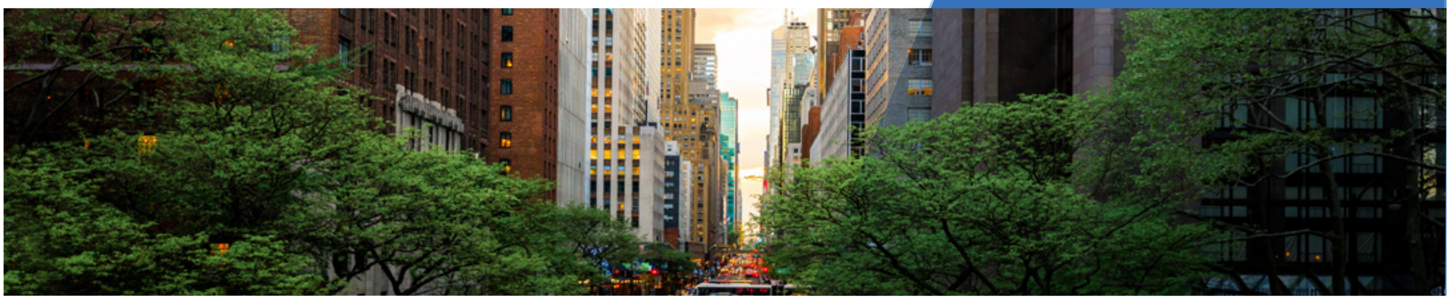
Signs Indicate Potential Attractive Vintage Era for Private Credit



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KEY TAKEAWAYS

- In our experience prudent credit investors are becoming defensively focused amid elevated and rising recession risk
- Rising yields, improving risk parameters such as leverage, and deal terms moving in the lender's favor are creating a trifecta of positive dynamics for well-informed credit managers
- Rigorous underwriting and conservative credit selection can be key differentiators for private credit managers
- Lower deployment due to lighter deal flow from core sources is being offset by high amounts of private equity dry powder and larger businesses turning to private markets as public debt options are closed off.

With heightened concern about the risk of a near-term contraction roiling public equity and debt markets in 2022, the attention of many investors swung firmly in the direction of capital preservation.

For private credit managers focused on backing businesses that they view as more likely to perform in an environment characterized by rising interest rates aimed at curtailing generationally high inflation, careful credit selection and tight underwriting can be key differentiators.

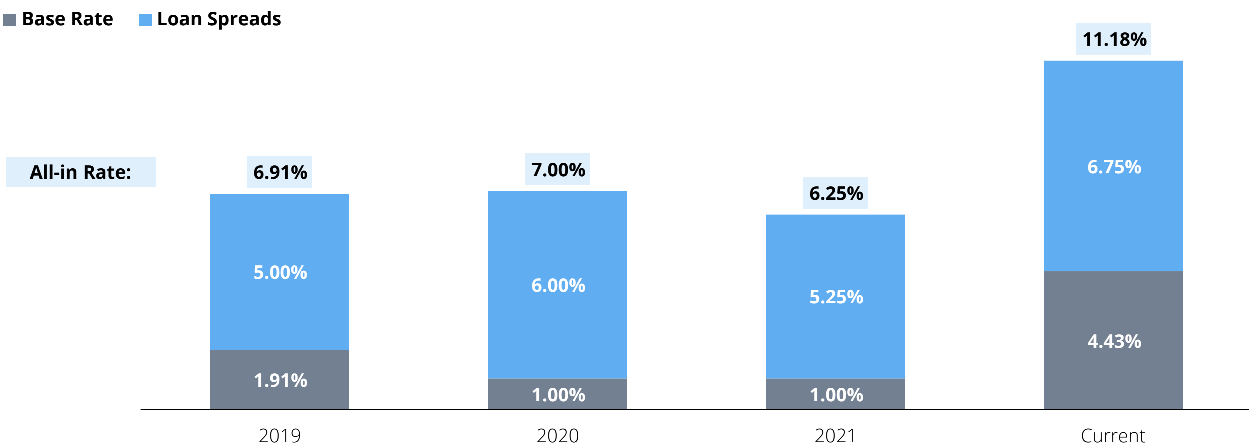
But alongside this mindset are several shifts in market dynamics that build optimism that we could be at the beginning of a fairly protracted and attractive vintage period for private credit.

Improving Metrics

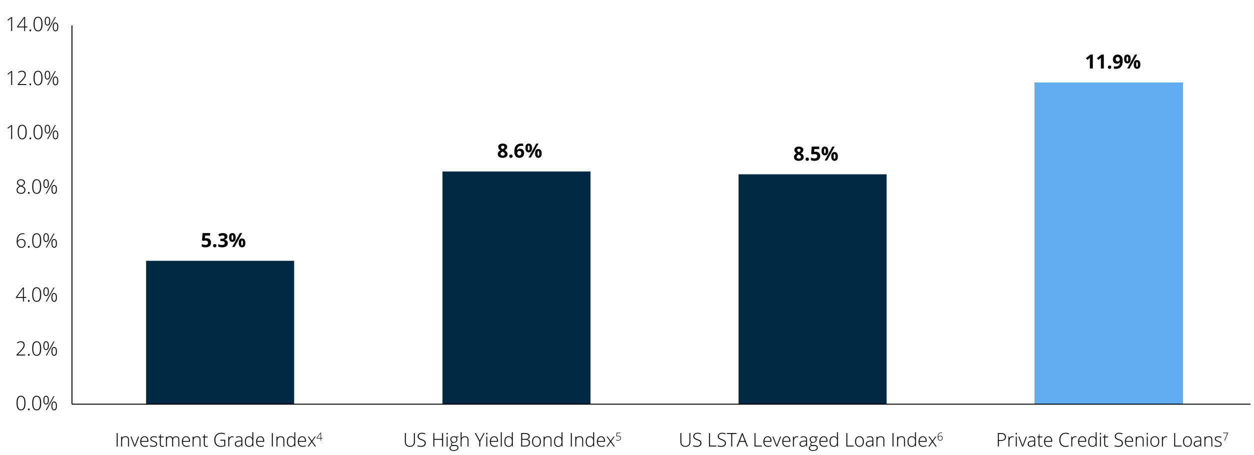
On a large number of key measures including absolute and relative yield, leverage, equity contributions, covenants, and lender's rights, we have seen the dial moving in favor of credit providers.

