2020: A Year of Surprises (Part Four)

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We continue our special series with the fourth of "Five Biggest Private Capital Surprises of 2020":

Surprise #4: Which Industries Mattered?

For experienced credit managers, diversity is a critical guiding principle. This applies to both industry concentration as well as commitment sizes. The question coming into last March's downturn was, have we made the right decisions on industries to lean into and ones to avoid?

Over multiple business cycles, it's empirical that certain sectors swing more heavily – the cyclicals – during recessions. For generalists that discourages investments in energy, chemicals, retail, high-end consumer, and real estate, though specialists in those areas are certainly active.

Once COVID began sweeping through the US, winners and losers were quickly ordered around the "haves" – businesses least impacted by shutdowns – and "have-nots" – those most affected. What surprised observers was both how clear the distinction was and how persistent the trend.

Unlike the Great Recession which was financially driven, the pandemic had its peculiar commercial victims and heroes. Not all retailers suffered alike, for example. On-line shopping prospered. Fitness centers, on the other hand, which fare reasonably well in times of higher unemployment, were stopped on their treadmills.

But when these patterns were set early on, investors and lenders found they continued.

Consumer-facing sectors such as retail, restaurants, travel and hospitality saw little or no recovery. That was reflected in diminished M&A activity for those industries. The haves found momentum in deal making as the second half of 2020 progressed, regardless of higher infection rates.

As our *Chart of the Week* (courtesy S&P/LCD) highlights, loan activity in defensive sectors remains high. Almost half of recent institutional volume is encompassed by business services and favored retail sub-sectors like pets and RVs.

Private credit reflects similar trends. Refinitiv LPC data showed the top five industries for sponsored middle market M&A volume were tech, healthcare, manufacturing, wholesale, and services.

LPC data also reveals that some of the usual cyclicals struggled. Middle market oil and gas syndicated middle market loan volume was at its lowest level in fourteen years. In a similar vein Fitch reports default rates for energy loans was approaching 20% at the end of the 2020.

With one-twelfth of 2021 in the history books, it's too early to tell what the new normal will be for have and have-not sectors. But credit managers who made it through last year relatively unscathed aren't likely to change strategies anytime soon.

Next week: Surprise #5: The M&A Big Bang