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The GFC: 10 years on

The mid-market continues to attract private debt investors as the Federal Reserve cuts interest rates. Could this provide more juice to the economy and fuel a red-hot deal market, or are we nearing the end of the credit cycle,

Andrew Hedlund asks a panel of experts

Private credit is in a precarious position, as it has been for several years. No one is quite sure where the economy sits within the now decade-old economic expansion, and lenders do not know if, or when, permissive EBITDA definitions and loose covenants will come back to haunt them. The appetite for private debt among limited partners, many of which have jumped into the asset class, shows no sign of abating. So, where does that leave us? Six industry participants offered their views.

Q Let's start with the age-old question: where do you think we are in the credit cycle, and what could be the catalyst for a downturn?

Randy Schwimmer: We've been saying we're in the seventh inning for a while. Now with the Federal Reserve rate cut it appears we're in a rain delay, so this cycle could go on for a while. That eliminates higher rates as a catalyst for a downturn – at least for now – which leaves trade issues as the most visible market worry.

Scott Essex: We are very late in the cycle. This is the longest-running recovery in economic history in this country. I think the question is what will tip this cycle, which is really unknown. International tariffs and the exchange rate environment – those are external [global factors]. An internal [factor] is a growing dynamic between the politicisation of the Federal Reserve [by] the executive branch. That's concerning.

Bill Brady: For me this conversation is *Groundhog Day* over the past four or five years. I actually think we have to move from baseball now to cricket, which can go on for five days and end in a tie and which is a whole other conversation.

Q What are conditions like in the deal market?

Eric Lloyd: The competition is fierce. And it's not just leverage and pricing, but documentation terms and other things. In market conditions like the ones we're seeing now, the scale of a manager's platform really matters.

We think it's critical to have large, well-resourced teams in place to underwrite transactions, work through challenging situations and prudently manage portfolios. It's

PHOTOGRAPHY: SALEM KRIEGER

Randy Schwimmer

Senior managing director,
Churchill Asset Management

Schwimmer supervises origination and capital markets. His firm finances senior debt and unitranche facilities for private equity-backed companies. He is also the founder and publisher of private debt industry newsletter *The Lead Left*, which has 50,000 subscribers and to which *Private Debt Investor* is a contributor.

Eric Lloyd

Deputy head of global markets and head of global private fixed income, Barings; chief executive, Barings BDC

Lloyd is responsible for managing all private fixed-income strategies, including mid-market lending, infrastructure debt and asset-backed securities. His firm pursues various investment strategies, from senior debt through to equity co-investments, in companies that generally have between \$5 million and \$75 million of EBITDA.

Ira Kustin

Partner in the investment management practice, Paul Hastings

Kustin advises fund managers on a wide range of regulatory compliance matters and on secondary transactions. He works on all aspects of structuring, formation and closing of hedge funds, private equity funds and separately managed accounts. Kustin also negotiates platform agreements between private fund managers and placement agents or other similar institutions.



Andre Hakkak

Co-founder and chief executive,
White Oak Global Advisors

Hakkak's firm offers multiple credit strategies, including term loans, asset-based lending and factoring, and equipment lending. White Oak's senior secured debt investments range from \$10 million-\$500 million with hold sizes of \$10 million-\$150 million in mainly non-sponsored companies. His firm operates multiple industry verticals, including healthcare, transportation, materials and government.

Bill Brady

Partner and head of the alternative lender and private credit group, Paul Hastings

Brady provides counsel on closing initial transactions as well as restructurings. He advises private lenders on an array of healthy and distressed debt structures in multiple forms: unitranche, first lien, recapitalisations and refinancings, among other transactions. His practice spans the US, Europe, Asia and Latin America.

Scott Essex

Partner and head of private debt Americas, Partners Group

Essex sits on multiple investment committees and chairs the global direct debt investment committee. His firm lends across the capital structure from senior debt to mezzanine loans globally in an array of industries including information technology, healthcare, and business and financial services.

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ERIC LLOYD
Barings



also important to be able to provide capital solutions that are flexible and that meet the needs of sponsors and borrowers as market conditions evolve.

