Hamilton Lane Research

RAINY DAYS, CREDIT QUALITY AND MARKET CONDITIONS: 5 KEY CONSIDERATIONS FOR PRIVATE CREDIT INVESTORS

By Drew Schardt, Head of Private Credit

When the Hamilton Lane marketing team first approached me about creating a "listicle" on private credit, my first reaction was that they were playing a cruel joke on me. Listicle just sounded too much like a magical, made up word – something a unicorn might bring to go grocery shopping. I was quickly informed that a listicle was typically a short, written article in the form of a numbered list of topics, which may or may not have any logical order or consistent theme. And, my charge was to create one that would encapsulate what's actually going on in the private credit market right now.

As I thought about it more – and attempted to stop thinking about unicorns – it struck me that as we venture later into the current economic cycle, there continues to be lots of noise, chatter and commentary in two notably distinct camps:

Debating whether the current environment will continue to extend the status quo of growth seen over the past ~10 years, or

Declaring that the warning signs are flashing red and the markets are bound for a correction, recession or worse in the not-too-distant future.

So, what I've endeavored to do here is identify some of the pros and cons of this cycle debate, while also taking a closer look at private credit as an asset class to explore how it might fare. Spoiler alert: We think private credit is a pretty good and relatively more predictable spot to be in when the going gets tough – whenever that may be.

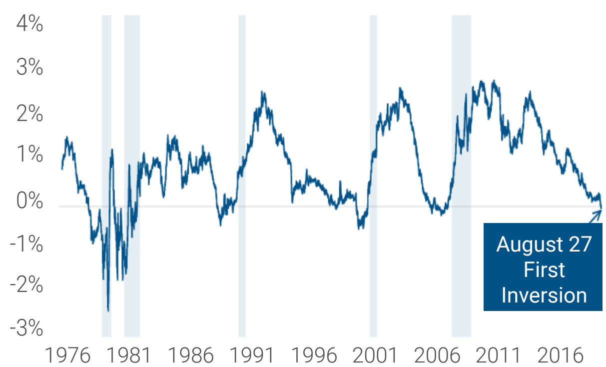
And with that, please enjoy my attempt at a private credit-oriented listicle, outlining the key considerations for private credit investors right now. Disclaimer: I might have gotten carried away and ignored a key feature of a listicle - brevity - but bear with me because this is jam-packed with some great info (if I do say so myself...)

1.) Here comes the downturn! (...Right?)

This question is certainly justified; we do believe it is crucial for today's investors to be exercising prudent levels of caution in decision-making in today's environment. That doesn't mean investors should be attempting to time the market. In fact, that can be a dangerous game. Inevitably, however, the music will eventually stop, and we are clearly closer to the end of this cycle than to the beginning.

Purchase price and leverage levels continue to tick upward, and are now at or near all-time highs. One particular indicator – the 2- versus 10-year yield curve – inverted for a brief (one-day) period in August. Historically, the 2/10 is undefeated in predicting a recession. Moreover, depending on which technical statistic you measure – first inversion, an extended 30-day inversion, concurrent inversions of 3-month and 2-year versus 10-year treasuries, etc. – then similar events of the past suggest that a recession is likely to occur at some point over the next 18-24 months. So yes, it's coming; the remaining questions are what does the next downturn look like and how best to prepare in terms of asset allocations.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



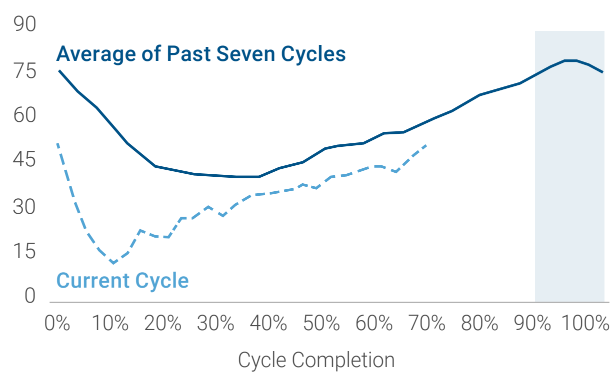
Source: Federal Reserve Bank of St. Louis Economic Research

2.) Why this time might be different

If you based decisions solely on the chatter in the market, then you might already be hiding cash under your mattress. However, for the better part of the past five plus years, many investors have declared that we are late cycle with a dip just around the corner. And, so far, they have been wrong.

