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

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As our *Quote of the Week* concisely frames it, the world is changing from one where risk-taking was rewarded, to one where it is punished if not appropriately managed. The question for private credit investors is, can you be rewarded while managing today's level of greater risk?

In a nutshell, the Fed's withdrawal of systemic capital and relentless rate hikes plus the flight of cash from liquid credit has opened a window of opportunity. Yet higher yields will drive up default rates based on tighter ability of issuers to meet interest payments. Squeezing capital supply and spending could then trigger an economic slump.

Ironically the current credit vintage, which sports lower leverage, tighter structures, and wider pricing, is significantly more investor-friendly than anything over the last decade. Not since 2010 have we seen near 10% yields for traditional middle market senior debt. But issuers who don't need to face the debt market could elect to wait until conditions ease.

3Q statistics show direct loan activity slowing. As the 4Q rolls out we suspect that trend will continue. After all, most private capital managers have enjoyed a strong 2022 run. No one feels like stretching when there's so little visibility on earnings and inflation, let alone continued supply-chain bottlenecks and geopolitical uncertainty.

Much depends on how PE firms play the current environment. As our *Chart of the Week* shows, velocity of investing and realizations has also contracted. Some buyers are pencils down, believing market multiples will retreat, improving investment opportunities down the road. Others have long-developed conviction around M&A strategies with select businesses expected to perform through every business cycle. They maintain healthy all-weather pipelines.

Experienced private credit managers have seen this movie before. A large, diversified client base and deal portfolio keep deal flow coming regardless of buying sentiment, and allows investors to benefit from uninterrupted deployment and allocations. It also means they will enjoy the better yields and structures being obtained in the current market.

Refinancing activity has ground to a halt. The lack of repayments suppresses lender dry powder – not necessarily a bad thing. Add-on financings are up as sponsors seek ways to build existing platforms in lieu of new buyouts.

The average hold period for direct loans of two to three years should accordingly lengthen. What are the implications of that trend? Duration risk is still modest compared with fixed income. But moving the needle on average yields and leverage in a large, diversified portfolio takes time. It also becomes tougher to trade into other strategies, sectors, or assets.

Nevertheless, for private credit investors the next several quarters will be constructive. Scarce assets are more highly valued. The question is, as the era of greater selectivity unfolds, will there be enough to go around?