PRIVATE MARKETS FOCUS

Quarterly edition Q1 20

RESPONDING TO DISLOCATION

PERSPECTIVES IN THE LIGHT OF CORONAVIRUS:
PRIVATE CREDIT'S HISTORY OF ADAPTING TO CHANGE AND CRISIS

By Reji Vettasseri

- Private markets often deliver their strongest returns when providing innovative solutions for dislocated markets

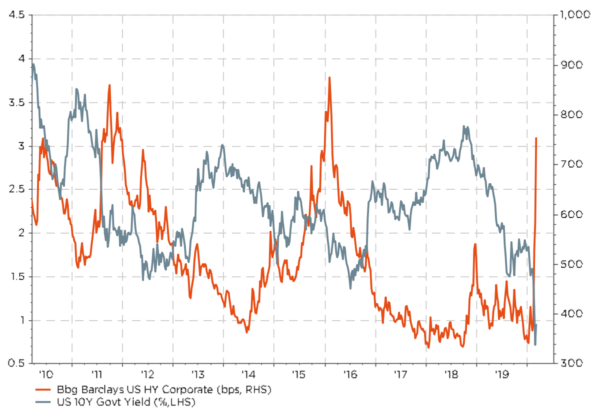
- Private credit stepped in to fill the gap left by the retreat of the banks after 2008
- Lower competition, strong service and thorough underwriting → impressive returns
- But rapid growth may have caused overheating in some areas (e.g. lending to PE)

- Coronavirus is likely to create a new set of dislocations in the credit market
- Specialised credit, the next wave of private market innovation, is positioned to respond

Adapting to a World After Coronavirus

Coronavirus has brought sweeping change to our lives and taken a tragic and growing human toll. It has also left investors wondering where to go. A flight to safety in credit might be a natural reaction. Yet with central banks again slashing rates to combat the crisis, many investment grade assets feel more like insurance policies than yielding investments. Meanwhile, it is hard to judge whether spiking high yield spreads are yet good value as historic underwritings are tested to their limits.

Evolution of Yields on US 10Y Treasuries and US HY Bonds 2010-2020



Source: Factset (17.03.2020)

Our hearts go out to those affected by the human cost of the pandemic. Yet to the investor, we will offer some comfort with a historical perspective – it is at times of upheaval that private markets have been at their most dynamic. Private credit, in particular, took off over the last decade as a response to the 2008 Financial Crisis. Over the next decade, the specialised end of this market is well placed to react to new shocks by offering solutions that benefit borrower and investor alike.

Lessons from History: Superior Risk Adjusted Returns in Turbulent Times

To illustrate this point, before surveying recent developments, it is worth looking at an earlier period in financial history to learn the enduring lessons from one of the most successful credit deals of all time.

In 1813, with America in renewed conflict with the UK, a US Treasury bond auction to fund the war effort fell flat. A banker named Stephen Girard stepped in with a private deal to buy most of the issue, which he syndicated to smaller investors. Military defeat was avoided and he not only became a hero ("the banker who saved America") but also one of the richest people in history. The operation generated profits of $4m, equivalent to a staggering 0.4% of US GDP at the time (*Geisst*).

Girard had invested in 6% coupon US Treasuries, and even if Uncle Sam had a shorter credit history than he does today, the return here was clearly not driven by risk-taking alone. Instead two other forces that have powered superior risk-adjusted returns throughout history were at work: **dislocation** and **innovation**. The Treasury had been cut off from its traditional European financial backers by the war; Girard filled the gap created by the dislocation. He was also an innovator who pioneered the then-nascent technique of loan syndication and set up new structures that rewarded him for his efforts.

The story is a reminder of a still-recurring pattern. Private investors who develop new solutions for undersupplied capital markets can earn returns out of all proportion to their risk. Even if Girard's success may never be repeated in US Treasury markets again, new opportunities still arise in markets in a state of flux.

