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Private capital themes: Four for '24

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2023 was characterized by several key themes in the capital markets: the U.S. Federal Reserve's battle against inflation; the resulting impact on issuers of higher-for-longer interest rates; a much slower pace of merger and acquisition activity as buyers and sellers dealt with mounting borrowing costs, valuation discrepancies and choppier portfolio performance and the steady disintermediation of buyout financings from public to private credit.

*We believe that 2024 may usher in a new **"Goldilocks"** era of growth and opportunity in private capital. Themes that are shaping that outlook include:*

1. ***New normal rates:*** The new macro environment and what it means
2. ***Winners and losers:*** Continued dispersion from multiple market dimensions
3. ***Stay alive to thrive:*** Portfolio excellence sustains investment activity
4. ***Next gen private capital:*** Financing technologies, the next phase of applications

These dynamics have put private capital, both private credit and private equity, in the spotlight. Our goal in this paper is to illuminate the emerging trends and complex dynamics of the private capital markets. And to separate market realities from persistent myths.

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Some have raised concerns about private credit's rapid growth and expansion in popularity with both issuers and investors, conflating "growth" with "risk." But we believe it is a mistake to attribute the historic behavior of public credit under stress with future private credit performance.

Additionally private equity's growth throughout 2023 raised concern for some due to persisting overallocation; first driven by the denominator effect, and second driven by materially depressed levels of distribution activity. We enter 2024 with a complex environment to make allocation decisions across private equity strategies.

We have identified four trends for 2024 emerging from the current market dynamics that will impact deal making and fundraising. These themes reflect the complexity of capital formation and the nuances of asset management. But they also illuminate less understood features of our core private capital strategies.

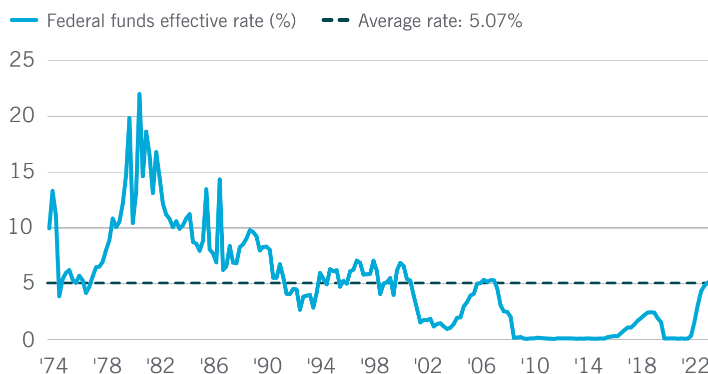
1. New normal rates: The new macro and what it means

In June 2006 the federal funds rate rose to 5.25%. This was the highest level for the benchmark since early 2001. The global financial crisis of 2007-8 ushered in more than a decade of generations-low rates, a period that finally ended in March 2022. Because many younger financial professionals began their careers during or after the 2008 downturn, their career experience has been limited to near-zero interest rates. That leads potentially to a false sense of confidence in the ability of more leveraged borrowers to withstand significantly higher rates, economic slowdowns and recessions.

Over the past fifty years the average fed funds rate has averaged just over 5%, close to where it is today. For credit managers such as Churchill, whose investment committee members have decades of investing experience, the new higher-for-longer environment is familiar. Indeed, tighter systemic liquidity is seen as favorable to credit buyers, given the tighter structures, lower leverage and expanded pricing. It also keeps market conditions from becoming too frothy.

Figure 1: U.S. federal funds rate close to 50-year average

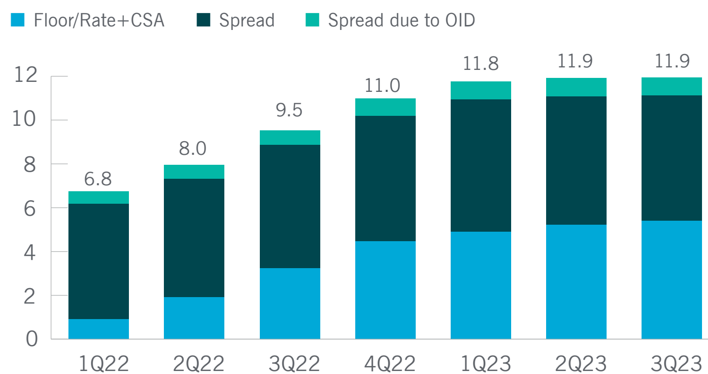
Historical federal funds effective rate



Source: Board of Governors of the Federal Reserve System (US)

