US Private Credit Perspectives

Making a splash:
The year private credit hit the big time
US Private Credit Forum
10 June 2020, Grand Hyatt, New York

Opportunities in US middle-market debt, from fundraising to origination to securitization

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It’s always exciting to watch obscure markets grow into household names. More than a decade ago, Creditflux began to write about little-known CLOs just as the global financial crisis lifted them into infamy. At the same time, Debtwire nourished a new wave of vultures, as common today as starlings.

It’s with great excitement that we now dig into private credit, a US$700 billion market, according to the Loan Syndications and Trading Association.

As we will see in this report, fundraising is tracking historical trends while the market share of new deals larger than your typical SME loans continues to grow. With larger loans comes more attention paid to terms and conditions. If there is one place that private credit documentation departs from those in broadly syndicated loans (BSL), it’s in the discretion of the administrative agent.

The life cycle of a direct lending loan is one area that we continue to track from several perspectives. We begin with business development companies (BDC) and how they serve as early indicators of borrower stress. So far though, BDC losses tied to non-accrual investments (loans not paying interest) are at historic lows.

This brings us to loans that are in restructuring. To cut a long story short: removing retail and oil & gas from the pool removes a primary driver of restructuring activity. This could all change with a macroeconomic swoon – a period that we seem to be entering because of the uncertain, economic implications of the coronavirus.

Nonetheless, the private credit market continues on its precocious growth path. Market experts from both the LP and fund management communities weigh in on nascent strategies and niches, including unexplored emerging markets.

Diversity is a sign of maturity. So are returns. Ultimately, that is what it’s all about for many institutional investors. As we look into the future of direct lending, let’s remember that the Cliffwater Direct Lending Index (CDLI) shows that of the past 14 years, the CDLI has outperformed the Barclays HY Bond Index and S&P/LSTA Leveraged Loan Index in 11 of them.
Largest private credit deals invading the BSL pipeline

Private credit used to be synonymous with the middle market – borrowers that were too small for banks to chase. But, in 2019, deal size grew to rival the traditional banking world of broadly syndicated loans.

Total primary loan issuance and the total number of deals in the private credit market grew 31% and 18%, respectively, in 2019, according to Debtwire Par. Middle market deals (defined as debt capitalization of less than US$150 million) accounted for the largest share of the market at 64%. Deals larger than US$150 million grew to 19% of the market in 2019 from 9% in 2018.

The rise in market share for larger deals portends a growing trend of privately placed deals invading the pipeline for BSL. In H2 2019, RSC Insurance Brokerage, a Massachusetts-based insurance brokerage and risk management firm, raised a Golub-led US$1.6 billion unitranche to refinance its existing capital structure. The deal involved eight lead direct lenders. Golub also originated a US$950 million unitranche financing to E2open, a Texas-headquartered cloud-based supply chain management solutions provider, to acquire Amber Road, a publicly-traded supply chain cloud software company.

M&A and buyouts remain key drivers for private credit, accounting for 57% of deals in 2019, compared to 53% in 2018. As well as the E2open acquisition financing, Parts Town, an Illinois-based foodservice equipment parts distributor, closed a US$788 million unitranche loan via Golub to acquire Heritage FoodService.

US direct lending loan activity – large cap & middle market

![Graph showing US direct lending loan activity for large cap and middle market from 2016 to 2019. The graph indicates a steady increase in the percentage of all direct lending issuance attributed to middle market deals over the years.]

Nancy Tai
Manager of Americas Fixed Income Data
Debtwire Par
Group from Windjammer Capital Investors and HarborVest Partners.

The private credit market would not be as large as it is today were it not for sponsor-backed financing. Indeed, it might not exist at all. In 2019, 73% of total loan facilities involved financial sponsors. More than 70% of these facilities were for event-driven activities. Meanwhile, non-sponsor-backed direct lending deals were on pace with last year’s deal count. Non-sponsored borrowers mostly used proceeds for new money purposes.

