GRANT'S
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By another name

Evan Lorenz writes:

"It's a golden moment for private credit," declares Blackstone, Inc. chief operating officer Jonathan Gray. Nor is Gray alone. Private financing for buyouts scores higher returns, lower defaults and better covenant protection than high-yield bonds or broadly syndicated loans do, the new narrative holds.

"Not so fast," is the burden of this unfolding analysis. We anticipate continued problems for the alternative managers in general and for the private equity industry, which continues to nurse its post-2021 katzenjammer, in particular. Concerning former picks-not-to-click Partners Group Holding A.G. (PGHN in Switzerland) and Moody's Corp. (MCO on the New York Stock Exchange), *Grant's* remains bearish.

While private credit is technically not new—business-development companies have been issuing non-traded loans to fund buyouts for decades—it has lately achieved the status of a near category killer. In the first quarter, according to Carlyle Group, Inc., private credit funded 94% of buyouts by number and 70% on a dollar-volume basis. Since 2010, non-traded, unregistered private borrowings have ballooned to $1.5 trillion from $250 billion.

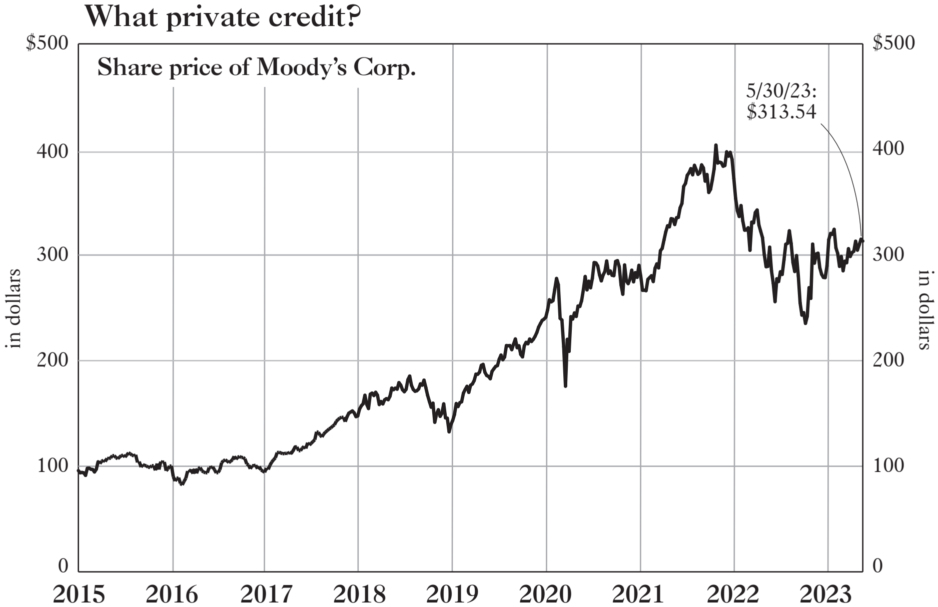
"If you're a bank today, you're generally in the moving business," Gray told his dial-in audience on the April 20 Blackstone earnings call. "You commit to a noninvestment-grade corporate credit, a private equity deal. You're trying to sell that down. But given the volatility, you're going to say to the borrower, 'Hey, look, I need a lot of flex in the pricing. I need to be able to gap out the pricing [by] 200 basis points, 300 basis points.'" Unconstrained, nimble and primed with committed capital, direct-lending funds, so the argument continues, offer fast execution at a guaranteed price.

Yes, Goldman Sachs analysts acknowledged in an April bulletin, "[p]rivate credit is more opaque, with borrowers tending to be smaller and on average lower rated, which may suggest higher default risk broadly, but the strategy may benefit from stronger covenants and closer relationships between borrowers and lenders. These benefits were on display during the depths of the pandemic, with private credit posting a lower default rate than leveraged loans."

Even so, it can be no source of comfort that SoftBank Group Corp., the veritable pope of the Wall Street Church of What's Happening Now, is reportedly getting ready to jump into the business. "For institutional investors, private credit feels like AI does for venture capitalists," Eric Doppstadt, CIO of the Ford Foundation, tells me. "It's on everyone's lips every time you talk to anyone in the institutional investment world about what's interesting. It's always on the top of their list: private credit. Whenever I've seen that in the past, it's usually not a good sign."

Good or bad, the private lending push is changing the contours of the public credit markets. The Federal Reserve's April Senior Loan Officer Opinion Survey showed that 46.1% of reporting

What private credit?