The Battle of New Orleans 1815 – financed by early credit market innovators

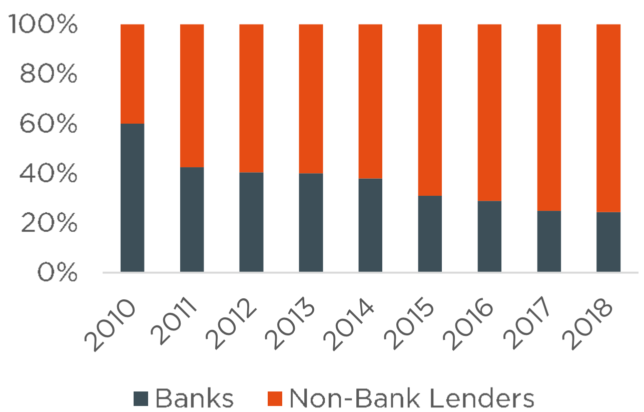
Private Credit After the 2008 Crisis: Filling the Financing Gap

Over the last decade those twin features of dislocation and innovation were clearly at work in private credit markets.

For most industries, the 2008 financial crisis resulted in a severe but ultimately temporary cyclical adjustment. Credit markets were different - there has had to be a permanent, structural shift in the way debt capital is provided that is still not fully resolved today. The cataclysm that befell the banking sector wiped out a large number of lenders (especially regional banks) and impaired the balance sheets of the survivors. Continuing waves of regulation including Basel III limited the ability of banks to generate a return on many types of credit asset. Meanwhile, the rocket fuel of interest rates that so successfully powered most other industries only fed the flames for the banks by putting pressure on net interest margins.

The result has been a sharp decline in the importance of incumbent lenders. The once-dominant banks provided just 25% of European primary loan financing in 2018 vs. 60% in 2010 *(S&P LCD Comps).* Bond markets picked up the slack for large corporate financings but were unsuitable even for mid-cap credit, as well as for more bespoke financing. Fund investors rose to the challenge of providing alternatives.

Bank Share of European Primary Lending



Source: S&P LCD Comps

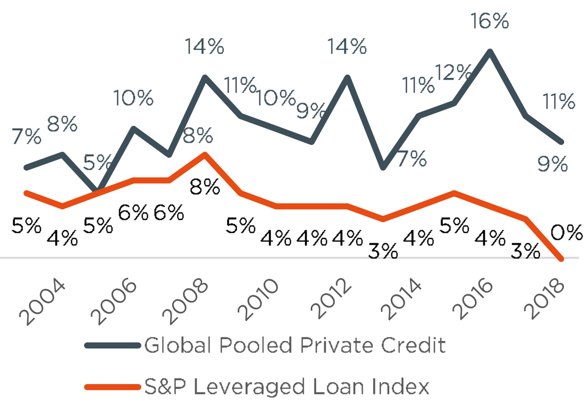
Private credit also brought a new breed of motivated and sophisticated investor. Avoiding bureaucratic, "tick the box" exercises, private credit funds moved faster and with a more tailored approach than banks. Borrowers were spared from raising funds under the full glare of a public process, while lenders drove better terms in bilateral negotiations. In addition, advanced due diligence techniques were imported from PE. As a result, in a less competitive market, private lenders commanded a premium for their higher quality of service while also managing risk in a more rigorous way.

The results were impressive. Over the last decade, private credit as a whole consistently generated high single-digit to low double-digit returns, even as bond and syndicated loan markets saw returns decline in the face of falling policy rates.

Private Credit in the Bull Run: Overreach?

However, these returns attracted a lot of new capital to the market. Private credit AUM more than tripled from $246bn in 2008 to $769bn in 2018 (*Preqin*) and it is on the cusp of overtaking infrastructure as the second-largest alternatives asset class after PE. It is thus legitimate to question whether the supply-demand balance in private credit still remains favourable.

