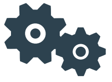


RESOURCES:
PRIVATE CREDIT

iCapital NETWORK

THE CASE FOR PRIVATE CREDIT

AN ATTRACTIVE ALTERNATIVE TO FIXED INCOME

The surge of interest in direct lending and the high level of dry powder that private credit fund managers have raised are giving rise to concerns that the opportunity is becoming saturated and there may even be a looming bubble. In our view, the growth in private credit over the past several years has generally been a healthy development and the supply-demand imbalance within direct lending, particularly in the middle market, continues to provide an attractive opportunity for investors. As always, fund manager selection is critical, and experienced firms with deep credit research teams and existing networks of borrowers are best positioned to take advantage of the current market environment.

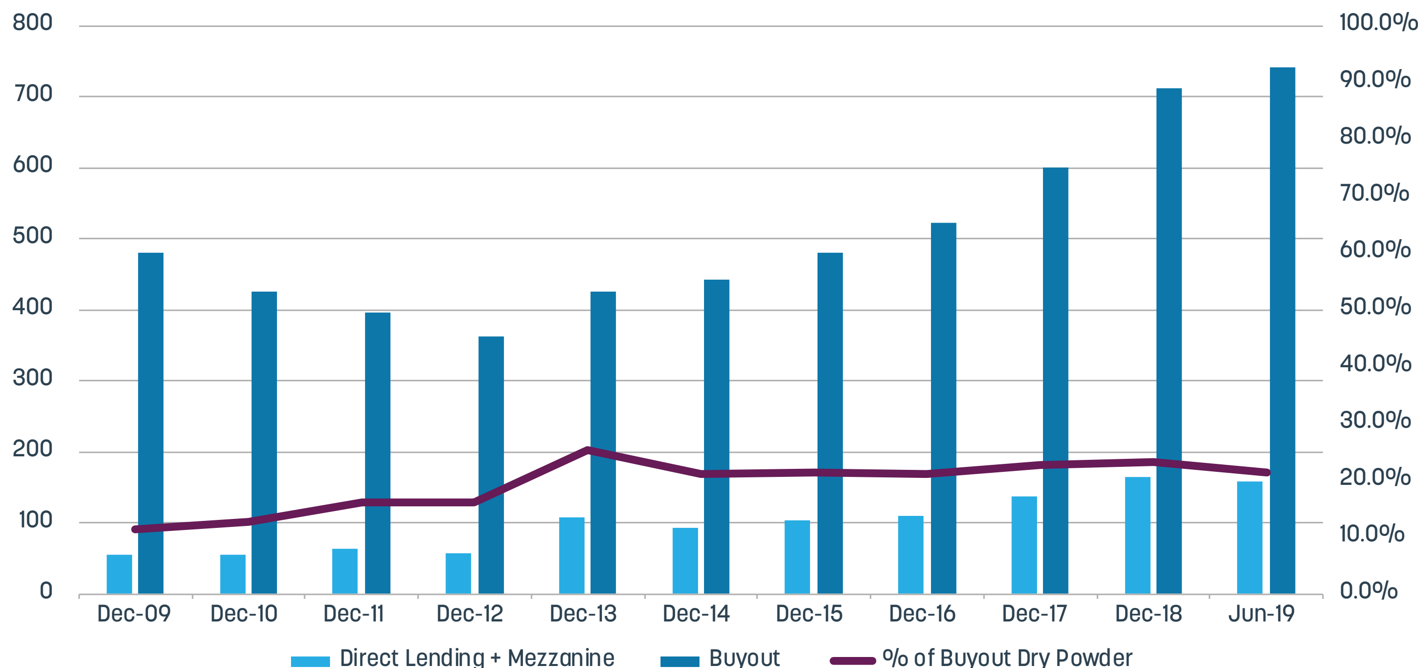
Two tailwinds have been building for direct lending since 2009: (i) persistently low yields across traditional fixed income markets, prompting a global search for yield and (ii) the industry-wide retrenchment of banks from middle market lending activities. The former catalyzed a global search for yield, while the latter created a massive financing gap, particularly in the middle market, allowing non-bank lenders to jump in.

Let's first address the supply-demand equation and look at the data to give some perspective to the dry powder concern and the significant increase in the number of funds. We'll then examine how private credit performs in a more volatile environment with rising interest rates and why we believe it remains an attractive asset class in today's market, especially if you believe a recession is on the horizon.

