EXPERT Q&A

In a dislocated market, there is a wider band of relative value and more opportunity to optimise risk-adjusted return through selectivity, says Northleaf's David Ross

Finding strong relative value in a heightened risk environment

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The market volatility during the first half of 2022 presented some challenges, but also led to opportunity. Traditional sources of capital retrench during times of dislocation while institutional private debt providers may be well-positioned to structure attractive deals. David Ross, managing director and head of private credit at Northleaf, highlights an approach to seeking relative value in a heightened risk environment.

Q How would you describe the market for private debt investing so far in 2022?

Unquestionably, the environment has been one of heightened risk. A confluence of risk factors has evolved rapidly – geopolitical risk, surging inflation, a slowdown in economic activity. But it's important to distinguish between the market sentiment and related activity in the first half of 2022 as compared to the second half of the year.

In the earlier part of 2022, the credit market was absorbing the rapidly changing macro environment and it was difficult to price risk. Not surprisingly, there was a general drop-off in new issue volume as private credit managers were more cautious. Having had time to adjust to the new risk environment, which is still elevated, new issue activity has started to come back, but with yields reflecting higher risk.

We are seeing attractive pricing and structures for high-quality credits: spreads have widened by approximately 100-200 basis points and upfront fees are 3-7 percent, which is reflective of the discounted secondary trading levels.

The liquid market for capital is still strained and banks have limited appetite for new underwriting, creating a huge opportunity for direct lenders.

Q How can managers make the most of investment

opportunities during this volatile environment?

Managers really need to be quite discerning. At Northleaf, our business model is predicated on being highly selective, and this is even more true in today's environment. We anchor on borrowers that demonstrate proven resiliency against macro shocks. We are focused on essential sectors such as healthcare, veterinary care and diversified financials, and we look to build highly diversified portfolios that are largely insulated from idiosyncratic or macro risks.

In a dislocated market, there is a wider band of relative value and more opportunity to optimise risk-adjusted return through selectivity. Well-priced and well-structured loans that would have been a portfolio fit six months ago are being passed over in favour of uniquely attractive loans with stronger risk-adjusted return. For example, we recently reviewed an opportunity to provide a senior loan to a large, stable provider of repair and maintenance services to critical warehouse infrastructure at a ~10 percent yield – that would have been great value six months ago but requires more attractive pricing in today's market.

Q What are the key risks to manage during this period?

The first risk, which we have seen before, is a compression of enterprise multiples in public markets and the related entry/exit valuation implications for private companies. We have seen a significant reset of enterprise values, which were at a historic high just months ago.

Other challenges include managing the impact of supply-chain delays, as well as wage and material cost inflation. As we manage our existing portfolio and assess new investments, we will be closely monitoring how management teams navigate an operating environment that is unprecedented relative to the past few decades. To be successful, management teams will need to execute significant price increases while managing supply-chain delays and liquidity constraints from higher material, wage and borrowing costs.

We have started to see slightly elevated levels of leverage and some margin compression in a minority of our borrowers, driven predominantly by wage or material cost inflation. Of the affected borrowers, most have put through pricing increases in Q2 and we expect to see a return to more normalised margins toward the back half of 2022.

A good example of this would be our HVAC borrowers who have been particularly effective at managing margins. Their performance through both covid and the first half of 2022 support our underwriting thesis that when these non-discretionary businesses achieve scale, they have the ability to exert both purchasing power and pricing power.

If we look at recent headlines, there is clearly a pinching of discretionary and consumer demand in the economy. We have systematically avoided sectors that have been impacted by these two factors, and thus far we have not experienced significant demand-driven softness in our portfolio.

Q Where are you currently accessing the most attractive opportunities?

We are seeing the most attractive opportunities in asset-based speciality finance investments. These are highly diversified portfolios of financial assets that have little or no correlation to the broader macro environment. This is an area that we have been investing in for many years and we have built specialised expertise within our broader private credit platform.

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We look for niche segments – litigation finance, commercial finance, healthcare receivables and music royalties – and highly diversified portfolios with consistent, stable cashflows through cycles. These are segments that, paradoxically, traditional capital providers retrench from in periods of volatility, creating more opportunity for direct lenders. Currently we are looking at several attractively priced, conservatively structured and low risk loans that would have been priced much tighter by commercial banks.

Q What are you hearing from LPs about their expectations in this environment?

Since the onset of the covid pandemic, LPs have been focused on assessing the resiliency of private credit portfolios. Although 2021 was a very strong year for most borrowers, and we continue to operate in a low default environment, the challenging environment in 2022 is leading to greater bifurcation in borrower and fund performance.

LPs have always sought managers with differentiated sourcing and asset underwriting capabilities, but in today's environment, many LPs are increasingly focused on portfolio analytics and the ability for managers to measure and manage risk in a structured way.

Ultimately, we expect 2022-23 will be a defining period for the performance of the asset class and for the performance of fund managers. We remain focused on building diversified portfolios of strong borrowers, including a balanced exposure to PE-backed corporates and asset-based speciality finance platforms. ■