PE Hub

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PE DEALS

Private debt attractive amid public asset volatility, increased inflation and rising interest rates

"Even with the strong deal flow we've seen this year, there's been an excellent supply/demand dynamic," said Churchill's Randy Schwimmer. "Deal terms remain well-balanced between being issuer- and investor-friendly."

Public asset volatility, increased inflation concerns and rising interest rates are driving more interest in private debt than ever before, finds The Lead Left Private Debt Survey, which was conducted between March 31 and April 5. The survey incorporates feedback from 62 respondents from asset managers, insurance companies, RIA/family offices, pension funds, endowment plans and foundations. Randy Schwimmer, co-head of senior lending at Churchill Asset Management and founder and publisher of The Lead Left, shared his thoughts on the results with PE Hub.

Randy Schwimmer, Churchill

Why is there more interest in private debt than ever?

The findings from our "pulse" survey showcased the tailwinds that propelled institutional investors' interest and appetite in private debt in the past several years – public asset volatility, increased inflation concerns and rising interest rates – have strengthened this year. The Russia/Ukraine war has accentuated all these effects. Similarly for the Fed's rate hike program, which will likely accelerate with steeper consumer price moves seen and expected across a variety of sectors, including food, energy and specialized commodities such as cobalt, lithium and nickel.

From an issuer's perspective, the buoyancy of liquid capital markets we experienced in 2021 has quieted, given the level of uncertainty in how high and how quickly the Fed will now have to act to tame inflation, and how the hikes will impact economic growth. That continues to make the private capital markets an easier path.

How are rising interest rates and inflation affecting private equity appetite for private debt?

Most PE sponsors with dry powder set the course and pace of their investing after mid-2020, and generally haven't changed their strategies. Granted, certain sectors, such as food and energy, have demonstrated more vulnerability in this latest bout of inflation, causing investors to re-think their projected cost models. But generally, it remains risk-on for interest in companies in defensive industries that have shown resilience over the last two plus years.

That means continued, even heated, M&A flow; perhaps not quite at 2021's record-setting level, but still pretty busy. And private debt providers, those that have the combination of scale and client partnerships, will continue to take share from the bank or syndicated loan market.

What are the main reasons survey participants said they are investing in private debt now?

A majority of institutional investors (70 percent) told us they were looking for attractive risk/reward returns, and almost half (42 percent) cited private debt as a source of reliable income. The third most popular rationale for private debt investing was to diversify their allocation in alternatives. Interestingly, only about 7 percent of the respondents wanted to use floating rate debt as an interest rate hedge. I suspect that's already baked into their framework, and the other screens are now higher priority.

Regardless, the interest in private debt remains quite high, with over 90 percent of investors surveyed saying they were either investing in private debt now or were considering adding it as an allocated asset class to their portfolios.

How is increased investor interest in private debt affecting private equity-backed deals?

Mega-unitranches provided by leading private debt managers will continue to take share from the broadly syndicated loan market and the upper mid-market. But even with the strong deal flow we've seen this year, there's been an excellent supply/demand dynamic. Deal terms remain well-balanced between being issuer- and investor-friendly.

It will also be the case that healthy purchase price multiples will translate to conservative loan-to-value percentages for lenders, in the 40 percent to 50 percent range. So even while headline debt-to-EBITDA leverage can sometimes look high, what you don't see is the significant equity cushion that's helping debt providers on the downside.

How is it affecting PE fundraising?

It's a virtuous circle. The more PE dollars raised, the more encouraging deal flow is for private credit managers positioned competitively to take advantage of it. The more private credit dollars, the more efficient the private market will become relative to liquids.

It's important to keep in mind for every new dollar of private credit dry powder, there's at least five dollars of new PE dry powder. Those who say private debt is a crowded space need to understand it's all relative.

It's also true fewer private debt managers are at the top of the pyramid today. As our own ability to hold large commitments, as well as underwrite them, has grown, the number of competitors we see has shrunk from pre-covid. As one of our close sponsor friends told us last month, "the world of direct lending is actually getting smaller."