

# Private debt: key observations 1H23

OCTOBER 2023

## Executive summary

- Contrary to earlier concerns, a recession has not materialized yet. This positive development has bolstered market confidence in the prospect of a soft landing and financial markets rebounded in 1H23 as a result. However, this increased confidence might have obscured the potential challenges that could adversely affect the economy.
- Transaction volumes fell significantly during 1H23. Subdued M&A activity is a big reason why. Under these circumstances, alternative sourcing channels such as secondaries offer attractive opportunities to deploy capital. 1H23 demonstrated a more lender-friendly market with new deals sourced with lower leverage.
- Middle-market companies also showed surprising resilience in the face of the current macroeconomic challenges. However, earnings growth is expected to soften in the coming quarters as the impact of higher interest rates flow through the economy.
- **Historically, private debt has demonstrated resiliency, even during economic downturns or market dislocations, thus offering attractive relative returns to investors. The current market environment may also produce an interesting vintage enabling the deployment of capital on favorable terms.**

# Public markets: increased risk appetite

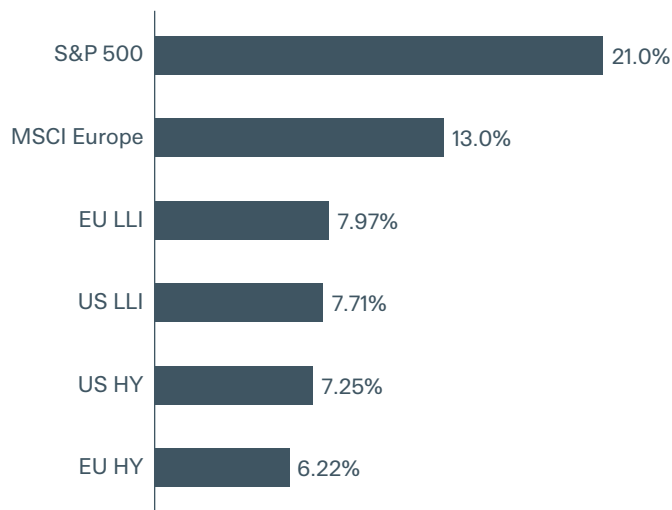
## 1H23 displayed a risk-on environment...

After the events of 2022, which prompted investors to retreat from the higher-risk segments of the market (e.g., public equities and sub-investment-grade credit), 1H23 witnessed a notable reversal of this trend. The investment environment shifted toward a risk-on sentiment. This shift resulted in double-digit returns within the public equity markets of the United States and Europe.

## ...which led to a “priced for perfection” situation in public markets

Additionally, there was a remarkable rebound in the public sub-investment grade debt market from the previous year. Returns in 1H23 ranged from 6% to 8%. Taking a closer look at the secondary spreads within the public debt market, current spreads appear to be close to their historical averages. When compared with the levels observed during the Great Financial

