Glasses Half Full (Last of a Series)

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In conversations with dozens of institutional investors over the past several months, consistent themes recur. First, there's the sense of continually being bombarded by unexpected bad news rocking markets. Then having few clues before each Fed meeting what the central bank will do with rates. Finally, there's the worry that too-high rates will send the economy into recession.

The net result of these pressures has been, no surprise, a "wait-and-see" approach. "We like private credit, but we're cautious right now," one fund manager told us. "We believe in the value proposition of the asset class and are pretty diversified in it, but not sure directionally if risk there has peaked. Investment grade bonds aren't necessarily the solution either."

Others who are not yet invested in private credit seem beset with FOMO. "Private credit looks attractive certainly," another wealth manager said. "We've scheduled second quarter to commit to a direct lending allocation. It's been late in coming for us, but public markets are too volatile. Our focus now is to understand portfolio sensitivity to higher interest rates."

While benchmark data is hard to come by, Lincoln International collects an impressive array of statistics from borrowers in manager portfolios it values. That should provide those with private credit interest plenty of ammunition to support their case.

One interesting example is how average private equity purchase price multiples of Ebitda remain at near-record levels, despite downward pressures on their public value counterparts. At 4Q 2022 that multiple actually rose to 11.0x from 10.8x, on the strength of new healthcare company investments. For five quarters these multiples have hovered in the same range.

This is generally true for new vintage transactions, albeit based on slower volume. New deals displayed a 12.3x Ebitda multiple at year end, down from a record high of 14.1x for 3Q. But this was on sharply slower deal flow, cut from 91 to 23. Nevertheless the cash equity cushion is a near record high of about 60%.

Of more concern is the tightness being displayed in interest coverage ratios. As our *Chart of the Week* highlights, that reported cushion shrunk from 1.86x to 1.58x. Assuming a *pro forma* 5% benchmark rate, that cushion is reduced to barely 1x. And of course SOFR is likely to climb.

Finally, Lincoln's portfolio had a modest pop in "defaults," as a recent news piece highlighted. It's important to note, however, that this increase – from 3.7% (3Q) to 4.2% (4Q) – represented trips of *financial covenants*, not payment defaults. These numbers are far below the 9% levels registered during Covid's peak.

While this trend bears watching, it highlights another crucial difference between private credit and BSL. With the latter market being largely covenant-free, investors there would be helpless to do anything about deteriorating borrower performance. Until it's too late.