CARLYLE

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Global Insights

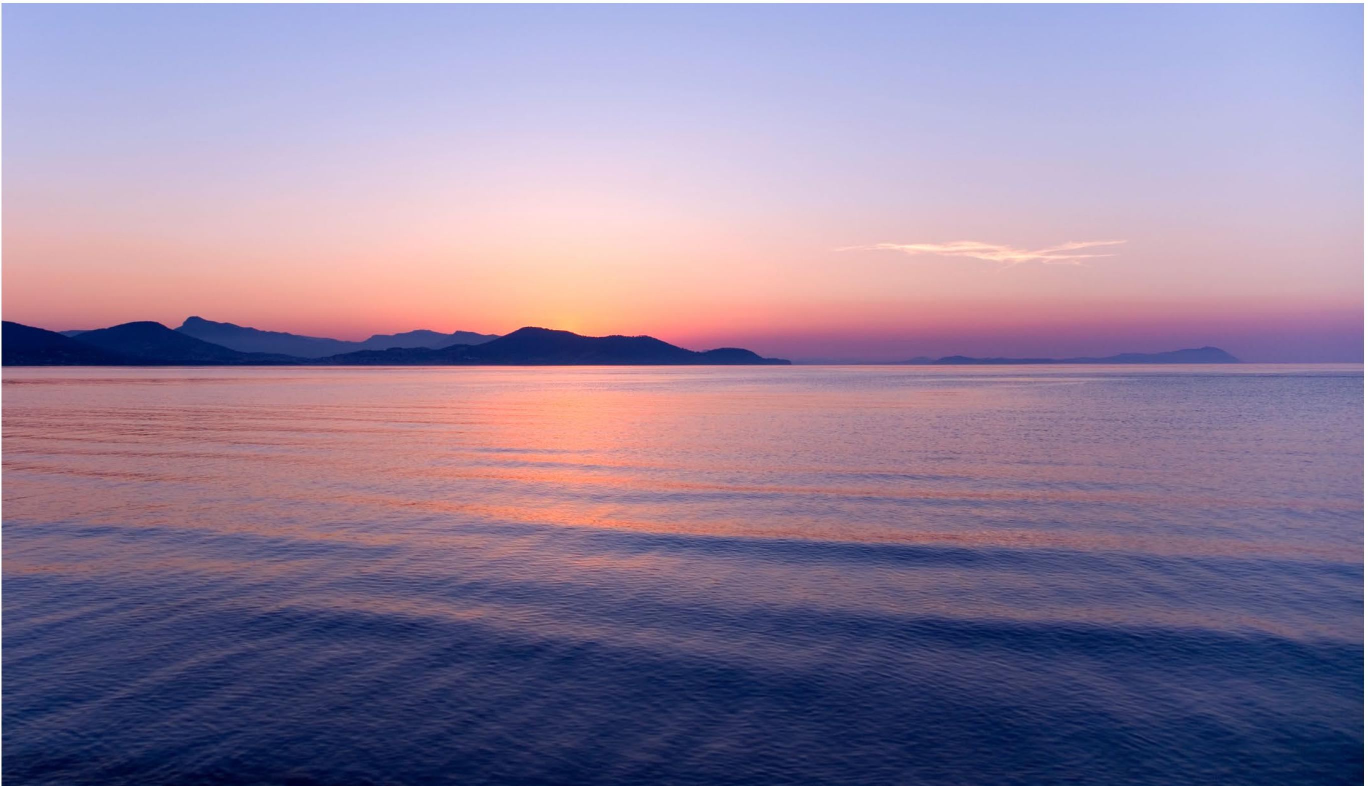
2023 Credit Outlook: New Landscapes, New Eyes

EXECUTIVE SUMMARY

→ Over the past year, private credit has experienced a surge in both return expectations and market share. Both developments can easily be cast as wonderful news for private credit but have come at the expense of other pieces of the capital structure or corners of the credit market.

→ Expect opportunistic lending to remain a key feature of the market going forward, as this piece of the capital structure helps to resolve the repricing between credit and equity. Direct lenders seem likely to respond to diminished competition by subtly de-risking their portfolios and expanding into territory vacated by regional banks.

→ With macroeconomic uncertainty unlikely to recede in the near-term, the next year is likely to be characterized by cautious optimism and metered growth, as private lenders exploit the relative strengths of their liability structures and focused business models while remaining conscious of the need to be fully compensated for growing downside risks.



2023 CREDIT OUTLOOK: NEW LANDSCAPES, NEW EYES

Two shocks transformed credit markets over the past year. First, the historic upward adjustment in interest rates dramatically increased yields on speculative grade loan packages, from just over 6% in January 2022 to 10% to 11% today. Returns that once required investors to underwrite exotic risks have become standard fare. Second, financing volumes have moved decisively in the direction of private lenders, taking market share from broadly syndicated loans and high-yield bonds. A market used to serving as an ancillary player has been thrust into a leading role.

Both developments can easily be cast as wonderful news for private credit. What's not to like about higher returns and increased market share? But beware of too much of a good thing. At current lending rates, prospective acquirers find themselves in a negative "cost of carry" position: corporate assets generally yield less than the liabilities issued against them. Deal mathematics has become more challenging, depressing deal volumes. And without robust issuance of broadly syndicated loans, markets become less liquid with diminished price discovery and the prospect of higher default volumes.

