RBC BlueBay Asset Management

Private credit – laugh now, cry later?

For professional investors only | Marketing communication

Andrzej Skiba
BlueBay Head of US Fixed Income

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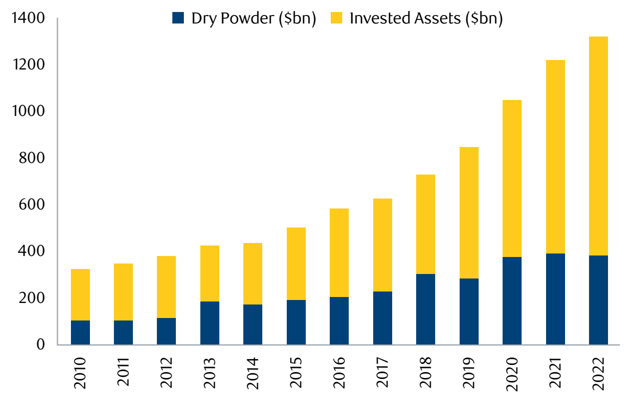
In our judgement, US high yield bonds are a compelling, attractive alternative to the risky private credit space.

Facing a potential US recession, investors could make a legitimate case for avoiding leveraged finance until the dust settles. While we understand this perspective, we struggle to share the sentiment, especially in the case of the US high yield bond market. The asset class has the support of limited maturities on the horizon and the lowest leverage since the Great Financial Crisis (GFC).

In recent times, however, both in client meetings and at investor conferences, we came across an altogether different perspective. A variety of investors expressed a view that facing an uncertain economic outlook, they strongly prefer to invest in private credit, while avoiding public bond markets. We find this perspective deeply troubling and likely misguided. In this note, we'd like to highlight five key reasons why this view does not stand up to scrutiny and we strongly believe that the opposite approach is a better one, on a risk-adjusted basis.

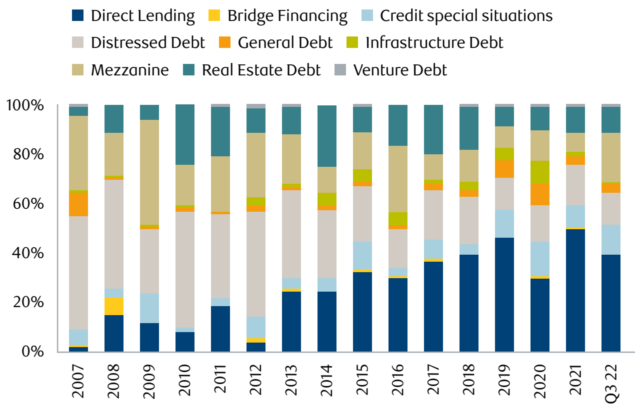
Before we share our reasoning, let's start with some basics. Assets under management in the private debt space are approaching $1.4trn according to Preqin data. About a third of those assets are in the direct lending space, though it's worth noting that, according to IMF data, in recent years as much as 50% of the capital raised was directed towards direct lending. The rest of the private debt universe is encompassing a variety of strategies including distressed debt and special situations. Our comments in this article refer primarily to direct lending activities.

Private credit (incl. dry powder) now as large as high yield bonds & leveraged loans



Source: Preqin.

Direct lending dominating asset growth within private credit in recent years



Source: IMF, Goldman Sachs, Preqin, Pitchbook LCD.

5 reasons why you should prefer public high yield over private debt

1. Companies borrowing funds from direct lending investors had no prior access to public markets for a reason

Companies using private debt markets to raise funding tend to be small. The standard in that space used to be a maximum of $1bn in revenues and EBITDA below $100mn. Companies of this scale tend to be seen as small, lacking diversification and, normally, more vulnerable to an economic downturn. There is a reason why public markets refused to lend to these businesses.

> **"With a recession on the horizon, none of the vulnerabilities exhibited by these companies have gone away, and there is no logic to a preference for these businesses."**

Even bank lenders (especially regional banks) that historically supported companies of this kind, were forced to back away from lending as US regulators imposed curbs on leveraged lending. Typically, banks would have to require that at least 50% of corporate loans be paid off from cash flow within seven years of issuance to conform to the new standard. That forced sponsors to consider alternative sources of funding and that's where private credit lenders stepped into the gap.

