ROUNDTABLE

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Private debt prepares to ride out the storm

A volatile macroeconomic environment presents both risks and opportunities for private debt – but five influential figures in the US private debt industry tell Robin Blumenthal that the asset class remains on a growth trajectory

The US economy has seen headwinds grow considerably over the past year as the post-covid boom subsided. Inflation is at a multi-decade high, supply-chain disruption continues and the Federal Reserve has been forced to raise rates faster than most anticipated a year ago.

But the private debt sector is more resilient than most. Indeed, rising rates and widening spreads have boosted investor returns, while deal terms have become more favourable to lenders. Fundraising stood at $48.2 billion in H1, down only slightly from $51.4 billion in 2021, a record year for securing capital. The average fund size topped $1 billion for the first time.

Despite this varied picture, the five industry leaders that gathered in New York for our roundtable agreed that private debt can surmount macroeconomic obstacles. In fact, as the industry matures, our panel sees opportunities opening up in areas such as the secondaries market, ensuring that the asset class will become ever more attractive to institutional investors over the coming years.

$48.2bn

Fundraising in the first half of 2022, running close to record highs

$1.1bn

Average fund size in H1 topped $1bn for the first time

How are rising interest rates and the economic downturn affecting private debt?

Theodore L Koenig: Anytime there's a period of rising interest rates, private credit is going to do better than periods characterised by a more dovish Federal Reserve. Rising interest rates translate into an increase in coupons, while widening spreads provide an added bump to returns.

From an investor's standpoint, the floating-rate nature of loans is a primary selling point across private credit. From a borrower's standpoint, however, it could represent a challenge. Currently, the increase in interest rates hasn't impacted the ability of most

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Carrie VanFleet

Partner, Kirkland & Ellis

VanFleet is a partner in the Investment Funds Group at Kirkland & Ellis. Her practice focuses on advising sponsors of private investment funds, co-investment vehicles and separately managed accounts, covering numerous sectors and strategies, including buyout, credit opportunities, mezzanine and real estate funds.

Jason Strife

Senior managing director, head of junior capital and private equity solutions, Churchill Asset Management

Strife is responsible for leading all facets of the business, including strategy, capital raising, capital deployment and management of the investment team, across Churchill's mid-market strategy, including PE fund commitments, co-investments and junior capital investments.

Mike Hynes

Managing director, originations, Antares Capital

Hynes is a managing director at Antares Capital. He works on the originations team covering the Chicago, New York and Boston markets. Hynes joined the Antares business in 2002 in an underwriting and portfolio management role.

Theodore L Koenig

Chairman and CEO, Monroe Capital

Koenig is chairman and CEO of Monroe Capital. With approximately $14 billion in AUM, Monroe Capital has specialised in direct lending and opportunistic credit investing since 2004.

Greg Myers

Global sector head, debt capital markets, Alter Domus

Myers is focused on shaping Alter Domus's strategy for lenders and debt fund managers globally and oversees business relationship management for Alter Domus's North America fund administration group. An experienced financial executive, he has over 20 years' broad-based financial services expertise.

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>
> **CARRIE VANFLEET**
> **Kirkland & Ellis**

borrowers to service their debt. But if rates continue to rise aggressively, it may create more pressure on company cashflows in the future, particularly those with a greater debt burden.

It will become clearer over the coming quarters which private debt managers have invested in the right companies with the right downside protections and covenants.

Mike Hynes: From a dealflow perspective, given the speed at which the increase in rates and the widening of spreads have transpired, the changes have not really made their way through the system yet. Not everyone has gotten around to recalibrating their expectations. There's a mismatch between buyers and sellers, and between buyers and capital providers.

We're having a lot of phone calls where we're having to explain a 150-200 basis point increase in pricing – which is not an easy message to get across. And then the unknown is what's going to happen in the back half of the year, in terms of M&A volume.

