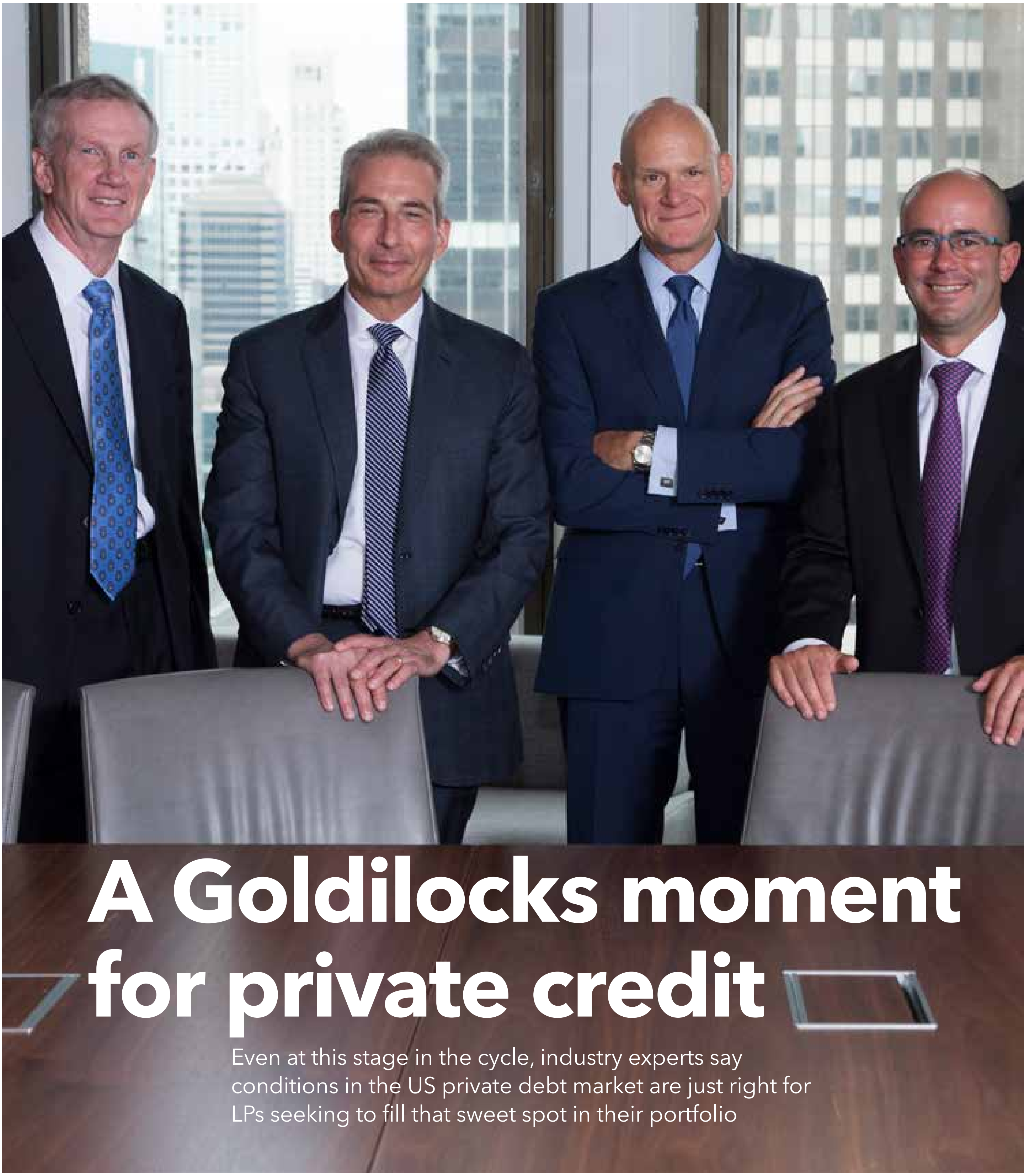
