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Aventine Investment Counsel

Blog Post #8

Thoughts From the Desk

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Hello from the Desk,

In the post-peak fin-meme era, few memes have brought as much laughter to the Desk as the "golden age of private credit" (attached below in all its glory).

As the impact of a protracted higher interest rate environment coupled with Basel III endgame implications has weighed on bank lending, the emergence of private sources of debt financing has continued to expand at an alarming rate.

While a stark proponent of free markets, as a child of the GFC, I will always remain wary of limitations in the degree of transparency amongst lenders and the financial stability of lending parties. While too big to fail remains a sensitive topic (on both sides of the current Basel III capital requirements debate), following the bankruptcy of Silicon Valley Bank, it is hard to argue with the stability in major lenders created by heightened regulatory policy and oversight. Thus, as we continue to see an immense deployment of capital by private lenders (governed by different oversight agencies and arguably less tested policy), it warrants whether these providers are net contributors or potential liabilities to credit availability in their respective markets.

As I began writing this post, Bloomberg released an article titled: "*Deals Too Dirty for Banks Feed $9[B] Private Credit Spree*". This article discussed the role of private credit in absorbing the bank-sized gap in lending to less-ESG borrowers like Oil and Gas and coal. Here, we note the industry's positives: they can provide 'affordable' credit options to essential areas of our economy that become less attractive to traditional lenders. Additionally, in a more restrictive environment, private lenders have ostensibly been willing to fund more risky opportunities, likely shielding the credit market from some of the unwinding that may have unfolded over the past few years had bank lending standards contracted to the extent they did without another party to make up for the slack. In both scenarios, we believe that smart capital, backing well-understood and well-collateralized opportunities, is an attractive place to allocate capital. However, in such an expansive market, this is not always how the story plays out.

As active investors in private debt, we continue to assess these opportunities on their deployment of capital, the returns on outstanding loans, and how well they safeguard capital through stringent lending standards and protective contractual provisions. While all three pillars remain vital, we have noted in the past that companies have capitulated on terms to secure deals due to heightened competition and pressure to deploy capital and preserve returns to secure deal flow. Additionally, one of the other concerns we have noted is the ability of private lenders to mark their books differently than industry peers. While not novel relative to its equity counterparts, we believe the contractual nature of these deals makes it more critical to have

pricing accuracy embedded in portfolio valuations and assessments. Thus, posing the question of, in an area that is allocating so much money so quickly, in an environment where collateral values are ostensibly diminishing, does one feel like their investment is safe? Asked differently, if the opportunity only returns high single-digit to low double-digit before fees, do I feel like my return is commensurate for the amount of underlying risk?

On balance, when evaluating private credit as an asset class and as an investment opportunity, we recommend that clients ensure their providers have transparency in their loan books, diversity in their allocations, sufficiency in their contractual safeguards, a track record of prudent deployment and a robust pipeline of candidates to avoid restrictive, forced deals.

Best from the Desk,
James, Jim, David, Shannon, and Nicho