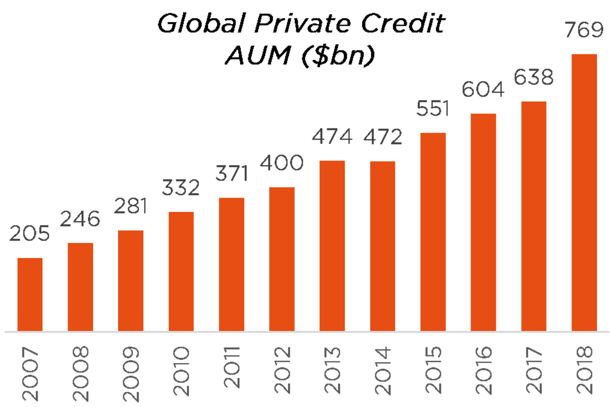
Private Credit Net IRR vs. Leveraged Loan Indices



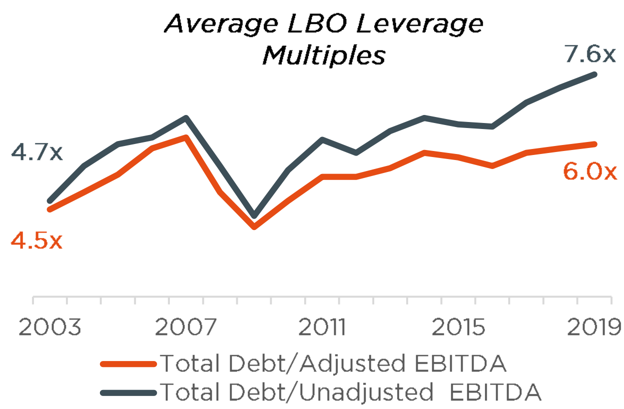
Source: Thomson One, S&P/LSTA

Responding to Dislocation

Private Credit's History of Adapting to Change and Crisis



Source: Preqin



Source: UBS

Certainly we have been concerned for a while by the segment that has seen the greatest inflows – sponsor-backed direct lending (i.e. financing for leveraged buyout deals). The large size of such deals and their natural integration with traditional private markets networks made them obvious targets for the first wave of private credit funds. The problem is that PE shops are dangerous clients – tough negotiators with no qualms about pushing capital structures to their limits.

Some worrying signs have emerged. Reported leverage is back around 2007 levels and is higher if we exclude the often-questionable adjustments that are now used to boost headline EBITDA. Covenant-lite loans have become the norm – they were seen in 82% of deals in the year to Q2 2019 (*UBS*) – eroding lenders' ability to act if things go wrong. Even if defaults have been low in a booming economy, when the cycle turns, losses could be higher than in previous downturns. Indeed Moody's projected that the average recoveries on new 2nd lien loans that run into default could be as low as 14% (vs. 43% in previous cycles). A coronavirus-driven shock could well test these predictions.

Private Credit for Today: The Rise of Specialised Credit

A new set of dislocations in credit markets will not be hard to find. EU banks are still grappling with the last crisis. They had €636bn of non-performing loans in Q2 2019 (*EBA*), and Basel IV reforms could increase the volume of risk weighted assets they hold by €1.3trn (*Citigroup*). With added stress from coronavirus-related issues, they are not well-prepared to deal with the more complex financial needs of even high quality borrowers.

However, sponsor-backed direct lending may not be the best place to look for new opportunities, especially if PE deal-making takes a pause. Instead we prefer leaning into the next wave of credit market innovation that caters to some of the most pressing needs of the economy.

There are large swathes of the credit universe where banks scaled back but less new capital has arrived. Lending to sponsorless companies, SME lending, consumer lending, real estate lending, asset-backed lending, project finance, receivables financing and equipment leasing are just a few examples.

At the same time, new segments have emerged that were never well-catered for in the first place. Lending to the tech sector is a good example. This fast-growing and traditionally resilient segment has spawned a large number of new, creditworthy firms. Yet traditional lenders have been slow to underwrite new business models in situations where assessing corporate value requires a look at more than last year's EBITDA.

Meanwhile, the growth of private credit has itself created an underserved need for robust secondary markets for LP interests in credit funds, as well as individual credit assets, that may be all the greater if portfolios need rebalancing in a downturn.

New players have been slow to enter these areas partly due to barriers to entry. Leveraged finance bankers can easily re-train to become direct lenders. Finding specialised credit experts is harder. However, those who have come have shaken things up. They have been good at designing bespoke financing solutions to serve clients with complex needs, whilst also building in strong creditor protections. Some have gone further and started to generate value at the operational as well as the financial level. For instance, as well as providing financing, some private lenders use a PE-style toolkit to help borrowers with growth projects or restructurings. In return they may get a free equity stake in the company, and working closely with borrowers also helps them take protective actions early if things do not go to plan.