With a recession on the horizon, none of the vulnerabilities exhibited by these companies have gone away and there is no logic to a preference for these businesses at the expense of larger, diversified high yield public issuers which have a variety of levers to protect their balance sheet in times of economic uncertainty.

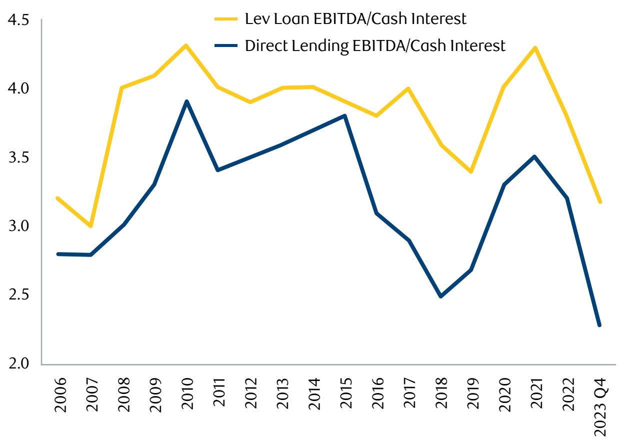
2. Funding costs are crippling to private debt portfolio companies, leaving no cash flow left to de-leverage

The dramatic rise in US interest rates had a disproportionately negative impact for private credit borrowers accessing the floating rate market. Most borrowers are paying in excess of 10% p.a. in funding costs. Further, this is unlikely to change anytime soon, as the Fed is determined to keep rates at elevated levels to contain inflationary pressures. This means that companies are facing the prospect of cash flow generation impaired by the significant increase in interest costs. As a result, the closer you come to the maturity of your debt facilities, the greater the risk associated with an over-leveraged capital structure and with no cash flow generation in sight.

This dynamic is aptly demonstrated by a dramatic fall in EBITDA interest cover ratio for middle market borrowers. Historically coverage has been running comfortably in the 3-4x range and today this key ratio is barely exceeding 2x, according to Pitchbook LCD data.

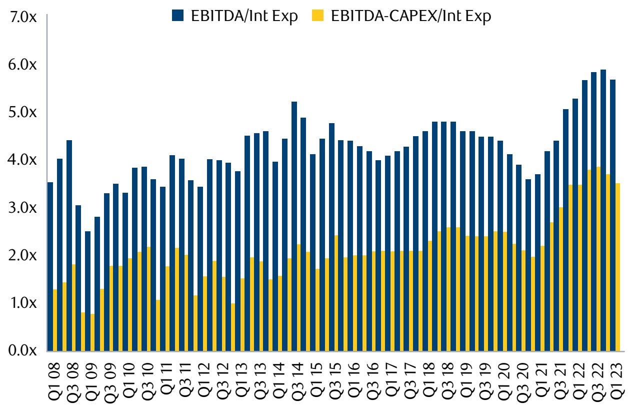
US HY average cost of funding is running below 6%, with issuers successfully refinancing and terming out debt obligations when the rates were low in post-Covid era. This contributed to new issue supply dramatically dropping in the last 18 months and no immediate prospect of average coupons re-setting materially higher, as new issue volumes should remain muted well into the next year.

Collapse in direct lending interest cover ratios...



Source: Pitchbook LCD, UBS. Note: Middle market loans used as representative of direct lending loans.

...while US HY bond interest cover close to record highs



Source: JP Morgan.

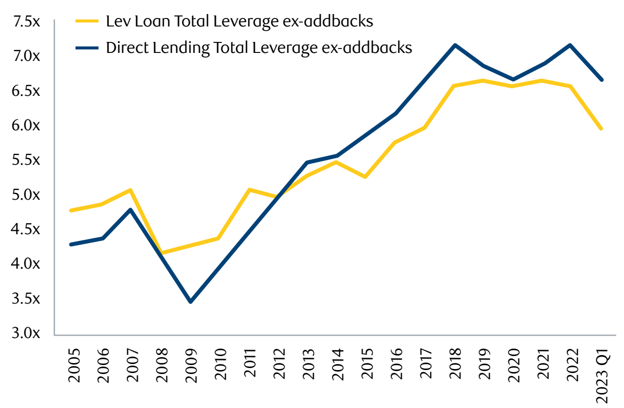
3. Peak defaults in private debt space could well exceed 10% whereas US HY could experience only half of that

Traditional expectations for a HY default cycle call for a 10%+ default rate in a recession. When you consider the limited cash flow generation and financial flexibility of middle-market borrowers and combine that with reliance on (in many cases) just one lender for a rescue, an expectation of 10%+ defaults is well grounded. Many of the transactions structured in the space are unitranche loans, with no loss-absorbing securities below the private debt loan in the capital structure. As a result, recovery expectations for these investments are likely to be inferior compared to public market secured tranche investments. Confirming this view, we're already seeing leveraged loan defaults running well ahead of high yield bond defaults in the current cycle and private credit borrowers should be faring worse than their larger public leverage loan market counterparts.

