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The New Paradigm (Second of a Series)

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Two economic dynamics are driving capital markets. First, GDP strength which, by many measures, remains steady if not buoyant. One of our favorite contributors is Caterpillar.

Hard to think of a better representative of cyclical industrials than the Peoria, IL-based manufacturer of heavy "yellow-iron" equipment. The company reported a 12% revenue increase to $16.8 billion for 3Q, from $15 billion in 3Q 2022. Operating profit margins were up, 20.5% vs. 16.2% on higher demand for energy and transportation-related construction.

For more defensive sectors, the Gryphon Index (derived from Churchill's senior debt portfolio) showed revenue and Ebitda improvement of 14.5%, year-over-year through June 30. This includes both organic growth and add-on acquisitions (see our ***Chart of the Week***).

The other factor, of course, is the Fed's determination to keep rates higher for longer in its effort to wrest inflation to the floor, or at least to 2%. That effort seems to be paying off, with the labor market loosening, and CPI drifting downwards.

Rating agencies are zeroing in on potential risks in direct lending portfolios. These center around defaults from higher interest costs squeezing operating margins, particularly in pre-2022 vintages when leverage was higher and rates lower. Concerns are mounting around the slowing economy next year, notwithstanding the current strength of many sectors.

To make these assessments, analysts are comparing private credit to the old paradigm of syndicated leveraged loans. They begin with how those loans behaved during the GFC, when leverage was significantly higher relative to equity capital.

It also assumes loans valued off secondary market prices, which in the case of direct lending are based instead on fundamental performance. Further, it uses the only publicly available portfolio data, which is from BDCs. Those vehicles are but one window into private credit portfolio health, with the other views available only to third-party valuation firms and investors.

Some analysts argue that the same risks present in the highly leveraged, covenant-lite deals not being executed in the bank market will be transferred to the less-visible private debt market. This ignores the nature of active management in a direct lending portfolio. As one manager told us, "It's a very different underwriting model when you know up front you're holding the asset."

Large CLO managers with analysts cover the complete spectrum of industries in the S&P 500, including energy, housing, chemicals, retail, and hospitality that are prone to higher defaults. Those managers can trade out of a position at the first sign of trouble.

While the threat of shrinking interest coverage is real, lenders won't sit waiting for a default. They work with sponsors to cut costs and add revenues, along with other remediation steps, to avoid a default. Or if one happens, to ensure the company recovers to minimize losses.