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Private Credit and Business Cycles (First of a Series)

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Just when we thought we were out of the economic woods with a strong report on April jobless claims (lowest since 1973), there came the 1Q GDP report showing anemic growth of 0.5%. That was enough to send equities down over 1% for the week.

This good news-bad news pattern is discouragingly familiar to market observers. No sooner does momentum of a real recovery in the US economy seem to take hold, when it gets knocked back by recession-ahead warnings.

Yet among some cognoscenti in capital markets, the economy's lack of clear direction points to opportunity in private credit. According to Christopher Godfrey, a partner at CEPRES GmbH, private credit has performed well in down markets. "When stock markets go down, everyone gets nervous," he told us. "That impacts the buyout market as well as traditional financing. That's when the banks pull back."

Backed by the firm's data reporting that goes back to the 1970's for private equity and mid 1980's for private credit, CEPRES sees a direct correlation between buyout and public markets. During the boom years, buyout pricing tracks to stock markets, Godfrey says, and there's plenty of financing available. During volatile times, traditional credit sources dry up and private debt steps into the vacuum at better yields.

"There's a counter-correlation with private debt," Godfrey said. "And more downside protection during the downturn."

CEPRES' data base consists of 2300 funds and 35,000 portfolio company investments, including private equity, private credit, infrastructure, and real estate. This includes a universe of 330 North American private credit funds of which about 130 currently report. Direct lender GPs and LPs feed CEPRES direct deal cash flow data and CEPRES calculates yields, default rates, and recovery rates, etc.

"We've seen improved recovery rates for private markets since the crisis," according to Godfrey. "Of course, it varies by strategy and region, but the metrics are much better than pre-crisis. Recovery rates are a good indicator of manager and market discipline which is a positive sign for investors. Default rates are also flat. Rising default rates can be a leading indicator of market stress, so this is a good news despite high leverage and pricing in equity markets."

So where are we in the cycle? Are we closer to a real recovery or a recession? Godfrey sees evidence of both. He says history points to a striking theme.

"If you look back over twenty years and compare lower quartile returns of buyout deals with private credit deals, buyouts have shown negative returns in eleven of the last twenty years. During that same period, private debt has had only two down years. This clearly shows private debt has significantly less downside risk than buyouts."

"We tell investors it's a great hedge. If you are concerned about overheating markets, you should think about hedging with private debt and reducing your buyout allocation."

For further insights from Christopher Godfrey and other leaders in middle market debt finance, join us at the 23rd Annual Atlantic Conferences Symposium on Mezzanine and Middle Market Debt Finance. [link]