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Public vs. Private Credit: How We Assess Both Opportunities

Rob Costello
Hi and welcome to another episode of Away from the Noise. The one big investment management's podcast on key investment topics, economics and market developments of the day. I'm Rob Costello, client portfolio manager for Global Fixed Income. Today, the topic is credit markets, specifically a discussion about private credit versus public credit Joining me is Ali Hassan, fixed income portfolio manager and managing director.

Ali has been with the global fixed income team here at Thornburg for the past nine years. Ali has spent much of his career focused on distressed debt and turnaround private equity areas. He is a graduate of Stanford University with a double major in economics and mathematical and computational science. Ali, thank you for joining us today.

Ali Hassan
Thanks for having me.

Rob Costello
So, let's start with the basics, which I suppose is a relative term as the word basic and private credit probably don't go together. But for the benefit of listeners, what is private credit? Is there a hard boundary that exists between the more, quote unquote familiar areas of fixed income, you know, syndicated deals like high yield, AIG and the sovereign space? And you know what private credit is?

Ali Hassan
You know, let's take that in turn. I think the first thing you know, what is private credit is basically it become a catchall term, maybe even a marketing term for a lot of different things. Private credit is most closely related to broadly syndicated loan market. And the main distinctions there versus the broadly syndicated loan market are maybe four different layers.

One is that the deals are directly negotiated between the borrower and the non-bank lender. The second thing is that the deals are typically very compact. They're small club deals. Perhaps you only even have just one single sole lender. And that also means that the loans are not traded. The third point would be that, you know, if you look at the skew of the deals, the deals are primarily coming from financial sponsors and from middle market companies that are private.

So that's the skew of the deal flow. And if you look at the vehicles that hold these types of deals, they're typically locked up funding structure. So, these are interval funds with long term capital or even permanent capital. And that's because the underlying assets are fairly illiquid. So, you need that long lock up to hold these assets Now, is there a very hard boundary between private credit and, say, the broadly syndicated loan market?

I would argue that it isn't such a strong boundary or very hard boundary. So, number one, the structure is very similar. So, you're getting typically floating rate loan structure with maintenance covenants in current covenants and so on, security package and so on. The analysis is also similar. So, the credit underwriting process is very similar You're typically investing in junk credits.

And so, there are some strategies that are investment grade, but this is primarily for kind of high yield or leverage loan type of credit profiles. The third point is that, you know, markets are fungible, you know, so private credit is competing with public credit markets when they're competing for borrowers. So, you know, smart borrowers are making it relative value assessment across sectors, across the syndicated bank loan market, a high yield convertible bond market and even structured products with seen with whole business securitization.

And so you'd think also that smart creditors should take a wide angle view and do the same. They should be looking at where they can get the best value for their money across these sectors that are pretty fungible between them. The last point is, you know, many in the private credit space argue that barriers are very high to entry.

And that's why there's something interesting that they're capturing in the private equity, private credit markets. And, you know, one could argue that the analogy with private equity being distinct from public equity doesn't match for private credit. You know, with private equity What drives value is that private equity firms are pulling on three different levers. They're doing stock selection.

They're also doing deal making. And they're also trying to sweat the assets, basically operating the assets more efficiently and with better strategy. Now, with private credit versus, say, a public credit analyst, they're doing pretty much the same analysis. You know, both are looking at deals, evaluating the deal structures, making the deals. They're also looking at the credits themselves and being good credit selectors.

The main difference is with respect to the origination and the fact that the deals are originated directly and the negotiation is done directly without a middleman. And the barriers to calling on financial sponsors aren't too great. I would say the main differentiator is with private credit firms that are able to reach into their origination Rolodex and reach into non sponsored deals.

And that could be a differentiator there. But I would say that the barriers between public equity and private equity are much higher than the lower about barrier distinction that you should see between private credit and public credit.

Rob Costello
Ali, now that we're properly schooled in private credit, let's transition to its application in today's market. And this is clearly been a very interesting time in markets, which I guess for most folks, maybe not interesting given that every asset class is pretty much down this year. But are there

aspects of today's macro picture, meaning the massive Fed tightening, the recession fears, the persistent inflation that you think affects or should affect private credit any differently than public credit?

Ali Hassan
I'd say there's two broad elements. So, one to consider is the risk profile of the credits, especially since we're going potentially into a recession or a cyclical downturn. And number two is thinking about the liquidity and the transparency into the positions themselves. Especially considering the volatility and the volatile environment that we're in. So on the first count, with respect to the credit profile, the main drivers are very similar between private credit and public credit.

I would expect that the average private credit deal is going to be riskier than the average public credit deal. And that's because typically you're funding LBO transactions in the private credit market. Those have higher leverage, more aggressive financial sponsors. You're also looking at typically smaller companies middle market companies and lower middle market companies. The transactions are going to be more complex.

