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All Ahead Full: Private Credit Outlook 2022 (Third of a Series)

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At recent private credit conferences we've been asked how managers think about portfolio construction. The answer depends on your experience over the past twenty-two months.

Covid clearly threw a wrench in investors' business assumptions. As one private equity partner told us, "we had a base case and a down-side case, but we didn't have a no-revenue case." Once operators developed a plan to deal with closures, it became an issue of matching funding with recovery expectations.

Consumer-facing sectors had a rough time early on, but patterns were quickly established. The toll on small retailers, particularly restaurants, was devastating. Defensive B2B businesses managed better, and in some cases, thrived. Post-vaccine regimes supported the consumer side as people edged back to work and (as one economist put it) "having fun."

Today, almost two years on, crosscurrents are at work. The Omicron variant threatens to upset reopening scenarios globally, roiling capital markets. Too early to tell whether this strain will mimic Delta, disappear (like Mu) without a ripple, or become a different brand of nasty.

Of more immediate concern to portfolio managers are continuing supply chain issues. As we've detailed extensively in our recent special series [link], getting goods from point A to B is a systemic challenge. Services similarly are hampered by labor shortages.

As our *Chart of the Week* highlights, demand is not the problem. Revenues are up for large corporate borrowers in the S&P/LSTA Leveraged Loan Index, driving leverage to a record low. Even for those able to pass higher costs along, the pace of price increases has created a drag on profitability. That demands closer attention by managers to monthly performance.

Even companies with Covid assists bear watching. With current funds demanding realizations, sponsors are compelled to recap portfolio companies, leveraging ebitda above pre-pandemic levels. What happens when "normalized" conditions return? Performance resets (up or down) may not be clear in all cases, leaving managers with tough credit decisions.

Beyond selectivity experienced lenders demand diversification, even within defensive sectors such as healthcare, business services, technology and software. As the last two years proved, expecting the unexpected preserves cushion for errors. Ensuring borrowers have sufficient liquidity to withstand product or service interruptions helps bridge the bumpy periods.

And most of all, having owners and financing partners aligned to preserve enterprise value will help keep defaults and losses to a minimum. No matter what surprises 2022 has in store for us.