Private equity

Pricing is back where it was before the covid crisis as demand for loans increases

Laura Holson

Head of capital markets, New Mountain

Bullish

Demand for loans to high quality businesses

Bearish

Capital structures that leave very little margin for error on cash

Biggest challenge

Tough conversations around allocations

Direct lenders have increasing hold sizes that allow them to speak for very large cheques

Following the vaccine recovery, private equity is once again flush with dry powder. 2021 is shaping up to be a record year for deal flow, with $2.5 trillion done year-to-date.

Pricing levels and terms have bounced back to their pre-covid levels and sponsors are able to access attractive financing given the strength of the credit market.

Holson says there is a "calmer tone" to her firm's discussions with lenders compared to the uncertainty during the depths of the pandemic.

"It's a competitive environment so lenders are focused on differentiating themselves with speed, certainty and a partnership mentality," Holson says.

Inflows into private credit have boosted managers' ability to compete with syndicated lenders, a trend Holson says she is keeping an eye on. "We've noticed the ability of direct lenders to provide large cov-lite unitranches, which can compete with syndicated debt deals on scale and terms," Holson says. "They have increasing hold sizes that allow them to speak for very large cheques."

Holson says now is a good time to raise second lien capital. "Spreads between first and second lien loans have compressed from 400 basis points to 300bp or even tighter in some instances."

Distressed debt

What distressed debt? You're better off looking at off-the-run credits

Tim Gramatovich

Chief investment officer, Gateway

Bullish

Off-the-run credit in the secondary market

Bearish

Unsecured high yield bonds and large broadly syndicated loans held by CLOs

Greatest challenge

The socialisation of credit: we have a system where any type of pain cannot be tolerated and government interference and manipulation is unlikely to go away

Let's be clear that the distressed market of times past simply does not exist today

US high yield and leveraged loan default rates are set to hit 10-year lows, according to Fitch Ratings, at just 1.5% and 1% respectively.

Gramatovich says this is a reflection of government intervention and has meant there are few traditional distressed debt opportunities available. "Let's be clear that the distressed market of times past simply does not exist today," he says. "It existed for about one week in March 2020, but post the Fed's various programme announcements, they took that away."

He cites Westjet, a Canadian airline, as an example of a credit trading at distressed levels, but which quickly bounced after being acquired. "In the blink of an eye that loan was back in the 90s, yet fundamentals still haven't even come close to catching up."

Distressed debt investors can instead find value in the secondary market, particularly with smaller companies. "We have historically made tremendous returns focusing on the size bias of rating agency models," says Gramatovich.

Companies that have sales below $1 billion are typically rated triple C based purely on size, not credit fundamentals, he argues. "The market between $150 million and $600 million in tranche size is over $500 billion today and provides us a significant hunting ground."

At $2.1 billion Ferrellgas Partners is the largest US high yield default this year (11 January), but the propane supplier's Chapter 11 filing was signposted late last year.

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