Private credit grows riskier as leverage, assets climb

BY ARLEEN JACOBIUS, P&I, AUGUST 7, 2017

Private credit — long investors' safer alternative investment — is getting riskier as capital floods the sector, with lending standards loosening and leverage increasing.

With private credit managers having roughly $600 billion in total capital, borrowers — typically private equity firms — have an increasing number of options to support their investments, industry insiders say.

In the past, a loan generally would be based on a percentage of a portfolio company's earnings. But lenders now are granting larger loans to borrowers in the expectation that future developments could boost a portfolio company's earnings.

That shift is making investments in private equity and private credit more risky, skewing private credit benchmarks and distorting the returns of some managers.

"I'm worried about the flood of (limited partner) capital," said Tom Cawkwell, San Francisco-based partner and head of private markets research at consulting firm Albourne America LLC.

Global private debt managers' assets under management totaled $605.5 billion — a combination of dry powder and unrealized value of invested assets — as of Dec. 31, up about $54 billion or 10% from Dec. 31, 2015, according to London-based alternative investment research firm Preqin.

But managers are set to add more capital to their coffers. There are currently 284 private debt funds aiming to raise a combined $112 billion in the market.

Limited partners increasingly are investing in some private credit strategies as they continue their hunt for yield. Some 32% of investors have allocated at least 6% of their total assets to private debt, with 17% targeting between 6% and 10%, according to an investor survey released in May by Preqin and Chicago credit manager NXT Capital LLC.

Investors are drawn to the asset class by the distributions of capital, with close to $100 billion returned to investors, and returns that have held their own against private equity. For example, 2008 vintage private debt funds have a global median IRR of 10.4% compared to 2008 private equity funds that have a global median IRR of 10.7%. While vintage year 2009 funds have a global median IRR of 9.5% vs 13% for 2009 vintage private equity funds, 2010 vintage private debt funds have a 10.4% global median IRR compared to 9.5% for the same vintage year private equity funds.

But, Mr. Cawkwell added, "the real risk is the amount of leverage in the transactions."

Lenders will add in "expected synergies" the portfolio company could achieve in the future, increasing its earnings, he said.

"Market participants are not incentivized to question. It makes the leverage levels look better," Mr. Cawkwell said. "It's a risk factor that is slowly building" and will continue to build unless it is managed by the industry."

What's more, loan covenants, which are supposed to protect lenders and their limited partners, are so lenient they have become meaningless, industry participants say.

"What we have observed is the mountain of debt that (private equity) portfolio companies are taking with close to no covenants," said Stuart Blair, director of research Canterbury Consulting Inc., a Newport Beach, Calif.-based consulting and outsourced CIO firm mainly serving endowments and foundations.

These loans go into technical default only when the portfolio company borrower misses payments, Mr. Blair said.

"There are absolutely no teeth to these securities," he said.

Outstanding debt backing private equity deals is also on the rise. Leverage levels in private equity transactions are up to pre-2008 levels, he said.

The median debt percentage for private equity deals was to 56.3% of enterprise value as of June 30, up from 50% in all of 2016, according to PitchBook Data Inc., an alternative investment research firm.

At the same time, the median price paid for transactions is higher than the amount paid in the cycle that ended with the 2008 global financial crisis. This means the average is well above that, Mr. Blair said.

For example, private equity managers paid an average of 10.2 times trailing earnings before interest, taxes, depreciation and amortization for middle-market businesses in 2016, surpassing the 10-year average of 8.8 times, according to S&P Capital IQ's first-quarter research review.

That amounts to a lot of risk lurking in investors' private equity and credit portfolios.

'No free lunch'

Private credit can be an attractive investment, especially the more senior levels of debt that get paid first when there is a default, Mr. Blair said. "But there is no free lunch," he added.

At the same time, some private credit managers are artificially boosting their internal rates of returns using lines of credit, with durations extending now to three years from the typical 12 to 18 months. To determine a manager's true return, investors and their consultants are having to dig down to the portfolio company level.

These lines of credit are also skewing benchmark returns, industry insiders say.

"We (investors) don't know which funds are using subscription lines of credit," said Travis L. Haney, senior investment portfolio manager, State of Michigan Department of Treasury, which oversees the State of Michigan Retirement Systems. "We look at the deals unlevered and we will get to (the actual returns) eventually, but it makes it more difficult."

