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Private Credit in an Age of Scarcity (Third of a Series)

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In a world where cash is either being withdrawn systemically through quantitative tightening or selectively by investor caution, capital formation is being challenged.

Public capital utilization is governed by fast cash, so when money flows out of retail funds at the pace it has, it's a headwind to deal activity. Private capital has long-term, locked-up funds. But in this period of uncertainty, managers are also carefully weighing risk versus opportunity. Does it make sense to wait for more direction from the economy?

The answer lies in the role of the manager in an illiquid asset class. For private equity and credit, portfolio construction is key. As we've seen in a prior series [link], the importance of picking the right assets from the start largely determines returns. Since you can't trade the assets, you can't unload a problem into a ready secondary market.

Asset and sector selection also matter across business cycles. Timing is a part of every BSL PM's tool kit to seek undervalued loans or out-of-favor industries. Liquidity allows them to pick exit and entrance points. But if a consumer-facing borrower or a heavy cyclical stumbles when the economy softens, a buy-and-hold lender may find themselves with a long-term problem.

Managers are also coming under greater scrutiny from credit investors. Issues such as differentiated sourcing, always part of standard diligence, are taking on increased importance in a world of deal scarcity. How do you find deals when there are no deals?

The key to sponsor-focused lending is relationships. Today it's not only who you know, but who trusts you to deliver. The impact of compressed interest coverage ratios and the risk of recession has caused lenders to more carefully allocate their remaining dry powder. That has dramatically reduced hold levels, not to mention forward underwriting commitments.

Sponsors are adapting by clubbing more transactions among a smaller group of trusted relationship players, rather than relying on one lead for the entire piece.

The prospect of a pause in M&A activity has compelled sponsors to looking to existing platforms for growth. Lending groups are accordingly fielding more add-on financing requests. They are also being asked with each deal, How much more dry powder do you have?

Higher all-in borrower costs are also pressuring PE firms to push the envelope on MFN (most favored nation) clauses. These credit agreement covenants protect lenders from issuers obtaining new debt on more favorable (e.g. higher spread) terms without treating existing lenders to the same terms, subject to certain baskets.

Another tactic is to expand DDTLs to fund acquisitions. As rates escalate, locking in today's spreads will no doubt be cheaper than waiting for whatever tomorrow may bring.