EXPERT Q&A

Private credit is well positioned to capture allocations from private equity, says Park Square's Robin Doumar

Disciplined managers set to enjoy spell in the sun

Rising default rates, falling M&A activity and renewed competition from the syndicated loan market could be interpreted as bad omens for the private credit industry. But that's not the whole picture, says Robin Doumar, founder and managing partner at Park Square Capital.

Doumar agrees that there will be more discrepancies in how managers perform, yet he believes private credit continues to benefit from powerful tailwinds – higher yielding strategies, he points out, can almost match private equity returns, with considerably lower risk.

The key to success, Doumar tells *Private Debt Investor*, is to remain disciplined in lending only to high-quality businesses.

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Q With the syndicated loan market showing signs of life, how will private credit perform over the next year?
For high-quality transactions, the market has reopened on both sides of the Atlantic after a year-and-a-half hiatus. To some degree, business will return to the syndicated loan market, especially for larger tranche loans.

Having said that, I do think that many of the inroads that private lenders have made into the syndicated loan market are likely to be sustained. Private debt firms will emerge with a significantly larger share of the lending business than they have historically held.

While we certainly like being in a lenders' market where we've had improvements in term structure and pricing, we don't want financing to be so expensive that it restricts transaction activity – that's been the world we've been living in for the past 18 months.

We were at a 10-year-low in terms of M&A transaction activity in the first quarter of 2023. The big benefit of the syndicated loan market's reopening is that we'll see more deal activity, and that's also fantastic news for firms providing solutions in junior debt.

I don't think it's bad for the existing mid-market direct lending business either. Mid-market companies will continue to use mid-market direct loans, and in the large-cap space, private debt firms have made gains relative to the CLO market.

Q Are you as optimistic about the outlook for the industry as you were a year ago?

Yes, I think it's a terrific market. A year ago, we were facing a substantial dislocation in the debt and equity markets, and so we deployed significant capital into the secondaries market, acquiring loans at a discount. And that has been great, but at some point, we needed to see new deal activity resume, because that's the bigger component of our business.

It's encouraging for me to see the syndicated loan market reopening for high-quality borrowers and it's a very promising time for the industry; base rates are up, leverage levels are lower than they were 18 months ago, and it's clear that the trend is pointing towards a substantial increase in transaction activity.

As buyers of loans have started to ramp up investment activity, the inventory that was for sale in the secondary loan market has now been cleaned out. Demand for loans has caught up, and the greater transaction volumes will likely soak up some of that demand.

Q Which key factors will determine how managers perform?

We're going to go through a period where highly leveraged companies will be tested by higher rates – there's going to be some pain out there for firms that have lent to the wrong companies.

> *"Base rates are up, leverage levels are lower than they were 18 months ago, and it's clear that the trend is pointing towards a substantial increase in transaction activity"*

I do think there's going to be more differentiation in how managers perform, something we haven't seen for quite some time because it's been a one-way market. A number of managers that came into being over the last 10 years have focused on building market share, so they can get to the next fund and grow AUM rapidly.

As an investor, market share isn't the right thing to focus on. The key elements are to maintain discipline in terms of new transaction activity, monitor portfolios aggressively, and to be very, very selective in lending. Avoiding losses and zeros is the fundamental thing we focus on.

Avoiding catastrophic losses tends to be all about business quality. I hear a lot of lenders talk about the leverage multiples that they're lending at, or their return per unit of leverage – but I tend to think of that as misguided. Lots of businesses should have no leverage; for example, zero is a good amount of leverage for a retailer or for the hospitality sector.

But the private credit industry is generally well positioned to weather a rise in defaults as the hike in base rates provides a lot of protection against losses at the portfolio level. Firms that have stuck to stable and predictable businesses with high-quality management teams – and maintained solid capital structures – are going to be just fine.

Q Are larger firms better suited to this environment?

You need to be large enough to be able to solve your client's needs; otherwise, you can't be in a position to provide solutions.

But you don't want to be so big that you just become a beta manager, and you have to do every deal that people put in front of you. I do think some managers in direct lending have got too big for the market. They're under pressure to deploy capital, which they prioritise over performance, and the sheer quantity of funds they need to raise just to stay constant is enormous; I don't think that's received the scrutiny it deserves.

Q There's a lot of excitement about the retail channel. What is the future of retail investment in private credit going to look like?

It's certainly an interesting opportunity. We want to be thoughtful and to make sure, from a distribution standpoint, that we're tapping into that channel in the appropriate way. But while I do agree that it's important, I think the emphasis might be a little overstated. Institutional investors have the level of sophistication that's required to invest in private credit – and most retail investors don't have that. There's a risk that they're misdirected towards a very high fee product that isn't right for them and doesn't generate the returns that it should.

Another challenge is that private credit tends to be tax-inefficient for most retail investors – it's a fabulous product for institutions, but returns for individuals are usually treated as ordinary income.

We ought to be open-minded, but a healthy dose of scepticism is warranted. Personally, I think private credit investing is a more natural fit at the most sophisticated end of the individual investor market.

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I left a big, well-regarded investment bank and formed Park Square because I felt that a business that solely focused on credit, had no conflicts, and was not competing with its customers, would have a superior business model. We could focus on being investors and delivering great performance for our LPs.

I see a number of these alternative investment firms have grown so big that they've effectively become banks; they're doing exactly what I left a big firm to avoid doing.

Q What do you expect to happen with interest rates in the long term, and how will this affect the private credit market going forward?

Higher interest rates are clearly going to create challenges for private equity and opportunities for private credit.

For private equity, higher rates generate a substantial headwind, as higher interest burdens come directly from the pocket of PE firms in terms of their returns. In addition to the rising costs of leveraged capital structures, we're also seeing multiple contraction and resulting longer holding periods, particularly in tech.

Whilst private equity remains a very attractive asset class, it seems evident that returns are likely to be lower in this new environment.

In contrast, I think private credit returns are going to be much larger. Yes, defaults might increase, but base rates are consistently higher. In our junior debt business, we generate between 13-15 percent net returns, very close to private equity levels – and we sit ahead of 60 percent invested equity in our deals.

I think you're going to see increasingly sophisticated institutional investors move away from private equity and allocate more capital to private credit, particularly into higher returning strategies. Of course, private equity remains an attractive asset class, but on a relative basis and in this environment, it makes sense for investors to put more of their eggs into the private credit basket. ■