EXPERT Q&A

Volatile markets create opportunities for direct lenders that are appropriately funded and flexible, says Brent Humphries, president of AB Private Credit Investors

Opportunities remain for well-positioned lenders

Q How do volatile markets create opportunities for direct lenders?

Direct lenders that have structured their capital base, first and foremost, to minimise the risk of forced asset sales and secondly, to ensure their ability to deploy capital in volatile markets, can view the current market as one that provides as much or even more opportunity relative to the challenge.

Of note, terms historically have shown a tendency to move in favour of lenders during periods of market volatility, and we are certainly seeing better terms today relative to six months or a year ago.

In addition, the universe of potential borrowers can expand during challenged markets for lenders with broad origination capabilities. For example, many high-quality and fast-growing tech companies that previously preferred higher valuation equity fundraises are now open to less dilutive capital solutions such as traditional credit and structured equity. Similarly, we are seeing the opportunity to finance larger companies that a year ago would have been financed in the BSL or high-yield markets, including take-private transactions.

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For private credit funds or alternative lenders with the flexibility to invest a portion of their capital into the leveraged loan secondary market, there are additional, attractive investment opportunities to invest in high-performing, scaled companies, given the recent market sell-off. That said, we will never abandon our core focus on private, directly originated corporate credit, even as we opportunistically participate in the secondary market during periods of dislocation.

Clearly, any private lender seeking to take advantage of market dislocations must have sufficient capital and liquidity available in the first instance. Private lenders that have not thoughtfully structured the right-hand side of their balance sheet will likely find themselves playing defence rather than offense in today's market.

Q How have direct lenders performed in prior periods of market volatility?

Generally, private credit has performed

well throughout market cycles.

It is important to distinguish between periods of broader market volatility where relative underperformance may be driven by fair value adjustments, which can be transitory, and instances where a private lender has suffered unrecoverable credit impairments, which can result in permanent losses.

Direct lenders are required to mark their books to market, though historically, the volatility exhibited by private credit generally has been less than the volatility observed in tradeable credit. That said, any markdown at the asset level will have a more pronounced impact on returns for funds that utilise portfolio leverage.

To the extent that private credit price adjustments largely reflect price dislocations in the tradable market, direct lenders are generally well-positioned as they can patiently manage their loan exposures over the long-term, provided their capital base is structured appropriately.

Therefore, a buy-and-hold private lender that is not required to liquidate its positions to meet internal liquidity needs can ultimately expect to fully recover any marks in a subsequent period, provided there is no credit mistake. In other words, the underlying loan is money-good. Volatility of marks in these instances is really just noise.

With regards to the risk of credit impairments, investors must assess and rely upon the capabilities of the manager, specifically its origination breadth and depth, investment philosophy, asset selection model, as well as its ability to actively manage its portfolio in the ordinary course and in the case of a restructuring. Ultimately, managers that exhibit strong capabilities across these areas are well positioned to generate lower losses and consequently, stronger risk-adjusted returns across cycles.

Again, I'll point to the importance of that right-hand side of the balance sheet and having diversified sources of portfolio financing and investor equity that is committed and long-term in

Q What are the key pieces a manager needs to have in place to navigate volatility?

We always say the easiest way to make money in this business is to not lose it in the first instance. So, the first line of defence is to focus on businesses with strong credit profiles and the wherewithal to withstand challenging economic periods. A discerning asset selection process that prioritises borrowers exhibiting certain key credit attributes has led AB-PCI to invest more significantly in certain sectors.

For example, we prefer to invest in companies with highly visible recurring revenue streams, which has led us to building significant expertise and a sizeable portfolio in software and digital infrastructure and related services. On the other hand, we typically do not lend to borrowers in discretionary or cyclical parts of the economy.

It is also important for the asset manager to have experience with prior cycles. That muscle memory provides a foundation of understanding with which to work with sponsors in challenging situations and, if necessary, to successfully restructure an investment.

For us, select members of our leadership team have worked together since 2004, and we invested actively through the great financial crisis and the various periods of market stress that have followed. That experience as well as the overall cohesiveness of the team is critical, in my opinion.