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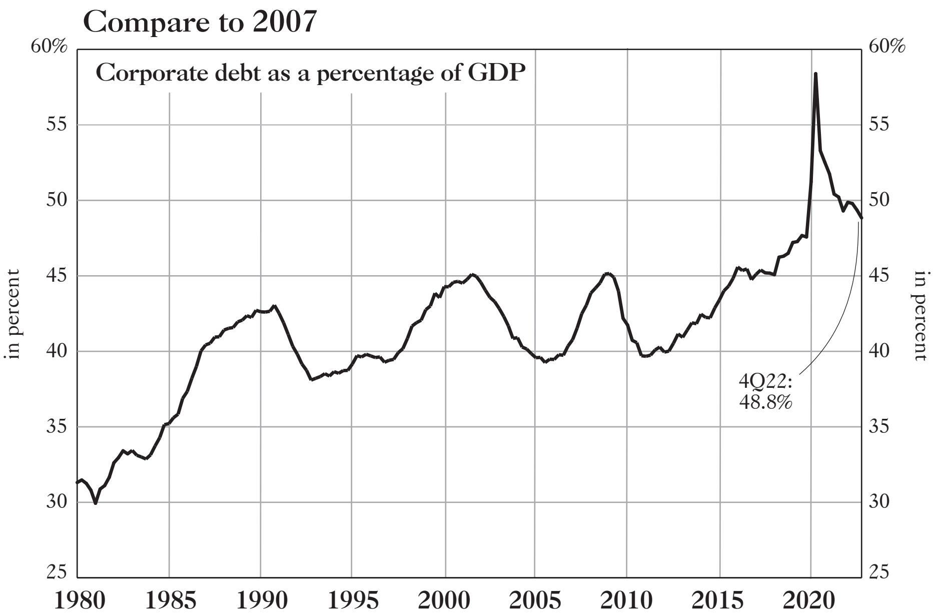

sources: Bureau of Economic Analysis, Federal Reserve

banks were tightening underwriting criteria on loans to large and medium companies; exactly none admitted to easing them. With this level of stringency at previous cyclical junctures, the median high-yield bond spread was 771 basis points, as Martin Fridson, CIO of Lehmann, Livian, Fridson Advisors, LLC, observed the other day. Today, the gap is a mere 454 basis points.

"They should be 150–200 basis points wider," an anonymity-seeking CIO of a private credit fund contends. "Why they are not wider is because of the presence of private credit. If you think about it, the illiquidity premium [i.e., while many loans and bonds trade, they do so infrequently] has moved out of the public markets and into the private markets."

Now higher interest rates are confounding the promoters' arithmetic. At the peak of the 2021 frenzy, the typical buyout transaction, financed with syndicated bank debt, was encumbered to the tune of 6.9 times adjusted Ebitda, of which first-lien leverage amounted to 5.4 times. The three-month Secured Overnight Lending Rate (SOFR) has jumped to 5.28% today from 0.09% at year-end 2021. Multiplying the first-lien leverage ratio (5.4:1) by the change in rates (5.28% minus 0.09%) means that interest expense is eating up an additional 28% of Ebitda.

Trailing 12-month fixed-charge coverage ratios, meantime, have fallen to 1.2 times in the first quarter from 1.4 times in the same period last year, according to the latest Lincoln International, LLC report on private markets. "While only 20% of companies had a fixed-charge coverage ratio [FCCR] of less than 1.00x in Q1," says the accompanying press release, "when accounting for current SOFR for a full one-year period (given fixed-charge coverage is based on trailing data), that number increases to nearly 45%."

Rising debt costs mean that something's got to give, and that something, for some leveraged private businesses, is their competitive position. "Companies have been able to manage their [fixed-charge coverage ratios] by cutting capex," Ron Kahn, co-head of Lincoln's valuations and opinions practice, recently told Bloomberg reporter John Sage, "which in some cases can be worse than a FCCR below one because it's a detriment to growth."

Anyway, the widespread flattery of "adjusted" Ebitda, through the anticipated cost savings called addbacks, means that leverage is probably understated. According to S&P Global Ratings's fifth annual addback study, which reviews the buyout crop of 2019, most of those margin enhancers never materialized. And so for buyouts in 2021, Ebitda was 30% below plan and leverage was 4.5 turns of Ebitda higher than forecasted.

"In general," S&P concludes, "Ebitda addbacks remain elevated, with addbacks for deals originated in 2021 representing over 32% of management-projected Ebitda, and over 48% of last-12-month reported Ebitda in our latest sample of large mergers and acquisitions and leveraged buyout transactions." In other words, the recent vintage of buyouts funded by private credit is even more prone than its predecessors to deceptive earnings adjustments.