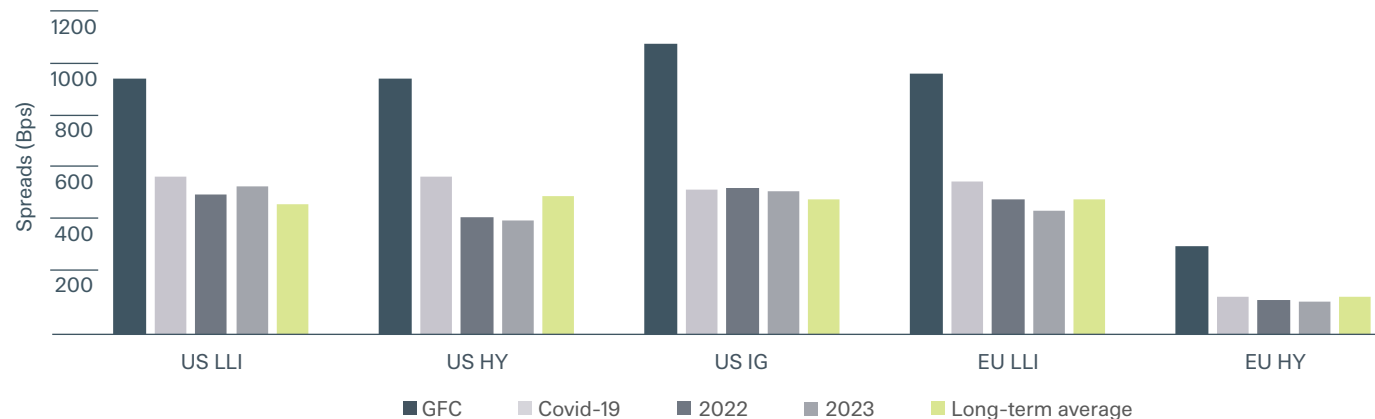
FIGURE 1: 1H23 TOTAL RETURNS ACROSS ASSET CLASSES



Sources: Credit Suisse and Bloomberg, as of June 2023.

Crisis or the pandemic, current spreads seem to imply that the market does not anticipate any macroeconomic challenges in either of these regions.

FIGURE 2: SECONDARY CREDIT SPREADS



Sources: Credit Suisse and Bloomberg, as of June 2023.

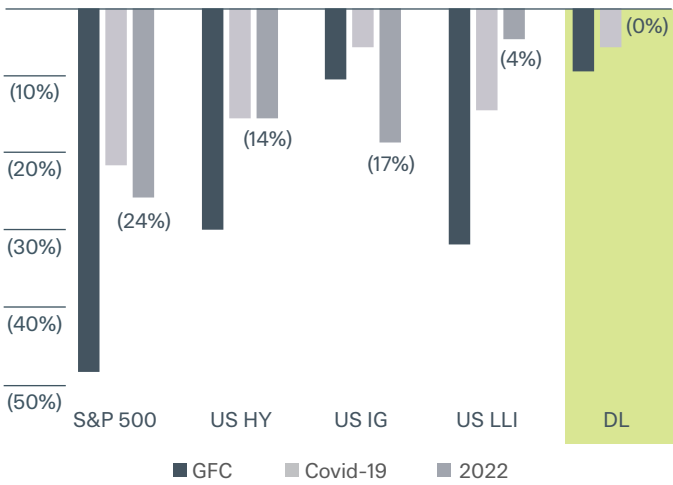
However, considering the uncertain macroeconomic outlook as we approach 2024, alongside the expectation that rates will remain higher for longer, public debt valuations may very well be inflated. These valuations may not account for the risks that investors could encounter in the near future. Against central banks' guidance, markets are pricing in rate cuts as soon as 2Q24 according to forward curves. The anticipated rate cuts are contributing to the current market enthusiasm, but the "higher for longer" stance may yet lead to a hard landing and a correction in valuations.

**We expect private debt to remain resilient and offer attractive relative value**

Rich valuations in public credit markets underscore the attractive relative value that private debt can offer. Direct lending has, on several occasions, shown its resilience through limited drawdowns and valuation stability when compared with its counterparts in the public market. These distinctive features of private debt could emerge as pivotal factors to safeguard returns, particularly if the economy takes a turn for the worse. Because of this track record of stability, we expect private debt to perform as it has in the past, any macroeconomic headwinds notwithstanding. Furthermore, owing to a lender-friendly market that allows lenders to be picky, the current vintage may provide ample opportunity to deploy capital on favorable terms.

A potential turn in the credit cycle could also create more opportunities in the secondary space. Activity picked up,

FIGURE 3: RELATIVE DRAWDOWNS



Sources: Credit Suisse, Cliffwater and Bloomberg, as of December 2022.

and we expect it to remain high in the upcoming quarters. If it does, investors could have even more possibilities to deploy capital with attractive discounts at a time when primary volumes are subdued. Moreover, other private debt strategies such as opportunistic lending or specialty finance stand to benefit from the situation. Companies with sound business models but stretched balance sheets could prove attractive investment opportunities with the potential for high returns.