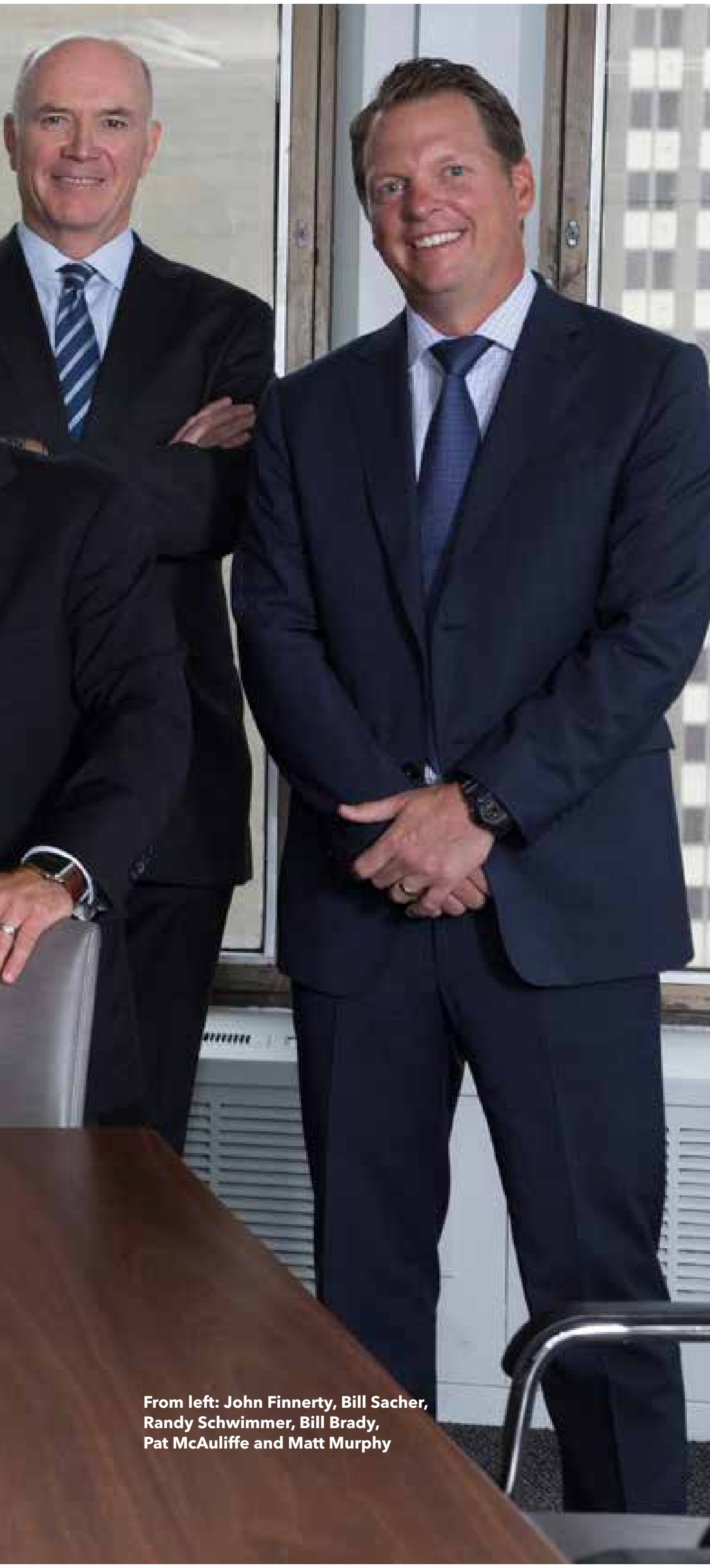
## MARKET INSIGHTS



