BENEFIT STREET PARTNERS

April 2023

PRIVATE DEBT MARKET OUTLOOK: THE OPPORTUNITY OF A LIFETIME?

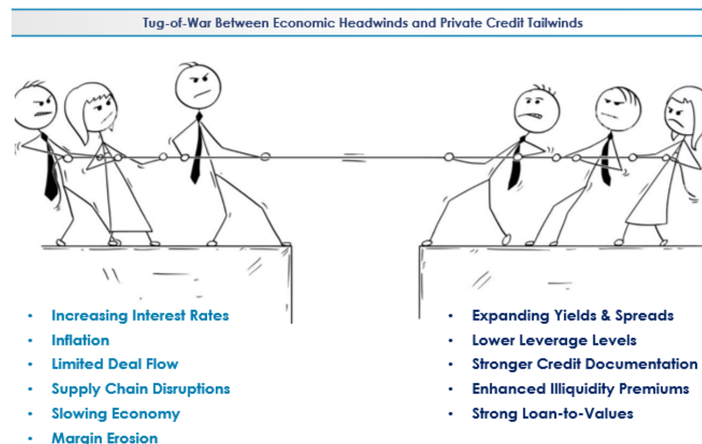
In the 1997 blockbuster *Titanic*, there's a scene after the "unsinkable" ocean liner has struck the iceberg. The ship's designer is telling the captain that the ship will sink, and soon. The president of the cruise line interrupts, "But this ship can't sink!" To which the designer replies: "She is made of iron, sir. I assure you, she can. And she will. It is a mathematical certainty." Meanwhile, in the first-class lounge, a piano player bangs out a lively ragtime tune, and no one there realizes the Titanic will be at the bottom of the North Atlantic before sunrise.

What does all that have to do with the private debt environment in 2023? Well, the financial markets recently hit an iceberg when interest rates went up so dramatically, and so quickly. While we don't think the consequences will be anywhere near as severe as those experienced on the Titanic, **investors should understand that existing private debt portfolios will ultimately feel some strain, as long as interest rates remain far above the historically low levels of the past 10-plus years.** The higher cost of capital has lowered interest coverage ratios for borrowers, essentially reducing their margin for error, and increased refinancing risk at maturity for all but the best credits. In the meantime, most private debt borrowers are currently performing well, and to date, managers have largely not experienced any outwardly visible ramifications from this added stress on their portfolio companies. It's not a mathematical certainty, but we think the dramatic shift in borrowing costs will have ramifications, and that's why we believe it is now more important than ever for investors to align with seasoned managers who run conservative and well-constructed portfolios.

However, there is some good news. **For those managers with dry powder to deploy, we believe the investment opportunity is as good as it's been since the global financial crisis of 2008.** Market conditions have led to a dearth of capital chasing loans, meaning private debt lenders will have their choice of good companies to which to lend, with higher spreads, lower leverage, and stronger levels of protection. Here, we'll explain why it's an opportune time to invest in private debt and explore some keys to help investors take advantage of this opportunity.

