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Where We Are (Third of a Series)

THE LEAD | June 4, 2024

Our keynote opening remarks at the 3rd Annual Sahar Private Credit Conference last week highlighted themes this special series has been developing. In particular, we delineated the distinction between demand in liquid credit, as driven by CLO capacity, and that of private credit, determined by availability of dry powder from direct lenders.

On the supply side, as other conference panelists noted, sluggish M&A issuance is a tough nut to crack. Digging deeper into the numbers, though, it appears as if that dynamic is beginning to change. While overall global M&A has declined since 2021, pure buy-out flow is holding its own.

Meanwhile distributions-to-paid-in-capital, a good indicator of how much cash is being returned to LPs, is at historic lows. As our *Chart of the Week* illustrates, 2020 vintage investments have distributed more than 80% less cash than the historic average between 2007 and 2016. Less even than the 2018 vintage which was 60% off the average.

But GPs have adapted to this new reality. One approach, of course, is simply to finance a dividend by recapitalizing portfolio companies. Lenders have been happy to oblige. The $15 billion in recaps recorded in the 1Q was the second largest in 15 years, per PitchBook LCD.

Another way to improve realizations is the continuation vehicle. As we’ve reported previously, sponsors historically sold underperforming borrowers into these special-purpose funds when the business failed to attract buyers at the expected price. Today, owners use CVs for stronger performers they want to keep until more favorable market conditions return.

In the current rate environment, leveraged borrowers and their private equity sponsors are walking a tightrope. On the one hand, they recognize we are in a risk-on climate with the likelihood of a hard landing *de minimus.* But the benchmark SOFR remains at a stubbornly high level. While lending spreads have eased since their peaks last year, overall financing costs for senior debt are still double-digit for all but the best BSL issuers.

The media seems to characterize amendments and extensions as financing gimmicks, but they are well-worn features of the leverage finance playbook. As interest coverage cushions are squeezed, giving borrowers room to maneuver enhances their flexibility and resilience. The same theoretically could be said about cov-lite and PIK-toggle features.

Sahar panelists spoke at length about how large-cap terms are being liberally offered to smaller companies. Part of the consideration is how well certain sectors such as software, tech and business services are faring. Also important is the quality of the sponsor and their experience in the relevant industry. Finally, at least for the PIK option, structuring deals to accommodate the pressure of higher rates is beneficial for issuers and investors alike. As with cov-lite, it’s not just the terms, but whether the candidates should qualify for them.

Next week we wrap up our series with a look at the market from an investor perspective.