The technology, media and telecommunication (TMT) industry took the largest market share in 2019, accounting for 23% of all direct lending deals. Of this, computer software companies were the most active issuers. Business service providers came in second with a 20% market share, followed by chemical and industrial companies at 13%. Though medical companies comprised the fourth most active sector, it saw the biggest year-on-year decrease (8%) by total number of direct lending loan transactions.
BDC portfolio marks hold firm but underwriting deterioration clouds the future

Loan portfolios for business development companies show few cracks despite ever-increasing competition to win new deals

Market participants and observers have long sounded the alarm of deteriorating lender protections and increasing borrower license. But you would not know it by looking at BDC portfolios. As of 30 September 2019, non-accrual investments totaled just 11% of BDC holdings at fair market value, according to Fitch Ratings. It is an important line item to follow because it tracks non-paying loans. Even though that 11% is low when compared to the 16% recorded a year ago, Fitch has a negative outlook on the BDC industry because of competitive market conditions and earnings pressure from low interest rates.

“We think the competitive dynamic hasn’t played out,” said Chelsea Richardson, an associate director with Fitch. “Non-accruals are low and are unsustainable.”

Some observers take the opposite view of low non-accruals, contending that they evince greater underwriting discretion inside the BDC industry. After all, many BDCs avoid sectors with deep distress like retail and energy.

“Credit quality remains relatively high,” said Larry Herman, a managing director at Raymond James who advises BDCs. “You haven’t seen a lot of non-accruals. It is episodic in terms of specific credits and industries.”

Different BDCs take different strategies to manage through the competitive dynamic. Ares Capital, the largest BDC by market capitalization, now lends more to larger and ostensibly stabler companies than ever before – certainly when compared to its peers. Others, like TPG Specialty Lending, lend to smaller businesses that pay higher interest and accept tighter covenants.

In 2019 BDCs also dabbled in large-scale deals that have become more popular among private credit investors. Apollo Investment reported a US$30 million position in Risk Strategies’ Libor+550bps US$1.6 billion unitranche loan as of 31 December. The unitranche closed in Q4 2019.

Another changing dynamic in BDC portfolios is higher leverage. Thanks to 2018’s Small Business Credit Availability Act, BDCs now have a 2x leverage ratio cap, double the previous figure. The average debt-to-assets ratio for BDCs tracked by Debtwire was 46% as of Q3 2019, up from 40.2% the same time the previous year.

BDCs use that additional leverage to boost returns. In exchange, they claim to offset that additional borrowing by investing in less risky, more senior loans. As BDCs compete to win deals, the true quality of their underlying assets may not be known until the next economic downturn.
Direct lending fundraising slowed down in 2019

Momentum for US direct lending fundraising decelerated in 2019, according to Creditflux and Debtwire data, with 17 funds collecting US$19.6 billion. That figure represents a stark decline from the US$33 billion logged across 23 funds in 2018, and just half the record US$38 billion raised across 30 funds in 2017.

Bifurcation continued to prevail, with ‘top tier’ managers raising larger funds. In 2019, the five largest funds accounted for 68% of total fundraising. The corresponding statistics for the two years prior were 58% and 42.4%.

“It’s quite hard to raise direct lending funds if you aren’t big funds like Ares,” said one London-based placement agent. “Investors have laid their bets and will just do re-ups with the big guys. If you are sub €2 billion, it’s quite hard for managers to differentiate versus the others that are doing it.”

The all too familiar tale of ‘overcrowding’ in the US direct lending market may be one reason why fundraising levels decreased.

NEPC has advised several clients looking to allocate to private credit in 2020 to focus on distressed debt, opportunistic credit and niche strategies. Despite having a negative outlook on US direct lending in general, the investment consultant believes strategies focused on lower mid-market companies (with less than US$50 million EBITDA) are relatively attractive. Investors should also focus on fees, more liquid vehicle structures and managers with historical discipline and transparency.

Newcomers help sustain market performance

Despite an ‘indigestion point’ in 2019, an influx of new investors will probably lead to fundraising being maintained in 2020, sources say. Many investors are yet to make the shift toward private credit from fixed income asset allocations. Furthermore, regulation has made it easier for insurers to invest in private debt. Family offices, for their part, are starting to come to grips with the asset class.

Market neophytes include the Pennsylvania State Employees Retirement System, which approved in December a new 4% allocation to the private credit asset class. The City of Baltimore Fire and Police Employees’ Retirement System likewise established a new private debt bucket.

2020 has already kicked off with a bang. Three direct lending funds – THL Credit Direct Lending Fund IV, Pathway Private Credit Fund II and HIG WhiteHorse Principal Lending Fund – have collected US$2.8 billion.