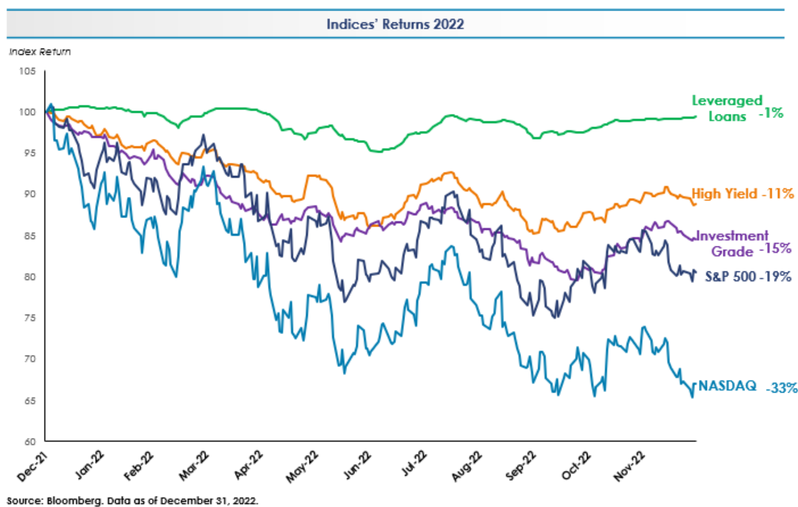
Key Takeaways

- Private debt has experienced dramatic growth over the past decade, with investors piling into the asset class in search of strong yields in a low-rate environment.
- The supply and demand balance has shifted negotiating power back to lenders, thanks to higher interest rates and more-limited capital in the market.
- Those with new money to lend have a great opportunity that could drive very strong risk-adjusted returns, even if the global economy slows.
- On the flip side, default rates are likely to increase as legacy issuers face the impact of higher interest rates, which could limit their ability to service debt and refinance at maturity.
- Top managers in the asset class who have constructed solid, diversified portfolios will likely outperform and take advantage of market dispersion to separate themselves from the competition when deploying new capital.
- As the below chart shows, many of the headwinds for private debt issuers, such as rising rates and inflation and a potential slowing economy, are being offset by tailwinds such as higher credit spreads, lower leverage, and stronger documentation.



Private Debt: What Is It and Why Has it Exploded as an Asset Class?

Private Debt — also known as private credit or direct lending — refers to privately negotiated loans made outside the public debt markets. Often, that means lending to private equity investors who raise capital to buy an ownership stake in companies. Private debt investors also raise capital, but to lend, not to buy. Taking a step back, companies that need debt financing can issue bonds or borrow from banks, which may hold loans on their balance sheets or "syndicate" them, sharing with other banks and investors through broadly syndicated loans. However, banks' appetite for credit has weakened amid a long-running, regulatory-driven retrenchment and banks' increasing caution in the face of policy tightening and recessionary fears. In recent years, with a flood of cheap money from the Fed and a pullback in corporate lending from banks, investors piled into private debt in search of strong yields at a time when they were difficult to find. That, combined with the challenge of earning a decent return in a low-interest-rate environment, helped the asset class balloon in size, from $250 billion in 2010 to an estimated $1.4 trillion in 2022.[1]



We view private debt as an integral, all-weather allocation for limited partners during any market cycle. Given today's attractive yields, there is a healthy amount of interest in US private debt from investors. Despite the uncertainty and volatility in certain areas of the market, which has caused some institutions to pause or pull back, the asset class remains attractive as interest rates rise. While there are many good choices where investors can earn competitive returns in fixed income, our view is that the risk-adjusted return profile of private debt is more compelling. This is especially true when considering that private debt loans typically reside at the top of the capital structure, and with their floating rates, private debt's yields climb along with base rates. Private debt has also outperformed most fixed income vehicles. As the above chart shows, the best-performing asset class in the credit market in 2022 was leveraged loans,[2] in part because they represent senior secured floating-rate loans. Private debt sits within the leveraged loan category, with the added benefits of even higher yields and stronger loan documentation.

Unprecedented Rising-Rate Environment

The Fed's interest rate hiking cycle, the fastest since the early 1980s, is intertwined with slowing economic growth as the key driver of investor sentiment. The central bank has raised rates to tame inflation, which reached 40-year highs in 2022. The war in Ukraine, the largest conflict in Europe since World War II, added geopolitical uncertainty to the mix and helped further stoke the flames of inflation by exacerbating the supply chain disruptions from the pandemic and reopening. Add it all up, and there's a lot for investors to fret about. In the risk-off environment of 2022, the tried-and-true, 60/40 portfolio lost more than 15%.[3] Now, investors are worried about the endgame: Rising rates could slow growth at the right pace, allowing the Fed to achieve its "soft landing" target. However, the Fed could slow the economy to the point of a long, deep recession, or they could fail to tame inflation and drive a combination of slowing growth and rising prices, known as stagflation.

With interest rates so much higher after a decade at near-zero levels, the risk of troubled loans will likely rise, as borrowers facing maturity will no longer be able to refinance at the favorable terms to which they're accustomed. Some have been, or will be, able to deleverage or perform well enough to get by. But for many other companies, **refinancing may require additional contributions or, in some cases, workouts may be unavoidable**. Borrowers have already slowed their rate of prepayments. This has left many managers with less recycled capital to invest or to help them navigate troubled deals.

