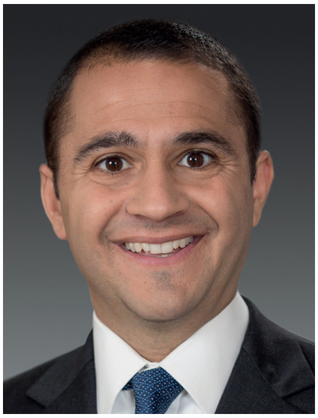
EXPERT Q&A

Financing trends are moving in favour of private debt, say Mat Linett and Randy Schwimmer, co-heads of senior lending at Churchill Asset Management



The mid-market proves its worth in a downturn

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Q In today's world of economic uncertainty and recession fears, what is your general outlook for private debt as an asset class in 2023?

Randy Schwimmer: This has been a developing story over the past 30 years. In the last decade, what's driven investors into private debt is the search for stability during economic uncertainty, causing AUM to now surpass $1.3 trillion. Nevertheless, there is anxiety that interest rates have reached levels to create defaults, and leverage levels may be too high.

That said, the private debt story is better than ever. We saw a foretaste during the pandemic of what's going on now. During that mini-recession, we saw public market valuations collapse while the private market did not. Despite being in the middle of similar uncertainty today, the economy continues to show real vigour, particularly in the labour markets. That will, of course, cause the Federal Reserve to try harder to quash inflation. Expect private markets to remain stable.

Because of our conservative investment approach at Churchill, we believe our portfolios are well positioned to withstand higher interest rates and a recession. The still-improving benefits of private credit – higher yields, better security, lower volatility and thoughtful alliances with private equity partners – suggest the opportunity is increasingly attractive. On a risk-adjusted returns basis, we are getting higher spreads, lower leverage and much tighter documentation on deals.

Q How are rising interest rates and tighter monetary policies impacting mid-market lenders and borrowers? Does

this change the way you are evaluating companies in the current environment?

Mat Linett: Rising interest rates and tighter monetary policies obviously mean a shift in the way we evaluate opportunities. On the underwriting side, the market is extremely focused on interest coverage. It used to be all about debt to EBITDA, but that was in a world where risk-free rates were close to zero. Now, reference rates have moved up, spreads have widened, and that has put a lot more pressure on companies looking to service debt.

We also spend a lot of time on fixed-charge coverage. Churchill does a lot of lending to service-orientated companies, where the closer your fixed charge ratio can be to your interest coverage ratio, the better. We are also looking closely at the quality of the EBITDA because those ratios are meaningless if that quality doesn't allow you to service your debt and still cover your fixed charges. Ultimately, earnings will play an even greater role than interest rates in influencing a company's ability to service debt.

On the portfolio side, some of those deals were completed in a different environment, so depending on how they were structured, you can see more or less pressure. To our benefit, Churchill is known as a more conservative lender to the mid-market, which has served us well, as the companies we have underwritten generally have more room to absorb these rising interest rates.

Q What do you observe in terms of origination trends and hot deal sectors for 2023?

RS: The overarching theme for the first half of 2023 is that M&A volumes have slowed. Sellers of assets in more consumer-facing cyclical businesses are struggling to find a price matching their expectations. Defensive businesses, such as B2B companies, healthcare, technology and business services, are performing well with purchase price multiples remaining at record levels.

Financing trends are moving in our favour, including the disintermediation from the public credit sector to privates, thanks to volatility in both broadly syndicated loan and high yield bond markets. With a leadership concentration of lenders at the top, we see fewer managers with scale representing the majority of mid-market PE financings. The reliance on relationships in private debt is also strong. In a challenging market environment, private equity sponsors increasingly tap lenders with whom they've previously closed deals and built familiarity and trust.

It's important to note that leading direct lenders don't need a major tailwind of M&A dealflow to succeed. Private debt managers with differentiated sourcing relationships can achieve record volumes when overall dealflow is down, as we accomplished last year.

Q How are higher asset yields and the denominator effect affecting private credit portfolio allocations?

