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Private Credit – Why Now? (Last of a Series)

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A veteran of leveraged lending and astute *Lead Left* reader disagreed with our statement last week that private credit terms have never been more investor-friendly. In a note to the editor he compared them to more conservative loan structures and legal protections in the 1990's.

Since then, he pointed out, private equity owners and their legal teams have found innovative ways to weaken lender positions such as moving assets out of borrower entities and diminish rights acceleration. Not to mention the elimination of financial covenants.

Our reader has a good point. Having been at JP Morgan during that period, we had a ringside market-leader seat on how a slew of lender protections in credit agreements eroded over time. The technology and sophistication of broadly syndicated leveraged loans over the past three decades has developed to the point where they match high-yield bonds in issuer-friendliness.

However, when we talk about private credit terms we typically mean the middle market, not large cap liquid loans. For smaller non-traded loans, term erosion has been less dramatic or pervasive. Cov-lite, for example, has been limited to larger companies. Same with liberal allowances such as unlimited debt and dividend baskets.

No question sponsors have become more adept at ways to get around certain restrictions. But they are also putting in multiples more of cash equity than the 10-20% prevalent in those days.

We might also point out that loan spreads have widened in the wake of the Fed's rate hike regime. That's different than, for example, the 2006-07 period when spreads compressed to restrain all-in borrower costs even as the benchmark rose. Hard to recall a time when senior loans were commanding 10-12% yields.

Finally private credit has become an institutional asset class only in the last decade. Before that managers might have been able to generate returns higher than fixed income or liquid loans but were challenged to do so consistently and at the same time scale their platforms.

This week the head of a global private credit firm weighed in on the topic of timing. "Private capital is not a trade," he told us. "Sure, there's an opportunity today to pick off some nice yields from the bond desks. But that's speculative versus strategic investing. Next year that trade goes away and where does that leave you?

"There's also a unique risk/reward dynamic with privates in a diversified portfolio," he continued. "Buy and hold is a very different animal than liquid credit. Being less correlated has served investors well over the past few years and is doing so right now. Private M&A multiples are up relative to public comps. In a higher for longer world, short duration risk is a big assist."

Finally, our friend said, private credit valuations only move with credit deterioration. "Think of private capital providing triple-B returns with double-B assets and only single-A losses."