SIGNIFICANT SUPPLY-DEMAND IMBALANCE

As of June 30, 2019, there was an estimated $103 billion in "dry powder" (or uninvested capital) held globally by direct lending firms and approximately $55 billion in mezzanine dry powder, bringing the combined available private credit for leveraged buyouts to about $158 billion.[1] At the same time, the total dry powder held by buyout funds was $741 billion.[2] Since today's buyout managers are typically financing their deals with 45% equity and 55% debt, the implied total amount of debt financing they will require over the next five years (which is the investment period of a private equity firm) to fund their deals should be around $906 billion. Spread across five years, this would suggest a need of about $181 billion per year of debt financing, yet the entire amount of senior secured direct lending and mezzanine financing currently stands at $158 billion. The chart below shows direct lending and mezzanine dry powder as a percentage of the overall buyout dry powder; note that this ratio peaked in 2013.

Fund Dry Powder (USD, billions)

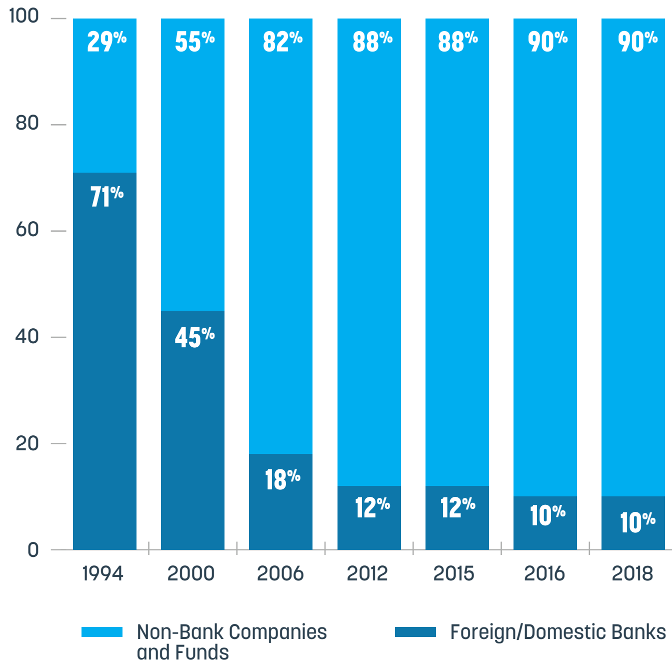


Source: Preqin. For illustrative purposes only.

Of note, this supply-demand analysis does not include all of the leveraged loan market maturities that will occur during this period; there is an estimated $840 billion in leveraged loans that will reach maturity by the end of 2024.[3] Some of these loans – perhaps a significant portion – will be replaced by new debt raised in conjunction with private equity firms acquiring the borrowers or simply recapping the loans of their existing portfolio companies, so there is some overlap with the estimated amount of private credit required to meet the needs of buyout firms during this period. However, many of the maturing loans will likely generate incremental financing volume, meaning the total debt needed per year should exceed our rough estimate of $150 billion.

It should also be noted that, in addition to private direct lending and mezzanine funds, the buyout market is served by traditional banks and the syndicated debt markets. However, bank participation in middle market lending has dropped precipitously over the last two decades. This trend has primarily been driven by massive consolidation within the banking industry, as the number of banks in the U.S. has fallen from over 10,000 in 1998 to approximately 5,400 in 2018.[4] Moreover, to reduce the amount of risk that banks take on, regulators imposed stricter reserve ratios and capital charges on banks following the global financial crisis, leading them to further recede from middle market lending. As a result, traditional banks accounted for approximately 10% of the leveraged loan market in 2018 and, while the current White House administration has been focused on rolling back regulations, there is little evidence thus far that traditional banks will aggressively re-enter the middle market direct lending business and reverse the decades-long retrenchment that has created a massive void that private credit firms have moved in to fill. Current bank participation remains $1 trillion below peak levels.