# A Goldilocks moment for private credit

Even at this stage in the cycle, industry experts say conditions in the US private debt market are just right for LPs seeking to fill that sweet spot in their portfolio


From left: John Finnerty, Bill Sacher, Randy Schwimmer, Bill Brady, Pat McAuliffe and Matt Murphy

A decade after the global financial crisis, a group of US private debt lenders and advisors remains optimistic. While it is apparent to all we are near the end of the current cycle, there is also the sense that the market has come a long way in 10 years. After a record-breaking year in 2017 – with $205.98 billion raised – it could be argued that gathering capital from new investors is getting harder. This is not the case, however. The formation of larger private debt platforms is helping new investors find their way to the asset class. That's good news for credit managers vying for new LP allocations. To get the full prognosis on the US private debt market, *PDI* sat down with NXT Capital's John Finnerty, NewStar's Pat McAuliffe, Adams Street Partners' Bill Sacher, Churchill AM's Randy Schwimmer, as well as Bill Brady and Matt Murphy of Paul Hastings.

**Q More than halfway through 2018, what does the loan market look like?**

**Randy Schwimmer:** It feels like the proverbial Goldilocks market, despite issuer-friendly terms that credit managers are concerned about, covenant-lite and so forth. For investors, middle-market senior loan yields have improved thanks in part to higher LIBOR rates. Leverage remains on the high side, relative to historic levels.

Still, as an equity-to-capital matter, structures are significantly more investor-friendly than they were pre-crisis, and middle-market dealflow has been quite strong for us all year. So, the loan market continues to be not too hot, not too cold, but just about right.

**Pat McAuliffe:** The club middle market hasn't dramatically changed, but there have been incremental changes to leverage, pricing and covenant structure. So, I guess one way of answering your question is things haven't gotten better from a lender's standpoint. They've gotten continually weaker.

**Matt Murphy:** Because of the low default rate that we've seen, the trust that people have in borrowers may be misguided. You see a lot of unique structures being put into place, or agreed to, that may not have been tested in a down market. And I think until they're tested, parties will continue to push the envelope.

**Q The market for sponsored deals continues to remain competitive. How has this affected the auction process?**

**Bill Brady:** From our perspective the really competitive auctions that we've been a part of in the middle market are companies with EBITDA as low as $20 million. In these competitive deals the key is to be commercial but with a laser focus on the critical issues that could seriously impair recovery.

**John Finnerty:** In the sponsor world, relationships that private

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credit managers have with private equity firms do serve as a barrier to entry. While there's a lot of new pockets of money raised, I think it's going to be a struggle to get in.

**Q What is the unitranche loans market like?**

**JF:** Right now, senior-stretch and unitranche are the most prolific products out there. Historically, the structure has been reserved for the more stable cash-flowing businesses. Currently, we are starting to see it offered more broadly and even on cyclical businesses.

**Bill Sacher:** Without disagreeing with that, in the last six months we have seen a surprising number of traditional senior debt-junior debt structures – mostly senior first lien and second lien – and I think it's been a pricing issue for the sponsors, where a traditional bifurcated structure has turned out to be cheaper.

**MM:** We spend a lot of time trying to figure out how the agreement amongst lenders (AAL) in a unitranche will play out in a down cycle – in a Chapter 11 case. Will the agreement be honoured by the bankruptcy court? Which lenders will be entitled to post-petition interest? Which lenders are entitled to provide debtor-in-possession financing, agree to a sale or credit bid at such a sale?

These terms have been more heavily tested in the true first lien-second lien scenario embodied in the inter-creditor agreement and less so in the unitranche AAL environment, which creates the need for a thoughtful analysis of these issues when structuring an AAL.

**PM:** The synthetic unitranche with the AAL, prevalent in 2016, has now moved to the dollar-one unitranche. A lot of the capital raised has been devoted to the unitranche product. It's an attractive financing option for many sponsors.

**Q Are there any factors that might mitigate the severity of any imminent downturn?**

**BS:** One of the potential contributors to a softer landing – and I think it still may be the bright spot in capital structures – is the amount of equity going in today's deals. They're running between 40 and 50 percent. In our portfolio, right now, there is 55 percent equity underneath the debt stack. If you compare the last time debt levels peaked in 2007, equity as a percentage back then was a fraction of what it is today.

