Lead Left Interview – Tod Trabocco (Part 2)

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This week we continue our conversation with Tod Trabocco, Managing Director at Cambridge Associates LLC. Cambridge is a leading investment advisor to foundations, endowments, private wealth, and corporations worldwide. ***Second of two parts – View part one***

The Lead Left: With all the funds in the market what can private credit funds do to differentiate themselves?

Tod Trabocco: Most direct lenders have similar return and loss profiles when you adjust for differences like senior versus unitranche or second lien, for example. Loss incidences in particular are low across the board, so I look for any key differentiating factors. One easy differentiation is between lenders who finance unsponsored companies and those who finance sponsors. Within the sponsor coverage model, you have lenders who are “go-to” lenders for a small stable of sponsors and those who actively diversify sponsor reliance. There are lenders who originate their own exposures, those who focus on participations, and those who do both.

On the underwriting side, there are direct lenders with strong analytical institutional backing in the form of high yield desks, CLO platforms and private equity ownership that enhance due diligence and those who do without. Culturally, some private credit funds are building for the long term, while others have a shorter term view.

And of course, fees are becoming a differentiating factor.

TLL: We’ve seen investors conflate credit strategies as if they were all “private credit.” How do you help them understand the varied risk/rewards?

TT: I’m actually going through this exercise with a large client right now. Our data and experience help us differentiate the different private credit strategies for our clients.

First, Cambridge Associates’ definition of “private credit” includes structured equity, distressed credit, capital appreciation, credit opportunities, mezzanine, royalties and senior lending. Second, we can categorize these strategies as to whether they emphasize capital appreciation or capital preservation, based on Cambridge’s experience in researching, selecting and allocating capital to these strategies over the past 40 years. Our proprietary database of returns and losses helps support the categorization. We can point to IRR dispersions, loss ratios and vintage importance when talking to clients in order to highlight the nuances among strategies.

TLL: What do you tell investors when they say market conditions are too frothy today?

TT: There are managers in the market at the moment from the different sub-strategies enumerated above and they can take advantage of illiquidity, distress, geography, etc. So while certain markets may be frothy, others are not, and we can work with investors to find those managers that can avoid the frothier markets. At the same time, certain defensive, capital preservation strategies, like direct lending and some specialty finance, can still deliver good risk-adjusted returns, even in frothy markets.

TLL: How about the argument that there's too much capital in the private credit space and too much competition?

TT: Let's tackle "too much capital" I mentioned earlier that almost $50 billion in direct lending capital is being raised in the US. Add another $15 billion in Europe and we are at around $65 billion – again, excluding SMAs, private BDCs and insurance company affiliates. Lincoln International pegs the number globally at more than 130 managers and $90 billion. In addition, I understand that anywhere from 10 to 20 European and Asian asset managers are exploring ways to enter the US direct lending market

If we are really seeing a secular decline in bank lending, then the opportunity looks large. The Fed tells us that the commercial banking market for Commercial and Industrial loans is about $2 trillion, the high yield market is $1.5 trillion, and the leveraged loan market is between $500 billion and $1 trillion. If we estimate that 10% of that aggregate amount is suitable for direct lenders, then we get a potential demand of $400 billion in refinancings and new loans.

However, not all of that demand comes all at once. It is important to keep in mind that the vast majority of direct lenders pursue the sponsor coverage model, tying it to the M&A and private equity fundraising cycles, which ebb and flow with the economic cycle. So while the long-term investable universe looks massive when compared to the current fundraising, many of the funds currently in market are more closely tethered to the shorter-term demand driven by private equity sponsors.

Now let's turn to "too much competition." This is tied to the strategy. For example, around 10% of all direct lenders emphasize unsponsored borrowers. Yet, the unsponsored market is not one-ninth the size of the sponsored market. Similarly, we see large asset managers providing loans as a high yield replacement. That requires capital and very few managers have the dry powder to step up and take down a $500 million busted high yield deal.

I often say this to our clients: whatever the numbers tell you, anecdotal evidence suggests that many direct lenders are overwhelmed with opportunities to prudently invest their capital. For example, we are developing new co-investment programs with managers to address this excess demand. We even hosted one lender who inquired about our clients' appetite to be syndication partners outside of any SMA or commingled vehicle. In other words, this lender was less interested in generating fees or carry, and more interested in accessing capital.

TLL: How can private credit thought leaders continue to support the asset class?

TT: First, keep making good decisions. Hold the line on pricing, structures and terms as more capital flows into this asset class. Keep posting the strong returns and miniscule losses. If performance deteriorates, attention and interest will wane. Just ask the nearest hedge fund manager.

Second – and this is easy – report into Cambridge's benchmarks. I mentioned earlier that LPs don't know where to bucket direct lenders. Having a specific benchmark so your readers don't wind up benchmarked against special situations or mezzanine managers would help this asset class come into its own. We are establishing a direct lending benchmark and would like more managers to participate in order to make it particularly robust and meaningful for our global client base. There are benchmarks that come close, but we are establishing one to include The Lead Left readers specifically. It's all confidential, and easy to do. A robust benchmark will also help accelerate the formalization of private debt. It would be great if your readers could work with us to build more investor awareness for their asset class.

TLL: How can Lead Left readers learn more about the Cambridge benchmarking process?

TT: The process is painless. Email me at PrivateCredit@cambridgeassociates.com.

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