In other areas of private credit, special situations funds proved popular. Carlyle Group and TPG Sixth Street Partners both closed billion-dollar funds in H2 2019. Carlyle closed its inaugural Credit Opportunities Fund in July at US$2.4 billion and, with leverage, the fund is anticipated to have US$3.1 billion firepower. At closing, the fund was more than 35% invested across 10 companies.

In 2019, the five largest funds accounted for 68% of total fundraising.
US-focused direct lending fundraising 2012-2012 year-to-date

Largest North American direct lending funds closed in H1 2019

<table>
<thead>
<tr>
<th>Fund name</th>
<th>Amount raised (US$bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broad Street Senior Credit Partners II</td>
<td>4.4</td>
</tr>
<tr>
<td>Ares Senior Direct Lending Fund</td>
<td>3.0</td>
</tr>
<tr>
<td>AG Direct Lending Fund III</td>
<td>2.8</td>
</tr>
<tr>
<td>NB Private Debt Fund III</td>
<td>1.7</td>
</tr>
<tr>
<td>Audax Direct Lending Solutions Fund</td>
<td>1.7</td>
</tr>
<tr>
<td>Adams Street Private Credit</td>
<td>1.1</td>
</tr>
<tr>
<td>Perfund Capital Fund VI</td>
<td>0.9</td>
</tr>
<tr>
<td>North Haven Senior Loan Fund</td>
<td>0.8</td>
</tr>
<tr>
<td>Hamilton Lane Strategic Opportunities Fund V</td>
<td>0.8</td>
</tr>
<tr>
<td>Integrated Private Debt Fund VI</td>
<td>0.6</td>
</tr>
<tr>
<td>Golding Private Debt 2016</td>
<td>0.6</td>
</tr>
<tr>
<td>Pathlight Capital Fund I LP</td>
<td>0.5</td>
</tr>
<tr>
<td>PineBridge Private Credit</td>
<td>0.4</td>
</tr>
<tr>
<td>NYSTRS/Stepstone Private Debt</td>
<td>0.2</td>
</tr>
<tr>
<td>LBC Small Cap</td>
<td>0.1</td>
</tr>
<tr>
<td>WHF STRS Ohio Senior Loan Fund</td>
<td>0.1</td>
</tr>
<tr>
<td>ICG Indiana Senior Debt Fund</td>
<td>0.1</td>
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</table>
Rise of LP private credit buckets

Private credit is becoming mainstream for US institutional investors, which are carving out separate buckets for investments in the asset class or looking to allocate for the first time

Ask 10 credit financial professionals to define private credit and you’ll get 12 different answers. Ask 10 LPs into which bucket they would place a private credit allocation and you’ll get the same range of responses.

“Allocations to private corporate credit historically came from investors’ private equity bucket and were initially focused on mezzanine strategies,” said Antoine Josserand, head of business development at Pemberton. He added that as allocators become more familiar with the asset class and understand its risk/return profile, they will begin to define separate buckets for their allocations.

North American LPs seem more eager to increase their allocations to private credit compared to their overseas peers, according to a study by asset manager Schroders. It found that 29% of North American investors see private credit as the asset class that they expect to increase their allocation to the most over the next three years. They were followed by Latin American (28%), European (23%) and Asia-Pacific (23%) investors.

In 2019, several US LPs created private credit buckets. The list includes, to name just a few: the Pennsylvania State Employees’ Retirement System; City of Baltimore Fire and Police Employees’ Retirement System; Employees’ Retirement System of Texas; and Alameda County Employees’ Retirement Association.

Soon, the California Public Employees Retirement System (CalPERS), the largest US public pension fund, with US$326 billion under management, will allocate to private credit. CalPERS has highlighted that private credit – with its diversification benefits and steady returns – has become an asset class that institutional investors cannot afford to overlook.

Allocators should pay more attention to private credit because an economic downturn would have less effect on private credit than it would equity valuations, according to Rick Jain, partner and global head of private debt at Pantheon. LPs also have a desire to capitalize on potential market dislocations with secondary allocations, distressed and debt capital opportunity funds.

With its diversification benefits and steady returns, institutional investors cannot afford to overlook private credit.

“We continue to see ongoing interest in direct lending to both sponsor and non-sponsor-backed companies,” Jain said.

US investors are gaining exposure to private credit through different routes, depending on their sophistication, scale and risk appetite. While some investors have committed to private credit through their private equity portfolio, others have used the asset class to diversify away from their traditional fixed income exposure.

