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Covid-19: The growth opportunities and challenges

Coronavirus was top of the agenda when Robin Blumenthal caught up with four private debt experts this summer. Although there are bound to be some casualties, everyone agreed that private debt is well-placed to emerge strongly from this most unpredictable set of events

The pandemic and ensuing lockdown in March caught markets by surprise, and upended the global economy in unprecedented ways. However, the US government's stimulus and the Federal Reserve's moves to flood the credit markets with liquidity by slashing interest rates to zero and purchasing all manner of public debt – including high-yield bonds and exchange traded funds – have restored some sense of stability in recent months.

Private credit has not emerged unscathed, but the disruptions have created long-awaited opportunities, as *Private Debt Investor* discovered when it took the pulse of the market with four leading participants.

Q What stresses has covid-19 caused in the private credit markets?

Ian Fowler: What's unique is that you had instantaneous supply and demand destruction. When the US government pulled the switch to shelter in place, all industries were affected. Covid-direct industries like retail, restaurant, and travel and leisure experienced a major impairment to the business model. Some of these companies suddenly had zero or very little revenue. Even non-covid businesses were impacted, unless they were considered essential services. The flip side is that the government turned the switch back on in 60 days with stimulus and unemployment cheques, and states began to re-open. In the liquid market, lenders had the ability to trade through the dislocation, albeit for a few short months. In the private market, lenders with covid-impacted companies or underperforming investments are kicking the can down the road. Unlike the liquid market, private market opportunities never materialised. Fortunately, we have very little exposure to consumer-facing businesses.

Brent Humphries: The pandemic has had a much greater impact on certain segments of the US middle market and the real economy than the global financial crisis. Nobody could predict large

Brent Humphries
President, AB Private Credit Investors

Humphries joined AB in 2014 as a founding member and president of AB Private Credit Investors, where he has primary responsibility for overseeing all aspects of the business, including chairing the investment committee, fundraising and investor relations.

Randy Schwimmer
Senior managing director, Churchill Asset Management

Schwimmer supervises origination and capital markets. His firm finances senior debt, junior capital and unitranche facilities for private equity-backed mid-market 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.

Ian Fowler, CFA
Co-head, global private finance group, Barings

Fowler is a member of Barings' North American, European and Asia-Pacific private finance investment committees and president of Barings BDC. He is responsible for leading a team that originates, underwrites and manages global private finance investments.

Timothy Lyne
Chief operating officer, Antares Capital

Lyne is responsible for leading the company's sponsor coverage and capital markets activities, as well as the marketing, operations and technology functions. He is a member of Antares's investment committee.

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>
> **IAN FOWLER**
> **Barings**

segments of the economy being effectively shut down. Early on, we thought that nearly 30 percent of our portfolio – even names that would typically be viewed as highly defensive and recession-resistant in sectors like health care and quick service restaurants – could be affected. Results thus far have been better than our initial fears, and we now estimate that only 15 percent of our portfolio companies operate in sectors directly impacted by covid. Within this group, the companies facing the greatest challenges make up an even smaller subset consisting of a handful of names, with the greatest stresses involving businesses that were underperforming before covid and that are directly impacted by it. That combination is very challenging. Fortunately, it's been manageable and fairly modest.

Randy Schwimmer: Frontline consumer businesses such as retail, travel, leisure and hospitality have all been negatively impacted. There have also been contrarian effects. Low-cost fitness clubs have historically done well in recessions, but with this iteration members were shut out of gyms. On the other hand, some catalogue businesses are growing because people are stuck at home reading their mail. Our long-term strategy of focusing on defensive, non-cyclical businesses carried us through the global financial crisis, and is paying off in this crisis.

Q What are the pandemic's lasting effects?

Timothy Lyne: Covid-19 has mainly just accelerated existing trends in the adoption of technology, such as the move to e-commerce and away from brick-and-mortar retailers, and technology that enables working from home. While people will return to the office, you are still likely to see a retooling and shrinking of the office space footprint, which will impact

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> **BRENT HUMPHRIES**
> **AB Private Credit Investors**

commercial real estate and related industries. In addition, a lot of service businesses – from health services to restaurants to lenders – have had to accelerate and improve their ability to serve their customers online where possible. Of course, there is the swelling government debt and other macro factors that will have a lingering impact, including low interest rates, for some time to come.

