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FUND FINANCE FRIDAY

Fund Finance Symposium Panel Recap: ‘Titans in Finance: The Rise of Private Debt’

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Coming off of the close of a badly bruised broadly syndicated loan market in 2022, it is no surprise that the global Fund Finance Association kicked off its 12th annual conference in Miami with a conversation with the “Titans in Finance” − Jonathan Bock, Senior Managing Director, Co-CEO of BCRED and BXSL, Head of Market Research, Blackstone Credit; Ken Kencel, President and CEO of Churchill Asset Management; and Art Penn, Founder and Managing Partner of PennantPark Investment Advisers. The panel was moderated by Jocelyn Hirsch, Partner at Kirkland & Ellis, and Nick Mitra, Managing Director at Societe Générale.

The Titans were first asked about inflection points and the reasons for success in the growth of their respective businesses. Surprisingly, they responded not by citing market acumen, timing or even luck but as true leaders: emphasizing the ability and commitment to build a talented team and to invest in diligent training and growth of their people. They noted that, when looking back, many people want to get into the private credit space, but few understand the importance of and were willing to commit to invest in the human resources that are required to build and run a successful private credit shop. Fast forwarding to the way these businesses have developed with multiple investment vehicles and strategies, they commented that over 50 percent of their human resources are devoted to investor relations, operations, and finance, thereby reinforcing why talent development is so important. Their longevity in this space was a thread that permeated the discussion, which underscored to the audience why these leaders were selected from a crowded private credit space to address the Fund Finance Association in 2023.

The Titans discussed two major themes: market segmentation of the companies in the middle market (generally companies with under $50MM in EBIDTA) and the diversification of funding vehicles and strategies utilized to fund their respective investments in middle market companies. Private credit has historically targeted the middle market because these companies could not access capital in public markets or the broadly syndicated market. They discussed how the middle market should be segmented into upper middle market ($50MM to $100MM in

EBITDA), lower middle market (under $15MM), core middle market ($15 MM to $50MM), and then by specialties, such as healthcare, technology, aerospace, consumer, food and beverage, as well as sponsor and nonsponsored companies. Commenting that experience through economic cycles has shown that lower middle market companies are less able to weather cycles of increased interest burden from rising rates, it was noted that the sponsor-backed companies are favored because of the availability of sponsor equity support. It was also noted, however, that the most recent COVID years are not a good indicator of how these companies and their sponsors will behave in a downturn because, during COVID, the market understood and expected the economic situation to be temporary. More importantly, it was a period of low interest rates that allowed companies significant breathing room. Conversely, the current economic environment of high interest rates, high leverage, and very light or no covenants presents a more challenging lender environment. They acknowledged that sponsors may be less inclined to support the companies they do not believe will survive.

The disrupter of 2022 was the rise of large club deals. Approximately 15 private credit firms in the market, putting their multiple strategies to work, were able to write checks of up to $500MM. This balance sheet strength is benefiting from the current volatile landscape. Public market volatility and uncertainty have also reinforced the popularity of private debt. All of the Titans reflected upon how their businesses diversified their funding vehicles and utilized structures such as BDCs, SMAs, CLOs, and institutional funds, and were additionally looking down the road to retail investors.

Comparing the syndicated lending market as “moving vs. storage,” private credit won favor in the “storage” business because banks in the “moving” business − taking large fees to syndicate the loans to other lenders − which proved to be unsuccessful in 2022, now found themselves unable to sell their commitments. Able to negotiate better legal and financial terms with their large checks in hand and negotiating directly with the intention of holding these loans to maturity, private credit moved quietly from the sidelines to center stage to deliver to sponsors the credit they were looking to raise while the stalled syndicated loan market essentially shut down. The efficiency of this “storage” model appealed to sponsors. Larger companies, which traditionally only looked to the broadly syndicated market, were able to tap private credit. Despite negative press reporting the lack of deal flow in early 2023, deals are getting done and valuations are holding steady for higher quality companies. Pricing is up, overall leverage is moderated, and the best private credit firms and their portfolios remain in good shape. Being vigilant about designing and managing the portfolio is key. These market leaders have long histories with certain sponsors and believe they know how these sponsors will behave in a downturn.

“When is a strong M&A market returning”? asked one of the moderators. Possibly midyear, came the response from the panel. With the public markets essentially closed, private credit is well poised with approximately $300BN in dry powder. This, coupled with the potential of a large retail market entering the space to provide additional funding, poses huge opportunities for private credit in 2023.