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Private Markets Forum 2023

Navigating new market realities

Insights from CRISIL GR&RS's closed-group discussion

July 2023

CRISIL GR&RS hosted its first Private Markets Forum in New York on June 27, 2023, where experts discussed and deliberated on various aspects of the private credit and private equity asset classes.

Panelists:

Hilary Lindemann
Principal
Portfolio Management
General Atlantic

Carolyn Glick
Managing Director
Member of Global Credit Platform
BlackRock

Josh Lafer
Managing Director
Portfolio and Asset Management
Blackstone Credit

Moderator:

Abhik Pal
Senior Director and Global Head
ESG & Research Practice
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Insights from the discussion are summarized below:

Theme 1: Current macroeconomic forces at play and their potential impact on investors

- **Private debt is shifting towards inflation-resistant industries:** Private debt, as an asset class, is expected to continue to grow in the short term. But there are also challenges to navigate, largely stemming from an uncertain macroeconomic environment. To be sure, private credit has had a good run over the years, and investors have benefitted in the longer duration. In the current environment as well, senior secured loans are a great investment opportunity as capital structures are adjusted for higher rates. Technology and product development have provided retail and institutional investors greater access to private credit as well. Also, private capital providers proved to be reliable and stable during the recent regional banking crisis at the start of the year. Hence, this could be a good value proposition for borrowers. In terms of portfolio positioning though, investors are focusing on larger companies in sectors such as technology and healthcare, which have proven to be inflation resistant.
- **Private credit filling the gap in special situations and distressed funding:** Private credit is benefiting from larger banks pulling back in the wake of the 2023 bank crisis. The market has also seen spreads widen, with higher liquidity premiums and larger deals within the private credit space. Concurrently, the importance of covenants has increased and there is sharper focus on better profiles. However, while direct lenders are stepping up on the capital stack, they are still relatively slow. There remains significant opportunity within the private space,

especially in the technology sector, where there is a mismatch between private and public valuations. Also, portfolios have remained intact as businesses, although slightly weak, continue to grow, indicating markets are being buffeted more by liquidity and capital structure issues. With limited access to public markets, borrowers are seeking extension in maturities as well as turning towards private credit, first senior secured structures and then some junior capital to fill the gap between maturities.

- **Private equity continues to focus on value creation:** Different measures are being implemented in private equity, such as extension of holding periods, as valuation gaps widen in an uncertain macroeconomic environment. The market is also seeing a rise in the number of structured secondary transactions, with a few companies even considering going public, expecting valuations to reset faster in public markets than in private ones. Sectors such as technology have chosen privatization as a suitable route as it helps with de-leveraging. There are also companies that are either overburdened by debt, face cash flow issues, have funded an unprofitable business, or have raised funding during good times, but are now running out of capital. In this milieu, private equity firms are currently consolidating their efforts on larger deals, where they can create value and drive the outcome, thereby helping bridge the valuation gap.

Theme 2: New growth avenues in private markets and increased regulatory oversight

- **Increased regulation in the private market space:** Private credit has evolved into a mainstream asset class, with higher yields, periodic returns, seniority in capital structure, and diversification driving the interest of high net worth and retail investors to the asset class. Hence, concurrently, there will be an increase in regulatory oversight and a move towards more transparency to protect the interests of investors. The primary area where private equity firms expect regulatory oversight pertains to portfolio allocation. This is to ensure all investors receive equal treatment in terms of allocation of higher-return deals, popular market deals, and safer deals across the firm's portfolios. The second area would be portfolio valuation. Currently, the industry follows multiple approaches to calculate the value of a portfolio, which kindles the need for standardization by regulators at some point, though direct lenders are already holding themselves to high standards in the areas of compliance and risk in anticipation of increased regulation. Internally, they have set up boards to keep their allocations in check.
- **Private equity firms are enhancing private credit capabilities**: Private equity firms are considering enhancing or integrating private credit capabilities in deal structuring, given the recent democratization of private markets and the growing significance of non-banking lenders. Private credit and direct lenders have spruced up deals with specific structures. There are two ways of expanding credit capabilities. First, through acquisitions. For example, a large private equity firm recently purchased a credit company, thereby adding credit as a capability. The other route would be providing flexibility via accounts receivable-based loans, and acting as a secret lender, thereby filling the gap between down round funding activities.

Theme 3: Operational and strategic challenges in portfolio and risk management

- **Focus on risk management and surveillance practices:** Private credit has clocked multi-fold growth over the past decade, and keeping up with risk management and surveillance practices is becoming the key differentiator for asset managers. Within portfolio surveillance, the ability to have an early warning system is crucial for better outcomes. Many large asset managers have dedicated risk and portfolio management teams with the senior leadership assessing the prevailing economic conditions, taking proactive approaches and engaging in quick actions. Indeed, there is a need to look over very large portfolios, have analytics and systems in place to stress-test the portfolios, and monitor several metrics.

- **Private equity firms are looking to effectively manage risks and drive valuation growth:** Historically, low-cost debt and higher corporate valuations have supported private equities in pursuing investment targets and achieving profitable exits. However, now, private equity firms, while looking for new investments, are focusing on better entry prices and risk management. For existing investments, instead of building up sales teams within their portfolio companies, private equity firms are focused on operations and reducing expenses as well as finding pockets to grow with limited costs. The private equity firms are helping the portfolio companies to grow in new markets in well-devised profitable ways to be better custodians of the cash on the balance sheet.
- **Caution while approaching certain sectors to avoid defaults and credit losses; focus shifting to companies offering wider margins:** With credit stress on the rise, private credit providers are likely to witness more defaults and credit losses over the next 12 months. Private equity firms prefer to invest in smaller companies that offer synergistic benefits with their existing portfolio companies rather than in big companies with similar offerings. Investors and lenders are also getting more creative by adding positions in companies that are already within the portfolio and performing well or in familiar companies run by management teams with a proven track record. In fact, capital deployment within the existing portfolio is expected to increase over the year, reflective of how investors and lenders think about buying right in the current market. At some of the large private credit firms, underwriting and management of the portfolio is industry specific. Some of the industries they are focused on include healthcare, trade services (such as heating, ventilation, and air conditioning), insurance, and financial services. While lenders have historically opted for companies with 6-10% EBITDA margin, the focus is now shifting to companies that offer margins >20% as that provides enough room to operate in the current challenging environment.

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