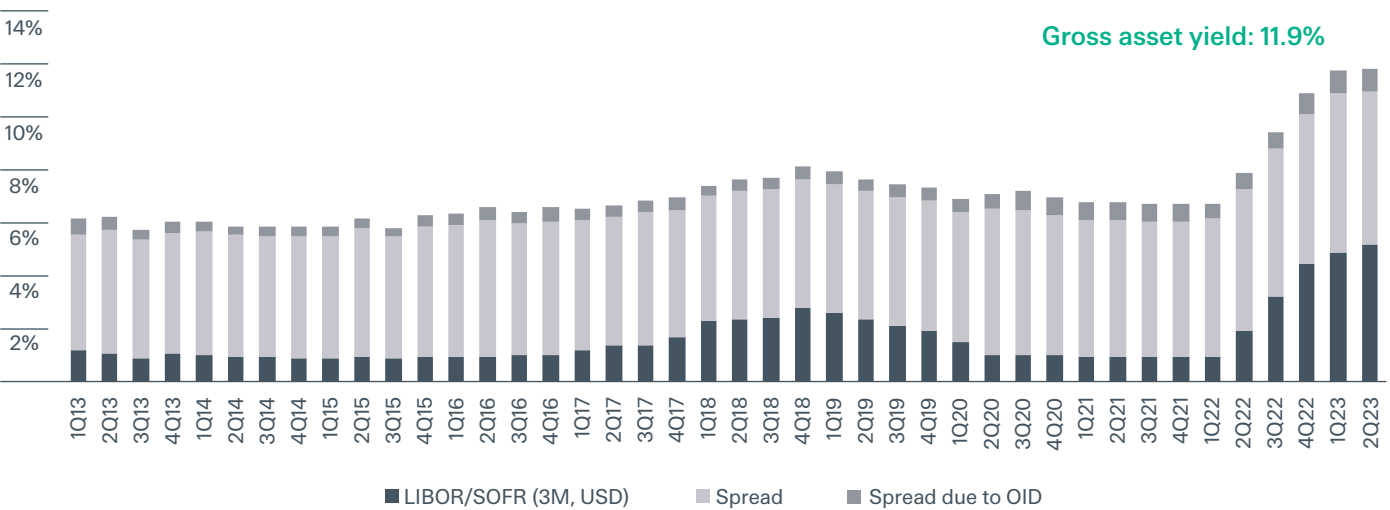
# Private debt: an all-weather\* asset class

## Higher base rates and stable spreads boosted yields

The surge in yields in 2022 due to higher base rates continued into 1H2023, probably stabilizing by the second quarter. In the United States, first-lien loans yielded around 11.9%, while second-lien loans yielded approximately 15.9%. Elevated base rates and reasonably stable (and in some segments even wider) primary spreads partially explain this strong performance.

If previous periods of high base rates are any indication, we would expect primary spreads to contract slightly. Nonetheless, the prevailing “higher for longer” stance from central banks implies that direct lending portfolios will continue to benefit from the income generation that accompanies elevated base rates. On the flip side, higher rates will create challenges for weaker credit, especially if economic conditions deteriorate. Such risks, however, can be mitigated by constructing broadly diversified portfolios.

