Murray Devine: Debt market evolution supports soft landing should volatility move to the private markets

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"Without tradition, art is a flock of sheep without a shepherd. Without innovation, it is a corpse." Winston Churchill, in a 1953 speech for the Royal Academy of Arts, was trying to convey the importance of heeding lessons from the past, while taking new approaches to flourish in a dynamic and evolving future. Of course, he was speaking to the historical development of art, but his words are just as appropriate to describe the ongoing maturation of the debt markets. And his larger point seems particularly relevant today as the credit cycle appears to be entering its later innings and as PE firms begin to consider the impact when the market transitions from one cycle to the next.

To be sure, based on recent metrics, the current credit cycle remains very much intact. While the total investment-grade and high-yield corporate bond issuance, at approximately $380 billion as of the end of March, was down compared to last year, it remains on pace to reach the elevated levels that have held constant since the recovery took hold around 2012. Meanwhile, the record amount of private debt raised last year, reaching $118.7 billion, according to PitchBook, speaks to the growth and presence of non-bank lenders.

While the current flow of capital tells one story, it overshadows many of the ways the market has changed over the past decade. A closer look, for instance, reveals that the largest lenders have far healthier balance sheets than 10 years ago, and PE firms, themselves have been structuring deals more conservatively providing bigger equity cushions even as valuations ascend to new heights. But these factors alone don't necessarily reflect why lenders and borrowers active today believe the end of the current cycle, whenever it comes, could be more muted than the last downturn.

Across the investment landscape, there seems to be general agreement that after nine years of uninterrupted growth, a pause could be forthcoming. JPMorgan, among those predicting turbulence, has quantified an 18% possibility that a recession could arise over the next 12 months, a 52% chance it could occur within a span of two years and a 72% likelihood that a recession begins sometime before 2021. The mounting uncertainty, even against a backdrop of rapid GDP expansion, robust consumer spending and soaring earnings growth, has led to renewed volatility in the public markets. Geopolitical wrangling—from the prospects of a trade war to populist movements in the U.S. and abroad—has certainly contributed.

The relative serenity of the private markets, however, is reflected in a steady level of activity as well as 1Q marks on existing investments that speak to impressive company fundamentals that are generally tracking in a positive direction. While some of the higher-profile bankruptcies in the first quarter received attention, these situations largely reflected sins of past eras—highly leveraged buyouts (from 2005 to 2008) in "buggy-whip" sectors (retail and media).

More recent activity, though, seems to demonstrate that an enduring institutional memory has shaped lenders' appreciation and approach to risk. Last year, for instance, the median percentage of debt in 2017 buyouts stood at slightly more than 53% of the total capital structure, according to PitchBook. This contrasts sharply with LBOs from 2008, when leverage comprised 60% of the median deal value.

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The terms have also evolved to reflect lessons learned. When covenant lite loans ("cov-lite") first grew in popularity ahead of the global financial crisis, many pointed to the borrower-friendly terms as a sign of a lax underwriter. In hindsight, we can now recognize that the flexibility afforded to borrowers through cov-lite structures helped these companies push through short-term volatility. And the numbers prove out that these loans produced fewer defaults on a percentage basis than debt with traditional maintenance covenants, according to S&P's LCD. As of February 2018, LCD tallied that cov-lite issuance exceeded 75% of all outstanding leveraged loans, up approximately 500 basis points versus this time last year.

Meanwhile, lenders today have also benefited from evolving business trends that may be hard to recognize when simply comparing high-level metrics around total issuance or leverage ratios. For instance, the share of buyouts in the technology and IT sector has grown considerably, jumping from 6% of total PE volume to 18% over the past 10 years, according to PitchBook data. This contributed to the record PE valuations recorded in 2017, a point we highlighted in Murray Devine's 2018 Valuation Report. But beyond the growing appetite for tech among sponsors, lenders' ability to underwrite these transactions was facilitated by the industry's transition from selling shrink-wrapped software on an a la carte, license-revenue basis—released every few years—to adopting software-as-a-service (SaaS) models with recurring revenues and far more visibility around longer-term cash flows.

The groundswell of interest in private market funds, particularly private debt, also speaks to the creativity of market participants. Institutional investors, naturally, are drawn to the advertised returns, typically in the high-single digits for traditional or levered private debt funds, mid-teens for mezzanine, and 20% or higher for distressed funds. And the expected cash yields can help eliminate the J-curve often associated with alternative asset allocations. But from the larger market's perspective, this massive flood of capital is helping fund credit strategies for nearly every corner of the market, from small-market deals to distressed investments to capital earmarked specifically for fundless sponsors. The fundraising activity in the distressed space, notably, underscores that capital will remain available as the backdrop changes. *Private Debt Investor*, for instance, noted that in 2017 the total volume of capital raised for special situations funds actually exceeded all other credit strategies, including senior-debt, mezzanine and CLO funds.

The ongoing evolution doesn't necessarily stop with the direct lenders either, as regulators have also modified their approach. The leveraged lending guidelines provided direction to restrict leveraged loan financings to 6x debt-to-EBITDA, although regulators have stopped short of mandating such a restriction. This ultimately puts the onus on market participants to manage these risks. Recent lawmaking efforts also seem to advocate for a "carrot-and-stick" approach. December's tax reform bill limits the deductibility of interest payments on corporate debt—curbing—but in the recently passed $1.3 trillion spending bill, signed in March, legislators doubled the borrowing cap placed on business development companies (BDCs), allowing for a 2-to-1 debt-to-equity ratio.

It's impossible to predict when the next downturn will take hold or the depth of any ensuing slump in the debt markets. But the industry's lessons from the past, coupled with its maturation over the past decade, should provide some cushion as it relates to liquidity in most scenarios. As valuations in PE are generally at the mercy of available debt, we do believe the industry's evolution will support a softer landing than what deal pros may remember from the 2008-2009 timeframe.

The industry's evolution will support a softer landing than what deal pros may remember from 2008-2009

It could even be argued that a little uncertainty could go a long way for value hunters who have eliminated multiple expansion from their investment calculus. And this would be a welcome sign for investors who have been sitting on their hands until valuations decline from their historic highs.

Don't miss Mark Emrich at the 4th Annual LPGP Connect Private Debt Conference in NY on May 22nd, where he's moderating a panel entitled, "Where are We in the Credit Cycle?