There's going to be some operational restructuring involved, maybe a carve out transaction, M&A dispositions happening during the life of the deal. A lot of the private credit deals that are being placed are subordinated positions. So, they're not first lean but rather second lien and subordinated or holdco positions. And lastly, because interest rates are floating, an interest rate curve has been going up that might also put pressure in terms of the credit worthiness of those transactions where there's more of a floating rate component to the interest that the firms are trying to cover with free cash flow.

The other element, as I mentioned earlier, is volatility, liquidity and transparency. We're moving into a very volatile market and one of the big differences between private credit and public credit is the liquidity in private credit. These are very small club deals. So those deals, you can't really trade in and out of them. The information that's available is very limited.

So even if you wanted to trade out of them, it would require some education in the market to get to develop a bid or a buyer on the other end if you wanted to get out of a position. When we look at the kind of volatility that we've seen in the past decade in 2016, 18, 2020, we've had very short, sharp dips, dislocations essentially.

And that's been an opportunity to add value if your portfolio is not frozen. And the problem with private credit portfolios is that those portfolios are illiquid. You're not able to rotate those portfolios into new opportunities that may be providing exceptional value during times of volatility, in times of dislocation and credit markets. The second thing is that the vehicles that private equity allocators into private equity are allocating into have long lockups and so you're not able to reposition your portfolio in order to take advantage of opportunities, you're going to be stuck and locked into those private credit deals.

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The second element, other than just liquidity, is transparency. And I would think as an allocator, you want to understand the risk profile of your portfolio, especially as time progresses and you're thinking about repositioning your portfolio. And the problem with private credit is the marks are a little bit infrequent. Transparency into the performance of those underlying credits isn't available because oftentimes those credits are not being followed by S&P, Moody's or by the market in general.

And so, you don't have a good grip on exactly what the credit profile might be of that private credit portfolio. And that's going to make it difficult potentially for you as an allocator to think about where your risks are. And if you're taking too much or too little risk when you're trying to reposition your portfolio, should the market move.

So again, just to crystallize a reiterate the point you know, the option value from having liquidity and transparency increases with volatility.

Rob Costello
So, Ali, let's stick with the point you made about liquidity. Because we hear in the news that private credit is holding up better than public credit this year, which is peculiar to me because at the end of the day, I see public credit and private credit as a similar fundamental bet. I mean that of the corporate balance sheet or more broadly speaking, the credit risk premium.

Am I correct on that front? Into the liquidity point is the reason private credit is holding up relatively better is simply because these underlying investments are being mark to market less frequently.

Ali Hassan
So let let's take a break that up into a couple of components. But the answers are yes and no. So, on the first count, I would say no public and private credit are not exactly the same. But it is true that private credit typically has floating nature of their loan portfolios and that's definitely cushioning some of the blow from inflation and the yield curve move.

So that's a positive for private credit. But this is not necessarily very different from the broadly syndicated loan market. It's different from the high yield bond market, which is typically fixed rates. So yes and no on that count, and I'd say also, yes, the volatility in private credit is understated and potentially misleading if you're using price volatility as an indicator of what risk you're taking.

So, the fact that the mark to market is infrequent, if at all happening, is actually disguising potential risk, risk of impairment and also disguising volatility relative to, say, the high yield bond market. You know, as we mentioned previously, you'd expect that the credit beta is much higher in private credit. And that's because the underlying deal flow skews to private equity deals, more leverage deals, companies that are in transition.

You know, again, you've got the pressure of floating interest rate, meaning that free cash flow coverage is much tighter in these private credit deals. And so, you'd think the risk of impairment is much higher going into a recession in these private credit deals. But it is hard to generalize. Again, there are some private credit strategies that focus on higher quality and investment grade.

There is some opacity in terms of deal terms and performance. So, it's only a guess rather than, you know, something that we that we know it's hard to generalize because there are wide variety of strategies against some looking at subordinated debt versus senior secured debt. There are a variety of fund structures. So, some that are very levered and use leverage to juice returns and that's an added element.

And then lastly, there's a wide variety in the quality of the origination platforms and underwriting capabilities of different players in the private credit market. And so, I would expect a wide dispersion in terms of outcomes.

Rob Costello
What metrics should investors look at, or at least you would look at, Ali, when comparing relative value between private credit and public credit?

Ali Hassan
When I look at private credit players in general and you can also you could many of those players are, for example, guys that are playing in the BDC space, for example, our business development companies or, you know, other specialty finance companies, you know, I look at, you know, what is the track record and we're looking at performance versus risk, the ability to pay out income and also preserve any view over time.

We're looking at the book quality, the underwriting quality, and that's tested through the track record. The second element that I would look at is the sustainability of that potential alpha that's being generated. And there you're really asking questions about the differentiation with respect to origination. So you want to ask questions related to, you know, what percentage of the deals are coming from non-sponsored deal flow?

