EXPERT Q&A

The reopening of syndicated loan markets is creating huge opportunities for junior debt lenders, says Park Square's Robin Doumar

Junior debt opportunities set to shine

Over the past few months, the European syndicated loan market has roared back to life, and private credit's junior debt segment is reaping the rewards. Robin Doumar, managing partner at Park Square Capital, tells us that the market's revival creates exciting opportunities for junior debt lenders to be part of financing solutions alongside syndicated senior loans.

However, Doumar warns that managers need to be disciplined to succeed in junior debt lending in the face of a volatile macroeconomic environment.

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Q How is the reopening of syndicated markets affecting the private debt market in Europe generally, and the junior debt market in particular?

From a junior debt perspective, we have been through a slow period after the syndicated loan market became dislocated a couple of years ago. Sponsors knew it was not the right time to sell most assets, so the amount of new issuance was limited, and the pace of deployment was slow.

Now that the syndicated loan market has recovered, it is white hot, with margins compressing. With a number of CLOs ramping up their portfolios, they have bid the secondary loan market to very aggressive levels. As a result, the combination of a low-cost syndicated senior loan and junior debt has become very attractive. The junior debt opportunity, mathematically, is much more appealing today than it was 18 months ago.

Typically, Park Square is part of a comprehensive solution where there is a senior component and a thinner, junior component. With the market where it is now, it makes much more sense to undertake a large transaction with a very attractively priced syndicated senior loan that has junior debt behind it.

The simple explanation is just maths: the market has reopened and we are at least back to a historically normal level in terms of syndicated loan market pricing. There is more M&A activity, which is very positive, and the

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pricing dynamic has changed dramatically. Overall, the syndicated senior loan market's snap back to health is absolutely fantastic for junior debt.

Q How are refinancing and deleveraging activities affecting the junior debt market?

As base rates have moved dramatically in the past couple of years, there are a lot of high-quality businesses dealing with a cash paying interest burden that is higher than the businesses and their private equity backers would like. Therefore, we are being called on to provide a solution to deleverage the debt with junior capital. While some might think of this as rescue financing, it's actually about optimising the capital structures to create more cash pay headroom.

Another theme we are seeing driving the junior debt business in this volatile environment is that private equity firms are holding assets for longer. However, in many cases, their LPs want a faster return on their capital. So, private equity firms are coming to us and asking if we can help them to recapitalise their business to allow them to pay a dividend and keep their LPs happy, while continuing to hold the assets.

Q To what extent is the risk of defaults increasing?

We are seeing relatively healthy performance in Europe and, in general, the quality of European borrowers tends to be higher than their counterparts in the US. Private equity tends to operate in sectors such as high-quality industrials, software, business services and healthcare, where there are many examples of stable and predictable business models. On the other hand, sectors that are more cyclical are going to see a fair amount of pain; managers who have exposure to consumer-facing sectors such as restaurants or gym chains are going to have issues.

Of course, we are in a higher interest rate, slower growth environment, and after a couple of years, inevitably, things are starting to bite. Our portfolio has performed very well, but in this environment, it is more difficult for management teams across the board to execute on basic things. To address this, we're seeing private equity firms changing out management teams more frequently, and where perhaps complacency has crept in, they have not moved quickly enough to rein in costs, or they have not passed through price increases quickly enough.

Q How do you expect managers to perform, given continued macroeconomic volatility?

I think we will see growing differentiation between managers. There are some, like us, who are extremely performance orientated. Then there are others who are more focused on growing their AUM and raising the next fund. A lot of these are newer entrants that do not have the right mentality for junior lending. We have already seen some car crashes – and we expect to see more.

You must have a very low risk tolerance to succeed in this business. Many alternative investment firms have a higher tolerance for risk because the returns can be much greater, they are rewarded for taking risks. In credit, you cannot make a 5x or 10x return on a transaction like you can in private equity, but you can lose all your money. Therefore, you must be much more downside focused, which is a specialist skill.

Q What is the key to success in navigating the market as a European junior debt lender?

The analysis for junior debt is more nuanced than senior lending. Recovery rates are always important, but they are critical in junior lending. We need to know that if something does happen, there is a genuine margin of safety. Therefore, our investments are orientated towards higher quality businesses.

This sounds obvious, but it takes discipline to stick to the principle of lending to higher quality businesses. It is easy to focus on the wrong metrics and get caught up in things like the return per unit of leverage and lose sight of the simple fact that there are some businesses that you should not lend to. Park Square is best in class with default and recovery rates, and I think that comes from our laser focus on the quality of the underlying business and maintaining our margin of safety. ■