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# Q&A with Bill Sacher: Private Credit Considerations for Investors in 2021



Jeffrey Diehl, Managing Partner and Head of Investments, recently moderated a Q&A with Bill Sacher, Partner and Head of Private Credit, to review how private credit fared in 2020 and discuss the outlook for 2021.

**Q: Private Credit has a very attractive 10:1 demand/supply imbalance that seems to be helping the asset class achieve a premium yield characteristic relative to leveraged loans and high-yield bonds. Has this ratio been consistent over the past 3-5 years, or has it grown or shrunk over that time?**

**BS:** While it did narrow slightly beginning in 2016, the 10:1 demand/supply ratio has been relatively stable over the past few years. Interestingly, spreads tend to be wider between private market senior loans and liquid market senior loans in more competitive markets. The 240-basis point advantage that private credit senior loans have today is, by historic standards, on the high side.

**Q: What do you think will ultimately happen with credit spreads? Will they widen or narrow moving forward?**

**BS:** We are seeing an uptick in competition in credit spreads – with more money flowing into the market, there is naturally more competition in private credit. It is something we are keeping an eye on, but thus far, the volume of deal flow has kept spreads somewhat in check. If deal volume subsides we are likely to see spreads tighten, whereas if it remains at today's levels, we expect them to remain relatively stable. We do not expect a full swing back.

**Q: Is the debt cycle more attractive today?**

**BS:** We view competitive debt cycles defensively, which yielded great benefits when we saw the debt cycle's downturn in March. After the competitive cycle subsided, however, we pivoted to a more offensive play in mid-2020 and put a significant amount of capital to work in areas such as the secondaries market and add-on acquisitions. Although the cycle is more competitive today, it has not yet returned to the same levels we saw in early 2020. For now, Adams Street is optimistic that we will see stability in the current debt cycle's favorable conditions, yet we are ready to adapt a more defensive approach should we see a rise in debt levels and covenants begin to come under pressure.

## **Q: How does Adams Street evaluate the US private credit market compared to other global or developing private credit markets?**

BS: US private credit rates remain more favorable for investors and the market itself is more advanced, so the opportunity set is currently larger. This causes the demand/supply imbalance to be greater, which leads to deal conditions and characteristics that are slightly more attractive.

For European investors, the FX hedging presents compelling opportunities in the private credit market. However, Adams Street still favors the US markets on the margins.

## **Q: Has private credit been used primarily for restructuring deals? Are you seeing any traditional de novo buyouts or buy-and-build activity?**

BS: The vast majority of deals today are de novo leveraged buyouts, new deals, and add-on acquisitions for existing portfolio companies. The opportunities for distressed deals do still exist, but the prime window for doing those opened and shut quickly last year.

## **Q: Where are you seeing default rates? What can we anticipate with default rates moving forward? Will there be a reversal between high-yield leveraged loan default rates and those we see in private credit?**

BS: Businesses that received waivers and liquidity injections in 2020 could run out of that cash this year, meaning that they may start to bump up against their covenants again. This circumstance colors the default rate projections that rating agencies had for this year, although I am personally skeptical that this situation will actually unfold. It is less about whether the underlying health of the defaulting businesses has changed, and more dependent upon the sheer access to liquidity that we're likely to see in 2021 through the stimulus programs in both private credit and leveraged loans. Those vulnerable businesses will likely find access to capital, which will at least forestall the default rate projections that many rating agencies are suggesting.

The shutdown due to Covid-19 did accelerate some trends in technology, as well as some secular trends that we were already beginning to see in retail, for example. These industries may receive a lifeline that buys them more time, but I think those industries that are in secular decline will remain challenged for quite some time.

## **Q: What are the trends around covenant protections for private credit lenders, and how does that compare to what's happening in liquid markets?**

BS: Liquid markets have recovered to pre-pandemic levels, and the deals are getting more aggressive with each passing day. The covenants in private credit have been great, and virtually every deal is coming with maintenance-based financial covenants. In some instances, we are seeing multiple financial covenants – leverage, fixed charge, minimum EBITDA – which we have not seen in more than a decade.

Just as importantly, however, the covenant maintenance levels are not as aggressive as they were either, so the trip wires are lower and easier to set off. Competition can affect this in a negative way as well, but that remains to be seen. At the moment, though, the deals we have done and are continuing to do today have some of the best covenant packages that we have seen in quite some time.



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**Q: Do you foresee an increase in waivers and forbearance of borrowers' financial covenants in your portfolio given impending lockdowns across cities and states?**

BS: In the market generally, if there are significant additional lockdowns – a scenario we believe to be possible but still less likely – we could see the need arise for additional covenant waivers. However, we do not expect to see much, if any, additional need for waivers in our portfolio. We were well-positioned going into the downturn and had only two companies that required material covenant adjustments. Both companies, while still being negatively impacted by the lockdowns, are stable, in compliance with their new covenants, meeting their cash interest payments, and have sufficient liquidity through 2021. The rest of our portfolio companies are performing at or close to expectations.

**Q: Do you expect the Biden administration to put additional regulatory or tax pressure on private credit funds?**

BS: It remains to be seen. While the private credit market does not appear to be in the crosshairs, the private equity markets have been under scrutiny. Carried interest and corporate taxes may be under pressure, but given that the new administration wants to keep the economy afloat, burdening it with a lot of new regulation right now would be counterproductive, in our opinion. ■

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