

Private Credit Update: Maintaining Stable Valuations in Uncertain Markets



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One of the virtues of private credit as an asset class is its history of generally holding up well during periods of uncertainty and dislocation in the financial markets. That reputation was borne out again, even in the midst of this unusual pandemic-driven cycle. In this update, we offer our perspective on private credit valuations in the US for the first and second quarters of 2020, as well as the outlook for both valuations and liquidity.

For many segments of the financial world, this may very well turn out to be the shortest market cycle in history. The fiscal and monetary action in response to the Coronavirus was swift, massive, and remarkably effective – producing a dramatic recovery in the public equity and liquid credit markets. At this writing, there is no agreement on an additional stimulus package in the US, so further market reactions remain to be seen.

As the following chart shows, the S&P 500 fell to a low in late March – down nearly 21%. It has since recovered, making up for the lost ground and then some. An index of leveraged loans was down around 15.5% over the same timeframe. That market, too, has made a remarkable recovery and is essentially flat year-to-date. High-yield bonds likewise declined about 14.5% by late March but are now basically flat again.

Historic Recovery in the Public Equity and Liquid Credit Markets¹

	YTD Mar 27, 2020	YTD Sep 24, 2020	6-Month Change
S&P 500 ²	-20.96%	+1.90%	+22.86%
Leveraged Loans Index ³	-15.46%	-0.50%	+14.96%
High Yield Index ⁴	-14.35%	-1.05%	+13.30%

It is important to emphasize that while the public markets are conveying optimism, fundamentals in the economy continue to be uneven and the outlook remains relatively uncertain. Consumer demand was aided to a significant extent by federal subsidies such as enhanced unemployment benefits. And while certain industry sectors, such as healthcare and technology, have held up well or are actually prospering, many sectors and the companies within them remained quite challenged.

Stability in the Private Credit Market

Characteristically, the private credit market was relatively more stable despite the volatility of the last six months. The explanation lies in the two primary drivers of valuations: *technicals* and *fundamentals*. Technicals include factors such as capital flows, investor sentiment, and the supply and demand dynamic for credit instruments in the market. Fundamentals include the general strength of the economy, inflation, and, most importantly, the operating performance of the underlying businesses.

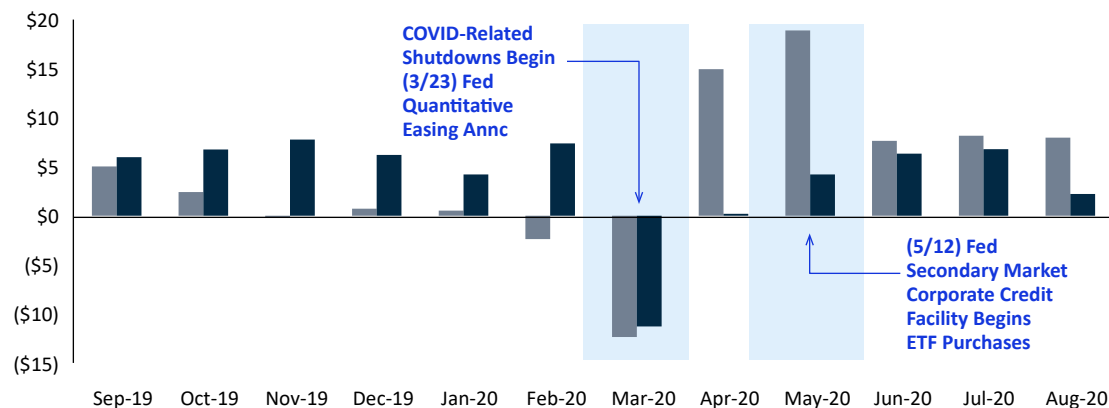
Private credit capital resides mostly in long-term institutional locked-up funds, or business development companies (BDCs), and these permanent vehicles tend to contribute to stability. This makes private credit much less susceptible to technical swings that can occur in the liquid markets, and much more dependent on the fundamental performance of the underlying businesses. To illustrate this point, consider the liquid markets and the impact of capital flows and technical swings, shown in the following chart.



