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Private Credit: The Rise of a Core Asset Class

Disruptive Forces in Investing

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Anu Rajakumar: The private credit market has surged over the last few years fueled by a growing interest in private investments, investor demand for higher yield and a significant restructuring of traditional financing practices. My name is Anu Rajakumar and on this episode of Disruptive Forces I'm joined by Susan Kasser, Neuberger Berman's Co Head of Private Credit who is here to provide insight on this differentiated opportunity set and its evolution. Susan; thanks for joining me.

Susan Kasser: Pleasure to be here.

Anu: Let's start off with the development of private credit as a core element of asset allocation. Susan, what was the market disruption that really led to the surge in private credit investment?

Susan: Well, following the Global Financial Crisis investors wanted yield and yield was scarce in pretty much every traditional asset class out there. The beauty of private debt is that it gives investors who have the ability to lock up their capital, higher yields through both an illiquidity and a complexity premium, and to put the premium into perspective we're talking about 150 to 300 basis points over comparable liquid credit. The other appeal, of course, is following the Global Financial Crisis people were looking for anything that demonstrated lower volatility and private debt does that, and that's because of both the illiquid nature of the underlying loans as well as the long term investment vehicles that investors use to access the asset class.

Anu: Yeah; that makes sense. Now, I've watched the asset class evolve and the flavors of debt proliferate in the last few years. Can you talk a little on the breadth of the private credit landscape and maybe just distinguish between the types of investments available.

Susan: That's a big question. There is really just so much. It could be to companies—those companies could be distressed, they could be performing, they could be located in the United States, they could be located in Europe, they could be located in Asia; believe it or not they could be located in frontier and emerging markets. The companies could be of various size; different types of borrowers. It could be secured by assets. It could be secured by cash flow; different kinds of assets. I could keep going, but I think the part here that I'd most like to get across, because I think it really does surprise people who are new to the asset class—this is not lending exclusively to small companies. So yes, private debt does lend to small companies, and small is a relative measure, but if the midpoint is a company with $20, $25 million of EBITDA, say $200 million of revenue, the range goes all the way to companies with over $2 billion of revenue and $250 million of EBIDTA.

Anu: Right; could be large. Now, we spoke about the surge in investment in this asset class, so what do you say to investors when they ask, often with some concern, has too much money been raised?

Susan: I think it's a good question. I think the question is motivated by if you look at capital raised year by year, as we like to say, it's up and to the right—that said, you can't evaluate excess supply without looking at demand. What people might not realize is that most private debt capital is invested into companies owned by private equity firms, so you can't look at supply of private debt without looking at supply of private equity because that's where the money is going. And private equity firms have also had up and to the right fundraising over the past five, ten years. In fact, private equity firms in the U.S. alone raised over $1 trillion last year. If you look at how much private debt was raised last year for the U.S., that's $175 billion, and that ratio of 17 percent private debt to private equity fundraising has been remarkably consistent over the last five years. Which leads me to believe that probably supply and demand are roughly in balance. You can also look at the numbers another way, so private equity is mostly buyouts. Buyouts are financed with equity capital and debt capital, and historically it's been about 40 percent equity capital. So if you look at the $1 trillion raised in 2018 you say that's the 40 percent equity capital, what does that imply for debt capital? That's a need for about $1.5 trillion of debt. Now, obviously that's not going to be deployed in one year; it will be deployed in three to four years and it won't be funded even primarily by private debt, it will be funded mostly by the leverage loan and high yield market but it does seem to indicate that fundraising of $175 billion in 2018, though larger than it was in the past, is really quite reasonable.

Anu: Yeah; I think it's very helpful to contrast those two. If the concern about too much money being raised is not the biggest risk for private credit investors, what is?

Susan: That is the most important question. I think the good and bad news to investors, particularly ones who think private credit is different and esoteric, is that it's not. The biggest risk for private credit is the same as regular credit, which is a sharp industry wide downturn and that will affect U.S. companies, and that will affect their ability to generate free cash flow, and that will affect their ability to service the debt. And whether the company is private or public or whether the loan is private or not, is really not nearly as important as the company's ability to service its debt. So this is something that we think about every day; we're always projecting, we're always stress testing because it is that environment when good credit selection by the portfolio manager truly becomes apparent.

Anu: Right; absolutely, and so we spoke about the link between the private equity market and the private credit market, what are some of the key differences between the two that investors should keep in mind?

Susan: Yeah; it's interesting. I think that by being in private debt you get many of the underlying benefits that you get in private equity. The company is well managed; it's becoming more profitable over time. You are giving up one very important thing, which is you're accepting capped returns as a debt investor; you're going to get your contractually agreed upon coupon, not potentially unlimited equity upside, so that's a negative that you're foregoing. But in exchange you get all sorts of wonderful downside protections, one of which is your first in right of seniority when it comes to repayment, when it comes to a claim on the assets. If things go wrong, you're in the best possible position to get all your money back. Your return is in the form of a contractual cash yield, which is paid quarterly, and is in cash, and it's contractual which people really like.

Anu: It's attractive given the illiquidity?

