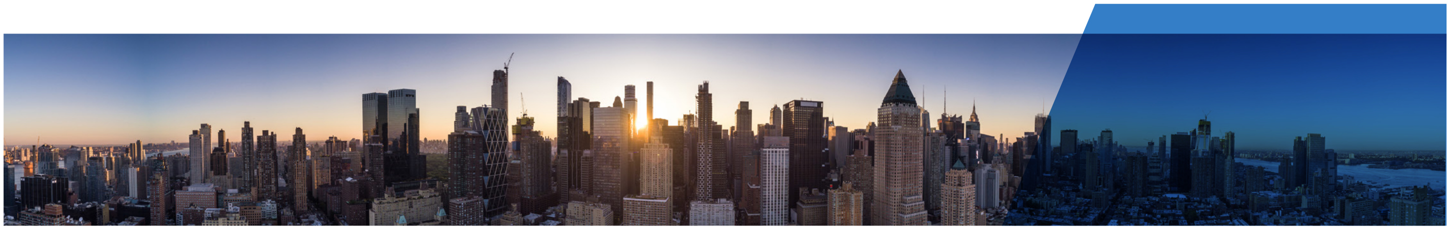
Private Credit Update: Resilience and Opportunity When Facing Inflation



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Private credit has the long-held reputation of being a relatively steady, resilient investment choice when faced with market uncertainty. The performance of the asset class through the first half of 2021 as well as the current outlook has continued to live up to this reputation. As the US and global markets continue to rebound in the wake of the pandemic, Adams Street believes that, as part of a broader portfolio, private credit remains a smart choice when confronted with the possible emergence of both short-and long-term inflation, the prospect of rising interest rates and their effect on the markets and the economy.

After dramatic declines early in the pandemic, and in contrast to the prevailing outlook in early-to-mid 2020, the broader securities markets have staged a remarkable recovery throughout the latter half of 2020 and first half of 2021.[1] Public debt today is at or above pre-pandemic levels, while public equity is significantly above where it was prior to the start of the pandemic.[2] As for the economy, the recovery has been no less impressive[3] and is also forecasted to finish 2021 strong,[4] bringing with it unemployment levels that have dropped precipitously since the peak of the pandemic and have continued to improve.[5]

Private credit has historically been seen as a stable choice in times of volatility and uncertainty, but the past few months have shown that the asset class can continue to exhibit strong performance even when market conditions are generally favorable. For instance, Adams Street has seen yields attainable in the private credit market that are 270-300 basis points above those available for credit alternatives in the high yield and leveraged loan markets.[6]

Private credit's strong historical track record sets a strong foundation for its future, which is important when considering the possible changes in both private and public markets in the period ahead.

Post-COVID Performance

Despite market fluctuations, 2021 has continued to show that the fundamental supply/demand imbalance, which has favored the private credit market over the last few years, remains intact.

Contrary to popular perception, fundraising for private credit has been relatively flat over the past five years, generally hovering between $40-50 billion annually.[7] In the face of this steady supply however, Adams Street has continued to see demand build for private credit financing over the past 10 years.[8] As of July 2021, the current pool of private equity dry powder was over $580 billion,[9] leading to an implied debt demand of $871 billion.[10] Across the sector, Adams Street has found that there remains over a 9:1 ratio of demand versus supply in the private credit space, with over $1 trillion in debt financing demand in the coming years.[11]

Today's private credit market has seen increased competition for deals, which has resulted in higher levels of leverage and tighter pricing as compared to the favorable conditions immediately following the shutdown in March 2020; however, the pendulum has still not swung all the way back to pre-March 2020 levels. Company valuations have been rising faster than the percentage of debt contribution, causing private equity cash contributions to reach 50-60% of transaction value (compared to 2019 levels of 40-50%).[12] These historically high levels of equity supporting the debt in today's deals remain a significant bright spot in the market.

The record levels of dry powder, low interest rates and high valuations have spurred a significant uptick in deal flow,[13] which has helped dampen the effect of increased competition and kept spreads relatively strong. Due in part to the prospect of increased capital gains taxes, we believe many sellers have been eager to put their business up for sale, which has further helped fuel the heavy level of deal supply. Adams Street believes these factors, which are driving deal flow, are firmly in place and likely to continue to foster this upward trend in deal activity.

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Facing Inflation

While the markets have performed well in the wake of the pandemic, Adams Street believes that the next great economic threat could be a longer-term inflationary cycle.