So while private credit's relative position in the investment landscape has undoubtedly improved, changes to its *absolute* position are more ambiguous and depend on market segment. With macroeconomic uncertainty unlikely to recede in the near-term, the next year is likely to be characterized by cautious optimism and metered growth, as private lenders exploit the relative strengths of their liability structures and focused business models while remaining conscious of the need to be fully compensated for growing downside risks.

CHALLENGED ARITHMETIC FOR SPONSORS

The increase in financing costs has not been met by a proportional decline in entry multiples. That means that creditors consume a much larger share of company cash flows, leaving far less for equity. When senior loans yielded 6.1%, a typical business could generate the cash needed to pay creditors in just half a year of operations.[1] After interest expense, equity was left with a cash yield of 11% (before netting taxes and capital expenditures). Financial sponsors could realistically underwrite 20% equity returns with a plausible strategy to grow company earnings by 9% per year.

At today's finance costs, debt service on the same capital structure would consume more than 10 months of operating cash flow and the cash yield to equity would be just 4%.[2] Instead of having to grow earnings by 9%, an acquirer would need to grow earnings by 16% per annum to generate the same return.[3] And with the senior (i.e. less risky) pieces of the capital structure earning so much more, one would expect equity investors to revise up their required returns proportionally (Figure 1).

Figure 1.
Deterioration in Deal Mathematics

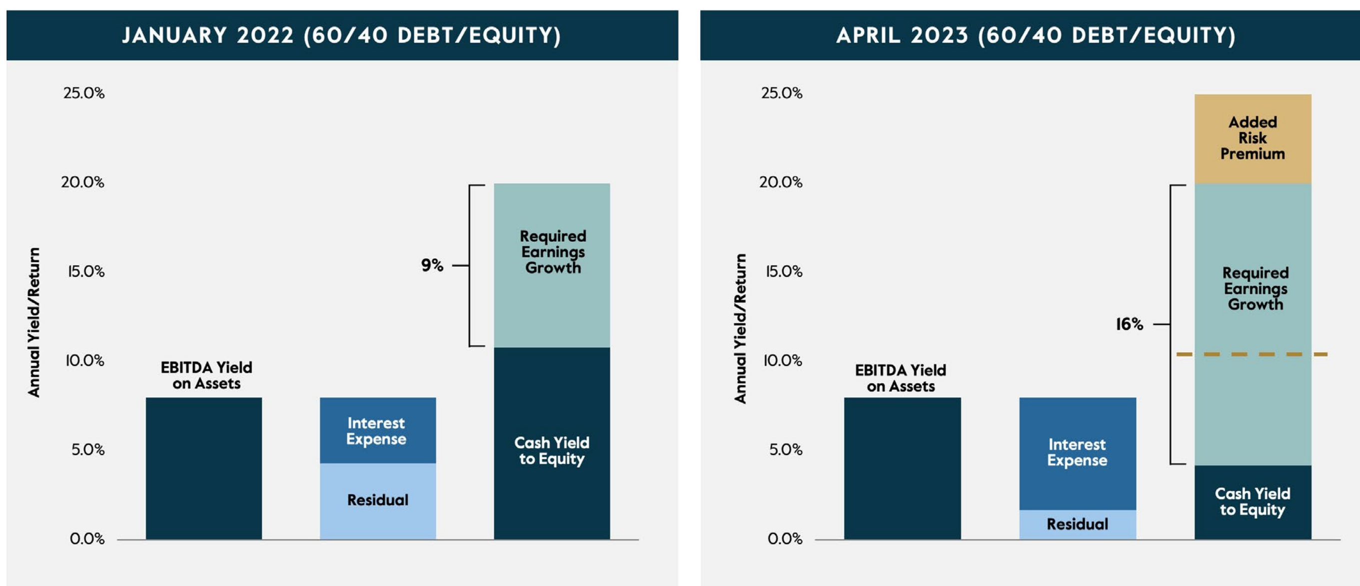


Figure 1. Source: Carlyle Analysis; LCD Database, April 2023.

1. Based on market-wide pricing and equity contribution data, LSTA LCD Database, April 2023.
2. At current valuations, single-B interest rates, and assuming no change in capital structure. LSTA LCD Database, April 2023.
3. This stylized example is for illustrative purposes only, as it involves simplifying assumptions such as a constant multiple and immaterial capex maintenance expense.

No surprise that fewer companies have proven able to meet this higher bar. With prices stubbornly refusing to fall, deal volumes have borne most of the market adjustment to-date (Figure 2). The number of private equity transactions dropped by 80% at the end of 2022 and any recovery has been modest. A number of large transactions were announced in Q1-2023, but generally involved outsized equity contributions that provided little content for credit investors. Prospective sellers have been advised to wait for a “Fed pivot” in Q3-2023 when rate cuts (and more accommodating financial conditions) are expected to arrive (Figure 3, left panel). It’s not clear that monetary easing will materialize on this timetable, however. The fed funds rate has only just reached levels implied by standard models, suggesting that rates may have to remain here for some time to work off the excesses created when policy rates were kept well below levels implied by fundamentals (Figure 3, right panel).