Leveraged Loan Market Fundings By Entity Issuance



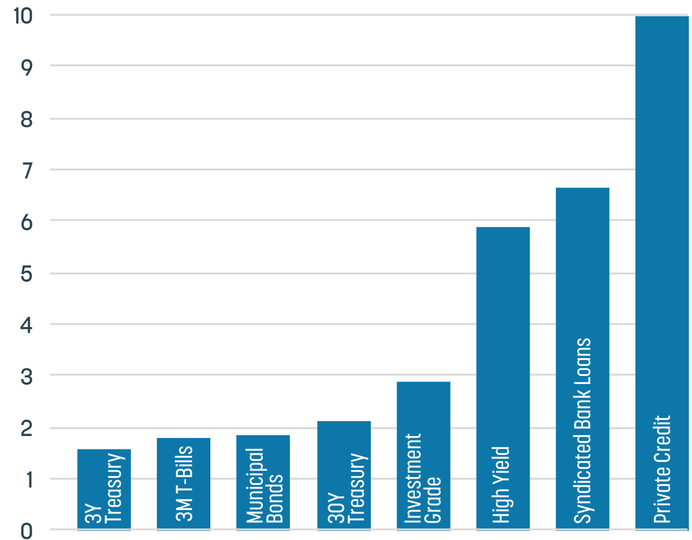
Source: S&P LCD Leveraged Lending Review Q1-19.
For illustrative purposes only.

THE ILLIQUIDITY PREMIUM

In addition to the "dry powder" question, we frequently hear from high net worth investors and their advisors with questions about the illiquidity premium, the level of downside protection, and how private credit performs in a rising interest rate environment. Regarding the latter, a major benefit to private credit in a rising rate environment – like we're currently experiencing – is that the vast majority of direct private loans are floating rate, so the cash coupon increases as rates go up.

Regarding illiquidity, investors quite rightly want to know whether the premium over more liquid fixed income investments is enough to justify the longer lock up that private credit requires. As shown in the following chart, private credit outperforms syndicated bank loans by about 300-500 bps on a relative basis and outperforms high-yield by 400-500 bps. Given how low rates have been, this premium represents a major boost in returns on a relative basis. And, compared to traditional forms of fixed income investments such as municipal bonds and investment grade bonds, the premium can end up more than doubling returns. Importantly, the duration of private direct lending funds has also come down in recent years with most now in the 6- to 8-year range and some even below that.[5]

Current Fixed Income Instrument Yields



Source: Cambridge Associates; Eaton Vance "Monthly Market Monitor" data as of 9/30/19. Private credit yield represents the midpoint of Pavilion Alternatives Group expectations for senior secured (7-10% unlevered; 11-15% levered).
For illustrative purposes only.

SENIOR SECURED LOANS AND STRONG DOWNSIDE PROTECTION

So how are private credit managers able to generate attractive risk-adjusted returns and how are these loans protected on the downside? With the current bull market now officially the longest in history and the risk of a recession seeming more likely, the latter question is on many investors' minds as they re-evaluate their portfolios and look for safer places to put their money while hopefully receiving a reasonable yield.

Most direct lenders invest in senior secured debt, including first lien and unitranche loans (which combine a company's first and second lien debt into a single security). These lenders are therefore positioned at the top of the capital structure and have a priority claim in the event of a default.

Experienced and disciplined private credit managers are typically able to achieve strong downside protection because the privately-negotiated nature of their transactions permits them to conduct extensive due diligence on potential borrowers and secure covenants. This process allows a lender to better assess the credit quality of a company by more thoroughly evaluating critical factors such as its cash flow profile, quality of revenue, competitive positioning within its industry, and the strength of its management team. This diligence process is extensive and can take four to eight weeks, in contrast to syndicated loan buyers who typically rely on materials provided by the borrower's underwriter and are often "term takers" – meaning they have little ability to negotiate terms or covenants. Broadly syndicated loans ("BSL") are typically focused on debt packages of $250 million and above, and the BSL market is relatively liquid with larger pools of capital providing a highly competitive market where there are generally fewer protections for the lender in the form of financial covenants. By contrast, many private credit managers have been able to take advantage of their due diligence findings and their direct negotiating position by including strong structural protections into their loan agreements, including financial covenants and prepayment penalties.