Into the first half of 2023, the iceberg's true impact has not been obvious. As a regular staple on recent quarterly earnings calls for many business development companies (or BDCs; publicly traded, closed-end investment vehicles that principally invest in private debt), there has been a flurry of questions from investors and analysts. They wanted to know about the health of portfolios. Specifically, investors were looking for signs of erosion in portfolio quality, such as downgrades, watchlists, amendment requests, or increased default rates. Managers' responses have been largely uniform — they attest that portfolios remain just fine. In fact, **earnings for most BDCs have actually been rising because of the tailwinds created by higher interest rates on their floating-rate-loan portfolios.** The ship hit the iceberg, yet nothing bad has happened — yet.

[1] Source: https://www.reuters.com/markets/rates-bonds/private-debt-markets-face-reality-check-companies-grapple-with-rising-rates-2022-12-20/
[2] Source: Bloomberg. Data as of December 31, 2022.
[3] Source: https://www.bloomberg.com/quote/BMA6040:IND?sref=C2JZ5EIg

Recalibrating a 2021 Deal

	Average Base Rate	Unitranche Cost of Debt[1]	Interest Coverage Ratio
At 2021 Underwriting	0.75%	6.50%	2.56x
Today	4.75%	10.50%	1.59x

Interest Coverage Ratio Sensitivity Analysis

	Coverage Ratio at Issuance	Coverage Ratio[4]	50bps Increase in Base Rates[2]	100bps Increase in Base Rates[3]
EBITDA at Issuance	2.56x	1.59x	1.52x	1.45x
↓ 10% Decline	2.31x	1.43x	1.36x	1.30x
↓ 15% Decline	2.18x	1.35x	1.29x	1.23x
↓ 20% Decline	2.05x	1.27x	1.21x	1.16x
↓ 25% Decline	1.92x	1.19x	1.14x	1.09x

Note: Views expressed are those of BSP as of March 8, 2023. Such statements cannot be independently verified and are subject to change.
[1] 2021 cost of debt is defined as average spread of 575bps plus LIBOR / SOFR rate of 75bps. 2022 cost of debt is defined as average spread of 575bps plus LIBOR / SOFR rate of 475bps, which accounts for a 400bps increase in base rates.
[2] Implies SOFR rate of 525bps.
[3] Implies SOFR rate of 575bps .
[4] As of 4/5/2023

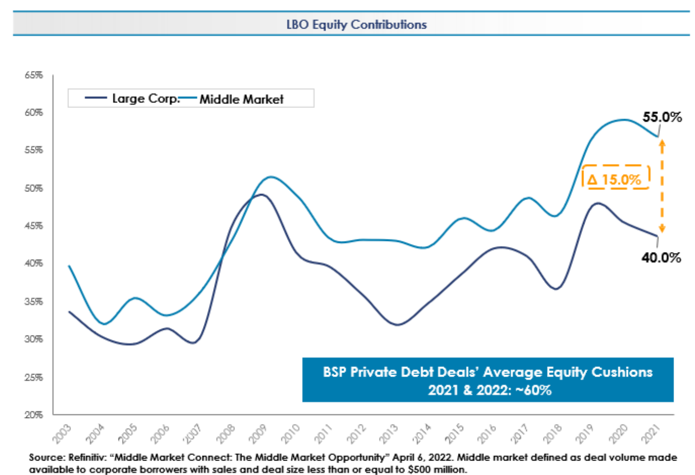
The chart to the left follows the impact of rising interest rates on a typical private debt borrower. In 2021, the average private debt deal had a base rate of 75 basis points. This cost the borrower approximately 6.5%, generating an average interest coverage ratio of 2.56x, meaning the company's cash flow covers its interest two and a half times. In other words, companies had significant room for error. By early 2023, with base rates in the range of 475 basis points, the cost of debt for this same deal was closer to 10.5%, driven solely by interest rates. The interest coverage ratio shrinks, to 1.59x. That's still healthy, of course, but it provides much less protection. Rising rates in inflationary times are designed to slow the economy, which could also have the knock-on impact of chipping away at a company's earnings over time. The chart shows the obvious: **the more rates rise and/or cash flow drops, the smaller the margin for error.** Defaults will likely rise in such a scenario, especially in certain vintage loan portfolios where lenders got caught up in the long, risk-on market and weren't careful. Deals getting done today are reducing leverage by about 1x in order to reset interest coverage ratios closer to previous levels.

