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Glasses Half Full (Second of a Series)

THE LEAD | March 22, 2023

As we continue our series examining the effects of higher interest rates and a potential recession on private credit, we also now need to throw in the impact of recent bank failures.

It's clear all sorts of economic and market indicators – the Treasury curve, Treasury spreads, stock prices, to name a few – are flashing to a more conservative risk posture. Analysts say the failures of Silicon Valley, Signature, and Silvergate banks were the equivalent of at least a 25 bps Fed hike, and perhaps as much as a 1.5% increase.

Was the Fed's tightening by another 25 bps warranted? Opinions as usual are mixed. Some hoped for a pause; others think hawkish messaging on inflation should continue, if for no other reason than to sustain the central bank's credibility on its mission.

Beyond liquid markets, reactions among investors and managers is muted. "I think things will settle down with the banks," one friend told us, "assuming First Republic finds a white knight." Or knights, as the case may be. Unclear at press time what that will involve.

Meanwhile trends in dealmaking generally continue on the path set before the banking crisis developed. The difference is that anything with a financial service or tech component is receiving extra scrutiny. A $1.16 billion refinancing for Russell Investments, according to LCD, was pulled. As was a similarly sized term loan B for Agiliti.

Headwinds to these repricings, amendments and extensions revolve mainly around lack of clarity on price-clearing levels. Investor pushback is centered around where the secondary loan market is trading. Given "market conditions," it's a challenge to improve existing terms.

For private debt data, no better place to look than Lincoln's Private Debt database. As we discussed in our first installment, this information from hundreds of borrowers provides helpful direction on valuations, loan prices, purchase price multiples, and financing terms.

An important element of Lincoln's valuation analysis is comparing private loan pricing (spreads, floors, and fees) with that of liquid broadly syndicated loans. More volatility in public secondary credit has led at times to higher yields there. Since illiquid credit deserves a premium to BSL, anything eating into that differential could make privates look momentarily cheaper.

But that disregards the disparate vitality of the two markets. Primary issuance in large cap loans has been largely dormant for months, while direct lenders by a 15:1 margin have led most of the leveraged buyout financings. That means private investors are benefiting from healthy deal flow even if private marks move within a tight band.

As our *Chart of the Week* highlights, private loan values have eased 2.5% since the end of 2021 as spreads have widened. While that makes historic prices look lower, it's critical for investors to understand that lower marks are not necessarily indicative of declining borrower performance.