So what is creating this disconnect? One reason is simply the magnitude of the recovery. It has been a slower and steadier recovery compared to previous cycles, and it extended past the historical average length of time of prior expansionary periods. However, from a magnitude perspective (cumulative percentage growth since the downturn), this recovery is still behind four of the previous seven economic cycles. Another likely factor is central bank policy. Mixed messages over the past 18 months – notably the "far from neutral" commentary from the U.S. Federal Reserve less than a year ago – have led us back to a period of accommodating global central bank policy, with rates coming back down after a three year period of interest rate tightening. Some believe this prolonged period of low interest rates will serve not only to (perhaps artificially) extend the economic cycle, but also to make the traditional measures of yield curve inversion less relevant as a predictor, given short rates are in the "Central Bank Policy Zone" and somewhat insulated from typical market forces.

U.S. Recession Risk

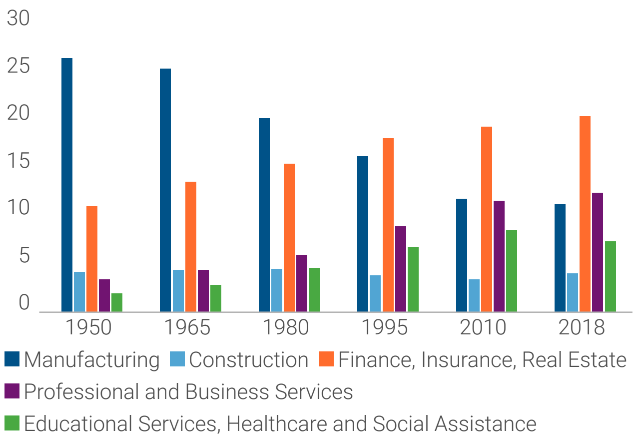


Source: Cornerstone Macro as of December 12, 2018

At the same time, the changing industry make-up of major developed economies can have an impact on the economic cycle itself, as well as the depth and magnitude of the recovery period. Certainly, if one looks at the construct of these economies, the transition to more service-oriented businesses (and away from "old-school industrials") continues. These industries tend to be less capital intensive, have differing free-cash-flow and margin characteristics, and are typically less volatile compared to those "old economy" industries. It isn't so far-fetched, then, to imagine that these new industries and underlying business characteristics will not only behave differently in a downturn, but also are likely to impact the depth and shape of a recovery.

