TALKING POINTS

Asset selection is more complex than ever, but the US private debt market still offers the potential for attractive returns if you know where to look, say Churchill Asset Management's Randy Schwimmer and Jason Strife

'An excellent time to deploy capital'

Q What does the senior lending opportunity look like right now?

Randy Schwimmer: We think the vintages of 2022, 2023, and probably 2024, will be very attractive to investors in – or looking to get into – private credit. That said, the senior lending opportunity has been there all along; higher interest rates have just raised its profile. Unlevered mid-market senior loans were generating unlevered 7 percent returns for more than a decade, which was heroic in a zero risk-free rate environment, but the general investing population didn't quite appreciate it.

Recently, more institutional investors have figured out the benefits of the asset class. That and an increase in retail investor appetite has driven private credit assets under management from a few hundred billion dollars after the great financial crisis to $1.5 trillion today.

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In the last 12 months, the rise in interest rates has boosted senior debt all-in yields to 12 percent. At the same time, we see structurally lower leverage, tighter covenants and more cash equity going into leveraged buyouts (LBOs), adding to the existing benefits of a floating rate hedge, stable valuations and illiquidity premiums.

From an issuer perspective, direct lending holds a strong position in the market and remains the preferred financing option for new LBOs over public credit by a wide margin. At Churchill, we are getting our share and more of that long-term trend towards private credit because of our scale, experience and differentiated private equity relationships.

So, even though M&A activity has been off this year, we are significantly outpacing the market thanks to our competitive advantages with strong dealflow, particularly on the junior side.

Q What about on the junior capital side?

Jason Strife: We get asked the same questions about junior capital ebbing and flowing in and out of the market.

I share the sentiment that, like senior lending, the opportunity has always been there as a space to generate attractive risk-adjusted returns.

From our perspective, junior capital is not cyclical at all. We have been deploying junior capital through the most bullish credit markets because there have always been private equity firms looking for it. In fact, our high watermark investment vintage was during the most aggressive senior lending markets.

That said, as Randy mentioned, the private credit opportunity today is heightened thanks to interest rates being higher and to more conservative capital structures. Junior capital rates of return are up at 13 percent, 14 percent or even 15 percent, with lower leverage multiples and the same blue-chip sponsors behind these tranches of debt.

Our junior capital dealflow has actually increased from last year, as sponsors are focused on structuring deals correctly in the higher rate environment, and in many instances, looking for fixed cash and payment-in-kind (PIK) coupons. In our view, it is an excellent time to deploy capital.

It is a little more complex on the asset selection side because certain businesses are dealing with some stubborn issues. We tend to invest in service-orientated, B2B durable capital opportunities, and those are still there. The market overall is slower, new LBOs from private equity are down, but sponsors are crafty and are good at sourcing and taking out assets that will trade in a more complex environment.

At Churchill, we benefit from aligning with the top private equity firms that we are invested in as an LP through our nearly $13 billion fund portfolio (as of 30 June 2023). We have well developed relationships with those decision-makers, so even in a slower dealmaking environment, they show us essentially every opportunity, enabling us to be highly selective.

Q How does the US private credit opportunity compare with that in Europe?

JS: The European private debt market has many similarities to that in the US and the unique opportunity today, with record all-in yields per unit of leverage, also exists there. Right now, the competitive environment is very good in the US because there is significant capital on the sidelines, but in the UK and Europe, the market is about 10 years behind us and there are far fewer scaled players. Larger firms, like our partner and Nuveen-affiliate, Arcmont, enjoy an advantageous competitive landscape, which investors are really interested in.

RS: Our platform in Europe with Arcmont now complements what we are doing in the US very well, providing balance and synergies with issuers and investors. We are seeing a growing number of cross-border deals and cross-referred deals.

Q What are your expectations for loan defaults in 2023, and how will valuations hold up versus public markets?

RS: Loan defaults are poorly understood in private debt. In public debt, defaults are visible. Since there are no financial maintenance covenants, there is little lenders can do about a borrower's deteriorating operating performance.

In private debt, there are reports of increased defaults in the mid-market, but in at least one case these are covenant defaults, not payment defaults. No question that there are interest expense pressures on portfolio companies right now. As lenders, we have those triggers to sit down with borrowers and start to help fix things. Even if there is a pick-up in payment defaults, it's losses that matter.

It is important to look behind the numbers. Private credit default rates according to one leading index were actually down 24 percent in Q2, quarter-over-quarter. Experienced direct lenders are proving they can proactively manage through this challenging time and minimise losses, particularly if their portfolios are comprised of resilient, counter-cyclical companies.

JS: What's interesting on the junior capital side of the business is that we are also a minority equity co-investor in many of the deals. We're seeing several reasonably solid performing businesses that have some capital structure constraint that needs to be worked through.

Typically, these businesses need more time to execute on a strategic plan, so we are finding strong collaboration with our PE partners. Generally, PE firms are acknowledging they need to put more equity into the business, and we are acknowledging we need to defer some of our cash coupon in the form of PIK interest. Together, we can give good businesses the time they need to work out the capital structure stress they are facing in today's environment.

RS: As with defaults, valuations in the public markets are different than those in private markets. Private credit valuations are driven by fundamental borrower performance which, unlike liquid loans, are not visible unless you are an investor or a manager. Our portfolio valuations improved in Q2, both because of better performance and some tightening in broadly syndicated loan market pricing.

Q Which managers are best positioned in this environment?

JS: You tend to see managers pull back deployment when they are spending too much time on their portfolio. The best positioned firms in this environment are those that have exhibited discipline, consistency and diversification over a long period, so that any issues, which are inevitable, are minimal as a proportion of NAV. At Churchill, for instance, the average portfolio position we have is approximately 1 percent across the various strategies we manage.

After sound underwriting and portfolio construction, I always point to scale and relationships. We are fortunate to have a multi-strategy platform with a scaled portfolio of incumbency positions, where we know the management teams, the owners and the capital structures, which enhances our ability to make decisions. We are also well positioned to capture dealflow from existing borrowers at a time when add-on acquisition volume is strong and actually rose 24 percent quarter-over-quarter.

Finally, we are really leaning on trusted PE relationships where we have proved ourselves over an extended period to be good partners. Our significant LP investments across a broad range of established mid-market PE firms go a long way. The reason we have had a good year on deployment is because we have been able to play offence, based on having the capital, having a diversified portfolio and having tried-and-tested relationships with PE firms.

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>
> **RANDY SCHWIMMER**

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> **JASON STRIFE**

Q Is now a good time to invest in mid-market senior loans and junior capital? Are there better risk/reward options?

RS: It is true that the risk/return dynamics in corporate bonds are attractive at the moment. They were not particularly attractive last year. Peaches are wonderful fruit for a few weeks in the summer. But apples are great and available in many varieties all year round.

Private credit is like that; an all-season asset with attributes that don't come and go. There's certainly a place for bonds, but the trade isn't always there when you want it.

JS: Even within our own set of strategies, there are other attractive relative value categories to play in, but we believe senior lending and junior capital are at the top right now, if you do it the right way with a tight strategy. You are seeing lower loan-to-value, strong sponsorship, a doubling of returns and conservative structuring, which absolutely makes now a good time to invest. ■

Randy Schwimmer is co-head of senior lending and Jason Strife is head of junior capital and private equity solutions at Churchill Asset Management

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