

Private Credit Demonstrates Resiliency Amid Current Economic Conditions



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MACROECONOMIC-INDUCED DISRUPTIONS ARE CREATING OPPORTUNITIES IN PRIVATE CREDIT

The outset of 2022 has been characterized by a brewing storm of rare conditions – the highest inflation experienced since 1981, rising interest rates to battle this persistent inflation, continued global supply chain constraints, labor shortages, and increasing geopolitical tensions. This is all while the world is attempting to return to a semblance of “normalcy” post-pandemic. These factors have ultimately forced investors across asset classes to evaluate their willingness to deploy capital, and issuers to assess the optimal time to tap financing sources.

Specifically, the public credit markets have experienced significant week-to-week swings due to the potential of an economic slowdown and the broader geopolitical tensions. In the private markets, although Q1 was off to a slower start, we believe sponsors are increasingly turning to private credit for financing, propelling increasing levels of deal flow.

General themes carrying over from 2021 are driving activity:

- Private equity has raised record levels of capital over the past three years and, as of June 2022, firms have \$524 billion¹ of buyout dry powder that they need to put to work
- Private credit has exhibited similar momentum, with record levels of capital raised bringing the asset class to \$398 billion² and dry powder sitting at \$141 billion²
- Underpinned by these favorable technicals, private credit broadly remains open and constructive in this volatile environment, often offering innovative solutions to sponsors
- Further, given the private nature of the asset class and the difference in the type of diligence conducted compared with the public markets, direct lending can be uniquely structured based on the borrower’s specific cash flows and business characteristics; this is particularly relevant during volatile times
- Relative to high yield, we believe that floating rate debt is the preferred option in this rising interest rate environment

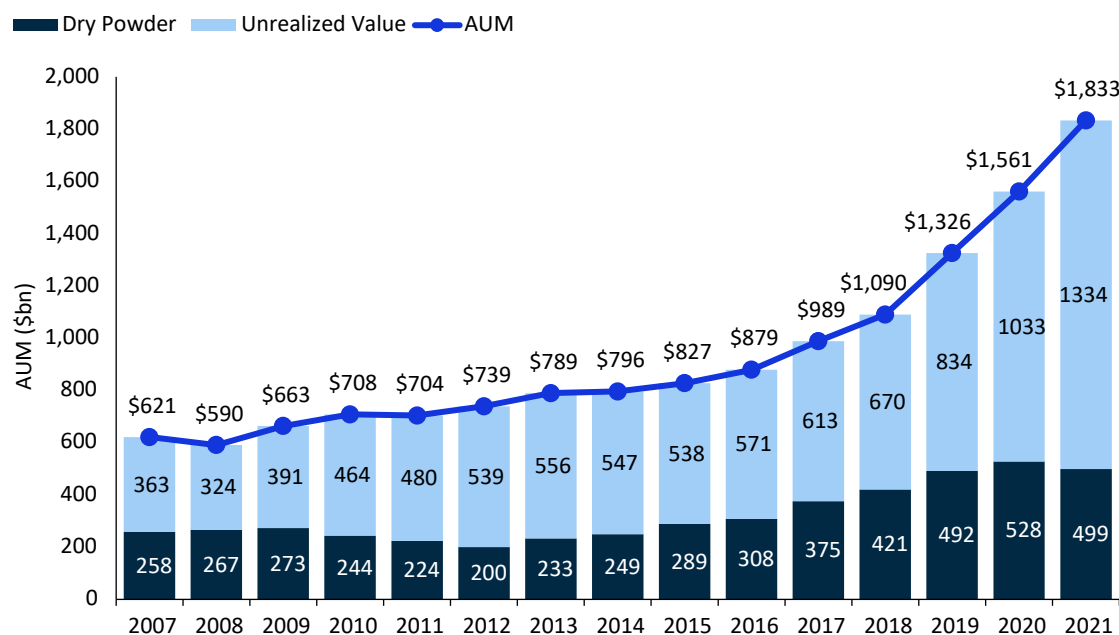
Therefore, even amid current economic conditions, we expect private credit to continue its positive momentum throughout 2022. That being said, outperformers in the private credit space need to continue practicing discipline on both credit and structure, especially when taking into account the ever-changing environment we’ve been experiencing post-pandemic.

Abundant Supply of Private Capital has Kept Direct Lending's Pace of Activity High

A large amount of private equity capital is sitting on the sidelines and needs to be deployed. Continued deal flow should be further supported by the strong momentum in capital raising experienced over the last three years. According to Preqin, North American buyout private equity firms raised \$237 billion³ in 2021, up from \$183 billion⁴ in 2020. The chart below demonstrates general willingness to continue to invest in private equity and a high level of dry powder that ultimately needs to be put to work.



