EXPERT Q&A

Private credit has fared well during this crisis, but the real test may come at the back end, say Barings' head of private assets Eric Lloyd and CFO of Barings BDC Jon Bock

Riding the refinancing wave

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Q Private credit has finally got the crisis it has been waiting for. How has it fared?

Jon Bock: I would say it has passed the test, so far, in that performance has been consistent with what investors expected going into this. Of course, individual portfolios are performing very differently, as you would expect, depending on asset composition. Some industries have been impacted more than others, both positively – logistics is one example – and negatively, such as with restaurants and retail. But it is important to remember that this crisis isn't over yet, and I think portfolio composition will continue to be a big differentiator going forward, even though the asset class as a whole has proven itself during this challenging time.

Q Has anything impressed or surprised you?

Eric Lloyd: What I have been most impressed with is the ability of management teams to innovate and adapt, whether that has meant transitioning online or refocusing their businesses. It has also become clear that long-term planning really does pay off. Managers with the right portfolio composition and good diversification have fared far better during this crisis than those overly concentrated by asset or industry. Additionally, those who were disciplined through the last cycle and able to avoid significant style drift – rather than chasing yield through higher leverage and looser covenant structures – have been better able to withstand volatility. Investors often don't focus as much as they should on how managers are achieving their targeted returns.

Leading up to this crisis, there were instances when highly leveraged first lien deals, in some cases with quite aggressive structures, were being marketed as more conservative senior debt. And investors were not necessarily being compensated, from an illiquidity premium standpoint, for the extra risk. When the rubber met the road, this resulted in some very real issues.

Q What questions should LPs be asking about what comes next?

JB: When we think about what's coming next, we think about repayments. Record stimulus packages are putting pressure on yields and spreads. Exacerbating this, we have seen a strong trend of retail inflows into the broadly syndicated loan market through the first couple of months of the year, a complete reversal from the previous two years. There was also an enormous amount of distressed capital raised last year, which is now looking for a home and effectively bidding up higher-risk assets. With repayments forthcoming, there are a number of questions LPs may want to consider asking – such as what happens when lower-quality loans that have been placed on the books repay.

EL: Manager discipline is key as well. Particularly as those repayments occur and the supply/demand balance shifts, LPs can benefit from ensuring their managers are remaining disciplined in how they're deploying capital and avoiding style drift. As we have moved through the pandemic environment, larger platforms with more diversified, stable capital bases and ample dry powder have been fairly well-positioned as activity and volume have resumed over the last two quarters. In cases where there was a lack of alignment or instances of style drift, we have seen greater challenges.

Q We are hearing a lot about this refinancing wave. Who will it impact?

JB: It starts with the large issuers and moves down from there. Next, of course, you have second liens – a predominantly junior capital book, for instance, particularly with companies of size, will likely refinance very quickly. One level below that, you have high-yielding unitranche.

To the extent that a unitranche deal was done at an attractive rate for the lender, that ends up translating into a high probability of refinancing too. At the same time, we are coming out of a trough from a ratings perspective. There are a number of mid-market companies that have fared well during covid and are now receiving a more favourable credit rating treatment, which allows them to access the liquid marketplace.

Finally, it is worth noting that if you participate in club deals, the less incumbency value you have as the sole lender or lead agent, and the higher the probability that one of those other lenders takes the deal. That is how we see the repayment wave taking shape.

EL: Jon's point on incumbency is exactly right. If you have an existing strong position in a company, and that company refinances or even trades from an M&A perspective, you are arguably in a better position than if you're on the outside coming in. I would add that having a wide origination funnel is more important than ever when you do have those repayments.

Q What role can speciality finance play in an investor's asset allocation?

EL: Speciality assets can play a complementary role to what we would consider core or traditional mid-market lending – $20 million to $50 million EBITDA businesses. The conversations that we have typically centre on the potential for these assets to offer incremental alpha above and beyond what a top-tier, mid-market financier can offer.

JB: Being able to provide a global perspective across multiple asset classes can also be very helpful. Engaging in that conversation with LPs, as Eric mentioned, and inwardly among our team enables us to unearth opportunities in a range of different categories, ultimately providing hyper-diversification. If you only focus on one area, that area has to provide the best risk-adjusted returns at every point in the cycle, which clearly isn't going to happen. The ability to make the right investment, at the right time, in the right structure, is an important differentiator.

EL: Absolutely. That breadth of perspective is key. In our case, for example, we benefit greatly from having a strong, global public markets platform, which can be a great benefit to us on the direct lending side. This visibility allows us to make an objective assessment of where relative value lies at any given time. But particularly in times of volatility, when illiquidity premiums are compressed, having that comparison with the liquid business is extremely helpful. Ultimately, viewing the market through a multi-asset class lens helps us ensure we are investing in the right place at the right time.

Q Most LPs are accustomed to a benign market. What advice would you offer as they adjust to a new normal?

JB: I would point to the benefits of scale, first of all. Larger platforms with strong structures have become highly attractive vessels for deploying capital, relative to those without that scale and diversification. But I would add that where you really want to be is where scale and alignment intersect – or invested in loans that compensate you for the actual performance of that loan. It is a point that is often overlooked, but I think covid has emphasised the importance of economic alignment.

EL: And it isn't only economic alignment that investors should be looking out for. We have learned a lot about the people we work with during this crisis. We have learned who is transparent and proactively communicating the performance of these opaque and illiquid assets. We have learned who is really prioritising ESG and incorporating it into their underwriting, and who is merely paying lip service.

We completed a deal in Europe last year that we are particularly proud of, for example. We added ESG components to the loan so that when certain criteria are hit, the cost of debt actually goes down. So yes, in times like these, economic alignment is critical. But we have also learned that real partnerships are based on far more than just economic alignment. Philosophical alignment is increasingly key and is something that is undoubtedly becoming more important to investors. ■