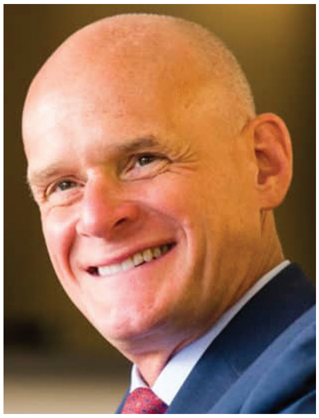
EXPERT Q&A

A high-velocity vaccine rollout, $1.9trn stimulus package and a year of pent-up consumerism mean the future is bright for US mid-market direct lending, says Churchill Asset Management's Randy Schwimmer



The big bounce back

Q It has been a brutal 12 months, with many predicting a severe downturn. What are you seeing in terms of the wider economic backdrop to 2021?

At the end of last year, before vaccines began rolling out in the US and with infections on the upswing, the mood was pessimistic. At that point many expected the recovery to be slow. Today public markets are reacting extremely favourably to improved vaccine distribution, the recently passed $1.9 trillion stimulus package and pent-up consumerism. That optimism is also reflected in the rise of long-term interest rates, with the 10-year treasury going from one percent to 1.6 percent in a matter of weeks. There's a clear belief we will be coming out of this downturn sooner and more energetically that anticipated. Analysts are increasing their US GDP forecasts; for example, Goldman Sachs expects almost 7 percent growth this year.

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Q How have different sectors of the economy been affected, and how is that translating into both portfolio health and new dealflow?

We break industries down into the haves and have-nots. The haves are companies either unaffected by or benefiting from the pandemic. Those companies operate in business-to-business industries such as healthcare, software, business services, technology and speciality manufacturing. Some pockets of retail have also fared well; shopping online, for example, or anything related to home improvement. The have-nots generally come from more consumer-facing parts of the economy – healthcare that requires in-person contact with the patient, fitness centres, leisure, hospitality and travel.

Churchill and other private debt lenders historically avoid the more cyclical industries – including real estate, chemicals and energy. That defensive posture has helped us weather past business cycles successfully. Because our portfolio had no covid-related defaults we were able to pivot back to new business opportunities from the middle of last year on.

Our dealflow is driven by private equity sponsors with whom we have deep seated relationships. The tempo accelerated towards year-end as founders and CEOs looked to sell their companies before potentially higher capital gains taxes in a new administration.

Q What are you seeing in terms of competition for those "haves" and what impact is that having on leverage profiles?

Purchase price multiples for covid winners are higher than pre-covid levels. If a business performed through the worst downturn in a century then it should do pretty well in normal times. Higher valuations have helped lenders as well. As sponsors put more cash into middle market buyouts, the ratio of equity to total capital has risen, now almost 60 percent. That's a record high. So, although debt to EBITDA multiples are returning to pre-covid levels, there's more cushion for senior and junior debt. We see that trend continuing this year.

Q Where in the capital structure do you choose to play?

Churchill's private capital strategy has four components: senior debt, junior debt, equity co-investments and private equity fund-of-fund investments. For most of the past 12 months, we have seen strong dealflow across all these disciplines. Our appetite is very deal-specific; each company presents a different growth and risk profile. Some have more steady, stable cashflows that are more attractive from a senior perspective. Others demonstrate higher growth potential, which aligns well with junior capital and equity. In some cases, the borrower exhibits both consistent cashflows and excellent upside, where it makes sense to participate up and down the capital structure.

Q Do you expect to see any change to the direct-lending landscape in the coming months and years as a result of the pandemic?

The biggest change was the shrinking of the number of go-to arrangers sponsors tapped to lead deals in the second half of 2020. Some of that related to covid's impact on some lender portfolios. Managers with troubled credits hit the risk-off switch. We saw only a handful of competitors around processes.

Scale and relationships were also behind this trend; amid last year's volatility sponsors needed to de-risk their financings. Increasingly competitive auctions compelled buyers to rely on lenders able to quickly commit and hold large dollars. Close familiarity with their PE clients allowed select credit providers to more efficiently negotiate documentation and to understand how to conform terms with the sponsors' strategies.

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Churchill has both scale and relationships, being an LP in funds of almost three-quarters of our priority sponsors. Getting the first (and often last) look at deals positioned us to frequently be working on multiple deals with the same client. That was certainly true at year-end. Incredibly, we closed almost 50 transactions, including add-ons, in the fourth quarter alone.

Q Do you think there are any lessons that the private debt industry will take from the covid crisis?

Liquidity is king. With consumers stuck at home last March revenues of certain borrowers were slashed. Those companies needed cash to survive – revolving credit facilities and/or equity injected by the sponsor. Direct lenders, and we were no exception, quickly engaged with clients to work through short-term cash needs. We then focused on their longer-term strategies, including expense reductions and credit agreement modifications, to help get to the other side of the pandemic.

That was the second important lesson: having an experienced private equity owner with deep pockets is critical to protecting enterprise value, and therefore a lender's position, during times of stress. Covid was a perfect test of that thesis. Ensuring the sponsor's investment strategy is aligned with the lender's – and that lenders in the lender group are working together – resulted in successful outcomes.

Finally, the value of a consistent defensive investment strategy has also become apparent. Those of us who historically stayed away from cyclical industries or more consumer-sensitive sectors were the clear winners last year and will be in the future. Not having to change strategies meant experienced industry players came through covid largely unscathed.

Private debt, which emerged from the GFC as an attractive asset class for investors seeking yield, conservative structures, and low volatility, has truly come of age during covid.■