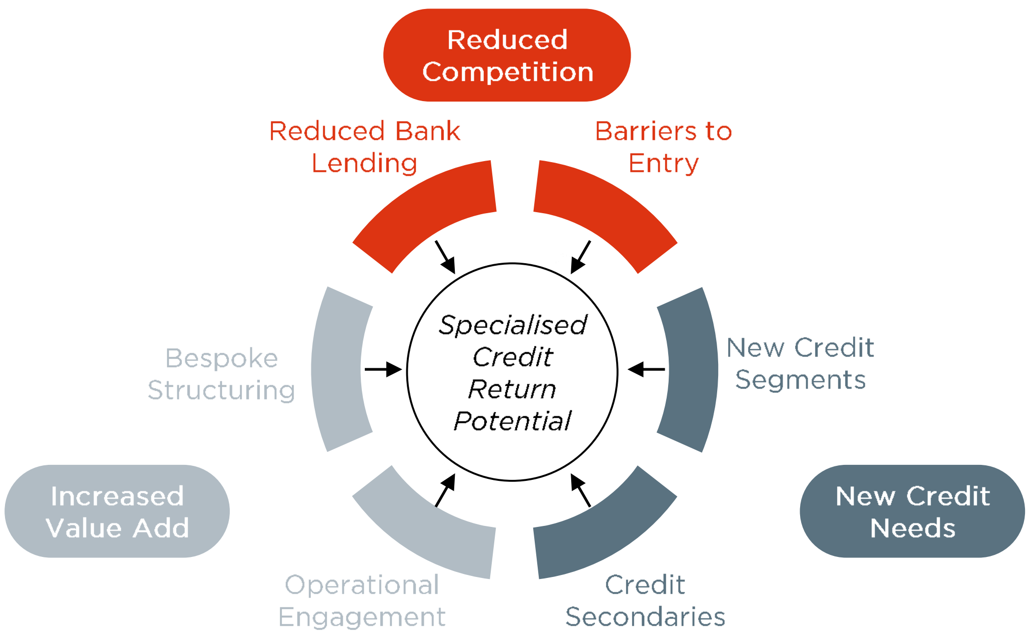
Direct lenders to mid-cap PE have been struggling to underwrite to double-digit gross IRRs even on junior loans sitting behind significant amounts of senior debt. However, in specialised credit, contractual returns at this level are achievable on less sub-ordinated structures. In addition, lenders often take free upside options (e.g. equity warrants) that can boost IRRs into the teens or above if they play out.

Specialised credit investors whose core skillset is managing complexity are ideally placed to adapt to any new macro stress. They have the ability to offer well-structured financing to strong borrowers if their traditional lenders pull back. Some also have the capabilities to pick up high quality credit assets at a discount from stressed sellers in secondary markets.

Conclusion

Private credit came of age in uncertain times and generated strong returns over the last decade due to innovation in a dislocated market. Specialised private credit is well placed to do the same over the next decade, even - and perhaps especially - if macro-economic conditions become more complex.

Factors Driving the Potential For Superior Risk-Adjusted Returns in Specialised Credit



Reji Vettasseri is Lead Portfolio Manager for alternative funds and mandates invested in private markets. Reji was previously a portfolio manager at Morgan Stanley Alternative Investment Partners, an executive director at Goldman Sachs Investment Banking and a consultant at Bain & Company. Reji received a B.A. (Hons) in Law and a Master of Laws from the University of Cambridge, and an M.B.A. with Distinction from Harvard Business School.

External sources include:

- Bloomberg
- S&P LCD Comps
- ThomsonOne
- “Wall Street: A History”, Charles Geisst (2018)
- “219 Preqin Global Private Debt Report”, Preqin (2019)
- “Basel IV Winners and Losers”, Citigroup (Sep 2019)
- “$2.5tr of Private Capital Dry Powder”, UBS (Sep 2019)
- “Convergence of Loan and HY Bond Markets Sets Stage For Worse Recoveries in the Next Downturn”, Moody’s (Aug 2018)

Front page and page 2 images from ShutterStock