ROUNDTABLE

SPONSORS

AB PRIVATE CREDIT INVESTORS • ALTER DOMUS • ANTARES CAPITAL
BARINGS • CHURCHILL ASSET MANAGEMENT • KING & SPALDING

Private debt roars back to life

Barely 18 months after the US economy seemed to be imploding, market conditions have rebounded spectacularly. Six leaders in the private debt industry spoke to Robin Blumenthal about the bounce back and the frenzied deal-making environment

When we held our US private debt roundtable a year ago, the participants were cautiously optimistic that the asset class would weather the storm of covid-19. But no one could have predicted the strength of the recovery and the extent to which, 12 months on, they would be worrying about the risks of the market over-heating.

The US economy has already wiped out its pandemic losses, helped on by the $1.9 trillion stimulus passed in March and the prospect of at least another trillion dollars in infrastructure spending on the horizon. Inflation, now at its highest levels since just before the 2008 financial crisis, has become the major macroeconomic concern in the US.

Private Debt Investor spoke to six key players in the US private debt market about the realities of operating in such turbulent times. Our panel agreed that the resilience of the asset class during covid has demonstrated its maturity and underlined its value to investors. Allocations to private debt are set to continue to grow – but growth is bringing its own problems. With competition for deals increasingly intense, managers are pushed to accept looser terms. And in such a frantic environment, well-established players that can afford to be highly selective in pursuing opportunities, enjoy a critical advantage.

Q How successfully has the private debt market bounced back from covid?

Amy Peters: We've had a surprisingly strong rebound. Private credit clients are clamouring for deals. As for deal terms, they are back at pre-covid levels of aggressiveness – especially as the deal sizes grow into these very large unitranches that we're starting to see on the market.

It seems that private equity sponsors are choosing private debt over BSL deals right now. The deals that we've been running trees on, for these multi-billion-dollar unitranches, suggest that those terms in the BSL market are coming down to the private credit markets and the execution for the sponsors is really, really good. So, I think private debt is only going to get bigger. It seems that trend is here to stay, at least while the economy continues to hum along.

Timothy Lyne: We thought that a V-shaped recovery was one of the plausible scenarios. But the degree to which the economy has snapped back has certainly been somewhat surprising. I don't think anyone was expecting the default rates to fall as sharply and as quickly as they have.

But because the bounce back has been so quick and there's so much money in the space right now, spreads have tightened. And we're seeing pretty loose pre-covid terms back in the market again.

Jason Strife: Covid only caused isolated problems in portfolios. Most firms came out with 95 percent of their names looking pretty good. And then there was private equity buying anxiety. GPs were on the sidelines for six months. But over the past several vintages, several very large funds have been raised, so we had a lot of buyer's anxiety coming to the market late in 2020. Plus, we had tonnes of government stimulus, excellent consumer balance sheets, and now the prospect of tax changes.

The market is in an absolutely frenetic state right now. It's wildly out of control across the capital structure of private debt. It's just completely uncorked.

Q Is this an accident waiting to happen?

JS: It depends what part of the capital structure you're looking at, but on the equity side you could put vintage returns at risk because most of the valuation multiples are 15-20x EBITDA at this point. On the finance side, we're seeing full capital structures on every asset. You're not even relevant to a deal if you're not putting a six times-plus term sheet out. In a market like this, the market quickly forgets that when you fully lever and a business slightly underperforms, the fully levered deal becomes the over-levered deal really fast.

Brent Humphries: Shortly before the onset of the credit crisis in 2008, Chuck Prince at Citigroup said, "as long as the music is playing, you've got to get up and dance". That was a late cycle comment, and we are seeing similar flashing late cycle signals currently. Nevertheless, our job is to adeptly navigate this environment for investors. We try to be active and selective in all markets – but we're highly, highly selective in this market.

Greg Myers: To add a little perspective, I'm a service provider to a lot of the market participants here and we see a macro view of what our clients are experiencing. We have a very active successor agency business that pretty much didn't get any dealflow after covid.

A post-crisis period is often a very active time as some of these borrowers are defaulting and the lead lending bank needs to get out. So, we were expecting a busy period and we had ramped up the team with the capacity to handle some of that activity. But, in fact, we've seen very, very little growth whatsoever in that space. It just didn't happen, globally.

