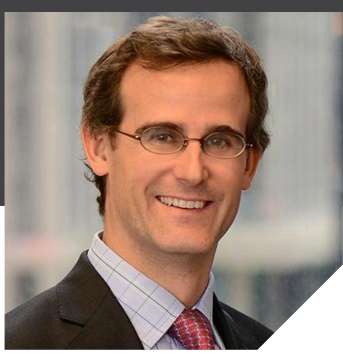
PRIVATE CREDIT IN THE INSTITUTIONAL PORTFOLIO

An interview with David Ross and Jon McKeown of Northleaf Capital Partners focused on the reasons why institutional investors should allocate to the asset class, how to build a diversified portfolio, and credit performance amid the COVID crisis.



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Privcap: Private credit has grown tremendously as an asset class. Why is that?

David Ross, Northleaf Capital Partners: Specifically with private credit, it has really followed similar trends to what we've seen in private equity, infrastructure and real estate, which are more mature alternatives. The growth has been driven by a confluence of factors. The key thing to start from is a recognition that the asset class goes back to the 70s and 80s – back to the founding of private equity. But, at the time, it was called bank debt. It then transitioned from a bank-driven asset class to more of an institutionally driven asset class.

The bigger factor is that banks evolved as a business model. They moved from being big balance-sheet lenders focused on interest income to more fee-based institutions. That left a big hole for institutional investors – backed predominantly by pension plans, insurance companies and sovereign funds – to move into the asset class. Borrowers, including private equity sponsors, like the flexibility that has been brought by institutional lending. LPs like the fact that it's a complement to their fixed income portfolios. It brings more yield and it brings floating rate exposure.

Privcap: What kind of diversification should an investor expect in a private credit portfolio?

Ross: Geographically, the asset class has extended into Europe and Asia Pacific. Now, you can have diversification across geography, industry, capital structure. Institutional lending started as more of a junior capital product doing mezzanine financings alongside banks. It has now moved into the more senior part of the capital structure. Lenders and investors have the option of a lot of different ways of achieving diversification.

Jon McKeown, Northleaf Capital Partners: There are other attributes that are not evident at first blush. For instance, a lot of the market is lending to private equity-backed companies. They themselves vary in many dimensions. Some are applying acquisition-led strategies where they're relying on inorganic growth. Others might be looking to take out costs or grow organically. So, lending to a range of private equity firms and also

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non-private equity-backed companies provides a further level of diversification in terms of business model, business drivers and some of the underlying risks that the companies are exposed to by virtue of the strategy they are looking to apply.

Privcap: Obviously, the world of fixed income is enormous. What makes private credit strategies of particular interest to institutional investors, when there are so many other public options like high-yield bonds?

Ross: There's certainly not one set of fixed income assets that make sense for every different type of investor. What ultimately differentiates private credit is the low loss rate that you get from the high security and protections that you have within mid-market lending, and the reduced mark-to-market volatility. So, for investors that aren't looking for liquidity and have long-term investing horizons, private credit provides a really attractive high cash-yielding asset with low volatility, both on a loss-rate basis and on a mark-to-market basis.

Privcap: Why don't we address the elephant in the living room, which is that we are currently in a COVID crisis? What does that mean for the private credit market?

Ross: Cycles come in all sorts of shapes and sizes and types. This is certainly not one that people would have predicted, although everyone anticipated that we were late-cycle from other characteristics. This has certainly been a unique catalyst to a very specific type of cycle. The challenges come down to three key ones. The first one is portfolio. In February or March, the challenge was to refocus on the portfolio. It required more attention; it required more analysis. It required working very closely with both the management teams and the private equity owners.

The second one is finding new deals and due-diligencing those deals, which in this environment can be very, very challenging. Volumes are obviously lower than they were pre-COVID, and we're all more selective. We're trying to make sure that we're understanding what's happening in a very dynamic environment. Ultimately, we're investing capital on behalf of our limited partners, and they're nervous. For some of them, this is their first cycle in this asset class. The third challenge is a need for transparency and being highly communicative with frequent updates to our investors, ensuring that they're understanding how the underlying portfolios are trending. We have supportive investors, and pretty significant pools of capital to take advantage of the opportunities we see today. But we're being patient and investing prudently. Typically, the period over the next few years is when the most attractive deals will be done.

Privcap: Northleaf has a very advanced analytics and data capability. What is that data telling you about the performance of the loans in your portfolio in this recessionary environment?

McKeown: The COVID crisis is demonstrating the value of the analysis we do. We look at geography in a pretty nuanced way. For instance, I'm not just looking at the U.S., but breaking the U.S. down into regions and then thinking about where borrowers actually earn their revenues, as opposed to just where they're headquartered. Going into the COVID crisis, we had a pretty diverse set of exposures across different regions, from lots of multi-region businesses.