Figure 2.
Transaction Volumes Fall Rather than Prices

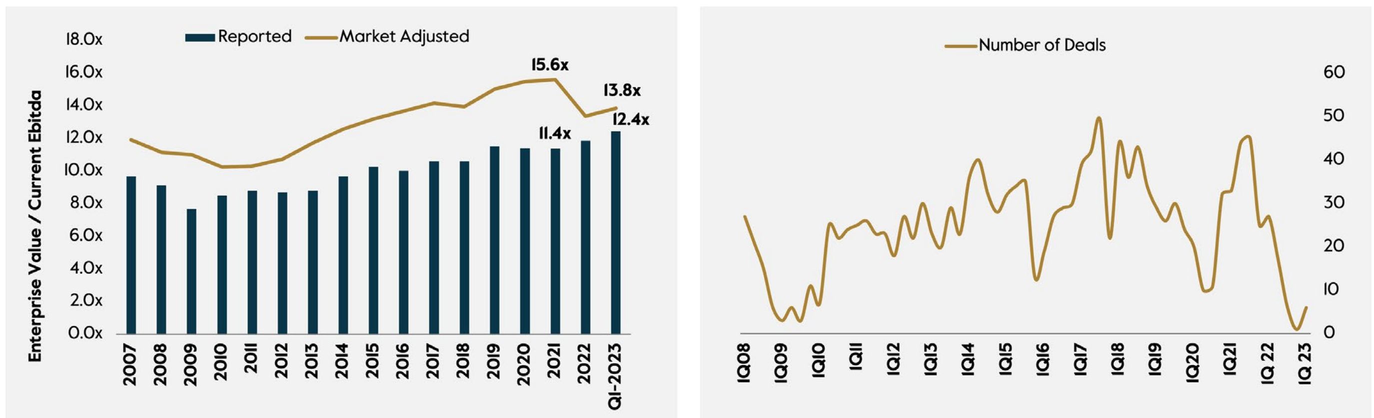


Figure 3.
Money Market Interest Rates

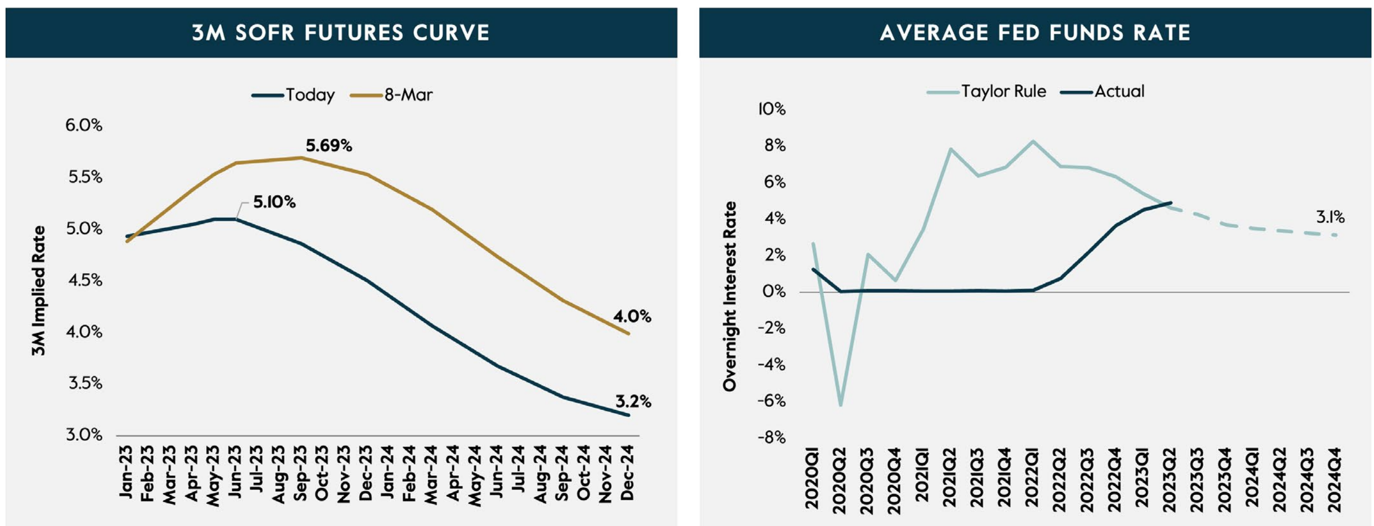


Figure 2. Source: Carlyle Analysis; Federal Reserve Board of Governors, LSTA LCD Database, April 2023.
Figure 3. Source: Carlyle Analysis Based on Taylor (1993), Bloomberg, April 2023, CBO Economic Forecast, February 2023.

OPPORTUNISTIC CREDIT STEPS IN

Until interest rates recede, deal finance seems likely to hinge on the participation of "opportunistic" lenders willing to trade upfront interest payments for upside participation. Their pieces of the capital structure retain seniority to equity and other standard protections, but are priced to earn 14% to 16%,[4] on average, either through a payment-in-kind (PIK) structure or a combination of reduced coupons in exchange for warrants. While expensive, such loans keep portfolio companies' debt service costs manageable and allow management to retain more cash to reinvest in growth initiatives.

This market opportunity may last several years. Wherever the Fed ends up on rates, one gets the sense that we're entering a new era, with policymakers much more cognizant of the downside risks associated with massive easing and capital growing scarce relative to ambitious public and private investment programs (Figure 4). It's possible that financing costs may not return to 2021 levels over any relevant planning horizon. And if they don't, a large swath of companies may find that their pandemic-era capital structures no longer make sense. This portends a potential increase in distressed investment opportunities, but also a proliferation of the creative financing solutions that are opportunistic lenders' bread and butter. With borrowers facing a maturity wall starting in 2025 (Figure 5, p. 7), there could be significant advantage for "first movers" eager to refinance into a more sustainable capital structures over the next two years.

