

Private credit: Resilience through credit cycles

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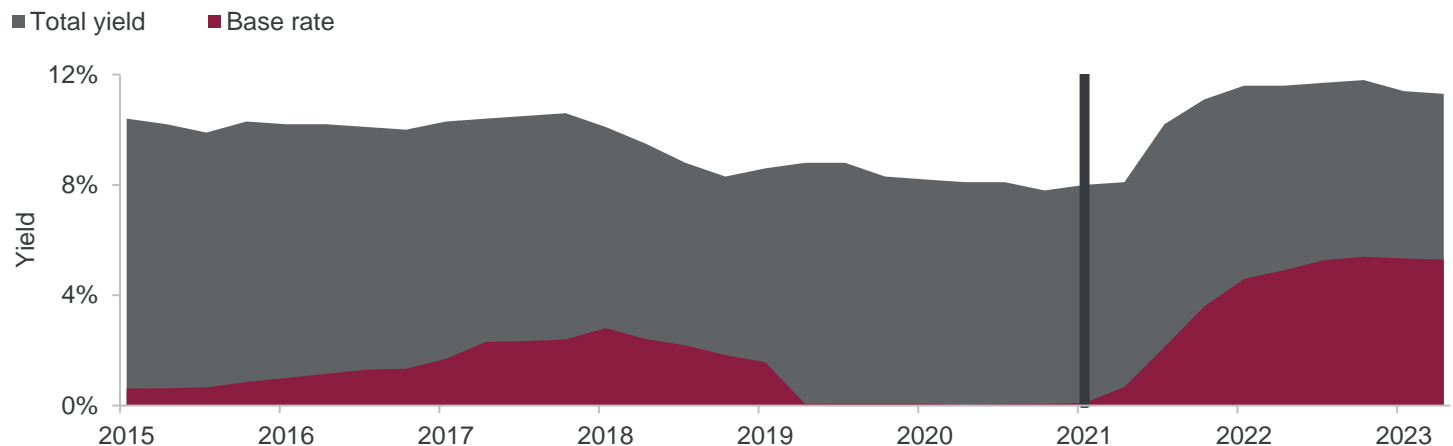
The meteoric rise of private debt as an established asset class has been almost as astounding as the robust performance realized by managers in the space. But as the credit cycle turns and monetary policy has clearly moved into a tightening phase, investors are wondering when will private credit start to reflect these issues, and what are the possible outcomes? In this piece, we explore what stresses exist for private credit funds and where we think you are best served in allocating at this point in the credit cycle.

Not impervious to the credit cycle...

We believe investors are right to question the road ahead for private credit and whether the past decade of experience will reflect what is expected going forward. The key difference between past and present is the same factors that can impact all financial markets—the highest interest rates we have seen in decades and a slowing economic backdrop. From an investor standpoint, higher rates have made private credit look more attractive from an all-in yield point of view given their majority floating rate structure. But now that we have lived through high velocity rate hikes and are contemplating the possibility that rates stay higher-for-longer, investors need to ask about the flow-through impacts to borrowers.

There are two sides to each coin—higher rates have led to higher yields captured by private credit investors, but borrowing companies have seen their financing costs increase substantially. This started in 2021 where the Secured Overnight Financing Rate (SOFR) began to rise from near-zero levels on March 31, 2021, to a peak of 5.4% on September 30, 2023. This increase in the base rate had immediate impacts on yields, thanks to the floating rate structure with all-in yields on senior direct lending deals moving from an 8% low to a high of 12% during the same period. Again, great for investors, but not so great as a borrower.

Exhibit 1: Yield on floating rate private credit



Source: Lincoln International. Based on Lincoln Senior Debt Index as of March 30, 2024.

Against higher financing costs, private credit borrowers also face the headwinds of a slowing economic backdrop. With expectations for slower global growth (if not outright recession), private credit portfolio borrowers may face demand destruction at a time when their cost of debt is a drag on their profit margins. This combination of headwinds requires investor caution as some portfolio companies may be experiencing more financial stress than during prior periods. However, does this mean private debt is a no-fly-zone for investors? Not by any stretch. We see many large and established private credit portfolios remaining resilient through this cycle.