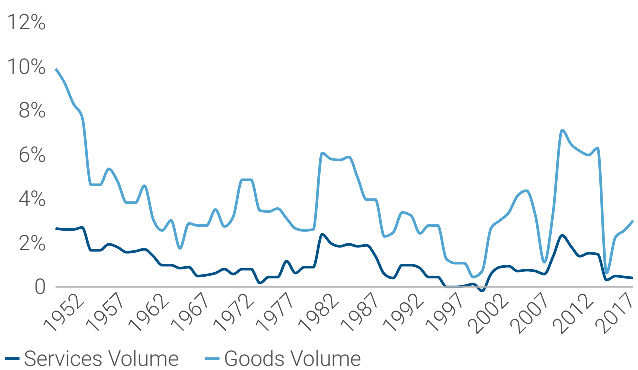
Value Add by Industry

As a Percentage of GDP



Source: Federal Reserve Bank of St. Louis Economic Research

GDP Growth: 5-Year Volatility Goods vs. Services



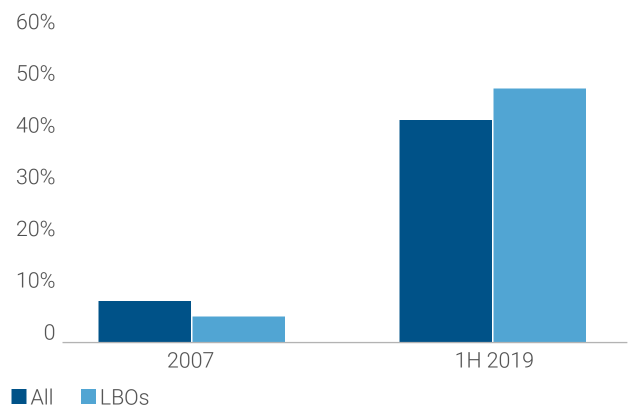
Source: Federal Reserve Bank of St. Louis Economic Research

3.) Credit quality and market considerations

What about the alarm bells sounding in the credit markets specifically? (This is a credit-focused listicle after all, is it not?!) Increasing leverage levels – now back above pre-GFC thresholds – as well as record covenant lite volumes are both key negative sentiment indicators. At the same time, EBITDA adjustments can be found in approximately 50% of all LBO transactions, a significant increase from a decade earlier. And, the pendulum of loan documentation primarily continues to swing in favor of borrowers, especially in the context of what has been an accommodating public debt financing market. Yikes! These components also have led to increased volatility in public credit markets; whereas for the past five years, this heightened volatility was mostly an equity market phenomenon, with public credit remaining somewhat insulated.

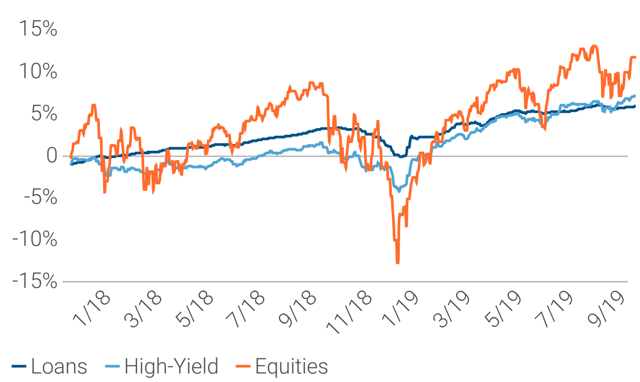
These concerns have some investors seeing red more recently, and they have begun to create cracks in the public debt markets in terms of volatility and capital outflows. Will this start to swing the pendulum back toward a more borrower-friendly environment? Or will there simply be a short depression followed by a quick snap back in the public credit markets as has been the case for much of the current economic recovery?

Transactions With EBITDA Adjustments



Source: S&P LCD (June 2019)

GDP Growth: 5-Year Volatility Goods vs. Services

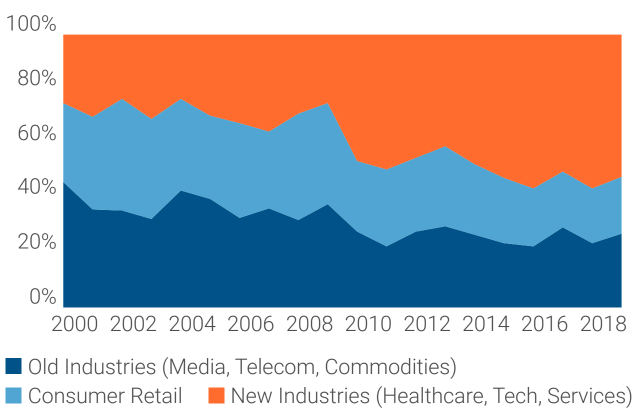


Source: Bloomberg CSLLLTOT Index, DLJHVAL Index, and S&P

Just as there are notable differences compared to the previous downturn in terms of industry composition, we observe a similar dynamic at the deal level. Again, using the public leveraged loan market as a proxy (i.e. all the debt for those PE deals), one can see some inherent market transitions as well. Compared to the market landscape during the Global Financial Crisis, there has been a shift toward more defensive industries. For example, the underlying business traits of healthcare, technology and service-oriented companies would typically be much less cyclical. At the same time, the average leveraged loan tranche within the public debt market has grown by 40% since the pre-GFC timeframe (but which have relatively similar leverage levels as a multiple of EBITDA), suggesting that the average borrower is a much larger company. This could speak to improved business diversification and enhanced overall borrower stability.

