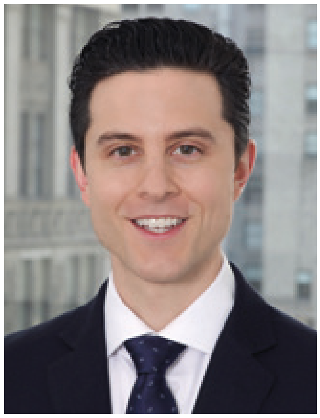
E X P E R T   Q & A

The opportunity set for private credit appears to be becoming more favourable, despite the challenges of inflation, tight labour markets and rising interest rates, say Adams Street Partners' Bill Sacher, Fred Chung and Justin Lawrence



Disruption creates openings for private capital

Q How would you describe the state of mid-market lending over the last 12 months? What were the challenges and opportunities?

Bill Sacher: The lending environment in the mid-market has become more competitive as the markets have recovered from the pandemic disruption in 2020. That said, in our view, the opportunity set for private lenders, and especially for Adams Street, has been quite favourable, so even with more competition the supply of deal activity has exploded over the last 12 months.

That explosion has struck a favourable balance between borrowers and lenders. While we have seen pricing come in a bit and leverage levels go

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up, we still believe the lending market today is materially better than what we were witnessing in 2019 with the late cycle conditions leading up to the pandemic.

The challenges that we are confronting today largely revolve around inflation, tight labour markets, shipping challenges and rising freight costs, all of which have impacted mid-market US companies in a relatively widespread way. We are not yet at a point where the market is expressing broad concern about credit quality and rising default rates, but margins are under pressure and, we are starting to see some softness in the underlying performance of certain businesses.

The volatility that we have seen recently in public equities, high-yield debt and even in leveraged loans hasn't significantly impacted the private markets yet but those markets do tend to lag, so we expect that it is only a matter of time. While lenders should be cautious about the challenges, at the same time, it has historically been in these disrupted markets that the value of private capital goes up and the opportunity set can become even more favourable.

Fred Chung: There are certainly some sectors that in the past have shown a level of natural resilience to inflationary conditions, for example, healthcare, critical business services and enterprise software, all of which tend to (i) be less correlated with macro factors and (ii) have the pricing power to pass on rising costs. Those are some of the primary factors that we focus on when underwriting new private credit deals as we seek investment opportunities that we believe are positioned to remain resilient in this market environment.

Q We have seen ESG rise up the agenda in private credit. What does that mean for mid-market managers?

Justin Lawrence: Adams Street has been a signatory to the UN Principles for Responsible Investment since 2010. We have a long history of integrating ESG considerations into our overall risk management framework and it is a standard part of our due diligence and our conversations between investment teams and private equity sponsors. We seek to review and analyse ESG risks in each of the businesses that we invest. Increasingly, investors are asking for more detail and paying closer attention to ESG issues.

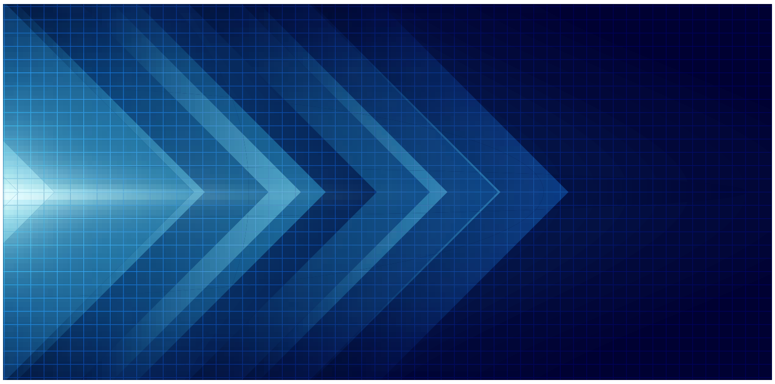
We have heightened our focus on ESG in the last few years and we currently include ESG considerations when assessing any new, or monitoring existing, investments. That includes several distinct steps to understand the ESG practices already in place, starting with assessing the private equity firm and/or the company. When performing ESG due diligence, we evaluate relevant third-party reports, such as ESG and environmental studies, and legal reports detailing regulatory and employment matters. We also engage with third parties directly, and have engaged a global ESG data provider that enables us to conduct reputational risk screens on all new opportunities before we invest and performs ongoing daily monitoring of ESG incidents in the portfolio on a post-close basis.

Our approach continues to evolve and we are currently working on increasing the standardisation of our process. For example, we are developing a proprietary ESG algorithm to support our investment team in evaluating the overall ESG risk level for every investment based on standard questions pertaining to a specific company's industry and geography. Identifying a specific risk level for each investment should allow us to better mitigate ESG risk and increase reporting transparency.