Money Flows⁵ – High-Yield Bonds & Leveraged Loans⁶

■ High-Yield Bonds ■ Leveraged Loans

Flows (US \$ Billions)

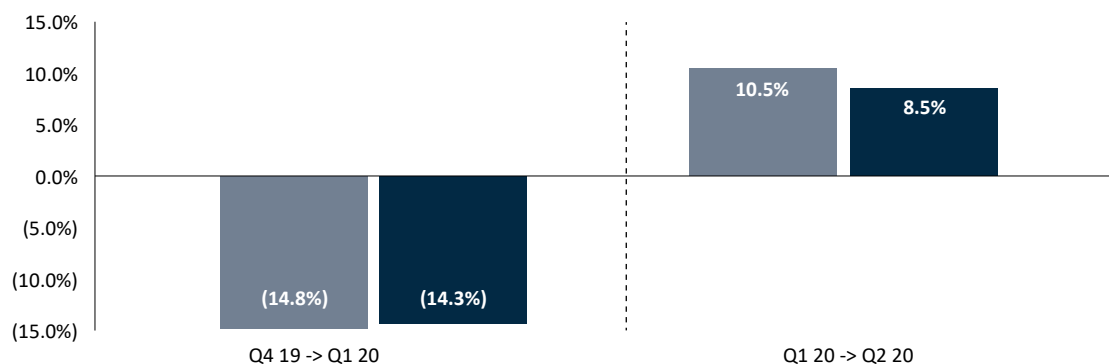


Because valuations for high-yield bonds and leveraged loans are liquid and actively traded, they can be disproportionately driven by technical forces

Valuations⁵ – High-Yield Bonds⁷ & Leveraged Loans⁸

■ High-Yield Bonds ■ Leveraged Loans

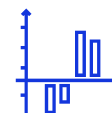
Quarter over Quarter Price Percent Change⁹



Back in March, coincident with the Covid-related shutdowns, we saw massive capital outflows from both the leveraged loan and high-yield sectors. The Fed reacted quickly, announcing a return to quantitative easing and a program to buy high-yield bonds, particularly of fallen angels, in the secondary market. The immediate reaction of the high-yield market was a massive money inflow in April and May. The leveraged loan market also responded; despite there being few secondary market purchases, the money flows reflected confidence in the market.

From a valuation standpoint, high-yield bonds declined about 15% from Q4 2019 to Q1 2020, while leveraged loans were down around 14.5%. That was followed by a rapid recovery in Q2 – up 10.5% for high-yield bonds and up 8.5% for leveraged loans, driven partially by fundamentals, but primarily by the money flows we see in the previous chart.

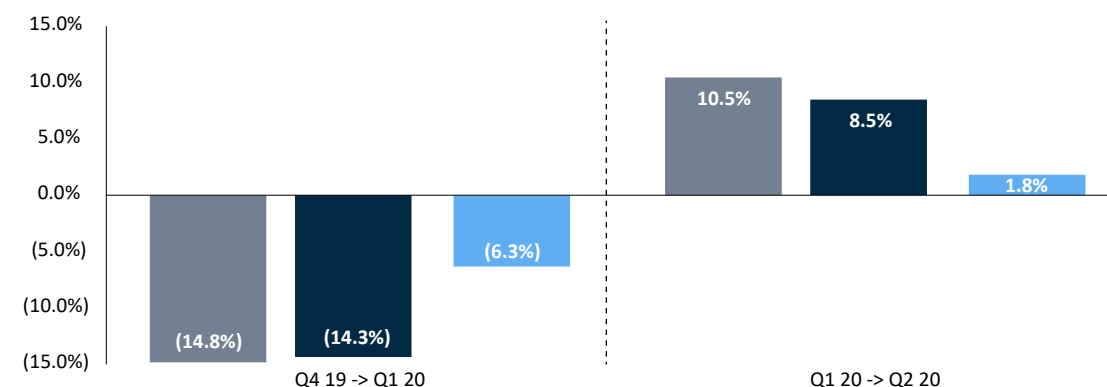
In contrast to the liquid credit markets, portfolio valuations in private credit were driven more by fundamentals than technical swings.



Valuations¹⁰ – High-Yield Bonds¹¹ & Leveraged Loans¹² & BDCs¹³

■ High-Yield Bonds ■ Leveraged Loans ■ BDCs (Private Credit Proxy)¹⁴

Quarter over Quarter Price Percent Change¹⁵



Private credit valuations, by contrast, tend to be driven more by fundamentals and are less affected by the violent technical swings that occur occasionally in the liquid markets

If we use business development companies as a proxy for private credit, the magnitude of that mark in Q1 for BDCs was much less severe, down 6.3%, less than half of what was experienced in the liquid markets. On the flip side, at the end of Q2, we saw a markup of just 1.8% for the BDC proxy, not a full recovery. While we are not intimately familiar with the condition of the underlying portfolios, the more modest markup is likely reflective of fundamental issues in some of the portfolios in the BDC world.