“Some investors will allocate to private credit out of their fixed income bucket for the more defensive parts of the spectrum, such as senior loans and unlevered direct lending, and often as a replacement to their high-yield and leveraged loans allocation,” Josserand added.

CalPERS has previously invested in mezzanine debt as well as distressed debt and special

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situations out of its private equity portfolio. However, the pension fund did not have a dedicated allocation to private debt, according to Yu Meng, its chief investment officer. Nevertheless, he recognizes the asset class’s rapid growth and says it should be part of the pension fund’s portfolio, according to CalPERS documentation.

Despite LPs’ appetite for private markets, they still face some challenges when investing in the space. North American institutional investors identify fees (69%), liquidity (56%) and complexity (34%) as the most challenging hurdles when investing in private assets, according to the Schroders study. Other hurdles include lack of internal investment skills and resources (24%) as well as government and regulatory barriers (11%).

### Highlights: US public pension fund allocations

<table>
<thead>
<tr>
<th>Pension funds that created private credit buckets in 2019</th>
<th>AUM (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of Baltimore Fire and Police Employees’ Retirement System</td>
<td>Established a new private debt allocation, approving 3% to the asset class</td>
</tr>
<tr>
<td>Employees Retirement System of Texas</td>
<td>Approved a 3% opportunistic credit allocation, with the investment strategies opening up including direct lending, mezzanine, real asset credit, real estate credit, specialty finance, structure credit, as well as distressed and special situations</td>
</tr>
<tr>
<td>Alameda County Employees’ Retirement Association</td>
<td>Decided to adopt a 4% allocation to private credit as it is looking to increase long-term risk-adjusted returns</td>
</tr>
<tr>
<td>Pennsylvania State Employees’ Retirement System</td>
<td>Approved a 4% allocation to private credit, according to a recent board meeting</td>
</tr>
</tbody>
</table>
Distress in brick-and-mortar endures as retailers shutter doors

Low footfall and the shift towards e-commerce is exacerbating liquidity trouble in the retail industry and closely-related casual dining sector

Despite US equity markets’ robust performance in H2 2019, the restructuring landscape remained active. The Debtwire Restructuring Database recorded 67 bankruptcies for companies with less than US$500 million in liabilities, against 59 recorded in H2 2018.

In the mid-market, the retail industry continued to exhibit weakness in brick-and-mortar consumer spending, with many name-brand stores entering bankruptcy protection. Many filers, including high-end department store Barneys New York and apparel companies A’GACI, Destination Maternity and Avenue Stores, were forced to liquidate.

Fast-fashion retailer Forever 21 received bankruptcy court approval for a sale to a consortium comprising mall owners Simon Property Group, Brookfield Property and Authentic Brands Group as it was the only alternative to liquidation. The new owners offered US$81 million in cash plus the assumption of letters of credit and trade debt. Assumed liabilities include up to US$30 million in post-petition claims and cure costs and US$53 million in trade payables, according to the stalking horse agreement.

The retailer, which filed for Chapter 11 bankruptcy protection in September, initially sought to shutter up to 178 stores in the US. Some of those stores later appeared to be spared as the company negotiated rent relief with landlords.

Increases in rental and lease obligations left many in the industry – including Barneys – with tightened liquidity and unable to continue operations.

In court documents the retailers also cited a tough operating environment, with increased competition and the shift away from brick-and-mortar shopping contributing to their demise. To that end, retail sales in department stores continued to decline in H2 2019 against the year prior, according to the US Census Bureau.

Unfavorable foot traffic and sales trends likewise affected the casual dining space, with Perkins & Marie Callender’s and Houlihan’s filing for insolvency.

Perkins sold its restaurants, generating US$72 million in proceeds from three buyers and providing secure creditors, owed US$89 million, a full recovery. Unsecured creditors are set to collect a guaranteed 13% recovery plus proceeds from commercial tort claims. Houlihan’s received court approval to proceed with a US$40 million sale to stalking horse bidder Landry’s.

Meanwhile, depressed oil and gas prices caused distress for several producers in H2 2019.

Facing the sharp market reversal, MDC Companies looked to increase its drilling activity to maintain cash flow to meet projections and satisfy covenants in its credit agreements. The company ultimately filed for Chapter 11 in October after it ran into liquidity trouble and couldn’t fund operations.

