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Private Credit: Opportunities and Challenges in the Current Macroeconomic Environment

Private credit strategies have surged over the past few years, with assets under management in private credit funds surpassing $1.2 trillion in 2021 and forecasted to reach $2.69 trillion by 2026.[1] Anthony Yoseloff, Chris Krishanthan and Patrick Dennis, co-portfolio managers of Davidson Kempner's global private credit strategy, shared their perspectives in a conversation on the current credit market landscape.

We are in unprecedented times with inflation at a 40-year high, fears of a recession and volatile markets. How does this affect the outlook for private credit and its place in investment portfolios?

TONY: For the last decade, allocators have been able to rely upon equity returns to drive results for their endowments, foundations, pension funds and family offices. We're on notice from the market that it may not be so easy in the next decade to rely upon equity returns. Fixed income has been an afterthought for many investors who have been primarily focused on how they spend their "equity dollars," so to speak. But in a market where equities are flat or down, or are repricing based upon growth expectations, both fixed income and alternative investments can become drivers of performance, rather than just the ballast in the portfolio against equities.

We believe private credit can offer higher yields compared to liquid fixed income investments. There are a few structural reasons for this. There is limited ability to set covenants in the liquid fixed income markets and the collateral coverage is generally not as good.

In general, we think allocations in private credit should be diversified and not too highly concentrated in any one area, as the majority of private credit funds are focused on middle market and sponsor-backed corporate lending.[2] We are particularly excited about the opportunities in asset-backed lending. Asset-backed lenders can demand a higher rate of return, and are able to have more robust due diligence and underwriting versus public markets, in addition to bespoke loan covenants.

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Asset-backed lending can also provide greater ability to actively monitor assets and set triggers. If you get into workout-type situations there can be better direct claims. This is important in a rising rate environment where borrower defaults are likely to increase. We believe strong tailwinds are also creating very good deal flow in asset-backed lending.

What's the current state of the private credit markets? What role does alternative capital play in lending?

PAT: We're excited about the credit market broadly, but before we dive in, it's important to do a quick review of the growth of the broader lending market over the last 20 years.

There's been a lot of discussion on the growth of alternative lenders. However, even through the Global Financial Crisis, the real growth has actually been on bank balance sheets where assets have increased from around $6 trillion to more than $22 trillion since the early 2000s.[3] That's much larger than the growth of alternative lending, which pales in comparison at about $1 trillion over the last 15 years.[4]

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Now fast-forward to 2022, where we see volatility in basically all markets and an increase in base interest rates, higher liability costs, lower enterprise value multiples, and a fear of recession. Banks are spending a lot of time tightening their own loan underwriting standards and increasing capital ratios to comply with changes in requirements. This is not only the focus of bank risk managers, but also the focus of bank regulators and the rating agencies. We've already started to see some announcements of bank downgrades, which is really a byproduct of concerns around capital adequacy at the bank level.

All of this leads to two developments. First, banks are hitting pause in some of the markets that they have been focused on, and some might exit these markets altogether. The second important point is that alternative capital is positioned to fill that critical need of lending in a market where banks are taking a step back.

TONY: I 100% agree with Pat that you're going to see more banks pulling back on lending, and that also could be a great sourcing mechanism for asset-backed lenders. So, you may not even need to be in markets that are overly inefficient to create opportunities for private lending. This is because lenders who offer lower interest rate loans in reasonably efficient markets may pull back or increase their pricing in this environment.

Can you tell us more about the $1 trillion that has been raised in alternative lending and the different types of private credit strategies?

PAT: The capital raised in alternative lending mainly falls into two buckets. The first is what we would describe as unitranche, or 1L opportunities, where managers are looking to disintermediate the Street. This has been the focus of the largest asset managers. The second is the middle market where lenders are really focused on the sponsor financing model, covering the largest or midsized private equity firms and providing financing for their portfolio companies.

> "The underwriting for asset-backed loans is focused on the collateral: What can be recovered, how, and when? This approach gives lenders a vast range of asset classes to underwrite."

In addition to these two buckets, there's the asset-backed lending that Tony touched upon. From our perspective, there's far less competition in the asset-backed lending space, and several attractive differentiating features. First and foremost, the loans are secured by an asset or a collateral package that can be heavily diligenced.

Second, lenders can underwrite rates of return that are in excess of similarly situated marketable securities. For example, we believe an asset-backed lender financing a commercial real estate transaction should be able to achieve rates of return that are in excess of the CMBS market.

Finally, asset-backed lenders can create a covenant profile to mitigate downside risk. This allows asset-backed lenders to create a margin of safety and achieve potentially better rates of return than the prevailing market rates.

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How does the underwriting differ between traditional middle market direct lending strategies and asset-backed lending strategies?

CHRIS: Asset-backed lenders generally aren't basing loans on corporate cash flows or growth, or how much equity a sponsor puts in. In the current environment, it's quite difficult to predict how corporates will perform over the next few years. The underwriting for asset-backed loans is focused on the collateral: What can be recovered, how, and when? This approach gives lenders a vast range of asset classes to underwrite, from residential mortgages to specialty assets such as consumer loans or receivables to structured corporate opportunities with hard security. There are also hard assets which include real estate, aircraft, ships, plants, and machinery.

In asset-backed lending, the "V" in LTV (loan-to-value) isn't simply the earnings or a multiple or a derivative thereof. In our view, this is important because in fixed income strategies, it's critical to protect downside risk and size investments appropriately. This means minimizing losses and knowing what to do when things go wrong – and most importantly – being able to do so in advance.

