Investment **INSIGHTS**

PRIVATE DEBT: ENTERING A NEW ERA

TREVOR CLARK
Founder and Managing Partner
Twin Brook Capital Partners

After years of generally favorable market conditions, asset classes across the investment landscape are being put to the test as the macroeconomic environment continues to evolve and predictions of a recession intensify.

The private debt space, in particular, has gown immensely in recent years. The range of manager and product options in that market has steadily expanded as investors have continued to pour capital into the asset class, all against the backdrop of consistently positive market tailwinds.

Now, in the face of an array of macroeconomic headwinds — including rising inflation, interest rate hikes, supply chain issues and geopolitical shifts — both managers and investors are being forced to consider a broadening array of factors and global challenges when evaluating potential opportunities. For investors, choosing the appropriate private debt managers to meet their unique portfolio objectives will be more important than ever. In this environment, expertise and experience will be key differentiators when it comes to both manager selection and groups' respective abilities to successfully navigate increasingly complex market dynamics.

"A buffet of financial and economic themes are impacting the private debt space right now. The most obvious one is the series of interest rate hikes from the Federal Reserve and how it has rippled through the financial markets," said Trevor Clark, founder and managing partner at Twin Brook Capital Partners, Angelo Gordon's middle market direct lending subsidiary. "Companies are feeling the effects of inflationary pressures while continuing to deal with supply chain challenges, issues with access to labor and the cost of human capital. The persistent effects of the pandemic vary across industries and geographies, but they all have a macroeconomic impact — both on businesses and, potentially, the private debt portfolios in which loans to those companies sit."

BROADER DUE DILIGENCE

Over the past two decades, private debt has emerged as an attractive asset class – from both the return and diversification perspectives. "If we reflect specifically on the 2010 to 2016 time period, investor interest in the asset class grew significantly. But it takes time to learn the nuances of the domain, and in a benign credit environment, manager differentiation is difficult to discern," Clark said.

There are a number of characteristics that have spurred the popularity of private debt as an asset class to date. "In our view, the floating rate nature of the loans is very attractive. Additionally, the non-mark-to-market volatility — particularly in the current environment — is perhaps an underappreciated element of the direct lending space," said Clark. "The seniority in the capital structure and — looking to the mid-market, specifically — the bilaterally negotiated credit agreements that provide for lender protections not seen in other parts of the market are also beneficial features. All of these attributes are coupled with a return premium over traditional fixed income — a characteristic that has generated substantial interest in this asset class over the last 10 to 12 years."

Today, however, we believe the landscape is much different than it was a decade ago, and investors have become more focused on manager experience, reliability, execution and return durability – particularly after navigating the challenges that came with eruption of the pandemic, Clark said. In addition, the flow and level of information available across the market is greater than it has been traditionally. "The increased focus on this space in recent years, coupled with the proliferation of more detailed market data, has made investors and consultants better equipped to evaluate direct lending managers' strategies. They have become more discerning when it comes to accessing the asset class and, in an environment like this, are understandably considering the potential effects of a dislocation on managers' respective returns," Clark added.

ASSESSING MACRO IMPACTS

In the private debt space, the effects of current macroeconomic factors can differ in intensity. "The markets look quite different today compared to where they were six months ago," Clark noted, "in part because of the Fed's moves to raise interest rates, which were front-and-center over the course of last year. Now we are looking at the immediate and medium-term impacts of those changes."

> *From an investment perspective, we believe you need to be scaled with experienced staff and structured to effectively navigate acute issues and a potentially sustained period of market stress.*

As the frequency of base rate increases slows, a variety of questions for consideration are coming to the forefront, including: What are the lingering effects of inflation? Are they evenly spread across different industries? And what is a given firm's ability to absorb these effects? "In an uncertain environment, breadth of domain expertise and depth of past experience are key," noted Clark.

"Senior members of our team have been focused on direct lending in the lower middle market for over 20 years, so we've worked through various macroeconomic cycles and headwinds, and we've observed how different factors contributed to or hindered different organizations' abilities to manage through those environments," said Clark. "From an investment perspective, we believe you need to be scaled with experienced staff and structured to effectively navigate acute issues and a potentially sustained period of market stress."

Naturally, higher interest rates can influence both the risk and the return sides of the investment equation. "In the world of private debt, which is predominantly floating rate, a rapid increase in interest rates theoretically means that one can generate a higher return without taking on significant additional risk," said Clark. "However, if a lender has been overly aggressive in how they structure credit facilities — not being thoughtful when it comes to the amount of debt put on individual borrowers and building in adequate cushions from a financing cost-coverage standpoint — they may face negative consequences. If the structures in place do not provide enough flexibility to absorb an increased cost of borrowing, as rates rise, so too may the risk of payment defaults. With this in mind, we believe those that have historically been more conservative in their structures are better positioned given the market dynamics at play."

Another critical factor during periods of economic stress is how investment firms source their deals, as M&A activity typically slows in periods of market disruption. "This has been a consistent theme, specifically in our world," noted Clark. "Firms that have robust in-house direct origination capabilities, strong sourcing networks and historically healthy pipelines comprised of both new platforms and add-ons via existing portfolio companies are, in our view, better positioned for a slowdown."

This is in contrast to direct lenders that have been more transactional, not focusing on building strong relationships that foster repeat lending opportunities, or those that primarily rely on syndicated opportunities to deploy capital — which can present a challenge as the broadly syndicated loan market is often the first to freeze up in the face of volatility, a phenomenon just witnessed at the end of 2022. "In times like these, we've found that lenders' behavior, foresight, and relationships are even more critical than they are in more placid market environments," said Clark.

THE ROAD AHEAD

Uncertainty remains when it comes to the go-forward actions of the Fed, though many predict interest rates could continue to rise. As rates increase, return expectations and the upfront fees earned on transactions in the direct lending space will also likely experience upward pressure. This dynamic, coupled with a possible recessionary environment where fewer deals are coming to market, brings back some key questions for investors and borrowers evaluating the private debt space, Clark noted, such as, "Who are the most reliable lenders? And what does the increased cost of financing ultimately mean when it comes to the loans in managers' existing portfolios and their respective abilities to deploy capital moving forward?"

"Looking at what has occurred during periods of economic disruption over the past 20+ years and, more recently, following the outbreak of the pandemic in 2020, we've seen those stable, established, experienced lenders gain market share. Even if broader M&A volumes are down in 2023, we believe those lenders will continue to win the lion's share of transaction flow moving forward," said Clark. "All of this reinforces the narrative that, for the right managers in the right underwriting microcosms, there can be a sustainable and durable premium for being a middle market lender versus other parts of fixed income, and we believe that concept will likely be further reinforced as we enter what is expected to be a tougher macro environment in 2023." ■

sponsored by:

Twin Brook
CAPITAL PARTNERS
An Angelo Gordon Company

pionline.com/TwinBrook-privatedebt23

P&I CONTENT SOLUTIONS GROUP

This sponsored Investment Insights is published by the P&I Content Solutions Group, a division of *Pensions & Investments*. The content was not produced by the editors of *Pensions & Investments* and *www.pionline.com* and does not represent the views of the publication or its parent company, Crain Communications Inc.