WHAT MATTERS MOST IN CONSIDERING A PRIVATE DEBT STRATEGY

Andrew Edgell, Senior Managing Director and Global Head of Credit Investments at CPP Investments sits down for a candid conversation about the current economic environment, investing in private debt and his views on the role credit plays in advancing ESG initiatives. CPP Investments is the majority owner of Antares Capital.

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Some investment advisors have recommended increasing allocations to private debt in the face of a stagflation scenario. How does CPP Investments think about the merits of portfolio allocation to private debt in terms of weathering the current economic environment?

We agree that private debt offers attractive attributes that justify a significant core level of allocation generally, and in particular, given a stagflation scenario. Clearly, floating rates—hence shorter durations—and seniority in the capital structure are beneficial attributes in a rising rate environment. However, we would note some caveats.

For one, we are focused on relative value and the current yield premium private debt typically offers has compressed compared to public debt. However, this is more of a short-term tactical caveat. There will always be moments when opportunities in the public markets might look more attractive, but private credit as a strategy is not something you can simply turn on and off. Also, private debt spreads have been widening more recently, with terms improving in the lender's favor and leverage is declining. We expect the asset class to continue to offer significant yield premium over the cycle.

Another caveat is that a prolonged stagflation environment is likely to be significantly more challenging for lenders to navigate from a credit perspective. We have come through an extended period of low rates, compressed spreads and a generally strong economic backdrop over the last decade, apart from Covid's impact in early 2020 (which though severe, was relatively short lived). This period proved to have been a heyday for investors that could originate assets, generate yield and quite easily minimize defaults. If there is an extended period of stagflation ahead, yields may be higher but so will defaults and losses. While the asset class as a whole will likely prove resilient and generate attractive returns, the difference in performance between strong and weak lenders is likely to widen.

Finally, while a stagflation scenario is a possibility, we don't pretend to have a crystal ball. Instead, we conduct scenario analyses to understand the range of potential positive outcomes and avoid deals where the skew of outcomes is negative or where there are fat tails. Since the outset of the pandemic this has helped us find more profitable opportunities.

Q: Speaking of dispersion in GP performance, in the current environment especially, what attributes do you see as key in differentiation among private credit (or direct lending) GPs? Is there anything that stands out as particularly relevant?

A: When we think about alpha in credit broadly, we tend to compare performance versus public credit indices in high yield or leveraged loans, although this is admittedly imperfect. In less liquid buy-and-hold markets such as direct lending, alpha becomes much more about loss mitigation.

On this front, it's important to have a broad origination funnel. This allows GPs to see the full spectrum of opportunities in the market, and then be really maniacal, frankly, about selecting the best credits in which to ultimately invest. So, there is inherent risk mitigation that comes from having a strong originations platform coupled with deep, experienced credit discipline.

In today's environment, it's particularly important to be very careful about picking credits that are resilient to rising inflation and interest costs. If you can conduct the diligence and get comfortable that a company is resistant to these factors, that's a pretty good combination because you can achieve higher yields while minimizing losses.

In our view, loss mitigation also requires strong PE sponsor relationships—we saw this play out during Covid when sponsors stepped in to support their portfolio companies—and dedicated workout capabilities to minimize losses if and when they occur. Other traits we look for in GPs include alignment of interests, strong governance and systems for asset management, a resilient capital base with diverse sources of funding to optimize the liability side of the equation, and a focus on anticipating, managing and integrating sustainability-related factors that are material to their business.

One of our guiding principles is partnership and the critical characteristics we look for in a partnership can be found in different forms. Antares Capital is a good example. Normally we tend to invest directly in markets that we are interested in; however, in mid-market direct lending, organically building a platform of Antares' scale—with its deep relationships—was not a possibility in a reasonable timeframe.

Q: There's a lot of discussion in the market about whether the U.S. is currently in a recession, particularly since GDP declined for the second consecutive quarter. How does CPP Investments think about this and what do you expect over the next 12 months both in the U.S. and global economies (what should readers be keeping their eyes on)?

A: As I noted earlier, we don't have a crystal ball and we rely on scenarios to stress test our investment theses, but I will offer a few observations.

In looking at markets, there is clearly a lot more risk that has started to be corroborated by widening credit spreads and liquidity drying up—especially in junior parts of the capital structure. There are also some technical pressures on markets. We see capital moving to higher quality, shorter dated paper. In addition, banks have recently underwritten some large deals that they have not been able to syndicate smoothly, so they are hesitant to originate new product. Inflation along with the Russian invasion of Ukraine are weighing on consumer confidence and this is impacting large markets like mortgage and consumer asset-backed securities. And further, supply chain issues have been exacerbated by China's zero-Covid approach, and more recently U.K. Gilt volatility and U.S. dollar strength are impacting global markets.

In terms of the fundamentals at the company level, credit metrics are generally still robust but starting to deteriorate and we are definitely seeing a slowdown in growth and margin compression in some areas. Some companies are resilient and performing well but others are increasingly afflicted by higher inflation, interest costs and supply chain issues. It's increasingly a mixed bag, which again underscores the point that being selective in picking credits is going to be all the more critical as we move forward.

Q: What role does CPP Investments see credit playing in driving ESG initiatives at the borrower level? Should lenders simply be screening for sustainability-related risk or do you believe creditors should play a more proactive role in trying to drive sustainability-related initiatives with borrowers? What, for example, is CPP's view on spread ratchets?

A: If companies cannot demonstrate that they look through a sustainability lens, and integrate it into their culture and their strategy, they will begin to lose the confidence of their customers, their suppliers, their employees, their regulators and, by extension, their investors. This lack of confidence translates directly into loss of value. Therefore, even if you look strictly through an investment lens, you need to put these factors near the top of your list for diligence.

In terms of credit investors helping to drive ESG initiatives, influencing change can be challenging without representation in the board room. Nevertheless, inaction is no longer a viable strategy. Sustainability-linked margin ratchets are clearly one area for future innovation for private credit over the next 12-24 months where lenders can more directly influence company behavior; however, there needs to be careful consideration of targets—not just window dressing for green marketing purposes. Also, ratchets that offer to lower the spread based on a target should also, in theory, represent a balanced proposition for both the lender and the borrower. This "win-win" opportunity presents itself when the lower spread charged reflects true de-risking of the credit and an equitable risk return adjustment—unless the lender has a specific impact mandate allowing for such a tradeoff of returns.

On the topic of decarbonization, our unique approach focuses on financing emissions reduction and partnering with select high emitters to spur meaningful and necessary progress to net zero in the real economy, and in doing so extract the value presented by the transition. On the credit side, we take a three-pronged approach: first, we are standing ready as capital partners for companies embracing this challenge and who have credible transition plans; second, we are maintaining a dialogue and engagement with companies that are innovating to capture the opportunities of the whole economy transition; and third, we are funding forward-looking solutions to the whole economy transition. Additionally, we are walking our talk through our own commitment to achieve carbon neutrality in our operations by end of fiscal 2023 and by increasing our investment in both green and transition assets.