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Alternative credit
Priming for the next cycle

Reshaping underwriting, tech investments, and niche strategies

Insights from a CRISIL GR&RS webinar

June 2022

Breaking barriers with disciplined lending, niche strategies and automation

CRISIL hosted a webinar 'Alternative credit at a crossroads: Time to reset, readjust, and refocus' on May 31, 2022. More than 120 delegates from the buy-side, sell-side, and investment banks attended the event. The panellists included Paul Kelly, Senior Managing Director and Chief Operating Officer, Blackstone Credit; Patrick Suchy, Head of Credit, Private Markets, HSBC Alternatives; and Nilesh Mandhare, Director, Ellington Management Group. Abhik Pal, Global Head of Research Practice at CRISIL GR&RS, moderated the discussion.

We summarise the key insights from the discussion here.

Theme 1: Headwinds vs tailwinds — turning the tide

- **Circumventing the maelstrom of negativity:** A confluence of headwinds, including inflation, Fed tightening, the Russia-Ukraine war, food scarcity, trade tensions with China, and pandemic-induced supply chain disruptions, have resulted in volatility in YTD-2022 and a decline in loan pricing. Notwithstanding these headwinds, private credit markets have been resilient and less volatile compared with most asset classes.
- **Investors remain watchful of higher rates:** Private credit investors benefit from the floating rate instrument amid changing yield environment. However, at a certain level, if higher interest rates adversely impact cash flows of underlying companies and the coverage ratios, the situation could be more problematic. Although the market participants do not foresee this over the next year, they are watchful of the changing yield environment
- **Opportunities for swapping credits in the CLO market:** There are ample opportunities for collateralised loan obligation (CLO) managers to essentially build par here or reduce risks by swapping credits perceived risky with better credits that are also presumably trading at a discount and not lose a bunch of par in doing so. That said, there are challenges too – widening CLO tranches raise questions over the lucrativeness of CLO equity arbitrage today. Significant stabilisation on the liability side is required for new CLO issuances to open up in a meaningful way.

Theme 2: Direct lending expected to be resilient, though untested for extreme shocks

- **Alternative credit markets are stable for now, but untested for crises such as the global financial crisis (GFC):** The private credit markets benefit from structural protections in the form of floating rate and no associated duration risk compared with investment grade or high-yield bonds. Borrower companies of direct lending are following the business models of private equity investment strategies. These are also typically more service-oriented businesses, with stable cash flows, and not prone to supply chain disruptions. Having said that, private credit markets are still to be tested in GFC-like situations
- **Default rates will rise but will remain manageable:** The default rates are still at considerably low levels and are likely to increase over the next 12 months. However, most market participants are confident they can manage situation. To address this, investors would need to look for managers with strong workout capabilities
- **Mid-market transactions will be resilient to downturns:** By nature, direct lending assets are valued on a quarterly basis, which takes a lot of volatility out of the asset class. While it may not necessarily mean less risk, one can measure lower volatility, and it helps reduce the maximum drawdown in the portfolio. As long as covenants are in place in more mid-market transactions and cash flows are sufficient for interest coverage, senior direct lending is likely to be a stable asset class and resilient to market downturns

- **CLO market prone to volatility:** While the CLO market does not have a mark-to-market (MTM) reporting, investors can build their own MTM model by referring the public instruments for a given CLO. CLOs are more volatile and more prone to market shocks compared with direct lending

Theme 3: A shift in underwriting structure is underway; due diligence largely unchanged

- **Jumbo deals, covenant-lite loans, and shorter deal cycles the new norm:** The overall underwriting framework remains largely unchanged, though private lenders have raised their guard. A structural shift is underway amid the crowding market, emergence of multi-billion-dollar deals, and covenant-lite structures. Market participants need to evaluate if they are comfortable lending to a creditworthy borrower for a billion or multi-billion-dollar loan, while also factoring a covenant-lite structures in the mix. As long as the underlying company risk is good, this seems okay. The market is also seeing increased risk awareness.
- **Due diligence largely unchanged:** While underwriting has dialled up a bit, the due diligence route has not changed much. Here the analyst will follow the same rules of credit or fundamental analysis, with a decided shift in focus for underlying factors

