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Private Credit Insights

November 2021

As the debate whether today's inflation is transitory or permanent rages on, mergers & acquisition volumes continue to reach new heights spurred on by record levels of private equity dry powder, low interest rates, and the prospect of strong economic growth. Private credit has taken on an increasingly prominent role in financing these leveraged buyouts as COVID further accelerated the long-term secular shift to private credit.

The scarcity of yield in the market has led investors to seek refuge in private credit, which has provided not only a reliable yield premium to the public fixed income markets but also consistently low default rates. It should come as no surprise that private credit has become a trillion dollar asset class and taken on an irreplaceable role in the M&A ecosystem.

Although we have seen record-breaking M&A volumes in the past, today's market represents a unique confluence of factors that are impacting how private credit is being originated and how deals are being structured.

Accelerated Dealmaking

One of the key characteristics of today's leveraged buyout market is the compressed timeline of M&A sales processes for companies. In a highly competitive M&A market, private equity sponsors have no choice but to utilize all the tools available to win a prized asset. This often includes pre-empting sales processes: either locking down an asset before a full auction kicks off or showing up to an interim bid date with all of their work done and fully committed financing papers in hand. The timeline for a full sales process today might be compressed from several months to mere weeks for the most coveted businesses.

This accelerated dealmaking has further reinforced the importance of long-term relationships between the private equity sponsor and its financing partner. The private equity sponsor needs an experienced lender who can maintain trust and discretion, efficiently complete due diligence, and deliver a turnkey financing solution. Prior industry experience and familiarity with a variety of business models will help lenders provide speed and certainty of close, which are of paramount importance to a private equity sponsor trying to pre-empt an auction process.

Value of Incumbency

In such a market, it is not surprising that being the incumbent lender to a credit can be highly advantageous. First, the incumbent lender has unique insights into the historical performance of the company and witnessed first-hand how the management team navigated challenges during periods of volatility, from a global pandemic to subsequent supply chain disruptions. As the incumbent, the lender is able to efficiently complete due diligence and provide certainty to a potential buyer in a compressed timeline. An incumbent has the ability to protect its position and stay in a credit – if it chooses to do so.

Finally, an incumbent lender can typically command premium pricing for financing new and follow-on investments for its portfolio companies. Incumbency allows a lender to differentiate itself on knowledge, speed, and execution – and not on price.

Importance of Scale

The importance of scale in today's market for a lender cannot be understated. Balance sheet strength and requisite scale allows a lender to differentiate itself and in many instances has become required to win financing mandates. This extends to not only the size of a private credit manager's organization, but also its capability to commit and hold significant amounts of capital. This creates a barrier for sub-scale lenders to be able to compete convincingly, other than by offering the lowest price and the loosest terms. Private equity sponsors are often looking for lenders that can commit to entire debt facilities or significantly anchor debt facilities in order to simplify their financing processes and take financing risk off the table. This is true across the capital structure – as much for senior secured facilities as for junior capital tranches.

Buy-and-Build Strategies

Furthermore, private equity sponsors are increasingly pursuing buy-and-build roll-up strategies today in order to buy down high purchase price multiples in this hyper-competitive M&A market. Although purchase price multiples continue to increase at a breakneck pace for high quality businesses, leverage multiples have stayed within a modest band, dictated by the company's ability to service the debt with cash flow from operations. This has resulted in higher equity cushions and lower loan-to-value percentages.

In order for private equity sponsors to execute a buy-and-build roll-up strategy, they need reliable, committed financing partners that have the dry powder and scale available to grow alongside them. Oftentimes this additional financing need is structured as a delayed draw term loan (DDTL), which provides the private equity sponsor the discretion to draw down the capital when needed to support an acquisition on pre-negotiated terms. DDTLs can be advantageous from a lender's perspective as well, providing a built-in forward deal pipeline with an effectively tight leverage covenant in the form of a DDTL leverage governor that limits the borrower's leverage in order to access the DDTL. Lenders without such scale or the ability to structure DDTLs are precluded from participating in this growing segment of the market.

Outlook

Amid concerns from inflationary pressures, supply chain disruptions, and the Delta variant, experience in managing through multiple cycles will be critical to private credit managers.

Ultimately, what matters is a specific borrower's ability to service the interest payments on its outstanding debt obligations regardless of what may be happening in broader macro trends. To this end, a private credit manager will need a broad and deep origination franchise with longstanding sponsor relationships so that they can be highly selective and invest in the best credits. The manager will also need a tenured investment team with established underwriting capabilities to perform fundamental credit analysis and a proven ability to structure both individual investments and a portfolio of credits prudently.

As we look ahead, we expect the robust demand for private credit to continue, both from private equity sponsors who value the experience, certainty, and partnership that a private lender can bring and from private credit investors who value the yield, low default rates, and defensive consistency that private credit can offer their portfolios.

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About Crescent

Crescent Capital is a global credit investment manager with approximately $36 billion of assets under management. For 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, and private senior, unitranche, and junior debt securities. Crescent Capital is headquartered in Los Angeles with offices in New York, Boston, and London and more than 190 employees globally.

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