since this summer — theoretically you can sell, but no one is selling because of the loss they would have to take. In the illiquid direct lending market, even though assets don't trade and no one makes a market, it is possible to sell loans. In a hot market, it may be a premium and in a dislocated market, it may be highly discounted. The advantage, though, with illiquid asset classes is that they are less volatile and less correlated to other financial assets, which investors enjoy.

P&I: What are some opportunities available to private credit investors right now, versus those in the public market?

FOWLER: On the direct-lending side, as the asset class has moved upmarket and disintermediated the lower end of the broadly syndicated market, we have seen larger deals that require more capital. In some cases, managers have gotten hung with deals that they thought they could syndicate but were not able to — in other cases, they looked to the liquid market to refinance, but that market was shut down. These managers have had to reduce their hold size, significantly paring back activity or, in the most extreme cases, shut down for the rest of the year. For managers with ample dry powder, this has resulted in opportunities to take market share.

On the investor side, the biggest challenge is to make sure that you're not only underwriting the manager's strategy and track record, but also considering the sustainability of the platform. If the platform is not strong enough or properly managed to deal with a conventional recession, then the platform is going to get in trouble.

BATES: One of the things that is attractive about private credit is its breadth. Investors have the ability to get diversification across corporate credit, hard assets, soft assets, consumer credit, commercial real estate, etc. You can invest in strategies that are backed by farm equipment or intellectual property. Those are

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things that typically have nothing to do with each other, so that offers diversification benefits. Clients find that breadth attractive, as well as the lower volatility associated with a private investment.

P&I: With increased flows into direct lending over the past few years, can the asset class support the incremental capital raised?

BATES: On a compound annual growth rate basis, the growth of direct lending has been amazing, but that's been on a very low denominator. We think about the question less from a CAGR perspective and instead look at the dry powder in private credit versus the dry powder in private equity. In that context, there's still room for growth in direct lending. Also, private credit is much broader than direct-lending or corporate-based opportunities. From our perspective, we see significant growth opportunity in private credit given its breadth.

KANTOWITZ: Yes. This is not a new market and the makeup of the constituency that supports the middle market has changed from banks to nonbanking lenders. But the overall opportunity set is still enormous. There are more than 200,000 middle-market companies today that represent about a third of private-side [gross domestic product] and employ almost 50 million individuals.

On the demand side, private equity represents more than 75% of the demand within direct lending and the asset class continues to amass record sums of capital. They have a finite period to invest that capital, and they can't execute their strategies without our support. So there's a big market and significant demand.

If you compare dry powder within private equity to dry powder within private credit, there's no supply-demand imbalance. If anything, there's probably too much private equity in the market today relative to direct-lending solutions.

P&I: How is the macro-environment impacting private credit? Have deals and activity changed compared with 12 months ago?

KANTOWITZ: Middle market direct lending opportunities continue to be robust and show no signs of abating. As I just mentioned, with private equity dry powder at record levels, and public valuations driving down purchase price multiples, our expectation is that private equity deployment will continue to drive our investment opportunity.

As we look forward to the second half of 2022 and onward, we believe direct lending opportunities will continue to be compelling, even when accounting for challenges facing the U.S. economy such as continued inflationary pressures, challenging labor dynamics, consumer stress and potential supply chain disruptions. Further giving us confidence in the opportunity set is the unique insight that the COVID pandemic provided into how certain companies and management teams were able to successfully navigate through a challenging business environment — in many cases, highlighting their ability to adjust business models to be more nimble and target more stable and resilient revenue streams. From our perspective, macro considerations have made these already-compelling opportunities even more interesting as transactions can now be closed with more conservative lending structures.

FOWLER: The macroeconomic environment has become more challenging. We still have supply-chain disruptions, and inflation of input costs and rising employment costs are impacting the market and creating headwinds. On top of that, you have rising interest rates. All of this follows an environment of historic growth in activity after COVID-19, where the back half of 2020 and 2021 saw incredible volume. Part of that was catch-up, with half the year in 2020 being on hold because of COVID, and a lot of the activity was not sustainable.

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conditions and acknowledge that there is some potential for margins and, eventually, valuations to decline from where they've been, based on these headwinds. For manufacturing businesses, for example, or companies where wages account for a large portion of cost of goods, inflation is much more likely to eat into those margins. So while we continue to see opportunities, albeit slightly below previous years, I would say the quality is less attractive and one has to be careful leading up to what may be a conventional recession.

BATES: We have not seen much pullback in terms of deployment. We saw some managers who were quite active in the dislocation of the public market starting to pull back a bit and pivot to the private side. Private credit has a strategic role in clients' portfolios. It's not meant to be the highest-returning asset class, rather it is meant to provide downside protection and diversification benefits with the potential for upside in some cases.

P&I: Are there specific industries or sectors that you prefer in the current environment?

FOWLER: We tend to lend to companies in more defensive and less cyclical sectors — particularly those with more pricing power and where demand remains strong — and that we believe have a reason to exist in every part of a cycle. Business services is an example. While demand could soften going forward as interest rates continue to rise and we could start to see more margin compression across the market, we believe our portfolios in North America and in Europe are well positioned to withstand the macroeconomic headwinds. So we like low volatility, 'boring is beautiful' credits that are extremely diversified in a portfolio, not only by industry and sponsor but issuer size as well. We have constructed our portfolio over the last few years expecting a dislocation, and we feel well prepared to weather the storm if there is one.

KANTOWITZ: When we think about good businesses, we look for companies that are boring and stable. We like to remind ourselves that we're not equity investors, so we're not looking for businesses with 20% top-line growth and 500 basis-point margin improvements. We don't do anything that's faddish. We avoid areas such as retail, high tech or energy. Rather, we look to those segments or sectors where we see stability and longevity. We like to invest in health care, business services, nondiscretionary consumer products and noncyclical industries — those industries where we see inherent stability.

BATES: We are finding opportunity in special situations and specialty finance. We also work with some general partners who have the flexibility to invest in the public markets as well as the private markets, and we like that flexibility. There are times that the public markets are more attractive, where there are dislocations. Generally speaking, those dislocations are short-lived, so being invested with a manager with flexibility and the appropriate vehicle structure can be attractive.

P&I: Looking ahead, what are other macroeconomic indicators that could impact private credit markets?

FOWLER: Right now, many companies seem able to successfully pass increased prices on to consumers, which is offsetting higher costs. So for companies with this fundamental value to their customers, we haven't seen any margin deterioration. Fortunately, we intentionally minimize our exposure to consumer-facing businesses, which served us well during COVID. However, in the broader credit market, more pressure on consumers and cracks in confidence could lead to companies being unable to pass along price increases, which could ultimately lead to margin compression. Margin compression and rising rates might lead to an increase in defaults for managers that have consumer-facing businesses and or manufacturing businesses. ■