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

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A private credit practitioner would have found no better place to spend this week than at the SuperReturn North America Virtual conference. Your correspondent was honored to chair day one, moderate two lender panels and participate in a third.

Our role also gave us a front row seat to hear GPs and LPs describe at length and in great detail how they were dealing with the effects of COVID-19 and its on-going impact on portfolios, new deal flow, and fundraising.

The astonishing thing was how consistent reactions were across multiple strategies and specialties. Everyone saw initial deal flow come to a stand-still in March and April. They witnessed a broad response by borrowers and their owners to quickly inject liquidity and cut operating costs. And they were surprised when valuations (and general performance relative to covenants) remained in a range not far from par.

Assured that portfolios had stabilized, direct lenders were more receptive to new transactions coming their way. Pricing, at first, was well above 2019 levels; leverage more in line with 2011 than 2020. But then as other credit providers recognized the opportunities, terms became more competitive.

Today we find ourselves with leverage and pricing heading gradually towards historic averages. The good news is that leverage is not yet expanding to meet purchase price multiples, even for less-COVID sensitive deals. So far, at least.

Senior leverage, which in April fell to three times ebitda for a solid middle market borrower in a defensive sector, is back to the 3.5-4.0x ebitda range. Stretch senior financings are up to 4.0-4.5x. Unitranche, which was unavailable in the early stages of the crisis, has re-emerged with leverage of 5.0x, and higher depending on the strength and size of the issuer.

Pricing has followed a similar pattern. Early stage first-lien spreads for midcaps were at Libor plus 750 bps, give or take. That's compressed by 200 bps over the past six months, but remains 100 bps above the low point during 2019. Unitranche spreads, depending on leverage and borrower creditworthiness, are L+600-650 – some 50-100 bps wide of history.

The sense we gleaned from SuperReturn panels was that competition for direct lending deals, while remaining keen for better sponsors and issuers, has one eye on the course of the coronavirus. If there's a second wave as we enter colder weather, or if vaccines disappoint, credit providers will be ready to touch the brakes.

Same goes for portfolios. If challenged borrowers that have stayed afloat for the past six months begin to run out of steam, or if sponsors top supporting that investment, affected lenders might back away from new issues.

? Next week: How are private credit managers thinking about new opportunities?