From a portfolio and investor perspective, rising interest rates have passed the base floor rates and are benefiting loan fund returns generally. The worry is what happens to default rates if interest rates rise too dramatically. Right now, the SOFR forward curve appears to top out near 3.5 percent in early 2023, which looks very manageable to us in terms of interest coverage, assuming EBITDA holds up.

Greg Myers: Once the rumours started that the Fed was really going to start pumping up the rates, we saw a flurry of deals both in Q1 and Q2. I think our clients and their counterparties saw an opportunity to get out before the rates really went up and started to impact their portfolio businesses. It was a very, very busy time for us. Our clients were doing 50 or 60 deals a week. Pre-covid, it was maybe 15 or 20 deals a week. It ramped up towards the end of 2020, then just hit the gas in 2021.

Carrie VanFleet: The sharpest increase that we experienced was at the very beginning of the pandemic. We were raising billions of dollars overnight with investors who would normally take six months to negotiate. After that, the dealflow never really slowed down. Things did normalise, but they normalised at a much higher volume than we had before covid.

A lot of firms in the market didn't predict the interest rate rise quite quickly enough. That means that they're going to market now, but they've missed the boat to a certain extent. The market is going to continue to change in a higher interest rate environment, and of course huge volumes of capital have already been raised in 2020 and 2021.

There's a huge amount of dry powder out there. Investors want to see that capital put to work before they make their next allocation decisions – especially as many investors aren't receiving significant distributions. Exit opportunities aren't great at the moment, which results in investors receiving a reduced flow of distributions on their current investments, and in turn causes investors to be more constrained in the amount of capital they have to deploy.

Does it feel like a recession has already begun?

Jason Strife: There's no better barometer than the mid-market portfolio companies of private debt managers. For us, the bottom line is that we may currently have fewer names on our 'early warning' list than at any time in the history of our firm. That's across our platform – senior lending, junior capital and equity co-investment positions.

In certain niche sectors, for example lower-income consumer purchasing, we're seeing some cracks in data on transaction value and volume. But with Churchill's portfolio made up mostly of service-orientated or B2B companies, we're just not seeing many signs of distress right now.

TK: The strong labour market and resilient consumer demand are providing significant support for the broader economy. This is despite the ongoing and persistent inflationary pressures, which continue to be exacerbated by supply-chain disruptions.

Eventually, we expect to see a rebalancing and have already started to see some challenges in more cyclical industries. However, if we look across our portfolio of over 500 mid-market companies, we have not seen any material decline to date in the quality of earnings.

What is the outlook for fundraising?

CVF: Most fundraising for 2022 was done very early in the year. Allocations were largely completed by March. It may have been to do with rates going

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> **JASON STRIFE**
> **Churchill Asset Management**

up, but I think the primary driver of that was that there was already so much dry powder in the market that LPs had already decided who they wanted to invest with before 2022 had even begun.

Because investors had decided at the very beginning of the year where they were going to put their money to work this year, we had a lot of clients that wanted to go to market but they were told by their investor base: 'Get in line for 2023, 2022 is already done with.' So, most of what I'm working on now is stuff for 2023. I have to ask the question of whether that will create a snowball effect at some point in time. It may well be that we have the same problem in 2023, and we have fundraising postponed until 2024. That must be giving asset managers some concern.

JS: In the near-term, the jury is still out on the 'denominator effect'. It's true that LPs have largely put their capital to work for the calendar year. But this asset class benefits from fundamentally good underlying tailwinds, so investors are very receptive. Particularly during uncertain economic times, private debt can serve as a less correlated portfolio diversifier. And as a lender, it's a more favourable time in terms of the absolute level of activity, while being able to price deals 100-150 basis points higher than we were even three, six or nine months ago.

In the medium- to long-term, private credit managers will be better positioned than most in terms of raising money from LPs. There's never been more private equity-owned companies than today – and that trend will continue. There's also the advent of tuck-in M&A in nearly every portfolio company owned by a private equity firm, so the sponsor ownership story in the US mid-market still has room to run.

