Swiss Army Knife of Capital (Part Three)

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During the recent PDI webinar we were asked, beyond yield, diversification, and deployment, what private credit areas are most vulnerable? What scenarios could likely create problems? These questions are excellent ones, because they allow us to tease out the differences among private capital managers, not just throw the entire asset class out with the bath water.

For inexperienced or under-resourced managers there are potential pitfalls. As we discussed last week, under-deployment is a major problem for investors. Unlike, for example, the broadly syndicated market, where CLO managers can access a relatively large number of well-traded secondary loan opportunities, middle market loans don't trade.

While the primary large cap loan market has boomed this year, the vast majority of this activity is refinancing or repricings. That means CLOs and retail funds likely already have the assets in their portfolio, so rolling into the new deal doesn't help volume much and probably hurts yield.

For direct lenders who can't originate strong, differentiated deal flow, the challenge is the same. They must rely on participations accessed from leading deal arrangers. Leading us to the second area of potential vulnerability: adverse selection. Given the extraordinary appetite from those arrangers' investors, any exposure being sold to smaller lenders may carry higher risk.

Note too that when research agencies publish data on the direct lending market, it covers all managers, regardless of credentials or capability. As our *Chart of the Week* highlights, lower industry volume this year does not necessarily reflect the experience of leading players.

Not surprisingly, lower quality incoming flow can easily lead to poor portfolio performance. What you end up with isn't great for investors either. All this becomes a non-virtuous cycle. A problem portfolio hurts the manager's track record. This impacts fundraising, making it difficult to commit enough capital to be relevant to the best private equity sponsors and borrowers. Adverse selection is thus reinforced, hurting fundraising, and so on.

Finally, there's mission creep. Managers under pressure from various dynamics in their existing business may find themselves looking to other credit strategies with higher yields, fewer competitors, but more risk. Given the current narrative around traditional direct lending ("crowded space, too competitive"), less-traveled specialty arenas are tempting targets.

But unless your team has the requisite resources and investment experience, the result will be suboptimal performance. Sticking to your knitting is still the best investing approach.

Ultimately, we believe private capital acts like a Swiss Army knife for investors by its capability of solving portfolio issues and providing corporate or PE owners with capital solutions in any market. Its uses and benefits are universal tools that have worn the test of time, continuing to grow in sophistication and adapt to meet the needs of a still uncertain future.