

# EXPERT COMMENTARY

*Investors need to start preparing for a future where they can no longer count on Fed support, say MGG Investment Group's Daniel Leger and Gregory Racz*



## What to expect as the 'Fed put' disappears

The US Federal Reserve finds itself in a bind. Inflation is on the march while Russian troops are stalled (momentarily?) in Ukraine. Fed chairman Jerome Powell stopped calling inflation “transitory” in November 2021 as food prices had risen by double digits in the previous 12 months and global supply chain disruptions continued apace.

The new calendar year has brought more of the same: the price of Brent crude rose over 40 percent in the first three months of 2022 and may well soar higher depending on Europe's decision regarding Russian oil and gas imports. Further, those supply chain disruptions are sure to worsen in the short term as

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Ukraine is a vital link in the global food supply chain.

The challenges of the Fed are, by extension, those of investors. In the public equity markets, the speculative frenzy of the last couple years has come to a screeching halt as companies with a vision but no obvious path to real earnings have collapsed in value and the overall market (except for energy) is down double digits from its highs. In the credit markets, high-yield spreads have widened by approximately 60bps

in first three months of 2022 and, not coincidentally, the pace of private equity acquisitions has slowed.

It is a truism on Wall Street that investors should not fight the Fed but how should investors be preparing for a future where they can no longer count on Fed support? The enormous central bank and fiscal support of the last 15 years cannot be assumed to be at the ready during the next recession.

After all, the Russian invasion of Ukraine is one of those exogenous events (like the Russian Default of 1998, the GFC, the European sovereign debt crisis, and the covid pandemic before it) that would have likely elicited some kind of market support by

the Fed. But that is not the case today.

The Fed is holding firm to raising rates several times in 2022 and several more times in 2023. Whether it can afford to do so remains to be seen but one thing is clear: the so-called ‘Fed put’ has disappeared and for those lending money to highly levered companies, things may get complicated.

### **Leverage on leverage**

In a recent market study, median private equity buyout transactions occurred at 15x EBITDA (rolling three-year average) with debt to EBITDA multiples of 7x, according to Pitchbook. No matter the quality of the business or its net margins, closing leverage at those levels is reckless and implies that the lender is pricing in a rosy economic environment for years to come. What could go wrong?

These levels are so alarming that, in December 2021, the US Treasury Department’s Financial Stability Oversight Council noted that “these valuation pressures make these markets vulnerable to a major repricing of risk”. Sixty basis points of spread widening in high yield in recent weeks does not yet represent a “major repricing of risk” but, then again, the Fed has so far only raised rates by 25bps.

### **Leverage plus cov-lite: Now things get interesting**

Before the global financial crisis, almost all loans contained covenants (limits on borrowers that protect lenders and their capital). Today, most levered loans lack true covenants. It was assumed – falsely – that the covid pandemic would expose the hidden costs of the watered down, “cov-lite” provisions that dominated private lending in the last decade.

Alas, this has not been the case. Cov-lite has eaten the world of private lending and as we enter an era of rising rates in the US, it is safe to assume that nearly all the loans to private equity backed companies include covenant provisions that have little to no bite.

The implications for the market are profound.

No matter the business cycle, conducting primary due diligence, demonstrating a healthy level of scepticism about management projections, and setting tight covenants matter. Tight covenants transfer power and influence to the lender – power and influence that are needed as much when times are flush (keep management focused and on target) as when times are tight (direct any restructuring and get paid for increased risk).

### **Capital raised must be invested**

By the end of 2021, Preqin estimates that the private lending market reached \$1.2 trillion globally, double from five years earlier and 4x the 2010 levels. It is further expected to grow to \$2.7 trillion by 2026.

Capital raised must be invested and capital of this magnitude will likely mean that spreads will have to tighten, and protections weaken, further. But the wave of capital is arriving at the very moment deal multiples are at their highest and the Fed is in the early part of a rate heightening cycle.

### **False sense of confidence**

Who can blame investors for their enthusiasm? Private lending has performed remarkably well across the last two recessions. But that outperformance occurred against the backdrop of an extremely accommodative Fed that intervened directly in the credit and mortgage markets. As a result, the covid pandemic and economic lockdowns did not expose the cov-lite, highly levered loans due to the enormity of the economic stimulus.

But with war in Europe, the highest debt to EBITDA multiples in history, a slowing economy, high inflation and a Fed just beginning to raise rates, what will happen during the next recession? It is important to note that most private debt investors have never experienced a proper business cycle contraction in their investment careers, as the last

of its kind occurred during the 2000 to 2002 period following the internet bubble.

### **How should investors think about private credit in a rising rate environment?**

Every market cycle begins with hope and euphoria, but all cycles come to an end.

The maths is unassailable: returns magnified by leverage in bull markets invariably return back to earth as inflation rises and the Fed is forced to reduce aggregate demand by raising interest rates. And no one ever rings a bell to tell investors how abrupt or disruptive these changes will be. Therefore, for credit investors, it is always best to invest conservatively with downside protection structured into every loan or investment.

### **The non-sponsor lower middle market: underserved with more modest debt levels**

As investors look to add capital to their private lending portfolios, or for investors looking to invest in the sector for the first time – the underserved non-sponsor US lower middle market still offers compelling risk-adjusted returns. The debt and leverage multiples are much lower in the non-sponsor segment of the market as family owned and entrepreneur led businesses are more conservative and jealously husband their equity. It is also much easier to negotiate tight covenants with real teeth in this segment of the market.

The lower middle market remains underserved, notwithstanding the massive inflows of capital mentioned above, because most of that capital tends to bypass this segment of the market as it follows the supply of private equity dealmaking taking place in the upper middle market. ■

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