Insights+

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PREQIN

Senior loans: why investors should stay focused on stable industries

Conservative portfolios will perform better amid higher rates and growing likelihood of default, say Murtaza Merchant and François Decoeur

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Private loans have been a success story for institutional investors over the last decade, with the private debt asset class growing steadily and providing strong risk-adjusted performance.

The asset class has grown by more than 200% over the last 10 years[1] and shows few signs of slowing despite higher interest rates in recent times. However, higher interest rates create the risk of higher default rates, emphasizing the importance of a conservative approach to loan portfolios.

At MV Credit*, we believe part of this conservative approach should be a focus on long-term factors such as ESG and an emphasis on larger companies, which typically have deeper pockets and better disclosure of key information.

Market conditions are positive for senior loans

Until recently, the private credit market was relentlessly borrower-friendly. This changed in early 2021 as global inflation picked up and interest rates followed suit. Power has shifted back toward investors, says Murtaza Merchant, managing partner of MV Credit, which invests in European private equity-backed, mid-cap businesses.

'Lower leverage, higher yields and the resulting risk profile mean 2023–2024 vintages are likely to be very strong in both credit quality and return profile,' says Merchant.

Although investors have regained some power in the market, they have to contend with lower issuance overall as corporate activity takes a pause amid higher rates. Sponsors are facing lower multiples at exit, so some are waiting on the sidelines for market conditions to improve.

This brings into perspective the relative experience of credit managers in sourcing deals. 'If you have a large number of relationships with sponsors and portfolio companies forged over many years, this undoubtedly helps with origination in times like this,' Merchant says.

In addition, investors with strong networks of private equity-owned portfolio companies will be well positioned to provide incremental financing, which can drive value through organic expansion.

On a 12–24-month view, loan origination is likely to regain momentum amid a wave of maturing loans and private equity dry powder.

There was some $1.26tn of sponsor dry powder as of June 2023, and a wall of maturing loans from 2025 onward that will require refinancing. These drivers are likely to ignite the origination pipeline.

Defensive approaches better suited to higher rate environment

The higher interest rate environment has not yet led to an uptick in defaults, but investors should be wary. Central to our strategy is the focus on conservative and cautious portfolios[2] and MV Credit has a 0.0% loss rate across its senior track record since the firm's inception in 2000.

'A long track record and experience of cycles is helpful in times like these,' says Merchant. 'Default rates are likely to increase, and we will see differentiation between credit managers.'

The COVID-19 pandemic was a notable test of credit resilience. MV Credit supported a number of portfolio companies through the pandemic including, for example, a prosthetic surgery company – a rare healthcare company not to enjoy a pandemic tailwind – which was successfully divested by its private equity sponsor in September 2023. Merchant says: 'We supported the company through the last three years until there was a successful bid for it and full redemption for us. This shows the importance of conviction

1 https://www.im.natixis.com/en-institutional/insights/private-debt-is-booming

2 https://www.im.natixis.com/en-institutional/insights/senior-loans-investors-can-rise-to-the-challenge-of-competition

in senior loans – you help companies through tough times and avoid being destructive at the worst possible time for a company.'

MV Credit's default position is to be prepared for adverse macro events by focusing on defensive sectors such as healthcare and IT software, which often have subscription-based repeatable revenues.

It also has a highly-diversified portfolio containing more than 50 companies across most industry sectors. François Decoeur, Portfolio Manager for MV Credit's subordinated debt funds, says: 'Diversification in senior loans takes time and effort. But we want to make sure no single position has a disproportionate impact if things go wrong.'

Investing in larger mid-caps provides a further degree of security – MV Credit's portfolio companies have typical EBITDA of €30–100mn. Larger companies often have higher credit quality, with revenues diversified geographically across Europe or globally, and diversified by product type, too.

In addition, larger companies tend to have more robust corporate structures and governance and are therefore more likely to provide the level of information investors require to assess ongoing performance.

Non-financial analysis is a key element of a conservatively managed portfolio

A conservative approach entails sound analysis of non-financial risk.[3] MV Credit has incorporated ESG in its portfolios since its inception in 2000. Since then, its ESG analysis has undergone formalization and is performed on all its investments – examining the policies of sponsors, assessing governance and diversity, and screening for regulatory and legal breaches.

Where MV Credit differs from most other debt investors is that we tie our ESG performance directly to compensation. The MV Credit team is only entitled to the full carried interest when all ESG key performance indicators (KPIs) are met. If none are met, only half of the carried interest is due.

'We think we were the first in the market to implement something like this and it shows we put our money with our mouth is, so to speak,' says Decoeur. 'It shows commitment to ESG principles and alignment with the ESG policies of our investors.'

DNA doesn't change, but opportunities do

While its investment approach is consistent – and the way it analyses financial and non-financial risks has remained broadly the same for nearly a quarter century – MV Credit regularly updates its views on the market.

'We don't play the cycles, and we remain focused on non-cyclical companies, but we are very much alive to structural market change,' says Decoeur.

This has led MV Credit to focus on healthcare and information technology/software companies with business-to-business models and a subscription-based client base with recurring revenues. 'Despite the strong rally in tech stocks over recent years, we think there will be still more demand for IT and more growth,' says Decoeur. 'We are also looking at AI with interest. AI is not just about new businesses, but its potential impact on existing portfolio companies, both positive and negative.'

3 https://www.im.natixis.com/en-institutional/insights/esg-is-your-private-debt-manager-leading-the-way

Murtaza Merchant joined MV Credit in 2006 as Managing Partner and Co-head of Business Development. He is responsible for driving AUM growth, managing investor relationships, and overseeing the development and implementation of products that align with the firm's long-term goals and objectives.

François Decoeur joined in 2005. As of 2023, he is Partner and Chief Credit Officer for MV Credit's direct lending strategies. He is responsible for investment selection, oversight, and restructuring, and works closely with the CIO, the investment team, and the credit monitoring team.

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