How long has have you had those relationships? How long have you been lending into these same companies? Are you the sole lender or are you the agent? Are you the anchor investor in these loan deals or are you taking a back seat and actually getting deal flow from other players? And basically, you don't really own the relationships into those deals?

I think those are aspects of the origination platform that would help you to understand whether there's something special going on. And then lastly, you want to understand the structure. What are the terms with respect to liquidity? What are investor rights information rights that you have, and what does the funding profile look like if there is leverage being employed?

So, I'd say that's how I would think about investing in private credit.

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Rob Costello
So early in this discussion, we've learned a lot about the private credit market. We've talked about its application, today's environment, relative value considerations. So, I guess I'll put you on the spot a little bit, but in your judgment, do you see an added or I should say a better value in investing in multi-sector public credit versus a private credit strategy?

Ali Hassan
I think there's merits to both sides. I think the flexibility in the multisector approach is more attractive, but there are merits to both sides. You know, when you think about private credit, what are they actually capturing? What's the advantage there? They're basically removing the middlemen. They're providing value to borrowers by providing certainty of close, especially in these private equity transactions.

They're providing speed to close as well in some urgent situations. They're also providing some creativity and structuring and perhaps the ability to stretch in certain terms. As we know, many banks are capped in terms of what kind of deals they're able to take on balance sheet and commit to in terms of leverage, in terms of the types of transactions and the riskiness of the transaction.

And so private credit is providing value there. They're also able to capture an illiquidity premium, too, and that might be a good fit, especially for long horizon investors that can lock up capital. And we'll have to see how that plays out. And so but there are good reasons to think that you are getting paid to take the risk you're taking in private credit.

What you do miss out again on is the option value that's available to you by having liquidity and by having transparency. And again, you know, private credit locks up the assets in a deep freeze. And private credit is very much focused on the premium market, and it misses vast opportunities to add value in the secondary markets. And as I mentioned before, volatility, you know, we think that there's going to be volatility ahead, and that's an opportunity for skilled players that are able to deploy capital into secondary markets.

Frozen portfolios are unable to reallocate to take advantage of these opportunities. Secondly, because they're facing the primary market as markets cool down, as valuations cool down, you might see a slowdown in terms of LBO deal flow and that restricts the opportunity the channel for private credit to really deploy capital. And then lastly, when you think about primary market transactions in private credit, there's really poor convexity there.

It's very much an income product. Remember that private credit transactions are primary loans. They have weak prepayment penalties in good times when credit spreads are tightening, these deals, they may be proprietary, but they get called as financial sponsors are very savvy in playing the markets and are looking to refinance into less expensive debt financing. And in bad times, you know, these loans not only experienced credit spread, or credit spread widening, but also LIBOR tends to go down.

And so, you get a double hit one from the coupon going down, but also from credit spreads declining. The last piece of caution I'd have is with respect to flows. And I kind of see flows as being a very strong contra indicator, contra indicator of where value is in a market. You know, we've seen inflows into private credit that have outpaced flows into comparable markets like in the broadly syndicated loan market and also high yield markets.

There's a huge amount of under-employed capital that is sitting on the sidelines still yet to be deployed in private credit situations. And there is huge pressure on these private credit managers to put that money to work. And this has negative consequences. Firstly, private equity sponsors are smart. They will look for the cheapest cost of funding and they understand that private credit investors have raised these huge funds and have huge pressure to deploy capital.

So, the bargaining power may be on the side of these private equity sponsors over private credit funds that don't have the flexibility to deploy capital in secondary markets and don't have the flexibility of deploying capital outside of private credit. The strong inflows have also come with, as you would expect, weakening underwriting and a worry about weakening underwriting standards.

So, in the past, they may have done a good job in terms of underwriting credit well and providing good risk reward. But as we move forward with this huge overhang, they may be tempted to take a worse pricing terms and worse covenant terms. We've seen that where there have been big flows into new markets like whole, whole business securitizations and also frontier markets.

And why wouldn't we expect the same here with private credit? Lastly, there are somewhat conflict of interests in in a sense with respect to private credit. You know, the deal flow is primarily coming from financial sponsors and private credit investors. That want to be in the game in the long run, need to treat their financial sponsors from whom they're getting deal flow perhaps with kid gloves.

So when deals are going bad, they're going to maybe over a compromise in order to make sure they continue to get the deal flow that's going to allow them to deploy all these on deployed capital in these funds. And so I worry about potentially these private credit managers being too lenient in terms of enforcing investor rights in view of better currying favor with these private equity sponsors in the race to keep that deal flow and origination flow coming.

Rob Costello

Thanks, Ali, for your expertise is your perspective. And I want to thank you all for listening today. You can find this and other episodes of Away from the Noise at Thornburg dot com slash insights as well as on Apple Podcasts, Spotify or wherever you prefer to listen to podcasts. Please rate subscribe and review us. Thank you all again and have a great day.

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