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SNL NASHVILLE NOTES

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Income post-mortem and coupon clipping

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I attended Creditflux's private credit conference in New York a couple of days before the Brexit vote. Unlike the media hysteria around Brexit, there was not much concern mentioned among mostly U.S. credit investors about it as a market or economic catalyst; nor was there much concern expressed about an aging credit cycle beyond the need to be selective at this point in the credit cycle. Falling (or crashing) government bond yields among developed countries and steps to bail out Italian banks indicate maybe there should be some concern, but I digress.

Two things stood out about the conference. One was the apparent emergence of private credit as a stand-alone asset class. There is nothing new about private credit; rather, it is the increasing institutionalization of private credit — especially for middle-market companies — that marks the sector today. The post-crisis years have seen banks cede market share to hedge funds, BDCs and other capital providers as updated leverage lending guidelines from 2013 forced banks to limit their involvement and theoretically sever it if the borrower's leverage exceeds 6x EBITDA.

Private credit as a stand-alone asset class is similar to the emergence of private equity, leverage loans and high-yield bonds as asset classes in the 1980s. Unlike the 1980s, there is not a driving personality associated with it. A generation ago it was Henry Kravis at KKR & Co. LP, Jimmy Lee at Chemical Bank (now JPMorgan Chase & Co.) and Mike Milken at Drexel Burnham Lambert. All were big personalities who helped draw traditional institutional investors (and lenders) to what were then emerging asset classes that offered great risk-adjusted returns before capital piled in.

The second theme is one I discussed in my prior post — the growing importance of income in a zero rate world. It is so bad *The Wall Street Journal* ran an article July 5 about corporate bonds as a refuge for safe income. The cited yield was 3.14%. That is better than cash, which yields nothing. Cash represents liquidity to redeploy if asset values fall. It is problematic in an inflationary environment, and it is golden in a deflationary environment. Our world is somewhere between the two, although global bond markets seem to be voting for the former or some sort of global political and economic disorder.

At the other end of the spectrum is equity. It seems to me to be priced to perfection in which the P/E on trailing (GAAP, not operating) EPS for the S&P 500 was 24.1x compared to a long-term average of 15.6x as of July 5. The virtuous combination of EPS growth and an expanding P/E that drove equity returns a few years ago is probably over and could easily reverse if slowing earnings growth turns negative.

As for high yield, the sentiment at the conference seemed to be relative value was OK, but not great, even though prices are well off their mid-2014 highs. If the economy can continue to trudge along with GDP growth around 2% with just a modest lift in default rates, the value proposition probably is fine. If the economy rolls over, high yield is problematic.

The same calculus related to the economy applies to middle-market credit, too. Banks may be slow moving, but they have centuries of experience in mitigating losses in the event of default. Given the amount of capital that has flowed to the sector since the financial crisis, private credit funds will have to prove themselves again as able lenders that can minimize losses in a downturn. With the 10-year U.S. Treasury yielding less than 1.40% as of July 5, the opportunity to do so may occur sooner than any of us wish.

So why be constructive on private credit when one of the tenets of the central banks' zero and negative interest rate policies is to push investors to take more risk? Maybe it is misplaced, but I think there is more value (all else equal) in high current income than waiting on a terminal value when asset values are inflated. This is especially true when debt is amortizing, thereby reducing the refinancing risk when the loan matures. I do not mean to imply poor underwriting, bad businesses and the like are not highly risky for creditors; they are. But there is something to be said for getting income and principal back sooner rather than later in our upside-down financial world.

And the asset class offers two additional modicums of return — premiums related to size and illiquidity. Middle-market credit provides extra yield compared to broadly syndicated deals for larger borrowers. Likewise, illiquid investments yield more than comparable liquid alternatives. Both may be obvious, but neither is an illogical risk to assume in the current rate environment. The illiquidity discount in particular may be lagniappe because credit funds usually intend to hold the credits to maturity. The key as seen with a few U.K. property funds recently is gating or funding structures that do not force the manager to liquidate inherently illiquid collateral to meet redemptions. BDCs do not have that issue as permanent capital pools, but underperformers were and will be acquired by the better firms as seen in Ares Capital Corp.'s deal for American Capital Ltd. and TPG Specialty Lending Inc.'s fight to acquire TICC Capital Corp.

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