Selectivity Is Key in Private Debt

Churchill, the private capital affiliate of Nuveen, on the key opportunities in the private debt market and the importance of selectivity and diversification in portfolio development

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In which areas are you seeing the most attractive opportunities in the private debt market?
We are focused on investing in directly originated senior secured loans to private equity-backed, traditional middle-market companies ($10-50mn of EBITDA), which we believe provide an attractive risk/return opportunity for investors. These assets can offer yields in the 7-8% range, along with reasonable leverage, solid loan-to-value, and financial covenants.

With record private equity capital fundraising and over $600bn in expected refinancing activity over the next several years, the opportunities for directly originated, middle-market senior secured loans are expected to remain attractive for larger investment platforms that can access the highest-quality investment opportunities. We also believe private equity is increasingly reliant on direct lending, as direct lending dry powder in North America is currently $70bn – just 16% of buyout dry powder.

Additionally, many investors believe a market correction is imminent, and the downside protection that senior middle-market loans can provide is often a key draw. Notably, historical performance data suggests that middle-market loans exhibit less risk, as measured by default and loss rates, than the closest comparable investment option, which are non-investment-grade, broadly syndicated loans.

In situations where business models are extremely resilient and cycle tested, we also believe middle-market junior capital can be an interesting risk-adjusted return opportunity, whereby we are able to access tranches of junior debt securities yielding 10-12%, but positioned under 50% of loan-to-value. These opportunities have been increasingly prevalent, as middle-market sponsors are driving up enterprise valuations for safer assets and accepting a lower base-case return on equity.

How have you positioned yourselves in the event of a market downturn?
While we don't know exactly when, there will be an economic downturn at some point, and we believe senior middle-market loans provide investors access to attractive yields from relatively conservative assets with inherent downside protection.

We believe that Churchill is particularly well-positioned for a downturn. In the current environment, it is essential to remain highly selective (closing 5-10% of deals reviewed) and focused on building diversified portfolios of loans with 1-2% position sizes, conservative leverage multiples, significant sponsor equity contributions and at least one financial covenant per transaction. We have also developed a strong position in the middle market as a trusted partner to lead traditional senior and unitranche credit facilities, which gives us an important seat at the table in case a credit issue arises throughout the life of an investment.

Lastly, we remain focused on defensive sectors, such as healthcare and technology, while avoiding lending to borrowers in industries reliant on commodities and heavy cyclicals. And, ultimately, it is essential to align ourselves with top-tier private equity sponsors with decades of successful experience investing in the same industries.

Is the increasing presence of covenant-lite loans creating more risk for investors?
In the current market, we have seen more aggressive structures typically found in the larger broadly syndicated loan market continue to creep into the upper-middle market, such as covenant-lite loans. We believe this trend will continue, until there is some sort of credit event that gives lenders pause.

We view financial covenants as being critical structural elements of credit documentation in the middle market. Covenants are intended to act as guard rails that provide an impetus for all parties to sit around the table and review financial performance, allowing for thoughtful, constructive solutions early on, often before more serious issues arise.

In general, Churchill targets loans with at least one financial covenant and has also significantly reduced exposure to the upper middle market (companies with over $50mn in EBITDA) in response to the market dynamics described above. Our core focus remains on the traditional middle market, particularly in companies with $10-50mn in EBITDA, as we believe that protection from covenants (such as an ongoing debt-to-EBITDA maintenance test) will serve our portfolios well in every phase of the credit cycle.

What are the main differences between European private debt opportunities and those in the US? From which regions are you receiving the most investor interest?
The European direct lending market is less mature when compared to the US, as alternative lenders began to emerge in reaction to the Global Financial Crisis. The European direct lending market is essentially where the US was about 10 years ago.

Banks in Europe have been aggressive about defending their market share, particularly with relationship sponsors, so direct lenders are driven to offer more unitranche financings, as well as more lower-in-the-capital-stack solutions, which are fundamentally riskier.

The markets in the US and Europe are also very different in size – over the past 15 years the volume of institutional leveraged loans in the US has, on average, been more than 6x greater than that in Europe. The pool of direct lending opportunities is substantially smaller in Europe, particularly as managers focus on the deals the banks are not doing. As a result, given the amount of capital raised, the pace of deployment is much slower compared to that of US funds.

On the other hand, if the US middle market were a country, its GDP would rank it as the third-largest economy in the world – ahead of Japan, Germany, and the UK.[1] US direct lending managers with scaled origination platforms and strong track records can really enjoy the benefits of this much larger market, which allows them to be highly selective and hand pick the very best deals for their portfolios. In our view, this gives investors access to better market dynamics and more conservative assets. Churchill's investment portfolio, for instance, consists of 100% senior loans to a diversified pool of middle-market companies backed by top sponsors – all with at least one financial covenant. At this point in the cycle, the risk/return for our credit profile is very compelling.

In terms of investor interest, we are seeing that Asian investors, in particular from Japan, have increasingly begun to adopt private debt strategies.

[1] *The National Center for the Middle Market*

Nuveen

Nuveen, the investment management arm of TIAA, is one of the largest investment managers in the world with $1tn in assets under management.Managing a broad array of assets across diverse asset classes, geographies, and investment styles, we provide investors access to a wide range of liquid and illiquid alternative strategies.

Churchill Asset Management, our private capital investment affiliate, is a leading capital provider for private equity sponsor-owned middle-market companies. With $19bn of committed capital under management, Churchill has broad experience in all aspects of the middle-market financing business, including origination, structuring, credit analysis, syndication, and deal monitoring and oversight.

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