On the capital raising side, having a full infrastructure in place to support investor requirements and new mandates coming in is incredibly important – whether it's creating new fund structures, enhancing ESG reporting, or abiding by side letter requests. We have to ensure that side of the business stays current and provides our investors with a best-in-class experience.

MH: While investors may worry about recession, which is causing some headwinds, higher yields and more lender friendly terms may ultimately benefit those allocating to private debt in 2022. As we have seen historically, returns for vintages during and coming out of a recession are typically above average, though performance certainly can vary among lenders. Defaults are forecast to rise but remain relatively benign. On a relative value basis, private debt is an attractive asset class in this market environment.

"Private debt is an attractive asset class in this market environment"

MIKE HYNES
Antares Capital

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> **THEODORE L KOENIG**
> **Monroe Capital**

Will we see a bigger secondaries market in private debt?

TK: Private debt has been the fastest growing asset class over the past 10 years. Now that many allocations have reached 10-15 percent of institutional dollars, there'll likely be more need for a secondaries market in private debt. This is particularly the case in a volatile economic environment, in which liquid securities see their values fluctuate and institutional portfolio managers are being forced to rebalance. Secondary transactions can help asset managers wind up their funds more quickly. This need has driven significant growth in the private equity secondaries market, and the same demand could drive growth in the private debt segment.

JS: The secondaries market in private debt will be a liquidity tool in times of stress and market dislocation. But it's a catalyst for raising money too. Private credit has been catching up because there's been so much expansion in the demand for it. The fundraising has been commensurate with that. On the private equity side, the secondaries market is now a significant catalyst to raise money in a more crowded market. And institutional investors are increasing their allocations to private debt, so there's new capacity to fight for.

How can managers increase returns?

TK: Amid the growth of the private credit market, there's been a reversion to the mean in terms of generating returns to investors. It can seem like everyone is targeting the same borrowers – cashflow-based buyout financing involving companies with $20 million-$75 million of EBITDA. So, absent a long track record that extends across multiple cycles, it's increasingly hard for investors to differentiate between asset managers.

We believe the future of the business needs to be about "alpha" generation. We've always tried to be a little different and focus on strategies with a barrier to entry, less competition and more specific industry experience. LPs, over time, are going to require firms to be more unique and they will gravitate to managers who are able to generate alpha. This has helped to form our own growth as a firm, as we've targeted several different niches that can provide LPs with differentiated yield that leverages some of the specialisations we bring to the table.

Meanwhile, approximately 25 percent of our total credit mix resides with non-sponsored companies. That's going to be a bigger focus for us in the next 12 months. Non-sponsored companies can compete in a less frothy market environment and, oftentimes,

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> **GREG MYERS**
> **Alter Domus**

deliver more attractive returns relative to the more competitive sponsored segment.

JS: There are some more exotic channels developing. There are new ways to lend to different vehicles linked to private equity. We've seen the advent of the private equity continuation vehicle market, multi-asset continuation vehicles, NAV-based financing at the management company – that's about as a recurring revenue business as you can get, with 10 years of fees from committed capital.

MH: We've had the same strategy for more than 25 years and it's served us well. We believe having strong originations ensures the broadest view of all the opportunities to allow for selectivity and diversification.

We don't try and time the market or stretch our credit box. We may shy away from some sector or subsector if there is some specific issue, but we generally don't make bets via sector rotation per se. Instead, we tend to avoid more cyclical areas like energy and retail and focus more on best-in-class companies within recession-resistant sectors like software, business and financial services, and healthcare where we see secular growth and more stable cashflow.

We also don't try to seek out hairy complex opportunistic credits that some might look to generate alpha, although we do have the ability to buy stressed credits we know well if and when we see an opportunity. As a credit manager, we view alpha primarily as loss avoidance that comes with our strong sourcing and lead manager positioning, our diligence in underwriting and portfolio management and our strong workout capabilities that enhance recoveries if and when things do go bad for a loan.

Will private wealth clients emerge as a major source of capital for open-end structures?