Some of that incremental equity is making up for the record-breaking valuations, and if valuations drop, the additional equity will act as a cushion. Sponsors are paying double-digit multiples for the underlying businesses, and even with leverage at 6x, that gap's going to get filled with something, and that something is equity.

**JF:** It'll be interesting to see behaviour in the next cycle. Sponsors do have significant money invested and have paid very full multiples. Given where covenants are set, 8-10x, when these companies default the equity is going to be significantly underwater, which begs the question: are sponsors going to put more money in, or are they going to require the debt to convert [into equity]?

I believe some sponsors are going to struggle with their path to a recovery and decline investing more money, or they will invest new dollars subject to a material restructure of the debt.

**Q What does the restructuring process look like?**

**BS:** Unlike a bank, which would have a separate restructuring team, I think, for most of us, the deal team that did the deal would remain involved.

**RS:** That's the difference between the middle market and the broadly syndicated loan market. As a buy-and-hold lender, our portfolio management and underwriting teams take into account the possibility of a credit going sideways. Unlike the liquid market, we don't trade out of loans. The same team manages the credit from beginning to end. Our senior management team

**Bill Brady,** Paul Hastings, *partner and head of alternative lender and private credit practice, member of special situations group*

- Advises private lenders on an array of healthy and distressed debt structures in the form of unitranche, first lien, second lien, mezzanine and other loans in connection with acquisition financings, recapitalisations, refinancings and other transactions
- Practice spans multiple regions, including US, Europe and Latin America
- Provides counsel on closing initial transaction and restructurings

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**John Finnerty,** NXT Capital, *senior managing director and group head of corporate finance*

- Provides senior revolvers, terms loans, first out-last out structures, and unitranche loans to primarily private equity-backed mid-market companies
- Transaction types financed include leveraged buyouts, refinancings and add-on acquisitions
- Borrowers generally have $5 million-$75 million of EBITDA

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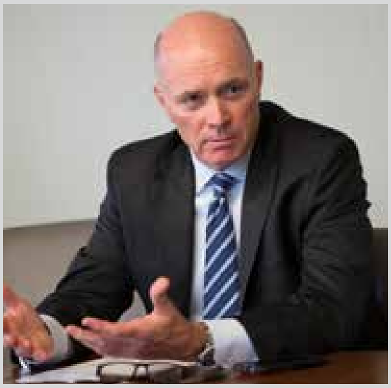
has workout experience. They know the key is working closely with the sponsor to maximise value for everyone.

**BS:** Over the last 16 years, and through the worst recession we've seen in generations, I have invested in close to 200 transactions and have had only one non-consensual workout. Every other one was consensual.

**BB:** Risk factors put a very large premium on lenders being extremely proactive once the default occurs. The number one mistake that I see made is the lender group taking a more reactive approach to the sponsor as opposed to a proactive approach. We've haven't had many [restructurings] that are non-consensual, but we've had at least a dozen where it was only consensual because we took those steps to prepare 100 percent for enforcement.

**JF:** Restructures are always a negotiation. As a lender you need to understand the bid, ask and your full range of options. Understanding all your options and demonstrating a willingness to pursue each option is your best path to a consensual agreement.

**Q How do you execute a restructuring if one of the parties is resistant?**



**Pat McAuliffe,** NewStar Financial, *managing director and head of direct origination*

- Finances senior revolvers, term loans, first out-last out structures, unitranche loans and equity co-investments
- Transaction types financed include leveraged buyouts, refinancings and add-on acquisitions
- Typical borrower is a private equity-backed single-B credit rating profile with operating cashflow of $15 million-$50 million of EBITDA

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**MM:** It depends on the party in interest. We try not to table-pound as much as simply point out how the documents are drafted and how they will be interpreted in a restructuring. We'll have a discussion with all parties in interest and say: "Let's talk, let's focus our energies on the proactive, consensual resolutions. But, if that does not work or we run into a difficult counterparty we will be prepared to execute on a strategy that's going to maximise the returns for our clients."