Mr. Haney, speaking at the Pension Bridge private equity conference in July, said he questioned whether managers' use of subscription lines of credit to delay capital calls for their co-investors is "a good use of limited partner capital."

Michigan officials continue to prefer private credit over equity in most situations because of the expected return for the level of risk, according to a June 8 investment report. But they are not without concerns.

"We're cautious about the amount of money coming into the credit space," said Ron Leix, spokesman for the Michigan Department of Treasury in an emailed response to questions.

As of June 30, the State of Michigan Retirement Systems had about $4.2 billion in private credit strategies, amounting to about 6.4% of the pension fund's $65.6 billion in assets.

Karen Rode, partner, Chicago-based global head of private equity and infrastructure, Aon Hewitt Investment Consulting, said credit lines skew the benchmarks.

"How much weight do you give a benchmark? The benchmark could be incredibly inflated depending on how many funds are using leverage," Ms. Rode said at the Pension Bridge conference.

These lines of credit including capital call facilities, tend to range from 5% to 40% of fund capital and used to extend from 180 days to 360 days so that general partners would not have to call capital from their investors as often, said Canterbury Consulting's Mr. Blair.

Maybe no, maybe yes

Managers do not consider these lines of credit leverage, even though some lines of credit these days are extending out three years, he said.

"These managers say `I don't have leverage' but they have capital call facilities," Mr. Blair said. "They say it makes them more efficient. They will have term and structural leverage on the fund up to 100% of the fund's (capital). It's leverage upon leverage."

Such lines of credit boost the fund's internal rate of return because the fund is lending money out and receiving payments on the loans without calling capital, Mr. Blair explained.

With the increased amount of capital raised and the competition, "you can see how people (managers) need to get creative and imaginative in terms of their underwriting," said Kevin Campbell, managing director, private markets at DuPont Capital Management, Wilmington, Del., which manages funds of funds for third-parties and the $14 billion E.I. du Pont de Nemours & Co. pension fund. "We are seeing folks with slightly lower underwriting standards."

"Institutional investors have to dig in to how the manager's historical returns were generated," from lending to companies or if the firm used lines of credit that gave their return an extra bump, Mr. Campbell said in an interview.

"When people are getting really creative with underwriting it looks like a car heading toward a cliff," Mr. Campbell said.

"At the same time, a lot of people said the same thing about private equity two or three years ago due to the high prices they were paying but there's been good exits and returns since then."

He declined to say how much DuPont manages in private credit.

Neil Rudd, chief financial and administrative officer in the Chicago office of credit manager NXT Capital, said his firm has seen lines of credit and inflated company revenues in the larger end of the market.

However, using fund-level leverage is becoming standard in the industry, said Linda Chaffin, Chicago-based managing director and head of institutional marketing at NXT Capital.

Especially loans for companies that have $50 million or more in EBITDA, "there are no more covenants," she said.

NXT uses fund-level leverage for the overall portfolio "but we have not and do not use lines of credit or what the industry calls `subscription lines' to bridge capital calls," Ms. Chaffin acknowledged.

The good news is that private equity firms are putting more equity into their deals of 45% to 50% of transaction value, she said. "So, companies will melt but they won't disappear."

NXT Capital had $6.8 billion in assets under management as of June 30.

Cash flow is key

Even so, cash flow is king, she said. In private equity, if a deal or two in a fund does not work out, it won't destroy the fund's returns.

"There is no luxury of getting it wrong in credit," she said. "Our portfolios have 100 positions and if something goes wrong it has a de minimis effect on the portfolio" because there are 99 other positions to cushion the impact.

That is why it is essential for managers to assess how much cash the company is generating and what is the "true equity cushion," said F.T. Chong, head of structured capital at money management firm PineBridge Investments, New York. Speaking at the Pension Bridge conference, Mr. Chong said that PineBridge does not include earnings projections after three months.

A large percentage of the credit transactions that executives at Crescent Capital Group have seen has boosted company earnings, said Chris Wright, managing director of the credit manager, speaking on a panel with Mr. Chong at the Pension Bridge conference.

"At the end of the day, it comes back to cash flows," Mr. Wright said.

In the past 12 to 24 months, he said he has seen so-called "add backs" — the industry term for increasing a company's revenues for lending purposes — that "are not the truth."

"Some of the add backs are true and some are fictitious," Mr. Wright said.