Another victim of the precipitous drop in oil and gas prices was Epic Companies. Left in a precarious liquidity position, the debtor filed for bankruptcy in August.

While 2019 extended a record economic expansion, a broad market sell-off in Q1 2020 stemming from the Coronavirus outbreak ushers in a period of uncertainty not seen in a decade. Stay tuned for how it affects restructurings.
Percentage of US bankruptcies by sector in 2019

<table>
<thead>
<tr>
<th>Sector</th>
<th>% of bankruptcies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative energy</td>
<td>0%</td>
</tr>
<tr>
<td>Automotive</td>
<td>0%</td>
</tr>
<tr>
<td>Chemicals and materials</td>
<td>0%</td>
</tr>
<tr>
<td>Education</td>
<td>0%</td>
</tr>
<tr>
<td>Electrical power</td>
<td>0%</td>
</tr>
<tr>
<td>Leisure</td>
<td>0%</td>
</tr>
<tr>
<td>Paper printing</td>
<td>0%</td>
</tr>
<tr>
<td>Real estate</td>
<td>0%</td>
</tr>
<tr>
<td>Technology</td>
<td>0%</td>
</tr>
<tr>
<td>Transportation</td>
<td>0%</td>
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<tr>
<td>Construction and real estate</td>
<td>0%</td>
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<tr>
<td>Financial services</td>
<td>0%</td>
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<tr>
<td>Industrial products and services</td>
<td>0%</td>
</tr>
<tr>
<td>Metals mining</td>
<td>0%</td>
</tr>
<tr>
<td>Other services</td>
<td>0%</td>
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<tr>
<td>Pharmaceuticals</td>
<td>0%</td>
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<tr>
<td>Telecommunications</td>
<td>0%</td>
</tr>
<tr>
<td>Consumer products</td>
<td>0%</td>
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<tr>
<td>Food beverage</td>
<td>0%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>0%</td>
</tr>
<tr>
<td>Retail</td>
<td>0%</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>25%</td>
</tr>
</tbody>
</table>
Administrative agents put skin in the game

Like a bond trustee, administrative agents are quiet professionals who go unnoticed until they are thrust into controversy. This changes in the world of private credit.

By July 2015, Bank of America had had enough. In its role as administrative agent on a US$1.9 billion term loan to Arch Coal, it was the rope in a tug of war between the borrower and lender factions that wanted to restructure the company. Caught between a directive to execute an exchange offer and a group of lenders who rejected it, Bank of America resigned and Wilmington Trust stepped in – just in time to be sued.

Arch Coal is not an isolated case; the PetSmart and MyTheresa trap-doors spring to mind. But it highlights how quickly a thankless, administrative job can become embroiled in a controversy not of its making. In the clubby world of private credit, that is less likely to happen.

“The roles of administrative and collateral agents are critical to both lenders and borrowers. In broadly syndicated term loans, agents may hold only a small percentage of the overall facility, yet are provided with discretion to extend or shorten numerous collateral delivery and notice periods,” said Meyer Dworkin, a partner in the Finance Group at Davis Polk & Wardwell.

Because the investors in a broadly syndicated loan are so fragmented, the administrative agent often has a lot of discretion to execute its terms. But in a private credit facility, administrative agents have less discretion and more borrower oversight. There is a much smaller pool of investors and the agent often cannot act without lender consent.

“In a direct lending transaction, the agent often is an affiliate of the largest lender,” said Dworkin. “As a result, the agent will have significant skin in the game and definite views and ready ability to canvass other significant lenders with respect to borrower requests.”

This intimacy among lenders is crucial when the borrower becomes distressed. In the broadly syndicated market, a restructuring will shake up the mix of loan holders. Par investors like CLOs reduce their positions while distressed investors replace them, creating a new dynamic for the administrative agent.

“As a credit becomes distressed, borrowers will increasingly require the cooperation of the agent and lenders to take necessary remediating steps,” said Dworkin. “However, at this precise point, the composition of the lender group in broadly syndicated term loans tends to shift from par holders to distressed investors, who may have different economic incentives.”

There is very little, if any, churn in the investor mix for a private credit facility. Rounding up lenders and engaging with the borrower is easier. Perhaps more important are the terms of a private credit facility, which are subject to less interpretation in a directly originated loan.

“The number of holders of the loan is now much less, so it’s less burdensome to get lenders together – or at least a required lender group to make decisions,” said Sean Solis, a partner at Milbank.

