DIRECT LENDERS FACE REALITY CHECK AT SUPERINVESTOR CONFERENCE

LONDON, Nov 18 (LPC) – Direct lenders are facing a reality check as spiralling inflation and the pace of rate hikes implemented since July are now impacting the asset class.

The tone among private creditors gathering this week at the SuperInvestor event in Amsterdam was much more muted than that seen at the Berlin conference just five months ago, when lenders were eyeing opportunities to edge out banks to win debt underwritings.

“There are three key topics in our minds today – inflation, rates and recession. This is the new definition of IRR. They’ve been on our radar screen for a while, but things are accelerating,” Blair Jacobson, partner and co-head of European Credit at Ares Management said at the Amsterdam conference. “These are the highest levels of inflation we have probably ever seen in our investment careers.”

During the conference, the UK's rate of inflation hit a fresh 41-year high of 11.1%. Meanwhile, the Bank of England is expected to raise rates by 50bp in December up from 3%.

The European Central Bank this year raised rates for the first time in 11 years. It surprised the market in July with a 50bp rate rise, higher than 25bp estimated by economists. It then lifted the base rate again by 75bp in September and made another rate rise a month later to 1.5%, its highest level since 2009.

To cope with the rate hikes, private debt funds are pressing borrowers to hedge the risk of rising liabilities.

“We are being proactive with our companies, showing them the math, putting them on notice and want them to figure it out. They can cut costs, sell assets, put equity in and do whatever they need to do. But don't say in a year that you're having problems paying our interest,” said Jacobson.

It is unclear how private equity-owned businesses, which have been financed by the private debt market, will fare through this cycle.

Direct lenders believe that the size of sponsor-funded equity cushions in such businesses will mean that sponsors are more likely to step in and save them if the market tone sours further. Sponsors are unlikely to want to see their equity investment being wiped out if they walk away and hand the keys to lenders.

“Sponsors have lot of skin in the game,” said Vivek Mathew, head of asset management and funding at Antares Capital. “We tested the sponsors’ interest in retaining their own companies during Covid. They showed an alignment of interest and were willing to put in more capital at the time.”

Moving the goalposts

Despite the volatility, direct lenders are still open for business. However, they have become more conservative in new deal underwritings, requesting better terms including interest margins, higher fees and call protections to reflect the increased risks.

“The cost of capital is clearly going up. The fees are going up. The margin for senior lending for now has been increased by 100bp-250bp in Europe,” said Ruediger Blank, partner at Park Square Capital.

Direct lenders have also cut down the size of their commitments in order to diversify their portfolios.

“Most people are not allocating their peak capabilities into deals,” said Mathew. “We have lowered the size that we're investing in each transaction right now. We want to be cautious and really lean into portfolio diversification.”

And there's still money to be made. With the yield on senior debt being increased to double digits and tightened loan documentation, direct lenders believe this year's loans could be the best vintage ever since the global financial crisis from a risk-adjusted return perspective.

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