Private credit’s ‘winner-take-all environment’

As more firms entered private credit in the decade post-global financial crisis, a stratification of managers left the top tier with capital aplenty and the brightest talent, says Madison Capital Funding’s senior leadership team.

The demise of banks providing capital to mid-market businesses spelled the rise of private credit managers, but it also had another consequence: the increased importance of hold sizes in transactions.

As a result, upper mid-market lenders have displaced the syndicated market and fewer lower mid-market lenders are needed to participate in a transaction. Senior debt fundraising figures speak to this — in 2012, managers raising vehicles for the strategy collected $16.89 billion, while in 2017 it hit a high of $64.58 billion, according to PDI data. The total for 2018 was $47.28 billion.

“The industry’s move to greater hold size is the most meaningful structural shift in the market post financial crisis,” says Ashish Shah, Madison Capital Funding’s head of capital markets. “Platform hold size has gone up meaningfully for scaled middle-market managers. Pre-financial crisis, a Madison $100 million deal would have four, five, six lenders, and now that can easily be done by one lender.”

While a positive upshot for credit managers that have locked down a capital base to write bigger cheques, it also benefits sponsors: private equity firms have the benefit of relying more on alternative lenders as their portfolio companies mature. “We think it is a fundamental shift in our market,” says Christopher Taylor, Madison’s chief executive officer. “I think hold size, in terms of being able to take down the whole deal and grow with the portfolio company, is a fundamental requirement for playing in the space going forward.”

Sponsors can rely on direct lenders to help them execute their investment plans, particularly on buy-and-build strategies when add-on acquisitions are key and being able to tap idle capital, often in the form of delayed-draw term loans, makes for efficient execution.”
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Q&A

How important is the usage of data analytics and technology in underwriting and portfolio management? Jennifer Cotton: In today’s environment, utilising data is really important to get to the core credit fundamentals. Credit analytics, in both underwriting and portfolio management, is much stronger when we can point to empirical data to support the story or investment thesis. Over our history, we’ve looked at over 1,000 transactions per year and collected an abundance of data and knowledge. From the start, when underwriters are reviewing transactions, they are identifying key indicators and using them in the underwriting that can then go into the portfolio management aspect of our business.

Robert Douglass: From a portfolio management perspective, we changed our own portfolio management database little over two years ago. We historically tracked data on a monthly basis. However, we relied heavily on our portfolio review process, which was done on a quarterly basis. What we quickly learned is the time lag from when we received the reporting to when we actually held the quarterly review discussions was creating a very reactive decision-making process. With the new database, we can track our portfolio accounts as our account managers input the monthly data. The portfolio management system further allows us to generate customised reports that help isolate potential problems within the portfolio across a variety of indicators in real time.

There’s a significant amount of delayed-draw term loans going into the capital structure, mostly to facilitate the investment there,” says Jennifer Cotton, chief underwriting officer. "For us, having the dialogue up front, understanding what the sponsor is trying to do, understanding the thesis is really important.”

Product offering is also becoming key, with many managers offering a suite of loan strategies. This has also worked to the private equity sponsor's benefit.

Robert Douglass (left) and William Kindorf (right)

Jennifer Cotton

"Now, along with the hold size, you have firms that have taken a multi-strategy approach, so they can offer senior, senior stretch, unrated, subordinated debt, if needed, on any particular transaction," says Sunil Mehta, a managing director and head of general industries.

"We’re going to sponsors saying, Where do you want us to play in the capital structure? Here are four term sheets, depending on what direction you want to go," Fundos focused on unrated have been raised, and managers have turned to these one-stop loans as direct lending returns have stagnated and the market has become flush with capital. In 2018, some $27 billion of unrated loans were completed, a 13 percent increase from 2017, according to data from LPC. “I don’t see the lower middle-market private credit space going back to a true deal syndication-type execution," Taylor says. "Which lenders survive the next cycle will determine what the competitive landscape looks like and what deal executions look like.” Sponsors have also become sensitive to how credit managers are funded – in the lender’s capital coming from a joint venture, a drawdown or fund or some other type of investment vehicle. "Private equity firms are very sensitive, as they should be, in making sure the partners that they are picking to finance their deals are able to control that capital," Taylor says. "If you ask them five to seven years ago, it was a less sensitive topic." One source of capital that has expanded quite rapidly has been mid-market collateralised loan obligations. The amount of active mid-market CLOs reached at least a six-year high in February, when the figure totalled $48.5 billion, according to LPC. Madison raised three such vehicles in 2017. The first was a $303 million deal that closed in March. The second and third were, respectively, a $325 million transaction in July and a $302 million deal in September. An additional CLO was issued last year, a $376 million deal.

"The base architecture of the private debt landscape has changed very meaningfully and resulted in more of a winner-take-all environment," Shah says. "That’s not to say that it is all good and well for private equity right now. Sponsors have been under pressure to grow their portfolio companies, given the liquidity attractions. Citing data from PitchBook, consulting firm Bain & Company notes private equity managers cited high purchase-price multiples as their biggest challenge in closing
MARKET STRUCTURE

Ashish Shah
Christopher Taylor
Souli Mehra

The growth of senior debt has resulted in some firms stretching on credit quality to generate dealflow, and that also means some firms are deploying capital outside of what many consider direct lending in the core mid-market.

