The 80/20 Rule of Private Credit

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"Capital is destiny." We're not sure this pronouncement will make it into the next edition of Bartlett's Familiar Quotations, but the notion sprung to mind as we recently addressed a top business school class. Topic? How private equity sponsors finance leveraged buyouts.

To show students how debt markets work, we discussed how issuers benefit when investors deploy cash in various asset classes. Cash flooding into retail loan mutual funds (as is happening today) causes spreads to compress in the broadly syndicated market. Issuers can then refinance existing debt at lower costs, or come to market with new deals at attractive all-in coupons.

The reverse is also true. When investors exit from high-yield retail funds (almost $5 billion have done so year-to-date), junk bond spreads widen creating headwinds for new bond issuance.

The more liquid, large cap market, we explained, is an "open" system where capital flows in and out, distorting prices and spreads. Capital-in" favors issuers; "capital-out" favors investors – all else being equal.

The middle market, and in general, private credit, is a relatively "closed" system. Private credit investors, including middle market asset managers, finance companies, BDCs, and insurance companies, raise vehicles with longer-term investing horizons. Quasi-permanent funding allows managers to patiently deploy capital to smaller companies, insulating them from the vicissitudes of daily market moves.

Not to say that private capital hasn't seen healthy in-flows. Indeed, much attention has been paid to the benefits of direct lending as a credit strategy. As your correspondent often notes, middle market loans check the boxes for institutions seeking non-correlated assets, illiquidity premiums, and a rising rate hedge.

These factors motivated $92.5 billion of new private debt funds to be raised in the US last year, according to Preqin. That statistic, or versions of it, have prompted worries that the middle market is overheated with too much cash chasing too few deals.

However, when you tease apart the composition of that $92.5 billion, it turns out only $20.9 billion is dedicated to senior secured debt. Fundraisers report that the majority of new capital is going to higher yield second-lien, second-out, or mezzanine debt. Those investments carry very different risk profiles. What's not clear is whether institutional accounts new to private credit understand *how* different.

Say the "sources" component of sources and uses for leveraged buyouts is $20.9 billion, then what's the "uses"? Per Thomson Reuters there was $52 billion in middle market sponsored loan activity during 2016. Year-end average leverage of 4.1x senior and 4.6x total debt to ebitda translates to over $45 billion in senior loans and less than $5 billion of junior debt. So almost 80% ($71.6 billion) of Preqin's tracked capital is dedicated to a small share of the private credit market. Even assuming non-sponsored second-lien and other higher-yield opportunities outweigh those from private equity firms that's still a crowded space.

When only 20% of new private credit fundraising volume is being dedicated to 80% of the financing activity, why aren't more managers pursuing this strategy? These loans provide returns in the 6-7% range – not very appealing to credit opportunity funds or BDCs, which target higher yields. Wells Fargo's Jonathan Bock points out that at current levels, BDCs need to invest in loans with at least a 9% asset-level yield to support their dividend (adjusting for the impact of limited leverage and higher fees).

Middle market lending is dominated by club players with long sponsor relationships. That's an impediment to firms with short track records. Finally, it's a space that demands high-touch, hands-on due diligence. Not a game for two analysts and a Bloomberg.

The 80/20 rule of private credit suggests that where capital is flowing does drive the types of investors who seek it and the firms who manage it. Maybe "Capital is destiny" will catch on after all.

This column first appeared in the April Creditflux, a leading global information source for the credit trading and investment market.