Seeking a Parallel in the Real Estate Market

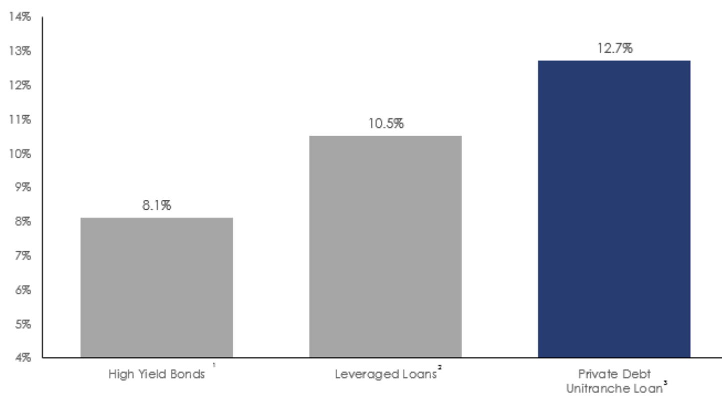
Underneath the surface, the pressure is building for many companies. Some corporate borrowers may feel (or they will soon) similar to a homeowner who took out an adjustable-rate mortgage based on his or her assumed paycheck, who then saw their payment double. This is further exacerbated by inflation and/or a slowing economy lowering their take-home pay. Maybe an even better analogy is that of an apartment building owner who borrowed money to make their investment. The math is about as simple as it gets. Rent payments received need to be higher than the interest payments, and that differential determines the value of the property. Since 2021, interest rates for multifamily loans have surged higher, and rents, while generally on the rise, have not kept pace. One year ago, multifamily loans could be had for as low as 3% interest. In early 2023, rates were suddenly closer to 9%. Borrowing costs tripled, and rents, though they rose overall, did not. When it comes time to refinance at maturity, the value of the building will be lower in the eyes of a lender or buyer, forcing the owner to put up more money, sell at a loss or hand the keys over to their lender. While there are more-nuanced factors at play and more to consider when it comes to valuing a company, the impact of higher rates has the same effect. Similar to the real estate borrower, we believe that weaker credits will face a day of reckoning over the next year or two, especially as the market continues to differentiate between the "haves" and "have nots."

New Investing Opportunities for Lenders

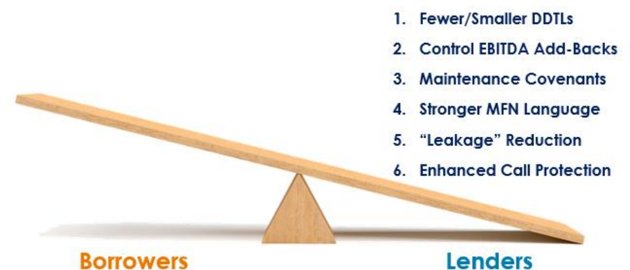
But what about well-prepared private debt investors with new money to invest? We believe it's a much different story, as there is a strong opportunity in the market for new capital deployment. **Private debt lenders can negotiate better covenant packages and deal structures, focusing on underwriting new loans for good companies with lower leverage.** Private debt's lure over the last decade of excess yield in a low-interest environment has changed, but it remains enticing. Now yields are much higher, as in the old days when high yield markets often paid 10% coupons and up. Back then, investors touted the asset class because its high coupons could offset a lot of mistakes as far as credit losses. You could literally lose 10% of the principal value of your portfolio every year without having a negative return. We are now back to that concept. Investors also covet private debt's floating yields, which can offer some defense against rising rates, inflation, and economic uncertainty. Private debt also has stronger equity cushions — the value of the lender's collateral in excess of the amount of its claim — than public debt markets, and the spread between the two is widening, as in the "LBO (leveraged buyout) Equity Contributions" graph.



Source: Refinitiv: "Middle Market Connect: The Middle Market Opportunity" April 6, 2022. Middle market defined as deal volume made available to corporate borrowers with sales and deal size less than or equal to $500 million.



