Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, senior members of Tortoise provide a timely update on trending topics in the market.

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, senior portfolio manager at Tortoise. If you've listened to some of my podcasts over the past few years you are probably aware that I am an avid fan of the HBO series Game of Thrones. Within the various seasons and episodes of Game of Thrones, the viewer is often trying to figure out what surprises are around the corner, who will not make it to the next season or episode (to put it nicely) and ultimately who will end up on the throne when all is said and done. Similarly in the financial markets, participants are often trying to figure out what surprises are around the corner and more specifically where the next systemic problem or problems may lie. If history is any guide, problem areas in the financial markets tend to arise in market pockets that are relatively opaque, potentially unregulated, advertise potential yields or returns exceeding the general market and have experienced hyper growth in monetary investment over the prior several years. Private credit, also referred to as private debt or the shadow banking system exhibits all of these tell-tale traits. In today's podcast we will briefly discuss the private credit markets, including the typical underlying investments, estimated size of the market, catalyst for growth, investor exposure and some of the potential risks within the broad asset class.

Defining private credit can be difficult. In general, private credit investments are debt like instruments funding small to mid-sized enterprises that have no publically traded market or quoted valuation, typically are below investment grade in credit quality (if rated) and do not reside on bank balance sheets. The most common private credit products are first lien secured loans, second lien secured loans and subordinate or mezzanine financing and they are typically floating rate in nature. Prior to the financial crisis, much, but not all, of this financing was provided by banks. Immediately following the financial crisis, banks were hamstrung by new regulations and capital constraints. As a result, less constrained non-bank lenders stepped in to fill the gap in the largely unregulated shadow banking system which in turn flourished. Despite limited data and transparency, some have estimated the current size of the private credit market at roughly $900 billion today versus roughly $200 billion immediately preceding the financial crisis, equating to a growth rate of roughly 15% per annum post the financial crisis. At approximately $900 billion today, the size of the private credit market is now only modestly smaller than that of the high yield and leveraged loan markets at approximately $1.2 trillion each. Growth in private credit has been the result of the changing regulatory environment for banks, monetary policies leading to a shortage of yield opportunities and the savings glut driven by changes in global economics and demographics.

Private credit borrowers tend to be smaller, riskier and more likely to have earnings volatility than the larger firms tapping the high yield or leveraged loan markets. Further, they turn to direct lenders in the private credit markets because they typically don't meet a bank lending criteria. As such, it is estimated the average credit rating of private credit borrowers is low single B versus mid-single B for leveraged loans and mid to high single B for the high yield market. It is estimated that technology, software, business services and healthcare constitute the greatest industry exposure within private credit as measured by average lending volumes since 2010.

The primary vehicles holding private credit are private debt funds, middle market CLOs (collateralized loan obligations) and BDCs (business development companies). Given the historically low interest rate environment post the financial crisis combined with the savings glut, yield reaching behavior has been rampant and has helped fuel the outsized growth in private credit. Some of the yield reaching has occurred simply due to greed while some has occurred out of necessity, such as pensions needing to meet their lofty liability yield hurdles. In fact, the largest end investors of private debt investment vehicles have been pension funds followed by sovereign wealth funds, endowments, foundations and insurance companies.

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Private credit has similar risks to various other types of credit investing although many of these risks tend to be amplified within private credit. As previously discussed, the average credit quality within the private credit market is lower than the average in high yield and leveraged loans equating to a higher average default rate over a full market cycle. Private credit is typically secured by a first or second lien position which should result in a high recovery rate than a typical unsecured high yield bond in a distressed scenario. However, given the previously discussed industry concentration in private credit which tends to be asset light, we would expect a lower overall recovery rate than the leveraged loan market. Liquidity risk is also amplified within private credit. Given the private and low transparency nature, relatively small size of the borrowers and small number of investors familiar with individual deals, secondary trading liquidity is sparse in normal market environments and almost non-existent in stressed environments unless price discounts get deep enough to attract the distressed community. Two of the three largest holders of private credit (private debt funds and BDCs) are mark-to-market sensitive whereas the majority of holders (banks) pre-crisis were not. Further, many of these holders employ some form of leverage. As such, mark-to-market pricing, which is typically achieved through third party pricing matrices or increased financing costs, can cause forced sales in these leveraged vehicles. Luckily, most of the investment vehicles holding private credit employ lock-up periods and hence don't allow for daily or even monthly investor redemptions. However, some private credit investments are finding their way into public investment vehicles that offer daily or periodic liquidity. This nuance could have bad consequences during a downturn if investor redemptions increase.

The influx of money into many areas of fixed income, including private credit, has in general caused lending terms to ease and risk premiums to shrink. This, however, is a result of a changed regulatory environment, a savings glut and low global interest rates; all of which could persist for a while. As such, while we are not predicting the imminent end of the current business cycle, we are acutely aware of where problems could arise. Just to be clear, while we see some tell-tale signs of a frothy private credit market at risk, we are not predicting an imminent implosion of the private credit market, we are not suggesting all investments in the asset class are bad, and more importantly any correction in private credit could create some significant investment opportunities for the savvy investor in the future.

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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