Figure 2: Better pricing in a higher-for-longer rate environment

Average first-lien middle market term-loan yield



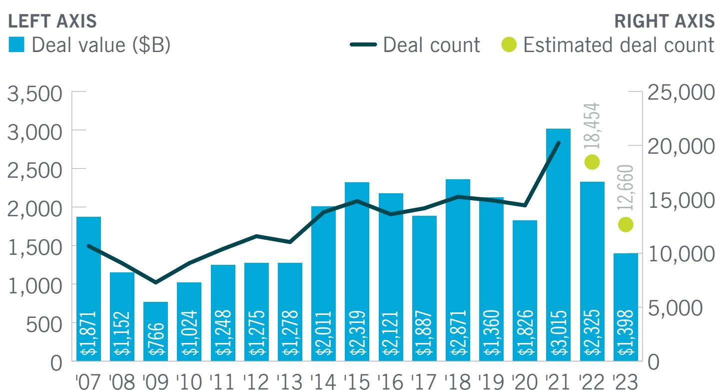
Source: LSEG LPC

While the Fed has signaled a halt to further rate increases, and instead has indicated at least three rate cuts in 2024, the longer-term outlook for inflation remains uncertain. The strength of the economy combined with pent-up financing demand suggests the pace of cuts may not mirror the pace of upticks we encountered in 2022-2023. If that happens, we may not see a return to near-zero rates soon.

This may be a "golden era" for credit investors, but it has been a challenge for issuers. With

interest rates easing, we expect a more forgiving financing environment for private equity sponsors. Considering the depressed levels of merger and acquisition activity during 2023, owners have been slower to achieve realizations for their LPs. With more favorable all-in debt costs, equity returns should start improving, accompanied by a more accelerated deployment of dry powder for 2024.

Figure 3: Slower M&A activity



Source: PitchBook Data As of 9/30/2023

However, these trends are also tailwinds for portfolio performance. A lower benchmark will bring interest and fixed charge coverages back to more comfortable levels and allow borrowers with payment-in-kind (PIK) instruments to activate cash-pay options.

In the first half of the year, our expectation is that absent a GFC-level recession, we expect the Fed to steer clear of another 2010-2022 era stimulus or attempt to wring out every last basis point of inflation to achieve a perfect 2% CPI landing. We could then be in for a more balanced economy with rates closer to old averages.

Instead of a "golden era" in private credit we could arrive at a new normal that benefits both borrowers and investors – a "Goldilocks Era" in private credit.

2. Winners and losers: Continued dispersion from multiple market dimensions

In the ever-evolving market landscape, the current multitude of macro pressures and broader uncertainty have combined to fuel an intriguing dispersion effect across multiple dimensions. In 2024, we expect to see continued dispersion across three key market participants: private capital asset managers, private equity firms and portfolio companies. As we navigate the risk of slowing economic growth, volatility and geopolitical shocks, it is even more critical to identify the attributes of both winners and losers in a rapidly changing environment.

The winners in today's market have a variety of distinct attributes.

- **For asset managers,** those with scale, diverse investment capabilities, diverse sources of dry powder and sustainable deal-sourcing advantages will thrive. These firms will continue to secure the highest quality deal flow, build the most resilient portfolios and attract the most diverse capital base, fostering resilience in any market cycle.
- **For private equity firms,** those with ample dry powder and a proven track record of valuation discipline will prevail as the "buyer of choice" for the best platform investment opportunities. These firms will adapt more quickly to the new normal for rates, developing multi-dimensional value creation plans that do not rely solely on financial markets for growth.
- **For portfolio companies,** those who have adopted prudent balance sheet structures or leveraged bifurcated financing strategies that offer PIK flexibility will be best suited to pursue organic and inorganic growth opportunities. These companies will further diversify their platforms, allowing them to protect and enhance profitability and cash flow generation – even more valuable in a higher rate environment.

