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Private Debt, Capital Solutions and the Early-Cycle/Later-Cycle Paradox

In many asset classes today, investors face a paradox. Due to unprecedented monetary and fiscal stimulus coupled with coronavirus vaccination programs, U.S. GDP is forecast by the Federal Reserve to be 7% larger in 12 months' time, and 3% larger than it was before the pandemic. At the same time, by any reasonable metric, many valuations are full or stretched, as if we were in the middle or even the late stage of the economic cycle. The early-cycle, recovery-scale growth prospects would normally be a clear incentive to seek out investments and deploy capital. But we believe later-cycle valuations, with their implied downside risk to multiples, are enough to give serious pause.

We think that senior lending to high-quality private equity-sponsored companies can be one way for investors to mitigate this paradox. In addition, many private equity sponsors face the same paradox when they look at their own companies: investing for growth can be difficult when assets are so expensive and debt financing often doesn't stretch far enough, and that is creating potential opportunity for those able to bring innovative capital solutions to the challenge.

For a short time last year, U.S. private equity funds had a trillion dollars of dry powder waiting to be deployed into leveraged buyouts (LBOs), potentially creating huge demand for leveraged lending, while the uncertainties of the pandemic looked set to weigh heavily on leveraged loan issuance and the rollout of new collateralized loan obligations (CLOs). Based on our experience of the recovery from the financial crisis of 2008 – 09, we anticipated a multiyear period of relatively wide credit spreads on relatively low leverage levels for those private debt funds prepared to move into the gap.[1]

That has not panned out. As the major central banks stepped in to stabilize credit markets and the economy has rebounded, private equity investment has indeed accelerated, with plenty of dry powder still to be deployed. But for the same reasons, lenders' risk aversion appears to have quickly evaporated, and robust CLO and leverage loan issuance has been generating tough competition for private lenders. As a result, spreads in the Broadly Syndicated Loan (BSL) market, as represented by the S&P/LSTA Leveraged Loan 100 Index, have compressed by around 150 basis points over the past nine months. In the new deals we have completed, spreads have compressed by approximately 100 basis points, and our most recent, high-quality mid-market first-lien and unitranche financings have been done with yields in the 5.5 to 7.5% range.[2]

Nonetheless, if the absolute value opportunity has not improved, the relative value opportunity arguably has, especially on a risk-adjusted basis. In our view, this is true not only when we consider liquid equity and credit markets, but also other parts of the less liquid lending market: as of July 16, for example, the JP Morgan Leverage Loan and Liquid Loan indices were yielding 4.84% and 4.33%, respectively.

A Private Debt Advantage: Private Equity's Move to Quality

Private debt spreads have compressed to reflect improved risk appetite in the market, but, in our view, it is notable that other important risk indicators have not moved in tandem.

Since private markets thawed out late last summer, we have witnessed documentation and covenants consistently moving in favor of borrowers. While these protections are idiosyncratic and hard to assess objectively for the whole market, our sense is that, on balance, the current market has moved back only in line with pre-pandemic standards. Our own market observations suggest that leverage in new deals remains reasonable, as of the first half of 2021: around 4.5 to 4.75 times EBITDA for middle market first-lien senior secured loans and 6.0 to 7.0 times EBITDA for unitranche arrangements that combine senior and junior lending. These levels do not differ materially from the market of late 2019 or early 2020.[3]

Moreover, in our view this lending is to companies that are, on average, of higher quality and with stronger growth prospects than in previous cycles, as private equity funds in general exhibit a marked quality bias. According to Preqin, over the 12 months ending in April 2021, 48% of private equity deal value was in information technology and health care, relative to a weighting of 36% for those sectors in the MSCI World Index[4]—and those preferences are showing up in the industry's growth projections. Our colleagues in private equity co-investment report that, during the first six months of 2021, and including investments still pending, 65% of the companies to which they committed capital were projecting annual revenue growth of 10% or more, as opposed to just 26% of companies six years ago.[5]

[1] Preqin, *Quarterly Update: Private Equity and Venture Capital Q2 2020;* Standard & Poor's LCD, *Q2 2020 Leveraged Lending Review;* Susan Kasser, "High Demand, Tight Supply: Private Debt Post-COVID" (November 2020) at https://www.nb.com/transfer?URL=insights/high-demand-tight-supply-private-debt-post-coronavirus

[2] There is no guarantee that other opportunities will have similar characteristics or results to those described herein.