> *"Private debt is a very attractive asset class. You're starting to see a lot of the wealth management platforms move into this space"*
>
> **IAN FOWLER**
> **Barings**

We were hoping that covid would add a little of this froth to the market. There are many managers that have team members who haven't gone through a credit cycle during a downturn and we were very intellectually curious to see how that would pan out, while a lot of our more experienced managers were raising those credit opportunities and special situation funds.

Q What are some of the key challenges in operating in current conditions?

Ian Fowler: The market is really competitive right now. The deal cycle has compressed significantly. Deals used to take up to 12 weeks to get to the finish line, and that 12 weeks has compressed down to a month in some cases. So, there is a lot of pressure on platforms to move quickly and get their diligence done rapidly. Often you are invited into a deal that a private equity firm has already been working on and you've got to catch up from a diligence perspective – because if you slow them down, they're going to replace you with a competitor.

GM: The cost of talent has increased a lot. Obviously with the uncertainty around the Delta variant and when you're going to have people coming back to the office, the ability to offer hybrid work schedules is really playing into our recruiting and retention. But the price of talent in some cases is 10 to 30 percent higher than pre-covid. Just as an anecdote, we have almost 100 open positions in North America. We have recruiters, we have headhunters, and yet we have a hard time finding talent as our business continues to grow.

Q Is inflation a major concern?

TL: I'd say I was more concerned about it a few months ago than I am today. The 10-year bond hit a high in March of 1.8 percent. It's now back around 1.3 percent. So, the bond market isn't too concerned about inflation in the long-term. If we had some inflation and a steepening yield curve, that would actually be a welcome sign from my perspective. But a lot of the drivers – for example, in used car prices, are likely temporary. Once supply catches up with demand, prices should ease quite a bit.

BH: I don't believe inflation is completely transitory. There are certainly transitory elements to it, evidenced by supply and demand disruptions from covid, but there are also structural changes. That doesn't mean we'll have hyperinflation, and a reasonable level of inflation isn't necessarily catastrophic for the markets. But the significant disinflationary trends we've had since the 1980s are probably behind us.

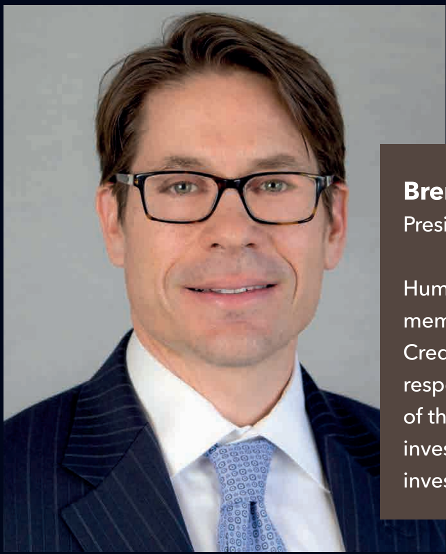
IF: In the past few years, the one area that hasn't experienced inflation is wage growth. Otherwise input costs have been rising for many industries and businesses. It's very likely we're heading for inflation, but the question is whether the Delta variant or another variant cools down the economy enough to dampen growth and inflation. We saw with the rebound from covid, consumer purchasing increased dramatically. I just don't think this consumer consumption is sustainable. At some point, people will say: "I've had

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.

Greg Myers
Global segment head – debt and capital markets, Alter Domus

Myers is focused on shaping Alter Domus's strategy for lenders and debt fund managers globally and oversees business relationship management for Alter Domus's North America fund administration group. An experienced financial executive, Myers has over 15 years' broad-based financial services expertise.

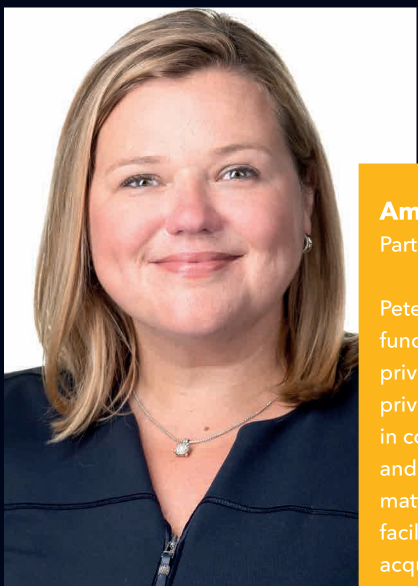


Brent Humphries
President, AB Private Credit Investors

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.

