BARINGS

PRIVATE CREDIT

North American Private Credit: Assessing the Landscape

INSIGHTS

The North American private credit market seems to be adjusting well to inflation and rising interest rates, but changes are likely coming, especially if a recession emerges and/or if rates remain elevated for longer than expected.

A Time of Transition

Compared with the last time a recession loomed, the North American private credit market today certainly looks to be in a stronger position. Loan-to-value ratios are now in the 40–50% range compared to ratios in the 60–70% range in the wake of the global financial crisis in 2007 and 2008, providing much more of an enterprise value cushion and incentive for PE firms to support portfolio companies.[1] Going into a potential dislocation, interest rate coverage is much stronger now at around 3x, versus 2x in 2007, although coverage has deteriorated with the rate hikes.[2] The asset class also benefits from having greater liquidity today than it did before the crisis, when balance-sheet capital at financial companies and insurers was constrained. Until now as well, many companies have been able to raise prices to reflect higher costs without affecting customer demand. Companies also are working on ways to reduce expenses and improve margins.

However, while there are many signs of stability, it is also important to recognize that a lag exists between the time base rates start to rise and the time their effects start to be felt. When second- and third-quarter financial results arrive, it is likely that the impact of rising rates and higher inflation will become more evident. That is when the value of well-constructed portfolios of good companies and the experience of lenders and managers will become apparent. We believe that a conventional recession will reveal the true strengths and weaknesses of managers, and wider and more fundamental disparities in manager performance will be more pronounced.

Current Market Dynamics

One aspect of today's market that is different from the past is the increased presence of new lenders, many of which have never experienced a conventional recession. If a downturn is indeed coming, it could present challenges, particularly if the downturn is longer or more severe than expected. While many of the newer platforms were able to make it through the stress surrounding the onset of COVID, that was relatively short-lived. A conventional, six- to 18-month recession would be a much different story.

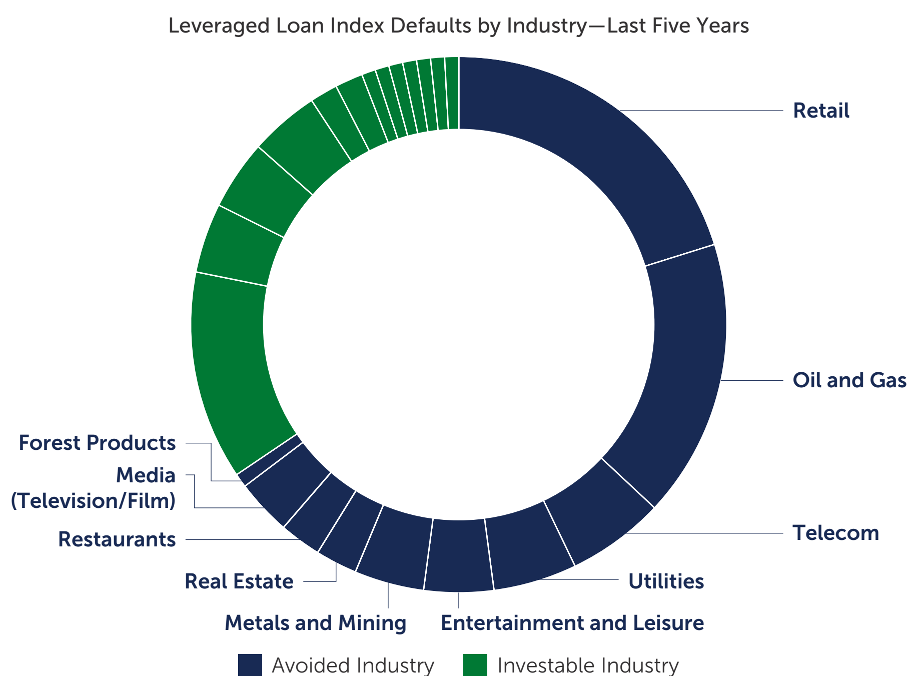
In a challenging economic and geopolitical environment, experience will ultimately win out. Experienced lenders with a large book of portfolio companies have the ability to continue to invest in new originations through portfolio M&A activity despite the economic headwinds. Essentially the buy-and-build investment thesis continues to make sense for lender and PE firms alike. For PE firms, it is a strategic way to add value and reduce their cost basis with add-ons at lower purchase price multiples. For lenders, it is the opportunity to put new money to work augmenting and strengthening the portfolio by investing in companies they know best, and—through successfully integrated acquisitions—make these portfolio companies bigger, better and more diversified credits. For managers not in this position, it is a daunting time to invest in new platform companies, let alone construct a portfolio of companies that truly have fundamental value and a reason to exist and survive a cycle. Lenders must be more cautious in a market like the current one to avoid potentially troublesome situations. In a challenging and anemic M&A market with lower-quality deals, assessing a company's true value has become much more difficult due to rising rates and higher inflation. Instead of scrambling for fewer and possibly riskier new deals—the position in which many new lenders now are finding themselves—experienced lenders can sit out the turbulence and instead look to bolster their existing portfolio companies with strategic acquisitions.