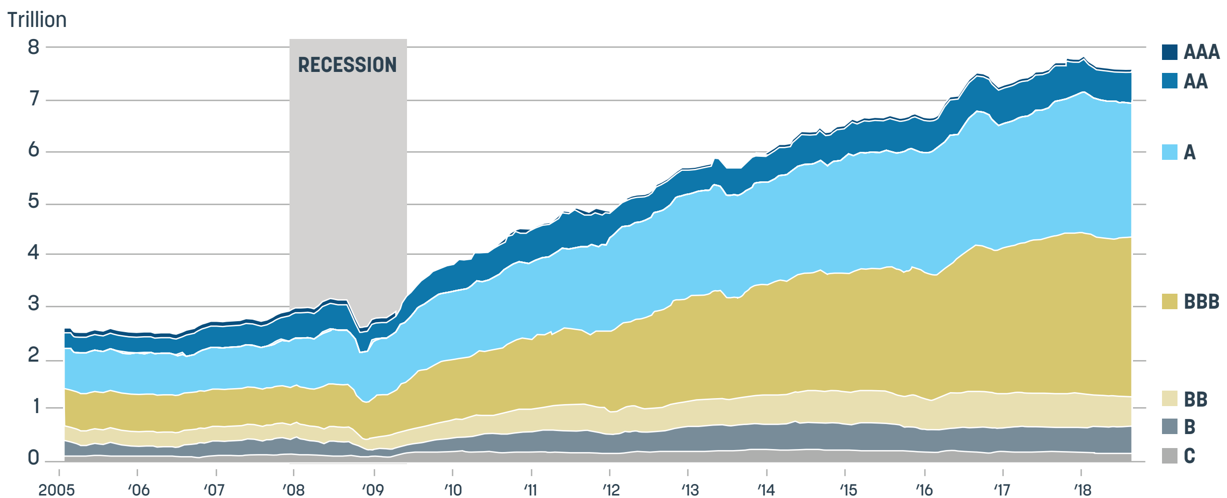
Also, private loans are not priced daily, offering protection against valuation volatility.

Direct lending managers are also often able to mitigate downside risk by gaining access to ongoing financial reporting as part of their loan agreements. Through proactive monitoring of a borrower's financial performance, lenders can often identify potential issues early on and work with management teams to address those issues before they hinder the company's ability to pay off its debt.

These features of private credit represent a stark contrast to the environment we currently see in public markets. There has been $6 trillion in investment grade bond issuance over the past five years, which has coincided with a continual decline in the overall credit quality of public fixed income markets.[6] Triple-B bonds, the lowest rated portion of the investment grade corporate bond market, now represent more than 50% of the investment grade market[7] and over 40% of all U.S. corporate bonds.[8]

Given the often weakened quality of underwriting over the past several years, moving down the credit curve in high yield or otherwise is a relatively high-risk approach. Added to these concerns, thinning liquidity in bond markets, because of

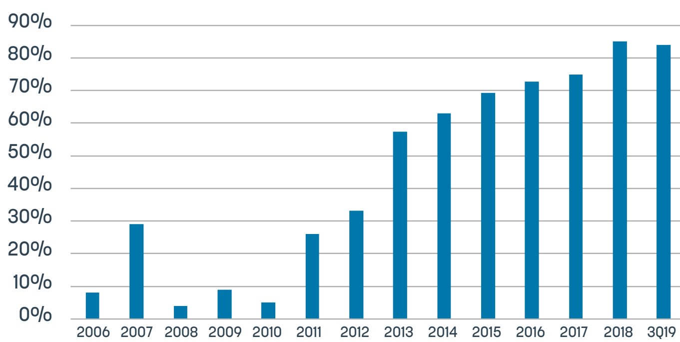
Value Of U.S. Corporate Bonds By Rating



Source: ICE Data Services. For illustrative purposes only.

changes to market structure and heightened bank regulation, poses additional risks to public market investors, particularly in the next market dislocation.[9] Finally, the re-emergence of covenant-lite loans (which include no covenants) adds to the concern of principal protection in the event of default.[10] Simply said, bond markets are not playing the same defensive role in portfolios today that they were playing 15-20 years ago.

