A Loan for All Seasons (Second of a Series)

THE LEAD | June 21, 2023

A frequent question from investors and others is, “When is a good time to invest in private credit?” What they mean is, “Is now a good time to invest in private credit?”

Readers of this column know one of our consistent themes is private credit is not a timing thing. On a panel at the US Private Credit conference last week, we were asked a version of that question by the moderator. Shifting into full metaphor mode, we replied “You don’t buy and sell car insurance every time you move your car in and out of your garage.”

The question is by no means simplistic. We watched an interview in which the CEO of a large global asset manager was asked whether he was “still as focused on private credit as you were several years ago.” This particular firm also owns a significant direct lender.

To our surprise, the CEO dodged the question a bit, saying “I don’t want to throw cold water on it, but the world is very excited about private credit.” Implying that perhaps he wasn’t. “In the steady state,” he went on, “you need both the public and private markets functioning.” When pressed on private credit, he said “We’re interested, but it’s ‘What’s the opportunity set?’”

The problem is the “steady state” doesn’t exist. Banks have lost almost all their share of buyout financings to direct lenders with their fundamental inability to structure and hold leveraged loans when clearing prices are indeterminate (see our *Chart of the Week*).

More generally banks have not been the majority of primary loan investors in over two decades. It’s unclear when or if they can recapture even the modest minority positions they held pre-Covid. In the meantime, private debt funds have been reaping the rewards of direct lenders’ increased allocation in better-priced, better-structured assets.

How about private equity sponsors being challenged to meet current fund return targets and raising new funds? “How does it work when the cost of the capital stack is 10%?” The answer is, as has been the case for decades, you need to be nimble and resourceful with capital solutions.

The best sponsors adapt. They add lower-multiple acquisitions to platform companies. They get LPs to put in more equity co-investments. Mezzanine providers, an even higher capital cost strategy, are busy working with issuers to include cash pay-to-PIK toggles in their financings.

But M&A is down this year. Doesn’t that bode poorly for “opportunities”? Bankers are clear on this point: Dry powder for buyers and sellers is plentiful, just waiting for more clarity on rates and the economy. If you’re on the sidelines, the second half will pass you by like a freight train.

So what is the “opportunity set” in private credit? The CEO referred to non-sponsored and special situation strategies, but acknowledged neither have broad application today. The more specialized you get, the tougher to deliver attractive returns over long periods of time. When cycles change – rates, growth, inflation – so do the settings for those boutique opportunities.