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THE DIFFERENTIAL

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IAS's Junying Shen discusses recent trends, risks and opportunities in private credit with PGIM Private Capital Head of Investor Relations for Alternatives, Tony Coletta.

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Junying Shen is a Vice President and Co-Head of the Private Assets Research Program in the Institutional Advisory & Solutions (IAS) group, focusing on traditional and alternative assets and developing asset allocation models. She joined IAS in 2017 from the Market Risk Capital & Analysis team at Goldman Sachs where she analyzed the market risks of various assets such as syndicated loans, public equity, private equity and real estate. Ms. Shen earned her BS degrees in Finance and Mathematics from the University of Illinois at Urbana-Champaign and an MS in Mathematics in Finance from New York University.

JS: Private credit investments are an increasingly important part of institutional investor portfolios. What are the different strategies to invest in private credit?

TC: Private credit markets encompass a wide range of ways to invest within the capital structure. Direct lending is a large category which generally includes senior secured, first-lien loans and consists of financial facilities like revolvers, term loans and delayed draw term loans. Loan amounts can range from 2x to 3x the borrower's EBITDA with more conservative lenders, or up to 6x with more aggressive lenders. Historical gross yields in direct lending have been in the high single-digit range (base rate plus 500 – 700bp of spread) and are significantly higher today due to a higher base rate. Unitranche financing involves lenders offering more leverage to borrowers, with these lenders effectively combining senior and subordinated positions, extending loan amounts that may range from 5-7x the borrower's EBITDA, and historically seeking floating rate yields in 9-12% range. Mezzanine financing involves providing subordinated debt along with preferred or common equity. Mezzanine lenders assume a subordinated position to senior lenders in exchange for receiving a higher promised yield (usually fixed rate) which typically ranges from 12-18%. In addition to these categories, there are literally dozens of other "niches" and specialized strategies in the private credit markets today.

JS: What drives the growth of private credit and the increasing allocation in institutional portfolios? Do you see this trend continuing?

TC: For many years, institutional investors could access debt only by buying public bonds. Public bonds make sense only for very large borrowers, since issuing debt (or, borrowing by issuing public bonds) generally requires a company's borrowing need to be in the billions of dollars to ensure float and justify large issuance fees. So, before the last twenty or so years, investors simply did not have access to smaller private company debt – since most of the debt to these companies was historically extended and held by commercial banks. There are hundreds of thousands of great private companies in the US and abroad, with annual revenues of $50 million to over $1 billion, which are great candidates for debt investors. But investors could not previously access these borrowers because banks so dominated the smaller company lending market.

Things changed following the GFC in 2008-09. Following that crisis, the regulation of commercial banks accelerated, and it became more difficult for borrowers to get higher-leverage loans. Private credit funds were formed and experienced large growth between 2010 and today as they moved in to fill the leveraged loan void left by the banks. These private credit funds now provide credit to thousands of middle market borrowers. Private credit funds are largely concentrated on supporting the M&A activities of private equity funds, which have also been experiencing significant growth and need higher leverage to make their equity returns work as they buy companies. Private equity funds love to use these private credit funds to provide financing to support the purchase and operation of the middle market companies since these funds are largely unregulated and have the ability to offer flexible terms and attractive pricing, while also offering higher leverage than commercial banks would consider.

From the investor's perspective, private credit offers institutional investors such as pensions and endowments higher yields relative to public bonds and other forms of more liquid credit – many funds target returns of about 2-3% higher than what is available in the broadly syndicated loan (BLS) market. If an investor is comfortable with the lack of liquidity that comes with investment in these private loans, and if that investor is investing in managers with diversified pools of well-underwritten loans, private credit could be a very attractive, higher-yielding complement to an overall investment portfolio.

While investors have for many years accessed private markets by investing in private equity managers, investing in private credit managers can be a way to access private markets at a less risky level. While private equity funds hold equity in the companies they buy, private credit funds invest (or lend) at the senior debt level. If a troubled company is liquidated or sold, senior debt has priority and typically must be repaid completely before subordinated debt and equity holders receive dollars back from their investment. Private credit funds (who are essentially lenders) usually have covenants that allow them to take precautionary or protective measures if a company underperforms, including increasing pricing to compensate for higher risk, mandating the use of a business management consultant, changing payment schedules, taking collateral, requiring equity injections, or in the more difficult situations, forcing a sale or taking equity. As a result of covenants and the priority position held by senior lenders in the capital structure, private credit funds should generally have fewer losses than private equity funds. By investing in a mix of private equity and private credit managers, investors can now diversify their private company exposure, staggering risk and return across multiple capital structure levels.

JS: As you mentioned, a significant part of the private credit market is loans made to support portfolio company acquisitions by private equity (PE) sponsors. What are the benefits of working with PE sponsors?

TC: Working with PE sponsors offers numerous benefits. First, PE sponsors conduct thorough due diligence before they make equity investments, and typically share this diligence with prospective lenders. PE sponsors also provide valuable governance by overseeing management, appointing new managers if necessary, and creating more active boards of directors, all in an effort to improve financial performance. Since they tend to have additional fund capital on hand, sponsors also have the ability to inject additional capital into companies that are running into trouble. All of these activities can be very beneficial to senior debt holders – though as a note of caution: lenders are aware that sponsors ultimately make moves that they feel will benefit their equity, and these moves sometimes conflict with the best interests of the lenders.

