DECALIA PRIVATE MARKETS

PRIVATE MARKETS **FOCUS**

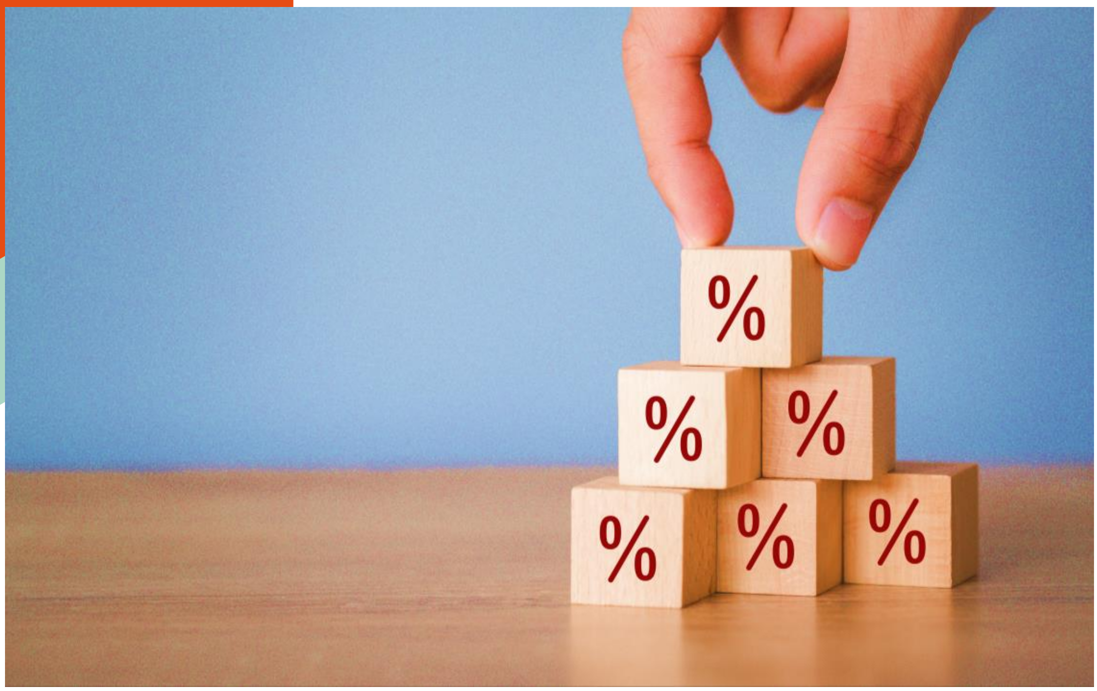


Image: Shutterstock

QUARTERLY EDITION | Q2 2022

REBALANCING FOR RISING RATES

REFOCUSSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

Reji Vettasseri, Lead Portfolio Manager of DECALIA Private Credit

Please see appendix at the end of this document for information on sources, important disclosures and disclaimers

REBALANCING FOR RISING RATES

REFOCUSSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

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).

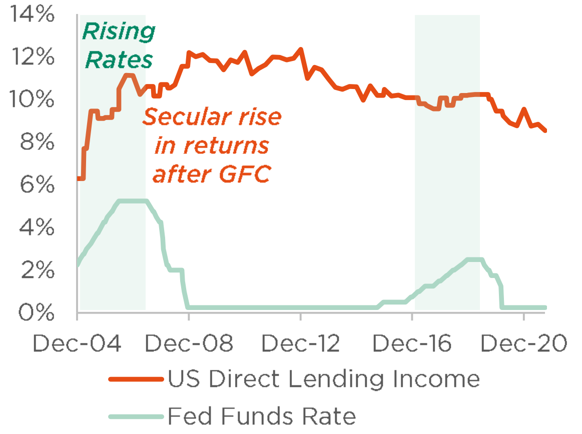
The Effects of Rising Interest Rates on Private Markets

1 The Income Effect	2 The Valuation Effect	3 The Leverage Effect
Higher interest income (for lenders)/ interest cost (for equity)	Pressure on equity and bond valuations; limited impact on private debt	Lower sustainable leverage level
Favours private credit over LBO deals	Favours downside-protected private credit over PE or bonds	Favours value adding strategies over financial engineering

