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Private Credit Insights

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2022 has already witnessed significant market volatility driven by multiple sources: COVID-19 variants, geopolitical risks, and tightening monetary policy from a newly determined Federal Reserve, to name a few. As a result, businesses today have to contend with rising borrowing costs, labor shortages, global supply chain challenges, and inflation. In the midst of such an economic transition, investors continue to seek out private credit for its attractive risk-return profile, consistent yield premium to public fixed income markets, and low default rates.

What does this period of change and volatility mean for a private credit manager? And what should investors be on the lookout for when evaluating private credit opportunities in today's market?

Monetary Policy and Interest Rates

All eyes have been on the Federal Reserve as the markets whipsaw in reaction to words from Fed Chairman Jerome Powell. With the unemployment rate at 4.0% and consumer price inflation at 7.0%, it should come as no surprise that the Federal Reserve would exercise its dual mandate to maximize employment and keep prices stable. 2022 will likely witness a pivot in monetary policy, with multiple interest rate hikes and the accelerated tapering of bond purchases, all attempting to cool down the economy amidst widespread labor shortages and elevated prices.

Since private credit portfolios are typically comprised of floating rate debt securities, rising rates will accrue to the benefit of the lender once the reference rate increases above the London Interbank Offered Rate ("LIBOR") floor.

Conversely, high rates will have a burdensome effect on borrowers. Barring any offsets, an increase in interest costs will result in lower free cash flow and subsequently lower interest coverage and fixed charge coverage ratios. Each new investment opportunity needs to be evaluated in the context of a rising rate environment with multiple downside scenarios run to determine the effects on creditworthiness while existing portfolio companies require close attention and monitoring. Furthermore, businesses will need to adapt to a new era of less government fiscal support that helped buttress various sectors in 2020 and 2021.

In the midst of rising interest rates and tighter monetary and fiscal policy, global financial markets are also working through the long awaited transition away from LIBOR towards the Secured Overnight Financing Rate ("SOFR"). Private credit managers need to carefully monitor and track existing portfolio companies to ensure that this transition occurs smoothly. New investments will have to take the new benchmark rate into account, as well as the fact that SOFR has historically been slightly lower than LIBOR. This discrepancy is being factored into pricing through credit spread adjustments or higher interest rate margins.

Supply Chain and Labor

Global supply chain disruptions and shortages have been well documented and are expected to persist well into 2022. This means sourcing parts and components could remain delayed and challenging, increasing the cost of raw materials and inputs, and affecting the ability to deliver product on time and generate growth.

When evaluating investment opportunities, it is important that the borrower has multiple sources of supply, preferably from different geographies, with an appropriate level of inventory and emergency stock to weather any short-term disruptions. Market leaders in their respective industries and niches typically have a better ability to secure raw materials and inputs given their relative importance to their suppliers.

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Further, portfolios that consist of more service-oriented businesses versus goods-producing businesses will likely be better able to manage through today's global pandemic-induced supply chain challenges. However, service-oriented businesses are more exposed to the labor shortages and wage inflation in the market today. Low unemployment, robust fiscal stimulus, and ongoing concerns with the COVID-19 pandemic have created the conditions for the Great Resignation and continuing labor shortages and wage inflation.

The ability for a borrower to attract, develop, incentivize, and retain talent is key. Market leading companies that invest in their workforce with training programs and thoughtful compensation plans will likely manage through this labor environment easier and emerge from the pandemic better positioned than before. It is also important to distinguish labor by skill level and end market during diligence, as different industries and skill levels can have different wage and labor recruiting dynamics. Building in potential supply chain disruptions, wage inflation, and their subsequent impacts to margins and top line growth should be routine in modeling and evaluating downside scenarios today.

Inflation

It is no surprise that against this backdrop, the persistent challenges in manufacturing goods and then getting those goods to customers have continued to fuel rising inflation with the prices of cars, building materials, computer chips, and other products accelerating at the fastest rate since 1982.

Private credit borrowers are not immune to such inflationary pressures, and so it is up to the private credit manager to diligence the ability of the borrower to pass along the increased costs to their customers in a timely manner to protect margins and free cash flow – pricing power is no longer a nice-to-have in this inflationary environment, it is a critical success factor.

Market leaders with long-standing customer relationships that produce mission-critical goods or services should have the ability to pass through cost increases. They can point to their critical nature and value-add to be able to justify higher prices. Oftentimes the ability to raise prices due to increased input costs is specified in contracts, and other times it is dependent on the ability of the management team to negotiate with their customers – diligencing both contracts and the strength of management are important when evaluating an investment opportunity.

Outlook

With an all-time record of private equity capital raised in 2021, robust M&A deal activity is expected to continue generating strong opportunities for private credit. Consumer and corporate balance sheets are healthy with US corporate earnings and GDP growth expected to continue. Acquisitions are still being capitalized with an overwhelming amount of equity, resulting in low loan-to-value metrics and healthy equity cushions. Amidst the continued global search for yield, investors have increased their allocations to private credit driven by an attractive yield premium over public markets, floating rate structures, low default rates, and low asset-value volatility.

The best tool to navigate today's extraordinary period of transition is what has worked through prior cycles: disciplined, bottoms-up credit underwriting with a focus on capital preservation, strong free cash flow generation, and robust debt service coverage. A broad and deep origination franchise with a long operating history and significant pipeline of new deals allows the manager to be highly selective and only invest in the best credits. Finally, strong diversification by end market, geography, and borrower will enable a private credit portfolio to not only weather supply chain disruptions, labor shortages, and inflationary pressures, but also generate the higher absolute and risk-adjusted returns that private credit investors have come to expect.

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About Crescent

Crescent Capital is a global credit investment manager with approximately $38 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 200 employees globally.
