EXPERT Q&A

The market offers unprecedented opportunities for disciplined lenders, says Park Square's Robin Doumar

Private debt set to prove its value

With the rise in base rates, investors in private debt are set to enjoy some of the highest returns ever achieved in the asset class. The downside, of course, is that dealflow has reduced, while more borrowers are struggling to service their debts. Robin Doumar, founder and managing partner at Park Square Capital, believes this market will produce a divergence in managers' performances. Lenders that have maintained discipline will ride out the distress cycle, he says, while achieving returns that will rival private equity even on an absolute basis.

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Q How does the outlook for private debt in 2023 compare with other alternative asset classes?

This is the most interesting time for private debt I've seen in over 30 years working in credit markets. Virtually all the structures in this asset class use floating rates, which in this environment of higher rates is a really big deal. As fund managers, in normal times, we're happy if we can move a fund return by 0.1 percent. And yet, the backdrop over the past year has been this 300-400 basis point rise in rates. It's hard to overstate the benefit – it's truly gigantic.

It's a massive tailwind for private debt – but of course it's generating a significant headwind for private equity. I used to say that high-returning private debt strategies compare very favourably to private equity, on a risk-adjusted basis. Now, I'm saying that it's very attractive relative to private equity – but on an absolute return basis.

If we can deliver up to a 15 percent net return in some of our strategies, that is going to be very strong compared with what most private equity funds can currently generate. Plus, we have some measure of security or preference in the capital structure, and we have a floating rate that protects us against any further rate rises.

I'm sensing from institutional investors that there's more interest in the higher returning elements of private debt than ever before.

In this environment, they're realising that they're better off taking a chunk of their private equity allocation and putting it in high-returning private debt strategies.

Q So, what are the best ways to pursue high-return seeking strategies at this time?

Mid-market direct lending, both unlevered and also with leverage, is very interesting. With leverage, some of these strategies can be very high returning indeed. Junior debt is very attractive right now because secondary markets are dislocated and there are opportunities to pick up pieces of debt that are trading at a deep discount.

But there's also going to be a wave of companies that need to find ways to restructure their debt. These are borrowers loaded up with highly levered unitranche financings. They might have been paying 6.5 percent interest just over a year ago; now, they're looking at 11 or 12 percent.

A lot of companies will not be able to cope with that. They're going to need some junior debt that's non-cash pay to come in and de-lever the cash pay senior debt. Many of these businesses are very established, with stable and predictable revenues – but they'll need a financing solution.

I really like going for high returns within the private debt space in this environment. Low-returning strategies are less attractive, frankly, because bonds are now yielding again. When the 10-year treasury in US dollar terms is hovering around 4 percent, you get paid something just in the bond market. So, I like that extra premium in the higher returning private debt strategies.

Q What do you expect the distress cycle to look like?

It's going to be a tale of two cities. The sorts of companies that disciplined credit investors have lent to are mostly in stable sectors like software, healthcare and business services. I think they're going to be just fine. They might need to de-lever their senior debt a little bit with some junior debt, but that's not the end of the world.

The more speculative businesses are in a much trickier position. Cyclical businesses such as restaurants or fashion

Q What is the longer-term outlook for private debt?

I think it's going to be a really, really exciting investment environment. The share of the market that is held by private debt firms is increasing.

For society, it's a very good thing to have long-dated, locked up capital owning these risk assets. If we look at where we were before the global financial crisis, there were a lot of risky loans on bank balance sheets. In many cases, the banks were not diversified and had outsized commitments to single deals, which was really unwise.

What's happened, as a result of pretty effective regulation, is that a lot of that risk has been transferred to fund managers where there's a deep alignment of interest. We have capable risk managers in this asset class holding nicely diversified portfolios, and we're holding them in a way where mark to market shocks that have nothing to do with underlying performance are easily weathered. We're creating a better shock absorber in the system for society.

This is an environment where banks find it incredibly difficult to lend because they know the mark to market could be down 10 points tomorrow. Whereas, in private debt, we're fundamental lenders and can hold to maturity without worrying about the daily marks, and this is a fabulous market in which to lend. So, the growth and development of the industry is a very big deal and a really positive step.

retailers will be in deep trouble. There's going to be a very significant rise in insolvencies in those kinds of sectors.

There will be big dispersions around manager performance. Longstanding credit investors like us know what to avoid. I feel very comfortable with our portfolio. But there are people who have entered the asset class over the last five to seven years that have taken more risk in lending to speculative business models – and they're going to be really badly impacted.

Q It's a good time to deploy capital in private debt – but how difficult is it to find deals?

There are certainly opportunities where you can get higher returns. I do think now is a time to be greedy – there's dislocation in the markets, it's a lenders' market, it's a time to have a positive bias towards deploying capital. Many of our competitors had a very positive bias to deploying capital a year or two ago. Our bias is to try to deploy capital into an environment where the odds have swung in favour of private debt investors.

The challenge is that transaction activity has been greatly reduced at the large end of the market. The value of levered companies has been reduced with the rise in base rates, and that has created a mismatch between buyer and seller expectations because of the limited availability of financing.

The broadly syndicated loan market is deeply dislocated. There are signs that it's beginning to heal, but over the last few months it's been badly broken because the biggest buyers are CLOs, and the assembly line of CLOs has been shut down. CLOs' cost of financing is too expensive to make the 'arbitrage' work.

We want to see the syndicated loan market reopen for business. You want the market to be good as a lender, but you don't want it to be so good that nobody can afford your capital. We need to find a clearing rate that works for both private equity and private debt. The markets are getting there – there are signs of life around the syndicated loan market and we're seeing a pipeline of activity building. What we haven't seen yet is big, new syndicated loans clearing the market – that may take some time, especially in light of the recent SVB events.

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"There's more interest in the higher returning elements of private debt"

Q How does this market compare with other periods of dislocation over the past few decades?

It's very distinct from a lot of our recent experience. The market reminds me most of the late 1980s and early 1990s, when there was a massive liquidity problem, the banks weren't lending, and there was no notion that the Fed and the ECB would ride to the rescue. Today is much more reminiscent of the market 30 years ago than anything from the last 10 years.

Most people in private debt have never worked in an environment where central banks are not in a position solve problems by easing interest rates. Today, for inflation fighting reasons, they are constrained from doing that. That's a gigantic difference. Markets will have to heal themselves. It's been a very long time since credit markets have had to sort things out on their own.

The key thing, in this environment, is to buy assets that are appropriate for the fund structures that you have. With this level of market volatility, the ideal is to have structures with long-dated, locked up funds.

Our fund structures tend to be up to 10 years – that's super important in this environment. You don't want to be worrying about where things trade in the secondaries markets, because things can trade down a lot.

If you're worried about your mark to market, you're in big trouble because the market is going through a price discovery phase. Loans can trade down a lot and you need to make sure you have a structure that can deal with that. ■