Let's revisit our theoretical company from the above real estate analogy, the one that's starting to feel like a homeowner or a landlord who's drowning under the weight of higher interest payments. But now, let's look at it from the lender's perspective. Yields and spreads are expanding. Our leverage levels are lower. One of the benefits of private debt is the illiquidity premium, which rewards us with higher yields in order to compensate for the fact that we can't buy and sell immediately. Those premiums are on the rise, and as the chart of the left shows, they are stronger than those of other credit assets, including high yield bonds and leveraged loans. Companies still need to borrow, and with fewer providers during challenging times, the supply/demand imbalance means private debt investors can pick and choose, providing stronger loans to better companies, who are likely to be successful in volatile market environments.



One key benefit of the new order is likely to be stronger loan covenants. Deal terms may be the most important tool a portfolio manager has to manage risk. These covenants, which protect lenders, act like smoke detectors, allowing managers to recognize and address any issues before they get out of control.

During the bull market, some of these safeguards were diluted, with terms shifting to favor borrowers. For example, many loan documents provided for multiple, generous EBITDA "add-backs," which permit borrowers to use some discretionary factors to creatively inflate their earnings. Delayed draw term loans (DDTLs), which allow borrowers to draw additional funds during a loan's term, grew in popularity. Maintenance covenants, which can provide lenders with early warning signals of potential issues, got weaker. Leakage, the term for money lost across the term of a loan in the form of restrictive payments, increased. And call protections, which help ensure against early redemption risk, grew softer. That's all reversing now, allowing lenders to demand higher pricing and improved terms. It's all akin to ensuring that our smoke detectors are fully charged and more sensitive than they were, allowing managers to better monitor portfolio companies and take corrective action before problems arise.

Another metric we pay attention to is the merger and acquisition landscape because acquisition financing accounts for the bulk of the supply of new private debt loans. M&A has slowed for several reasons. One is that during periods of significant market volatility, there is typically a lag time for price discovery between buyers and sellers. Sellers want the elevated prices from the 2021 market, and buyers insist on something that reflects today's valuation metrics. Reaching equilibrium between the two takes time. So, while *supply* has dramatically declined, *demand* is down even more because **private debt fundraising has dried up. Also, most private debt investors are sitting on the sidelines either because they're hoarding liquidity or because they are in vehicles, such as BDCs, that can only invest based on proceeds coming back in the form of prepayments, and those have slowed to virtually zero.**

Private debt also benefited from new sources of M&A transactions. This was in part due to the tension from banks' unwillingness or inability to provide loans. Rising rates left banks unable to move tens of billions worth of "hung deals," including the massive buyouts of Twitter and Citrix Systems, off their balance sheets. The issue was less acute by 2023, but as companies — even big, higher-quality firms — turned to private lenders, demand and deal flow increased in late 2022 and early 2023. In environments like this, private debt firms can really differentiate themselves by their ability to originate differentiated deals, structure them the right way, and make the right bets. Meanwhile, the lack of competition allowed lenders to be selective, picking from a pool of higher-quality loans with the ability to demand stronger covenants and better pricing.

It also helps that many borrowers see advantages in private debt providers, given the speed and convenience they offer. These arrangements tend to involve a partnership mentality, where lenders and borrowers build relationships, negotiate protections, and understand the companies well, with regular dialogue between lenders, sponsors, and the management teams. Such partnerships can be especially valuable in challenging market environments.

Setting Yourself Apart from the Herd

Reward doesn't come without risk, and in private debt, there's no better way to reduce risk than by investing with the right firm. Private debt is labor intensive. Managers must identify, structure, and monitor their own deals. There are generally no reliable secondary markets for private debt, and Wall Street analysts don't follow most issuers. For these and other reasons, private debt investors are compensated by earning excess risk premiums relative to those of broadly syndicated loans. **To be successful in this**

asset class, a manager needs to have a lot of resources, expertise, and experience. That means people get on planes, trains, and automobiles to find attractive opportunities, perform extensive due diligence, embed the right covenants, and extract appropriate risk premiums for their efforts. Portfolio monitoring is going to be even more important going forward, as companies struggle to keep up with their added interest burdens or run into challenges around maturity with refinancing. Successful managers must be willing — and have the resources and abilities — to restructure, foreclose, and run the business, when necessary, to protect investors. The fact is, we saw some errors during the short-lived COVID-19 crisis, as it became clear that banks and other lenders did not have the teams to handle the many troubled companies in their portfolios. It could be even worse this time around, which only underlines the importance of picking the right manager.