Against today's uncertain backdrop, diversification in portfolio construction is as critical as ever. To the extent that diversification can be maximized or optimized, portfolios remain in a position to potentially generate targeted returns even if one or two companies encounter troubles that may lead to losses. Indeed, managers that have constructed well-diversified portfolios are in a much better position to weather the turbulence that can arise when the business climate turns stormy.

1. Source: PitchBook. U.S. PE Middle Market Report Q4 2022. As of December 31, 2022.
2. Source: PitchBook. U.S. PE Middle Market Report Q4 2022. As of December 31, 2022.

Also, industries that tend to experience defaults in recessionary times often are repeat offenders. Portfolio construction to avoid those industries is critical, particularly given the illiquid nature of private credit investments, which suggests that holders cannot easily sell out of their positions. At Barings, we tend to avoid all commodity-related businesses, such as oil/gas and metals/mining, cylical businesses as well as anything with a consumer trend risk including restaurants, retail, health clubs and leisure. These typically are the first and hardest hit in times of pressure.

Figure 1: Leveraged Loan Index Defaults Often Concentrated in Sectors With Consumer Trend Risk



Source: S&P LCD. As of June 30, 2022.

A Likely Watershed

If business conditions do take a turn for the worse, it is likely that the landscape of managers and capital providers will shift. Since so many of today's managers have never experienced the downward phase of the cycle, they may not have a playbook for more challenging times. They may also lack experience when it comes to working out a portfolio of middle market loans, which often entails getting into the trenches and working directly with smaller companies. That process is labor intensive, resource intensive and capital intensive, as portfolio companies often require liquidity to manage through a downturn. For those reasons, recent entrants into the market may find they do not have the bandwidth to undertake and complete the work that will need to be done.

Going forward, one pressing question is whether the newer managers who have made large commitments to megadeals will have enough capital to support their portfolio through the tough phases of a full cycle. Some of those larger companies are inevitably going to need a large amount of capital. Since these are not going to be $10 million or $20 million fixes, it is likely that a downturn will usher in a period of dislocation and, most likely, consolidation among managers in the private credit market. For established players with ample capital, this is likely to present an opportunity to attract and retain talent. Experienced managers also look well-positioned to benefit from the inflow of capital to private credit as institutional investors increasingly recognize the attractiveness of the asset class and its performance. In what looks to be an upcoming watershed moment for the market, those struggling in private credit may be left behind.

Which Half of the Glass?

By nature, credit professionals tend to view the world from the perspective of the glass being half empty. Experienced managers tend to understand the value of discipline and are often more focused on the downside and committed to risk mitigation.

At Barings, we place a strong emphasis on discipline and on choosing high-quality companies. As part of our risk-mitigation efforts, we stress-test portfolios regularly to ensure the ability to service our debt as well as maintain ample cushion on our earnings and cash flow-based covenants. Over the past eight years, our comprehensive risk-assessment and risk-mitigation efforts also have included screens for environmental, social and governance (ESG) risks.

When the next recession—probably the most widely anticipated in history—comes to pass, the value of partnering with managers who have maintained a disciplined approach to the asset class, rather than chasing yield through higher leverage or looser covenant structures, is likely to become clear. Since every recession is different, managers can't know with certainty how each company in their portfolio will perform. But being proactive and following a time-tested playbook are likely to be advantageous. Perhaps most significant for investors, however, is having a manager who invests alongside them and has a stake in the downside as well as in the upside.

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