ALTERNATIVES WATCH

Northleaf eyes global private credit shifts and opportunities

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Private credit is a global business, and David Ross, who runs $22 billion Northleaf Capital Partners' private credit program out of London, finds U.S., U.K. and European markets are facing similar headwinds from their banking industries and rising interest rates, although the differences are profound in each market.

A key difference Ross is following is that the European market takes a long time to respond to changes in the investing climate.

He notes that American lenders are highly transactional; they are willing to change prices quickly as needed, while European lenders tend to be more anchored to enterprise value and take time to absorb new information. "Because of differences in market structure and capital flows, the U.S. market adjusts quickly and will find a market clearing price to transact while Europe takes longer to absorb or reprice risk and new information," he said. "If you take COVID as an example, it took a lot longer for European deals to start to happen again."

Northleaf's portfolio managers work opportunistically with mid-market companies across the capital structure. Right now, the concern in both the U.S. and Europe is the relative weakness in the banking systems. "The anxiety it has created so far has been reasonably muted so far," he added, but it can be seen in the pullback of liquidity.

The main source of bank liquidity, deposits, are not as sticky as bankers had assumed. Interest rates are now high enough that many savers are shopping around and moving assets to money market mutual funds. This is reducing bank competition in corporate financing, Ross said. Bankers are looking for fee income, while institutions are looking for interest income.

One effect that Ross has noticed is a steady increase in the duration of loans. He said, "Our loans typically remain outstanding for about three years before they are repaid or refinanced. Now, we're probably up to three and a half years."

Companies are staying private, and refinancing is more difficult right now. Many companies have their own liquidity issues, and the IPO and M&A markets are drying up, Ross observed. For several years, businesses have been optimizing their working capital. This leaves little slack in a time of rising inventory costs, deteriorating margins, and foreign exchange volatility.

"Liquidity issues drive companies to the ground quicker than anything," he said. "And today's environment is putting more pressure on liquidity needs that could potentially dilute equity returns if not well managed." He sees this as a bigger concern for equity holders and an opportunity for lenders.

The denominator effect remains a factor, with many investors finding that they are now overweight in the private markets and want to reduce that relative allocation, which is hurting fundraising. Those who can invest in the sector are being rewarded.

"Given today's attractive investment environment, investors can generate higher yields while maintaining strong downside and collateral protection," Ross said. "For example, we are underwriting 12%+ senior secured asset yields with conservative structures and strong equity cushions." In particular, the biggest U.S. investors tend to be public pension funds that need return, and so they are more interested in asset-backed and leveraged loans than their European counterparts.

Ross views the asset-backed sector as one that is particularly attractive. The opportunity in music royalties, litigation financing, and factoring is not highly correlated to other assets and offers competitive returns, he said.