Finally, you need the ability to take a long-term approach during restructurings to maximise value for investors – which brings us back to the importance of a thoughtfully-designed right side of the balance sheet.

nature. Furthermore, it is important that the availability of portfolio financing is not subject to market fluctuations or deal-by-deal approvals from financing providers. I would also be concerned, in this market, about any portfolio financing that enables the lender to revise advance rates based on the performance of an individual asset.

AB-PCI prefers to finance our portfolios using structured finance technology, which is not subject to mark-to-market adjustments and is committed for five years or more. We believe this approach ensures we will never be a forced seller into a bad market. Moreover, we expect to capitalise on volatile environments by being a liquidity provider during periods of market dislocation.

To summarise, having sufficient capital and liquidity is a key determinant of a direct lender's ability to take a long-term position and manage the business to minimise credit losses while also executing yield-enhancing investments when others may be side-lined.

Q Given the importance of the team's experience and cohesiveness, particularly during challenging market conditions, what steps can direct lenders take to retain talent in such a competitive hiring environment?

One of the things that we are most proud of at AB-PCI is the team we have built, the quality of the individuals, their capabilities, our culture and the way we all work together. We remain focused on hiring and retaining the right talent in all markets. Specifically, we recruit team members that are highly capable, share our core values and believe in our culture.

Attracting and cultivating new and diverse talent into our business is a priority, and we believe training and mentorship are key components of developing younger professionals.

Ultimately, we maintain the belief that our people are our most important asset, and the quality of our team directly contributes to our effectiveness as stewards of capital. This is a virtuous cycle as a talented and cohesive team leads to further platform growth, which in turn provides attractive professional growth opportunities for our colleagues.

"The market is active, albeit in a different manner"

Workplace flexibility is another aspect that is critical today. We seek to strike the right balance for our team, providing flexibility to work from home a couple of days per week, while encouraging in-office attendance the other days to foster relationship building, collaborative learning and a strong culture.

We also think our location in Austin, Texas, contributes to our recruiting and retention as people seek fulfilling work outside of the large coastal cities. Austin offers a great quality of life, lower cost of living and no state income taxes, which is compelling for many on our team.

Lastly, there is compensation. We have endeavoured to build a business that is resilient throughout cycles, as exhibited by a visible and growing revenue stream. To the extent we excel at minimising credit losses, we believe this will continue to be the case. In turn, this enables us to pay our team competitively without subjecting them to wide swings in annual compensation.

So, we see talent recruiting, development and retention as directly related to our performance for our investors. We have very strong retention in our business and that cohesiveness gives us a real competitive edge.

Q How are borrower demands evolving and where do you currently see the most activity?

Transaction volumes have softened relative to the second half of 2021, but we are still very active and our year-to-date deployment exceeds the prior year. Regarding the slowdown from H2 2021, consider the software sector. Owners of private software companies remain anchored to higher valuations prevalent in the space just a few months ago. By contrast, buyers of software businesses are focused on transacting at today's lower valuations as reflected in the public markets. That bid-ask spread has impacted the volume of deal-making. Ultimately, we expect the valuation gap to narrow, thereby contributing to a recovery in deal volume.

Sticking with the software sector for a moment, the overall slowdown in dealmaking has been somewhat offset with an increase in the number of take-private transactions. Opportunities to acquire strong companies at levels representing significant discounts to valuations from six months ago are providing a foundation of activity for sponsors targeting the sector.

Further on the software sector, we see an increasing trend of later-stage growth companies tapping traditional credit or structured equity solutions as a source of funding. Many of these companies historically have raised repeated rounds of common equity at higher-and-higher valuations.

Due to the downward move in valuations, growth companies are reticent to raise subsequent equity in the current market given the potential risk of a down-round and the resulting dilution to existing shareholders. This provides opportunity for firms such as AB-PCI, which can provide flexible, less dilutive funding in the form of recurring revenue loans and/or structured equity solutions.

The market is active, albeit in a different manner, and we remain a provider of financing solutions, although the current market is one that merits the highest selectivity. ■