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Tyranny of Dry Powder – An Update

THE LEAD | June 20, 2024

Back in October 2020 we introduced the concept of how supply and demand imbalances in private markets affects credit quality and performance. Too much capital chasing too few deals leads to overly aggressive terms – great for issuers, but for investors not so much.

In the immediate aftermath of Covid, conditions were quite different than they are today. Deal flow had seized up. Credit managers of all stripes were busy assessing whether liquidity was sufficient to keep portfolio companies going. Consumer-centric industries such as retail and restaurants were reeling. Private capital fundraising had slowed markedly compared to 2019.

“This performance,” we wrote four years ago, “is due less to COVID than the massive 2019 capital raise by mega-funds; a challenge to match this year.”

We also noted “many equity and credit funds are behind in their 2020 investing budgets, making the urgency to generate income-producing assets particularly acute. In recent years, this drive led some to deploy capital unwisely, resulting in vulnerable portfolios this year. Experienced managers resisted the temptation to jump into whatever deals floated into view, choosing to wait for better conditions.”

These observations hold true today. Raising fresh capital is a necessity for managers to remain relevant, but the tyranny of dry powder may drive poor asset selection. Better to keep building AUM, the reasoning goes, than risk disappointing LPs not earning the yields they hoped for.

Prioritizing quantity over quality is particularly fraught for those platforms experiencing an inrush of retail cash. Putting billons of dollars to work when there may not be the equivalent supply of good deals doesn’t do investors any favors.

So how do investors guard against being swept along with this current of aggressively priced and weakly structured assets? One answer is to choose managers whose sourcing does not rely on winning financings with the most issuer-friendly terms. This skews portfolios towards businesses that are less equipped to perform well through multiple cycles.

Another is to balance exposure to the BSL universe by allocating to managers who focus on the traditional middle market. There the borrowers generally don’t qualify for cov-lite and PIK-toggle options that become more problematic if operating performance deteriorates.

Partnering with top-tier private equity firms also creates alignment with more defensive, growth-oriented sectors. Not coincidentally, these businesses retain the highest purchase price multiples, thereby assuring the most conservative loan-to-value ratios. Finally, these PE sponsors and their operating partners identify secular trends in industries where roll-up strategies can build long-term value. Rather than waiting to see what emerges from investment banks in auctions, they have a curated pipeline of acquisitions ready to launch in any market.