January 26, 2023

RPM Ep 24 Transcript

MY: [00:00:00] Welcome to RPM, the podcast that explores the world of private markets. I'm your host, Maribel Yoo. We recently issued our 2023 market outlooks. Joining me to discuss the private debt market outlook for 2023 are two members of our private debt team, Ariel Goldblatt, partner based in our New York office, and Mark Tsang, a managing director based in London. Thank you both for joining me and welcome to our RPM.

MT: [00:00:22] Thank you for having us, Maribel. We're looking forward to the discussion today.

MY: [00:00:26] Sounds great. There are a handful of themes impacting private debt performance. And in this year's outlook, you've pointed out how some macroeconomic factors are expected to affect the asset class from a shift in monetary policy to a resilient US job market. What are the key drivers this year and how do you think they'll impact private debt?

AG: [00:00:44] Thanks, Maribel. A very timely question. The key driver impacting the private debt market include inflation. Hard to miss. Inflation is expected to have peaked in 2022 and moderate in 2023, but still remain above our central bank targets throughout 2023. This has an implication on corporate revenue and costs depending on how fast companies can actually pass on increasing costs to their customers. This likely can lead to much tighter corporate margins. The second thing I want to talk about is monetary policy and interest rates. Aggressive monetary tightening in 2022 has led to higher base rates, and as a result, overall higher return expectations for private credit. On the flip side, the rise in interest rates could further strain tighter corporate margins and result in liquidity challenges. This could lead to borrowers needing to seek more creative financing solutions due to these cash constraints, which provides an opening for opportunistic strategies. And then from a corporate growth perspective, a recession would negatively affect EBITDA growth and likely adjusted EBITDA, which could result in potentially higher leverage levels and tighter free cash flow fixed charge coverage levels.

MT: [00:01:54] I think also what's interesting, in addition to interest rates and inflation, that Ariel has mentioned, I think just across the economy, you've got geopolitical tensions, you've got impacts around the supply chain and energy supply and potentially an upcoming recession. And a lot of these factors, you know, we've seen an increase in pressure on corporate liquidity, and that develops an uncertainty around how to approach underwriting and structuring on financing transactions. And I think the focus on corporate liquidity is interesting because I think, you know, how we look at private debt, we're seeing dislocation across the whole ecosystem. So if we observe capital markets, there's been a liquidity shortage in capital markets and the market closing there around issuing syndicated loans or high yield bonds. And so we observed opportunistic credit coming into that arena to kind of essentially plug that shortfall of liquidity. You also see an equity market valuations come down that makes it increasingly dilutive and expensive to raise equity capital. And again, we're seeing opportunistic debt funds come in there as an alternative to equity. And then again elsewhere in the ecosystem, we've seen LPs looking to rebalance their portfolios, potentially setting stakes and again, another investment opportunity for buyers. And then again, other players include private equity GPs, private debt GPs needing capital, as well as banks looking to reduce assets. So I think, you know, the way we looked at the private debt market is that there's impacts across the whole ecosystem and not just at the corporate level.

MY: [00:03:43] That's helpful perspective on both private debt market and the private markets ecosystem as a whole. Now, given the uncertainty in this current environment, can you talk about why you believe this strategy is an all-weather* investment solution?

MT: [00:03:55] Maribel, Interestingly, the number one top of mind question we have been receiving is does it make sense to invest in private debt in this market? To tackle this question, I want to first highlight a chart that came from a research report BlackRock published in August 2022. This chart shows that the expected return projections for private debt falls in the high single digits to mid-double digit range. If you compare that to the public markets, which are showing low to mid-single digits, you can see there is a significant premium to investing in private debt. Secondly, we've tracked historical volatility of the private debt market versus the public equity and the public debt markets. And the private debt market has experienced much lower volatility than the public markets. For example, over the great financial crisis and COVID periods, the direct lending market only declined 5 to 8% versus the high yield and leveraged loan markets at 20% plus. As you can see from a risk adjusted return perspective, private debt is expected to achieve higher returns with lower volatility than the public credit markets. From our perspective, this means it is a great fixed income replacement, but also given the ability to achieve double-digit returns, it can also be a very defensive equity replacement strategy given you are the top of the capital structure.

