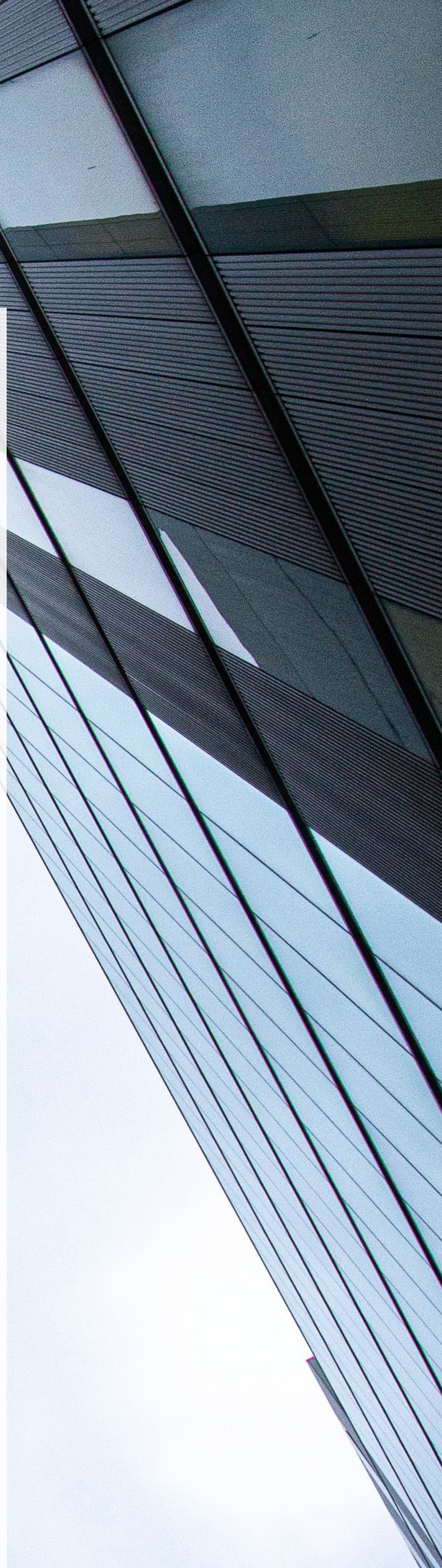
Antares Capital

CPP Investments

Will Private Debt Pass Its Next Stress Test?



Private debt has been around for more than two decades but really only became a more recognized stand-alone asset class following the Global Financial Crisis (GFC), with a wave of new entrants. According to Preqin data, global Private Debt AUM has grown from just $310 billion in 2010 to an estimated $1.5 trillion today, with nearly $700 billion being deployed in North America. Looking forward, some skeptics might argue that most of the post GFC period was a low interest rate and low default rate environment and that too much capital may have been attracted to the space. The 2020 Covid recession was deep and certainly a stress test the asset class unquestionably passed, but it was also short-lived.

With this context as a backdrop, we chatted with Andrew Edgell, Senior Managing Director & Global Head of Credit Investments at CPP Investments about how he sees private debt faring in the credit cycle ahead. CPP Investments is one of the largest institutional and private debt investors globally and last year won Private Debt Investor magazine's Private Debt Investor of the Year recognition both globally and for North America.

Q&A with Andrew Edgell

Senior Managing Director & Global Head of Credit Investments at CPP Investments

Where do you think we are in the cycle? What do you think the odds are of a recession over the next year or so? If it comes, do you think it will be mild or more severe?

Central banks across the world continue to communicate the need to maintain restrictive monetary policy to achieve their inflation targets and that has had serious implications for the prevailing economic environment. I think governments are in this fight with inflation to win— they have too much to lose if inflation persists. I'm in the camp that thinks we are likely to see higher rates for longer, and persistently high rates may well cause a recession. How big a recession and default cycle is still to be determined.

A combination of our scale, certainty of assets, and our long investment horizon make us uniquely positioned as a global investor. We assess the prospects of our strategies and opportunities over decades, not just quarters or years. We can withstand short-term downturns to create value over the long run. Because of this, we are careful not to live and die by making good recession timing or depth predictions which are notoriously fallible. I feel like we've been discussing that a recession is three months away for at least three years now. Instead, we see more value in stress testing our entire portfolio and all of our positions under various scenarios with the aim of ensuring that the skew of potential outcomes is more positive than negative. This has tended to be a winning strategy over the long run.