Investors have noticed. According to an April survey of 150 private credit lenders by law firm Proskauer Rose, LLP, 54% of respondents expected deal activity to decline over the next year while 76%, a five-year high, anticipated rising defaults. A May 12 Bloomberg dispatch notes that private credit managers are ramping up hires of restructuring pros. "Everyone who thinks they are adequately staffed probably isn't," Salman Mukhtar, a managing director at asset manager Barings, is quoted as saying.

The oft-heard contention that direct lenders achieve lower default rates than their public-market counterparts may be put to the test shortly. "Working together to find solutions," Goldman's previously quoted paean to the supposed new spirit of lender-creditor cooperation in private markets, sounds a lot like distressed debt exchanges, which, in public markets, go by the name of default.

"Ultimately, there is a huge amount of overlap in terms of the borrowers that private credit firms lend to and the borrowers that the leveraged loan market lends to," Will Caiger-Smith, the U.S. managing editor at loan-research boutique 9fin, tells me. "It's hard to argue that there's something special about the borrowers that private-credit funds lend to that intrinsically means they are separate or insulated from the broader pressures that are driving increased defaults in the more transparent, broadly syndicated leveraged-loan market."

Besides, the software business, notoriously short of GAAP earnings, takes down one-quarter of private credit loans. In a concession to this dearth of profitability, lenders typically offer loans to tech borrowers tied to annual recurring revenues rather than Ebitda or free cash flow. Return of the creditors' funds may therefore depend on some happy future contingency—say, a bulge in the borrower's bottom line or a serendipitous acquisition.

Meantime, private equity is dealing with the consequences of the culminating, all-you-can-eat phase of the credit cycle. It was no coincidence that the typical buyout was priced in excess of 11 times Ebitda in 2020–22, compared with an average of 8.9 times, the prior p.e. top, in 2007. EZ money and yield-starved lenders facilitated aggressive deal-making.

From 2016 through 2021, p.e. managers were returning money to their LPs faster than the LPs could write checks to their managers. In that half-decade, American private equity promoters raised $1.6 trillion in new commitments while exiting investments worth $2.7 trillion. In those circumstances, a pension fund targeting, say, a 10% allocation to p.e. would have to over-allocate to the asset class simply to keep exposure steady.

That problem, at least, seems to have been resolved. Last year, U.S. private equity managers disposed of $312.2 billion's worth of investments while raising $361.6 billion in new cash. In the first three months of 2023, capital raises of $66.8 billion topped exits of $40.6 billion by a cool $26.2 billion. The anemic pace of exits will likely weigh on fundraising.

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Partners Group is the largest alternative asset manager that you may not have heard of except in the pages of *Grant's*. Founded by a trio of Goldman alumni in 1996, the Baar, Switzerland-headquartered firm looked after $135 billion at year-end 2022 across private equity (53% of the total), private debt (20%), privative infrastructure (15%) and private real estate (12%) strategies. Best known on the Old Continent (59% of its AUM is from Europe), Partners holds 53% of its investments in North America.

Good relative performance is the group's first calling card. In 2022, the company's real estate funds did generate a 0.4% loss, but private debt delivered 2.1%, private equity gained 2.8% and infrastructure earned 13.5%. For comparison, over the same span, the MSCI All Country World Index lost 17.9%.

Those relatively strong, absolutely anemic returns caused a steep drop in 2022 performance fees, to CHF 268.9 million, or 14.8% of revenues, from CHF 1,196.6 million, or 46.2% of revenues, in 2021. If management's forecast is on the beam, 2022 will mark the p.e. bottom. "For 2023, we expect performance fees to return to the mid- to long-term guidance of 20% to 30% of revenue," CFO Hans Ploos van Amstel said on the March 21 earnings call. "They will be skewed to the second half [of the year]."

As of Dec. 31, 2022, the Partners balance sheet showed net debt of CHF 289.9 million or one-quarter of trailing Ebitda. Last year's operating income covered interest expense by a whopping 56 times.

Anomalously for a European stock, Partners commands a large valuation premium to its American peers. Down by 20.6% in dollar terms since we had our say in the issue of *Grant's* dated April 1, 2022, the shares nonetheless trade at 19.2 times the guesstimate of 2023 earnings versus a 13.7 average forward multiple for Blackstone, Apollo Global Management, Inc., KKR & Co., Inc. and Carlyle.

Not one of the 21 analysts who follow PGHN advises selling it, though over the past 12 months, insiders have sold a net 2,986 shares for proceeds of CHF 2.6 million. One insider is voting with his feet: On May 24, Ploos van Amstel, 57, announced that he is stepping down; he joined the company in 2020.