IF: We can't predict the sustained impact on human behaviour. But the effects on companies are unlikely to be isolated to those that were directly impacted by covid, given secondary and tertiary relationships with suppliers and others. In the short term, many consumer-facing companies will have to adjust their business models, and may need to revise their cost structures, because you're not going to be able to operate as efficiently as before.

For example, we thought dental management practices were fairly recession-resistant based on previous cycles. However, in this environment, most if not all were shut down with shelter-in-place orders. There's no way a dentist can see the same number of patients as before, because they have to sterilise the rooms and social distance by keeping people in the parking lot until they're ready to come in. There will be an impact on many consumer-facing businesses until we can return to normal.

Q How do you rate the Fed's actions? Are we in danger of a bubble?

RS: Bubbles exist when asset prices grow beyond fundamental levels. It's hard to see evidence of that in private credit. If anything, loan prices are depressed by the economic outlook. The good news is the Fed jumped in early and often to inject liquidity into public debt markets.

For example, it bought high-yield bonds in covid-impacted industries like cruise ship lines. That effectively gave investors confidence and buoyed prices. The goal of the Paycheck Protection Program and the Main Street Lending Program was to provide liquidity at a more grassroots level.

TL: The Fed has provided unprecedented liquidity and reassurance to markets that has helped avert a deflationary depression. However, the cost and side effects of this medicine have yet to be determined. The markets do seem to be baking in high expectations for recovery, relative to current conditions in the real economy, and government debt is soaring. The real question is: if this is a bubble, will it pop or can the Fed let the air back out slowly? There are clearly some challenges ahead.

IF: Interference like that obviously distorts the market, especially in the

liquid market with direct purchases – so it theoretically could create a bubble. However, the Fed's purchases may not be a bubble but just a suppression of spreads. For higher-quality, non-speculative issuers, there is capital out there and the Fed is basically crowding out those investors.

In private credit, we focus on the illiquidity premium, and it's been a roller coaster. At one point, at the start of the dislocation, liquid deals were generating wider spreads than middle market deals. That has now reverted back the other way, and the Fed's buying has generated substantial liquidity that has, in effect, flattened out the default curve that we normally would have seen at this point in the cycle. This will have to be addressed at some point unless we make a full recovery.

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> **TIMOTHY LYNE**
> **Antares Capital**

BH: The Fed's actions were disappointing to us as a fund manager because of the potential for moral hazard. For example, investors with exposure to the riskiest portion of the broadly syndicated market – highly levered, cov-lite, second lien loans – were rewarded by the Fed's actions, which propped up the markets. We have established our platform with a very long-dated, sticky, committed equity base, and we financed it with very long-dated, flexible financing vehicles. We have structured our business defensively, such that we will never be a forced seller into a bad market. We also believe we are set up to play offence as well, by being a liquidity provider to dislocated markets.

The window to play offence was very fleeting, largely because of the Fed's actions. The government is making the decisions they think are best with the information they have, and this was unprecedented for everybody. Those PPP loans, for example, were necessary in my view as a bridge for middle market companies until the economy restarted. They may end up becoming a bridge to nowhere, however, if we see a return of broad-based shelter-in-place orders. If this drags on for an extended time, there will be significantly higher bankruptcies across a number of industries.

Q What's the situation in the private market?

TL: Our private equity sponsors have been incredibly helpful so far through this crisis. They've been very proactive and taken action, running scenarios and cutting costs to get ahead of the curve. Our dialogue has been very constructive. We haven't just kicked the can down the road. Many of our sponsors have stepped up with additional capital support, and we have helped by amending deals to help our sponsors get to the other side.

RS: The end of March was the first checkpoint for lenders on portfolio performance. Borrowers drew down on their revolvers, so they had plenty of liquidity. Sponsors have also chipped in additional capital, as needed, and cut

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operating costs for impacted businesses. Lenders, for their part, are working closely with PE owners to provide covenant flexibility for the next six to 12 months. These elements are why we focus exclusively on financing sponsor-backed companies. The virtue of alignment of interests is being proved again in real time.

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>
> **RANDY SCHWIMMER**
> **Churchill Asset Management**

Q What about the opportunities?

BH: As a private lender, the best way to make money is not to lose it in the first instance, and excelling in the area of portfolio management will provide direct lenders with an opportunity to deliver best-in-class performance. That said, there will be good opportunities to deploy new capital on attractive terms over the next year and beyond.

