The future of private credit

As part of the fifth annual LPGP Connect Private Debt Fundraising Conference, Richard Phillips, Director of Private Debt at the Aztec Group, moderated a virtual discussion on the future of private credit. Richard was joined by Sandro Näf of Capital Four Management, Antonella Napolitano from Deerpath Capital Management, Ross Morrow from DunPort Capital Management and Ewan Macaulay of MetLife Investment Management.

Moderator, Richard Phillips (RP): The focus of our discussion is the future of private credit, but can you share your reflections on 2020?

Sandro Näf (SN): March was particularly tough. First, we had to work our way through the portfolio to see what was affected most. Then, we needed to consider how our LPs would want us to behave before moving forward with the investments we had. This meant working closely with portfolio companies, introduced new covenants and business plans that would hit different key performance measures in the light of COVID. It was about striking the right balance between being supportive for companies while doing what our LPs would want us to do.

Antonella Napolitano (AN): Valuations took an enormous hit across the board in Q1, and deal flow plummeted for the better part of Q2. On the LP front, investors took a pause on allocating, and focused on existing portfolios. We saw an immense pick-up around August and September, and in the US, a lot of lending firms had their best September and October deal volumes ever.

Ross Morrow (RM): We had experienced our two busiest quarters in Q4 2019 and Q1 2020, then everything came to a shuddering halt in Q2 of this year. But towards the end of Q3, we began seeing investors willing to reassess or consider new risk. Patience, forbearance and a focus on liquidity was the name of the game for the last six months.

Ewan Macauley (EM): This has been a real-life stress test for all of our portfolios. We have definitely seen a return of clients looking to deploy capital, and also in terms of issuers looking to tap liquidity. One of the benefits of our asset class is that it should perform well compared to other types of debt, or other financial instruments, during a downturn. We're not out of the woods yet, but it's been encouraging to see this being borne out.

RP: What challenges, in terms of valuations, do you see coming next year?

SN: The true test of any private debt manager is dealing with those inevitable, difficult situations, and in protecting and recovering value via active management. This means valuations need to be considered through to the lens of a fund's ability to follow their money, as well as to be able to hold an asset for an extended period where necessary.

RM: We won't shy away from the fact that some assets may be underperforming relative to their underwriting case. Being transparent, and communicating with your LPs in a clear manner, is important, but you should also be able to explain how you plan to deal with a particular challenged asset. When speaking with our LPs, we have a very clear policy of how we will value our positions and the steps we are prepared to take, regardless of the market backdrop.

EM: Valuations are important, but people need to view things through a long-term lens. This is an illiquid asset class, and all the protections we put into our investments are designed to allow us to ride through the peaks and troughs seen during economic cycles. We remind clients not to get overly fixated on month-on-month movements, and that usually the best approach is to look at the asset over the long term.

AN: We typically get each portfolio company revalued independently once a year, but we revalued our book during COVID because we thought investors needed an independent view of the entire portfolio in light of the unprecedented environment. Valuations declined about 5%, but since then, we have seen writeups each quarter as businesses recover from shutdowns and regain pre-COVID profitability levels, as we continue to receive interest and principle on all of these loans and also as market-required yields stabilise.

SN: These are good opportunities to be transparent about processes and show LPs how we work with third parties to issue valuations. Of course, LPs are grateful when we can add colour to the valuations and explain what's going on, not just throwing numbers at them.

RP: Are there benefits to having a sponsor in certain transactions, particularly given the liquidity stress of the past six months?

AN: I would say 90% plus of our deals are sponsor-backed. When sponsors put a substantial amount of equity into the deal, the sponsor acts like an airbag cushioning you against an accident. The sponsor has an economic incentive to protect their investment and support companies, because they have a lot at stake. If we didn't have sponsors in place, we would be doing more restructurings these days.

RP: What are you sensing when it comes to future allocations of capital. Will there be deployment opportunities?

RM: You hate to refer to the pandemic as an opportunity, but its impact will clearly create opportunities for private debt participants, particularly in Europe. I think there will be managers that, over the course of 2021, will reap the benefits of how they responded to the pandemic this year. The "proof is in the pudding" as they say, and I think LPs appreciate how private debt as an asset class has gotten through this first great test.

EM: We felt allocations would probably be quiet for the rest of the year, but we have seen a noticeable uptick in interest over the last six to eight weeks. People are realising that private debt has been holding up well, and have a bit more confidence now than they had back in the spring or the summer. It definitely seems to be going in the right direction.

RP: Will there be a shift in borrowing undertaken

as a result of COVID, maybe even contrasting with how the global financial crisis impacted markets back in 2008?

SN: I’m proud the market has done so well through this test period. In contrast, bank solvency mechanisms are still based on centuries-old thinking, lending within a structure that forces you to raise money at the worst possible moment! None of that applies to private debt. Not one single LP came to us in March and said they wanted their money back. More importantly, we can show LPs how we managed the situation with companies during some very challenging times.

RM: Most borrowers and sponsors have had a relatively positive experience that will give further confidence to market participants that this structure works. But for borrowers, working capital still needs to be funded, and bank appetite has just about disappeared. Can private debt lenders step in and provide some form of working capital solution for companies? I think that question is yet to be answered.

RP: What are your thoughts on how EBITDA (earnings before interest, taxes, depreciation and amortisation) is going to be assessed in the coming 12 months?

RM: Pressure has been building on covenants generally in recent years. Lenders are always very focused on cash flow but particularly in the last 12 months. There will be more scrutiny on definitions like EBITDA, as well as covenants more generally, to make sure that they are fit for purpose. Personally, I think definitions will begin to tighten up somewhat in favour of Lenders, but time will tell.

AN: We have always been very careful on EBITDA add-backs generally, and there has been something of a trend for sponsors to try to get approval to add-back even forgivable covid-related government loans as income. That’s not a true company cashflow line item that a company should get credit for, so that’s something we’re continuing to monitor.

RP: Can we finish with your expectations for 2021?

AN: Everything is going to be scrutinised more closely now, particularly with companies that suffered even a mild COVID impact. We now require 13-week cash flow forecasts from companies, because we need to estimate any future imminent liquidity needs that weren't part of our initial investment thesis. Potential new shutdowns and renewed social distancing across the U.S. coupled with no movement on additional fiscal stimulus, makes the near-term economic environment quite uncertain. This is why it's important to invest in a strategy designed to provide protection when uncertainty is high. The direct lending asset class is here to stay. Every survey suggests LPs are either sticking with their same allocation or increasing.

SN: We now have a thriving private debt market that uses debt as a capital instrument for companies to thrive under private ownership. These are not weak companies; they are businesses empowered by capital structures that incentivise management and employees. So, investors will want more of this, and companies will want to use it more as a capital instrument. Things will only go one way from here.

RM: I echo the positivity of the panel, but we shouldn't underestimate the levels of government support that still needs to wash its way through the system. Also, we've seen a huge amount of flow and volume into so-called 'COVID-proof' businesses. These are interesting companies, but none of them are isolated from all the other normal business risks that come with day-to-day transactions.

EM: We are still cautious, but so far, the asset class has stood up really well to this real-life stress test. Some clients have viewed private credit as just a bit of yield pick-up compared to what is available in the public markets. The value of true downside protection – in the form of covenants – has now been proven in real-time, which will give LPs more belief in the benefits of private credit in future.

To watch the roundtable, please click here.