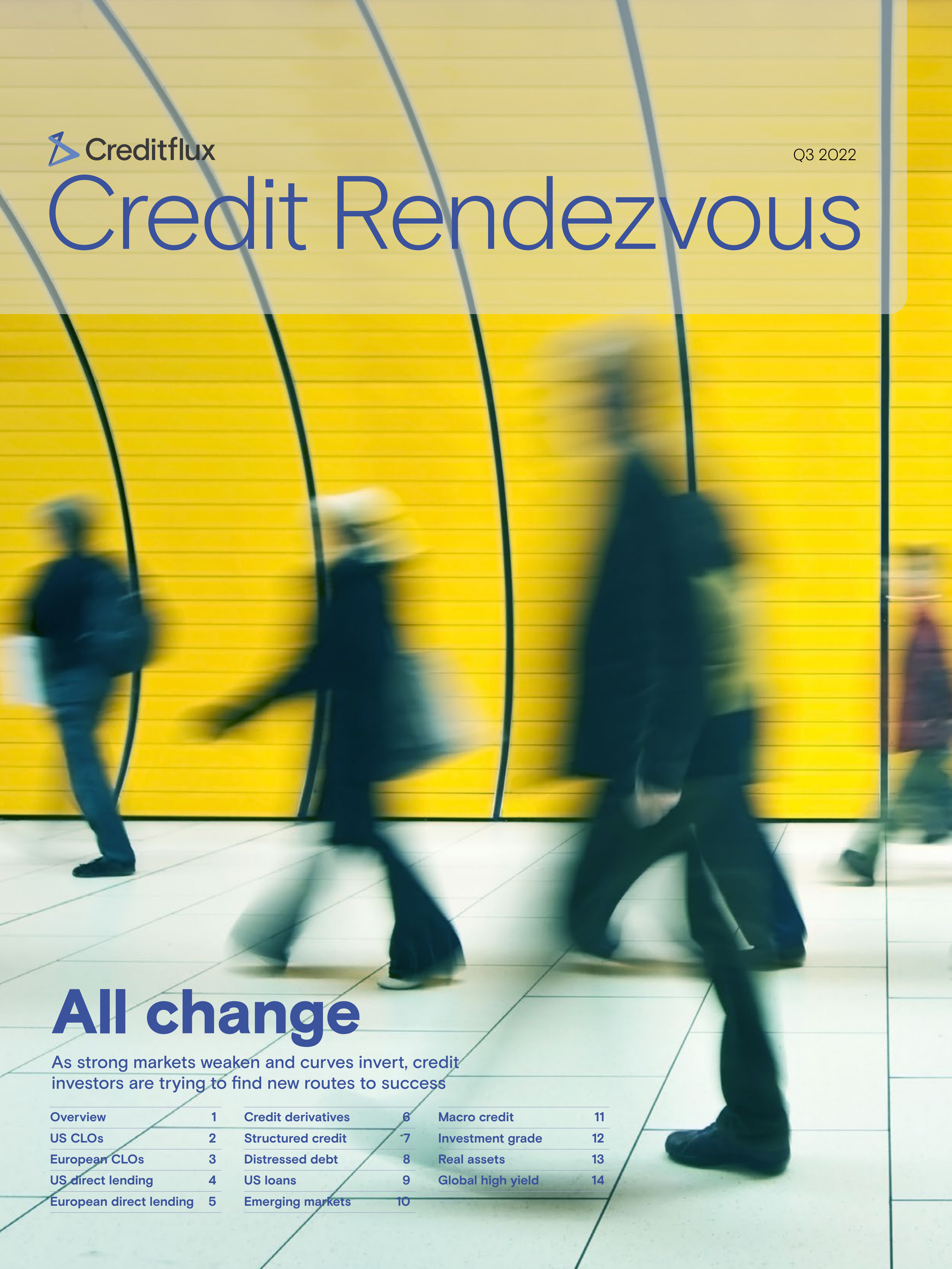

Creditflux

Q3 2022

Credit Rendezvous

All change

As strong markets weaken and curves invert, credit investors are trying to find new routes to success

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US direct lending

Rising input costs are piling pressure on small companies — but large-scale defaults are unlikely