Perhaps he found the footnotes to the Partners financial statements as baffling as we do. The notes, and the text to which they refer, tell you little about how the Partners funds have performed, or whether the funds' positions are properly marked to market. The group's published returns exclude such incidentals as taxes, as well as "expenses typically incurred at the start of the investment program, search fee, admin fee, ongoing operating costs or expenses incurred by the investment program (e.g., audit, hedging) or cash drag." In contrast, U.S.-listed p.e. shops typically report actual fund performance, i.e., net of all fees. Partners reports its investees' earnings on an adjusted basis while not excluding the benefit of acquisitions. With that said, portfolio company Ebitda rose by 16% in 2022.

While Partners is guiding for a return to portfolio exits in the back half of 2023, U.S. alternative asset managers are less sanguine. "[W]e're seeing a pretty quiet monetization outlook there right now," KKR CFO Robert Lewin cautioned investors on the May 8 earnings call. "That's what we're seeing. Our current pipeline and our expectation are probably going to remain that way for the duration of the year."

On top of this, Partners appears to have pulled forward performance fees, both through the 2021 bulge in exits (equivalent to 27% of that year's starting AUM) and through accounting tweaks. "From 2012 they moved from booking only 'locked in' performance fees which 'cannot subsequently be reversed,' to include gains which can be clawed back and/or unrealized gains also," James Spalton, a partner at Odey Asset Management, LLP, which is short shares of PGHN, tells me. "From around 2018 onwards, they then started lowering the thresholds for booking unrealized performance fees too. This broadly coincided with a rapid and material build in Long Term Accrued Revenue, performance fees booked but not yet invoiced, from 2017 onwards."

As of Dec. 31, 2022, the footnotes to the balance sheet show that Partners has booked a CHF 703.8 million receivable for unrealized performance fees, including CHF 420.2 million in long-term performance fees. Now there's an expression of optimism. The fees are to be plucked from portfolio realizations that Partners does not expect to happen within the next 365 days.

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Everybody knows about Moody's, which, alongside Standard & Poor's, forms a bond-ratings duopoly (Fitch Ratings, Inc., try as it might, remains a distant third). The mainstay Moody's ratings segment, Moody's Investors Service, delivers 48% of the company's trailing revenues but 63% of its trailing operating income. An analytics, data and research unit accounts for the rest of Moody's output.

The growth of private credit funds, which don't pay for ratings, along with the 14.7% year-over-year drop in U.S. corporate bond issuance, has weighed on first-quarter results. An 11% fall in the ratings division drove year-over-year declines of 3% in revenue and 15.5% in operating income. A plunge in the first-quarter tax bill, to 1% from 18.2% in the same period last year, explains a 1.5% increase in earnings per share. For the balance of 2023, management has guided for higher taxes—but for more bond issuance, too.

"[W]e now expect first-half [Moody's Investors Service] revenue to decline in the mid-to-high-single-digit percent range, and second-half MIS revenue growth in the mid-to-high-teens percent range," CFO Mark Kaye explained on the April 25 earnings call. "That's, again, based on our expectation for market volatility to partially abate in the latter half of 2023."

Longer term, the Moody's front office projects growth in revenue and EPS in the low double-digit range. Informing this guidance are expectations that the analytics unit can expand in the low- to mid-teens range while the bond-rating division can increase in the respectable single digits.

As of March 31, the Moody's balance sheet showed $5.3 billion in net debt, equivalent to 2.5 times trailing Ebitda. Over the past 12 months, operating income covered interest expense by 7.9 times. Moody's sports a triple-B-plus credit rating (its competitors so appraise it), near the bottom of investment-grade.

Since we laid out the bearish case in the issue of *Grant's* dated June 10, 2022, MCO has rallied by 15.9%. As a result of its strong price and weak earnings, the stock trades at 39.8 times trailing earnings, a premium to the 18.8 multiple that the S&P 500 commands as well as to the average of 24.2 times at which Moody's traded during the five years before the pandemic.

The 25 analysts covering the venerable bond rater are broadly friendly. A little less so are the Moody's insiders who, over the past 12 months, sold 110,387 shares for proceeds of $32.2 million while buying none.

Its overzealous fans may exaggerate, but private debt does boast some advantages over public markets, and the new/old financing vehicles may wind up taking some permanent share from the legacy ratings-buying lenders. Moody's, like Partners, is priced for an imminent return to the 2021 bubble times, not for the kind of economic downturn that typically causes borrowers to retrench.

On that note, U.S. corporate debt peaked at $6.6 trillion in the third quarter of 2008 and did not overtake that high-water mark until the final quarter of 2012. Not coincidentally, Moody's revenue did not surpass its 2007 level until 2011.

As an additional historical marker, corporate credit today is much larger than it was at the precipice of the housing bust in 2007, both in absolute terms—$12.8 trillion versus $6.3 trillion—and as a percentage of GDP—49% versus 43%. Of these sobering facts, the Moody's analytical division is no doubt well aware.

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