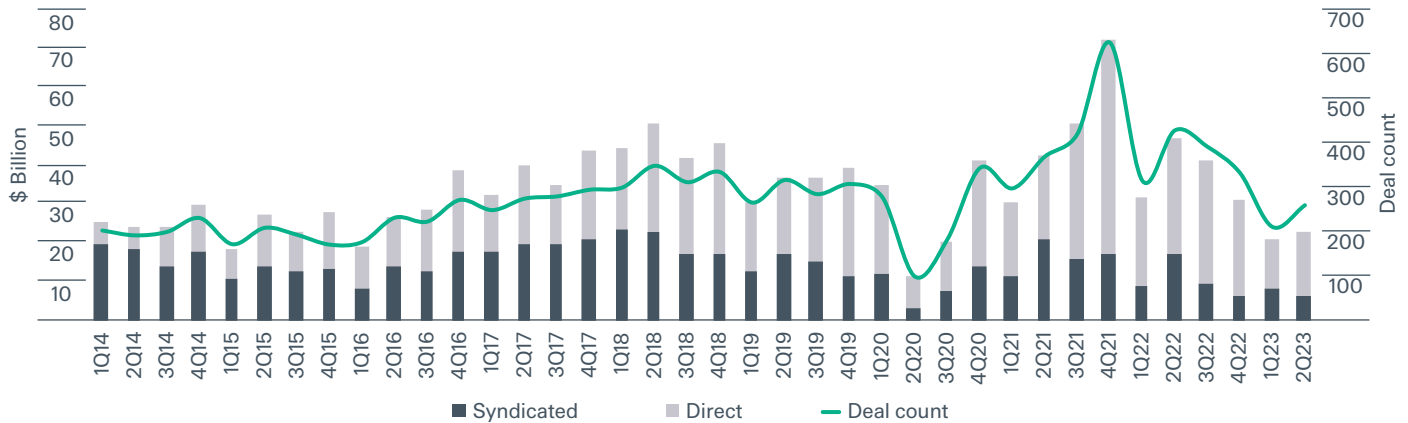
FIGURE 4: US MIDDLE-MARKET FIRST LIEN PRIMARY YIELD COMPOSITION



Source: Refinitiv LPC, as of June 2023.

\* “All-weather” refers here to private debt as an asset class. It is expected that a broadly diversified private debt portfolio may generate long-term attractive returns in favorable market environments, while reducing volatility and maximum drawdowns in adverse market conditions.

FIGURE 5: MIDDLE-MARKET SPONSORED LOAN VOLUME



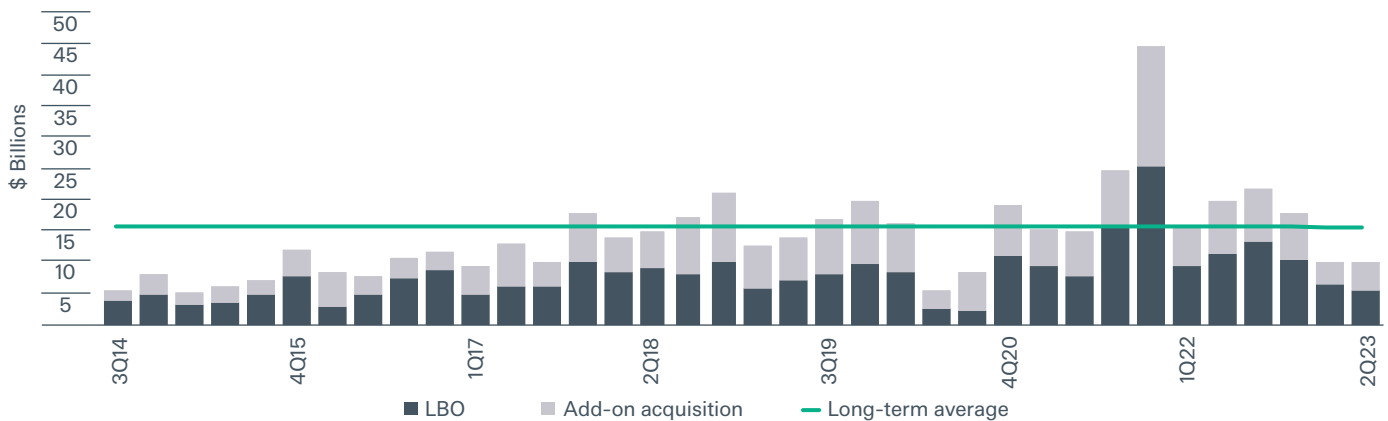
Source: Refinitiv LPC, as of June 2023.

## Middle-market transaction volumes were low in 1H23...

Following 2022, middle market loan volumes fell significantly in 1H23 across the United States and Europe. Current volumes are near record lows even when factoring in an uptick in the number of transactions in 2Q23. In dollar terms, direct lenders

were able to deploy more money than the syndicated loan market, but levels remain subdued compared with earlier years. Consequently, it has become paramount for investors to explore complementary deployment channels such as secondaries, which are experiencing an uptick in deal flow, to deploy capital efficiently and counter the soft patch in primary deals.