That is especially true when it comes to recently acquired companies in software, medical technology, and other fast-growing sectors. These companies generally don't generate much cash – the higher the EBITDA multiple paid for a business, the less cash it generates per unit of enterprise value – but many creditors were willing to look past weak cash flow metrics if equity sponsors were willing to inject a loss-bearing layer of capital equal to 60% to 70% of the purchase price. Unfortunately, rate hikes arrived well before operating earnings in many cases, pushing some of these companies into financial distress.

Recent belt-tightening in the tech sector likely reflects efforts to raise cash to meet elevated debt service costs (Figure 6, p. 7). But such cuts feel like a short-term solution. Depriving innovative companies of the resources necessary to grow destroys far more equity value, over time, than swapping out some high interest-bearing liabilities for a PIK layer of opportunistic credit. When hopes for a sudden and swift fall in interest expense are dashed, expect a sizeable increase in capital deployment opportunities.

Figure 4.

Estimates for Equilibrium Interest Rate

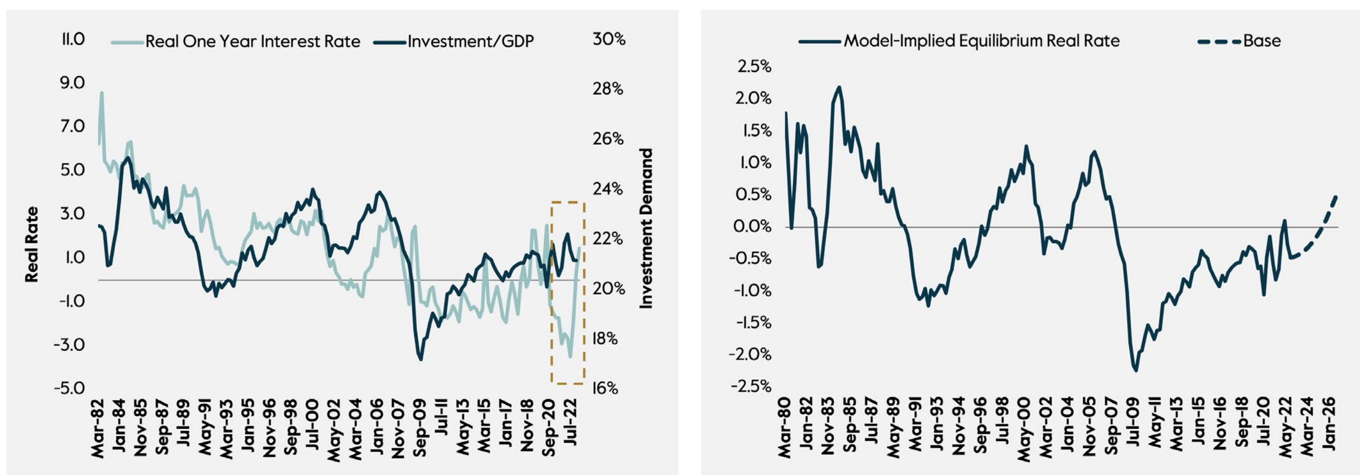


Figure 4. Source: Carlyle Analysis; Federal Reserve Board of Governors, March 2023.