Because private credit valuations are much more dependent on fundamentals, the actual results will vary materially from one manager to the next. Those managers that were well-positioned for the downturn should fare better, while the valuation changes could be much more severe for managers that were poorly prepared.

Outlook for Valuations: Fundamentals Matter

In terms of what the future holds for private credit valuations, we believe fundamentals will eventually outweigh technicals. It may take some time, although the timeframe for credit strategies is relatively truncated, since credit instruments must deal with contractual obligations, interest payments, covenant levels, etc., that have to be met every quarter.



In terms of the fundamentals that are driving the private credit market, although there has been material improvement in the underlying economy, the overall economic picture continues to be mixed and there is a significant level of uncertainty clouding the outlook.

On the plus side, consumer demand is strong, pumped up by CARES Act subsidies and enhanced unemployment benefits, which pushed discretionary income to 10-year highs. While that impact is beginning to run off, at the moment consumer demand remains quite strong. The unemployment rate is also down significantly. The number of unemployed Americans peaked at 20 million¹⁶, but has fallen to around 12.6 million today and is continuing to decrease. Many businesses adapted to the Covid economy in a truly impressive manner, and we're seeing operating results at the portfolio company level that compare very favorably to the period immediately following the shutdown. The Fed's action has been extremely effective in keeping markets open and, most importantly, providing companies with the capital they need to buoy this cycle up.

On the cautionary side, many sectors such as airlines, live entertainment, sporting events, travel and hospitality, restaurants, and much of retail are still depressed and are expected to remain so through at least early 2021. Default rates in the leveraged loan market are at 10-year highs.¹⁷ While S&P has lowered their default projections somewhat, their recent projection is still materially greater than the peak 10% default rate that was seen at the height of the great financial crisis.

There are also significant uncertainties around the upcoming election and whether another stimulus package can be agreed to and executed in the market. And, while unemployment clearly has improved, the current rate of 8.4% is still very high by historical standards. Last but not least, the return of the cold weather flu season and the possibility of increased Covid-19 cases raise the risk of another wave of shutdowns.

Outlook for Liquidity: Cause for Optimism

There are a number of reasons to be optimistic about liquidity in the private credit market. Buyout activity has recently picked up, and we are seeing a strong pipeline in the offing for the fourth quarter. On the sell-side, supply is also recovering – due to the prospect of higher taxes, resilient equity valuations, and the performance of some companies that have benefitted from the shutdown – all of which have caused sellers to come back into the market. Lastly, a sustained period of near-zero interest rates should eventually induce borrowers to refinance. All of these factors should contribute to portfolio turnover, a greater number of realizations, and ultimately liquidity for investors.

In Conclusion

Although the economic outlook really is quite clouded at the moment, private credit should continue to exhibit more stability than investors would typically find in the liquid markets. For investors that were attracted to private credit pre-Covid, now that interest rates are back near zero and likely to remain there for a while, the yields on this asset class should be even more attractive in this environment, resulting in more inflows. But as we have noted, the fundamentals will vary significantly from portfolio to portfolio and from manager to manager. Valuations will continue to be very fundamental- and manager-driven, underscoring the importance of a selective approach to private credit assets. ■

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1. Sources: LCD, an offering of S&P Global Market Intelligence, Bloomberg, FRED Federal Reserve Bank of St. Louis
2. S&P 500 Index Total Return.
3. S&P LSTA Leveraged Loan Index Total Return.
4. ICE BofA US High Yield (H0A0) Index Total Return.
5. Data through August 31, 2020. Sources: Refinitiv Lipper, LCD, an offering of S&P Global Market Intelligence
6. Leveraged Loans Money Flows include both retail fund flows (Mutual Funds and ETFs) and institutional fund flows (CLO Issuance Volume).
7. ICE BofA US High Yield (H0A0) Average Bid Price.
8. S&P/LSTA Leveraged Loan Average Bid Price.
9. Quarter over quarter figures reflect changes from 12/31/19 to 3/31/20 and from 3/31/20 to 6/30/20.
10. Data through June 30, 2020. Sources: LCD, an offering of S&P Global Market Intelligence, BDC public filings
11. ICE BofA US High Yield (H0A0) Average Bid Price.
12. S&P/LSTA Leveraged Loan Average Bid Price.
13. Reflects mean values for BDCs with Total Assets above \$500mm.
14. Private Credit Proxy refers to aggregated financial metrics for publicly-traded BDCs with Total Assets above \$500mm.
15. Quarter over quarter figures reflect changes from 12/31/19 to 3/31/20 and from 3/31/20 to 6/30/20.
16. US Bureau of Labor Statistics.
17. LCD, an offering of S&P Global Market Intelligence.

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