That said, on the positive side, if you look across the US high yield and leveraged loan issuer market, we have had eight consecutive quarters of positive, albeit decelerating, revenue and earnings growth. Many issuers are growing into their higher debt service, so even though rates have gone up, they are growing into it. Debt service coverage ratios have been declining—so there is reason for concern—but in our own portfolio, we haven't been seeing any meaningful revolver drawdown activity which is often a signal of how much heat companies are feeling. I'd say on balance, the leveraged space and the economy generally have been trending better than one might have expected.

From a historical perspective, loan-to-value ratios are much lower (more favorable) than they were prior to the GFC. PE firms have a lot more skin in the game and also more capital available to support their investments. Also, while there were more covenants around during the GFC than today, ironically, that is giving PE firms more option value and more to fight for if they can help companies through temporary liquidity squeezes. Of course, these are just some observations from our current vantage point. How things ultimately play out if we go through a deep recession is undetermined.

What about the question of saturation? Has there been too much capital raised in the private debt market relative to the market opportunity?

There's no question there has been a lot of growth. Global private debt AUM is estimated at about $1.5 trillion which puts it at roughly the same size as the broadly syndicated loan market. We expect AUM to continue to grow with more coming in from the Middle Eastern funds, insurance companies and other areas. Interestingly, recent Goldman Sachs research showed that money flowing into private debt was coming from a rotation out of equities. So it hasn't been so much a rotation from public credit into private credit—at least not recently – which is noteworthy looking more broadly across credit markets. Also, private credit is expanding beyond just corporate cash flow credit into asset backed credit like structured credit and other areas, some of which we've been investing in for years now.

Of course, this strong investment demand is currently happening at a time when LBO and M&A activity has been sluggish. However, the pull-back by banks in the syndicated market has given more share of the supply to the direct lenders which has been something of an offset. Right now, spreads and terms on new deal flow appear attractive, so lenders are being disciplined for the most part. Also, supply is cyclical and there will come a point where the bid-ask spread narrows and PE firms start to transact again. Private equity firms also have a lot of dry powder to put to work, and the ratio of Private Debt to Private Equity dry powder does not look excessive.

All that said, it's true there have been a lot of smaller new entrants into the private credit space that have taken advantage of an entry opportunity due to the bank pullback from the space. One thing to consider is that a new smaller fund isn't going to have the same risk management, oversight, governance, procedures, etc., compared to a larger established player or a bank. We have had a long period of relatively forgiving market conditions with low default rates, and as stress levels rise, we will no doubt see a greater dispersion of performance among lenders.

On balance though, we see private debt as offering attractive risk-adjusted returns and it remains a very important part of our portfolio.

So, what does it take to be successful these days as an investor in private debt? What attributes should an LP look for in a private debt GP?

As with any asset class, it's critical to choose smart partners that have the right capabilities and a strong alignment of interests. In the case of private debt or direct lending more specifically, it's important to have a large, scaled originations platform with strong PE relationships so that you can be selective across the broadest possible set of opportunities and take the lead position on transactions. Having a very large portfolio is also a critical source of incumbency advantage in terms of winning deals and continued investment opportunities when market activity is depressed. Of course, it goes without saying you also need deep experience and disciplined credit underwriting, including proper assessment of sustainability-related risks and opportunities.

Finally, it's important to have experienced, dedicated workout capabilities. Of course, you want to avoid troubled credits and invest in the most recession-resistant industries to begin with, but inevitably there will be some troubled credits along the way—particularly if we do get a tough stress-testing cycle ahead. Alpha in private credit is mostly generated by avoiding losses and maximizing recoveries, so this is a very important part of the mix, and many smaller newer entrants in private debt lack dedicated workout teams.

I know this is talking our book, but we own 83% of the equity in Antares Capital and believe they possess all these attributes and that it's been key to their success. It's been one of the best investments across the firm since we bought it in 2015—and the type of smart partner we're proud to work with.