Jason Colodne

Managing partner, Colbeck Capital Management

Bullish

Increased opportunities to finance companies going through periods of transition

Bearish

Heavy industrial and lower market businesses, given generally higher cap-ex requirements and limited ability to pass through cost increases

Greatest challenge

Traditional direct lenders could have trouble with underlying borrowers trying to ride inflation and interest rate volatility

Mark Slusar

Managing partner, Enhanced Capital

Bullish

Renewable energy

Bearish

Brick and mortar retail

Greatest challenge

Inflation and supply-chain issues

Onshore opportunities have opened up

Rising interest rates are a net benefit for direct lending, with the appeal of floating-rate products drawing inflows to private credit in the first half of 2022. Default rates remain at just over 1% but, amid talk of recession, lenders are increasingly concerned about the ability of small companies to pass on costs.

According to Mark Slusar, inflation is a problem for small borrowers, with input costs at some of his portfolio companies having risen by as much as 70% in a year. But supply-chain crises following the pandemic have largely resolved themselves.

"The lower end of the middle market was hit harder by some of the supply-chain issues than larger corporate America, as the largest customers were building excess inventory to prepare for continued disruptions, while smaller businesses were put at the end of the line by vendors," he says. "Most of these businesses have weathered that and a lot of opportunities have opened up. Since they have onshore supply chains, some of our borrowers have the opportunity to sell to other US-based chains because of their geographic locality."

Along with rate hikes, energy price increases and labour shortages are putting pressure on direct lending portfolio companies. As such, July earnings reports are likely to paint a less rosy outlook than other recent quarters. But those stresses are unlikely to translate to defaults on the level of 2020, let alone 2009, says Jason Colodne.

"We actually expect the number of bankruptcies and subsequent debt refinancing to remain relatively low, primarily due to three factors in the market," he says. "These are: the lack of covenants that many of these middle market companies have; private equity's significant influence, given the competition in their pipeline; and the amount of capital raised in the private credit space."

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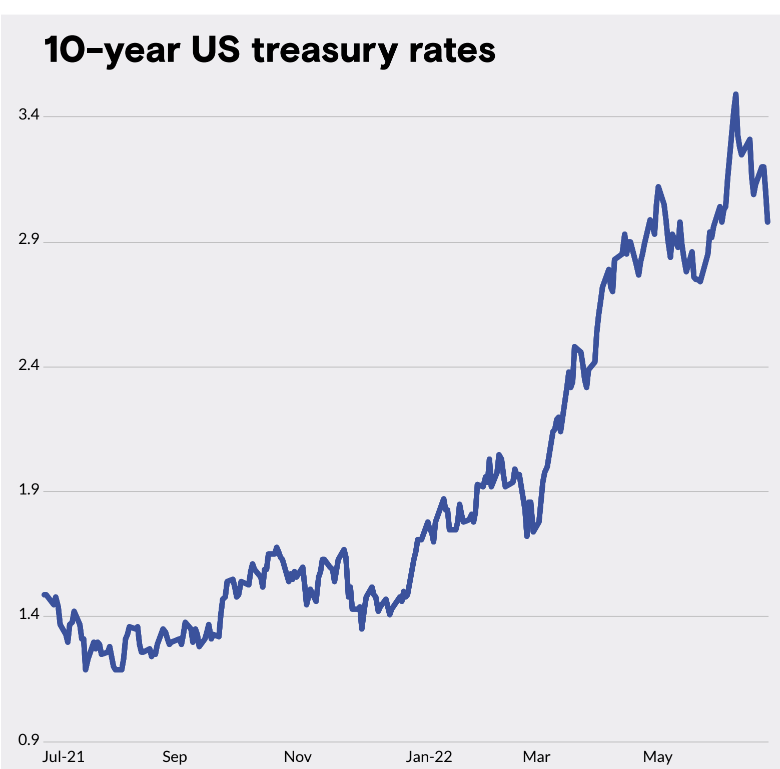
Source: US treasury



10-year US treasury yields hit their highest level in 11 years in mid June, peaking at 3.49%, as investors sought to get ahead of rate rises. The term curve is inverting with three years proving to be an inflection point.