**Q Early this year there was a lot of volatility in the stock market. Have these gyrations showed up in the loan market?**

**RS:** Volatility shows up a little bit in deal pricing at issuance. If broadly syndicated loan spreads gap out, the middle market tends to maintain the same illiquidity premium. You can't launch a middle-market loan on top of where liquid single-B-rated loans are getting done. One benefit of private credit is it's not a correlated asset class. You generally don't care where the Dow is trading. Supply/demand is more a driver of loan prices and spreads.

**BS:** We live in a more stable world.

**JF:** We see the impact more on the fundraising side. You find more and more LPs shying away from the equity markets and moving to the debt markets.

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**Matt Murphy,** Paul Hastings,
*partner in corporate practice and member of the restructuring practice and special situations group*

- Advises clients on out-of-court and Chapter 11 bankruptcy restructurings, clients include borrowers, alternative lenders and institutional lenders
- Firm restructuring expertise spans all industries with a recent focus on retail, oil and gas, media and technology and healthcare
- Corporate practice advises on domestic and cross-border transactions in Asia, Europe, Latin America and the US

**"YOU SEE A LOT OF UNIQUE STRUCTURES BEING PUT INTO PLACE, OR AGREED TO, THAT MAY NOT HAVE BEEN TESTED IN A DOWN MARKET. AND I THINK UNTIL THEY'RE TESTED, PARTIES WILL CONTINUE TO PUSH THE ENVELOPE"**

**Q Is the mid-market opportunity big enough to absorb the dry powder?**

**RS:** Investors ask us all the time: "Are we too late? Are there still opportunities in private credit?" The answers are no, and yes. You read headlines about this firm raising $2 billion, or that manager raising $5 billion. Much of that is going to higher-yield strategies, not first-lien senior debt. Compare those numbers to the opportunity set of about $500 billion of middle-market new issue and $500 billion for the refinancing cliff over the next five years.

There are 7,000 middle-market companies owned by private equity firms in this country out of a total universe of, depending how you measure, 200,000 middle-market companies. Do the math. We've got a long way to go. I'm going to be working for a while longer.

**Q Fundraising has dipped this year. Is that something credit managers should be concerned about?**

**JF:** Yes, it's been down, but last year was a record year. I think the amount this year is more in line with 2014 or 2016 numbers. Maybe it's back to a normalised level. It seems like a lot of money has moved out of the hedge fund strategies and moved into private credit strategies.

**Q In recent years we have seen private equity firms launch their own private debt groups. Will this trend continue?**

**RS:** The private equity industry has not been growing, in general, as fast as private credit. Adding private credit sleeves gives sponsors another option for their LPs. It also diversifies their overall business. But since the users of credit are other PE firms, there's potential for conflict.

As far as other asset managers go, the performance of private credit through the downturn, and the exiting of regulated banks from the space, have created an attractive investment opportunity. That's not going to change anytime soon.

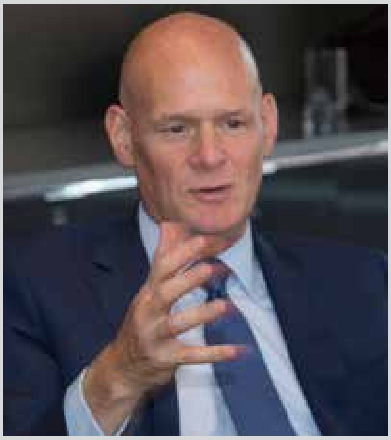
**PM:** If [private equity firms] do a lot of work on a deal and lose it, and that deal is in the market, they say: "Hey let's take the piece of the debt". They've done a lot of work on it from a credit standpoint and an investment standpoint. I think they're trying to leverage the work they've done and get something for it. And it's a natural extension to do a debt fund.

