# Navigating Manager Selection as Private Credit Looks Poised to Perform

## MARCH 2023

**We believe private credit appears poised to outperform in 2023 as public markets struggle to find direction and the macro picture points to economic contraction.**

The current environment particularly favours private credit lenders for several key reasons:

1. **Higher yields[1]:** All else being equal, higher base rates are advantageous for lenders as both fixed and floating rate loans price with higher coupons. This is the case of a rising tide lifting all boats. Of course, there are two sides to every loan; higher expected income accruing to the lender is only as good as the borrower's ability to pay. There becomes a tipping point where default losses will overcome yield. In this environment, a strategy focused on conservative underwriting, to strong counterparties, at appropriate terms, is more likely to deliver strong performance.

2. **Robust demand:** Business owners plan strategically: 5-year plans, 10-year plans and even longer time horizons. We see a strong pipeline forming with proceeds used both to finance M&A and consolidate competitive positions, and to fund CapEx as owners position for long-term growth. Further, the generational transfer of wealth has created significant opportunities to support management buy-outs.

   In addition, the IPO market remains largely shuttered, increasing the holding period for private equity sponsors. This creates significant demand for refinancing and the opportunity for lenders to term-out higher coupon debt.

3. **Lack of competing supply:** Bank balance sheets are increasingly constrained as they operate under ever-more-stringent regulatory controls and remain risk-shy after experiencing balance sheet losses. Debt syndication is at a near halt for any but the most stalwart borrowers, and the leveraged loan markets remain shuttered.

4. **Value of certainty:** Public market bond yields and spreads continue to get whip-sawed amid inconsistent liquidity, sentiment swings, and lack of market directionality. Borrowers' confidence in public market execution has eroded. Even those borrowers that could potentially access public market financing are increasingly tapping the private markets to ensure smooth execution.

These positive tailwinds for private credit have brought many investors, new and experienced, into the market in search of incremental return per unit of risk. However, the influx of capital, and democratization of access, has also led to a proliferation of strategies.

> **"The very real challenge now presented to private credit investors and their consultants is "who do we choose"?"**

The very real challenge now presented to private credit investors and their consultants is "who do we choose"? In the often opaque and complex land of private credit, distinguishing between managers is no easy task. However, as global interest rates continue to rise, and recent data lends credence to the "higher for longer" narrative, there is building evidence that default rates are poised to increase as the interest burden on some, now-stretched, borrowers becomes untenable. For many private credit lenders, this may be their first real test. **As such, manager selection is now more critical than ever.**

1. Statements source: Fiera Capital

## When an Apple Tastes a lot like an Orange

**All private credit funds are not created equal and the differences can be especially difficult to spot in this asset class loosely held together on the premise of "downside protected financing".**

In public markets, managers are judged based on demonstrated performance relative to an easily observed benchmark. We understand fees and agree on the allowable use, if any, of financial leverage. Comparison across managers, and attribution of "skill" becomes substantially mathematical.

In a world without standardization or benchmarks, and often lack of transparency on key points like fees and leverage, comparing one manager to the next is far from simple. As such, in the spirit of caveat emptor, here are a few things to look for when assessing different investment strategies in private credit. In a market where there is truly a flavour for every palate, we believe the goal should be to get what you ordered!

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1. **"Senior secured":** As we head into a period of weakening economic activity, private credit managers, especially in the direct lending space, are touting their focus on "Senior Secured" lending at increasing decibels. Senior secured simply means that the loan occupies the top of the capital stack and is secured by… something. If underlying deal leverage is at 8x EBITDA with a small and deteriorating equity cushion, that senior loan has a very different risk profile than a senior loan attached at 3x to a borrower with robust earnings visibility. Security can also differ wildly from a claim on hard assets with durable resale value to a claim on expected future cash flow. The value of this security differs significantly between these two loans and may materially impact recoveries in the event of a default.
2. **Loan structure:** Regardless of seniority, loans that are Pay-In-Kind (PIK) or carry deferred coupons are not delivering regular cash distributions to investors and effectively add borrower risk exposure over time. These structures are more aligned in terms of risk/return with an equity owner rather than a passive lender. These structures can help generate attractive returns when used judiciously in the right context. However, as a core strategy, these types of loans are associated with higher risk venture or growth businesses that are reinvesting cash to fund growth rather than paying lenders.
3. **Leverage:** Borrowing, by definition, provides leverage to equity owners. However, the amount and type of equity supporting the loan is critical to determining the risk. Further, the business fundamentals, and the stress testing thereof, should be matched to the amount of leverage placed on a business. Investment managers that have legacy portfolios built during headier market conditions, may well see credit impairments overshadowing some of the yield benefits of higher rates.

Private credit managers have also increasingly been using leverage at the fund level to increase returns. This has become more rampant as (1) competition at the larger end of the market has proven to compress yields; and (2) newer entrants, potentially less familiar with offering memorandum small print, may fail to scrutinize and fully understand the use, and implications, of levered strategies. While levered strategies can play a role within a private credit portfolio, the variable use of leverage significantly increases the comparison challenge.

4. **Portfolio concentration:** As private credit fund sizes have grown rapidly, so too has the need to deploy capital. As a result, we have seen some "style drift" where funds stated to be targeting mid-market will hold larger and larger positions in order to deploy capital quickly. Portfolio construction, and the free lunch of diversification, should never be overlooked, especially as we head into an environment where there are bound to be some bumps on the road, even for the most diligent underwriter.

> **If you head to the store for an apple, be careful to leave with an apple, not an orange or… a chocolate bar!**

As we continue through 2023, we believe private credit is well-positioned to provide attractive absolute and risk-adjusted returns and should be considered an important component of a diversified investment program. Allocations to private credit should be made through a strategic lens, looking beyond near-term public market noise and volatility, with the recognition that, depending on the strategy, private credit may provide ample structural liquidity through regular cash distributions.

As we head into this next phase of the asset class's lifecycle, it is wise to be prudent. Understand what you are looking for, be clear on the role your private credit allocation is designed to play in your portfolio, stick to your objective, and ask the necessary questions. If you head to the store for an apple, be careful to leave with an apple, not an orange or… a chocolate bar!

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