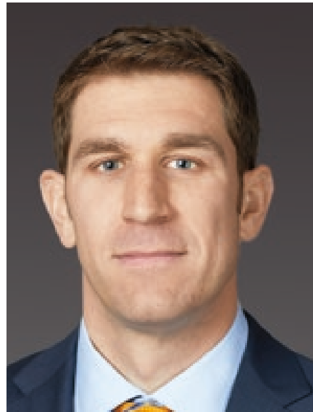
EXPERT Q&A

Platform deal volumes may still be down, but portfolio-based activity is keeping lenders busy, say Churchill Asset Management's Jason Strife and Mat Linett



The portfolio effect

Q To what extent has loan volume picked up when compared to a lacklustre 2023?

Jason Strife: We find that one of our best barometers for mid-market activity is our fund of funds portfolio, where we have LP capital deployed with over 135 different GPs, across more than 300 active funds, invested in over 3,800 underlying companies. With more clarity around the economy in 2024, we continue to see a pickup in dealflow, although new buyouts levels remain muted. That softness is, of course, being driven by stubbornly high interest rates and an elevated cost of capital. Regardless, as a firm, we have been very busy – in fact, 2023 was effectively a record year for us and that momentum has continued into 2024.

Mat Linett: Absolutely. Right now, a significant portion of our transaction volume stems from our existing base of portfolio companies. It is that portfolio effect that has been a key foundation of our dealflow. Sponsors are aggressively pursuing tuck-in acquisitions, which are providing us with opportunities on virtually a daily basis. That trend is helping to mitigate a market-wide slowdown in new buyout deals.

However, I would add we are also starting to see some evidence of green shoots on the senior lending side when it comes to new transactions. All signs point to a strong latter half of the year.

JS: I completely agree. Lenders, private equity firms and advisers all recognise that an inflection point is coming. Investors in funds need distributions and there is a huge amount of dry powder that needs to be deployed. Today, there are more private equity-owned companies between four and six years old sitting in portfolios than at any time I can recall in my career. At some point, the natural order needs to be restored. It has just taken longer than most expected as rate compression has taken longer. In the meantime, our scaled portfolio of over 450 portfolio companies continues to provide attractive add-on and refinancing opportunities for us.

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Q How has the resurgence of the BSL market affected senior lending in the private credit industry?

ML: I think it is fair to say the BSL market has awoken from its slumber, but it has awoken to a very different world. There are now a number of scaled direct lenders that can meet the quantum debt requirements for all but the very largest mega-cap buyouts.

In the upper mid-market, however, we are seeing renewed competition, spread tightening and loosening terms. While we have remained largely insulated from this dynamic in the traditional middle market, we have seen spread compression to the tune of 25-50bps. We have not seen an impact on volumes, as the BSL market is not a substitute for what we do in the mid-cap space.

Q What dynamics are at play when it comes to the junior capital market?

JS: It is an interesting time for junior capital. We're observing that only the highest quality assets are equipped to trade in the market today, and that is holding up valuations nicely. Meanwhile, solid performing, tier two companies may not feel that now is the best time to transact, but they are still looking to play offense despite the high interest rate environment. They have productive uses for capital, including both acquisitions and organic growth initiatives, and a solid equity cushion supported by relatively strong valuations, which creates a great opportunity for junior debt to fill a gap in the middle of the balance sheet.

As a result, we are doing a lot of what we call hybrid junior capital deals including fixed rate, subordinated debt and preferred equity, with the mindset of supporting high-quality companies with good uses of proceeds. There are a lot of high-performing businesses out there that are more capital constrained, given where interest rates are today, but are looking for ways to play offense. That is where junior capital, in year two or three of private equity ownership, can be a very attractive solution and that is where we are spending a lot of our time.

Q How are private credit portfolios holding up in this higher-for-longer interest rate environment and what are your expectations for loan defaults in 2024?

ML: Generally speaking, I am very pleased both with the performance of our portfolio, and, with the exception of a few outliers, the industry overall. This narrative is resonating well with investors today.

