

E X P E R T Q & A

*For investors mulling US private debt allocations, there are plenty of openings amid the covid-19 chaos. But investors should take a considered approach, advise Partners Group's Christopher Hardison, managing director for private debt Americas, and Anna Filipovich, senior associate*



# Play defence – but don't ignore the opportunities

## **Q** Where do the opportunities lie in US private debt?

**Christopher Hardison:** Private debt has increasingly shifted to unitranche style loans and first lien structures. As a global private markets investment manager, we like this type of loan because it represents very strong relative value for our clients. It is senior in the capital structure, almost always has a financial maintenance covenant and comes with the opportunity to increase the investment size as a company grows.

These unitranche-style financings have become very competitive compared with what a bank has to offer, and we have seen several significant

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unitranche financings recently – a trend we expect to continue. Sponsors are increasingly savvy. Many have built out in-house capital markets teams over the past few years, and these people work with direct lenders to provide financing solutions away from the syndicated or public markets.

## **Q** What are the challenges of which investors should be mindful in the current market?

**CH:** Lack of high-quality dealflow, poor underwriting standards and an

inability to successfully work through issues in the portfolio. Sponsor relationships have always been important. But, as the private debt market has become more mainstream, it has become more competitive for dealflow. At the same time, we are seeing investors becoming focused on differentiated dealflow. So, as a private debt manager, it is critical to have an investment sourcing strategy that's capable of delivering this.

We also see investors very focused on a manager's underwriting and diligence process and we expect this to become an even greater focus post covid-19. Because private debt investments tend to be illiquid and long-term hold positions, it's important that the level

and depth of underwriting reflect that. For us, this is an area where we leverage our broader platform and industry expertise from the private equity side of the house. Our industry value creation team is deeply involved in our due diligence processes, and we believe this leads to better underwriting outcomes.

Finally, the market has been anticipating a downturn for a while now and investors have become focused on a manager's ability to weather a storm. We always get the question, "talk us through an investment that didn't go as expected – what did you do and what are your restructuring capabilities?" In response to this, we've spent the past several years building out a dedicated in-house debt restructuring team.

### **Q** What's the best way to stay active during a crisis like the current pandemic?

**CH:** The first order of business is to play defence. This crisis has been different than those of the past. Certain sectors that are typically less insulated did very well, and some sectors that the market thinks were insulated were hit hard. It was impossible to predict how portfolios would be impacted ahead of the pandemic. But that doesn't mean you couldn't prepare. This is where having a strong restructuring team in place is important; it allows you to work through any issues in the portfolio.

Once you get through that, it is equally important to play offence. The new issue debt markets came to an abrupt halt. But we were able to take advantage of secondary market opportunities where we saw high-quality credits trading at distressed levels. In these instances, prices were distressed because there happened to be a distressed seller of the credit, not because of the underlying asset. We worked with our liquid loans platform to take advantage of dislocation in the broadly syndicated secondary market, on behalf of our clients.

We also maintain a list of high-conversion direct lending names. These are names that we know and like. We

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**ANNA FILIPOVICH**

saw some managers looking to sell high-quality, performing private debt investments in order to free up cash to address broader portfolio issues. These were good opportunities to pick up some of these names at below par prices.

**Anna Filipovich:** It is also very important to maintain an active dialogue with our key sponsors. They knew we were "open for business" throughout the crisis. That is particularly important now. With add-on and new issue opportunities starting to come back to market, we are top of mind because we stayed in touch with our sponsors throughout the initial period of the crisis.

In several cases, sponsors have existing portfolio companies with large syndicated capital structures in place. They may be looking for a small piece of add-on debt to finance an acquisition or growth opportunity at a company. Because of the current crisis, their preference is not to go back to syndicated capital markets. In these instances, private debt can offer a solution. For example, there are opportunities to structure an illiquid first lien tranche that sits alongside the existing capital structure, which comes with an attractive yield premium.

### **Q** What is your approach to underwriting and diligence post-covid 19?

**CH:** As a private markets manager,

Partners Group has always focused on non-cyclical industries – this is more important now than ever. In the depths of covid earlier this year, even the most stable businesses were impacted. As things opened back up, it is in these defensive industries where we have seen the most recovery. We have always been focused on company cashflow and liquidity. The crisis highlighted the importance of doing so. As the economy shut down, liquidity, in the absence of any revenues, became the lifeblood of companies.

I wouldn't say that covid has changed how we underwrite credit, but it has reinforced what we always saw as critical: non-cyclical industries, liquidity and cashflow, strong margins, top-quality sponsors and management teams and market-leading positions. We will continue to focus on these fundamentals. We see some managers shifting focus to distressed credit and we see some managers chasing yield by taking on greater risk. But we continue to find opportunity in our core strategy, given the uncertainty that still exists in the post-covid world. We can focus on high-quality credits with conservative leverage, while achieving attractive returns.

### **Q** As you communicate with LPs, what are they most interested in these days as it relates to private debt?

**AF:** We have seen increasing interest in the asset class, post covid-19. Pension plans have increased their private debt allocation for the next couple of years or introduced new allocations. There has also been growing interest in private debt from insurance companies. Senior secured opportunities are offering better downside protection, while achieving more attractive spreads, with stronger covenants and lower absolute leverage levels than before the pandemic.

There is no doubt that private debt presents a growing opportunity. We expect this to continue as the syndicated loan market and the private debt market become more intertwined. ■