Top Ten Myths About Private Credit (Sixth of a Series)

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We spent our winter break last week at an Arizona dude ranch. In the horse barn we spotted a sign: "There will be a $5 charge for whining."

Heading into the home stretch of our special series on private credit myths, we like the cost for complaining. For faithful readers of *The Lead Left*, however, there's no charge.

Myth #7: "Private credit recoveries will be worse than 2009"

The notion that leveraged loan performance will be worse during the next recession rests on the current prevalence of record high borrower leverage and cov-lite structures. If performance deteriorates, lenders have no triggers until a payment default. By then, the business could be worth much less than what the sponsor paid for it. And possibly less than the value of the senior debt.

Moody's historic data shows first-lien loan recoveries (back to 1983) of 66.5% and project 2020 recoveries of 59% (see *Chart of the Week*).

These elements, however, refer to broadly syndicated loans. Decades of data show middle market loans have lower defaults and losses, and higher recoveries than BSL. That's because lenders' and sponsors' interests are aligned to maximize enterprise value. Recoveries depend on experienced managers navigating credit risk appropriately. In a downturn, they realize avoiding cyclical borrowers and selecting defensive sectors greatly improve outcomes.

Finally, what could hurt recoveries are questionable add-backs and adjustments. Understating leverage because actual Ebitda is overstated is likely the biggest risk facing private credit today. Partnering with private equity sponsors whose companies have historically succeeded in realizing operating synergies will go a long way to protect credit managers and their investors.

Myth #8: "High valuations make private credit unattractive."

High valuations are the result of too much private equity dry powder, not too much private credit. And higher prices are being paid for companies in defensive sectors, such as technology, that have proven track records through multiple business cycles.

These valuations are partially offset by sponsors supplementing platforms with add-on acquisitions at lower Ebitda multiples. These can lower the effective entry multiple, making desired returns more achievable.

Enhanced enterprise value makes higher leverage more tolerable. But private credit managers are challenged by the increasing share of all-senior or unitranche structures.

For senior lenders, the more cushion below their first-lien tranche, of course, the better. Sponsor cash is skin in the game (average middle market LBO balance sheets carry about 50% cash equity), but second-lien or mezz in cap structures help first-lien recoveries.

? Next week: Myth #9: "Without a public benchmark, private credit returns aren't reliable."