E X P E R T Q & A

Investors continue to enjoy a strong debt market, with newer transactions potentially offering lower leverage and increased returns, say Barings' Adam Wheeler and Mark Flessner


Higher base rates provide tailwinds for private debt

Economic volatility over the past year has created anxiety across the private markets. Some lenders fear that a rise in base rates will cause a downturn in volumes and a rise in companies facing debt servicing difficulties. But Adam Wheeler, co-head of Barings' global private finance group, and Mark Flessner, a managing director in the same team, believe that the asset class will prove its resilience. Providing that managers have been prudent in their lending, they say, investors are set to benefit from "an incredible vintage".

SPONSOR
BARINGS

Q Can a floating rate capital structure built in a very low interest rate environment be sustainable with much higher base rates?

Adam Wheeler: It really depends on what the capital structure looks like. In the direct lending space, you see structures that are very conservative through to structures that are incredibly aggressive. But if you've been prudent in the way you've pulled your capital structures together, and if you've picked high-quality companies, then you should be in a good position to see yourself through the next six to 12 months.

Some people focus on the LTV, but from our perspective, the important thing for debt serviceability is cashflow generation. And we look for a significant equity buffer underneath us. That gives protection, assuming you're realistic about the enterprise value, and assuming you have the ability to do something if there's a breach in your loan document.

Q To what extent are managers experiencing difficulties as companies struggle with debt servicing?

Mark Flessner: Fortunately, we haven't had to deal with that yet. Our book is probably levered a little more conservatively than some others. But we're conscious that debt servicing costs are at one of the highest levels we've ever seen in this asset class in North America. There are situations where companies are now paying 12 percent interest, as opposed to 8 percent interest.

The market can often find solutions for those companies where liquidity is getting a little tight – so long as companies are performing, and cashflow is only tight because of the capital structure and those debt servicing needs. The market can be creative in those situations. Some ARR loans or highly leveraged unitranches are setting up preferred tranches or non-cash pay tranches between the senior debt and the common equity held by the private equity firms.

AW: We've yet to see the full impact of higher interest rates on the asset class. Base rates started to increase around the middle of last year, and because of the way that interest periods work and the way the rate is set in the loan document, it takes time for the impact to flow through, and therefore it will be felt more acutely in direct lending over the course of this year.

Indeed, while we're not seeing cracks in many portfolios from higher interest rates yet, we will likely see a divergence of performance between managers going forward. Those that are exposed to more cyclical sectors will be impacted to a greater extent by the challenging economic backdrop.

Q Once the dust settles on the current economic volatility, do you expect spreads to compress significantly?

AW: In the short term, spreads will likely remain near current levels with the existing base rate. Because the broadly syndicated market is effectively shut, more transactions are coming into the direct lending space. Particularly in Europe, the balance between the supply of capital and the demand for that capital has shifted significantly. So, the current vintage, at least in the short term, will likely remain attractive for investors. We're looking at some of the highest absolute returns in recent history.

As the broadly syndicated market starts to open and more capital flows into the space, you would expect spreads to contract. It will take a bit of time for things to normalise. The direct lending market moves at a slower pace than the public markets.

MF: This market will be here for a little while – spreads will ultimately compress, but not back to pre-GFC levels. The market 15 years ago wasn't a unitranche market, it was more of a senior mezz market – so we're at higher leverage levels on the senior basis, and the market landscape looks a little bit different.

> *"We look for a significant equity buffer underneath us"*
>
> **ADAM WHEELER**

Q Is it really a bad thing if interest coverage is tighter because base rates are higher?

MF: It's been a while since the market tipped in the lenders' favour like this. Obviously, it's going to be more challenging for private equity firms to generate a return when senior debt is generating 10 or 12 percent. The reality is there's probably a balance to be found between where we were for the last few years and where we are now.

AW: For new transactions, it means lower levels of leverage. We're probably going to see a contraction in enterprise value. Financial engineering can't provide part of the return story for private equity anymore. Given the economic outlook, I think there is going to be some transfer of return from equity to debt in terms of what comes out of an asset. That's a great thing for private credit.

Q Will higher base rates reduce mid-market loan volumes?

AW: Private equity firms have generated significant dry powder, and they need to put that money into assets. But there's a lot of economic uncertainty – it's not a great time to buy an asset, because you're wondering what the economic outlook is. And it's probably not a great time to sell unless you're forced to do so. So, we expect PE activity to be relatively quiet for a quarter or two.

But that's a short-term outlook. The structural trend for both the direct lending industry and private equity is clearly positive. People continue to allocate to the asset classes; I don't think the next few months is going to change that.

Q So, overall: are higher base rates more of a headwind or tailwind for direct lending?

MF: For this asset class, and for the investors, it's a tailwind. It's going to be an incredible vintage. We're getting compensated better than we ever have, essentially for taking the same risks we were taking a year or two ago. The headwinds come as we drop down the capital structure into the equity side.

AW: Particularly going into new transactions, investors get lower leverage and higher absolute returns. If you're with the right manager, you're still getting access to high-quality dealflow. From an investor's perspective, it's a great time to be deploying capital into this asset class. ■