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REBALANCING FOR RISING RATES

REFOCUSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

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REFOCUS ON PRIVATE CREDIT VS. LBO DEALS

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- Private credit instruments set to earn higher yields as rates rise
- Downside protection matters given valuation and macro headwinds

REFOCUS ON PRIVATE CREDIT VS. PUBLIC CREDIT

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- Hold-to-maturity private credit is not impacted by mark-to-market volatility
- Private credit has higher exposure to floating rate instruments

REFOCUS ON VALUE ADD VS. FINANCIAL ENGINEERING

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- Strategies reliant on very high leverage, may be pressured
- Strategies focussed on fundamental value creation can still outperform

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A Turning of the Interest Rate Tide

Inflation has reared its ugly head again and central banks are reacting. The Fed put up rates by 50bps in May – its largest increase in over two decades. The BoE has moved four times since December. Even the more cautious ECB is widely expected to start its own hiking cycle within months. And as the interest rate tide has turned, public market valuations have drifted lower, not helped by a number of other macro and geopolitical headwinds.

Even if they seem difficult at the time, we have previously argued that periods of dislocation and change can often prove surprisingly attractive for opportunistic private deal-making. However, this article will focus on why rate rises specifically may have differential effects across private markets strategies.

Private Market Winners and Losers

As rates go up, we favour **private credit over highly levered PE (and bonds)**. Private credit is defensive, will yield more as rates rise, and does not face the valuation pressure on equity and bonds.

We also prefer **fundamental value creation over financial engineering**. Leverage levels and valuation multiples are at risk of declining, exposing any strategies that have relied on juicing up essentially passive returns with debt. In contrast, those that truly earn their upside (by supporting value creation in companies with secular growth prospects) should continue to shine.

To explore further, it is worth breaking down three distinct effects of rate rises.

1 The Income Effect

Favours **Private Debt** vs. **LBO Deals**

The most obvious effect is higher interest income for lenders and hence higher interest costs for equity.

Most private credit deals involve new origination and, if base rates rise, fresh loans should carry higher coupons. Also, importantly, much of the private credit market is floating rate. Not only was this always the norm in many segments, but investors with flexible mandates are also increasingly pivoting to floating rates given the outlook. Many existing private loans thus automatically benefit from rate hikes (unlike bonds).

The Effects of Rising Interest Rates on Private Markets

1

The Income Effect

Higher interest income (for lenders)/ interest cost (for equity)

Favours **private credit** over **LBO deals**

2

The Valuation Effect

Pressure on equity and bond valuations; limited impact on private debt

Favours downside-protected **private credit** over **PE** or **bonds**

3

The Leverage Effect

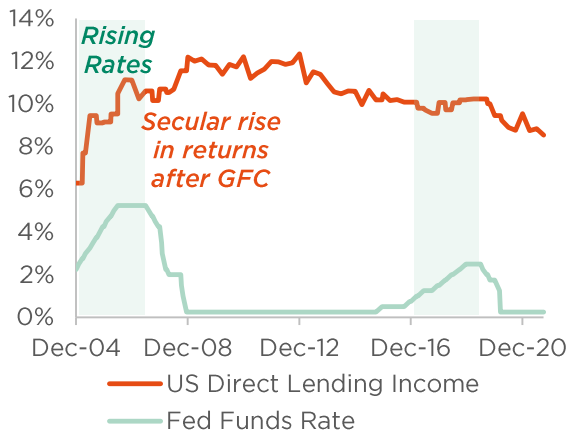
Lower sustainable leverage level

Favours **value adding strategies** over **financial engineering**

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US Direct Lending Income vs. Fed Rates



Source: Cliffwater Direct Lending Index

The effect (and its limits) can be seen in the historic data. Direct lending coupons tracked base rates upwards in the mid-2000s. The modest tightening of the late 2010s was also more supportive for private credit than the subsequent ultra-easy post-Covid policy that followed.

The anomaly was after the financial crisis, when private lenders charged more despite monetary loosening. This can be explained by the step change in opportunities for private credit, and the consequent boost to returns, as it rushed to fill the gap left by the retreat of the banking sector. Although private debt was one of the few yielding asset classes to offer attractive returns in this period, it did so *despite* low rates, *not because* of them.

