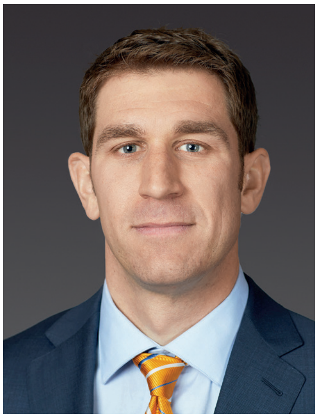
EXPERT Q&A

After a record-breaking 2021, the managers that performed well through covid are in good shape to deal with challenges on the horizon for 2022, say Churchill Asset Management's Jason Strife and Randy Schwimmer



Scale, execution and relationships emerge as key traits

Q Who were the covid winners and losers in private debt, and how will managers have to adapt their approach for a post-covid environment?

Randy Schwimmer: Since our inception in 2006 we've had a consistent underwriting theme. The same sectors we liked then – business services, healthcare, technology, software, distribution, logistics and financial services – held up well during the great recession.

The pattern for success through two years of covid was also established early. When the pandemic emerged, we focused on how our portfolio might be impacted. We worked closely with our private equity sponsors to ensure plans were in place to get through the most acute phase of disruption, which lasted about three months.

By the summer of 2020 the resilience of our credits was clear and we were able to pivot to new business. Having had the right strategy of sticking to defensive, non-cyclical sectors going into the crisis, we could put significant dry powder to work as market liquidity and confidence returned.

At the same time, investors who had been circling around private credit before covid witnessed the performance of our portfolio and the differentiation of our origination strategy on both the junior and senior side. Their attitude shifted from doubts about the asset class to asking how quickly we could put their money to work.

Jason Strife: Covid was a proof point for private capital providers with scale, execution capabilities and strong private equity relationships. If you didn't have that combination going into covid, you are coming out having lost a step or two competitively. Most important for us was our excellent private equity relationships going into this. So, when we couldn't travel and get in front of people, our platform still accelerated. You saw sponsors relying on a smaller group of lenders with whom they had strong, long-term relationships.

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Q What are you currently observing in terms of origination trends and hot deal sectors for 2022?

JS: We are coming off arguably the busiest couple of quarters in the history of our firm and arguably for the middle market private credit industry as a whole. From our platform's standpoint, our deployment of senior and junior loan capital was nearly $9 billion last year, which was a 100 percent increase versus the prior year. Our Q4 figures alone were half of that annual total. We saw an incredible acceleration in the second half of last year.

The factors driving that did include some looming tax changes that pulled forward some 2022 deals into 2021, but it was still incredible. It is going to be hard to sustain that kind of momentum. The market is taking a bit of a breather at the start of this year, after a very frenetic period and other developments including the war in Ukraine, inflationary pressures and some of the supply chain issues impacting product-based business models.

Still, the expectation is that 2022 will be another very active year, driven by the sheer amount of private equity capital raised in the past few years and the fact that so many of the private equity portfolios constructed in 2016, 2017 and 2018 are now naturally bringing assets to market. We are hearing from investment banks that the pipeline for new investments is building nicely, but the timing for those deals is in flux due to geopolitical issues.

RS: Our record year was compounded by successful fundraising, as we brought in $13 billion of new committed capital in 2021. With investors leaning in and trusting our platform and underwriting thesis, we were able to build significant scale to commit up to $500 million per deal on the senior side. That puts us among a select group of direct lenders that can create that kind of one-stop capability. In this highly competitive M&A environment, private equity sponsors are seeking to work with a small lender club they know and trust to execute financings quickly and effectively.

Q How can investors get comfortable with the additional risks that come with investing in higher yielding junior capital?

JS: It really depends on the type of junior capital structure you are after. There are many different flavours. Our bread and butter has always been sponsored junior lending working with private equity firms with which we have long-lasting relationships. In fact, our position as a significant limited partner to middle market private equity funds allocating close to $1.5 billion annually drives direct dealflow and provides us with an information advantage. We know which GPs perform best and we align with them.