Timothy Lyne
Chief operating officer, Antares Capital

Lyne is a founding partner of Antares. He is responsible for leading the company's sponsor coverage, capital markets and enterprise risk activities, as well as the operations and technology functions. Lyne is a member of Antares' Investment Committee.



Amy Peters
Partner at King & Spalding

Peters represents private credit funds, financial institutions, private equity sponsors and private and public companies in connection with domestic and cross-border transactional matters, including credit facilities related to leveraged acquisitions, recapitalisations, and loan workouts and restructurings across a diverse spectrum of industries.

Jason Strife
Senior managing director and head of private equity and junior capital, Churchill Asset Management

Strife serves as the head of private equity and junior capital for Churchill. He is responsible for leading all facets of the business, including strategy, capital raising, capital deployment and management of the investment team, across Churchill's mid-market private equity investment efforts, including fund commitments, equity co-investments and junior debt investments.

my fun, I've bought my boat" – you can't keep consuming at this pace forever. So, I'm not convinced that this growth will continue.

Q The CLO market and the BDC market seem to have coped with the crisis. Are there any pitfalls that haven't been widely recognised?

TL: I think the vast majority of CLOs have performed very well over time. They have defied the warnings of many journalists who compared them to mortgage-backed CDOs. That said, you're going to have performance vary by manager. I agree that most of the BDC market has fared okay. More recently we've seen some BDCs – not the established managers, but some smaller players stretch on credit as they look to keep assets invested.

BH: We manage private funds, including a private BDC. Despite being private, our funds benefit from quasi-permanent equity capital. Our funds are also regular issuers of cashflow CLOs, which mitigate volatility inherent with mark-to-market based structures. Our quasi-permanent equity capital and long-dated CLO financings mitigate the risk of liquidity constraints, which could otherwise require the sale of good loans into a bad market.

Public BDCs present certain challenges compared to private funds, in our view. Consider, for example, borrowers' massive drawdowns on unfunded commitments during the early covid period in 2020. It is difficult for public BDC managers to set aside cash for these extreme situations, and the drawdowns led to multiple public BDCs issuing stock at prices below NAV to shore up liquidity. Also, a public BDC's NAV and stock price can deviate materially due to 'risk-on' or 'risk off' market sentiment rather than loan portfolio fundamentals.

> *"We try to be active and selective in all markets – but we're highly, highly selective in this market"*
>
> **BRENT HUMPHRIES**
> **AB Private Credit Investors**

JS: We have to ask: What is the nature of the BDC as a funding vehicle? On our senior loan business, a BDC is one of over 20 different vehicles that takes allocation. It does not drive deal sourcing. It is another vehicle that we allocate to, so that we don't make decisions on the business based on where the BDC is.

Q Just how do you think that lenders in the US mid-market will be affected by the transition away from LIBOR to SOFR?

AP: Large investment banks are leading the way on the transition to SOFR. Term SOFR has now been set and that will help us see how syndicated loans will be issued in the fourth quarter. I think you'll start seeing a switch to SOFR then. My experience in the middle market with our direct lenders is that they prefer to deal with the change when it happens. Once the fourth quarter rolls out in the large market, we will start to see a unified approach in the middle market private credit deals as well.

Q We're seeing more efforts to make private

> *"Covid only caused isolated problems in portfolios. Most firms came out with 95 percent of their names looking pretty good"*
>
> **JASON STRIFE**
> **Churchill Asset Management**

> *"Because of the way EBITDA is defined, the covenant is becoming less and less important. That deterioration could have long term impacts when we head into the next downturn"*
>
> **AMY PETERS**
> **King & Spalding**

debt investing more available to the retail investor. Is this a significant trend in the industry?

IF: Yes, especially for accredited retail investors searching for yield, I think private debt is a very attractive asset class. You're starting to see a lot of the wealth management platforms move into this space. This is a trend that will continue for a while, as long as we're in a low-yielding environment with investors searching for yield on an attractive risk-adjusted basis.

GM: We have seen more of our clients trying to create a more broadly available product for that registered investment adviser market. To date, they don't seem to have been very successful, given the risk profile of some of the assets they intend to put into them. But we have seen some large managers put together more liquid senior debt pools and evergreen funds that provide liquidity over time but still have that called capital model for initial periods to get larger allocations for more retail-based investor representatives, or RIAs. So overall, the market is becoming a little bit less dominated by institutional investors. The challenge is how to solve for illiquid assets for investors that require more liquidity for redemptions, when needed.

Q Are we entering danger zones with deal terms?