Nonetheless, what is given to credit by rising rates is taken from equity. Rates a few percentage points higher can be sustained by most companies. Yet combined with macro headwinds, they could hit those leveraged buyout deals that push debt levels to the limits (and increase default risks for their lenders). Our constructive view on credit thus needs to be paired with a call for sensible capital structures in all deals.

2 The Valuation Effect

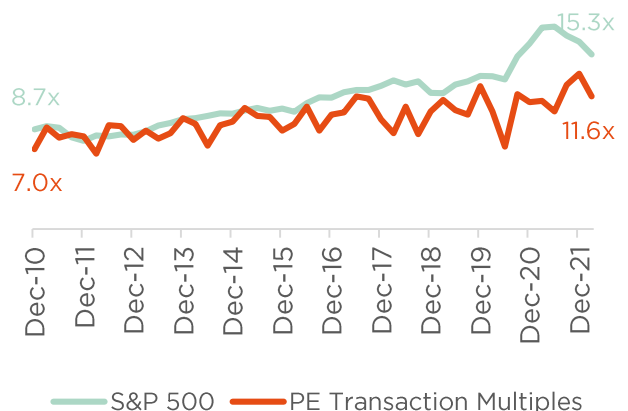
Favours *Private Credit* vs. *PE* and *Bonds*

Even more significant than the income effect, is the impact of rising rates on valuations. The S&P 500 and EuroStoxx 50 ended April respectively 11% and 12% lower than six months previously when rate worries first started to bite. Yet with multiples still above long-term averages, and a host of other concerns weighing on investor sentiment, there is a real possibility of further declines.

This would have a direct read across for PE, where public comps are a key reference point for valuation. Successful PE investors will thus need discipline on entry pricing and a redoubled focus on value creation to overcome potential valuation headwinds going forwards.

Some hope is provided by the chart below. For all the talk of record buyout multiples, the data shows that PE has actually been less frothy than stock markets. Over the last decade PE entry multiples have always been lower than public multiples, and in recent years the gap has only increased. This gives a margin of safety for all those managers who maintained a value orientation.

EV/ EBITDA for S&P 500 and PE Deals



Source: Bloomberg, Preqin

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Moving to credit, public bonds have also suffered. The Bloomberg high yield indices in both the US and Europe are down 7% over the last six months. However, private credit is insulated from this effect. Not only are some deals floating rate - where yields adjust by coupons rising rather than prices falling - but, as hold-to-maturity assets, even fixed rate private loans do not incur mark-to-market losses.

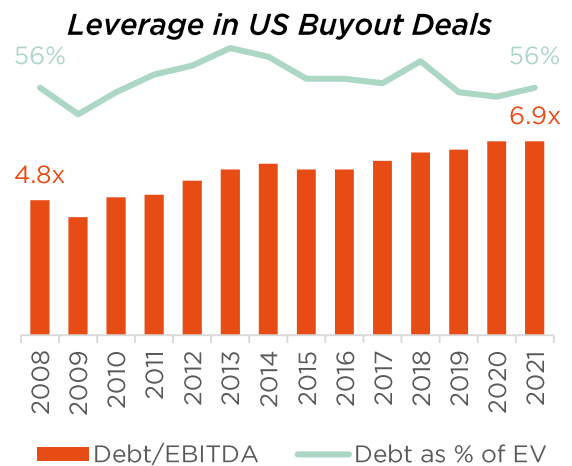
This is not just accounting optics; it reflects the real risk position. If you purchase a long-dated bond and try to exit in a few years, there is a real chance that you will fail to recoup your principal, if markets have tumbled. But with private credit, the aim is to either hold medium duration assets to maturity when contractually principal will be due in full. Early exits can happen but generally due to borrowers deciding to refinance, in which case pre-payment penalties boost IRRs for lenders.

Theoretically hold-to-maturity strategies are also possible with bonds. Yet returns would be capped by moving down the yield curve with shorter dated paper. And if there is no plan to benefit from the liquidity of a bond portfolio, there is limited downside from swapping it for higher returning private debt.