While PE sponsors provide many benefits to the lenders in their deals, there are some aspects of sponsored lending that investors should be aware of. PE sponsors excel at running auctions when selecting their lenders, sometimes soliciting term sheets from 10 or more private lenders who are competing for the business. As a result, the "winning" lenders for sponsor-led deals often end up with the lowest pricing and the least creditor-friendly terms and covenants – concessions they had to make to get more loan volume.

Investors in private credit funds should be focused on understanding where their managers' deal flow is coming from, and how reliant these managers are on bidding aggressively to win non-relationship sponsored business, which leads to weaker structures and pricing. Moreover, institutional investors should assess how reliant their private credit managers may be on a small set of PE sponsors for a significant portion of their deal flow – some lenders may be inclined to take on riskier deals to ensure continued deal flow from their PE sponsor relationships, highlighting the importance of a broad group of PE sponsors as a source of deal flow. With senior debt investing, which has no equity upside, just a few losses can very negatively impact returns!

JS: How has private credit performed in the rising rate environment of the past 18 months? Are you seeing signs that rising rates have affected borrowers' ability to service debt? Do you see more defaults as a result?

TC: A higher interest rate environment is a double-edged sword.

Private credit, which generally consists of floating rate loans, performs well from a yield point of view in a rising rate environment. With SOFR (the base rate) approaching 5% and with a bit of spread widening, private senior loan yields are solidly double-digit now. For investors, this is a good thing.

On the flip side, a fund's borrowers now face the challenge of significantly higher interest payments even when maintaining the same amount of debt. These companies will have to balance the effects of interest payments that may have doubled or tripled with needs to make other short- and long-term capital investments. It's simple math: all else equal, a private credit manager with a preponderance of borrowers that are aggressively leveraged, at say 5-6x those borrowers' EBITDA levels, will have many more borrowers facing cash flow challenges compared to a manager with average leverage in the 3-4x range. While some larger borrowers with more diversified customer bases may be able to handle more leverage, the impacts of higher interest rates affect all companies regardless of size.

Over the past decade, private credit has exhibited strong performance due to a robust economy, with borrowers generally generating consistent performance and strong cash flows that allow them to handle higher leverage. So far, even as interest rates have risen, we and other private credit managers have seen borrowers fare reasonably well in most industries, as the economy has remained resilient. We have not yet seen meaningfully higher default rates (in terms of missing interest or principal payments), but we are beginning to see more borrowers experience covenant-related defaults (e.g., maintaining the required interest expense coverage ratio) which tend to occur before actual payment defaults. Good lenders who have experience in up and down markets, and who have been disciplined in negotiating good covenants for their deals, should be able to move more quickly to work with borrowers, protect their debt, and achieve better outcomes for their investors in more challenging environments.

JS: How would you expect a recession to "play out" in the private credit market compared to the public market?

TC: Public debt markets are very different from private debt markets. Public bonds generally have ample liquidity (i.e., many potential buyers) and no covenants, so holders of a company's public bonds that are concerned about that company's performance only have the option of selling those bonds, presumably at a discount, hopefully before the discount widens.

In contrast, private debt holders don't typically have the ability to sell underperforming loan positions, so lenders/managers have to use their skill to actively work with their borrowers to get better performance (repayment) on their loans. These "workouts" with underperforming companies that are not meeting their debt service requirements can sometimes take 3 years, 5 years or more. During a recession, credit managers will spend significant time with many of their borrowers – working through cash flow models, negotiating amendments to loan agreements, positioning against other lenders, negotiating with sponsors/owners about who will put in needed cash, potentially getting involved with the management of companies, writing endless memos, and getting internal approvals required to make many of these moves.

As a result of all of this, managers without robust workout teams (which is most of them) may be "out of the market" and will not have the capacity, manpower, or capital to originate new loans or investments during those times. They simply might not have the time to go out and look for new loans! Those managers with more diversified portfolios, less risky companies, more conservatively underwritten portfolios (with better covenants and lower leverage), and with experienced workout teams may be able to benefit by making new investments when capital is scarce, the ability to be selective is high, and terms and pricing are very lender-friendly.

JS: Do you see regulatory changes (e.g., reporting transparency, oversight & supervision) on the horizon for the private credit markets?

TC: As the private credit market has grown, private credit managers have been increasing the level of transparency for their investors, with more and more data available on the financial health of their portfolios, the impacts of fund-level leverage and subscription lines, and the loan-level performance of their borrowers. Funds have been driven to increase this transparency not only by the SEC and FINRA, which make sure that managers are marketing to investors with proper disclosure, but also by competition and by institutional investors who demand more data in due diligence before they make investment commitments. I expect that fund complexes will continue to step up their transparency in these areas to ensure that they do not tempt regulators to assess fines and extend their reach.

No doubt, private credit funds have encountered a much lower degree of regulation relative to banks. Obviously, pension funds – which serve everyday, hardworking (and voting) employees and retirees – make up a substantial portion of the investor base in private equity and private credit funds. We all know how our political systems work -- while it does not seem likely now, a significant failure or collapse of one or two large private credit funds that severely impacts the retirement accounts of pensioners could quickly spur actions by Congress and regulators. Time will tell.

JS: What other trends and developments are you seeing in the private credit market?

TC: Large private credit managers continue to grow in both size and influence. As they grow, they tend to target larger and larger borrowers. However, there is still space for smaller funds – and for some larger funds with unique origination capabilities – to cater to lower middle market segments which feature smaller sized borrowers, better pricing and terms, and more relationship based lending than in those larger markets.

JS: Thank you, Tony!