FIGURE 6: MIDDLE-MARKET M&A VOLUME



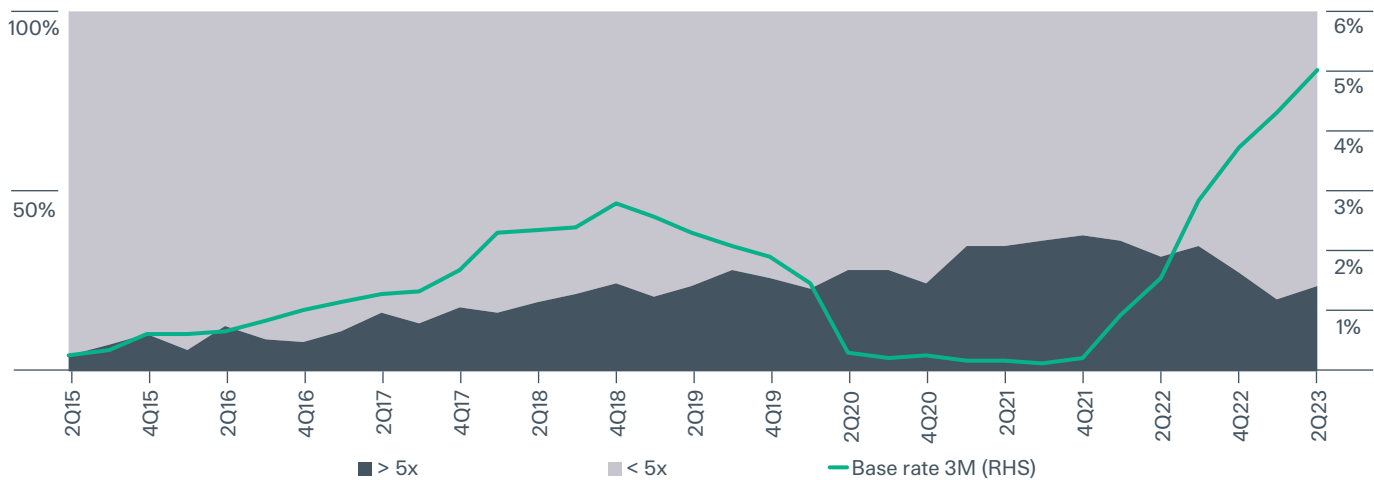
Source: Refinitiv LPC, as of June 2023.

## ...Due to muted M&A activity

One of the factors contributing to lower loan volumes is a decline in M&A activity on both sides of the Atlantic. Buyers and sellers alike have grown cautious, owing to

macroeconomic uncertainty and the expectation that rates will remain elevated, potentially affecting valuation levels. The current volume, hovering around \$10 billion, is well below the long-term average.

FIGURE 7: US SENIOR LEVERAGE DISTRIBUTION



Source: Refinitiv LPC, as of June 2023.

However, some direct lending GPs seem to hint at an increase in direct lending transactions toward the end of the year and early 2024 thanks to a potential pick up in M&A activity.

**The market remains lender-friendly with lower leverage...**

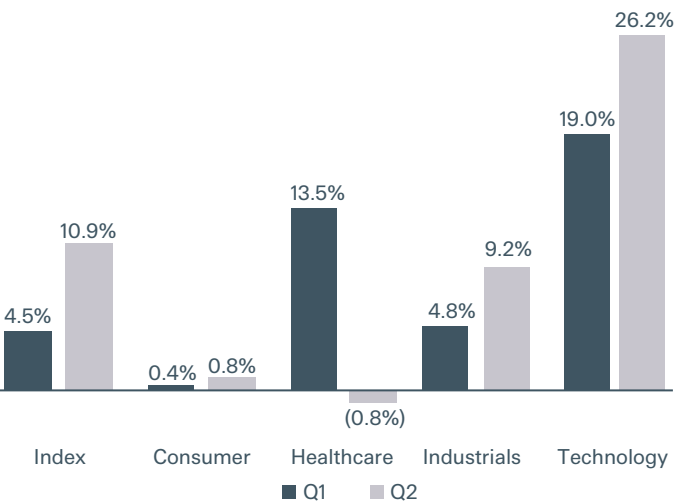
As base rates rise, lenders use less leverage, and markets become “lender-friendly.” The share of deals using >5x leverage hasn’t been this low since early 2020. This trend has been observed in both Europe and the United States.