“Are the funds raised truly being deployed in the asset class? It is something I think investors need to be mindful of,” Shah says. “Or is it just covenant-lite syndicated or covenant-lite upper-middle-market loans? I think understanding the manager’s ability to source and deploy capital in the asset class is critical.”

Indeed, more than half of investors are seeing GPs deviate somewhat from their stated strategy. Some 55 percent of investors across multiple alternative asset classes, including private debt, are seeing “occasional examples” of style-drift among their GPs, according to the PDI Respective 2019 LP survey.

“If you had asked the same question four years ago, I think there would have been a greater percentage of managers who were focused on deploying assets in the core sponsored middle market versus simply raising assets for the asset class,” Shah says. “The sheer amount of capital that’s available is a problem. As the market has heated up over the past 16 months has led to an oversupply of dollars in the market, and I think those dollars are getting deployed all over the place.”

Investors routinely inquire about sourcing capabilities and wonder whether the firm has the “appropriate sourcing capabilities” to allow the lender “to construct diversified portfolios,” Shah adds.

“I will also ask about hold size capabilities as well as personnel and infrastructure,” he says.

Where it’s really changed over the last 36 months is the institutional investor base has focused on extracting more value from their capital commitments,” Shah says. “Due to the importance of hold size on a platform’s competitive position, scaled institutional investors have focused on driving greater influence over the dollars they commit to a platform. Investors recognise that if they write a meaningful cheque into a platform, that platform’s value proposition to sponsors increases and the investor wants to get paid for that.”

There are smart ways to pursue growth, though, without compromising an investment thesis.

“It’s growing the number of sponsor relationships we have, so we’re not reliant on the same base of sponsors we’ve always been working with, and growing the actual number of companies in our portfolio,” Taylor says. “It’s not just about more dollars in the same number of portfolio companies to generate more AUM growth. It’s about doing more transactions, building more diversity and granularity in the portfolio at this point in time.”

Growing doesn’t necessarily require a compromise of underwriting standards, the GPs say.

“I still think we’re sticking to the same core principles,” Cotton says. “There’s probably more tumults early on than we’ve seen before. I wouldn’t say the standards have changed. It’s just evolving with the times and being able to move quickly.”

Douglas adds: “With Madison’s focus on company New York Life being around for over 173 years, it looks at growth in decades and not necessarily one given year. While they want us to grow, there’s not extreme pressure to aggressively grow assets, particularly in the late stages of the cycle.”

THE RECIPE FOR SUCCESSION

As private debt has mushroomed at an incredible rate, the growing pains have not been just capital related; they have also been related to leadership and personnel.

“Among these are succession and ensuring firms can remain competitive for the top-tier talent — or being able to cultivate first-rate front- and back-office personnel,” Cotton says.

“From an origination perspective, a lot of our folks are homegrown,” says William Kindorf, a managing director and head of specialty industries. “So, they’ve come up through the underwriting ranks, and we kind of prefer that because they know how we view credit. It’s competitive if you try to go out and make a lateral hire. We try to grow those folks internally and provide career opportunities.”

Succession has become a prominent issue in recent years. The founding generations of many alternative asset managers across private credit and private equity have reached, or are reaching, retirement age — or at least a point in the founders’ and chief executives’ lives where they step back from overseeing their firms’ day-to-day operations.

Debt managers face unique challenges that private equity firms, namely those without credit operations, do not need to contend with. Largely, this spring’s flurry of the vast array of products credit firms can offer: mid-market lending, CLO management, syndicated loan desks and more. Another integral factor is remaining and in the good graces of those banks or institutional investors that provide leverage facilities, a phenomenon much more common in credit investing than in buyout strategies or other equity-based products.

Madison executed its succession plan in 2018. In January of that year, the firm announced Taylor would succeed then-chief executive officer Hugh Wade at the end of June. Wade became chairman until he formally retired in December.

“Communication of that both internally and externally across functions, across constituents made all the difference. There were no surprises,” Taylor says. “I think one of the downfall of succession is if it happens in an accelerated, unplanned fashion where the appropriate parties — whether they be employees, investors, or clients — don’t have time to digest, understand and react to the change.”

Of course, that gives rise to a unique challenge among asset managers: the senior leadership team must not only be good investors and stewards of third-party capital but also adept leaders.

When asked what’s more important, being a good investor or leader, Madison’s leadership team agreed they were interlinked.

“If you don’t have the right level of talent and the right level of infrastructure inside the business, you can’t invest and lend and deploy capital on behalf of your investors prudently,” Taylor says. “In my mind, they work in concert together.”

Ultimately, they answered in a manner other firms might have dodged: people over dollars, the latter will likely follow the former: “If we don’t have the human capital, the financial capital is not going to be there,” Douglas says. “Sourcing is always a focus of our investors, portfolio management is always a focus of our investors. There’s no question the financial capital is essential for growth, but it starts with the people.”