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Private Credit Funds Get Pickier as Downturn Fears Intensify

- 'Recession-resistant' software finds interest among lenders
- Demand for private credit rises even as dealmaking wanes

by Silas Brown and Lisa Lee
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Buyout firms that contact private credit funds to gauge their interest in backing multibillion-dollar acquisitions are finding that only specific types of borrowers are guaranteed a call back these days.

Lenders in the $1.4 trillion private credit market are favoring industries such as technology and health care that should hold up relatively well should the economy shrink, according to private credit managers.

"Lenders and private equity are currently looking for industries where you can invest capital while feeling comfortable despite a challenging macroeconomic outlook," said Mike Patterson, a governing partner at HPS Investment Partners. "Both software and health care are historically recession-resistant."

Private credit managers are increasingly being asked to finance big deals as investment banks pull back from lending as the market for high-yield bonds and leveraged loans remains challenging.

Just before Christmas, Sixth Street led a $2.25 billion financing to support Advent International Corp.'s acquisition of satellite owner and weather forecaster Maxar Technologies. In Europe, Goldman Sachs Asset Management LP led a group of four lenders in a €700 million ($741 million) loan backing the acquisition of Italian pharmaceutical firm Neopharmed Gentili SpA.

Announced private-equity deals for targets in North America and Western Europe over the past six months have fallen 46% to $357 billion from the preceding six months, according to data compiled by Bloomberg. Still, the proportion of deals that are seeking financing from private credit managers is up significantly, market participants say.

"Lenders can be choosy now as there is a lot of demand for our capital," said David Golub, president of Golub Capital. "We are focused on providing good loans to companies that are likely to do well even if market conditions, macro-economic conditions, get more challenging."

Companies in certain segments of the health-care industry are seen as particularly resilient during recessions as they often benefit from long-term contracts and less volatile demand for services.

Within the technology industry, software firms are by far receiving a disproportionate amount of attention from private credit lenders. That's even true for fast-growing companies that don't generate positive earnings and would therefore struggle to obtain financing from banks.

Software Succeeds

Firms including Sixth Street, Blackstone Inc., and Apollo Global Management recently piled money into the multibillion-dollar buyouts of firms such as Coupa Software Inc., which helps companies manage their spending.

Good software companies have a stable core business and a predictable growth trajectory, according to Golub, as well as solutions that enable business clients to be more effective and to save money.

"This makes customers renew their subscriptions at high rates like 95%, and because the companies understand their customers so well, they can up-sell improvements and other products as well as bring on new customers," he said.

These deals can be struck as recurring-revenue loans, a structure in which credit metrics are based on a measure of recurring sales as opposed to earnings, which are typically negative. Deals this year for Avalara Inc. and Zendesk Inc. are among those that were structured with that format.

Another key driver for software deals, which isn't true with health care, is the dramatic drop in value for some publicly traded companies, said Patterson.

"Buyout funds can pay a premium to take private a publicly-listed software firm that has dropped in value by 80% and still buy it cheap relative to recent history," he said. "The larger private lenders, those that can credibly speak for $1 billion, are unique in getting a disproportionate number of calls at the moment."

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