Figure 1: Private Equity Buyout AUM (\$bn)⁵



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Note: Dry Powder, Unrealized Value, and AUM data for 2021 are as of September 30, 2021. Data for other years are through December 31.

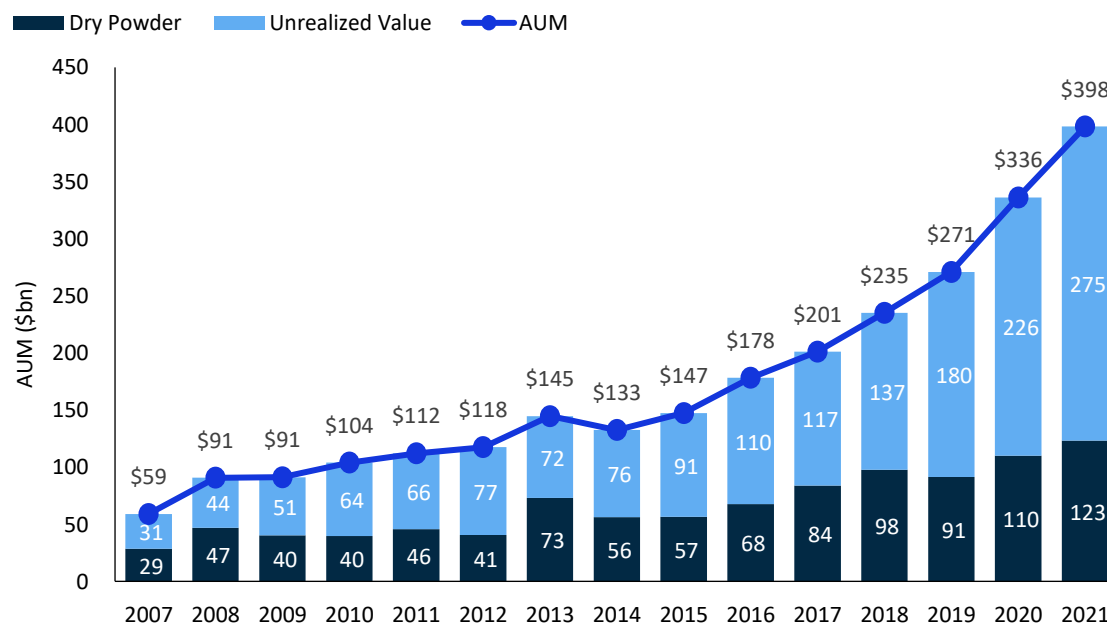
When translating to actual results, although middle market deal activity slowed in the first quarter of 2022 from a record quarter in Q4 2021, the volume of transactions was in line with Q1 2021 levels.⁶ In our view, the decrease from Q4 was primarily due to typical deal flow seasonality and a rush to close deals before the end of the year due to potential changes in tax policies. Notwithstanding the above, we have seen a resurgence in auction processes and momentum across private equity in the last couple of months.

Meanwhile, direct lending dry powder sits at about \$141 billion,⁷ according to Preqin. This compares to over \$1 trillion of debt financing demand that we estimate will be required over the next three years when taking into account (i) upcoming cumulative scheduled leveraged loan maturities of over \$200 billion, and (ii) implied debt demand based on existing private equity dry powder of \$597 billion⁹ and assuming deployment of dry powder incorporates an average LTV of 40-50%. In 2021, \$78 billion of private credit capital was raised, increasing from \$51 billion in 2020 and \$46 billion in 2019.¹⁰

Capital continues to pour into the private credit asset class in 2022, with \$47 billion raised through June 2022, demonstrating that private credit continues to be attractive, especially in this rising interest rate environment.



Figure 2: Direct Lending AUM (\$bn)¹¹



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This contrasts the broadly syndicated loan market, which has experienced some choppiness in supply. Collateralized Loan Obligation (CLO) issuances are down 13%¹² year-over-year through June 2022 as compared with the same period a year ago. Since CLOs make up approximately 70% of the institutional leveraged loan market, this dynamic has impacted issuers’ abilities to bring deals to the broadly syndicated loan market. Meanwhile, the leveraged loan index is down approximately 5.1% year-to-date through mid-June,¹³ which is viewed as reflecting investor sentiment after taking into account broader economic challenges and digesting Q1 2022 company earnings. These factors have largely driven weaker leveraged loan primary activity over the last three months when compared to the same period last year.