RS: This is exactly why investors allocate capital to private debt: to offset volatility in liquid asset classes. The denominator effect is real; as we saw last year, liquid asset valuations plummet when investors flee to quality. That magnifies imbalances based on expected ratios in an allocation programme set up to achieve diversity around market concentration.

The unexpected and rapid nature of rate and recession dynamics left little

Q What do you see as the key drivers of success today?

RS: Sound underwriting and unique deal sourcing are the key drivers; that is where investors are focused. They are looking for both origination quality and quantity, continuing with our conservative due diligence approach while fulfilling their allocations with significant asset deployment. To accomplish that means being able to scale fundraising. That allows you to commit large dollars to meet your private equity clients' needs and simultaneously satisfy your investors' requirements.

ML: On the underwriting side, our differentiated relationships bring the quality dealflow and then it is down to doing the credit work. Ultimately, capital chases performance, so the market is looking for track records of high performance and low defaults when judging success. Institutional investors also appreciate alignment. In Churchill's case, for instance, they know that TIAA, our ultimate parent company and a likeminded conservative institution, is invested side by side with third-party clients in our loans and on the exact same terms.

time for institutional investors to react, leading to an overweighting to private credit. However, in our view, the denominator effect is more than offset by the benefits of the asset class.

It is therefore understandable that investors are hesitant over incremental investments in private credit. Nevertheless, we are pleased to see a number of public pensions receiving amendments or waivers to their allocation policies to allow modest overinvestment in private credit from original guidelines.

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

ML: We definitely anticipate an uptick in loan defaults, but we are starting from a very low base. There are certainly sectors under pressure but the asset class as a whole will hold up well. Looking at S&P, LCD and Moody's data on a historic basis, overall we have seen an average annual loss rate of 1.15 percent between 1995 and 2021 for mid-market lending, which compares with 2.24 percent in syndicated loans.

It is possible we have a mild recession, but we are not looking at a global financial crisis. For well-structured transactions where the lender has a reasonable percentage of loan to value, the vast majority of companies will make it through, even if some kind of restructuring is needed. Ultimately, lenders will be able to retain value.

"On the underwriting side, the market now is extremely focused on interest coverage"

MAT LINETT

Q What's the future of the asset class over the next five years?

RS: We have seen the ratio of private to public LBO financings jump to eight to one. Public markets, ie, the banks, can't compete effectively because they can't hold these assets. Their model is based on distribution to CLOs and funds. This dynamic relies on a functioning liquid market. The private credit ecosystem, on the other hand, has long-term capital dedicated to long-term investors.

Over the next five years, we expect private debt to double in size, far outpacing either the bank or bond markets. We expect this to be fuelled by growing interest from retail investors. At that size, privates are likely to evolve with their own version of a distribution model, allocating commitments to relationship lenders off their own balance sheets. Churchill has similar partners that lack their own origination capabilities yet are on the lookout for good assets. We can become a sourcing vehicle for these secondaries investors.

Q Responsible investing continues to grow in importance. How are private debt managers aligning with private equity sponsors and borrowers, while integrating ESG considerations into their investment processes?

ML: The biggest takeaway on the ESG front is how rapidly the landscape continues to evolve. What things look like from an ESG perspective today is vastly different from what they looked like even a year ago. We have a comprehensive approach across due diligence, underwriting and portfolio management, which includes exclusion lists, a proprietary ESG rating tool, annual re-ratings and a growing focus on climate risk. A year ago, we rarely got ESG reports from our private equity partners, but today that has become common. In fact, for the majority of new credits, private equity firms commission an industry expert to deliver a comprehensive ESG report. We have also built up our internal resource with a head of ESG, Mickey Weatherston, who is building out a team.

"The private debt story is better than ever"

RANDY SCHWIMMER

We really need to work in tandem with private equity firms on this, as the owners of the companies are the ultimate drivers of policies and governance. We have a differentiated edge here because we have a division that invests in private equity funds, with $13 billion of commitments across about 250 PE firms and board seats on more than 200 of those, as of 31 Dec 2022. That allows us to talk to private equity firms about ESG matters and tap relationships to build a collaborative process. ■