Pensions&Investments

Click here to see the story as it originally appeared on P&I

INDUSTRY VOICES

Commentary: Catch your drift — how to stay in your private credit investment lane

Symon Drake-Brockman is Managing Partner of Pemberton, a London-based private credit asset manager.

By Symon Drake-Brockman

December 17, 2021

Symon Drake-Brockman

With assets under management in private credit strategies surpassing $1 trillion globally in 2020 according to Preqin, institutional investors are increasingly wondering whether surging inflows might raise the likelihood of style drift creeping into the sector.

Long a hidden danger in public equity and fixed-income strategies, style drift occurs when a manager puts money to work in assets with materially different risk-return attributes to those they were mandated to invest in.

Higher risk, lower returns

One reason why style drift is an issue in public bond markets is that it is becoming harder to generate the 5% to 7% return institutional investors typically target from their fixed-income portfolios. As a result, demand is growing for riskier issuance, with average yields for CCC bonds dropping to just 5.66% in early May, a record for the junkiest of junk paper.

For example, just three months after emerging from Chapter 11 bankruptcy protection in early January, Chuck E. Cheese owner CEC Entertainment Inc. issued U.S. $650 million of bonds that Moody's rated Caa1, its riskiest tier. Yet demand was so strong that the company borrowed more and cut the interest payment to 6.75%.

According to S&P, the global corporate annual default rate in 2020 for issuers rated CCC, CC, and C was almost 50%, compared with about 1% for BB companies, which begs the question: Are investors being adequately compensated for all this extra risk they are taking?

Against this backdrop, it isn't surprising that allocators are becoming more jittery at the thought of portfolio managers reaching out to the furthest extremes of the credit spectrum to find the yield they need to meet long-term obligations.

Negotiating control

Yield compression is already evident in U.S. private credit markets, where competition between 200 or so managers is putting downward pressure on returns.

Pensions&Investments

Commentary: Catch your drift — how to stay in your private credit investment lane (Contd.)

However, there are significantly fewer managers in Europe, where the top 10 account for approximately 60% of mid-market direct lending, so that the biggest providers tend to be the sole participant in a transaction. That gives them more control over negotiations with borrowers and private equity sponsors, which limits the extent of yield compression. It also allows them to resist pressure from borrowers to ease off on protections such as covenants and documentation that help to keep strategies within their risk-return profiles.

Strong pipeline

Deployment pressure can be another major catalyst for style drift, and a key way to mitigate it is by having a sizable origination pipeline. A large team with broad expertise allows the manager to select from a higher number of deal-introductions. Managers that are not under pressure to deploy capital can focus on opportunities that fit optimal investment criteria while avoiding situations that don't fit their capabilities or risk appetite.

Managers that are better placed to resist feeling pressured into doing unsuitable deals solely to keep a private equity sponsor onside can focus on backing viable, growing businesses in robust sectors of the economy, and to ensure that their investments give them capital structure seniority and adequate controls and protections.

Range of options

By providing a broader range of strategies, managers can offer a further layer of protection against style drift over those with more limited investment options. Offering distinct pools of capital, each with differentiated risk-return profiles, creates more origination options, provides consistency in metrics such as average leverage and arrangement fees and provides institutional investors the latitude to choose mandates that serve their targets and risk tolerances.

And a final key point to remember is that, should a large-cap U.S. growth equity portfolio manager drift into emerging markets, mid-cap or value, it is pretty straightforward for a client to pull funds, which isn't the case in illiquid private credit funds, where capital is typically committed for a longer period.

A checklist for private credit providers could therefore comprise:

1. Invest in companies in growing sectors and regions with modest leverage.

2. Ensure deals have appropriate capital structure and managers have strict underwriting discipline and clear investment parameters.

3. Build a strong origination platform, allowing for a high degree of selectivity.

4. Provide a range of strategies that match investment targets with risk tolerances.

Symon Drake-Brockman is co-founder and managing partner at European private credit manager Pemberton Asset Management, based in London. This content represents the views of the author. It was submitted and edited under Pensions & Investments guidelines but is not a product of P&I's editorial team.