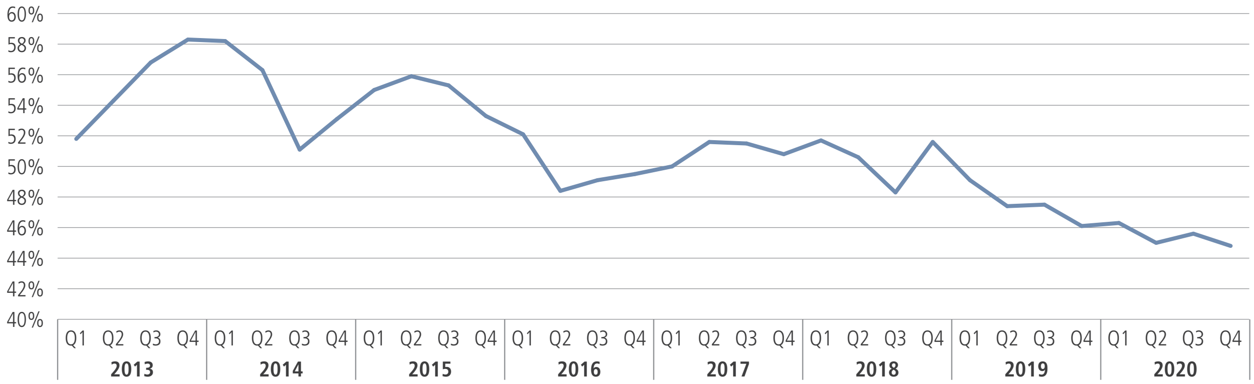
[3] Similarly, Pitchbook's *U.S. P.E. Breakdown Q1 2021* reports that the median debt-to-EBITDA ratio for U.S. buyouts has been 5.9 times to 6.0 times since the beginning of 2020, down from 6.9 times to 7.1 times for 2019.

[4] Preqin, *Quarterly Update: Private Equity and Venture Capital Q1 2021.* The benchmark comparison is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of each benchmark may be different than the investment objectives and strategies of a private credit fund, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future.

[5] Neuberger Berman analysis of co-investment capital across the NB Private Markets platform committed from January 1 to June 18, 2021, in which the NB Private Markets strategies invested $15m or more. There can be no assurance that any pending investments will close, or that any of the terms of such transactions described herein or under discussion will be achieved. Metrics exclude energy and venture capital investments, which are not expected to be a core part of NB Private Equity's current co-investment investment strategy. These figures are based on expectations, estimates, and projections and no party provides any guarantee or assurance that these projections are accurate. Such figures involved known and unknown risks, uncertainties and other factors, and undue reliance should not be placed thereon. Actual events or results may vary significantly from those reflected or contemplated. Assumptions are for modeling purposes only and alternative assumptions may result in significant or complete loss of capital. **Past performance is not necessarily indicative of future results.**

FIGURE 1. A MULTIYEAR LOW IN U.S. BUYOUT LOAN-TO-VALUE RATIOS

Median U.S. buyout debt-to-enterprise value ratios, rolling four-quarter periods



Source: Pitchbook, *U.S. P.E. Breakdown Q1 2021*. Data as of Q4 2020.

In addition, enterprise values are rising: according to Pitchbook's *U.S. P.E. Breakdown Q1 2021,* the median enterprise value to EBITDA ratio for U.S. buyouts went from 10.5 times in 2015 and 12.3 times at the end of 2018 to 13.2 times by the fourth quarter of last year. Combined with the subdued movement in leverage, that leaves the market with the lowest loan-to-value ratios we have seen for many years.

Among the higher quality companies that we lend to, the move has been still more substantial: between 2017 and 2019 our portfolios averaged an enterprise value multiple of around 14 times EBITDA, whereas those we have been lending to since 2020 average around 16 times—while leverage has remained at around five to six times. That is translating into 30% to 35% loan-to-value ratios in the deals we are doing: at these levels, equity valuations would have to decline by two thirds before senior loans are impaired.