Pent-up consumer demand and a glut of stimulus money fueling discretionary spending has led to stress on supply chains, which has caused prices to rise across sectors. While it is unclear whether this inflation will be transitory or part of a long-term cycle, the risk of the latter would likely be consequential to both the securities markets and the broader economy. That is particularly true for the current record company valuations,[14] which are in part being supported by low interest rates. Should an inflationary cycle emerge, we would expect that interest rates would rise, which in turn could trigger a meaningful correction in company valuations across the board.

While the prospect for an inflationary cycle poses a significant risk for the market as a whole, private credit may have an advantage here as well. Private credit loans are predominantly floating rate, which makes them less susceptible to interest rate risk. When interest rates rise, those increases are picked up automatically in the private credit coupon. Undoubtedly, an inflationary cycle will pose many challenges but private credit, due to its floating rate nature, is well suited for a rising rate environment should one arise.

Adams Street believes that low rates, high company valuations, and ample dry powder will provide a strong runway for future transactions.

Private Credit Outlook

Looking ahead to late 2021 and into 2022, Adams Street remains optimistic that private credit is a smart investment for investors, despite some levels of uncertainty.

We believe there are several considerations for private credit lenders to watch for in the period ahead. The threat of inflation hangs heavy on the market and the subsequent political and economic policies that will be implemented to mitigate the inflation threats are hard to ascertain at this time. Additionally, the increase in the number of COVID virus variants is concerning, as spikes in infection rates and regulations to contain the virus need to be taken seriously. The rapidly evolving political climate also needs to be considered.

Despite this, the current economic backdrop appears to be strong and likely to provide a solid foundation for underlying credit performance. Default rates have been decreasing, and rating agencies continue to lower expectations for future defaults.[15] For the near-term, Adams Street anticipates that further fiscal stimulus and the Federal Reserve's continuation of their "easy money" policies will provide for a positive economic environment.

In our opinion the outlook for private credit remains favorable. The floating rate nature of the asset class positions it well for an inflationary environment should one arise, and Adams Street believes that low rates, high company valuations, and ample dry powder will provide a strong runway for future transactions.

While Adams Street is beginning to be slightly more defensive in its portfolio construction due to the increased competition in the market, we anticipate that private credit will remain a steady and solid investment for investors for the period ahead. ■

1. *See, e.g.*, S&P 500 Index Total Return, S&P LSTA Leveraged Loan Index Total Return, ICE BofA US High Yield (H0A0) Index Total Return.
2. See footnote #1.
3. Based on Quarterly GDP growth as reported by the Bureau of Economic Analysis.
4. Based on estimated full year 2021 GDP growth as reported by the Conference Board Economic Forecast for the US Economy, July 2021.
5. Based on overall unemployment rate and 4-week moving average of initial unemployment claims published in Federal Reserve Economic Data by the Federal Reserve Bank of St. Louis, dated July 2021.
6. Private credit yields calculated based on observed private credit senior loans with average spreads of L+600 and assuming LIBOR floor of 1.0% consistent with observed market trends; data from Lincoln International. High yield and leveraged loan market data from relevant S&P Global indices, including, respectively, High Yield YTW of single B bond index and US S&P / LSTA Leveraged Loan Index. Data as of July 2021.
7. Preqin data as of 07/09/21. Data based on Direct Lending and Mezzanine funds with a North America investment focus.
8. Based on a measurement of private equity dry powder in North America focused buyout funds as reported by Preqin, as of July 10, 2021 and assuming that private equity dry powder will be deployed in transactions at a given percentage along with credit.
9. See footnote #8.
10. Assumes July 2021 private equity dry powder is deployed at an average equity contribution of 40%. There can be no guarantee that dry powder will be deployed with this level of equity contribution.
11. Total private credit demand is calculated is estimated at approximately $1 trillion including the implied debt demand of $871 billion based on private equity dry powder as well as $225 billion in cumulative middle market loans scheduled to mature between 2021-2025 as reported in the Thompson Reuters 4Q 2020 Middle Market Lending Review and which may be refinanced, although there can be no guarantee that such loans will ultimately be refinanced. Supply is calculated as private credit dry powder in North America focused direct lending and mezzanine funds, which was equal to $119 billion as reported by Preqin as of July 10, 2021.
12. Percentage of transaction equity contribution represents Adams Street's analysis based on the firm's internal deal flow and market observations. There can be no guarantee that this represents a complete universe of private credit data.
13. As measured by private equity loan volume and including loans for leveraged buyout, acquisitions, refinancing, and dividends as reported in Leveraged Buyout Quarterly by Leveraged Commentary & Data.
14. *See, e.g.,* Refinitiv LPC "2Q21 Sponsored Middle Market Private Deal Analysis"
15. *See, e.g.,* FitchRatings "Fitch Ratings Lowers HY Default Rate Forecast to 2% for 2021, 2.5%-3.5% for 2022"

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