There is no clearer example from 2023 than a private equity allocator active in both primary

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LP commitments and equity co-investment. The stark correlation between distribution activity in one's primary portfolio sustaining co-investment dry powder became visible throughout the year. Churchill experienced significantly less competition in the equity co-investment market as those institutions with typically only one source of dry powder for both primary LP commitments and equity co-investment exited the market as distributions continue to wane.

Conversely, the losers have taken the opposite approach in each of these categories. Asset managers lacking scale, comprehensive capabilities and struggling with deal origination will face significant hurdles or find themselves on the sidelines in an already slower deal environment. Similarly, private equity firms lacking valuation discipline and without sufficient dry powder or the ability to raise new or larger funds will fall short in competitive processes where value-added partnership counts most. Portfolio companies with aggressive capital structures and significantly higher cash interest burden will find themselves at a disadvantage, shifting all available cash generation to debt service and compromising on growth initiatives with little cushion to weather economic turbulence.

The dispersion effect across these key market participants will be a pivotal investment aspect in the year ahead. Gone are the days of hiding in the middle. Mediocre performers will likely diverge into more distinct camps of winners and losers. The strategies adopted by winners – embracing scale, cultivating diverse capabilities, leading with true sourcing advantages, exercising valuation discipline and maintaining conservative and flexible balance sheet structures – will highlight a brighter roadmap for success in 2024.

3. Stay alive to thrive: Portfolio excellence sustains investment activity

The gap between winners and losers will only be accelerated as today's winners continue to thrive in the current market. Private capital managers with healthy, high-quality portfolios can and will continue to play offense and take market share. We see this in Churchill's own portfolio, with the firm closing or committing more than $11 billion in 2023, effectively equaling its 2022 all time record, despite material softness in the overall M&A market.

What goes into creating portfolio excellence? We believe it is by following the below principles:

- **Diversification as a shield:** Diversification must be evaluated across numerous dimensions: sector, deal structure, leverage profile, sponsor relationships, company model and so on. Absolutely fundamental is position level diversification. The average position size for Churchill is ~1% across the portfolio. This intense focus on diversification minimizes the impact of any challenged investment. So, while we have certainly seen headwinds in certain areas (e.g., multi-unit healthcare, third-party logistics and digital marketing), the platform continues to play offense.
- **Flight-to-quality approach:** Prioritizing high quality assets should always be a focus, irrespective of economic conditions. By consistently backing strong businesses (in both bull and bear markets), investors can have a durable portfolio that continues to see sustained growth despite a tough environment with minimal names on the "watch-list." When thinking about quality, top of mind are businesses that 1) have strong cash flows and margins; 2) offer non-discretionary products or services and 3) operate in service-oriented, business-to-business end markets.
- **Clear alignment:** Investing behind sponsor-backed portfolio companies has been crucial to mitigating risk. GPs not only bring deep experience creating value through market cycles, but more importantly have meaningful stakes in the outcome, typically through an equity investment. In our lending portfolio, we usually are seeing sponsors contribute anywhere from 40 to 60% equity. This creates a real commitment to drive a positive outcome ultimately and to act as a true collaborator with their private capital partner should a bump in the road arise. Additionally, by eliminating non-sponsored opportunities from the aperture, private capital investors can efficiently and wisely focus resources on the best opportunities.

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By maintaining a diversified portfolio, focusing on resilient sectors, and mitigating risk through strong alignment, private capital investors will not only survive challenges but can also thrive amidst uncertainty. In 2024, if overall market M&A volume picks up as expected, we believe that these winners should be very well-positioned for sustained growth.

4. Next gen private capital: Financing technologies, the next phase of applications

In the absence of fully functioning public markets during the Fed's intense anti-inflation campaign, liquidity was drained, not just from the economy but from bank reserves, trading desks, CLO formation and retail fund flows. Of course, this was in addition to the decades-long effort by regulators to discourage banks from holding leveraged loans on their balance sheets.

