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Managers turn to niche areas as they wait for a downturn

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The next market slowdown still seems to be some way off, according to speakers at this week's Private Equity Exclusive conference, so private debt managers are looking at opportunities outside of distressed for returns.

Private debt managers are increasingly looking at niche areas for yield as industry experts predict the next market downturn could be years away.

Speaking at the Pension Bridge Private Equity Exclusive conference in Chicago on Tuesday, Alex Navab, head of KKR's North American private equity business, said it could be two to three years before the next downswing, while some of his peers believed it may be as many as five.

With debt managers arguing that assets were well-priced or even over-priced, opportunities outside of distressed investment were becoming more attractive.

Brendan Carroll (pictured), senior partner and co-founder of Victory Park Capital (VPC), a Chicago-based debt and equity manager, told a panel that his debt business did not necessarily focus on distressed environments, but rather distressed or special situations.

He said VPC invested in online lending, which was not distressed, per se, but an area where alternative lenders could step in because many traditional lenders were not comfortable around novel financial instruments.

Chris Semple, portfolio manager at Crestline Investors, said energy credit plays have been an area of focus for his firm, particularly in the midstream space. However, he and other speakers on the distressed panel said it was a good time for exits in the distressed area. Asset prices overall are high and private equity managers are taking advantage of the market to exit while strong money multiples are on offer.

Meanwhile, managers and consultants on a mezzanine panel talked about the reality of grappling with lower mezzanine issuance and different levers mezz managers could pull to enhance returns.

Tom Westbrook, managing partner at Five Points Capital, said he had seen mezz decline and often be replaced by unitranche deals.

Managers had also been using more leverage or equity in their portfolios to improve returns. As an example, Westbrook said Five Points' first fund had 11 percent exposure to equity, the second 12 percent, and the third should have 12 percent to 15 percent.

Scott Essex, co-head of private debt at Partners Group, said his firm looked at equity separately from credit and has a large separate private equity business.

Tom Cawkwell, head of private markets at Albourne America, said he was wary of mezzanine or debt managers that put too much equity in their portfolios. "If you hired someone based on their credit underwriting, you didn't necessarily hire them for equity underwriting," he said.

Albourne and its clients will not normally go with debt managers that have a large equity exposure, though exceptions can be made for firms that have big private equity parents and an equity expertise they can lean on. "But there is also a conflict between equity and mezzanine, especially if the company runs into trouble," Cawkwell added.

Speaking on a credit panel, Keith Berlin, another institutional consultant and director of global fixed income and credit at Fund Evaluation Group, said his firm had recently been interested in structured products and other specialty areas of credit. Some of his recent client investments included an emerging market debt fund and a CLO equity fund, for instance.

Tom Gregory, founding partner at Maranon Capital, which runs mostly mezzanine strategies, said his firm is looking to do its first structured credit product soon.

Westbrook added that a lot of senior and unitranche debt is well priced in at the moment, while distressed opportunities in energy could be interesting. "We're in silly season, where virtually any deal can get done, but we're holding true to our quality of underwriting, while others might not be," he said.