MT: [00:05:10] I think in addition to what Ariel talked through, I think a lot of that definitely relates to direct lending around more credit opportunity strategy. Kind of what we're seeing through the cycle is that there's always the need for capital solution for complexity. I think we're seeing complexity throughout the cycle and so that dictates a certain level or whether activity in that complexity could arise through being able to navigate certain transaction processes, whether you need regulatory approvals or whether there's a tight timeline to that transaction. I think during COVID, we saw a lot of companies needing capital to bridge essentially a period of time where they had depressed cash flow generation. So I think we see even on the credit opportunity side, an all-weather* nature around the need to solve for complexity. However, when there is a dislocation, we do see elevated volumes in deal flow as well as potential returns.

MY: [00:06:16] Great. Now, earlier you both touched on key macroeconomic drivers. What do you consider to be drivers for the continued growth and performance of private credit?

AG: [00:06:24] Yeah, there are several factors that will further drive the growth and performance of private credit. First, this is a floating rate product. As a result, increases in base rates positively impact overall returns. Second, private credit has much lower volatility, as we discussed before, because it has a contractual coupon that is paid quarterly. This leads to a very stable cash yield for investors. Third, private credit tends to have lower losses due to its senior position in the capital structure. And lastly, private credit loans are short duration with most loans refinancing every 2 to 3 years.

MT: [00:07:00] And to add to that, I think from a, in a very simplistic way, you know, we're going to see continued disintermediation of banks. You know, we feel that in a private debt is still a relatively under-penetrated market. If you were to look at private debt AUM as a whole versus the private equity market, private equity is still five times larger by AUM. And if you look at where equity and debt, how they sit within the capital structure, you know, we do think that private debt should be of a similar size to private equity. So there's definitely a lot of room for growth that other areas where we see that will drive the growth of private credit is that there's an increasing sophistication of the private credit solutions for companies, and we're seeing the evolution of more sub strategies and we'll touch a bit on that later. But around kind of credit specialty finance strategies, for example. We're also seeing a great sophistication of CFOs get comfortable with private credit solutions going beyond just direct lending. And that sophistication is also increasing the uptake of debt fund solutions.

MY: [00:08:19] Now, I'm sure our listeners would love to hear more about the current investment environment. Are there any specific observations to note as we think about the direct lending market over the next 12 months, compared to this time last year?

AG: [00:08:34] Yes, and I think there are four areas I want to touch on. First is pricing. Second is volumes. Third is lending terms. And the fourth is fundamentals. So as we think about pricing, as we mentioned earlier, the direct lending market is priced variably. This means as the base rate increases, lenders benefit. So, for example, about 12 months ago, the SOFR floor or the SOFR was at about 25bps. Today it's over 4%. So add that 4% to the 625bps+ coupons you're getting in this market, in addition to the OID, and you get a double digit return on a very plain vanilla direct lending loan. And then as you think about volumes, you may think great, pricing is up a lot. But can you actually deploy in this market given M&A volumes are down? And the answer is yes. And this is driven partly by bank retrenchment, meaning that the syndicated loan market is essentially shut down and banks have retrenched from the market, as well as the fact that sponsors have more than five times the available dry powder as direct lenders, meaning that there is still significant deal flow available, but only for the best borrowers. And then as we think about lending terms. In a more challenging market environment, terms become much more lender friendly. Covenants, for example, have become much more common, even in larger EBITDA borrowers as well as does overall tighter terms. Right? Lower leverage, better cushion from an equity perspective. Et cetera. And then lastly, as we think about fundamentals, given the lower growth expectations, corporate fundamentals are expected to moderate. Diversification as a result is key in private debt. And it's free. It is also highly beneficial to be at the top of the capital stack in a senior secured position.

