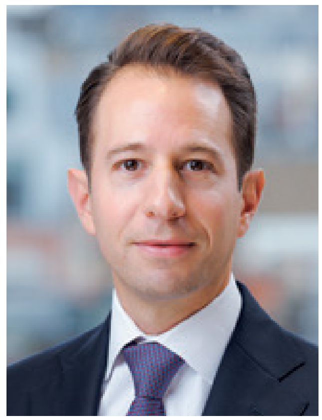
EXPERT Q&A

*The popularity of the direct lending market is likely to be structural and long-lasting, say Bill Sacher, James Charalambides and Leland Richards from Adams Street Partners*


# Shift to private debt represents 'a step change'

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**Q Where do you see the best opportunities for private debt investors within the current market environment?**

**Bill Sacher:** There are a number of interesting places to be right now. NAV [net asset value] lending is a fairly nascent area with a large potential market opportunity. Then there's lending to venture capital firms, which have recently become a bit more challenged in terms of raising finance.

Despite the variety of alternative structures, we believe plain vanilla senior term debt remains one of the most compelling areas for investors. This segment of the market is yielding very close to 12 percent, a level not seen for well over a decade. Senior term debt is also in the safest part of the debt capital structure.

The twin benefits of high yields and defensive positioning make senior term debt a very hard proposition to beat, particularly in highly uncertain times. We generally do not think there is much need to stray into more esoteric segments of the market.

**Q What is driving such an attractive rate of return?**

**BS:** Start with the base rate. Central banks around the world (particularly in the US and Europe) have tightened monetary policy significantly over the past year. Climbing interest rates have pushed the base rate of private credit loans up by 400 basis points or more during this time.

Credit spreads have also widened by between 100 and 150 basis points as a supply and demand imbalance has shifted the negotiating balance of power from borrowers to lenders. Previously, it was possible to get leveraged buyout financing in the broadly syndicated loan market. But as that market has effectively shut down, the private debt market has become the only viable alternative for many.

**Q There has been quite a lot of talk about unitranche club deals recently. What advantages do these financing structures offer?**

**James Charalambides:** The US private debt sector has been a club market for quite some time, while the European market has generally operated on a bilateral basis. Bilateral deals usually have a single lender, while club deals may have two or more lenders coming together under a single loan agreement.

The European market is changing and there are a few important factors driving the adoption of club deals in Europe. One is that a number of lenders have been reducing ticket sizes in light of the challenging macroeconomic conditions. Lenders are thinking about fundraising cycles more conservatively. This helps them stay within concentration limits and means that they can lengthen the time between fundraising rounds. In conjunction with sponsors turning to direct lending for larger transactions, these factors have forced lenders to form clubs.

So, while unitranche deals have historically been bilateral in Europe, a relatively significant share of direct lending transactions last year were club deals. Club deals require a bit more work on the front end, but the benefits are clear – a deeper pool of capital for incremental financings.

This trend has accelerated over the last 12 months in Europe and early signals point to the trend continuing in the months ahead.

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**BILL SACHER**

The combination of the base rate going up 400-plus basis points, and spreads widening 100-150 basis points has contributed to that 12 percent yield.

**Leland Richards:** The credit metrics of the deals also look a little bit different than they did two years ago. Leverage has fallen, equity contributions have gone up and documentation terms have become tighter. By virtually every important metric, the terms and conditions are better than we have seen in quite some time.

In combination, that creates a rare and compelling set of dynamics for private credit investors – while yields are rising significantly, lender protections are also simultaneously strengthening.

**Q Are prevailing macroeconomic headwinds having much of an impact on the private lending market?**

**BS:** Inflation is taking its toll on company earnings, while higher interest rates are also compressing margins. We are not actively predicting a recession, but we do think that the risk of one occurring is relatively high.

On the other hand, rising interest rates are also forcing debt levels to decline. Companies simply cannot afford to have the same amount of leverage as they had 12 months ago when interest rates were close to zero. Lower debt level is good from a credit perspective.

**LR:** Inflation affects all aspects of the economy and heightens investor uncertainty. It is important to identify those companies that can protect and act defensively in this kind of rising inflationary environment, concentrating on those sectors that are able to pass these higher costs on to their end customers. The ability to identify those opportunities has always been our focus, but it is even more important in the current environment.

**Q What is the best approach for coping with rising uncertainty in the markets?**

**JC:** Flexibility is key. As a capital solutions provider, we try to find the right structure for each transaction. Having a tailored approach allows us to deliver solutions for private equity sponsors while maintaining good risk management oversight. This becomes even more important during times of high uncertainty.

By having flexible pools of capital, Adams Street can be active wherever we see the most attractive opportunities – at any point in time – rather than being forced to just take whatever is offered. Credit markets are cyclical in terms of where the liquidity sits, so it enables us to be selective.

*"Many European sponsors have had no alternative but to turn to direct lending for their financing needs"*

**JAMES CHARALAMBIDES**

**BS:** I totally agree. The syndicated loan market must appeal to a very broad audience, and there are many rigidities around what can be accomplished in that market. The bilateral private market can make it much easier to secure flexible financing that is suited to prevailing market conditions and the borrower's needs. This is a key reason why private credit has started to take market share away from other lending avenues.

Retaining a flexible capital structure gives investors a competitive edge in private debt. A broad market presence, deep understanding of the asset class, and experience of different investment styles are all critical to successfully identifying and selecting the right opportunity across market cycles.

We are pretty bullish on private credit at the moment, and we think we may be on the threshold of a very attractive vintage period for the asset class generally.

**JC:** In highly uncertain environments, private credit often becomes more of a priority for LPs that want to think defensively while still seeking to generate attractive returns. Strong equity cushions, more conservative capital structures, higher yields and better documentation are what we think make the asset class so attractive when looking at the overall macro picture.

**Q So, do you think growth in the private debt market will be short-lived, and will fade away as soon as some form of stability returns to markets?**

**JC:** What we are seeing now is something of a step change, which we believe will remain long after the current period of macroeconomic uncertainty.

The European private credit market is at an earlier stage of development than the US. Banks have been pulling back from the lending market for some time, and this retrenchment continues.

Over the past 12 months or so, many European sponsors have had no alternative but to turn to direct lending for their financing needs. And we are consistently hearing that sponsors are enjoying the experience, which we believe is also accelerating market penetration. The very clear benefits of the private debt market have been reinforced by the growing number of deals that are being done in the market, and we expect that sentiment will remain.

*"By virtually every important metric, the terms and conditions are better than we have seen in quite some time"*

**LELAND RICHARDS**

**BS:** To put this shift into context, the visible forward demand for private debt financing in the US over the next three to five years is more than $1 trillion. This demand compares with a little more than $100 billion of dry powder currently available in private credit funds. We believe that there will likely be a similar situation in Europe. ■

Bill Sacher is partner and head of private credit, James Charalambides is partner and head of European private credit, and Leland Richards is a partner on the private credit team at Adams Street Partners