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Private Credit – Better than Ever (Second of a Series)

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“October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February.”

Mark Twain’s famous dictum on investing came to mind as we watched recent choppiness in public markets. With the waning weeks of summer passing and an uncertain fall ahead, elections, vaccines, and tech valuations are weighing on equities.

In contrast, private markets are just gearing up. As we’ve detailed in prior commentaries, middle market M&A activity has seen solid uplift in the last month or two. We suspect the same worries bedeviling liquid markets are supporting the trading of properties. As a seller, why not cash in your chips today, rather than risk a reduction in your after-tax proceeds tomorrow?

Private credit, the handmaiden of private equity, is demonstrating support for the “haves;” that is, those businesses less-impacted by the pandemic. Financings are being issued at a faster clip than was the case only a few months ago. And while terms have eased somewhat in favor of issuers compared to the early panic days of the crisis, they remain more investor-friendly than pre-COVID levels.

What factors will determine the direction of terms for the rest of the year? Well, for one thing: supply/demand. Unlike large cap credit that moves with fund flows or CLO appetite, mid caps are creatures of competition. The bigger the pipeline, the more choices investors have, so the more likely issuers will see push-back on terms.

But there are caveats. Asset managers are acutely aware that the coronavirus has not run its course. While the state of portfolios has settled into a period of watchful waiting, a renewed batch of infections or disappointments on the vaccine front could swing the outlook negative.

Direct lenders are also mindful that liquidity – routinely offered pre-COVID in the form of outsized revolving credits and DDTLs – is now a precious resource. Sponsors are being asked bluntly, “Is that a must-have, or a nice-to-have?”

And the past six months have demonstrated that covenants are no longer theoretical. The cushion between tests and projected issuer performance made the difference between lenders having a seat at the negotiating table, or watching helplessly as cash flows deteriorate.

Finally, leading private credit providers are much more cautious underwriting chunkier commitments. We estimate those arrangers are holding roughly half of what they did at the start of the year. With the economic and political outlook still uncertain, no one wants to take sell-down risk if they don’t have to.

? Next week: We look at leverage and pricing for the “new” private credit.