3 The Leverage Effect

Favours **Value Adding Strategies** vs. **Financial Engineering**

In recent years leverage in PE deals has expanded, reaching around 7x in US buyouts in 2021. Low rates have enabled this: firstly, by ensuring interest service costs have been manageable even with heavy debt burdens and, secondly, by supporting corporate valuations and so keeping equity cushions looking healthy.



Source: McKinsey

If rates rise, aggressive debt financing becomes harder. This was already seen in Q1 22, when European high yield issuance dropped 48% y-o-y (*Fitch*) and several bank financing deals for PE deals struggled in syndication (e.g. SPX Flow, Covis Pharma).

In PE, The greatest impact will be felt on the traditional large cap buyout model, which involves taking a mature cash flow generative company and leveraging it up to boost IRRs. However, where PE returns are primarily generated by helping companies deliver on secular growth potential through operational value add, the potential for superior returns exists even without leverage.

Simple LBO maths shows that, today, a PE asset with mid-single digit growth and a capital structure in line with US market averages could hit 20% IRR. But with a turn less of leverage and 250bps of additional interest costs, the IRR would drop by around 3 percentage points. In contrast, a double-digit growth deal with 3.5x leverage, would lose just 1 percentage point of IRR.

Our preference for low leverage and value creation holds for private credit.

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Mature companies with high debt loads are vulnerable to macro and inflation risks which have an outsized impact on their financial health due to leverage. They also face refinancing risk in a rising rate environment.

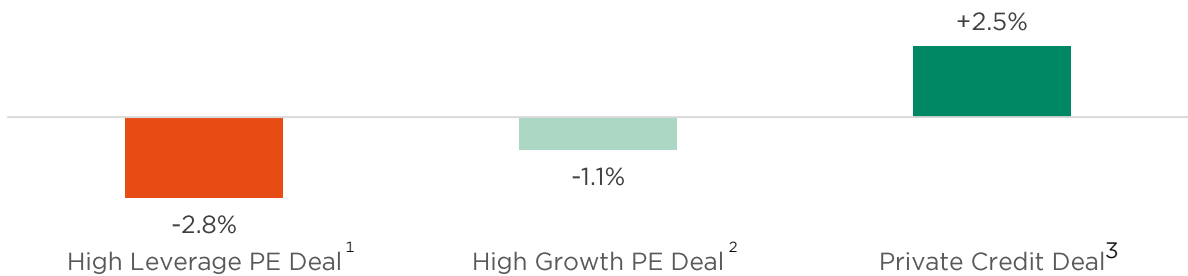
In contrast, in niche or smaller cap strategies, it is possible to achieve high returns without excessive leverage by providing credit to strong borrowers for secular growth projects that banks do not have the skillset to underwrite quickly. Risk in such deals tends to be idiosyncratic (and thus manageable through diversification) with much less correlation to macro dynamics.

Conclusion

Today base rates are still low by historic standards, but after a decade and more of ultra easy monetary conditions, even a gradual shift in policy could bring new risks for many asset classes.

Fortunately, there are well-positioned private market alternatives. Private credit is on the right side of rising rates, offering rising yields on the one hand and protection against operational and valuation downside on the other. Meanwhile, across all segments, value-added strategies offer a resilient source of upside in any environment.

Illustrative Impact of a 250bps Rise in Interest Costs and a 1.0x Reduction in Leverage on IRRs for PE and Private Credit



¹ High leverage PE deal assumes 12.5x entry and exit multiple, 6.5% EBITDA growth, 85% FCF conversion giving 20% IRR with 6.0x ND/EBITDA and 6% borrowing costs prior to sensitivity

² High growth PE deal assumes 12.5x entry and exit multiple, 10.4% EBITDA growth, 85% FCF conversion giving 20% IRR with 3.5x ND/EBITDA and 6% borrowing costs prior to sensitivity

³ Private credit deal assumed to benefit from 250bps improvement in interest income



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External sources include:

- Cliffwater, "2021 Q4 Report on U.S. Direct Lending"
- McKinsey, "Global Private Markets Review 2022"
- Fitch, "European High Yield Market Insight – 1Q22 Update"
- Pitchbook, "Q1 2022 European PE Breakdown"
- Preqin
- Bloomberg

All analysis based on latest available data as of 30 April 2021

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