EXPERT Q&A

Managers can take advantage of rising yields – providing they can manage risk, says Audax Private Debt's Kevin Magid

Navigating risk in a downturn

The market volatility that has characterised the US economy thus far in 2022 has produced a mixed outlook for many alternative investment asset classes, including private debt. A widening of spreads clearly has the potential to boost returns, but managers are facing an economic situation fraught with downside risks, as rising interest rates also impact the balance sheets of leveraged companies.

Kevin Magid, president of Audax Private Debt, predicts that firms with experience managing through downturns will have a crucial advantage in this environment. One of the keys to risk management, he says, is to pay close attention to the fixed charge coverage ratio of borrowers and to also focus on operating flexibility – pricing power, as well as having a moderately variable cost structure.

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Q How is private debt situated, compared to public market lenders, as we head into a possible recession?
Private markets moved more slowly to widen spreads, though the widening has recently materialised. Broadly syndicated loan spreads gapped much wider, very quickly, when worrisome data on GDP and inflation was posted, due to the billions of dollars of hung commitments owned by banks. Banks had underwritten these loans in a frothy market, at leverage ratios and spreads that were no longer "market" given the rapid change in economic outlook. Loans were sold at lower prices, depending on credit quality, and broadly syndicated spreads widened by 200-400bps. As of mid-August, the market firmed somewhat and spreads were only ~150bps wider.

Private debt spreads have now widened by approximately 100-150bps. The private debt markets are not in a "forced sale" mode. We make decisions based on what we think is a good relative yield for the credit we're going to own, so spreads usually don't widen as much or as quickly. It doesn't happen as fast given it's not a traded market, as the deal negotiating process takes longer.

The good news for private debt investors is, after years of low rates, which were still higher than investment grade, high yield, and broadly syndicated loans, base rates are up. That means investor returns are moving higher. It's our job to now manage the risk that comes with increased interest rates.

Q What are the key elements to being a successful manager in this environment?

When the economy is strong, everyone thinks it's a great time to be a private debt manager. Money flows to GPs, and that is often tied to a perception of lower risk, usually resulting in lower yields and lower returns due to oversupply of capital. And the reverse is true when risk seems to be rising.

Our investments benefit from rising rates, but now we have to focus on mitigating the risk from inflation and interest rates. The rising cost of servicing debt for our borrowers, and the impact of inflation on companies' operating expenses are risks that are top of mind for us.

The most important metric for managing risk in this environment isn't interest coverage, and it isn't total leverage (although that matters – you can't have an unreasonable leverage ratio). The key metric is a company's fixed charge coverage ratio. Can a company comfortably meet all of its fixed charges: interest expense, taxes, capital expenditures and amortisation, while handling working capital demands? That's what truly determines if a company can service its debt. Our views on risk mitigation have been formed over the last 20-plus years together, through multiple cycles, and we have learned and experienced what matters most in different parts of the cycle.

Q Which sectors are the strongest and weakest from a credit perspective?

There are some industries we've consistently avoided, namely restaurants, retail, apparel, energy, and travel-related businesses. This has been our strategy for over two decades and proved particularly beneficial as covid presented itself. If you consider the industries with the most bankruptcies over the last 40 years, there's a pretty clear overlap with the industries that we avoid.

The industries we have consistently allocated to include healthcare, distribution, business services, software, food/food service, consumer services, and logistics. We don't lend to retailers, but we do lend to consumer service companies. For example, a plumbing business is resilient, because it provides a service that consumers can't easily go without. We believe these sectors are more recession resistant in the long run.

"What will matter in the next six months, as the data comes in, is whether managers executed their underwriting well during the post-covid 'boom'"

Q What questions and concerns are you hearing from LPs?

Regardless of the environment, LPs expect us to not lose their money. Simple in concept, but many lenders lose sight of that while chasing returns. Right now, LPs are more focused on not losing principal, rather than maximising returns to the last basis point.

Their biggest concern is what we are doing about potential risk in our portfolio. We're fielding more questions, we're sharing our views, we're reiterating the industries we favour and those we don't. We provide our current leverage ratios vs leverage at closing to depict the relatively strong position of our portfolio heading into a more uncertain economic environment. LPs value that our senior team has experienced multiple downturns throughout the course of our respective careers.

Additionally, we're able to provide LPs with more information because the middle market reports performance data on a monthly basis. Broadly syndicated loans, on the other hand, have quarterly reporting, leaving you four to five months behind current performance.

A benefit of middle market lending is that you have much more information on the companies you're investing in, allowing you to go deeper in your underwriting. With tighter covenant packages and more information, you're better prepared to make lending decisions and manage your portfolio.

Q What is the outlook for the asset class over the next few years?

What will matter in the next six months, as the data comes in, is whether managers executed their underwriting well during the post-covid "boom". We'll soon find out who underwrote well and who simply added assets into their portfolios. The managers that will garner more fundraising dollars over the next few years will be the ones that prove their underwriting was sound as their portfolio companies navigate the potential downturn.

Due to rising rates, perception of increased risk may lead to slowing the growth of private debt from an explosive pace to something steadier. But if you look one, two, or even five years ahead, I would say that in all of those time frames, private debt is going to take share from bank underwriting and the public markets.

A wide array of institutions have allocated to private debt for the excess yield and structural control it provides. They've been able to diversify their portfolios, so now they have broadly syndicated loans, middle market loans, mezzanine debt, distressed debt, and many of the other private debt asset classes. Institutional investors continue to support and allocate to the managers that have done well – and they will shift away from the ones who have not. Downturns widen performance disparity and provide more clear choices to LPs. ■

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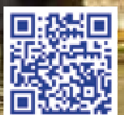

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