> **"We expect high yield bond defaults to be significantly lower than in past recessions."**

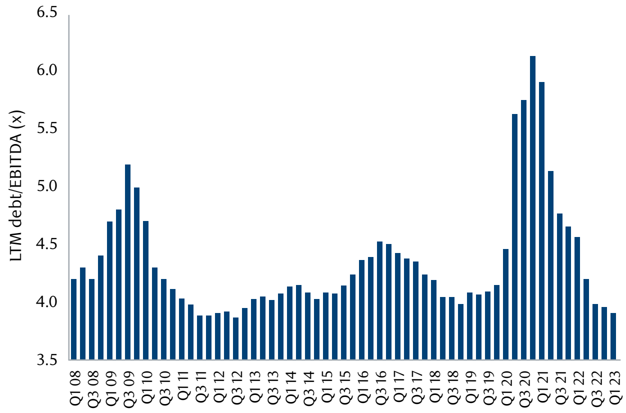
In contrast to that, we expect high yield bond defaults to be significantly lower than in past recessions. There are a few unique reasons for this. Firstly, the US HY bond maturity wall is very small by historical standards. Less than 20bn remains for this year, and the approximately $50bn in 2024 represent a small fraction of the $1.4trn US HY asset class. In essence, there is very little to default on in the quarters to come. Secondly, US HY leverage stands at sub-4x, the lowest level since the GFC. This is in stark contrast to direct lending space, where total leverage (excluding addbacks) is running above 6x, on average. Finally, a lot of companies with challenged business models, where investors expected a default, already defaulted in 2020. These included a number of "old economy" issuers like department store operators or traditional wireline companies. The Covid crisis in 2020 accelerated their demise, with the result that at this juncture the slate is relatively clean heading into another economic slowdown. Said differently, there are no zombies left to default.

Direct Lending leverage (ex-addbacks) close to multi-year highs



Source: Pitchbook LCD, UBS. Note: Middle market loans used as representative of direct lending loans.

US HY leverage at the lowest point since GFC



Source: JP Morgan.

4. Many of the qualities that made private debt space attractive have deteriorated of late

Beyond the well-publicized lack of mark-to-market accounting, investors were drawn to the space for a number of reasons that no longer ring true. It used to be the case that private debt investors got much better covenant packages, affording compelling creditor protection. It has been repeatedly stated to us that those packages weakened substantially in recent years as the flood of money coming into private credit led to weaker underwriting standards.

Another benefit of private credit investing related to the significant spread pick-up over the leveraged loan space. Five years ago, you could easily command 300bp of extra compensation. That compensation advantage has diminished greatly in recent years as competition for assets led to pricing only 100-150bp above leveraged loan levels and, in some cases, they are on par with each other.

5. Are you really in good company? When queried, investors claim to have picked competitive strong managers

Our last point is purely intuitive, but an important one, in our view. In conversations with asset allocators, we have repeatedly heard the refrain of "yes, we know the private debt space will face challenges, but we've picked a strong manager". With so many people claiming competitive strong manager selection skills, it's virtually impossible for everyone to be right, and upcoming economic slowdown should exhibit marked differentiation in performance of different private credit managers. Given the sheer growth in the space over the recent years, we expect fireworks in the quarters ahead when multiple structures come under the pressure of evaporating cash flows, too much leverage and private credit investors unwilling, or unable, to bail out all portfolio businesses in need of assistance if there are too many fires burning at once.

Compare that to the US HY space where yields are around 9%, leverage is dramatically lower and the average credit rating is B+. You can also trade in and out of the asset class rather than being trapped in highly illiquid investments. While you may see mark to market volatility, you benefit from price transparency. Conversely, investors in direct lending funds are lulled into complacency as lenders rarely mark down loans until they are already deemed non-performing. Finally, you also have a much broader pool of investors to rely on if an issuer hits trouble, something that could make a dramatic difference in a recession.

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