Ultimately, we know the private equity decision makers personally and their position on risk, business model quality, due diligence and portfolio company support. All of that helps the relative value discussion we are having as a junior capital investor. We think that is really attractive relative to more opportunistic strategies in the junior capital universe.

"We saw an incredible acceleration in the second half of last year"

JASON STRIFE

Q One difference from two years ago is the number of larger unitranche financings taking share from the broadly syndicated loan market. How is Churchill participating in that trend?

RS: That trend has been developing for a while. Unitranche is one of the most efficient financing vehicles because there's one lender and one credit agreement. Our scale and depth of sponsor relationships, not to mention the backing of our parent company Nuveen and its $1.3 trillion balance sheet as of 31 December 2021, allows us to be a leader in the one-stop market.

While the unitranche is increasingly popular in the traditional middle market, the largest direct lenders are employing them to take share from the broadly syndicated market. This year has already seen a $5 billion financing and we expect that trend to continue.

JS: The market continues to expand and our junior loan programme hit its high-water mark in 2021 in terms of investment activity. While we certainly see growth in the prevalence of one-stop financing solutions, traditional capital structure solutions aren't going anywhere.

Many private equity firms are still looking for bifurcated senior-junior structures, or structured equity-PIK solutions. Private equity firms have varying appetites for third party leverage and if they can partner with a strong lending relationship in the middle of the balance sheet, often that creates a junior loan opportunity.

Q How can equity co-investments complement private debt strategies?

JS: When you're talking about equity co-investment, our view is that is an attractive feature in a private credit deal but you need to make the most of it. Our platform is already a robust co-investment partner to private equity firms irrespective of our loan programmes; we are a large equity co-investor alongside GPs and only a fraction of that is on the credit side.

If we did not have expertise in underwriting equity, that could be seen as non-core. But it is extremely core to what we do because our platform invests across the capital structure. We have expertise in the bottom half of the balance sheet through our co-investment programme.

> *"Loan prices will be insulated from public market volatility"*
>
> **RANDY SCHWIMMER**

An independent credit shop that dabbles in equity co-investments is a less attractive partner than a platform like Churchill that has in-house expertise on underwriting equity. We are not just taking an allocation because a sponsor offers it. We have an industry-leading co-investment platform and we bring a different lens to how we evaluate those opportunities.

Q Finally, do rising interest rates and an inflationary environment create threats or opportunities for private debt?

RS: So far in 2021 we are seeing a continuation of last year's rise in prices for both products and services. But now there's a clear sense that this will not reverse anytime soon, particularly given the war in Ukraine.

Indeed, energy and food prices are spiking higher as a result of shortages and sanctions. The US Federal Reserve seems committed to hike rates to combat this new level of inflation, but hopefully without negatively impacting the economy in a meaningful way.

Private credit tends to be insulated from exogenous shocks and episodic headline issues. Our portfolio companies continue to perform well, with higher revenues and the ability to pass along higher costs to their customers.

Sponsors anticipated these challenges and accounted for them in their investment theses. Enormous effort here goes into understanding these credit dynamics, with keen attention paid to worker shortages and wage inflation.

It's not clear if the Fed will stick to the frequency of rate increases the market expected earlier this year, but as a floating rate asset class, senior secured loans are positioned well regardless.

JS: We do a mixture of floating rate second lien and fixed rate mezzanine investing. Depending on the pace of those interest rate rises, we could see sponsors trying to do more fixed rate junior capital to lock in a natural hedge. Generally speaking, the sponsors we work with assemble capital structures that are appropriately cushioned. Even with interest rate hikes looming, we don't see that as a big deterrent or catalyst for change in the market.

RS: We expect private credit to continue to perform well. Loan prices will be insulated from public market volatility, top-tier direct lenders with scale and relationships will continue to finance strong businesses for experienced sponsors, and M&A will be active in sectors proven to be the most resilient. Leading fund managers should end up on the other side of the current crisis – whenever that happens – in as strong a position as they did on the other side of covid. ■

Jason Strife is head of private equity and junior capital and Randy Schwimmer is co-head of senior lending at Churchill Asset Management

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