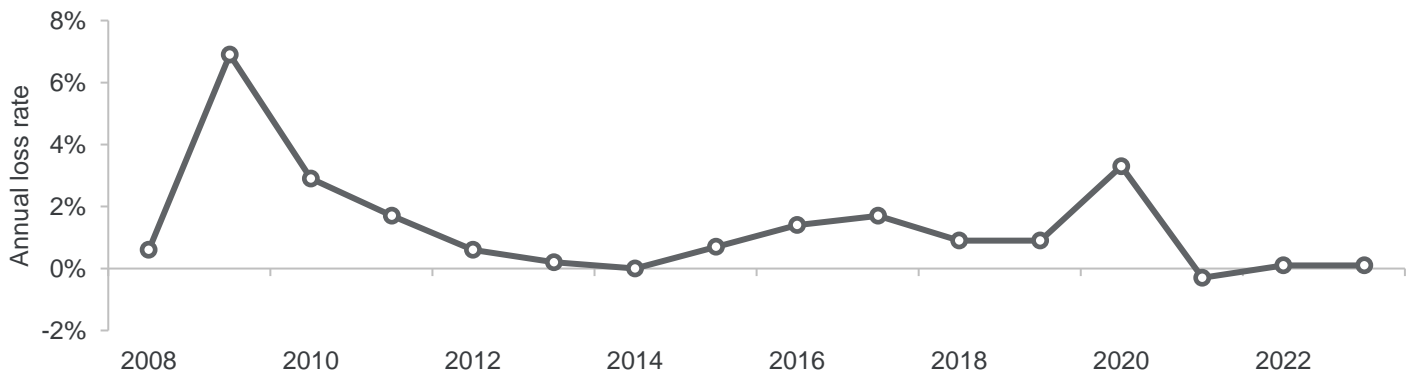
...But resilient in the face of the credit cycle

Thus far, large and well-established private credit portfolios which focus on senior secured direct lending have shown resilience despite headwinds.

Low default rates

Twelve-month trailing default rates finished 2023 at 3.4%, lower than the 4.5% level observed in the first quarter.¹ In this case, default rates are defined by the strictest of measures, including any loan where covenants (such as coverage ratios) have been breached, overstating actual levels of stress in the market. In other words, default rates don't necessarily equate to delinquency of interest payments. Even when loans are delinquent, actual losses are low, because recovery rates are higher than most other forms of debt. As seen in Exhibit 2, annual loss rates are relatively low, reflecting the financial health of private credit.

Exhibit 2: Higher interest rates are not translating into greater loss rate



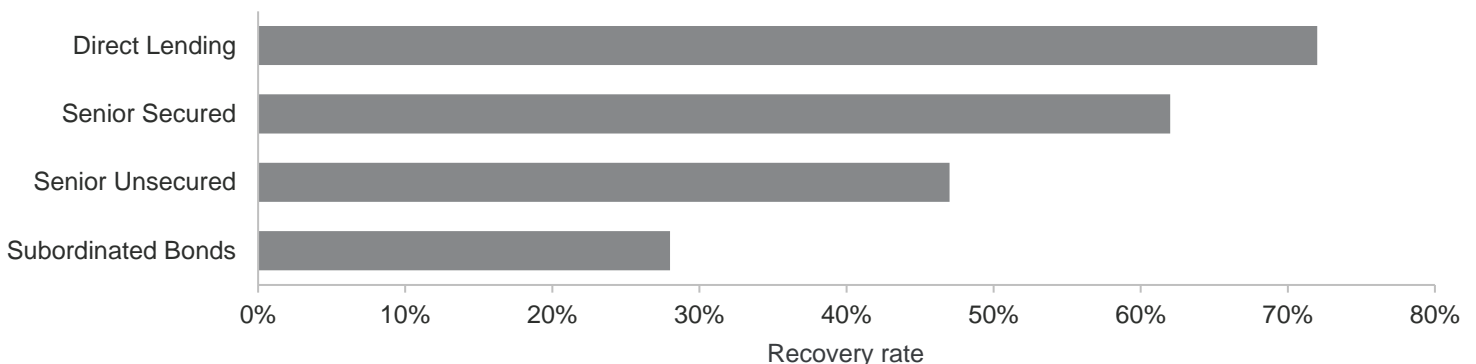
Source: Cliffwater, as of December 2023.

Structural benefits

The other tailwind for private credit remains the structural advantage offered by direct loans vs. public market equivalents. First, most direct lending is made to private equity sponsors. This means that if companies face tougher roads ahead, their private equity owners could inject further equity into the business—something much harder to do with public market issuers. Second, as senior secured and highly structured paper, private debt provides strong covenant protections for investors. Monitoring by private debt managers includes constant covenant testing, which provides early warning signals of borrower stress and gives private debt managers runway to intervene before stresses appear in a borrower's business.