Andre Hakkak: We see some examples of loosening provisions in loan documentation. For example, the definition of EBITDA used to be very clear. Now, when you search for the legal definition of EBITDA within a loan and security agreement, the definition could be five paragraphs, maybe a whole page. Similarly, many companies today can add leverage on property, plant and equipment that’s separate from just your cashflows.

BB: The key in approaching deals in a market like this is to be commercial and competitive, but with a laser focus on what will matter most in a workout or restructuring. It’s important to focus on conditions [relating] to any leakage, by way of restricted payments or investments, on the borrower’s ability to incur additional debt, whether it is junior debt or pari.

RS: Conditions remain very constructive. Yes, there are fundamental credit concerns, like higher leverage. Those are medium- or longer-term issues. They’ll become real when the economy hits a bump or anything

that creates hurdles for issuers trying to make pro forma adjustments work. Otherwise you’re looking at a very different credit than what you signed up for.

AH: The other thing that one has to be thoughtful about is the cure period [on any defaults]. Assuming there are any sort of financial covenants and assuming that they can even be breached, the cure period has extended. There is so much money on the sideline, there’s a lot of opportunity to provide protective advances to cure what seems like a one year-plus cure period for credits that may deteriorate over time.

SE: Despite the covenant-lite deal terms, there’s something to be said for having a little bit of cushion allowing the sponsor, in our view, to work through their challenges without having to come to the table. However, when there’s a payment default, it’s a bigger problem.

Q What are the less-explored areas of concern in the deal market?

RS: Leakage, particularly with the debt incurrence baskets that allow the borrower to raise additional debt outside of the facility that you’re focused on – that’s a cause for concern. Leverage is debt over EBITDA.



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ANDRE HAKKAK
White Oak Global Advisors



“I think it’s still pretty rare to guarantee co-investment opportunities to LPs outright”

IRA KUSTIN
Paul Hastings

If the EBITDA is squishy, thanks to adjustments, and you’ve got squishy debt, thanks to debt-incurrence, then leverage is squishy. It becomes a challenge to make a solid underwriting decision.

EL: There are a lot of ‘smaller’ changes to the terms in transaction documents that are happening. In isolation, these can all be rationalised, but in the aggregate, they become more concerning. When you start layering looser terms on top of looser terms, the risk can grow exponentially. For us, this means redoubling our efforts when it comes to credit underwriting and risk management.

BB: A hole that exists in a large part of the market is who can provide the new debt. A most-favoured nation clause keeps [an outside lender] from ratcheting up the rate,

but often the MFN only applies to the incremental debt. A worst-case scenario, regardless of an MFN, is a situation where the company needs additional liquidity, which the sponsor provides in an incremental equivalent. The sponsor ratchets up the rate on their loan and they’re getting cash-pay interest, which is like a recurring dividend over time but with pari treatment in an insolvency – while you are potentially watching the ice cube melt.

Q A lot of investors have got more familiar with private debt post-2008. Given that, what are the most common questions LPs are asking about the asset class?

Ira Kustin: One development I think is relatively new – and we’ll see where it goes – is some high-net-worth ‘platforms’, sponsored

by brand-name banks or brokers, starting to put together arrangements with private managers in the credit space to get access to sophisticated, high-net-worth individuals who qualify to invest in the funds.

AH: One thing that we’ve been known for in the marketplace is being more of a traditional lender [to non-private equity-backed companies] and less focused on the sponsored marketplace.

Given some of the topical headline points that were made earlier, we believe that a lot of investors are leaning toward a non-sponsor approach because the reputation is that you’re going to get more favourable terms.

SE: I would add that what we hear – it’s consistent with the diversity already mentioned – is that differentiation and lack

of correlation to other traditional lending strategies. Sourcing of transactions certainly brings that differentiation – the ability to bring unique content – as well as relative value within the capital structure, [which] has always been an important element to selecting the right strategy within the private debt community.

RS: Unique or differentiated origination is critical, based on investors we speak with. Our scale and LP-GP relationships are extremely helpful to address that question. Also, being late in the cycle, it's common to hear the question, "What's your workout experience?" Fortunately, our team has worked through a cycle or two. And after that, the most common question investors ask is, "How quickly can you put money to work?"