Theme 4: Covenant-lite structures — a slippery slope ahead

- **Covenant negotiation hindered by a borrower-friendly market:** Lenders do seek better protection in terms of a covenant structure; however, the current competitive dynamic makes it difficult to negotiate terms with borrowers. Participants feel that covenant quality is more a function of market cycle, and currently, the market is ripe with investor demand — leaning towards weaker covenants. Covenant is key for the mid-market or lower mid-market borrowers, as it provides insights into the borrower's risk position
- **Wider restrictive and incurrence basket seen in the CLO market:** In terms of the CLO covenant structure evolution, the market has seen restrictive payment baskets, and much wider investment baskets and incurrence baskets than they used to be. Further, we noted significant addbacks to EBITDA, and easing of covenants on moving assets that led to huge losses in certain cases. Lately, there have also been coupon step-downs based on some leverage ratios
- **Make-shift arrangements:** While the maintenance covenants have largely disappeared from loans these days. Private lenders are tracking the borrower performance in-house on an ongoing basis, be it leverage or cash flow analysis or future trajectory of earnings
- **Disciplined lending comes to the fore:** Market participants believe a disciplined lending approach is important. Being able to push back for better covenants on non-standard asks or not entering a deal on sub-optimal conditions are important from a disciplined underwriting perspective. If the asks are reasonable, lenders can accommodate by relaxing covenants. In case the changes requested are not acceptable, then the transaction is discussed in an internal committee before opting out of the race. Smaller players are comfortable opting out of transactions, where they are not convinced with the downside protection or covenant structures

Theme 5: Leveraging technology for better data aggregation and operational efficiency

- **Tailored automation — the need of the hour:** Private lenders seem to be lagging while incorporating technology or automation when it comes to day-to-day operations. There is too much dependence on manual processes, and it is done by investing more in headcounts than in technology. Hence, it is critical that private players use more technology. Nonetheless, there are larger players that have invested significantly in database infrastructures over the last year

- **Combining analytics with human acumen:** Market participants are working towards consolidating their own databases to identify any shifts in performance, link the data sets with external data and use the outputs efficiently to drive decisions. Advanced analytics is another area that remains in focus especially on the BDC side and syndicated loans. Smaller industry players are leveraging information provided by data aggregators; however, concerns surrounding the data quality remain. Further, the end-analysis largely depends on the projections of an experienced analyst analysing the deal or transaction. Thus, manual intervention still plays an important part in the analysis at this point

Theme 6: Bespoke strategies, impact investing and scale to drive next cycle of growth

- **Niche and hybrid strategies into play:** While choosing the right strategy, lenders need to factor in the underlying economy, seniority, and phase of the market cycle, as well as the asset base. There is a huge structural shift from public to private markets. There is also increased focus on various sectors such as tech, healthcare, and asset-based lending. It is not easy to find the right strategy, and one needs to define parameters under which the lender is comfortable investing — growth factor, product differentiation, and stage of lending (venture debt, early stage). Given its complicated nature, talent and time are crucial while analysing these markets

- **Impact investing in the direct lending space:** Energy transition in general has been a huge market in the direct lending segment, followed by environmental social governance (ESG) that is gaining a lot of traction. With rising investor demand, the importance of ESG has increased exponentially over the last couple of years. That said, it comes with its own set of challenges. From a management perspective, ESG investing is still in a nascent stage in terms of application of standards which carry some reputation risks with data and information not being consistent across the Board. This is taking a lot of thought and efforts of the market participants. This product will be larger in the coming 2-3 years' time

- **Scale advantage for large CLO managers:** Large CLO managers have generated higher alpha by virtue of their scale. From the view-point of alpha deconstruction, tier I managers get a very good execution on their liabilities and with 10x levered equity, even a marginal benefit from good execution has a good amplification. However, in an attempt to bridge this gap, the smaller and mid-sized managers should differentiate themselves by focusing on fundamental credit picking, be much nimbler in terms of trading to build par and improve their performance. However, with scale come its own set of problems, as large managers tend to have larger positions and it becomes very difficult to trade in and out which is kind of an advantage for smaller fund managers.

Theme 7: Embracing sustainability

- **SFDR and EU taxonomy rules driving private credit fund market:** The ESG EU taxonomy rules and SFDR classifications have helped in providing more transparency. In the private credit fund market driven by Europe, many new funds offering are Article 8 classified funds in Europe, a new development over 12 months. The ongoing transition has exceeded industry participants' initial expectations. The market is transitioning well with a good traction to sustainable finance disclosure regulation-compliant (SFDR) funds. Global funds have started offering SFDR Article 8 compliant funds and there is a clear demand for it

- **ESG-related products in the CLO space:** Most managers have their own internal rating system with little standardisation, resulting in difference in the perceived ESG risk of one issuer to be different for different managers. While there will be a demand for ESG-related products in the CLO space, the industry participants do not have a clear line of sight on execution without having a standard rating scale or standardisation across managers

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