Based on deal flow we have seen in recent years, and as the two below graphs show,[1] yields have climbed significantly since 2019 to more than 11%, which we view to be a compelling return for the level of risk associated with senior, secured debt. Similarly, recent deal flow suggests the credit spread demanded by investors has widened to about 6.75% from around 5% in the same time frame and has the potential to grow further. Relatively, private credit provides a premium spread of between 200 and 300 basis points over a number of more liquid options. Meanwhile, the floating-rate nature of private credit provides a hedge against interest rate risk that fixed-coupon instruments lack.

Deal Terms: Private Credit Benefits From Higher Yields, Widening Spreads[2]



Yield Premium: Private Credit Yields Compare Favorably to Alternatives[3]



Lower Leverage

Most major risk parameters are also moving in the right direction for private credit investors.

Leverage has decreased to roughly 5.5 times earnings before interest, taxes, depreciation, and amortization (EBITDA), from a peak of six times EBITDA or more in 2021, based on Adams Street private credit market observations. We believe those figures are likely to decline further, because rising interest rates are acting as a governor on companies' ability to carry much more than five times debt to EBITDA.

Higher Equity Contributions

The equity element in deals is also increasing, with contributions rising by 10 percentage points to about 50% of deal value since 2019, according to Adams Street private credit market observations. This implies the enterprise value of a portfolio company with that level of equity investment would need to contract by half to create a risk of impairment in the underlying loan.

The dislocation in public markets has shifted the balance of power back in favor of lenders, with bolstered protections including strong collateral, beefier covenants, and capital structure seniority that provides additional security and rights in workouts and bankruptcies.

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Intensive Underwriting

Critical to the ability to write money-good defensive loans are comprehensive underwriting and careful credit selection.

Acting as lead lender provides primary access to the data needed to accurately analyze potential pressure points that may adversely impact a business. A forensic accountant can gain a keen appreciation of revenue, profit, and fixed and variable costs, and determine whether to exclude certain proforma add-backs to arrive at a high-confidence, underwritable EBITDA number. External consultants can appraise supply chains, market dynamics, and competitive positioning within a sector.

A six to eight-week underwriting process typically creates a deal binder running to thousands of pages. Such extensive due diligence creates a very favorable environment from which to select credit deals with the attributes that most closely match core investment parameters.

Resilient Credits

We believe defensive, mission-critical businesses with pricing power and the ability to pass on costs are more resilient than businesses that are historically more closely correlated to economic growth. Further, businesses in capital-intensive sectors that rely on discretionary spending by businesses or consumers, or ones that provide labor-intensive services where wage pressures and personnel churn can create problems in a tight labor market, are typically less resilient.

In general, we view private equity-backed deals as being safer, as sponsors tend to use their resources to support portfolio companies, including providing additional liquidity when necessary. We believe having that anticipated backstop, and particularly on the brink of a potential recession, is of great value. Further, in our experience working with deal sponsors with strong records and sector experience can give private credit providers such as Adams Street a competitive advantage.

Deal Flow Offsets

Market disruption is likely to result in a slowdown in deployment, since it's harder to sell a business when valuations or earnings are depressed. While a tighter filter creates a reasonable expectation that deployment pace will slow, we believe $586 billion in dry powder in North America focused buyout funds as of Nov. 22, 2022, according to Preqin,[8] will likely fuel deal flow. Another potential offset to a slower pipeline is that larger businesses are tapping private markets after banks pulled back materially from issuing broadly syndicated loans and acting as syndication agents during 2022.

There's a saying in the private credit business that some of the best loans are written in the worst of times. With the potential for investors to earn attractive returns while positioning themselves more defensively thanks to an unusual combination of higher yields, improving deal terms, lower leverage, tighter underwriting and stricter credit selection, there are encouraging signals that private credit could be an important part of allocation considerations given current market conditions, and that we may be at the start of an attractive vintage period. ■

1. The use of graphs, charts, formulas, or other devices are subject to inherent limitations and difficulties; investors should not make investment decisions, including whether to purchase or sell or the timing of such actions, based solely on the information presented in such devices.
2. Based on Adams Street Private Credit market observations. Base Rate represents 3-month Libor as of the last day of each calendar year for 2019-2021 and 3-month term SOFR as of November 30, 2022, for Current.
3. Based on latest available index information as of November 30, 2022
4. US Investment Grade from S&P 500 Investment Grade Corporate Bond Index as of November 30, 2022.
5. High Yield Bonds from S&P U.S. High Yield Corporate Bond Index as of November 30, 2022.
6. Leveraged Loans from S&P/LSTA U.S. Leveraged Loan 100 Index as of November 25, 2022.
7. Private Credit Senior Loans yield calculated based on observed market spreads of +/-650bps, 443bps base rate as of November 30, 2022, and upfront fees of 2.5% amortized over 2.5 years.
8. Source: Preqin, North America focused Buyout funds only, as of November 22, 2022.