

E X P E R T Q & A

We see a historic opportunity to achieve double-digit unlevered returns on senior secured debt through rigorous underwriting and mindful credit selection, says Blair Faulstich, senior portfolio manager at Benefit Street Partners



Why private credit is the best option for mid-market buyers

Q How would you describe the current environment for mid-market private debt?

This is a bifurcated market. On one side, there are multiple macroeconomic headwinds including inflation, rising wages, worker shortages and supply chain disruptions creating caution within the private debt ecosystem.

On the other side, there has been a historic recent rise in base rates. SOFR is hovering around 5 percent, going higher, and is likely to stay there for the foreseeable future. Given the floating rate nature of private debt, that translates into low double-digit unlevered returns for first-lien secured credit. In addition, leverage levels for new deals

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have decreased by an average of one turn and illiquidity premiums remain attractive. Private debt offers strong relative value, providing investors an additional several hundred basis points of return versus high yield and leveraged loans today.

Another large benefit of the current environment we are seeing is stronger documentation and credit protections for lenders. Private debt managers in today's market are able to negotiate stronger covenant packages and deal structures. Maintenance covenants

ensure underlying portfolio company operating metrics are tested on a regular basis. Credit documents have tighter controls over permitted EBITDA add-backs, stronger most-favoured nation clauses and enhanced call protections.

Q Why is the asset class still attractive to LPs?

We view private credit as an integral, all-weather allocation for limited partners during any market cycle. Given attractive yields, today there is a healthy amount of interest in US private credit from investors. Despite volatility elsewhere causing some institutions to pause for various reasons, there is still

a sustained, elevated focus on the asset class. While there are other areas to earn yield in fixed income, our view is that the risk-adjusted return is more compelling at the top of the capital structure. Those that have capital to deploy in illiquid assets recognise this as a good opportunity.

Q Which areas of the mid-market offer the best opportunities?

The mid-market opportunity set is generally divided into three segments: the lower mid-market, sub-\$25 million EBITDA; the core mid-market at \$25 million-\$100 million EBITDA; and the upper mid-market at \$100 million-plus EBITDA. Since the pandemic, a number of private credit managers have migrated to deals in the upper mid-market, with unitranche loans in excess of \$1 billion-\$2 billion.

Large unitranche deals have typically pitted private lenders against big banks, and put downward pressure on the illiquidity premium earned. We are, however, in a window where the commercial and investment banks are less active. While we generally think that the core mid-market is the most attractive place to deploy capital, the above-mentioned dynamic has generated larger illiquidity premiums more broadly across all segments of middle market private debt.

Q How do you explain the sluggish M&A landscape?

The M&A landscape has slowed for several reasons. One is that during periods of significant market volatility, there is typically a lag period for price discovery between buyers and sellers. Sellers want the elevated price from the 2021 market and buyers want something that reflects today's valuation metrics. Reaching equilibrium between the two takes time.

It is tricky to be predictive in today's economy, which in turn makes large, strategic transactions difficult. Rates are high, but for how long? How

much more will they rise? Will pockets of distress in certain industries have ripple-on effects? If you are a management team or board of directors, there may be hesitation to increase the debt on your balance sheet until you have more confidence in the economic outlook.

Q How do you think about leverage today?

Broadly speaking, leverage needs to come down regardless of your view of the economy, given the elevated

interest rate environment we are currently in. Leverage levels we are underwriting today are, on average, at least one turn lower compared with late 2021 or early 2022. Borrowers had grown accustomed to low-cost debt for well over a decade, and higher rates necessitated a shift in mindset and renewed focus on debt serviceability. We expect to continue to see lower leverage levels for new opportunities, more appropriately reflecting the current overall environment.

Q When do you think we might see a return to a more robust M&A environment?

The wheels are slowly beginning to turn and there are pockets of M&A activity. In the software industry, for example, valuations have come down significantly from 2021 and that has led to an increase in public to private transactions. Our origination channels suggest that talks are starting again in other sectors as well, which could be indicative of more dealflow in the second half of 2023.

Even with a muted M&A environment, private credit continues to grow market share in leveraged finance. Big banks, and now regional banks, are sidelined. Private credit is, at the moment, the most viable option if a middle market buyer needs committed capital to fund an M&A transaction.



Q How are mid-market private debt portfolio managers preparing for a rising default environment? And how are companies managing their liabilities?

This is one of the most pressing questions facing private debt managers. No one expected the cost of debt to double over the course of one year. Deals originated several years ago have had the benefit of time to de-risk and de-lever to help support a higher interest burden. However, more recent deals will naturally have more exposure to higher interest costs, putting pressure on free cashflow generation.

A unitranche loan completed in 2021, for example, originally had a cost of debt of around 6-7 percent, but that is now nearly 11 percent and rising, at least in the short term. We are very focused on projected interest and fixed charge coverage ratios because it is significantly harder to service debt today. Certain deal vintages could face liquidity pressures over the next 12 months, which will, we anticipate, necessitate interesting discussions between debt and equity holders.

Having said that, recent deals are performing relatively well. Cash equity cushions are also historically high (deals in our portfolios average around 60 percent). Given this embedded value, an equity owner is unlikely to hand over the keys because of a liquidity issue. We anticipate more negotiated settlements that share responsibility versus a default.

For example, a private debt manager might agree to PIK a portion of their interest in exchange for an award of incremental equity. Although overall default rates will likely rise in this environment, we believe all parties (debt, equity, management) remain motivated to find productive solutions.

Q Where do you see the best opportunities for underwriting new recession-

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resilient deals at the moment?

Over the course of an investment cycle, sectors vary in their level of attractiveness due largely to a combination of valuations, leverage and document terms. We approach all sectors opportunistically, targeting certain sectors when we feel they offer compelling risk-adjusted returns, or deploying at a slower pace when leverage and terms are aggressive.

Software is one example. This is an area that we avoided in the post-covid rush of 2021. In the back half of 2022, however, valuations reset and lending market dynamics improved, providing an opportunity to deploy capital.

Q What about other sectors and sources of opportunity?

The other areas we are focused on today are more defensive, less cyclical industrials where we continue to see resilient performance and interesting opportunities.

The healthcare space is another area of focus where we remain bullish. Although we are more cautious because of continued worker shortages and persistent wage inflation, demographic trends in North America should drive tailwinds in US healthcare.

We are working diligently with our core sponsors and anticipating a pick-up in dealflow later this year. Benefit Street Partners has a long history of doing non-sponsored deals and our origination teams are focused on this segment of the market as well.

Our origination efforts also benefit from a large team of dedicated sector research analysts, which affords us extensive industry knowledge and provides valuable insight in the underwriting process.

Covering the healthcare, business services, industrials, financial services, software, media and technology industries, these analysts are instrumental in helping guide our macroeconomic perspectives and determining how best to deploy capital. ■