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RPM—42 | Private debt in the high-rate era with Richard Schmidt and Jovan Samardzic

Michael Venne: [00:00:02] In this episode of RPM, we're talking about whether we are entering a new regime in private debt.

Private debt as an asset class really began to take off during the low-rate era that began in the wake of the global financial crisis. Now, for the purposes of today's discussion, I'm going to say that low rates equal abundant and inexpensive capital for corporate borrowers, M&A deals, and private equity sponsors that are often entangled with both of these things. It also means that an outward demand shift caused the prices of previously issued bonds to rise, thereby dropping yields and forcing fixed income investors to search for alternatives that provided higher yields. Private debt capitalized on both phenomena.

Contrast this to the current state of the market. Private equity exits and fundraising activity have slowed, and the same goes for real estate transactions and M&A. And as a consequence, private debt fund managers have found it more challenging to deploy [00:01:00] capital and raise new funds, and higher interest rates weigh heavily on borrowers' balance sheets. Understandably, it took some investors time to get comfortable with how a then relatively new asset class could flourish under post-GFC market conditions. By that same token, it's understandable that many of those same investors are wondering how private debt can cope with the prevailing and expected conditions in the post-pandemic marketplace.

Here with me to discuss private debt in the new interest rate regime are two members of our corporate direct lending team based in Zurich, Jovan Samardzic and Richard Schmidt. Jovan, Richard, welcome to RPM.

Jovan Samardzic: [00:01:40] Pleasure to be here. And thanks for having us.

Richard Schmidt: [00:01:42] Thanks. Happy to be here.

MV: [00:01:44] So, Jovan, let's turn to you first. As I mentioned in the introduction, market conditions are significantly different now than they've been for most of private debts, relatively short history: rates are higher, transaction levels are lower and borrower's balance sheets are under more [00:02:00] duress. Here's the million-dollar question for you. Is it fair to say we've entered a new regime in private debt? And if so, does private debt's relative value to other asset classes change?

Jovan: [00:02:12] Well, as you have indicated in the introduction, private debt has mostly existed in the low interest rate environment and high rates are definitely something new for the asset class. Hence, one can say that we have entered into a new regime. At the same time, it's important to say that even though it is something new and the asset class continues to perform very robustly, and we have evidence also from the year '22, when the rates started to increase, when direct lending outperformed asset classes such as public equities, investment grade bonds, but also subinvestment grade credits such as syndicated loans and high yields. And the reason for that outperformance was the fact that direct lending loans are almost exclusively floating rate, and investors [00:03:00] were profiting from the higher cash coupons that these loans were generating.

Now, taking a step back and just comparing, , currently direct lending to other asset classes such as equity and investment grade bonds, the outlook, very importantly, still looks very positively. And the way that we have analyzed is, is just by looking at the reward part of the risk-reward analysis. Effectively we have compared the earnings yield on equities, the yields on investment grade bonds and yields on private debt / direct lending loans with ten-year Treasury yields. And what one can see is that, uh, just given the strong performance and the current valuations in the public equity markets, one has the earnings yield premium over ten-year Treasury in public equities of roughly 50 basis points. The premium that one has on investment grade side is roughly 100 basis points. But the premium that one has on direct lending is close to 750 [00:04:00] basis points, which is representing quite a material difference relative to equities and investment grade bonds. Hence, based on the premium over the ten-year treasuries, private definitely looks very attractive at the moment.

MV: [00:04:13] Richard, I'm going to turn to you next to talk about interest rates. Also a very loaded topic, but specifically I want to tuck into their apparent double edge. On the one hand, direct lending investors benefit from higher rates, which accrues to them in the form of higher interest rate receipts. The floating rates that Jovan alluded to. However, higher rates also impose a greater debt burden on the borrowers. How concerned should investors be about higher rates?

RS: [00:04:42] Well, it is true that the higher rates did put downward pressure on interest rates and fixed charge coverage ratios given the higher debt burden. But, we actually do not think that the investors should be too concerned about it. And actually, there's some insight as to why we actually think so.

First [00:05:00] of all, it should be noted that we usually prefer to look at the fixed charge coverage ratio relative to the interest coverage ratio, as we see it as a more comprehensive measure of credit risk. And the reason for this is that it looks at the actual cash flows available to service the debt and includes not only the interest payments, but also other factors such as the principal amortization and leases, for instance.

Having said that, as you mentioned just before, the higher interest rates did have downward pressure on the coverage ratios. However, firms are usually not passive in front of raising interest rates, and they have multiple ways to mitigate the impact of higher interest rates at their disposal. Some of the ways in which they can address this includes, for example, lowering CapEx spending in the short term, which can free some additional cash flows. Unused revolving credit facilities can be utilized to cover some liquidity needs, and additionally, the loan documents usually allow [00:06:00] one part of the cash coupon to be transferred into payment in kind, which we usually call PIK, which effectively defers the coupon payments, helping the company with the liquidity in the short term.

So overall, while financial stress could actually, occur for certain companies due to higher interest rates, investors need not to be overly concerned as there are actually tools to mitigate the impact. I would also add that higher interest rates are only one part of the story in those coverage ratios. They are impacting primarily the denominator of the ratios. And the numerator tends to be more impacted by the actual earnings of the company and its capability to generate cash flows. And that's also something that needs to be taken into consideration.