**...While middle-market earnings remained robust but are expected to soften.**

US middle-market firms demonstrated resilient earnings growth throughout 1H23, albeit with signs of moderation during the second quarter. Significant disparities among sectors can also be observed: The healthcare sector saw negative earnings growth in Q2 owing to strong wage growth and mounting cost pressures, whereas the consumer and industrial sectors both saw earnings growth double. Moreover, lenders should expect idiosyncratic challenges. High interest rates, supply chain disruptions, increased labor costs, reduced demand and other factors may put

individual companies under pressure. Because the current economic outlook for European companies is less favorable, we expect earnings growth to weaken in this region. Again, this underscores the importance of avoiding portfolio concentration and being selective when evaluating new opportunities in this environment.

FIGURE 8: GCAI - EARNINGS GROWTH 2023



Source: Golub Capital Altman Index Q1 & Q2.

## Higher borrowing costs are putting interest coverage ratios under pressure temporarily...

As mentioned earlier, the rise in base rates made borrowing more expensive. As a result, lenders have begun using less leverage. This reduction, however, may not have eliminated the negative base rate impact, hence leading to lower interest coverage ratios. With expected moderation in base rates – forward curves suggest rate cuts over the next 12 months – we expect that the ratios will recover. Regarding existing positions, while we observe a similar downward trend, it is important to acknowledge that a temporary decrease in interest rate coverage does not mean an imminent surge in defaults. Companies possess a range of tools, such as PIK, drawing on the RCF, or managing capital expenditures more carefully, to get through this period. Moreover, as for new transactions, ratios for existing deals may recover as the currently high base rates are expected to be temporary and rates will settle at lower levels from today.

## ...Nonetheless, default rates are expected to increase only gradually

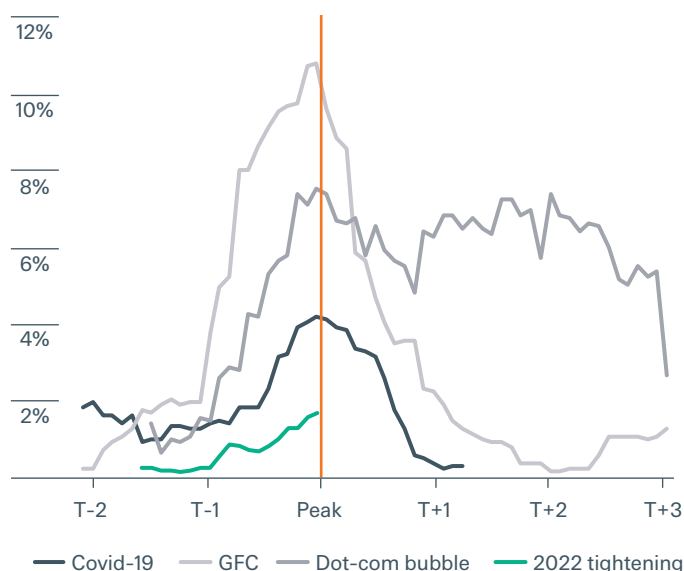
Default rates in the syndicated loan market, which are used as a proxy for the direct lending market, have continued to climb from record low levels in recent quarters to reach 1.71% in June. This supports the view that the increase in base rates during the past 15 months did not have a material impact. For the remainder of 2023, we expect defaults to return to their historical average of 2.7%. Forward-looking measures such as credit rating upgrade/downgrade ratios confirm a gradual process at this stage.

FIGURE 9: US EBITDA TO INTEREST RATIO



Source: Refinitiv LPC, as of June 2023.

FIGURE 10: U.S. SYNDICATED LOANS DEFAULT RATE CYCLES



Source: PitchBook LCD, as of June 2023. The chart displays default cycles in the syndicated loan market. The peak shows the highest default rate of a particular cycle while showing the default rate development 2 years prior and 3 years after the peak (e.g., T+1 shows the default rate 1 year after the peak).