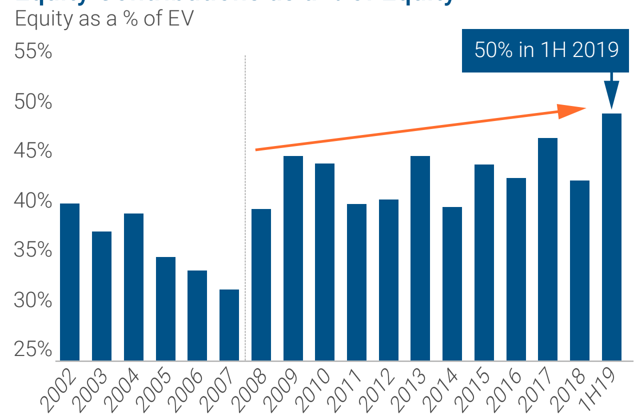
Another measure of risk to lenders on the corporate side and in LBOs is the equity cushion, or the capital subordinated to lenders. This statistic is meaningfully higher on average than what we saw during the 2007-2008 time frame. Despite increases in overall leverage levels, on a relative basis, purchase price multiples have seen even greater expansion. And, don't forget that interest rates are a fraction of what they were during the last downturn: For example, the 3-month Libor is currently ~2% versus ~5% before the GFC, which has contributed to much higher interest and fixed charge coverage ratios (a measure of a borrower's ability to service its debt) for most companies comparatively.

Changing Industry Composition



Source: S&P LCD (June 2019)

Equity Contributions as a % of Equity



Source: S&P LCD (June 2019)

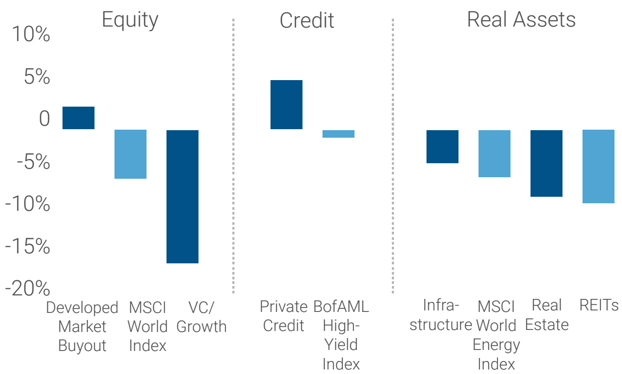
We are not saying that there won't be an increase in defaults, or that the credit markets will not experience challenges, or that weakening lender terms are not a cause for concern. These things keep me and any other lender up at night. Instead, what we are saying is that, on a relative basis, it appears that borrowers are better capitalized and generally have better cash flow characteristics today than prior to the last downturn.

4.) A rainy day is less rainy for private credit

Wait, but does this really matter? After all, much of the analysis above is focused on public debt financing markets and characteristics. Won't the private markets behave differently? Well, yes and no. There is no question that the private markets are correlated and not fully immune to activities in the public markets. However, while public debt markets are certainly correlated to performance on the private side, the private credit space is still relatively less efficient than the public markets. Probably nothing too shocking there, but those relative inefficiencies and differences in borrower motivation for utilizing a private credit option should provide opportunities for private credit managers to structure better loan documentation and more attractive lender terms. These opportunities are typically most pronounced when public debt markets are on their heels or during periods of increased uncertainty or volatility.

So now to the $64,000 question: How does private credit fare? The short answer is that a rainy day is less rainy for private credit. The data bears this out. The chart below illustrates the lowest five-year trailing performance of various private market strategies (pooled median net IRR) compared to public market equivalents.