**BS:** I'm noticing that the private credit

**Bill Sacher,** Adams Street Partners,
*partner and head of private credit*

- Leads investment, portfolio construction and fundraising for private credit group
- Firm finances first-lien and second-lien loans, mezzanine debt and unitranche loans
- Targets private equity-backed companies

**"SPONSORS ARE PAYING DOUBLE-DIGIT MULTIPLES FOR THE UNDERLYING BUSINESSES, AND EVEN WITH LEVERAGE AT 6x, THAT GAP'S GOING TO GET FILLED WITH SOMETHING, AND THAT SOMETHING IS EQUITY"**



**Randy Schwimmer,** Churchill Asset Management,
*senior managing director*

- Supervises origination and capital markets
- Firm finances senior debt and unitranche facilities for private equity-backed companies
- Founder and publisher of industry newsletter *The Lead Left*

**"STRUCTURES ARE SIGNIFICANTLY MORE INVESTOR-FRIENDLY THAN THEY WERE PRE-CRISIS, AND MIDDLE-MARKET DEALFLOW HAS BEEN QUITE STRONG FOR US ALL YEAR. SO, THE LOAN MARKET CONTINUES TO BE NOT TOO HOT, NOT TOO COLD, BUT JUST ABOUT RIGHT"**

new entrants are beginning to specialise a little bit and leverage the unique capability that the private equity sponsor may have – slightly stressed deals or the healthcare industry, for example. They are less of the universal debt providers like most of us.

**BB:** In addition to the new entrants, what I'm seeing in the market related to that is existing US asset managers entering Europe and existing European asset managers entering the US market on the direct lending side. Many of our clients fit that description.

**Q Many LPs have begun investing in private credit in recent years. Have the investors likely to move into the asset class done so, or are there still new LPs to tap?**

**RS:** Educating investors on the virtues of the asset class has been going on for almost two decades. I'd like to think our firm has had a major role in that. There are LPs who haven't fully gotten the message yet. And there always seem to be new investors interested in the space. But it's a long learning process. It can take years. You have to be passionate, persistent and very patient.

**PM:** Their knowledge base has developed very rapidly. Not too long ago, you'd go into LP meetings – this is when LIBOR was 1 percent – and they'd say: "You're telling me a 6 percent to 6.5 percent return and the other guys are telling me from 8 percent to 8.5 percent return, I don't understand the difference."

We'd say: "OK, let's walk back on that and go over what first lien senior secured actually means." We don't find that anymore. When we go in there, they ask: "OK, you have a workout – tell us the steps you take to protect your interests." They ask us good, detailed and well-researched questions.

**BS:** I think probably the biggest dollars of demand [and one of the reasons why LPs find private credit attractive in the first place] is its use as a yield enhancement to the credit portfolio. In addition, given how late we are in the cycle and how high valuations have become, some private equity-oriented investors are turning to private credit as a safe way to play the cycle.

**Q What types of questions are those LPs asking?**

**PM:** We get a lot of cycle questions: "What did it look like last time? What deals went sideways? What did you do with them? What industries were they in? How long did it take you to get your money back?"

**Q Are LPs backing more niche strategies, such as speciality finance?**

**JF:** LPs – now that they understand the asset class and they've invested in it – realise it is a good place to generate returns. So, yes, I believe they are looking for more and more ways to get exposure to private credit without overlapping on the same deals. So, going into some of these niches really helps expand their exposure.

**PM:** I guess, but I don't know if it's the right time. We are certainly well into this cycle and it's our opinion that the time to go into the niche strategies was before so much capital had come into the market. Today we would encourage a flight to quality and staying down the middle of the fairway.

**Q Fees are always something that are on LPs' minds. Have your firms felt more pressure than usual to lower those rates?**

**JF:** There is always pressure on fees. Investors prefer lower. What you are seeing in the SMAs and funds, larger investors who are willing to write a large ticket have more negotiating leverage.

**PM:** I think it's normal as the industry matures that there is going to be fee discussions. The same occurs with private equity. LPs want to pay less. But they also are vetting managers for credit skills, reputation, track record, etc, and recognise you get what you pay for. ■