EXPERT Q&A

The testing market makes this the ideal time to assess which managers have the most resilient portfolios, says MV Credit's Frédéric Nadal

Tough conditions shine light on performance

Q What impact do higher interest rates have on lenders and borrowers right now?

We have been in an elevated interest rate environment for some time now, which provides us with the opportunity to see how companies are responding to this shift. This is much like how we observed the way in which companies reacted to the global financial crisis. After a year of high base rates, lenders can now review loans, look at company performance and consider how resilient those businesses proved to be.

Private equity and private credit managers have a unique window into how well management teams can react and adjust, and how resilient both companies and underlying markets really are. From a diligence perspective and from a credit standpoint, we are in a strong position to assess the strengths and weaknesses of these companies. The fact that the increase in interest rates happened so quickly had a big impact and was in some ways a valuable test for companies and their capital structures.

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For borrowers, it is not always comfortable, and some companies have struggled since the start of last year. That said, for our industry, private credit markets have tended to focus on businesses with high margins and strong underlying cashflows, which have typically suffered less than others.

Q How does the higher-for-longer outlook on rates impact behaviours?

We are not expecting to see any more increases in interest rates in the short to medium term, but at the same time, it looks unlikely that rates will come down significantly any time soon. More dovish policy is beginning to show: Sweden's central bank cut its key interest rate on 8 May and indicated that it was likely to cut it again in the second half of the year as inflation pressures remain mild, but we will see whether the European Central Bank takes the same view.

Capital structures for us have been built on the basis that current rates will remain where they are for the short to medium term. We are not playing with interest rates and if they come down,

> *"The most important thing is downside protection, for which depth of experience is critical"*

that is a plus; if not, there is no impact to what we are doing. The cash coverage ratio, which for us is the most important metric we can use when assessing the stability of a capital structure, has been high enough and strong enough across our portfolio for us to cope with this type of environment for a while.

The second part of this story is that the people who are most sensitive to interest rates are the financial sponsors, because it has an impact on valuations and on growth expectations of their investments. Our job is to have headroom when we look at capital structures and decide whether or not to lend.

For sponsors, the impact is felt more directly, most notably in the M&A markets. It is clear that higher for longer interest rates are not ideal and a cut to rates will create more M&A dealflow by lowering the costs of borrowing. For companies that are struggling, a delay to interest rate cuts is going to delay any potential recovery and push back that rebound in healthy M&A markets.

Q What should LPs look for in private credit managers if they want to outperform market expectations?

If I was an investor, I would always start by looking at the track record of a manager. We have seen a dramatic increase in the scale of the direct lending market since 2010 and there are many newcomers without any experience of severe downturns. The most important thing is downside protection, for which depth of experience is critical.

The other important element for credit managers is discipline. LPs need to assess their portfolios to see to what extent there has been a deterioration in credits over the past year. Today is a good time to be an investor because you can see in detail how portfolios are performing and how resilient investments have proved to be when tested.

Still, liquidity is tight for LPs because they have not received dividends from their private equity investments, which is hampering their ability to deploy more capital into the asset class.

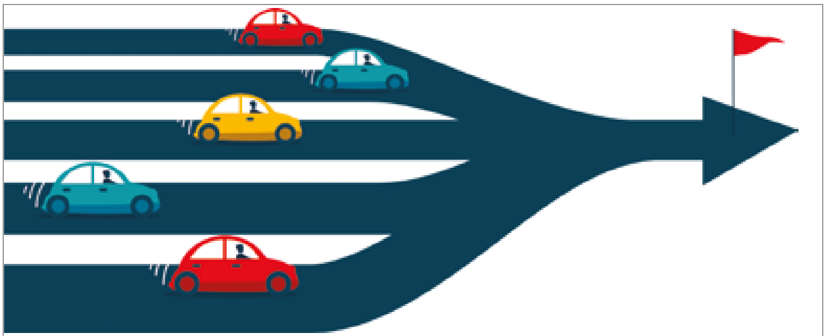
Q What do you expect the outlook for private credit markets to look like through 2024 and beyond?

The big theme for the next 18 months is going to be liquidity. Everyone wants liquidity and we need to recreate M&A activity in order to get the money travelling back to investors so that they can start redeploying.

Investors are pushing managers to create liquidity by selling companies, even if that means making sacrifices on enterprise value. We expect that will be the story for the rest of 2024, as more private equity managers feel pressure to sell assets at sub-optimal enterprise values just to create that liquidity.

For us, that means we expect a significant increase in primary activity, which has been pretty quiet until now. We expect that will continue over the coming year, and we are already starting to see sponsors preparing sales. We also expect amend and extends to continue until at least the end of the year, irrespective of the interest rate environment.

How rapidly the M&A markets recover remains to be seen. If people start to feel more comfortable with the geopolitical situation, the European Central Bank decreases interest rates and it declares that inflation is under control, then we will see much higher levels of primary activity. Until then, we expect the market to remain cautious. ■



Q What are the current drivers of ongoing growing demand for private credit?

The majority of activity over the last 18 months has come from existing portfolio companies. M&A has been quiet, and we haven't seen any signs of recovery there yet, which reflects the market as a whole. Fortunately, at MV Credit we benefit from having many companies across our various portfolios that create origination opportunities on several levels.

We are seeing a lot of demand from companies looking to push out maturities, considering the environment we are in. There are also some portfolio acquisitions creating demand for subordinated debt financing. However, we really see two drivers of demand, one being the need for liquidity solutions, and the other being amend and extends.

Frédéric Nadal is managing partner, CEO and co-founder of MV Credit Partners