4. For illustrative purposes only based on a survey of recent lending terms offered to acquirers.

Figure 5.
Maturity Wall

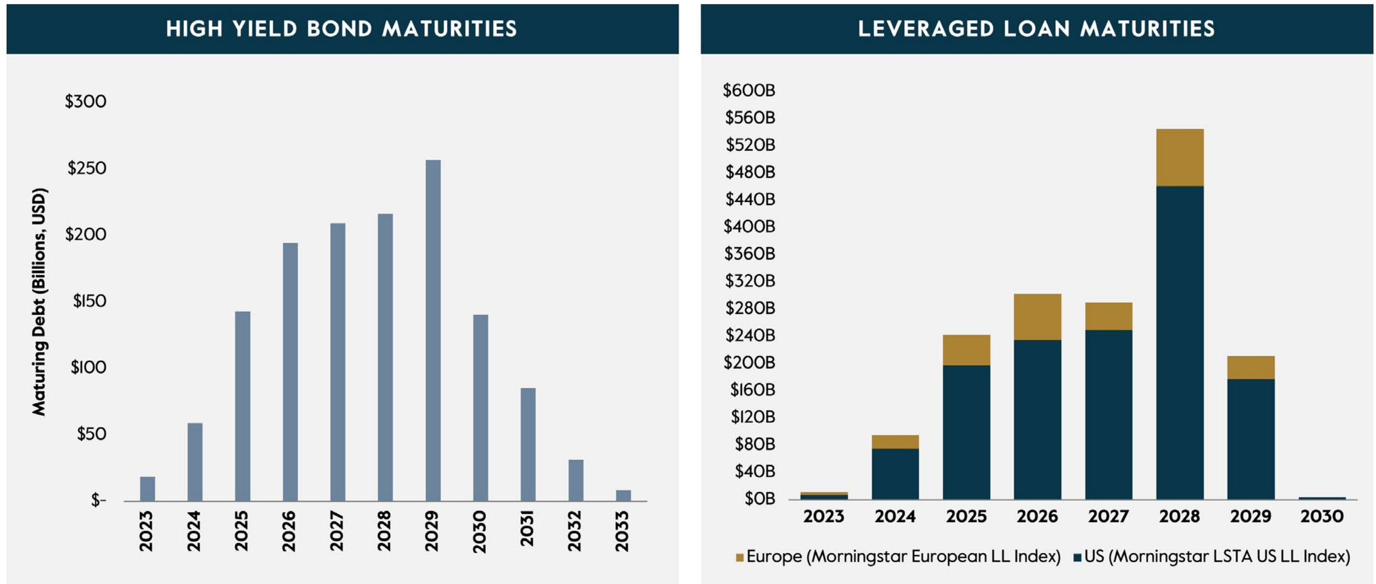


Figure 6.
Higher Rates Impact Tech Sector

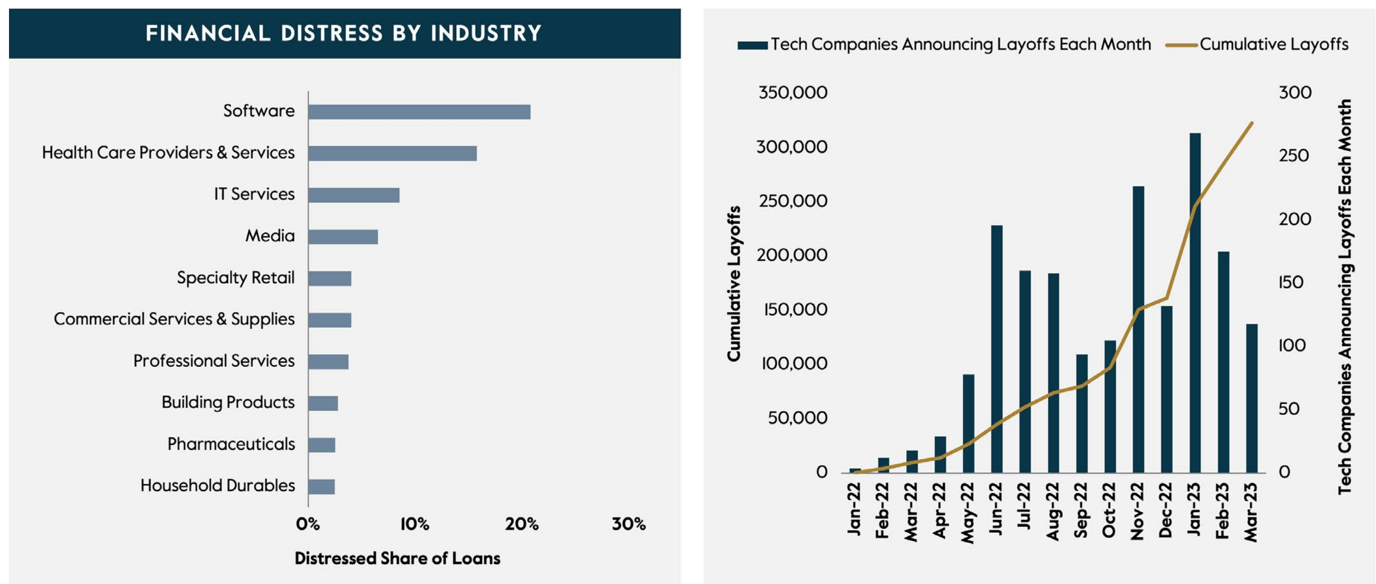


Figure 5. Source: The Wall Street Journal; CreditSight; S&P LCD, March 2023.
Figure 6. Source: Carlyle Analysis; Layoffs.fyi Tech Sector Layoffs Tracker, April 2023. Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index, December 2022.

SUBTLE DE-RISKING OF DIRECT LENDERS' PORTFOLIOS

With diminished competition in deal finance markets, direct lenders can assume a more discriminating posture. In Q1-2023, direct lenders financed 94% of all buyouts by number and 70% by loan dollar volume.[5] This is hardly a market where lenders are doing whatever comes across their desk; the decline in overall deal volumes suggests that private lenders are skimming the cream. While the failure of spreads to "gap out" has been cited as evidence of a market poorly positioned for impending recession, the disconnect could be explained by a subtle de-risking of portfolios. If a loan originated at SOFR +650 in 2021 would now be priced at SOFR +800, a lender may rationally choose to forego a similar loan and instead respond to the decline in competitive pressures by finding a safer credit to which to lend at SOFR +650. The return on the portfolio remains the same, but its quality has improved. Underwriting has tightened but is not reflected in spreads (Figure 7).

We think of private credit as mainly displacing broadly syndicated loans (BSL), but about one-third of opportunities come from non-sponsored origination.[6] This segment of the market could become significantly more interesting over the coming months given stresses endured by regional banks. While any crisis is likely to be concentrated in commercial real estate given regional banks' concentrated exposure to the space (Figure 8, p. 9), losses on mortgages issued against office and retail properties could erode bank capital levels and produce a more generalized credit crunch. If promising small-to-medium sized businesses cannot access finance through traditional bank channels, direct lenders can make significant inroads, adding diversified portfolio exposure at generally lower entry leverage multiples.[7]

It is difficult to overstate private lenders' room for growth outside of traditional sponsor networks. According to the annual business census, there are more than 20,000 businesses with more than 500 employees operating in the U.S. today that combine to generate over $18 trillion in receipts. Of these, only about 4,000 have public listings. The rest are either backed by private equity funds, proprietor's capital, or other types of outside investors. And the private share of these businesses has increased over time as "listing propensity" – the likelihood that businesses of a certain size will pursue an IPO – has waned (Figure 9, p. 9). While turnover in ownership among the roughly 10,000 private equity-backed companies will continue to account for the vast majority of direct lenders' volumes,[8] the accessible market opportunity for private credit is far larger.

