Report from the Front

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Valentine's Day is still months away, but for early planners we pass along the following:

The world's second largest diamond was discovered in a mine in Botswana last week. Weighing in at 1,111 carats, the giant gem is the size of a tennis ball. One expert reported it had "the potential to be one very expensive diamond."

While our budget was unlikely to accommodate such a gift this year, we found gems of another sort at last week's outstanding Wells Fargo BDC conference. Private debt and equity chiefs produced trenchant observations on market challenges and opportunities.

First, Marc Lasry of Avenue Capital said that generating outsized returns required buying from "uneconomic sellers." He cited $2 trillion of non-core assets that would need to come off European bank balance sheets to meet regulatory restrictions. This year's migration of $150 billion was expected to expand to $200 billion in 2016.

In the US Lasry identified energy, where borrowers' "issues have issues," as needing financing the most. BDCs and hedge funds benefit from locked-up capital so are well-positioned against the $300 billion in distributed energy debt.

Perception of risk creates volatility, top BDC and asset managers reported, not necessarily risk itself. In fact, market liquidity and volatility are distinctly separate issues. As Eaton Vance's Scott Page pointed out, the broadly syndicated market has been through decades of cycles with no redemption problems for asset holders.

On the topic of middle market credit, David Golub emphasized that extracting value meant finding ways for investors "to access the asset class." That involved experience with multiple sponsors and companies, and "private equity style due diligence."

Under the rubric *"Breaking Bad: Credit Risks and Rewards,"* BDC maestro Jonathan Bock led a roundtable on the outlook for defaults. Moody's data show higher rating downgrades than upgrades – a trend that historically has been predictive of a downturn.

After a lively recounting of KKR's history (including his initial $10,000 investment in 1976 with his cousin, George Roberts), Henry Kravis reiterated that long-term capital was key to energy investing – an informed view from someone who grew up in the oil patch.

A panel of alternative asset managers (Ares, Babson, CPPIB, and New Mountain) discussed the competitive landscape. Those readers familiar with our "cargo pants" thesis [link] will appreciate this related poll question: "*What's the most important competitive feature for a manager?*" More than two-thirds of the audience replied: "*The ability to have higher hold levels.*" Only 32% answered: "*The ability to syndicate.*"

Even when a syndication is involved, “selling down middle market loans is a risk management exercise, not a distribution effort,” one panelist said. All managers agreed, given where we are in the business cycle, knowing who your lending partner is has never been more important.