Share Of Outstanding Leveraged Loans That Are "Covenant-Lite"

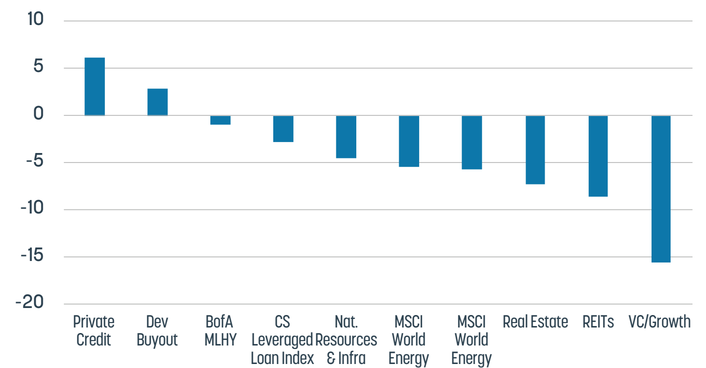


Source: S&P/LSTA Leveraged Loan Index. LCD, an offering of the S&P Global Market Intelligence, As of September 2019. For illustrative purposes only.

PRIVATE CREDIT PERFORMANCE IN DOWNTURNS

So how does private credit hold up when there is a market correction? The historical data suggests that it outperforms heading into, and coming out of, a recession due to its floating rate nature, downside protections, and access to greater lender information. To this point, Hamilton Lane recently measured the worst rolling five-year performance by asset class over the past 20+ years and found that private credit generated the best results with a 6.1% positive annualized return during its worst five-year stretch (as shown in the following chart). Every other asset class in this analysis delivered negative performance during its worst five-year period, except for developed market buyouts.[11] While not guaranteed, this outperformance is indicative of the downside protection potential in private credit, often achieved with thorough upfront due diligence and the ability to rely on covenants to protect against principal loss.

Lowest 5-Year Annualized Performances (1992-2018)



Hamilton Lane data via Cobalt; Bank for International Settlements (November 2019). For illustrative purposes only.

It is important to note that while the overall features of the private credit market make it an attractive opportunity, it is crucial for investors to select managers who are highly disciplined and well-equipped to execute the strategy properly. Given that many direct lenders rely on transactions backed by private equity sponsors to drive the majority of their deal flow, experienced managers who have developed deep sponsor relationships have a considerable competitive advantage over newer entrants. Further, direct lenders do not compete only on price, but also on the certainty of closing and the speed of approval execution. Thus, experienced managers who have strong networks and sector expertise, as well as greater scale and deeper resources, are often able to win deals without being the lowest priced option. By providing borrowers with assurance that their financing will close on time and at the negotiated yield, which is appealing in today's volatile and competitive markets, such managers can often command a premium for their loans.

From a portfolio perspective, private credit can offer investors diversification benefits as well as the chance to seek a return premium stemming from the illiquid nature of the market. The share of private credit of the overall market is still relatively small and the supply-demand imbalance continues to favor experienced lenders. As interest rates rise, resulting in a decline in bond prices, private credit offers an attractive risk-adjusted return and, arguably, a safer option for investors seeking to reduce volatility and protect against rising interest rates.

WHAT IS DIRECT LENDING?

Direct lending refers to loans made by non-bank lenders to privately-owned companies, many of which are backed by private equity sponsors looking to finance an acquisition. In most cases, lenders focus on middle market businesses that have an established market presence, proven customer base, and stable cash flows, but which lack the necessary size to tap public fixed income markets or receive coverage by rating agencies. This type of lending is distinct from the traditional sources of debt capital for corporate borrowers, namely bank loans and syndicated public debt. Like syndicated leveraged loans (but unlike most high yield bonds), these private loans feature floating interest rates, positioning investors to benefit from any rise in rates while mitigating duration risk (the likelihood that rising interest rates will push security prices down).

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END NOTES

[1] Source: Preqin. As of Q3 2018.

[2] Source: Preqin. As of Q3 2018.

[3] Leveraged loan market maturities S&P LCD as of May 30, 2018

[4] Source: Federal Deposit Insurance Corp.

[5] Source: iCapital market research.

[6] New York Times, "Riskier to Own High Quality Corporate Bonds," August 2018

[7] Danielle Dimartino Booth, August 2018

[8] Source: ICE Data Services

[9] United States Treasury Department; "A Financial System Capital Markets," August 2018

[10] Forbes,"Banks Are The Largest Holders Worldwide Of Leveraged Loans And Collateralized Loan Obligations," July 2019.

[11] Hamilton Lane data via Cobalt; Bank for International Settlements (November 2019)

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