MT: [00:10:19] Just to add also to Ariel's point, around the dry powder is going to be accessible to kind of the highest quality borrowers. So there's a certain element of what happens with other borrowers and kind of looking into the market, where's that liquidity going to come from? So I think going over the next kind of 12 to 24 months, quite a few of our financing refinancings are coming up with upcoming maturities. So I think there's definitely an element increase in and activity around amending extends. But it's also interesting to keep track and see how some of these capital structures might play out. I think you're seeing situations where new capital is coming in. And that new capital from another lender group could come in, in a super senior, could come in, junior could be in the form of structured credit. Or there could be situations where you're seeing sponsors injecting equity. You might get scenarios where existing lenders will have to take haircuts and there could be restructurings. But I think you're going to see a multitude of different kind of scenarios on how some of these capital structures might play out. And something we're observing also is that potentially there could be lower levels of defaults relative to the global financial crisis, where we're seeing more lenders coming in before a default happens to help the borrowers trade through what may be a difficult period.

MY: [00:11:49] Ariel, earlier you had briefly touched on a defensive strategy. For those interested in implementing the strategy. Can you walk us through the difference between defense and offense when it comes to private debt?

AG: [00:11:58] Sure. I'll tackle defense and I'll let Mark tackle the offense piece. But, you know, direct lending is a through the cycle product and we are coming into a period with much higher returns, as we discussed earlier. In addition to just base rates coming up, we also are seeing much better terms in coupons. And then as we think about private debt and investing in this market from a defensive position, our view is that diversification is free. So make sure you have a very well diversified portfolio. Make sure you're also senior in the capital structure and that you are selective in your manager selection. And those are kind of the advice I would give in this market. And I'll let Mark tackle the offensive piece.

MT: [00:12:43] Yeah, I think, you know, definitely as Ariel highlighted, one of the key points on defense is the point around diversification. And then on the offense side, I think the key, the key characteristic that we're looking for is actually flexibility. And that's essentially how we see it. You know, how we explained earlier on the podcast around, you know, we're seeing opportunity sets evolve across the whole ecosystem. And being able to predict when these opportunity sets arise is going to be it's going to be difficult. And so how we sit is maintaining the flexibility to be able to move capital into those opportunities sets as and when they arise. So, you know, examples of kind of how we how we look to set ourselves up on our platform, prepare our capital is that, you know, there's the capital solutions opportunity set where we just walk through companies needing liquidity. And then there's kind of more niche strategies that are growing where there, for example, something like credit specialties, where there's an element of non correlated strategy and you can lend against asset values in inflationary environment. And given they're relatively niche, there's definitely a supply demand dynamic in their favor, allowing them to negotiate more attractive terms with borrowers. And then obviously you also have the distress opportunity set and kind of as we see greater levels of defaults, I think there's opportunity to invest in there, but there's going to be multiple opportunity sets. And I think the key point we see on the offense side is to maintain flexibility to be able to move capital into opportunity assets as and when they arise.

MY: [00:14:30] I appreciate you taking the time to walk us through that strategy. Thanks again for joining me today. Take care and look forward to catching up with you both soon.

AG: [00:14:37] Thank you for having us, Maribel. We appreciated the interactive discussion.

MT: [00:14:40] Thanks very much, Maribel, for having us on the podcast today.

MY: [00:14:43] Absolutely. That does it for this episode of RPM. Thanks for listening. For more research and information on private debt at Stepstone, visit us at Stepstone Group.com. RPM is available on Apple Podcasts, Spotify, Stitcher, and other podcast platforms.

*"All-weather" refers here to private debt as an asset class. It is expected that a broadly diversified private debt portfolio may generate long-term attractive returns in favorable market environments, while reducing volatility and maximum drawdowns in adverse market conditions.