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NASHVILLE NOTES

Crushing private credit

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Alternative asset manager Hamilton Lane published a great thought piece in late April titled: "The End is Near for Private Credit, Right?" The firm's thesis is that going into and coming out of an economic downturn is when private capital "crushes it." I like the explicit confidence, though I doubt the compliance department would allow a "crush it" tagline to be included in the marketing material.

Private credit has existed since the dawn of time, and it may be better defined by what it is not rather than what it is. It is not a publicly floated corporate bond or a bank-originated loan that is retained by the bank, although underperforming bank loans that are sold to credit investors would qualify. Today, the term usually is ascribed to middle-market lending by a credit-focused fund that targets a yield of 8% to 10% or higher depending upon the borrower's profile and where in the capital stack the debt resides. The borrower often is a levered company that is owned by private equity, or it may be down on its luck — also known as "hairy" by some lenders.

As an asset class, private credit began to gel 15 or so years ago and reached critical mass after the financial crisis when banks were forced to pull back from highly levered transactions. According to stats compiled by Hamilton Lane, private credit has increased from less than $50 billion in 2001 to about $700 billion by 2017; yet the outstanding debt represents less than 6% of global non-financial corporate debt securities. The implication is that there is room to run, notwithstanding signs that there is a lot of capital sloshing around in search of yield and maybe chasing good post-crisis returns.

So when will we see Hamilton Lane's outperformance thesis tested? I do not know. The corporate bond market remains a sea of tranquility. Credit spreads for high-yield bonds and leverage loans remain near cycle lows. The first-quarter earnings season for U.S. banks, other than perhaps card portfolios among larger lenders, reflects more of the same: Very low charge-offs and a low level of problem loans.

Business development companies' first-quarter earnings were uneventful, although the credit record of a number of BDCs the past several years has not been great, as reflected in declining book values per share and dividends, even though the credit and economic backdrop has been supportive of lenders**.** Medley Capital Corp. was the standout this quarter, though not in a good way, as the company cut its quarterly dividend to 10 cents per share from 16 cents per share. Also, the board of American Capital Senior Floating Ltd. has put forth a plan to liquidate by selling assets and distributing the proceeds to shareholders.

Issues that are popping up in the corporate bond market seem to be idiosyncratic or tied to the Amazon effect that is overwhelming a vastly overbuilt U.S. retail sector. Moody's reports that retail corporate defaults hit an all-time high in the first quarter, but who is surprised? Restaurants may be next, as operators find it hard to raise prices to offset rising labor and food costs. And maybe I am imagining it, but doesn't the U.S. seem to be just as saturated with restaurants as is the case with retail?

In one sense it might be easy to scoff at Hamilton Lane's claim, but on the other hand, private credit can exhibit great timing. Private credit that piled into the oil sector in the wake of the collapse of oil prices a few years ago to recapitalize over-levered companies or take-out banks that were pushed by shareholders and regulators to reduce exposure look smart today, with oil trading around $70 a barrel.

How will private credit crush it in the next downturn? To state the obvious: Credit losses will have to be modest relative to the risk taken. That is an amorphous standard, at least as proposed by me. Maybe a tighter definition is that the majority of the good (or very good) returns private credit has produced in the years since the financial crisis will not be wiped out in the next downturn.

Among the reasons Hamilton Lane argues private credit will outperform in a downturn is the obtainment of better, or "tighter," structures to protect investors. If true, it stands in contrast to the levered loan market where lenders or investors have surrendered to borrowers in the pursuit of yield as credit-lite covenant structures have proliferated. Perhaps the private credit funds are better negotiators than the banks, or maybe they hold more sway over their borrowers when the owners are private equity. Certainly, private credit funds that originate and hold loans have more at stake than a bank that originates and distributes levered loans into the market.

As for the current rising rate environment, Hamilton Lane notes the vast majority of private credit is floating rate, and the rising coupon provides incremental return vis-à-vis fixed-rate high-yield bonds. That, too, is not a bad spot for credit investors as the economic expansion ages and the Fed raises short-term rates.

Hamilton Lane's arguments for outperformance seem reasonable to me, but the backdrop is a massive increase in corporate debt compared to before the financial crisis. Offsetting to some extent is the low cost of the debt that has existed for nearly a decade. Maybe private credit will crush it, but it appears the seeds exist for decent losses for investors in the broader leveraged credit markets whenever the next downturn occurs given what the *Financial Times* calls the "credit boom." The red flags include wide-scale acceptance of covenant-lite deals; questionable earning power assumptions for borrowers through lots of addbacks to borrowers' EBITDA; and a large proportion of investment-grade bonds that are issued just above high yield as BBB/Baa-rated credits.

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