MV: [00:06:45] You know, I'm actually really glad that you brought up earnings. Um, how have middle market companies, which is, you know, the bulk of the direct lending market, um, how have they been faring so far?

RS: [00:06:57] Well, interestingly, despite the various [00:07:00] macroeconomic challenges and uncertainties that we have faced in the previous quarters, middle market companies have been pretty resilient and achieved positive earnings growth overall in 2023. And looking at the latest Golub middle market report, they actually reach even double-digit earnings in the first quarter of 2024. So far there have been pretty strong. But in any case putting the borrower perspective aside and putting ourselves more in the investment investor's perspective, the direct lender can actually find some comfort in the fact that they usually sit at the top of the capital structure thanks to, firstly, loans, which actually represent the vast majority of loans in the direct lending space. Effectively, that means that junior debt and equity will act as a shock absorber for senior lenders. And substantial stress will be required for senior debt to take a hit and cause higher loss rates for investors.

MV: [00:07:56] And, Richard, I want to stick with you for one more. One more minute. Um, because [00:08:00] you brought up another interesting topic, and that's loss rates. Um, now, I kind of want to avoid the trap of looking for the desired outcome while ignoring signs of weakness beneath the surface. I think the saying goes "still water runs deep." Are there any indicators that might suggest default and loss rates could rise over the short run?

RS: [00:08:20] Well, loss rates have been increasing from the historically low levels seen in the post-Covid period, but so far we did not see any systematic underperformance in companies. Hence, we could see this more of a normalization than signs of trouble ahead. But of course, there is always a possibility for loss rates to go higher. But it is important to remember that loss rates are not only stemming from default rates, but also coming from the recovery rates. And we believe that it's an important point, especially for direct lenders since they tend to be well positioned to maximize those recovery rates thanks to multiple factors. [00:09:00] First, as I previously said, their loans are mostly first lien, meaning that they are at the top of the capital structure, and they will be the first to be repaid in case of a default. They also have a direct access to borrowers if underperformance is observed, leading to potential preemptive measures rather than letting the situation sour further. And, there is an alignment of interest also between the GP and the investors as the GP, usually all the loans in the funds that they manage. So that's also another good point for direct lenders. So even when a payment default happens, there are actually many factors that can positively impact the ultimate recovery rates, which in fact can have a positive impact on the loss rates even if default rates go up.

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MV: [00:09:47] All right. Thanks for entertaining that deep dive into some of the technical fineries of direct lending. And for our listeners out there, we have a whole series of papers that address each of these points. They're all available on our website. [00:10:00] So far, we've focused on capital that has already been deployed. But from what you guys have told me previously, there are mounting concerns about undeployed capital, which largely stems from a reduction in PE deal volumes and M&A. Jovan, what is the outlook for direct lending volumes, and what are some of the things investors can do in the meantime until deal volumes perk back up?

JS: [00:10:26] Yeah, so I mean, during ‘23 and there were concerns around capital deployment as volumes were materially down relative to, let's say, ‘22. And this was primarily due to the lower private equity volumes, where concerns were, primarily driven by valuation challenges because it was not quite clear how to value underlying companies when the interest rates moved as much as they did. These basically then lowered the number of transactions and consequently led to lower volumes on the private debt [00:11:00] side. However, the outlook started to change already this year, and one is now definitely observing a better deal flow. So that's based on Q1 and already some of the observation that we have from Q2. Hence, from the capital deployment perspective, we would not see a major concern at this moment. However, we do believe that it's important to be well positioned for the situation where the deal flow might again go down. And the best way to do this is to diversify across sourcing channels. So what does that mean in practical terms? It effectively means that one should not invest only through the primary channel, but one should ensure as an investor that there is access to co-investments and secondaries. And primary investments are the most common way to access the asset class. And it's either through having an investment through a flagship fund or establishing an SMA.

[00:11:53] So in other words, basically that is the main, deployment driver. However, one can expand further [00:12:00] deployment by moving into Co-investments. And the way this is done is then just having a relationship with many more GPs through which Co-investments can be sourced. So basically they help with the deployment, but at the same time, Co-investments, basically do not carry any management and performance fee from the GP side so they also contribute very positively to the IRR or performance side. The other sourcing channel, which is becoming more and more prominent in the market are the secondary deals. And there it's about acquiring the whole portfolios of private debt loans. And the benefit is that these can be acquired at a discount. So on one hand side, they enable more efficient capital deployment because one acquires more or less fully ramped up portfolio. And on the other side, they also enable return pickup because they are acquired at a discount. So let me just to summarize, we are positive when it comes to the private debt market volumes going forward. But in order [00:13:00] to maximize the capital deployment and to be able to manage the deployment risk going forward, we do think that having diversified sourcing channels, so having the capability to do co-investments and secondaries is definitely a key consideration for the investors.

MV: [00:13:15] Gentlemen, this has been excellent. Thank you for your time and insights and I hope to see you again soon.

JS: [00:13:22] Thank you again. And, we hope we'll talk soon.

RS: [00:13:25] Thank you. Talk to you soon.

MV: [00:13:29] Thank you for listening! For more color on today's conversation, head to stepstonegroup.com where you can download our primer on Corporate Direct lending along with the rest of our thought leadership library. Listen to RPM wherever you listen to podcasts.