KEYNOTE INTERVIEW

The flexibility premium

Solid relationships and flexible solutions are key to private debt's ongoing success in the PE mid-market, says Audax Private Debt president Kevin Magid

Q Private debt, as an asset class, has grown massively over the past five years. To what do you attribute the growth?

When you consider the attention that private credit is getting today, you might think it is a new asset class, but the industry has been growing steadily over the past two decades. At Audax Private Debt, we have been providing private debt solutions for nearly 25 years, with the senior members of our investment team having been doing it for even longer.

The most recent surge in interest is due to the fact that, in the early days of the pandemic, many of the prevailing incumbent lenders – the commercial and regional banks – got stuck holding loans they had planned to syndicate. When those institutions at the larger end of the market moved to the sidelines, private lenders stepped in to provide new loans.

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Those relationships with sponsors have further developed because private debt has the advantage of offering product depth, financing flexibility and bilateral relationships, with lenders working directly with sponsors to meet their specific financing needs.

Q What does flexibility look like to a borrower?

As we look back over the last two or three years, the rapid rise in interest rates has allowed many private debt providers to demonstrate their versatility. At Audax, we invest up and down the capital structure: senior secured first lien, second lien, mezzanine debt, unitranche debt and preferred structures, as well as equity co-investments. In the mid-market, that covers the majority of what PE sponsors are seeking.

In benign market conditions there was already a migration toward private debt. For instance, the rise of unitranche was driven by the efficiency of having a streamlined process that eliminates syndication risk for sponsors and provides a simplified capital structure, as well as the ability to negotiate a single set of credit documents and financial covenants, often with one provider. The recent introduction of jumbo unitranche loans only underscores this trend.

But, in an inflationary, rising-rate environment, numerous borrowers have been navigating unfamiliar territory. For instance, we see a lot of private equity firms looking to pursue add-on acquisitions while facing constraints in their existing capital structures – such as MFN clauses – that would otherwise make investing in portfolio company growth costly and often unfeasible.

As a result, many sponsors turned to mezzanine debt to add funding without having to reprice their entire capital structure. Mezzanine financing provides flexibility through less restrictive covenants, debt subordination and allowing for pay-in-kind structures that lower the cash component of interest payments.

These are just two examples, but product breadth has become a critical differentiator.

"During periods when there is less liquidity... that is when strong relationships make the difference"

Q What are some of the factors that have allowed you to put capital to work at a solid clip over the past year?

In mid-market lending, relationships are everything. It sounds trite, but it's true. Given our extensive platform, we are often a first call for sponsors seeking financing, and we usually have an existing relationship. For our originated debt strategies – unitranche and mezzanine financing – we have been sole or lead lender on nearly 90 percent of our transactions. Our relationships drive dealflow at the top of the funnel.

But these relationships also inform our underwriting. We have supported over 275 sponsors that we believe are top-tier firms who bring extensive resources to invest behind their portfolio companies' growth. For us, there is an element of manager selection in who we work with, and that also drove activity last year.

At the top of the cycle, when deals are more plentiful, private debt can feel more transactional. There will always be competitors that can beat you on price, document flexibility or leverage. But during periods when there is less liquidity in the market, when sponsors may need to revisit their plans for companies, that is when strong relationships make the difference between a positive, rewarding outcome or a headache for all involved. Our collaborative approach and the depth and length of our relationships made the difference for us last year, and over the last two decades.

Q What is your philosophy around risk management?

There is no lending without risk management. Managing risk, for us, starts with a credit-first approach and a focus on capital preservation; without that, you won't last long. That focus requires underwriting discipline. We aim to provide a level of consistency that sponsors recognise and that feels fair to them. We are not going to say yes to every deal, but we provide transparent and timely feedback.

Maintaining discipline in good times and bad allows us to deliver for our investors, which is critical to consistently raise capital. Sponsors pick up the phone and expect us to have money to lend. In this sense, we see ourselves akin to a 'private bank', but it begins with a sense of capital stewardship and a focus on risk management.

Discipline can take many forms. We generally don't provide financing to more cyclical industries, such as the restaurant, retail, apparel/textile or travel and leisure industries. Just as importantly, we seek diversification across industries and across sponsor relationships.

Discipline in our underwriting leads us to companies with positive cashflows, strong market positions and staying power. Given our heritage in junior capital, going back to our founding, we believe we dig deeply to manage risk. Even before the rising rate environment, we focused on fixed-charge coverage ratios, versus interest coverage, and we closely scrutinised EBITDA adjustments.

Finally, we benefit from being laser-focused on the US mid-market, which represents a large universe of both sponsors and acquisition targets, and is somewhat insulated from the capital market volatility that impacts the large-cap market.

Q Where do you see the market heading in 2024?

We are optimistic. Dealflow has already picked up, thanks to a perception that rates are stabilising and will potentially come down in the US later this year. The economy is in relatively good shape, inflation has been reduced, portfolio companies have generally performed well and been supported by owners and sponsors are seeking exits that will drive activity. Buyer and seller pricing expectations are also becoming more aligned, so, from a private debt perspective, there are several tailwinds that instil confidence.

While we expect bank lending to make a comeback in the large-cap segment, private lenders will likely remain the go-to source of capital in the mid-market. Accordingly, we're optimistic about the future of the asset class, and the pace and quality of dealflow in the year ahead. ■

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At Audax Private Debt, we believe experience and relationships are the foundation of a successful business. Our team of seasoned investment professionals provides dependable, flexible financing solutions to private equity sponsors in the middle market. Thank you to our clients and investors for your continued partnership and support.

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