On the senior side, you are currently looking at low double-digit risk-adjusted returns for only the second time in the past 20 years. We are still seeing significant equity cushions and have the opportunity to invest in high-quality, recession-resistant businesses generating strong cashflow.

Portfolios that were constructed in the old macroeconomic environment are also generally holding up well. The industry saw a slight uptick in defaults in April to around 1.3 percent based on value, but that is against all-time historic lows, and still well below 2008 and 2020 levels. Furthermore, I don't believe higher-for-longer will result in a wave of defaults later this year.

Interest rates will certainly accelerate the fate of marginal borrowers where the business model was already broken, but I don't think the current environment will bring down many otherwise strong companies. That is particularly the case, given the strong levels of support we are seeing from the private equity community. Our expectation is that we will see slightly higher defaults, but this will create an opportunity for disciplined managers with strong track-records over cycles to shine.

Q Which managers are best positioned to succeed in this environment?

JS: Private equity firms are continuing to gravitate towards platforms that have scale and broad-based execution capabilities, together with long-standing and enduring relationships. We have firsthand experience of this trend. In 2023, when the market was demonstrably softer, we experienced one of the busiest years in our firm's history across every strategy.

"It is a really interesting time for junior capital"

JASON STRIFE

"We are also starting to see some evidence of green shoots on the senior lending side when it comes new transactions"

MAT LINETT

This volume is a direct result of the constant communication between private equity firms and our senior and junior lending originators, co-investment professionals and our secondaries investment teams. Learning and understanding their entire spectrum of needs allows us to command a lot of market share with those managers.

The dynamics at play vary by individual strategy, of course. The fact that we were able to deploy a record level of co-investment last year despite overall deal volume being significantly down, for example, was largely due to the fact that we were able to speak for the whole co-investment cheque. We had committed capital ready to go for our long-standing relationships and were often their first call.

Co-investment capital linked to fund of funds businesses, by contrast, is heavily reliant on distributions, which have declined precipitously in recent months. A lot of co-investment capital therefore evaporated from the market.

We have been able to take advantage of those dynamics and our value proposition to increase market share. In short, having multiple investment strategies at scale, with differentiated execution capabilities, and high quality and time-tested private equity relationships, is something that really resonates.

ML: That institutionalisation is really important because it allows the asset manager to continue to raise capital and take advantage of opportunities that exist in different parts of the market. Depending on your industry source, dealflow was down by between 20 and 40 percent last year. We were still able to grow despite there being fewer deals transacting, however, by taking larger hold sizes and diversifying them between our various investment vehicles. That enabled us to gain market share without increasing our risk.

I would add that in an uncertain environment such as this, private equity firms welcome the opportunity to work with a partner that has that historical experience and track record. Additionally, having an institutional parent – in our case TIAA Nuveen – is something that really resonates well both with GPs, and with our underlying investors, particularly in times of volatility. ■

Q What sectors are you finding most attractive today?

ML: One sector that we are excited about is the specialised consulting space, particularly engineering or environmental consulting companies. Private equity has targeted a number of these platforms, and we are quite positive about the opportunity they represent.

This began during covid when President Biden announced the Bipartisan Infrastructure Law, which earmarked more than $1 trillion of federal government stimulus money to be spent repairing the country's ageing infrastructure.

The companies we are financing within this sector are not the construction companies, taking risks on raw materials. They are the companies doing the front-end engineering and design work to assist with the tremendous backlog in infrastructure spending that still exists.

This is an incredibly fragmented market. The businesses are characterised by strong recurring revenues, pricing power and high margins – all reasons why private equity firms are attracted to them. Private equity firms are looking to support buy-and-build strategies driving industry consolidation. We have already taken part in a number of these deals which, of course, leads to incremental business as we become known as a trusted partner within the specialised consulting space.

Jason Strife is senior managing director and head of junior capital and private equity solutions and Mat Linett is senior managing director and co-head of senior lending at Churchill Asset Management, which is an affiliate of Nuveen