Lowest Five-Year Annualized Performance
1995-2019

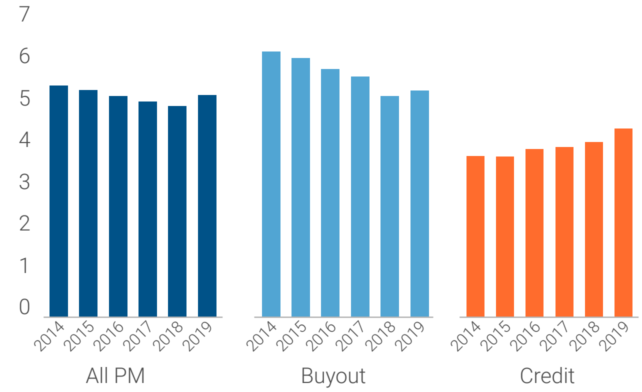


Note: Infrastructure & Natural Resources from 1998–2019
Source: Hamilton Lane Data via Cobalt, Bloomberg (October 2019)

How do you like them apples? As one might expect, being in more senior parts of the capital structure should have clear advantages of downside protection. And, operating in a private market structure where credit general partners typically employ a long-term view and investment horizon should incentivize some level of increased caution at the outset as compared to a public debt market where there is more liquidity. Ultimately, this should lead to better risk-adjusted performance. Part of this dynamic is due not just to the relative public versus private inefficiencies mentioned previously, but also to the fact that with any new loan, credit managers understand that they are – in all likelihood – going to need to live through a downturn at some point during the course of the investment period. Thus, the capital structures and leverage profiles implemented today must have wherewithal. Managers must remain disciplined. As Jim Zelter of Apollo recently commented, "If you're in credit, you're paid to worry."

Then there are the benefits of predictable cash yield and shorter investment duration that are inherent to credit. Shorter investment durations also should serve to help mitigate some level of risk as we get later into the cycle. You can see this when comparing credit to other parts of the private markets: The average credit investment is held for 3-4 years, compared to an average hold period of 5-6 years in buyouts and other areas.

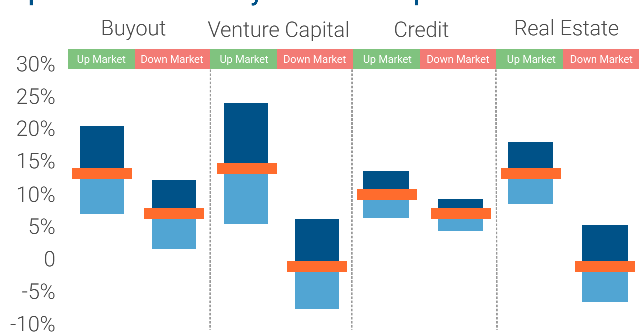
Weighted Age of Capital by NAV



Source: Hamilton Lane Fund Data (August 2019)

A significant part of the attractiveness of private credit stems from its ability to perform in good times and in bad. On the whole, the space is generally more predictable. That can be seen in evaluating the dispersion of credit fund returns in up and down markets, as seen in the chart below. Again, compared to other areas, investors should expect less volatility from their private credit portfolios.

Spread of Returns by Down and Up Markets



Source: Hamilton Lane Fund Data (October 2019)
Up market: buyout & venture capital pooled returns > 12%, credit & real estate pooled returns > 9% Down market: buyout & venture capital pooled returns < 12%, credit & real estate pooled returns < 9%

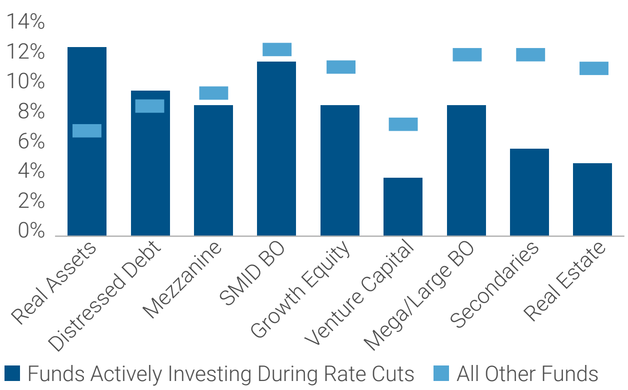
5.) And don't forget stressed and destressed