REBALANCING FOR RISING RATES

REFOCUSSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

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

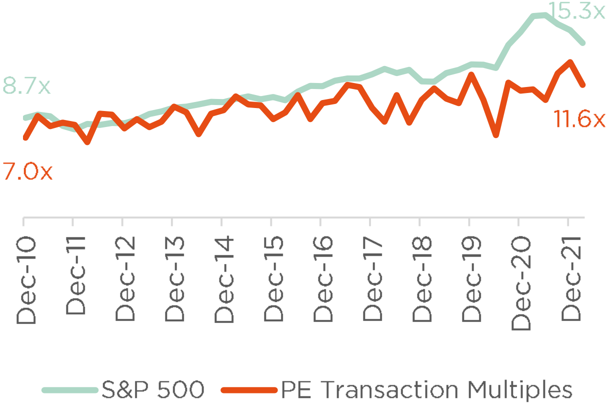
*Favours **Private Credit** vs. **PE** and **Bonds***

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

REBALANCING FOR RISING RATES

REFOCUSSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

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.

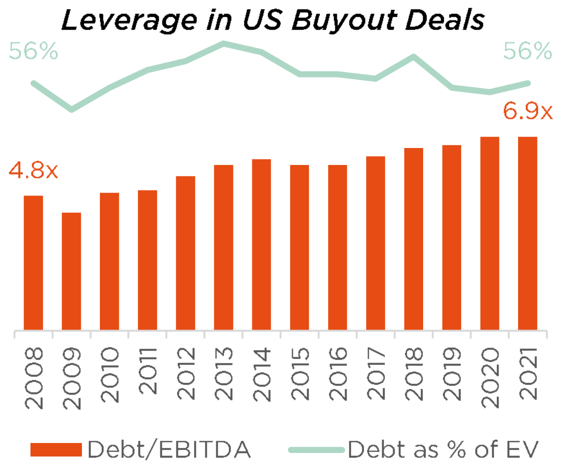
This is not just accounting optics; it reflects the real risk position. If you purchase a long-dated bond and try to exit in a few years, there is a real chance that you will fail to recoup your principal, if markets have tumbled. But with private credit, the aim is to either hold medium duration assets 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 levering 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.

REBALANCING FOR RISING RATES

REFOCUSSING ON CREDIT AND FUNDAMENTAL VALUE CREATION

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.

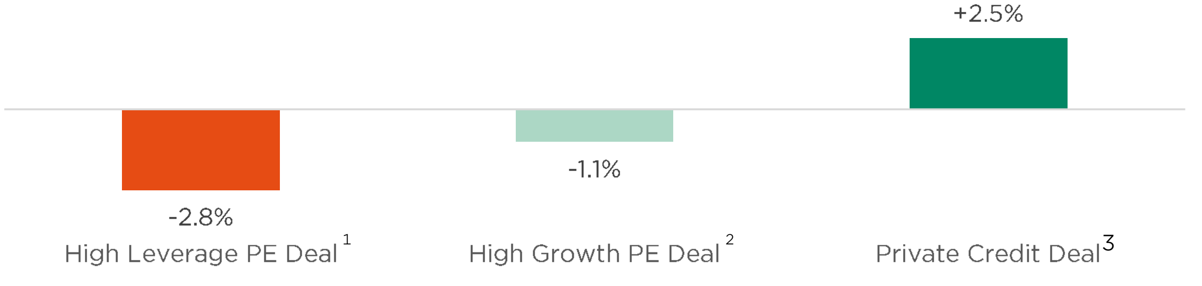
In contrast, in niche or smaller cap strategies, it is possible to achieve high returns without excessive leverage by providing credit to strong borrowers for secular growth projects that banks do not have the skillset to underwrite quickly. Risk in such deals tends to be idiosyncratic (and thus manageable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

Ilustrative 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
[1] 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

Reji Vettasseri is Lead Portfolio Manager for alternative funds and mandates 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.

CONTACT

DECALIA SA
Rue du Rhône 31
CH-1204 Genève

Tél. +41 (0)22 989 89 89
Fax +41 (0)22 310 44 27

info@decalia.com
www.decalia.com

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

Front page image from Shutterstock