> "If your private credit portfolio only had exposure in the middle market lending space and you were actively investing over the last two years, you now own a portfolio that's probably not priced to where the market is."

What considerations should investors keep in mind regarding their private credit allocations?

PAT: Private credit strategies generally fit into the alternatives bucket of a fixed income portfolio. In addition to diversification and collateral protection, we believe investors also need to think about the duration and amortization of their alternatives risk.

To highlight an extreme case, if your private credit portfolio only had exposure in the middle market lending space and you were actively investing over the last two years, you now own a portfolio that's probably not priced to where the market is. This is due to a combination of the increase in base rates and spreads widening given the fears of a recession on the horizon.

> "We believe deep experience in underwriting and structuring in credit markets is a must, along with a strong and proven risk culture. Protecting capital is an incredibly important mindset to have when you're a lender."

We believe it's optimal to construct a private credit portfolio with true amortizations within a portion of the portfolio, while allowing for prepayments with call protection in other areas of the portfolio. This can provide a real advantage in a rising interest rate environment, where capital can be redeployed or recycled at market rates or better-than-market rates.

What are some unique ways lenders can structure asset-backed loan covenants?

CHRIS: A key advantage of asset-backed loans is that they generally aren't capital markets-driven transactions with many advisors around, where the investor is taking a slice of someone else's transactions. Asset-backed lenders typically aren't just creating a portfolio of five- to seven-year bullet maturity high yield loans. Asset-backed lenders who can focus on smaller deal sizes, between $25 million to $50 million of equity, can benefit from less competition.

Ideally, the lender is in direct dialogue with a borrower and tailoring bespoke solutions specifically for that borrower. Astute lenders will negotiate creditor-friendly documents for protection. There should be covenants that are monitored regularly, and lenders should not shy away from requiring a borrower to put in money or take other steps to cure a trigger event. Typically, there's amortization to reduce exposure and LTVs, in addition to cross-collateralization and other structural protections such as special purpose vehicles, cash boxes and account monitoring.

Importantly, we believe lenders should be prepared to walk away from a deal if they can't structure appropriate protections. Because asset-backed lenders aren't beholden to equity sponsors for deal flow, they have the flexibility to select opportunities that have in their view the most attractive assets and terms.

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The proliferation of private credit lenders means that there are more choices than ever. What are important characteristics of a private credit lender?

TONY: We believe deep experience in underwriting and structuring in credit markets is a must, along with a strong and proven risk culture. Protecting capital is an incredibly important mindset to have when you're a lender.

Lenders also need to have the ability to structure loans with strong covenants to protect against the downside. And lenders need to be set up to handle restructurings and workouts. If something does go bad, many private credit lenders may not actually have those capabilities in house.

> "We also believe it's important for lenders to have a local nexus as much as possible. You don't want to be a lender sitting 8,000 miles away, where you don't really know the local system, don't have the experience, and don't have people on the ground or the ability to get people on the ground quickly."

In terms of sourcing, a global team of credit investment professionals who can see different types of opportunities across geographies and industries is ideal. We think an all-weather approach to geography and sector allows lenders to be strategic and nimble. We believe it's much better to have more holistic sourcing than to be just focused on one area – you want to be in a position to have robust relative value conversations. We believe lenders with joint venture relationships or similar networks have an important advantage because proprietary sourcing capabilities can give them early looks at opportunities.

We also believe it's important for lenders to have a local nexus as much as possible. You don't want to be a lender sitting 8,000 miles away, where you don't really know the local system, don't have the experience, and don't have people on the ground or the ability to get people on the ground quickly. That's a scary place to be, in my point of view.

> "Skilled lenders can drive returns by minimizing losses from defaults through the right structuring and lending in a diverse range of asset classes or geographies. Lenders can set covenants that require borrowers to take curative steps in the event of a breach or improve the terms and credit quality of their loans."

CHRIS: As Tony mentioned earlier, in a rising rate environment, we are more likely to see an increase in borrower defaults. Skilled lenders can drive returns by minimizing losses from defaults through the right structuring and lending in a diverse range of asset classes or geographies. For example, lenders can set covenants that require borrowers to take curative steps in the event of a breach. Covenants can also enable lenders to improve the terms and credit quality of their loans by forcing borrowers to increase the coupon or post additional collateral to reduce the overall risk.

PAT: I'd add that lenders who always take a long-term approach to how they treat their counterparties are held in high regard. Is the lender known for doing what they say they're going to do? That's hugely valued by counterparties and partners. Going from conversation to term sheet is the easy part. Going from term sheet to close is much more difficult. Success begets success – repeat business is something that reputable lenders can benefit from.

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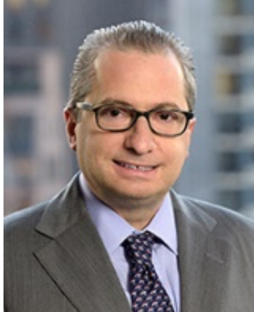
Anthony Yoseloff, Chris Krishanthan and Patrick Dennis are co-portfolio managers of Davidson Kempner's global private credit strategy.



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Tony received a J.D. from Columbia Law School and an M.B.A. from the Columbia Graduate School of Business Administration. He earned an A.B., cum laude, from the School of Public and International Affairs at Princeton University.

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[1] Source: 2022 Preqin Global Private Debt Report

[2] Source: 2022 Preqin Global Private Debt Report

[3] Source: Board of Governors of the Federal Reserve System. Release: H.8 Assets and Liabilities of Commercial Banks in the United States

[4] Source: 2022 Preqin Global Private Debt Report