# Macroeconomy: Uncertainty ahead

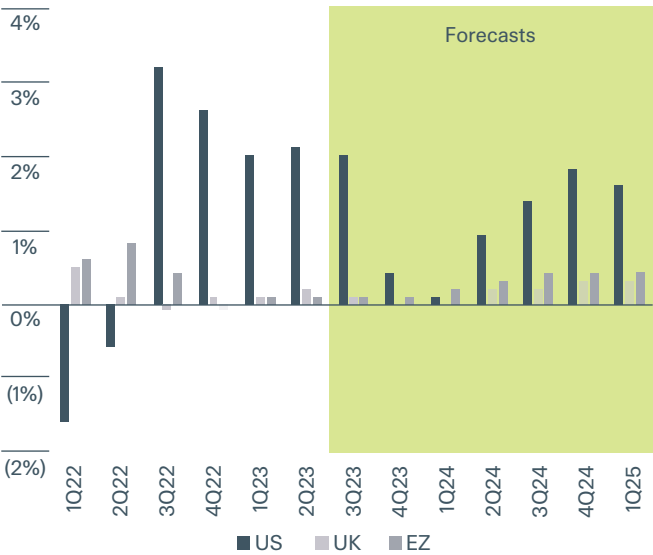
## Real GDP growth has been surprisingly resilient...

Real GDP growth was surprisingly strong in Europe and the US, and the widely anticipated recessions did not materialize. This surprising economic development has sparked growing optimism that central banks might be able to orchestrate a soft landing. Nevertheless, the road ahead remains uncertain as the full impact of monetary policy on the economy has yet to unfold. Concerns include persistent inflation and the fragility of consumer spending in the UK, geopolitical tensions and energy price fluctuations in Europe, and the soured US-China relationship. These factors could adversely affect future growth and the capacity of companies to protect their EBITDA margins.

## ... But remains uncertain; softness is expected

Moreover, some would argue that the manufacturing sector is already in a recession: Its PMI has been below 50 for several quarters now. That the health of the service sector is also trending downward is cause for concern because it is likely to have been the main driver of growth in the preceding quarters

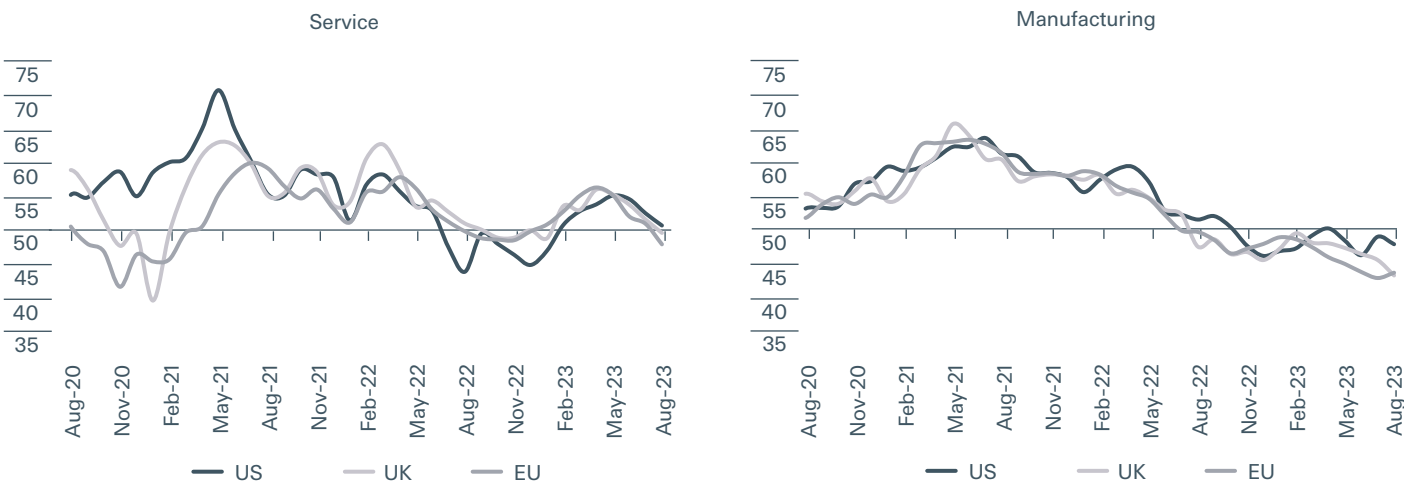
FIGURE 11: REAL GDP GROWTH



Source: Bloomberg, as of August 2023. US numbers are annualized.