How has the Supply of Private Capital Impacted Demand for Direct Lending?

In an otherwise lukewarm market, the supply dynamics described above have encouraged sponsors to turn to their private credit partners. The relative speed and ease of execution in this market are generally viewed as further draws for sponsors, especially when considering the ratings and syndication process undertaken with a broadly syndicated deal. In our view, sponsors also take comfort in the fact that they maintain dialogue and/or direct relationships with their private credit partners, making financing structures more open for discussion. For example, direct lenders are typically more receptive to bespoke structures. Firms like Adams Street, with a flexible capital base, can exercise creativity in structuring debt with the goal of achieving desired yields while simultaneously negotiating for desired protections and seeking to mitigate credit specific nuances. Specifically, direct lenders can be thoughtful about creating tailored financing solutions that help sponsors achieve targeted capital structures while also addressing potential credit concerns.

The benefits of direct lending to sponsors coupled with the choppy nature in the public markets have paved the way for direct lenders to take share from the broadly syndicated loan market. Importantly, fundraising success has directly translated to much larger bite sizes for direct lenders, including Adams Street, which has made it easier to execute on jumbo \$1+ billion unitranche deals among a small group of lenders. In 2021, Direct Lending Deals tracked a total of 21 deals, aggregating to \$49 billion, that were funded by \$1+ billion unitranche deals;¹⁴ this trend has continued through 2022 thus far.¹⁵ Some examples over the past six months include unitranche deals backing Permira's leveraged buyout (LBO) of Mimecast, Thoma Bravo's LBO of Anaplan, and Harvest Partners' recapitalization of Galway Insurance.

We expect the private credit market to be a compelling alternative for sponsors, given the higher certainty of financing and the comfort of knowing that a constructive partner is holding the loan. Although we are still focused on lending to middle market companies of less than \$1 billion enterprise value, Adams Street has been opportunistically active in capitalizing on this environment and has stepped in to provide certainty of financing to its larger sponsor clients when execution risk in the broadly syndicated market was uncertain.

What if the Current Environment Persists?

In our view, the outlook for private credit remains positive. Markets continue to digest the Federal Reserve's actions to fight inflation and private credit tends to be relatively insulated from rate hikes given its floating rate nature. Further, private credit's ability to structure deals based on a company's long-term credit fundamentals remains unchanged from short-term market disruptions.

The question at the forefront of everyone's mind is at what point will some of the broader global issues begin to negatively impact private credit if they continue to persist. While a potential recession could negatively impact the outlook for future LBOs and M&A activity, which ultimately drives the private credit market, the reality is that, as it stands today, (i) we believe the private credit asset class will continue to yield a risk/return premium relative to public credit alternatives, and (ii) given where private equity capital currently sits, a company's cost of capital would have to significantly increase to substantially slow down sponsors' willingness to transact. Notwithstanding the above, in order to stay balanced and prudent with capital, private credit firms need to maintain sector discipline and put money to work in the right structures that appropriately marry the respective credit risks. This puts a premium on manager selection, which should favor those that have demonstrably managed through markets with the types of risks being posed today. ■



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1. Preqin. Fundraising and dry powder statistics reflect North American buyout capital.
2. Preqin. AUM and dry powder stats reflect North American direct lending and mezzanine capital as of June 2022.
3. Preqin. Fundraising and dry powder statistics reflect North American buyout capital.
4. Ibid.
5. Source: Preqin.
6. Refinitiv's LPC 1Q22 Syndicated Middle Market Review, April 2022 ("Refinitiv 1Q22").
7. Preqin. AUM and dry powder stats reflect North American direct lending and mezzanine capita, as of June 2022l.
8. Estimate based on reported loan maturities of US sponsor backed middle market loans over 2022-2026 as reported in Refinitiv 1Q22. Middle-market defined as issuers with revenue of less than \$500mm and total deal size of less than \$500mm.
9. Preqin, charts and league tables, current through April 30, 2022.
10. Ibid.
11. Source: Preqin.
12. S&P Global CLO Weekly.
13. CS Leveraged Loan Index as measured on May 12, 2022 and reported on LevFin Insights.
14. Direct Lending Deals "Full Year 2021 Insights & Outlook," January 14, 2022.
15. See, e.g., Butterworths Journal of International Banking and Financial Law, "Rise of the jumbo unitranche: a continuing trend in 2022?" February 2022.



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*Firmwide AUM as of December 31, 2021 was \$49.3 billion.