In short, we believe that since 2020 we are lending to those we view as better, more highly valued companies than we were lending to four or five years ago, but with a thicker equity cushion beneath us in the capital stack, at yields of around 5.5% to 7.5%.[6]

A Private Debt Advantage: Variable Rates With Secure LIBOR Floors

The other way in which private debt can potentially mitigate an important current risk is by offering variable interest rates. Most investors are aware that loans tend to come with variable rates above a given LIBOR "floor," often but not always set at 1%. Fewer are aware of how common it is for issuers of BSLs to take advantage of high investor demand to re-price existing loans down to a lower spread over Libor. S&P LCD data indicates that U.S. borrowers repricing in the first six weeks of this year were able to cut the spread they are paying over Libor by an average of 66 basis points.[7]

By contrast, when loans are held by only one or a few investors, they generally have more power to insist that a borrower go through a full refinancing of the debt if they wish to secure a lower spread: even taking into account the Libor-plus-a-spread liabilities that a leveraged private debt fund may incur, that ability to resist spread repricing can keep investors more exposed to the upside of rising rates than they would be with a portfolio of BSLs.

Capital Solutions: Financing Growth When Growth is Expensive

When growth prospects are characteristic of an early-cycle rebound but equity valuations and credit spreads are characteristic of later-cycle exuberance, standard private debt deals can provide risk exposure to high quality, growing companies, with the security of a senior position in the capital stack and secure exposure to rising rates.

[6] There is no guarantee that such results or characteristics will persist in the future.

[7] S&P Global Market Intelligence, "Leveraged loan repricings surge as borrowers, eyeing investor demand, cut costs," at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-repricings-surge-as-borrowers-eyeing-investor-demand-cut-costs-62740812

But there is also another way to look at this opportunity set. If you, as an investor, struggle with this paradox of early-cycle growth expectations and later-cycle valuations, consider what it means for a private equity sponsor to face the same paradox when considering its portfolio companies. We believe this paradox is responsible for the relatively abundant demand for tailored capital solutions in private credit—and particularly for solutions that include contracted returns without cash-pay interest.

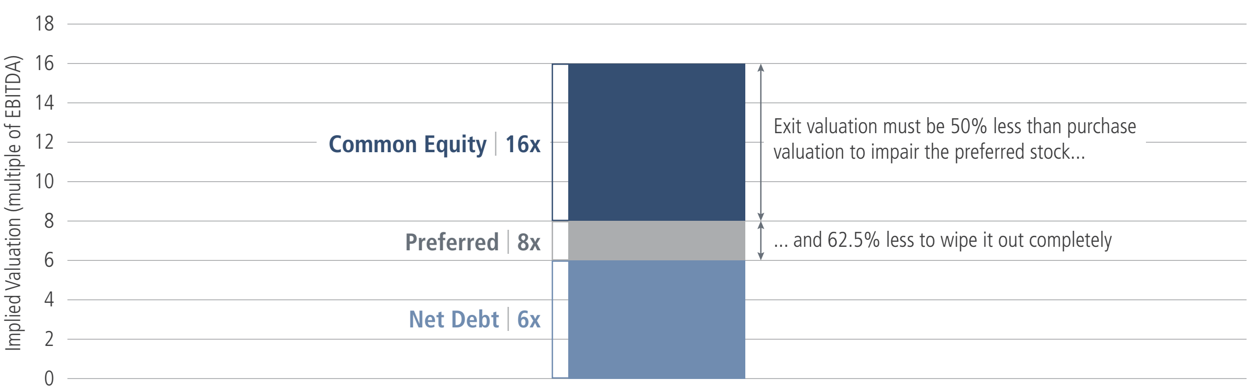
Picture a private equity sponsor that owns a fast-growing company somewhere around the middle of its investment lifecycle. It is likely to have strategic projects, quite likely including acquisitions, that it would like to finance now, while growth expectations are highly favorable. It would normally issue debt, but today's conditions make that difficult or inadequate. High equity valuations mean that acquisitions demand a lot of capital. But at the moment, senior-debt and unitranche lenders are typically willing to extend only to around 5.0 to 6.5 times EBITDA—which means that most borrowers are already tapped out, or would be, if they financed an acquisition that way. Even if lenders were more willing to stump up the cash, regulatory and rating agency constraints are likely to limit leverage to 6.0 or 7.0 times EBITDA. Besides, a fast-growing company in a fast-growing economy is likely to have more pressing uses for its cash flow than servicing the high interest burden that this kind of leverage typically implies.