and may have prevented an outright recession. Consequently, diversification is imperative in mitigating concentration risk and safeguarding returns.

FIGURE 12: PURCHASING MANAGERS' INDICES



Source: Bloomberg, as of August 2023.



### Headline inflation has been trending downward in 2023...

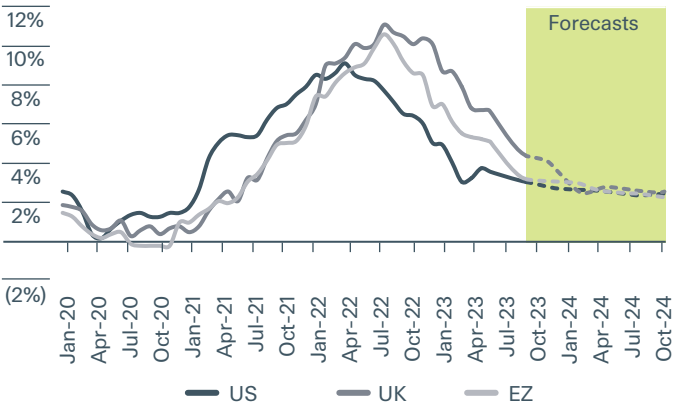
After peaking in late 2022, inflation fell sharply and is on track to return close to central banks' target rate of 2% by the end of 2024. Core inflation has also fallen. If it continues to do so, central banks may have more flexibility regarding their monetary policy. While a surge akin to what we saw in 2022 is improbable, inflation still presents potential risks.

### ...But remains higher than the target, prompting a "higher for longer" narrative

The volatility of commodity prices could increase consumer expenses during the upcoming winter months. Simultaneously, persistent wage growth, especially in the UK, could also fuel inflation. Moreover, the growing regional disparity in economic outlooks between the US and Europe is driving a strong rally for the US dollar, which could increase import prices for European consumers while adding more downward pressure to the US's manufacturing PMI.

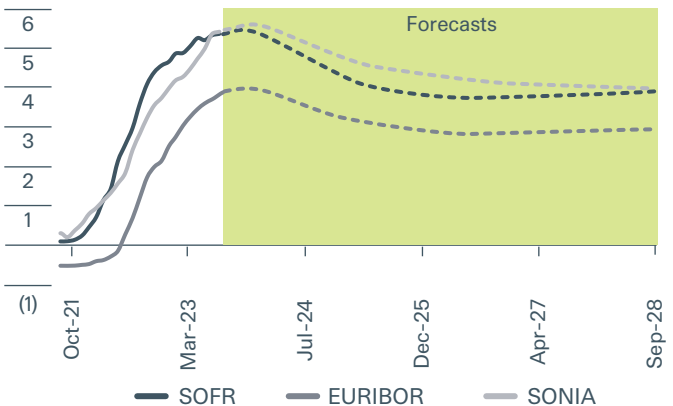
Starting in 2022, central banks embarked on their most aggressive monetary policy tightening since the 1980s. These abrupt rate increases enhanced yields for floating-rate asset classes while precipitating a sharp decline in fixed income and equity markets. Nonetheless, disinflation could prompt central banks to end their tightening cycle sooner rather than later, especially if higher rates start to affect economic growth significantly.

FIGURE 13: HEADLINE INFLATION



Source: Bloomberg, as of August 2023.

FIGURE 14: INTEREST RATES



Source: Bloomberg, as of August 2023.

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All data is as of October 2023 unless otherwise noted.

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