BS: At a more nuanced level, we operate the direct lending business integrated within our global fund of funds

"There are private deals getting done today that are larger than ever before"

FRED CHUNG



Q What are the prospects for the mid-market going forward? Where do you expect to see the most activity for lenders?

BS: Our expectation right now is for a continuation of the high levels of deal activity that we saw in 2021, coupled with those windows of opportunity that could present themselves to direct lenders if we see volatile periods in the market. At the moment, we anticipate some ongoing volatility over the coming year or two, which could create secondary purchase opportunities and the opportunity to provide rescue financing for companies that are more directly affected by some of the inflationary forces and disruption.

FC: As I mentioned earlier, the average deal size that is relevant for direct lenders is continuing to grow. There are now deals that would have been broadly syndicated loans five years ago but it's now possible for direct lenders like Adams Street to provide a more custom-tailored solution for financial sponsors and issuers.

JL: There is also an enormous amount of private equity dry powder sitting on the sidelines that we think is likely to further drive dealflow and result in a lot more activity in the mid-market.

platform where we are able to leverage the firm's 350-plus GP relationships, so much of the sponsor deal activity that we finance involves Adams Street GPs.

Adams Street is already applying ESG considerations to the selection of those GPs, which means that the sponsors we are working with are already more likely to be compliant with our ESG screens. Our Private Credit team then applies another layer of ESG scrutiny at the asset level, so we believe this represents a very comprehensive approach.

Q Fund sizes have continued to escalate. Why does size count in the wake of the pandemic?

FC: Fund sizes certainly continue to grow, driven by the merits that the market has seen in private credit as an asset class. We frequently hear that the higher relative yields and superior credit protections offered by private credit, when compared to traditional fixed income and broadly syndicated loans, are important considerations in the decision to invest in private credit.

As a result of the recent increased supply of private credit capital, we are seeing issuers and sponsors increasingly turning to private markets for their financing needs. There are private deals getting done today that are larger than ever before. Based on our experience in the current M&A environment, private equity sponsors are increasingly attracted to the certainty of financing and ease of execution that the direct lenders are capable of providing.

Size does count in this market because a lender needs to be of sufficient size and scale to underwrite a full deal, and there are still many lenders that don't have that capacity. Adams Street frequently has the necessary size and scale, and that provides a meaningful solution for private equity sponsors we work with. We typically approach the market as a lead lender and engage with sponsors directly to underwrite and structure deals on a bilateral basis.

We believe this provides our borrowers with an efficient capital solution while also potentially enhancing deal economics. We see the size of direct deals continuing to increase and we believe that there is a portion of the broadly syndicated market that will ultimately concede share to the direct lenders like us.

BS: The value that issuers have told us they see in coming to the private markets is certainty, very little in the way of syndication or market risk, the ability to custom design the underlying financing to meet a specific set of goals and objectives, and knowing the lender is likely to hold that investment for the lifetime of that asset in the private equity fund. If there are opportunities that sponsors want to capitalise on, they feel comfortable they have partners they can call on in a way that is generally more predictable and supportive.

Although private market solutions command a bit of a premium, for many sponsors the motivations for going to the private markets seem to be worth the additional costs associated with them.

Q Finally, what impact might an inflationary environment, with rising interest rates, have on private credit managers?

BS: Given the effects on underlying borrowers of rising inflation and rising interest rates, credit selection is going to be more important for credit managers during this period. Managers that get that right will likely have the benefit of better performance over the next few years.

As a general point, when compared with other types of debt, private credit is particularly well positioned for an inflationary environment that includes rising interest rates, given its floating rate nature. As soon as there are increases in short-term rates, private credit loans will typically get the immediate benefit from that. The expectation in a rising interest rate environment is that the yields or returns on private credit will go up; thus the exposure to interest rate risk that is common within fixed income credit is significantly reduced in private credit.

It is therefore our expectation that those dynamics will further enhance interest in the private credit asset class as well as the total amount allocated to and resultant capital flows into, the asset class. On balance, we remain bullish in our outlook for the coming year, even given the challenges in the macroeconomic environment.

"Deal activity has exploded over the last 12 months"

BILL SACHER

FC: As Bill mentioned, credit selection will be a critical factor in order to benefit from the attributes of private credit as an asset class. Adams Street's investment philosophy emphasises a loss-avoidance approach to credit underwriting and we focus heavily on building stable underlying loan portfolios that we believe can weather varying market conditions, which are likely to be very important given some of the conditions we are seeing in today's market. ■

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