For those who do not wish to raise a further large tranche of dilutive common equity—and very few do—PIK preferred capital is potentially extremely useful, as it bridges the gap between senior debt and an acceptable level of common equity.

Preferred stock is structurally senior to common equity in that it is prioritized for both distributions and return of capital, and often comes with credit-like protections, such as leverage-limitation and restricted-payments covenants, contractual minimum returns and call protection. It is junior to debt in that it receives distributions only after debt coupons are paid, and its distributions come in the form of more of the same security rather than cash; on the other hand, it also has the potential to participate in equity valuation upside, via convertibility or warrant ownership, in some cases.

Let's take a model of a high-quality, growing company with around \$500m or \$600m of EBITDA.[8] Figure 1 shows a typical capital structure once PIK preferred stock has been added. The PIK preferred stock sits above the senior debt, attaching at 6.0 times EBITDA and detaching at 8.0 times: in other words, the exit valuation for the company must be 50% less than the purchase valuation for the preferred stock to be impaired at all, and 62.5% less to wipe out the preferred stock completely. At a time when the future is so uncertain and common equity valuation multiples are so high, rendering them particularly vulnerable to any contraction when it comes time to exit, we think this is a very attractive level of protection in the capital structure.

FIGURE 2. TYPICAL CAPITAL STRUCTURE OF A MID-MARKET BUYOUT COMPANY, INCLUDING PREFERRED STOCK



Source: Neuberger Berman. For illustrative purposes only. There is no guarantee that exit valuations will be realized or achieved or that an investment strategy will be successful, and realized valuation may be significantly lower.

[8] The model discussed does not represent an actual investment. It should not be assumed that the example discussed was or will be profitable. There is no guarantee that future actual investments will have similar characteristics or results to those described herein.

What does that mean for return expectations? In today's environment, the senior debt of a borrower like this would be broadly syndicated and tend to yield 3.0% to 3.5%, and its common equity would likely have an estimated return of 15% to 20%.[9]

The same company's PIK preferred stock will tend to offer a 14% to 16% contractual, credit-like yield to its first call date—despite the investment being made at an implied valuation of less than half that of the common equity.[10]

Capital Solutions: The Relationship Edge

While we have described these opportunities as "relatively abundant" due to the current early-cycle/later-cycle paradox, they are far from abundant in any absolute sense. Four out of every five investments in preferred stock or other structured debt and equity that Neuberger Berman has made have been sourced through our own established relationships, depending on deal flow from across our $68 billion private markets platform. These are often highly tailored capital solutions, built upon a thorough understanding of the company that comes from being, elsewhere in our firm, a limited partner in the fund that holds it, an equity co-investor in it, or a direct lender to it.

A good recent example is an internally sourced and specially structured investment that we made in the U.K.'s leading used car auction platform, Constellation Automotive Group (which includes British Car Auctions and WeBuyAnyCar.com), in January 2021.[11] The investment is designed to support the rapid expansion of British Car Auction's direct-to-consumer online channel, "cinch." This solution, which combined senior PIK preferred stock with junior mandatory convertible preferred (MCP) stock, was just the latest in a series of investments we have made in the company, as structured capital providers and equity co-investors, which total more than $450m.

A Core Portfolio Allocation

The current market environment may not be the source of abundant value that many private debt investors anticipated nine to 12 months ago—but as risk appetite has come roaring back, we believe that is now true for virtually every asset class.

Nonetheless, in our view the unusual mix of early-cycle growth expectations and later-cycle deal valuations reinforces private debt's role as a core portfolio allocation.

On the one hand, senior debt in high-quality growth companies remains a relatively high-yielding way to stay exposed to the growth recovery, with the common protection of low default expectations and the high recoveries that come with seniority in the capital stack. On the other, investors with a little more risk budget and the ability to give up cash coupons may be able to tailor capital solutions that address this same paradoxical mix of early- and later-cycle dynamics, including potentially achieving equity-like returns at half of the actual equity's current valuation multiples.

[9] This material includes estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed.

[10] Targeted contractual returns are typically based on the stated coupon, original issue discount and call schedule, and do not represent actual returns. There is no guarantee that the contractual yield will be realized or achieved or that an investment strategy will be successful, and actual returns or yield may be significantly lower.

[11] The case study discussed does not represent all past investments. It should not be assumed that an investment in the case study was or will be profitable. The information supplied is intended to show investment process and not performance.

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