For example, we are starting to see opportunities to finance consolidation among some of the industries that have been impacted by covid, such as dental practice management. There will be sponsors that view the challenges faced by this sector as an opportunity. Similarly, within practice management and more broadly, there will be opportunities for private credit managers to back the sponsors that have the expertise to take advantage of dislocations and capitalise on situations to acquire businesses at depressed valuations and to implement operational improvements.

IF: In every cycle, there are platforms that don't make it through the cycle. Managers with scale that have a diversified capital base by vehicle, investor type and strategy are well positioned to successfully withstand a cycle and seize opportunities. There are managers who might have raised too much capital or have fee structures that forced them into higher risk, higher spread, more junior capital type investments. It will be a tough road if you are a one-dimensional platform without scale and diversification in your capital base and have portfolio issues. Either you get consolidated or become some kind of zombie-like vehicle and are effectively out of business. This will be an opportunity for well positioned platforms to acquire assets, people or other platforms.

TL: Historically, vintages following market downturns have provided attractive opportunities. We also think this stressed environment is an opportunity for differentiation in performance among lenders and potentially for continued consolidation, as weaker, sub-scale lenders either go out of business or get swallowed up. It could also present attractive fertile ground for the considerable stockpile of available PE investment funds.

Q How does this cycle compare with 2008?

BH: Certain competitors will be on the sidelines for a time, like in 2008. During the financial crisis, many private credit managers were in shock about their portfolios, their liquidity and

their funding sources. There weren't many firms actively deploying capital in the private markets in the second half of 2008 and through most of 2009. We were one of the few private credit managers that did, and our predecessor business, Barclays Private Credit Partners, generated very attractive returns.

This time, for segments that aren't impacted, such as software and digital infrastructure, there will be significant investor interest and deal volume. For the most impacted sectors, there will be consolidation, and an opportunity in distressed. This time, the banking system is healthier and there is generally more liquidity in the market. In the financial crisis, many private credit managers mistakenly had financed their portfolios short term, and banks did not roll over those commitments. Those managers were, as a result, forced to liquidate assets in a very bad market. That caused a lot of value destruction for the sellers, but a lot of opportunity for liquidity providers.

Q What's the appetite among LPs now?

TL: The outlook for interest rates is lower for a longer period in the post-covid world, but pensions and other investors still need attractive risk-adjusted yield. An increasing percentage of investors plan to boost their private debt allocations as recent surveys have shown, although they are becoming more selective in who they invest with.

RS: Before covid there was media noise about private credit being oversaturated: too much competition, too high leverage and too low spreads. Suddenly the picture has changed. Spreads have widened, leverage has contracted and structures have tightened. This could end up being the best loan vintage in a decade. Investors are realising over time that private credit is a resilient asset class. Experienced managers drive the right outcomes by investing in the right businesses, being secured at the top of the capital structure and having covenants. Ironically, investors are now asking: how quickly can you put money to work?

Q Can you elaborate on terms?

TL: We are seeing wider all-in spreads when including fees and LIBOR floors, as well as lower leverage, and tighter docs than pre-covid. Of course, if the economy recovers sharply and risk subsides, this may not last too long.

RS: Back in February – ancient history – a first-lien term loan earned you a LIBOR spread of 475 basis points. That easily gapped out to 750 in March. We've seen yields coming in some since then. Today that loan is in the LIBOR plus 550-600 range, with unitranche 100bps or so higher. Leverage was easily lower by a full turn or more. That's up a bit recently, but not to pre-covid levels. Finally, cov-lite terms are not being offered to middle market companies.

Q How are returns and fees trending?

BH: When we started AB Private Credit Investors in 2014, we established return targets ranging from 8 percent to 12 percent, depending on the cycle and a variety of factors, such as the portion of our portfolio mix allocated to traditional first lien loans versus unitranche. Long term, we continue to believe those target ranges are still very achievable.

For new investors allocating to the space today, for the next couple of years we expect returns to be at the higher end of the target, as we foresee a meaningful recapture of the marks taken in the first quarter due to covid, combined with a more friendly market backdrop. In terms of fee pressure, we hope investors first and foremost look at net returns as their primary focus. We also recognise, however, that it's a competitive marketplace.

As investors start to allocate larger amounts to certain managers, they're going to look to try to optimise on the costs they're paying. I think there will be a natural negotiation that will occur. Managers with poor relative performance or an over-reliance on a handful of large institutional LPs will be likely to see the greatest fee pressure. ■