While the broader US economy hummed along through a record expansion, there were few examples of clubby deals gone bad. That could be the result of a rising tide lifting all boats, or a feature of private credit’s fundamental architecture.

“There is less room for controversy in a direct origination,” Solis said. “The documents are tighter and borrowers tend to be less aggressive given how more involved with the lenders they are.”
Massive opportunity in emerging markets

Private credit is booming in developed markets, but investors should look to emerging economies for the most compelling risk/reward opportunities

Gregory Bowes
Co-founder and managing principal Albright Capital

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Investors have poured more than US$650 billion into private credit since 2012, according to Goldman Sachs. Of that, just 7% went to emerging markets (EM), as reported by the Emerging Markets Private Equity Association, indicating that many investors are overlooking one of the best environments in decades for private credit.

Private credit is a broad category ranging from preferred equity to senior debt, according to Cambridge Associates. That range may be even broader in EM, including an attractive alternative to equity growth capital: customized ‘EM Mezzanine’. It differs from mezzanine in developed markets, with the potential for higher returns. It is generally not a component of acquisition financing for a private equity sponsor, and requires direct origination efforts, including bilateral negotiations with management and shareholders.

Acute capital shortage across EM, especially outside Asia, magnifies the current opportunity for EM Mezzanine. This capital shortage derives from various sources, though a key factor is currency weakness – the JP Morgan EM Currency Index is down 45% since April 2011.

Many EM private market investors have suffered and retreated, resulting in an unusually large liquidity premium across EM. To illustrate this point, target returns for EM Mezzanine portfolio investments normally range from the low to high teens, with further upside possible, compared to the current ~6% yield of EM high-yield corporate bonds. This gap between public and private valuations compares favorably with developed markets.

Many experienced EM private market practitioners have long regarded EM Mezzanine as the most attractive way to provide capital in an EM context, essentially seeking the downside protections of creditor rights while retaining significant equity upside. The goal is to capture alpha while mitigating the volatile outcomes common to EM investments.

Middle market EM companies seeking growth capital are typically limited to local senior bank debt or highly dilutive private equity capital. This presents an opportunity for private credit investors to design attractive alternatives for all parties: companies gain access to much-needed financing, shareholders avoid dilution, and the credit provider acquires far greater certainty of return of capital.

EM Mezzanine is structured as junior debt, convertible debt and/or redeemable preferred equity. It can be supported by real assets or other collateral. Moreover, it can enjoy relative seniority in the capital structure, current income to accelerate return of capital and strong governance rights, with deals ideally booked in developed-market jurisdictions.

EM Mezzanine structures help avoid the pitfalls of minority ‘plain vanilla’ EM private equity, which have spurred investors’ retreat from EM beyond Asia. These include misalignment of interests with closely-held or family-owned businesses; long holding periods that depress IRRs, given the challenges of IPOs and strategic exits in EM; and over-exposure to potential currency depreciation in a period of prolonged currency weakness.

Ironically, investors’ retreat from EM private markets comes after decades of reform to bankruptcy codes across EM. The gap between high- and low-income countries in the World Bank’s Strength of Legal Rights Index has almost halved since 2013. Senior management and owners in EM must account for the possibility of more effective legal redress by creditors.

The acute shortage of private capital for middle market companies ex-Asia, combined with advancements in creditor rights, strengthens the already strong case for EM Mezzanine. Investors currently attracted to private credit may want to consider EM, where their capital is more highly valued.
“Proliferation of private credit has created an intense landscape that leads to the mispricing of risk”

Giacomo Picco, head of capital solutions at Sound Point Capital Management, tells USPCP about the evolution of private credit and the market’s attendant risks

What are the trends behind the increasing allocations to private credit?
Private credit is a broad term covering many types of non-syndicated lending, including secured and mezzanine loans for sponsor backed companies, distressed and specialty financing, and venture debt, among other strategies. Drivers include increased dealmaking and the continued growth of market share of CLOs in the syndicated market. This leaves borrowers that are unrated or too small to be attractive to CLOs with fewer options. Low interest rates have led investors to seek niches that offer superior yields to the public markets. Borrowers accept that private credit can be a preferred source of financing over public credit markets. On the investor side, compelling returns have led investors to seek niches that offer superior yields to the public markets. Borrowers accept that private credit can be a preferred source of financing over public credit markets.