The result was the steady disintermediation of buyout financings away from the broadly syndicated loan and high-yield bond markets to private credit managers. Issuers had the benefit of quick execution without relying on a syndication process and price certainty with managers holding (not distributing) debt. Simultaneously investors enjoyed the higher premiums, better protections, tighter terms, and consistent returns afforded by less correlated assets.

Lower interest rates will likely create more advantageous conditions for liquid loans as the improved equity arbitrage for CLOs supports more vehicle formation. It is a fairly typical feature of the cycle to then have banks invade the higher end of the middle market, borrowers with EBITDA above $100 million, with higher leverage, unitranche, cov-lite structures and tighter pricing.

Today the difference is that in the intervening years the largest private debt managers have armed themselves with hold levels above $1 billion for cov-lite term loans. They are also creating expertise and capacity in specialized industries, such as retail, software and technology. For traditional middle market borrowers, with EBITDA between $25-100 million, direct lenders have benefited from a wildly skewed ratio of private versus public financings. A healthy new crop of private lead agencies will produce refinancings and new leveraged buyouts for years to come.

Select middle market arrangers, such as Churchill, have also built powerful one-stop platforms, allowing private equity sponsors to choose from a wide range of sophisticated options, up and down the balance sheet, to accommodate their capital solution needs.

An example is the PIK coupon structure. Prevalent since the rise in interest rates and resulting pressure on borrowers' cash flows, securities can be structured as holding company subordinated notes, or preferred equity with the entire contractual return in the form of an accrued return. They can also appear as traditional operating company mezzanine debt investments with more PIK flexibility, allowing borrowers to still pay a cash interest component, but with a higher PIK mix.

A powerful demonstration of next generation capabilities among private capital leaders is equity secondaries. Born out of purchases and sales of LP interests in private equity funds to free up investor liquidity, secondaries are now a tool for GPs and LPs to manage portfolio issues such as navigating concentrated exposures, extending the duration of top-performing assets and wind-down tail-end positions.

Most notably has been the recent proliferation of continuation vehicles (CV). CVs refinance the equity stack of one or more businesses in a sponsor's portfolio, without a change of control. They can also extend the duration of existing holds and provide follow-on capital for accretive M&A and platform investments. The role of CVs has evolved to allow firms to hold on to high-quality assets.

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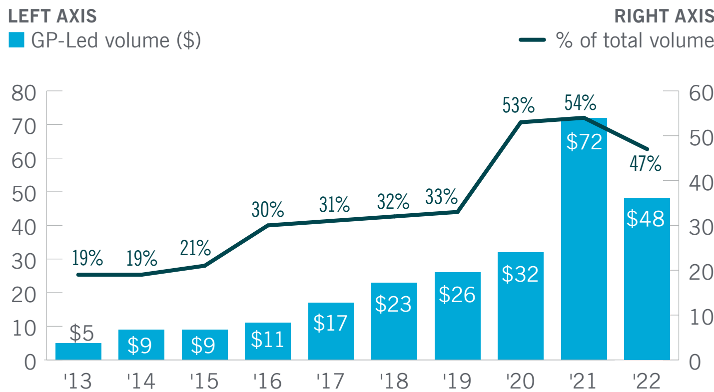
Figure 4: Increased use of continuation vehicles

GP-led transaction volumes ($Bn) & market share



Source: Jefferies, as of 31 Dec 2022

***Asset managers** lacking scale, comprehensive capabilities and struggling with deal origination will face **significant hurdles** or find themselves **on the sidelines**.*

CONCLUSION

In 2024, we expect market dynamics will create opportunity for those best positioned to capitalize on emerging market themes:

- A more balanced economy with rates closer to old averages,
- Dispersion across three key market participants: private capital asset managers, private equity firms and portfolio companies,
- High-quality portfolios should continue to play offense and take market share as M&A volume picks up,
- Increased use of next generation financing technologies offered by one-stop private capital platforms to meet the needs of the private equity marketplace.

These themes present opportunity and risk for investors in today's market. However, we believe that with careful navigation this could be the beginning of the ***"Goldilocks era"*** of private capital.

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Endnotes

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