Susan: Actually, that's a very good point that people sometimes make, which is that the asset is less illiquid than you think if you're getting high cash coupons on a regular basis, so that is a very good point.

Anu: Exactly.

Susan: And I guess the last thing that I would say is private equity, you should expect your investments in an underlying company to be outstanding for five years. The fund lasts much longer than that. In private credit you should expect an individual investment to be outstanding for only three years on average in the U.S.

Anu: We talked a little bit about the companies being backed by private equity firms, can you talk a little about that relationship and why that might be helpful for private credit investments?

Susan: Yeah; there are two things that I think are pretty interesting here. The first is that leverage levels, which is debt over EBITDA, that's a commonly used measure of risk, has been stable for middle market leverage buyouts since 2014 at about 5.5 times. Over that same period of time though purchase price multiples for those same companies have been growing and reached 10.6 times through June of 2019. So if leverage levels are stable and purchase price multiples are growing, that means equity as a percentage of the capitalization or the equity cushion under the debt is increasing—and that reached 44 percent as of June of 2019. That's equivalent to a mortgage provider saying, well, I'll give you this loan, but I want you to put down a bigger down payment. Except, instead of 25 percent or 30 percent as a down payment the private debt investors are benefiting from 44 percent down payment by the private equity firms. That might link into this second benefit, which is that in the Global Financial Crisis when defaults spiked for all loans, companies that were backed by private equity firms defaulted at less than half the rate versus companies that were not backed by private equity firms. So if you had private equity backing, the defaults on the Global Financial Crisis were 7.5 percent. If you did not they were 16.3 percent.

Anu: Wow; that's a very big difference and I'm very curious, why do you think that was?

Susan: So nobody really knows of course, but we can speculate, and our experience investing through multiple downturns is that when the economy turns against you and your company stumbles, the most important factors to survival and success is more cash invested as quickly as possible, and that can be for defense. We just need the cash to bridge a shortfall in earnings and cover fixed expenditures, or it could be for offense to make opportunistic acquisitions to sure up our strategic position. A company that is owned by a private equity firm has this unique advantage that they control governance, so they can act quickly, but also they have access to capital because they can call capital from their underlying investors in any market environment, no matter how dire, and those are two advantages that are not universally held by other forms of private ownership, let alone public ownership.

Anu: I'm going to switch gears a little bit now and let's talk about the market. So it's a competitive market, there's a lot of new funds, strong investor demand, how does a private credit investor really differentiate from its peers in this space?

Susan: This is where I like to remind people that credit is not about picking winners; it's actually about avoiding losers which I personally think is easier. So if you think about a good loan, a fine loan, an excellent loan, they all return the same thing—you get your principle back, you get interest and maybe you get some fees; very different than a good or great or spectacular equity investment. So what you have to worry about with credit is avoiding mistakes. It's true that recoveries in middle market loans are quite high, so if you have a default the average recovery is 82 cents on the dollar. That's high but it's not 100 cents on the dollar so the key is to avoid mistakes as much as possible. And we believe that there are really two factors here that help: one is the luxury of time, so having a three to four year investment period and investors who are patient and who understand that if you don't make investments, sometimes for three months, that is actually a good thing; that is not a bad thing. And then the second thing is relationships with the private equity funds, because they are the source of deal flow, that they are multi-faceted. If you have a relationship that is multi-faceted they might not see you as the most commercial lender, but they probably keep calling you because of other aspects of the relationship.

Anu: And what exactly do you mean by multi faceted in that context?

Susan: You know, if you're just a lender and you don't lend, you have no usefulness. Especially as you said, in a competitive market where somebody else is stepping up to lend and you might think to yourself, well, that wasn't a good idea but in the immediate term they cemented their relationship and you didn't. So a multi-faceted relationship means you have to be something to these private equity firms besides just a lender, and so it happens to be at Neuberger Berman that we have large businesses focused on investing into the private equity funds themselves as a limited partner, for example. And our colleagues hold over 150 LP advisory board seats which speaks to our importance to those firms as a significant investor.

Anu: And related to that then how can private credit investors really compete for a significant allocation from an issuer, particularly in an environment as we have now of looser terms and greater leverage?

Susan: So I love that question because I want to pick it apart; apologies.

Anu: Please do.

Susan: Yes; so in an environment of looser terms and greater leverage perhaps we should not be competing for a bigger allocation; perhaps we should be passing and waiting for the next one. So that's sort of the first point, is that in a late cycle environment everything is going to feel stretched, and that's okay because in a late cycle environment there is a lot of investment activity, so there is a lot of opportunity to choose from. The key really is having these relationships with private equity firms that lets you pass on the vast majority of opportunities, until the right one does come along, and of course, the patience and the discipline to do so.

Anu: I think that's a great place to close this episode, Susan. Thank you so much for sharing those insights. A couple of important things that you said that I'll just quickly recap—the private credit, the kind of yield that you're getting is based on an illiquidity and complexity premium, and the other important takeaway that you made that I thought was super interesting was that loans to companies backed by PE firms have historically experienced lower defaults. I think that's just an important takeaway for listeners to keep in mind, so thank you again, Susan, for being here.

Susan: Thank you.

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