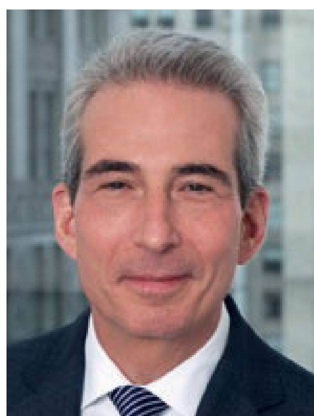
EXPERT Q&A

Yields from private debt are currently at decade highs, potentially making this a very attractive vintage for the asset class, says Bill Sacher, partner and head of private credit at Adams Street Partners



The compelling opportunity in mid-market credit

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Q We are in what has been described by some market observers as a 'golden age' for private credit. What makes it such an attractive time to be investing in the asset class?

I don't love the term 'golden age' but for a number of reasons I do think this is likely to be a very attractive vintage period for the asset class. For a start, in our opinion base rates are likely to remain relatively high as compared to the past 10 years, so the yields that can be obtained in private credit are at decade highs.

In addition, the risk profile of these investments is generally lower, which is the aspect that we often hear makes the opportunity so compelling, given some of the looming uncertainties in the market. That combination – high yields that compare favourably with most credit investment alternatives, and the ability to play defence at the same time – is unusual and can make private credit particularly well suited for the times.

While in the intermediate to longer term time horizon, there is an expectation that interest rates are more likely to come down rather than go up, they are also likely to stay higher than the levels we have experienced over the past decade. In our opinion, we are entering a period with rates returning to historic norms. Even in the optimistic scenario where inflation does come down to the Federal Reserve's 2 percent target, we are likely looking at interest rates of 3 to 4 percent, which we believe should favour private credit yields.

Q But there are always potential downside risks, so what do you see as the main challenges facing the sector?

The challenges include inflation, which has taken its toll on company earnings and margins. In addition, companies that financed in a low interest rate

Q In this kind of environment, is it preferable to be a club participant or to have lead lender status in a mid-market buyout transaction?

We do go to market as a lead lender and we achieve that role in 80 to 90 percent of our deals. By being lead, we believe we can pick up some important advantages, which start on the underwriting side.

We generally have better access to the underlying companies because we are brought into the investment at the very front end, while the private equity sponsor is evaluating the investment opportunity themselves. During what is typically an eight- to 10-week period, we get access to all the company files and records, to the management team, and we receive all third-party reports, so we are ultimately making the investment decision based on our independent work and access to the raw data. We are determining the underwritable EBITDA figure, for example, rather than being presented with that number by someone else.

Once the private equity sponsor owns the company and is in the market to club up the financing, lenders don't have the same access to the borrower. So being a lead lender allows us to obtain insight into the underlying investment that is hard to obtain otherwise.

Lead lender status also typically allows us to exercise direct influence over the capital structure design, negotiate the covenants using our own loan documents and get paid incremental economics.

To achieve lead lender status, you do need significant AUM scale to be able to commit to most, if not all, of the underlying financing. You also need to have the infrastructure to perform fundamental due diligence and the role of administrative agent. And, most importantly, you need to have a reputation in the market for being an effective lead and a credible source of that lead-orientated finance.

environment at high debt multiples are also experiencing pressure on their ability to service debt and meet their fixed charges.

From an investor perspective, in this environment manager selection is paramount. In the low interest rate environment that characterised the last decade, we saw very little dispersion between investment manager returns because there were few defaults and most managers were earning their coupons. That made it difficult to discern one manager from the next. If interest rates do stay higher for longer, we believe we'll begin to see dispersion in manager returns and that will start to reveal the skillful managers from the rest.

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Managers need more than capital today – they need to differentiate themselves in the market with a competitive advantage. At Adams Street, we have been investing in private equity firms for 50 years and our relationships are broad and deep. Being an actual limited partner in the funds you are hoping to obtain dealflow from represents a significant competitive sourcing advantage that very few debt providers possess.

In addition, our experience operating through multiple cycles and the knowledge advantage that comes from it provide invaluable insights that inform our credit selections. These advantages are extremely difficult to replicate.

Q On the other side of the ledger, what do you see as the drivers of opportunity for private credit?

Private credit is still filling the void left by commercial banks that were historically the primary providers of debt capital to middle market businesses. Those companies are numerous and represent, by some estimates, 30 to 40 percent of US GDP, therefore driving a significant proportion of demand for

Q When you are targeting opportunities in a market such as Europe, or seeking business through established relationships with GPs, how important is it to have an established private markets platform to leverage?

For us, from a competitive standpoint, it is extremely important that the firm has an institutional relationship with private equity sponsors that spans decades. So, as long as our lending terms are competitive, we find that the vast majority of those 'jump balls' tend to break our way because of the institutional relationships we have enjoyed for so long. You can probably count on one hand the number of our competitors that can say they have the same.

We are one of the world's larger primary private equity investment managers, and that business represents the majority of our $59 billion in AUM. We are invested in hundreds of private equity sponsors, and they align almost perfectly with our private credit target market.

As an analogy to illustrate the importance of these relationships, if you owned a business and you had an investor who was competing to provide a service, and they were equivalent in every way with a competitor that was a third party, who would you pick? We don't have a 100 percent win rate, but it is pretty high.

underlying debt capital. So the opportunity set is quite vast.

In terms of sector preference, we are generalist by design, trying to build portfolios that are highly diversified by both issuer and sector, so we try not to make any big bets. That said, right now the sectors that we are favouring are more defensive and less cycle-prone. Those would include aerospace and defence, healthcare and non-discretionary consumer products and services.

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Q And what about regionally? Do you see opportunity in particular geographies?

We operate in the US and Europe, and view the opportunity set in both as being quite attractive right now for all of the reasons we have discussed. The drivers are also relatively similar, starting with the banks withdrawing from markets. Europe is maybe a few years behind the US in that development, but clearly moving in the same direction.

Adams Street has been investing in Europe for over 35 years and has had a presence in the region for that same time period, so our relationships are as deep in Europe as they are in the US, and we are enjoying many of the same competitive advantages with regard to dealflow and lender status in Europe that we have in the US.

One of the differences in the European market versus the US is that creditor rights and remedies vary from country to country. So one definitely needs a local presence and expertise to be able to structure a deal in each market. Aside from that, we see the opportunity set being driven by private equity as very similar on both sides of the Atlantic. ■

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