That all may sound foreboding, but there is good news built into the risk for those who can execute. In recent years, there has not been a lot of differentiation between private debt managers. The risk-on market—wherein just about everything everyone bought went up—limited the opportunities for dispersion, or for managers to set themselves apart. **In the past, the difference between the top quartile of managers and the third quartile was usually that the leaders took more risk. That seems likely to change,** putting a premium on choosing the right credits, picking the winners, and structuring deals well. If, as expected, default rates rise, finding financing will become more difficult, companies will get squeezed by maturing debt, and the **markets will now punish the losers and reward the winners, allowing the best managers to outperform.**

Conclusion

The private debt asset class has many compelling attributes: Most loans sit at the top of the capital stack, have floating interest rates, strong yields, and improving terms. In addition, private debt portfolios can offer strong diversification, provide consistency of cash distributions, and have attractive risk-adjusted returns.

We believe that right now, the investment opportunity for private debt is as good as it's been in a very long time. We view the current vintage of new loans as representing an extremely attractive risk/reward profile. We also believe that the recent sharp rise in base interest rates will result in tighter interest coverage ratios and greater refinancing risk for many borrowers. These two phenomena can be true at the same time, and both provide the best managers with an opportunity to significantly outperform their peers.

At Benefit Street Partners, we often hear from potential investors that they're intrigued by private debt but feel restrained by the crisis du jour on the horizon. Maybe it's inflation, a recession, geopolitical events, or — in early 2023— the still-developing banking crisis. Since it is nearly impossible to precisely forecast all of these potential externalities, we observe the market on a micro basis, through our portfolios of hundreds of individual loans. We listen to what has happened and identify the opportunities we see. In short, **just like the Titanic's iceberg, we believe the crisis may have already hit, and we are ready to take advantage of the opportunity.**

About Benefit Street Partners

Established over a decade ago, Benefit Street Partners ("BSP") is based in New York City with six offices across the country. BSP, together with its affiliate, Alcentra, represents $75 billion of assets under management across a broad spectrum of investment capabilities, including corporate performing and distressed private debt, structured credit, and commercial real estate credit.
www.benefitstreetpartners.com

Richard Byrne
President
Benefit Street Partners

Richard Byrne is the President of Benefit Street Partners, a wholly-owned subsidiary of Franklin Templeton. He is also Chairman and Chief Executive Officer of the two BDCs advised by Benefit Street Partners: Franklin BSP Lending Corp and Franklin BSP Capital Corp. In addition, Mr. Byrne is Chairman and Chief Executive Officer of Franklin BSP Realty Trust, Inc. (NYSE: FBRT).

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stocks tend to fluctuate dramatically over the short term. Bond prices generally move in the opposite direction of interest rates. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. Investing in private companies involves a number of significant risks, including that they: may have limited financial resources and may be unable to meet their obligations under their debt securities, which may be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of realizing any guarantees that may have obtained in connection with the investment; have shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and changing market conditions, as well as general economic downturns; are more likely to depend on the management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a material adverse impact on the portfolio company and, in turn, on the investment; generally have less predictable operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence, and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position.

Views expressed are those of Franklin Templeton and BSP. The information provided herein is provided for informational purposes and general interest only and is not, and may not be relied on in any manner as, legal, tax or investment advice or as an offer to sell or a solicitation of an offer to buy an interest in any fund or investment vehicle (each, a "Fund") managed by Franklin Templeton or Benefit Street Partners ("**BSP**"). A private offering of interests in a Fund will only be made pursuant to such Fund's offering documents (the "**Offering Documents**"), which will be furnished to qualified investors on a confidential basis at their request for their consideration in connection with such offering. Investors should have the financial ability and willingness to accept the risk characteristics of a Fund's investments. Investors should consult their legal and tax advisors regarding the matters addressed herein.

IMPORTANT LEGAL INFORMATION

The comments, opinions and analyses are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user.

Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser or Franklin Templeton institutional contact for further information on availability of products and services in your jurisdiction. Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIALBEN/342-5236, franklintempleton.com - Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton Investments' U.S. registered products, which are not FDIC insured; may lose value; and are not bank guaranteed and are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.