The market opportunity in stressed and distressed credit continues to build. Although created in private fund structures, many of the underlying investments involve trafficking in public high-yield and leveraged loans that are trading at discounted levels. Or, strategies that focus on credits that are out of favor or industries/businesses facing challenges. And, while the last decade – given a favorable macro context – has somewhat limited the opportunities available, today nearly half of public credit markets are rated as BBB or just one notch above junk status. That represents more than $3 trillion of debt securities, which is greater than four times the size of the BBB market in 2007!

Back to the data and another important factor: distressed funds in the private markets tend to outperform other private markets strategies during periods of interest rate cuts, compared to funds in the same strategy invested during other time periods (i.e. during a flat or rising-rate environment). It's also worth noting that distressed and opportunistic capital currently constitutes more than half of the dry powder in private credit-oriented strategies, versus origination-oriented capital.

U.S. Private Equity During Rate Cuts

Median Net IRR, Vintages 1985-2016



Source: Hamilton Lane Data (September 2019)

So, to wrap up this dazzling listicle, I offer some concluding thoughts. Is a downturn right around the corner? Maybe. On the other hand, is there reason to believe this downturn could be relatively mild compared to the GFC, the ferocity of which continues to linger in investors' minds? Perhaps.

Regardless of what takes place, it is our view that a strategy utilizing private credit makes sense especially as investors prepare for whatever is to come. That is what the asset class and its performance characteristics are built for. Investors need to consider it.

Now, back to thinking about unicorns and their grocery lists.

Definitions

All Private Markets: Hamilton Lane's definition of "All Private Markets" includes all private commingled funds excluding fund-of-funds, and secondary fund-of-funds.

Buyout: Any private market fund that generally takes control position by buying a company.

Venture Capital: Venture Capital incudes any private market fund focused on any stages of venture capital investing, including seed, early-stage, mid-stage, and late-stage investments.

Growth Equity: Any private market fund that focuses on providing growth capital through an equity investment.

Credit: This strategy focuses on providing debt capital.

Infrastructure: An investment strategy that invests in physical systems involved in the distribution of people, goods, and resources.

Natural Resources: An investment strategy that invests in companies involved in the extraction, refinement, or distribution of natural resources.

Real Estate: Any closed-end fund that primarily invests in non-core real estate, excluding separate accounts and joint ventures.

Indicies

MSCI World Index: The MSCI World Index tracks large and mid-cap equity performance in developed market countries.

BofAML High Yield Index: The BofAML High Yield index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

MSCI World Energy Sector Index: The MSCI World Energy Sector Index measures the performance of securities classified in the GICS Energy sector.

FTSE/NAREIR Equity REIT Index – The FTSE/NAREIT All Equity REIT Index tracks the performance of U.S. equity REITs.

Disclosures

The following hypothetical example illustrates the effect of fees on earned returns for both separate accounts and fund of funds investment vehicles. The example is solely for illustration purposes and is not intended as a guarantee or prediction of the actual returns that would be earned by similar investment vehicles having comparable features. The example is as follows: The hypothetical separate account or fund of funds consisted of $100 million in commitments with a fee structure of 1.0% on committed capital during the first four years of the term of the investment and then declining by 10% per year thereafter for the 12-year life of the account. The commitments were made during the first three years in relatively equal increments and the assumption of returns was based on cash flow assumptions derived from a historical database of actual private equity cash flows. Hamilton Lane modeled the impact of fees on four different return streams over a 12-year time period. In these examples, the effect of the fees reduced returns by approximately 2%. This does not include performance fees, since the performance of the account would determine the effect such fees would have on returns. Expenses also vary based on the particular investment vehicle and, therefore, were not included in this hypothetical example. Both performance fees and expenses would further decrease the return.

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