TK: This is an important channel for fundraising, and it's become a lot more sophisticated in the last several years. The high-net-worth individuals and family offices that have fuelled the private wealth segment tend to be represented by investment advisers, who are really no different than consulting firms for pension funds. It's their job to analyse track records and help their clients invest in the most attractive funds that provide the best risk-adjusted returns.

The biggest challenge for open-end vehicles is managing the liquidity needs inherent to these structures. Every quarter, money needs to be put to work to avoid J-curve dilution in returns. That is going to become more of a challenge for smaller platforms that

don't have the breadth of investment alternatives and the depth of longer-tenured managers with the requisite scale.

GM: We've been doing fund administration for a number of the open-end private credit structures that include private wealth clients. A lot of the managers we work with are familiar with close-end structures; they might have $500 million of committed capital and they know they can call it in three years and put it to work. With an open-end structure, there's a lot to figure out: how do they call initial capital amounts, how do they queue the investors, how do they rebalance?

Using a queuing structure can create conflicts with the investors. How do you avoid appearing to favour certain investors? The investors can't sit in a line for two years, waiting for you to find a deal for them to be called, because they have to put their money to work. It's much easier to do in liquid markets, like the broadly syndicated loan market. You can go out and just buy more of the same name potentially, or just get in primaries, and then you can add leverage to it, and you've got this constant pool of new capital coming in.

Sometimes with mass distribution, a vehicle may be represented by a single LP for a pool of RIA clients, but it can still be like herding cats on the fund admin side. If you do a capital call, you have to have confidence that the RIA can ensure that all the 500 investors can co-ordinate the funding and get them to wire the money to cover the call. It can become problematic when there are shortfalls, so managers need to learn to call a little bit earlier.

What changes are you seeing with deal terms?

MH: It's early innings, but I think there's been a shift in the pendulum that has swung back in the favour of the lenders. We've seen pushbacks obviously on spreads, but also EBITDA definitions, add-backs, call protection, some sizing of baskets within the credit agreement. All things change over time, so we're trying to strike a balance.

There is a top echelon of credits, and in many cases these are in areas seen as the consolidation plays. We're seeing them in sectors such as residential services, physician management, medical devices – for a while it seemed we got a HVAC deal in every week.

And there is also a bifurcation between the primary issuance or the initial buyout on the one hand, and the M&A activity in the portfolio on the other. We are having conversations around the MFN protections that are afforded in the existing deal, and the implications of the M&A activity on the existing deal. Those conversations can become a little uncomfortable.

While M&A activity has slowed a bit of late, we are still seeing a lot of add-on activity which comes as a benefit of having a very large portfolio of incumbent borrowers. Almost 80 percent of deals have come from within the portfolio year to date.

JS: It's a tricky time right now on the new platform side of the market, because of the more conservative viewpoint of the capital structure.

We have really seen a bifurcation. The highest-quality borrowers in the market are getting good execution. They have premium valuations, and their capital structures look similar to last year. The rest of the market is having a more challenging time. Certain lenders want to hold less per deal, leverage has come in a little bit, pricing is up modestly, and you have some buyer-seller mismatch on valuation. There are still some portfolio companies trying to play offence in the M&A market, but lending for those follow-on investments is a tougher ask right now.

We're seeing more private equity firms enter the debt space. Is this a concern?

GM: Many of our private equity clients are hiring teams and launching a private credit strategy. It can be a culture shock for PE firms to suddenly have a credit business, because PE shops are run in such a lean way. Plus, the underwriting process and the documentation of deals and ongoing loan activity and reporting to potential co-lenders and syndicates is vastly different from a metric perspective than what you'd have in a PE shop.

CVF: Even within private credit, we're seeing sponsors wanting to branch out into things they haven't traditionally done. I'm seeing more debt sponsors want to explore investing in structured finance solutions, for example. I'm seeing more clients want to understand what they need to do to have a direct lending business when they haven't run one before, or traditional PE clients that want to play in the secondary market. There's more competition from within private credit, as well as from firms that haven't been in private credit historically. ■