Figure 7.
Subtle De-Risking of Portfolios

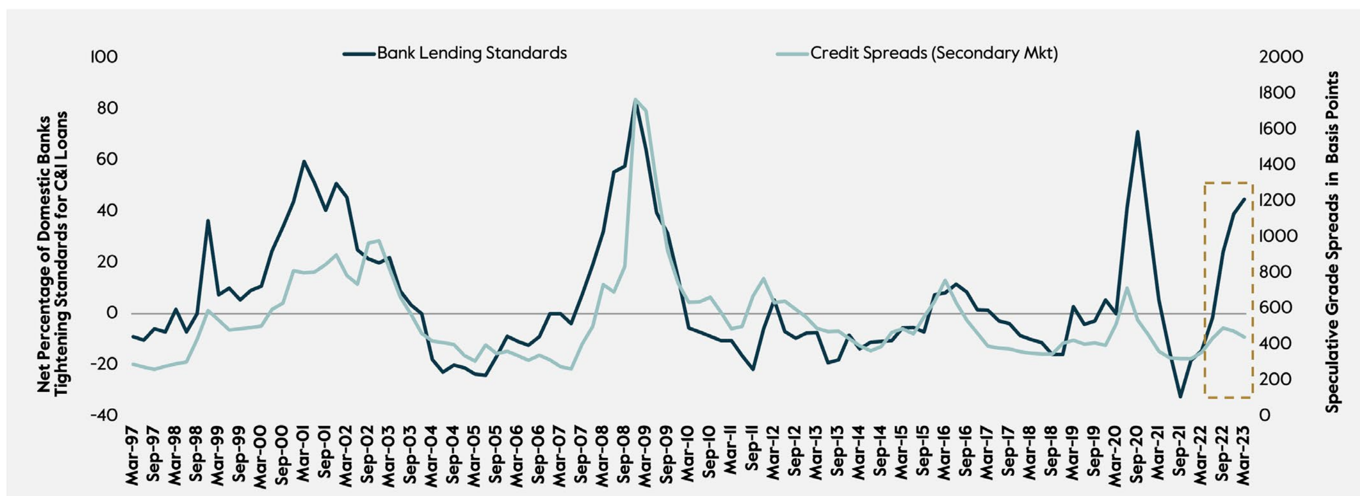


Figure 7. Source: Carlyle; Federal Reserve Board of Governors, April 2023.

5. LCD Pitchbook, April 2023.
6. "US Private Credit Perspectives," CreditFlux, June 2020.
7. "The Ascent of the Non-Sponsored Market," Private Debt Investor, April 2023.
8. Carlyle Analysis; PitchBook; CRSP, January 2022.

Figure 8.

Exposure to U.S. Commercial Mortgages by Holder

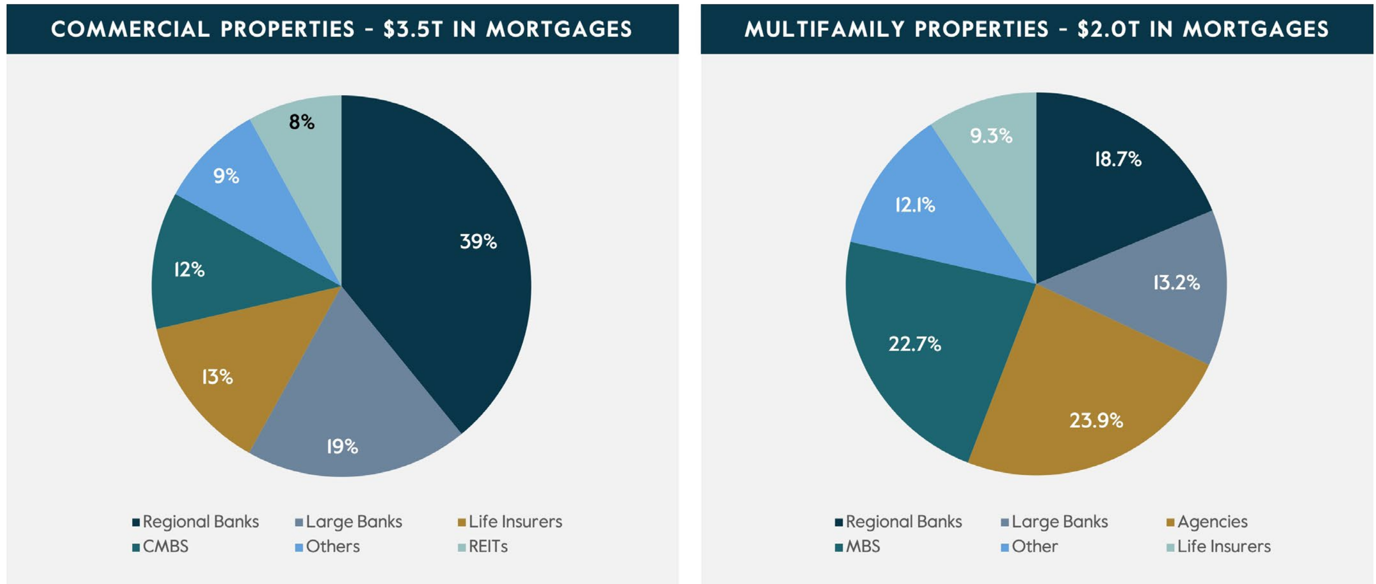


Figure 9.