IK: One other trend I'm seeing develop is investors coming to a manager and saying, "I know this product is intended to focus on X, Y and Z market segments. I'd like to commit solely to a subset that will focus just on X. Or I'll participate in the overall vehicle's full strategy up to some percentage of my capital commitment, with the remaining percentage allocated solely to the narrower strategy."

"The key in approaching deals in a market like this is to be commercial and competitive, but with a laser focus on what will matter most in a workout or restructuring"

BILL BRADY
Paul Hastings



Q How often has co-investing been coming up with LPs? It's growing pretty quickly in the private equity asset class, but have you guys noticed any significant growth in private debt?

SE: It's been a conversation for many years. There's a desire to do co-investments, and it often is determined by the size of the team that has the willingness to do a co-investment and the size of their capital pool. Probably the most important element is meeting transaction timelines. Often, deals have fairly quick timetables for underwriting [and] completing diligence, and the ability to transact can be a hurdle at times.

IK: I would say managers often are willing to give significant investors not a promise of co-investment opportunities, but at least a willingness to offer them up if the terms, timing and certain other factors are appropriate. But I think it's still pretty rare to guarantee co-investment opportunities to LPs outright.

Q What are some of the issues that are unique to private debt in terms of fund fees and expenses?

IK: Expense reimbursement is an area where this investment strategy is treated slightly differently than others. For example, this might include an affiliate that specialises in workouts or restructurings and can provide these services to an affiliated fund or account more efficiently than an unrelated third party.

It may make sense for the credit manager to charge those expenses to the fund, whereas in a private equity fund that would be subject to a management fee offset. Those are things that just have to be disclosed clearly.

Q Has LP demand for the asset class been softening, or has it remained relatively robust?

EL: At Barings, we've been fortunate to see continued support from our existing investor base. We've also seen new investors coming into the asset class across all regions, including the US, Europe and Asia-Pacific. And while I think there's some merit to the argument that most of the investors who are going to invest in private debt are already there, I'd also keep in mind that the longer this low-yield, low-rate environment persists, the more investors ultimately need to find some form of yield.



And, we believe private debt is a logical place to look for that.

RS: Our investors show no signs of slowing in terms of continued interest in investing in the asset class. There remains, though, a continued need to educate them on the nuances of private credit.

The term encompasses a variety of strategies with different risk-return parameters. It's like a big circus tent. There are a lot of acts going on under that tent. You have to understand whether you're with the lion tammers, the clowns or the jugglers.

SE: We've seen increased appetite for programmes that bring not only diversity from a capital structure risk perspective and geography, but also the types of content. That would include real asset-based [debt], and therefore infrastructure and real estate [credit] coming into the same pool as corporate loans. That has been something that we've been able to raise capital for across the world.

AH: Overall, the demand for private debt globally remains robust, especially for managers who can offer differentiated strategies. However, each conversation can be more nuanced. For example, a recent LP told us, "[We're at the] top of the cycle, I'm going to slow down private debt [allocations]."

"Our investors show no signs of slowing in terms of continued interest in investing in the asset class"

RANDY SCHWIMMER
Churchill Asset Management

"The most important element is meeting transaction timelines"

SCOTT ESSEX
Partners Group

But in the same conversation, we hear they are adding to private equity. Why is that? If investors are worried that we are at the top of the cycle, we wonder why they would want to go lower in the capital structure by investing in equity.

Q What's the best way to tackle a restructuring scenario?

BB: I think the number one mistake that I see made in some of these workouts is lenders being reactive instead of proactive and failing to get out in front of things. You can be proactive without being necessarily aggressive. You can be proactive externally if the relationship calls for it. You can be proactive internally [also] so you're ready if things take a turn for the worst.

AH: It's a delicate balance when a sponsor is involved. In the non-sponsored space, timing is everything – the earlier a team comes in to evaluate the business and come up with a plan of action, the better.

EL: Each one is so unique. You may have one interaction with a sponsor on a deal where you're the sole lender. They may say, "OK, now you're the agent on the next deal, we know how you're going to interact." And you may respond, "Well, not really." Because there might be four or five other firms involved in those deals. ■