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Private Debt Should Soften, Not Exacerbate, the Next Downturn

The rapid growth of corporate debt in recent years has raised concerns of a bubble that could hasten and even deepen the next recession. Borrowing by companies with large amounts of outstanding debt grew 20% in 2018 to $1.1 trillion, according to the Federal Reserve's most recent Financial Stability Report. The percentage of loans going to highly leveraged borrowers now tops previous peaks of 2007 and 2014.

Notable? Yes. Cause for alarm? No—and for one key reason: Thanks to the tremendous growth of debt funds and other sources of non-bank financing since 2008, the vast majority of businesses, including many in distressed situations, are likely to have better access to capital during a downturn than they have in the past. Those funds could give them the wherewithal to not only survive but to also prosper.

Debt Funds and Access to Capital

From 2009 to 2011, when the banks and other institutions all but shuttered their lending windows, many viable companies suffered and even sank for lack of access to credit. The cascade of business failures significantly worsened the economic situation.

Today, owing to the tremendous amount of investor assets flowing into debt funds, that scenario is unlikely to be repeated. Having worked with some 150 private financing transactions ranging from $25 million to $4.5 billion in the past five years, it is apparent that the amount of credit chasing deals far exceeds demand. There are plenty of debt funds out there that are either distressed funds, special situations funds, rescue funds, or just flexible funds that can do healthy front-end deals, as well as distressed or rescue finance. There is still a lot of "dry powder" in the financial marketplace.

Why are debt fund investors so sanguine? It's partly a matter of having only limited options to earn high yields at a relatively modest risk. For the most part, managers of debt funds have gotten smarter about identifying, quantifying, and minimizing risk—or at least optimizing the risk/reward ratio of their portfolios. There's no safer place to be in a capital structure than senior secured debt. And if you're putting new money into a distressed situation, you will expect to be compensated for it handsomely.

In a hyper-competitive financial marketplace, non-bank lenders are more diverse than ever, which opens up new avenues for both borrowers and investors. Some funds gravitate to more special situation loans, while others seek out distressed or rescue financing deals. Some lenders are looking for a quick flip—in and out in 24 months for a modest or pretty good return. Others will hold onto it for much longer to try to hit a home run. Many private debt funds have their own banks they work with so they can lever up their deals—anywhere between one to one and two to one—which can have a dramatic impact on returns.

Keys to Success

For a fund's Manager, the key to sustainable success is less a matter of philosophy than execution. As with all investing, diversification across different regions, industries, and types of deals will mitigate the risk that one deal or event can have a major negative impact on overall returns. Let's face it: No matter how much diligence goes into researching asset targets, some investments aren't going to pan out, and it may be the one you least expect.

Therefore, it is critical to analyze every prospective deal through the lens of how it would look in a restructuring. It is also important to work with outside counsel who are cross-trained in both finance and restructuring who can think through what might happen if the deal goes sideways. That will help you document the loan in a way that preserves your lender's rights in a workout or restructuring. Focus on the terms in the document that are going to be the most critical points if there is a default and you need to work out a solution with the sponsor. The more leverage you can provide for yourself in that scenario, the better—and the healthier your fund will be.

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