Private credit enters potentially attractive vintage era

Rising yields, improving capital structures and favorable deal terms signal the potential onset of an attractive vintage for private credit investors who focus on rigorous underwriting and credit selection.

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Concern about the rising risk of a contraction roiled public equity and debt markets in 2022, shifting the attention of many investors in the direction of capital preservation.

For private credit managers focused on funding businesses in an environment characterized by volatility, interest rate hikes and generationally high inflation, careful credit selection and tight underwriting can be key differentiators.

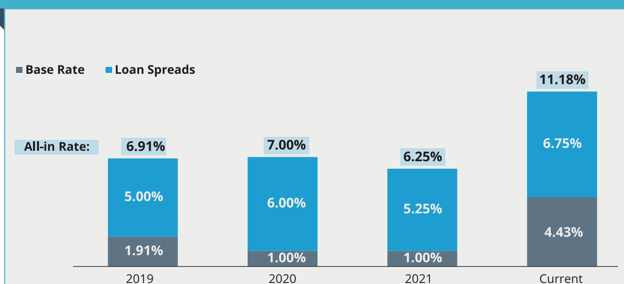
But alongside this mindset are several shifts in market dynamics that lead to optimism that we could be at the beginning of a fairly protracted and attractive vintage period for private credit.

Improving metrics

On many key measures, including absolute and relative yield, leverage, equity contributions, covenants, and lender's rights, the dial has moved in favor of credit providers.

Based on the deal flow we have seen in recent years, and as Figure 1 and Figure 2 show[1], yields have climbed significantly since 2019, to more than 11%, which we view to be a compelling return for the level of risk associated with senior, secured debt. In the same time frame, our deal flow suggests the credit spread demanded by investors widened to about 6.75% from around 5%, with the potential to grow further. Relatively, private credit provides a premium spread of 200-300 basis points over a number of

FIGURE 1: DEAL TERMS - PRIVATE CREDIT BENEFITS FROM HIGHER YIELDS, WIDENING SPREADS



Source: Adams Street Partners, based on Adams Street Private Credit market observations. Base Rate represents 3-month Libor as of the last day of each calendar year for 2019-2021 and 3-month term SOFR as of November 30, 2022, for Current.

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more liquid options. Meanwhile, the floating-rate nature of private credit provides a hedge against interest rate risk that fixed-coupon instruments lack.

Lower leverage

Most major risk parameters are also moving in the right direction for private credit investors.

Leverage has decreased to roughly 5.5 times earnings before interest, taxes, depreciation, and amortization (EBITDA), from a peak of six times EBITDA or more in 2021, based on our private credit market observations. We believe those figures are likely to decline further, because rising interest rates are acting as a governor on companies' ability to carry much more than five times debt to EBITDA.

Higher equity contributions

The equity contribution in deals has also climbed by typically 10 percentage points to about 50% of deal value since 2019, according to our private credit market observations. This implies the enterprise value of a portfolio company would need to contract by half to risk impairing the underlying loan.

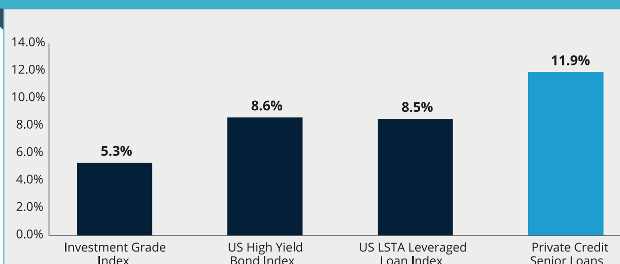
The dislocation in public markets has also bolstered protections for lenders, including strong collateral, beefier covenants and capital structure seniority that provides additional security and rights in workouts and bankruptcies.

Credit analysis

Extensive due diligence also helps credit providers to select deals with the attributes that most closely match core investment parameters. Acting as lead lender provides access to the data needed to accurately analyze potential pressure points that may impact a business. A forensic accountant can determine an underwritable EBITDA number, while external consultants can appraise supply chains, market dynamics and competitive positioning within a sector.

In our view, defensive, mission-critical businesses with the ability to pass on costs through higher prices are more resilient than those that are historically more closely correlated to economic growth. On the other hand, companies in capital-intensive sectors that rely on discretionary spending, or ones that provide labor-intensive services where wage pressures and personnel churn can create problems in a tight labor market, are typically less resilient.

FIGURE 2: YIELD PREMIUM - PRIVATE CREDIT YIELDS COMPARE FAVORABLY TO ALTERNATIVES



Source: Adams Street Partners, based on latest available index information as of November 30, 2022. US Investment Grade from S&P 500 Investment Grade Corporate Bond Index as of November 30, 2022. High Yield Bonds from S&P U.S. High Yield Corporate Bond Index as of November 30, 2022. Leveraged Loans from S&P/LSTA U.S. Leveraged Loan 100 Index as of November 25, 2022. Private Credit Senior Loans yield calculated based on observed market spreads of +/-650bps, 443bps base rate as of November 30, 2022, and upfront fees of 2.5% amortized over 2.5 years.

In general, we view private equity-backed deals as being safer, as sponsors tend to use their resources to support portfolio companies, including providing additional liquidity when necessary. Such a backstop, particularly when recession risk is heightened, can be of great value. Further, in our experience, working with deal sponsors with strong records and sector experience can give private credit providers a competitive advantage.

Deal flow offsets

While depressed valuations and tighter credit selection create a reasonable expectation of a slowdown in deployment in 2023, deal flow will likely be supported by $586 billion in dry powder in North America focused buyout funds as of 22 November 2022, according to Preqin. Another potential offset to a slower pipeline is that larger businesses are tapping private markets after banks pulled back from issuing broadly syndicated loans and acting as syndication agents during 2022.

There's a saying in the private credit business that some of the best loans are written in the worst of times. With the potential for investors to earn attractive returns, while positioning themselves more defensively thanks to an unusual combination of higher yields, improving deal terms, lower leverage, tighter underwriting and stricter credit selection, there are encouraging signals that private credit could be at the start of an attractive vintage period. ■

1 The use of graphs, charts, formulas, or other devices is subject to inherent limitations and difficulties; investors should not make investment decisions, including whether to purchase or sell or the timing of such actions, based solely on the information presented in such devices.

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SUMMARY

Rising yields, improving risk parameters and better deal terms form a trifecta of positive dynamics for well-informed, defensively minded private credit managers.

Rigorous underwriting and conservative credit selection can be critical differentiators.

Lighter deal flow from core sources is being offset by high amounts of private equity dry powder and larger businesses turning to private markets as public debt options are closed off.