Even in the face of an extreme cyclical downturn, private debt instruments provide the added benefit of higher recovery rates. While many people do not pay much attention to recovery rates in times of low uncertainty, in times of stress, recovery rates captured through highly structured, senior secured direct lending offer a meaningful “buffer” to any defaults facing investors. For example, in 2022 the average direct lending fund recovered 72 cents on the dollar vs. only 47 cents by senior unsecured credit.

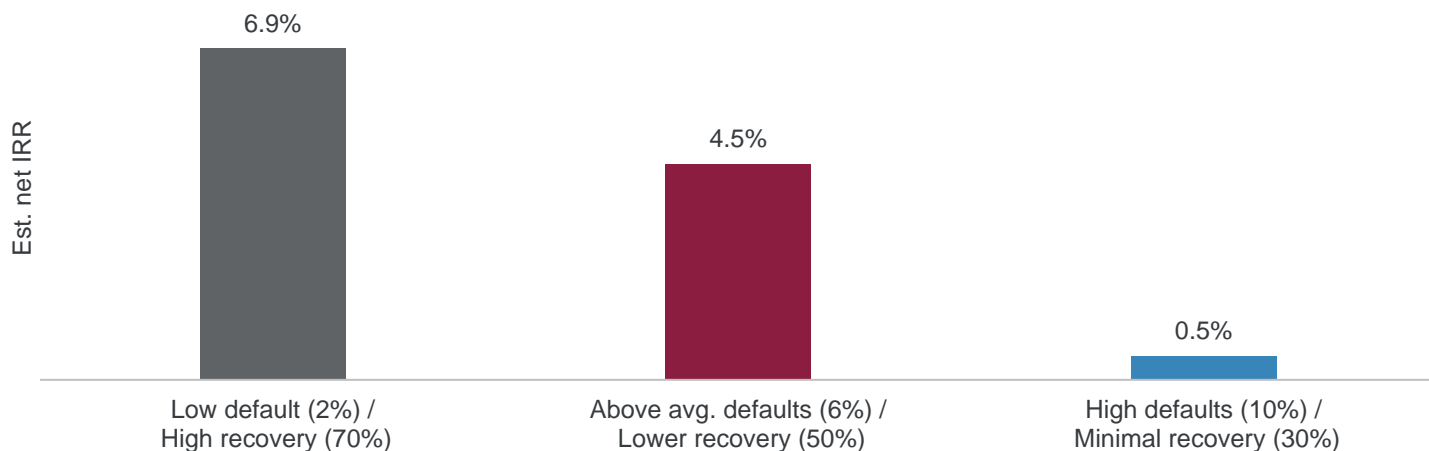
Exhibit 3: Default recovery rates for various types of lending 2023



Source: Moody's Annual Default Report 2023; 1987 – 2023. Direct lending proxied by Term Loans.

Even in a worst-case scenario where default and recovery rates are stressed to extreme highs/lows, private credit can produce a positive net return as proxied by IRR (internal rate of return). Take for example a 10% default rate (equivalent to levels seen in the Great Financial Crisis) and 30% recovery rate (a level only seen in extremely stressed scenarios)—**even in this hypothetical worst-case scenario, investors would not see a loss of capital**, which should make it relatively more attractive compared to other asset classes.

Exhibit 4: Even in a hypothetical worst-case scenario, investors experience no loss of capital



Source: Stepstone Group. Shown for illustrative purposes only and is not indicative of future results.

Resilience in the face of declining base rates

Private credit also offers limits on how low yields can go if we do face economic slowing and lower rates. The majority of deals include rate “floors” which ensure floating rate income cannot fall below a base level of compensation for lending risk. Even when base rates were near-zero in 2020 and 2021, all-in yields on senior secured direct lending remained in the 8-9% range. This compares favorably to public market floating rate notes which may not have coupon “floors” and whose yield can fall just as fast as it rose over the last few years.