AP: When we talk to clients right now about documents and planning, we're focused on the risks to the specific industry that they're dealing with. But the flexibility by asset class to add in documentation limitations is pretty limited right now. When we're talking about tech, for example, we don't have a lot of ability to add any limiters. That industry has survived covid pretty well, so they are not putting up a lot of guard rails.

A lot of our clients are very motivated to get into deals and win deals and put money to work. And so, it's a matter of knowing the company, and the strength of it, and the story. But it's about balancing those considerations. And as we think about going into covenant-lite in private credit, which we are already seeing, I'm hearing more and more that because of the way EBITDA is defined, the covenant is becoming less and less important. That deterioration could have long term impacts when we head into the next downturn.

IF: There are platforms that have moved down into the middle market who don't appreciate how important covenants are in terms of capital preservation and loss given default. I like to point out that during the Great Recession, the liquid market was only 30-40 percent covenant-lite. It was available only to a very limited set of large, high-quality companies in the liquid market. No data exists on middle market covenant-lite performance during a normal extended downturn. I'm concerned about managers pushing covenant-lite deals just for the sake of increasing volume and adversely impacting the performance of this asset class.

BH: We spend most of our time in the core middle market, where nearly everything we do has a real covenant. Documentation protections typically weaken with larger financings, and we too face these pressures when we move up market.

Covenant-lite deals garner attention in the media and among investors, but we see a dynamic in which there can be little difference in lender protections provided by larger loans that include a maintenance covenant and those without. For example, does a loan with a leverage covenant set at 40 percent to the borrower's projections and a loose EBITDA definition really have a covenant?

We mitigate risk on larger deals by selectively pursuing the best credits with real scale, maintaining single-name diversity and partnering with reputable sponsors, as we can no longer rely on strong documentation.

> *"Because the bounce back has been so quick and there's so much money in the space right now, spreads have tightened"*
>
> **TIMOTHY LYNE**
> **Antares Capital**

Q Investors seem to be increasing debt allocations – will this continue?

JS: The number of private equity-owned companies in the US mid-market is going to continue to proliferate. Far fewer middle market companies are going to be public – we've seen that trend for the past 15 years. A big chunk of the private credit growth has got to be fuelled by the amount of private equity dry powder and the amount of private equity-owned companies, which will continue to grow.

"We have seen some large managers put together more liquid senior debt pools and evergreen funds"

GREG MYERS
Alter Domus

IF: Investors have now seen how well the asset class performed through a cycle. What we are seeing now is the asset class becoming a more formal allocation of an investor's portfolio, similar to the development of private equity 20 years ago.

Many sophisticated investors want to co-invest directly. The reality is, for this asset class, you can't really access the underlying assets unless you have the platform to directly originate the loans. Many investors would love to access it directly if they could, especially the larger and more sophisticated investors. But the only way they can really do it is through established strategic relationships with managers and co-investing directly with those managers.

BH: The illiquidity premium in middle market direct lending is at a near-historic wide right now. Despite modest asset yield compression in direct lending in recent years, the yield compression in traditional fixed income has been more pronounced such that direct lending's relative value has strengthened. Also, for our funds that use CLOs for financing, the cost of that financing has fallen quite dramatically, thus providing an offset to falling asset yields.

Q In such a richly competitive market, are the more established managers finding they can dominate the market?

TL: Investors throughout the world have learned over these five-plus years that middle market private debt offers a very attractive yield premium, it's a very attractive risk-reward trade. So, there's been huge capital attracted to the space and that's led to increased competition. If you're one of those investors looking to allocate to the space, you want to find a GP that has a very strong originations franchise and deep sponsor relationships so they can be highly selective in choosing the right credits.

New entrants in the market will oftentimes suffer from what I call a negative selection bias. If they win a deal, that means that they're likely either offering really low pricing or they're willing to finance a deal at a much higher multiple than the more established players. They also have very limited portfolios. We see a lot of our transaction volume – 70-plus percent of it – come from our portfolio.

JS: The institutions with scale are going to continue to scale and continue to win. Those with a broad set of deep private equity relationships, full balance sheet capabilities, long-standing track records of supporting private equity firms – those are the institutions that are going to continue to grow quickly, whether organically or through some buy and building.

We've definitely seen a bifurcation in the market in terms of who is winning, who is scaling, who is able to come to the market with a good value proposition – and who is not. ■

GAR-1820936PR-O0921W