2021 PREQIN GLOBAL **PRIVATE DEBT** REPORT

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Why Private Credit Managers with a Dose of Paranoia Can Thrive

COVID-19 has sent many countries into a recession, with more defaults and financial restructurings the likely outcome. Against this background, attention has turned to the challenges facing private credit managers

Frédéric Nadal
Managing Partner,
Chief Executive Officer

MV Credit
www.im.natixis.com/mv-credit

Founded in 2000, **MV Credit** is one of the first private credit firms to be established in Europe and has the longest-established management team in the private credit space. It invests in senior and subordinated debt across Europe, targeting noncyclical, defensive industries and regions where it has a deep understanding. It offers tailored financing solutions to high-quality businesses and adds value through active engagement. Over the years, MV Credit funds have invested more than €5bn in debt financing solutions and have delivered a consistent top-quartile track record. MV Credit funds invest in the debt tranches of companies undergoing leveraged buyouts or refinancing supported by reputable European private equity owners.

Private credit is in a different space compared to during the GFC. It has moved from being specialist and niche to a more established component of a diversified investment portfolio, with greater commitments to private corporate credit, greater AUM, and more opportunities for direct lenders and other non-bank institutional investors.

Which strategies within the private debt landscape will be the most robust as we come out of the current downturn, and how can private credit managers find opportunities to mitigate risks?

Credit Selection Is Critical for Downside Protection

We think managers should adopt an approach of 'healthy paranoia' at all times and ensure selectivity and caution when originating opportunities.

Some industries prove more resilient over credit cycles. For example, healthcare and subscription-based services generally prove more stable than highly cyclical industries, such as fashion retail, automotive, and leisure and travel. A key lesson we learned from investing during the GFC was to avoid industries such as household durables, which are correlated to economic cycles and are less able to sustain the leveraged structures deployed by private equity sponsors in a downturn.

We also learned to avoid businesses in the paper and forest products industry, where exposure to raw material price pressure can have a negative impact on company performance. In comparison, we have never experienced a loss on a company in the healthcare or information technology sectors which are less cyclical in nature.

Additionally, we target upper mid-cap companies which typically have lower credit risk. Smaller companies are usually more local or regional in nature and can have revenue streams more reliant on a single geography or product. Higher revenue diversification and larger scale make borrowers less sensitive to external shocks. This would suggest that strategies targeting smaller borrowers may be less resilient during a downtown. Private credit managers with strong monitoring processes can usually spot when a borrower company is underperforming by looking out for early warning signals. MV Credit, for instance, has a dedicated and impartial credit monitoring team that systematically reviews and monitors each investment alongside the deal team. This ensures that troubled credits can be proactively addressed early.

The Advantages of Private Equity Ownership

Private credit managers can seek to increase downside protection by investing in companies sponsored by private equity. Why? First, sponsors can be relied on to manage borrower companies and may be preferable to family-owned businesses, particularly in a stressed environment.

Second, private equity sponsors are typically able to reinforce or change a management team in difficult times. We believe this option is less likely in a family-owned business where the owners and management are sometimes the same person or related.

The support of private equity sponsors can be crucial in achieving a recovery on an underperforming business. We saw examples of this during the GFC, where some sponsors injected new equity and even undertook debt buybacks to reduce companies' leverage.

The Pitfalls of Distressed Credit

As investors seek attractive opportunities during this period of market turbulence, they may look to opportunistic strategies such as distressed credit. However, we believe that distressed lending has limitations.

Following the last downturn, for instance, private equity sponsors have tightened documentation on loan transfers, which has limited the opportunities available to distressed funds. Additionally, distressed buyers typically invest in more cyclical industries such as hospitality, retail, and automotive. We believe that the COVID-19 crisis may dramatically change the business models of such industries, potentially over the long term.

Distressed lending may create a conflict for ESG-conscious investors. For example, it creates additional pressure and instability on management teams and longer-term 'par' stakeholders during restructuring processes. Investors may be conflicted with the methods used when extracting value from failing companies.

Finally, subordinated credit funds outperformed distressed credit funds 60% of the time between 2003 and 2017, and their returns were less volatile. Distressed credit is a highly opportunistic asset class and tends to offer less favorable risk-adjusted returns compared to subordinated credit, apart from the odd vintage.

Sourcing Attractive Opportunities

During a downturn, volume and issuance of loans initially decreases, but an experienced private credit manager can leverage existing relationships to create opportunities.

Take the secondary market: the average bid price for leveraged loans in the S&P European Leveraged Loan Index (ELLI) took a sharp nosedive in Q1 2020, falling to 78.92 in March 2020 before rebounding somewhat. However, we were able to commit to a number of high-quality investments at attractive yields on the secondary market. Experienced managers with a focused database of credits are in a particularly strong position, as they have tracked some companies for years.

Then there are primary market opportunities. Private credit managers with a reputation for being reliable and constructive during the credit structuring process are still able to originate attractive investments. Also important are strong relationships with private equity sponsors.

Looking Ahead: A Reset Credit Cycle

Following a downturn, the credit cycle typically enters a period of repair and recovery. The post-GFC period was marked by better economics which drove attractive returns for private credit, with 2008 vintages notable for their high performance. We believe that 2020/2021 vintages will behave similarly.

Coming out of the downturn, we expect the strongest credits to come to market first, with portfolios that invest in cyclical industries struggling. Lenders may gain more information rights and other documentation rights (such as reducing cash leakage). ESG will likely remain an important consideration.

We believe this is a particularly attractive time to invest in private credit to secure attractive risk-adjusted returns. The best managers can draw on significant investment experience across multiple cycles and aim to build and proactively manage resilient portfolios.

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