Decline in Public Companies & Listing Propensity

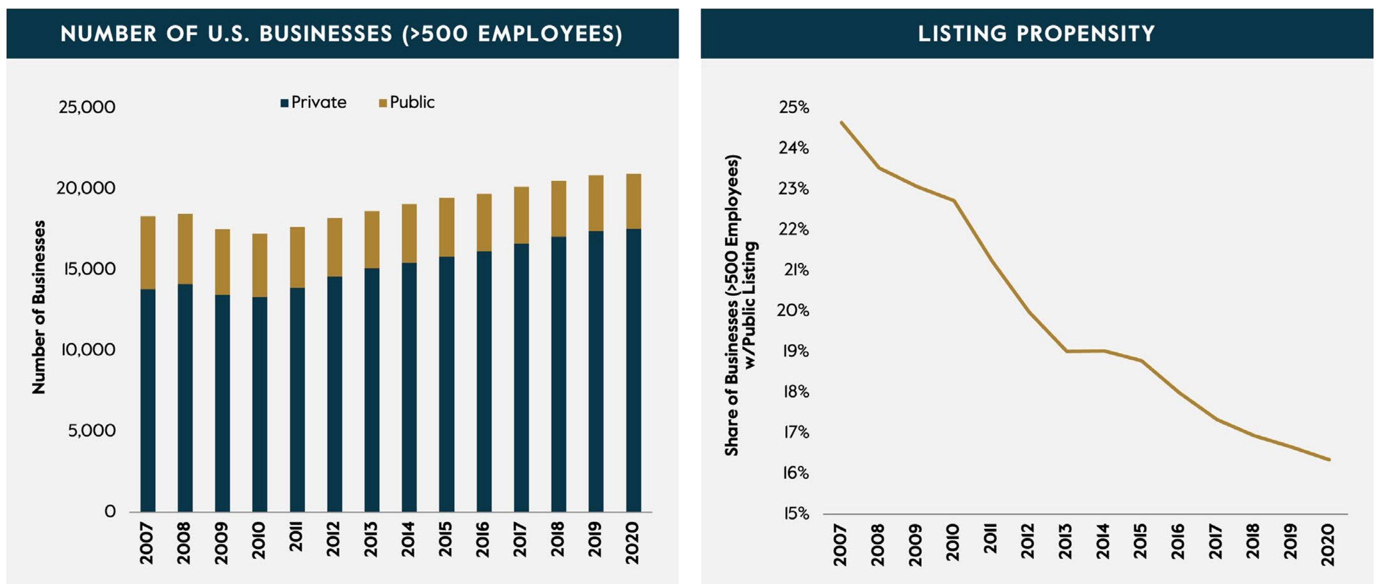


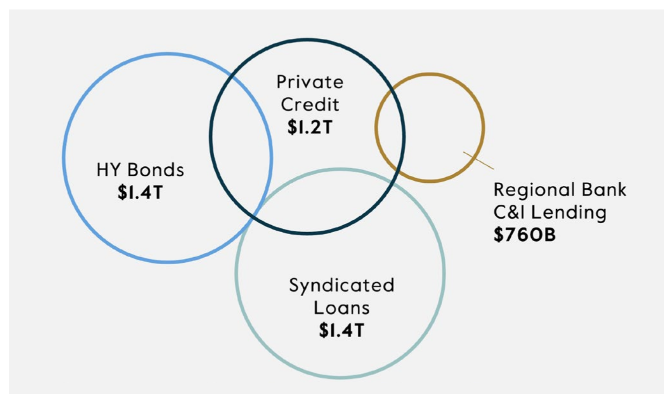
Figure 8. Source: Carlyle Analysis, Federal Reserve Board of Governors, March 2023.
Figure 9. Source: Carlyle; Statistics of U.S. Businesses (SUSB), U.S. Census Department, Center for Research in Securities Prices Database, April 2023.

MORE DURABLE LIABILITY STRUCTURES & FOCUSED OPERATIONS

Bank stresses serve as a reminder of how durable liability structures allow certain intermediaries to put money to work when others cannot. A credit crunch may prove impossible to avoid because of the way regional banks must manage asset exposures with one eye on their deposit base. Depositor withdrawals not only deprives banks of the funding necessary to make new loans but could also force them to liquidate assets to meet depositors' outflows. By contrast, Business Development Companies (BDCs) allow lenders to originate new loans when others cannot. Longer-term capital also obviates risk of having to engage in "fire sales" to fund outflows.

To this advantage, one must add the simplicity of private lenders' business model. Unlike banks, where fees generated by M&A transactions, initial public offerings (IPOs), advisory services, securities underwriting, and cash management can dwarf net interest income, direct lenders are focused on a single activity: making loans that deliver strong returns after accounting for any default losses. This means that loans can generally be underwritten without any ancillary considerations or serving as a "loss leader" for more lucrative lines of business. Without the distractions from "runnable" liability management and diverse fee streams, private lenders can compete aggressively for business across all credit markets (Figure 10).

