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Private Credit in an Age of Scarcity (Second of a Series)

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Supply chain issues aren't limited to bikes and baby formula. As the Fed withdraws liquidity from the banking system and investor cash exits public credit, it's more challenging to deliver capital to traditional buyouts and M&A.

In pivoting from a world of abundance to one of scarcity, credit markets are struggling to adjust. Direct lenders have built up record levels of dry powder over the past five years, but they have also been busy putting it to work. For several reasons, experienced managers are becoming more judicious about deploying the capacity they have left.

First, credit fund investors are more cautious about new allocations, thanks to public market volatility and concerns around a slowing economy. Ironically the better the yield prospects for floating rate assets in a rising SOFR environment, the more tempting to wait for even better returns down the road.

The dislocation in broadly syndicated loans has also compelled issuers to pivot to private markets for credit solutions. An estimated $1 trillion of capital is invested in private credit today, but the amount of dry powder is less.

While recession worries may slow M&A between now and the end of the year, pent-up demand from private equity sponsors flush with LP cash will drive flow once conditions allow.

So it is that top private credit managers are increasingly weighing risk versus opportunity in allocating capital to deals. The opportunities are seen through the lens of a possible recession that could upend earnings and valuations of companies that have performed well, even through Covid.

Future deals with tighter coverage ratios will also be scrutinized carefully. A 4% SOFR world isn't as conducive to mega cov-lite unitranches with leverage over 7 times. Cyclical sectors, or businesses with high capex, are less likely to make the cut.

Finally, while the amount of private credit dry powder (see our *Chart of the Week*) is greater than ever, it remains dwarfed by the money raised by private equity sponsors. Will sponsors find a more challenging fundraising environment over the next several years?

2022 data seem to suggest as much. Similarly with deal activity. Certainly, a real recession will hurt purchase price multiples, but given their lofty levels, that might be welcomed by PE buyers.

How is manager selectivity manifesting itself? Beyond better pricing and terms, hold levels are down and underwriting commitments off sharply. Without more visibility on inflation, rates, and the economy, GPs are reluctant to get stuck if market conditions worsen.