Where we did have borrowers who were focused on a single region, they were pretty diversified. It was somewhat gratifying to see that analysis pay off. But, in other ways, we certainly had to do a double click and think about the drivers of COVID stress. Businesses that are relatively small and operating at quite the local level are probably most vulnerable. Businesses that we initially thought might face challenges with global supply chains have held up pretty well.

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>
> –David Ross, Northleaf Capital Partners

Privcap: Northleaf is a global firm. What advantages do you have from being active in multiple geographies?

McKeown: As well as having investments in different regions in the U.S., each of our portfolios have exposure to Canada, the UK and continental Europe. Being global diversifies that risk. If we look at the past, recessions have tended to be concentrated in certain economic regions. With what's going to happen in the coming period, likely driven by COVID, I think we feel better about having a more diversified geographic exposure.

Ross: Private lending is a very regional product. You need to have people in the markets. It's very different from the larger liquid space. Northleaf has offices in Chicago, New York, Toronto and London. Having the local presence in those markets is critical. You can't be global without the regional presence. It enables us to build portfolios that are more diversified, but also to draw from a broader set of opportunities, which really raises the bar in terms of the relative value in the risk-adjusted return that we think we're able to generate.

Privcap: Let's talk about supply and demand dynamics. To what extent are institutional investors pressing the "pause" button or pulling back a bit from private credit? And, if that's the case, does that have implications for supply and demand and therefore loan terms and conditions?

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Ross: There has been some slowing in terms of the institutional fundraising. There are a lot of investors that we spoke to six or eight months ago who said, "We're late in the cycle. We like the asset class, but we're going to wait because it doesn't feel like the right time." So, there's actually a huge number of investors that are now returning to the asset class. They see it as the start of the next cycle – or in between two cycles – and are reengaging. A bigger issue for supply-demand today has just been a lack of deals. When you come out of this type of crisis, there's virtually no deals getting done. We've gathered some speed in North America through June and July. Europe has been a lot slower. Part of the benefit of being global is that different markets behave differently when it comes to supply-demand dynamics. In Europe, we see a lot of capital having been raised over the course of the past couple of years, and really not that many transactions coming to market. In North America, there's a number of levered institutional investors, such as BDCs, that have seen some of their capital constrained.

Privcap: What does the history of prior recessions tell us about how private credit tends to perform through these types of disruptions?

McKeown: The pricing of risk is to some degree a self-regulating market. As people see the risk of loss going up, the price of risk going forward increases. If you look at the Great Financial Crisis, the return on the capital tended to be elevated for a few years after the initial shock. And that's a period where, paradoxically, investors often get their best returns. Now, if they were in the asset class prior to the shock, it needs to be balanced against that. But, over a multiyear period, we are expecting to see strong returns going forward, given that dynamic.

Ross: Where we're most focused for private credit in this recession, as we compare it to previous ones, is ultimately what will be the impact on company cash flow? How dispersed across industries will that impact be? And what will happen to multiples, because what we've seen is that multiples in the public markets declined and then have bifurcated, but really recovered overall. If you see a recession where multiples are able to retain a degree of what they have today, I think you'll see a pretty benign impact. Private equity owners continue to support their businesses.

Privcap: There is an expected wave of workouts that are going to take place across the lending world. What do investors need to understand about that and how it should impact on their manager selection?

Ross: There's no doubt that we're seeing defaults and issues within the market start to increase. We're fortunate that our portfolio continues to perform well, but every portfolio will have some situations that you need to manage through. A couple of things that are critical from our standpoint: one, you need to be prepared for and have internal expertise for workouts.

The second thing is the scale of the portfolio and really doing diligence and understanding where the existing portfolios are tilted and how much time and resource and bandwidth from the team is going to be taken up on the existing portfolio, maybe not leaving as much time for the institutional investor to invest new capital going forward. The mindset that investors have as they lend money is incredibly important: making sure that the institutional investor you're talking to is thinking about lending in the right way.

Privcap: What would be your elevator pitch to an investor for either doubling down on private credit or starting to allocate to private credit in the midst of these unfortunately interesting times?

Ross: What I've always said to investors is that private credit is much more of an asset-class allocation than it is a trade. While it's always helpful to build exposure to it at a particular point in a cycle, we always think about it as an accordion, where private credit fits into many portfolios to a certain percentage. And, during times like these, it may be time to accordion out and take slightly larger exposure to an asset class that has more protected structures, better downside protections against loss and mark-to-markets, and also has significant cash yield.

Ultimately, it's very different from other asset classes. The investors that are truly successful in private credit keep permanent allocations and accordion those allocations up when the market becomes more attractive. It's very difficult to move in and out of private credit and to take advantage of it as a trade. ■