Figure 10.
Credit Market Overlap



COMPLEMENTARITY BETWEEN DIRECT LENDING & SYNDICATED LOANS

Given these competitive advantages and market share gains (Figure 11, p. 11), there can be a temptation to speak of private credit in triumphalist tones. Striking this chord feels discordant at the current moment, not just because of uncertainty regarding future defaults, but also because of the extent to which banks and institutional lenders have willingly ceded territory. Inflation's persistence raises the chance that rates will remain elevated for some time to come, destroying demand and depressing corporate earnings. Bank failures, increased market volatility (warehousing risk), and greater regulatory scrutiny further diminish banks' risk appetite. Roughly 93% of the $66 billion in leveraged loans issued in Q1-2023 were used to refinance existing loans.[9] Bankers remain willing to discuss new deals, but far less inclined to act on them.[10]

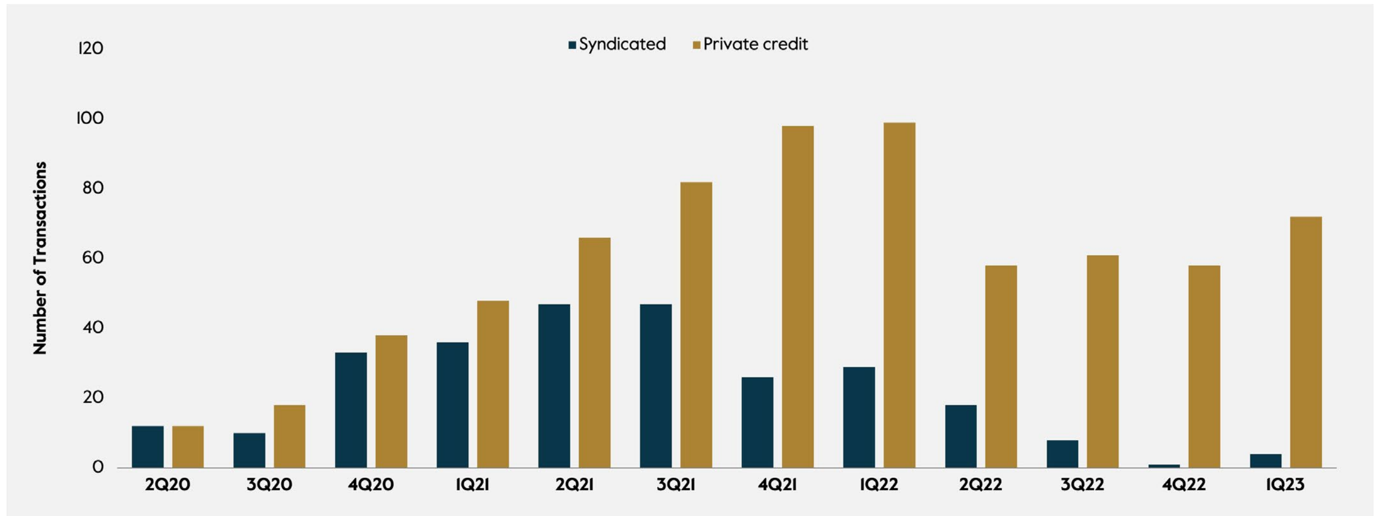
This is unfortunate. Private credit cannot fill the entire M&A finance void, particularly for deals in excess of $10 billion and the more cyclically-sensitive businesses direct lenders tend to avoid. And even if it could, the market benefits from bank participation and, especially, the new primary loan supply that banks originate to distribute. Loan origination, syndication, and trading not only liquefies the leveraged credit market but also generates data essential to investment and underwriting decisions more broadly. Syndicated loans back Collateralized Loan Obligation (CLO) liabilities, which generate additional data streams across ratings tranches of additional use to market participants.

Direct lenders have always focused on the middle market, where specialized knowledge of sponsors and businesses is critical because the risks tend to be idiosyncratic. Private credit's sizeable outperformance[11] is in part explained by those relationships and that expertise. But those company-specific and illiquidity risks are priced in relation to parameters largely determined on the liquid side of the market. The more leveraged loans that are originated, the greater the size and number of CLO collateral pools, the more rich the dataset available to inform these complex pricing decisions.[10]

Figure 10. Source: BAML ICE Indices, Preqin, S&P LCD data, March 2023. Presented for illustrative purposes only.

9. LCD database, accessed 4/7/23.
10. Or on terms that are not competitive with those offered by direct lenders.
11. Boni, P. and F. de Roon. (2023), "Uncovering the Public and Private Components of Private Debt Returns," Tilburg University.

Figure 11.
BSL Pullback in Deal Finance



Many analysts expect leveraged credit markets to normalize later this year and for banks to reengage more aggressively. That would be welcome, but this forecast seems predicated on the same optimistic assumption about the Fed and easier financial conditions. If easier monetary policy does not arrive and macroeconomic risks do not recede, the banks may not return in force. That would diminish market liquidity, increase pricing uncertainty, and potentially result in larger default losses. Broadly syndicated lending is more complementary to private credit than commonly supposed. One hopes its prolonged absence is not how market participants learn this lesson.

CONCLUSION

Over the past year, private credit has experienced a surge in both return expectations and market share. Some of those gains have come at the expense of equity, which has led to a decline in deal volumes. Others reflect a pullback in syndicated loan issuance that's unlikely to prove healthy for the market over the medium-term. And this situation develops as macroeconomic storm clouds continue to gather. Expect opportunistic lenders to remain a key feature of the deal landscape and for direct lenders to respond to diminished competition by subtly de-risking their portfolios. Private credit's relative position has improved meaningfully, but now seems hardly the time for triumphalism.

Figure 11. Source: LCD Pitchbook, accessed 4/5/23. For illustrative purposes only.

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Mr. Jenkins earned a B.Comm degree from Queen's University. He served on the boards of Wilton Re, Teine Energy, Antares Capital and Merchant Capital Solutions.

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