EXPERT Q&A

The year of junior debt

Conditions in 2024 are primed for junior debt strategies to take off, says Park Square's Robin Doumar

After a strong 2023, market sentiment around private debt remains bullish. Robin Doumar, managing partner at Park Square Capital, predicts that 2024 will be another good year for the asset class, though he cautions that managers who have failed to be sufficiently selective will be hit hard by an anticipated rise in defaults.

Doumar adds that the market is moving in favour of junior debt strategies, and predicts that the need for businesses to refinance senior debt loans, combined with a rise in private equity firms looking to return cash to LPs, means that conditions are primed for junior debt strategies to take off.

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Q How do you feel private debt has performed over the past 12 months?

The asset class has performed strongly throughout 2023, partly owing to the dramatic movement in base rates. At Park Square, we have about $10 billion invested in our portfolio and since base rates started moving up, we've been able to earn about $400 million a year in additional interest income, a massive boon for us and a reflection of the strong tailwinds that a 'higher-for-longer' environment offers the private debt industry.

In more normal times, we would be excited by a 0.1 percent move in net fund IRRs, so for the returns on each floating rate investment to move upwards by around 500 basis points gives rise to a huge tailwind.

Another factor often overlooked is that the amount of time a loan is outstanding has a huge impact on our returns as private debt lenders. When the market is buoyant, we tend to see a lot of refinancing activity, but currently most borrowers don't want to refinance because margins are wide and base rates are high.

As a result, hold periods have been getting longer, which significantly increases the returns we can achieve on each loan. It's a trend that's likely to persist for a while, even as markets recover.

Q Can positive performance be maintained in 2024?

Yes, private debt is going to continue to perform well and will remain attractive compared with private equity because private equity is still dealing with high entry valuations and the much higher cost of debt. That said, private equity deal volume is likely to increase – partly because the syndicated loan market

has reopened – and consequently, we'll see more volume at lower prices this year.

However, I expect 2024 will see increased divergence in how private debt managers perform. We're in an environment where more and more companies are struggling, and some managers are going to be exposed because they chose to lend to riskier businesses. Too many managers take a formulaic approach and end up getting distracted from the fundamental question of whether they're lending to high-quality businesses.

In a potentially tougher macroeconomic climate for portfolio companies, management and execution become more challenging. Private debt managers that can draw from the experience of investing through multiple cycles clearly have an advantage in these conditions and are going to be rewarded for their experience.

Q What will private debt's biggest challenges be in 2024?

Of course, there are geopolitical issues, with upcoming elections and ongoing conflicts globally. Companies have now been struggling over the last two years with inflation, high interest rates and other macroeconomic challenges, so inevitably we'll see a rising level of defaults. Some private debt funds are increasingly going to find themselves having to take the keys of various businesses.

At Park Square, we are laser-focused on performance issues. Of course, the key to managing risk is to be highly selective in the companies we lend to. With private equity, you might earn spectacular returns on a few of your investments, which can offset losses in others. Private debt doesn't work like that – you can't afford to make mistakes.

This is going to be a year where selectivity is rewarded – managers that have been selective and built their portfolios carefully are perfectly positioned to reap what they have sown.

Q What strategies are best suited to the current market?

This is going to be the year of junior debt. We're coming off a spectacular period for senior debt, which of course benefited from the effective shut-down of the broadly syndicated loan market throughout 2023. But now the opportunity set is shifting into the junior space – we're coming into a golden era.

The key driver is the demand for deleveraging transactions, where companies need some form of non-cash pay junior capital to pay down their senior debt. This applies for companies who took out loans before the rise in base rates and have found themselves struggling to pay their debt interest, while also investing in growth. So that creates a fabulous opportunity for mezzanine capital or junior debt.

Another trend that works in favour of junior debt is the longer hold periods in private equity. Given the downturn in valuations, it's not a good time for private equity firms to exit their portfolio businesses, but firms need to find a way to return capital to their LPs in order to start raising their next fund.

How can they do that without selling a business? Private lenders can help provide solutions through junior debt recapitalisations, enabling firms to pay dividends to their LPs. But there's still work to do around educating investors about the benefits of junior debt. People entering the asset class tend to start with direct lending and then as they get more sophisticated, they become more attuned to the opportunities offered by junior debt.

Q How do you manage risks around junior debt lending to businesses that

“Hold periods have been getting longer, which significantly increases the returns we can achieve on each loan”

might have had challenges in paying interest on their senior debt?
This is a really important distinction for us; Park Square is not a distressed debt investor. We see opportunities in lending to high-quality businesses that need to refinance because their current debt structure doesn't work in the new higher rate environment. The term “rescue financing” gets used, but we see it more as senior debt refinancing.

There's certainly a huge trend of business owners finding ways to deal with an unsustainable senior debt burden. Refinancing with junior debt is a better alternative to a private equity sponsor having to increase their equity investment in a deal.

Q Why are more LPs considering co-investment opportunities?
There's certainly more appetite among the LP community to do things themselves and reduce their fee burden, and co-investments are a great way to do that. If LPs can co-invest with a manager that they have a good partnership with, they get the benefit of working with an experienced manager and effectively receive a big discount; that's the best of all worlds for LPs.

In fact, Park Square started as an LP-inspired initiative conceived by several Canadian pension plans, and consequently co-investing is very much a part of our DNA. It allows us to invest in larger deals, an increasingly important capability as private debt transactions grow in size. And so, we are investing internally in our model of providing co-investment opportunities and working systematically to provide opportunities to a broader group of LPs.

Q Practically, what needs to happen for LPs to take advantage of these co-investment opportunities?
Most LPs would probably like to do co-investments, but in reality, timing is critical in these kinds of transactions. That puts a lot of pressure on the LPs' execution teams, and the resourcing required can be a challenge. From a manager's perspective, in most cases you want to bring in the LP at closing, rather than underwriting the whole deal and bringing them in later. The latter approach is more viable with private equity because valuation changes tend to be more gradual.

At Park Square, we offer co-investment opportunities to our LPs on a ‘no fee, no carry’ basis. For several of our larger LPs, we manage dedicated vehicles where they have an opt-in or opt-out opportunity. We present them with a deal, provide all the materials they need, give them around 10 days to decide and then we make the investment on their behalf. We find this structure works.

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Q How confident are you that allocations to private debt will increase this year, given the expected macroeconomic trends?
We've been pleasantly surprised by the fundraising environment over the last year, and 2024 certainly looks promising. I think investors prefer the private debt asset class; as they become more educated on quality and better understand the deals, allocations to private debt increase.

I think investors are becoming more discerning around what makes a good manager, and that makes me very optimistic about the market from a fundraising standpoint. I think it's super-attractive for insurance companies with an increased need for private debt, and both public and private pension funds.

In the UK, we have had the legacy of the LDI problems to contend with, but we are hopefully past the worst of that, and regionally, we're seeing deep interest out of Europe and Asia, as well as the US. So, the picture for 2024 is encouraging. ■