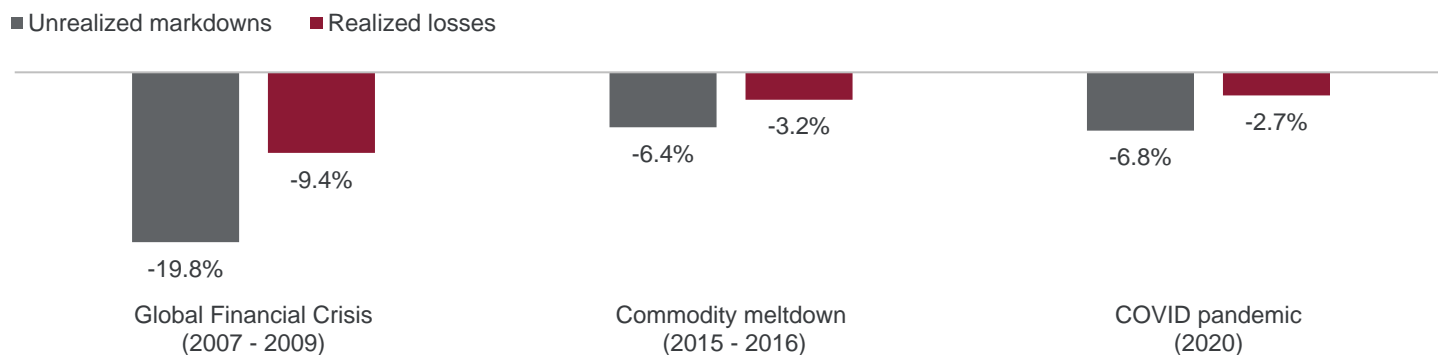
A note on valuations

Many pundits point to lagging valuations in private credit suggesting that true portfolio stresses are not reflected the same way as in marked-to-market portfolios of public asset classes. We disagree with this viewpoint. Private credit managers with credible valuation processes do reflect fundamental stresses in their portfolios—what they are not reflecting is the day-to-day noise of publicly traded markets.

Investors must remember that valuations for private credit (and private markets in general) reflect an estimate for projected losses in a portfolio due to fundamental company issues. They do not reflect day-to-day supply-and-demand imbalances that come with public market investments, and which can increase price volatility even with no change in fundamentals. While fundamentals drive a portion of valuations in public credit, day-to-day trading introduces large amounts of “noise” into prices/spreads which is not present in private markets.

Both intra-day and lagged valuations have their places—this “noise” is often how active managers can exploit the market and generate alpha. Conversely, private credit is a buy-and-hold strategy, so loans only need reflect the fundamentals of the business rather than prices another buyer would be willing to pay on any given day. Historical data shows that large, well-established private credit managers have tended to be more conservative in their valuations, overestimating losses vs. the write-downs actually experienced during major stressed periods. This helps to debunk the idea that managers are hiding stresses by manipulating valuations.

Exhibit 5: Comparison between private credit manager estimated vs. realized losses during periods of stress



Source: Cliffwater, as of December 2023.

Is private credit overvalued relative to public credit?

The value of private credit vs. public is another headline-grabbing issue now that public markets offer more attractive yields. While the relative yield between private credit and high-yield has narrowed, investors must recall that the main driver of higher yields has come from higher base rates (government bonds or rates like SOFR). Spreads (the additional yield above the base rate) in high-yield markets are actually trading near some of the tightest levels we have seen in years, which means public credit investors are not receiving as much compensation for credit risk.

The difference of spread between high-yield and private credit (senior secured) sits at approximately 300 bps, below the longer-run average of 360 bps but nowhere near a level we would consider overvalued. One trend to watch is the record levels of idle cash sitting with private credit managers waiting to be invested. This puts a premium on managers who are selective in deals and comfortable maintaining high pass rates for loans that do not fit quality criteria.

Cycle-proof private credit investing

How does one minimize the impacts of a cyclical downturn and the possible effects on a private credit investment? We believe there are two key questions that one must consider: What type of private credit do I own? And what type of manager have I hired?

Private credit is often referred to as a singular asset class but is in fact a conglomerate of multiple different asset classes from the more fixed income-like senior secured direct lending and specialty finance to more equity-like risk found in opportunistic and distressed credit. All have their place to generate strong returns through the credit cycle, but investors should clearly know where they are invested and consider vehicles whereby expert managers are given latitude to move exposures around based on where value lies.

We also believe the type of manager hired is the cornerstone of building a resilient private credit portfolio that performs well through credit cycles. Important aspects include long-standing and refined underwriting processes in which managers have experience underwriting risk based on multiple scenarios, including the worst case. Also, a data-driven portfolio monitoring team is hugely beneficial when identifying stresses and borrower problems far in advance of them becoming critical issues. Teams that are conservative with valuations and have depth of experience working borrowers through stressed periods and even extracting maximum value in worst-case defaults should have a clear advantage, especially in times of economic slowdown and monetary policy pressure. In summary, partnering with the right managers is a critical component of private credit investing.

We believe these key elements are the best “hedge” against any headwinds facing private credit markets and place a real premium on manager selection. But with these elements present, we would urge investors to not get caught-up in headline noise on private credit reckonings and other hyperbolic statements. There is no doubt private credit, and frankly all other asset classes, occasionally face challenges. But with the right ingredients, private credit will deliver through the cycle.

*For more information on private credit,
please reach out to a member of your CIBC Private Wealth team.*

1. Goldman Sachs, June 2024.

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