How have private credit strategies evolved over the past three to five years?
Larger deals are getting done as more capital has entered the space and funds have grown. It is no longer an anomaly for single funds to do a US$500-800 million deal. Second, the lender community is becoming more solutions-based, offering borrowers different products for various points in a company’s life cycle. Lastly, private lenders have expanded into less-trafficked areas, such as non-sponsor corporate lending and esoteric asset lending or stretch ABL lending.

Where do you see opportunities in private credit?
The most attractive opportunities typically come from proprietary deals and situations where a borrower urgently needs capital and a premium is placed on speed and certainty of execution.

The less crowded the niche, the better the opportunity. Given the ever stricter regulation of commercial banks, it has become much more complicated for traditional banks to maintain risk to troubled companies. Especially in Europe, commercial banks have taken a much harder stance with troubled borrowers on revolving credit lines – creating opportunities for creative and flexible credit funds that offer speed and certainty of execution.

Where do you see the risks in private credit?
The proliferation of private credit has created an intense competitive landscape that leads to the mispricing of risk and, worse, may result in the weakening of underwriting standards. More covenant-lite deals are getting done today than were done over the past few years. Moreover, many private credit funds use long-term leverage to enhance returns, a strategy that will be tested when we encounter a recession, especially if the underwriting and structuring was compromised. For this reason we prefer to target borrowers with immediate liquidity needs so that speed and certainty of execution are more important to the borrower than cost of funds.

What types of deals have you been doing?
We have done several global off-balance-sheet receivable financings for companies in distress, having completed US$500 million of those transactions in the last 18 months. Provided that the existing credit agreements allow for assets to be sold into unrestricted subsidiaries, it is a compelling and economical product for management teams that need a capital infusion but can’t access the traditional capital markets.
“Private credit has outperformed leveraged loans by 400 bps over the past three to five years”

Oliver Fadly, research consultant at NEPC, speaks to USPCP about the performance of returns in private credit and the opportunities arising in the market

What are the trends behind the increasing allocations to private credit?
Private credit can mean different things to investors, and the reasons for investing in it vary by client type. Insurance clients have increased allocations particularly through rated structures to help with capital charges. These tend to be more in income-oriented, capital preservation strategies. Another example is endowments and foundations that have higher risk tolerances and longer time horizons. These investors tend to seek strategies that focus on return maximization with more capital appreciation. Public pensions will have a combination of both – usually through a more core-satellite approach and more diversified portfolios.

How do the returns in private credit over the past five years compare to returns for public credit (e.g high-yield and leveraged loans)?
Private credit has outperformed leveraged loans by approximately 400 bps over the past three to five years. Direct lending has largely underperformed versus high-yield, due in part to the rebound in 2019. Over the past three years our direct lending managers have outperformed high-yield by approximately 100-150 bps on a levered basis. Distressed or opportunistic credit managers have outperformed both high-yield and leveraged loans but have fairly different risk/return profiles.

How have private credit strategies evolved over the past three to five years?
Three to five years ago private credit was seen as a barbell: direct lending & mezzanine and distressed strategies. Since then, the rise of niche and opportunistic credit strategies has become more prevalent. Investors have sought other types of strategy for various reasons: higher risk-adjusted returns, reduced portfolio volatility, reliable income streams and lower correlations to other asset classes. These strategies have become more segmented, including strategies that require some type specialization or expertise. These are some that the market can’t or won’t execute for different reasons. In addition, these strategies may target different parts of the capital structure, stages in a company’s life cycle, underlying collateral and cash flow, etc.

Where do you see opportunities in private credit?
NEPC has started to look at areas where there is a supply/demand balance. These strategies tend to be more opportunistic and in areas that are overlooked or avoided – and can provide advantages in low-return environments. There are different types of niche strategies for different risk/return objectives. NEPC has been spending a fair amount of time in what it calls growth debt in sectors such as tech and healthcare. NEPC has also been looking at asset-based and specialty finance strategies as well as the royalties space.

Where do you see the risks in private credit?
Some of the biggest risks include scalability, leverage and cash leakage. Scale can be an issue in niche strategies. Investors should assess the quantum and uses of leverage as well as the terms. Loose loan documents and fewer protections mean that lenders may see payments delayed or stopped with no formal way to recoup them. As many investors have heard, this includes pro-forma adjustments and EBITDA addbacks.
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