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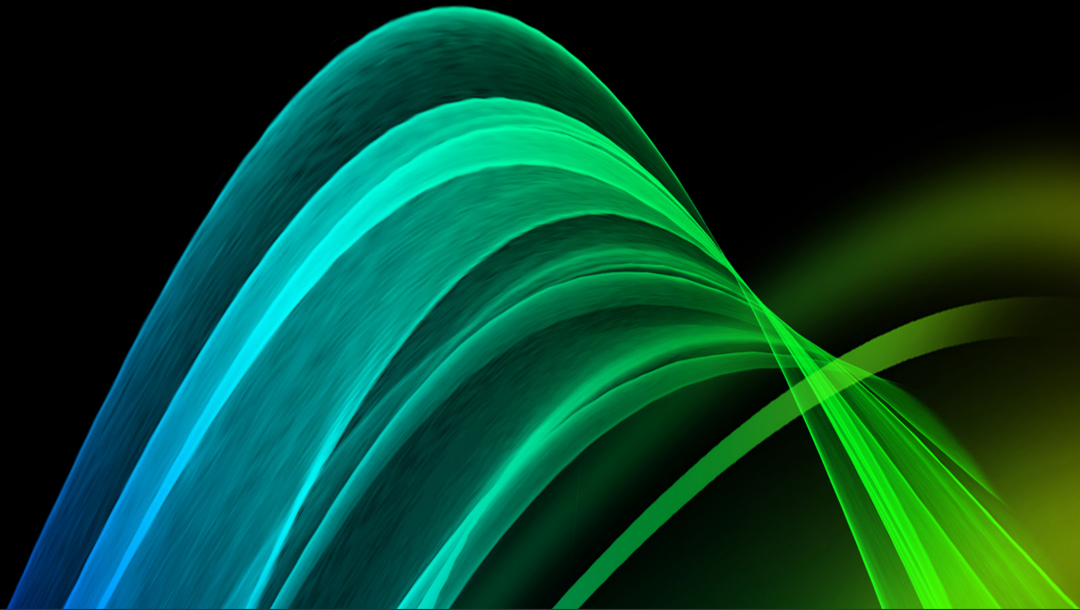


Solgen Capital Insights: November 2023

The Attractiveness of Healthcare Private Credit

Introduction

Private credit, or direct lending, refers to non-bank lending where the lenders are typically private debt funds or other non-bank financial institutions.

The private credit market has grown rapidly over the last decade, with an increasing number of institutional investors turning to this asset class for its attractive risk-adjusted returns and portfolio diversification benefits. As we navigate through 2023, the private credit space continues to present a plethora of opportunities.

The Current State of Private Credit

The private credit market's growth rate has accelerated recently, from a 12% average annual growth between 2010 and 2019 to 23% annual growth from 2020 to 2022. Private credit assets under management globally have increased from $726 billion in 2018 to an estimated $1.5 trillion in 2023[1]. But that growth has taken market share from the high-yield and leveraged loan markets, rather than adding leverage to the economy[2].

Private credit providers have rapidly replaced regional banks as the main source of term lending to private companies in the U.S. This shift has accelerated over time as banking regulations have continued to make leveraged lending to private, less–liquid companies uneconomical for banks[2]. The recent bout of regional bank stress presented direct lenders with a new opportunity to take even more share from banks as lending standards tightened again[2]. We feel that the growth in private credit is sustainable given it stems from a shift from banks to private lenders, rather than an increase in overall corporate leverage. With a seemingly tightening regulatory environment, we expect this trend to continue.

Chart 1: Source of LBO Debt Financing (by deal count)

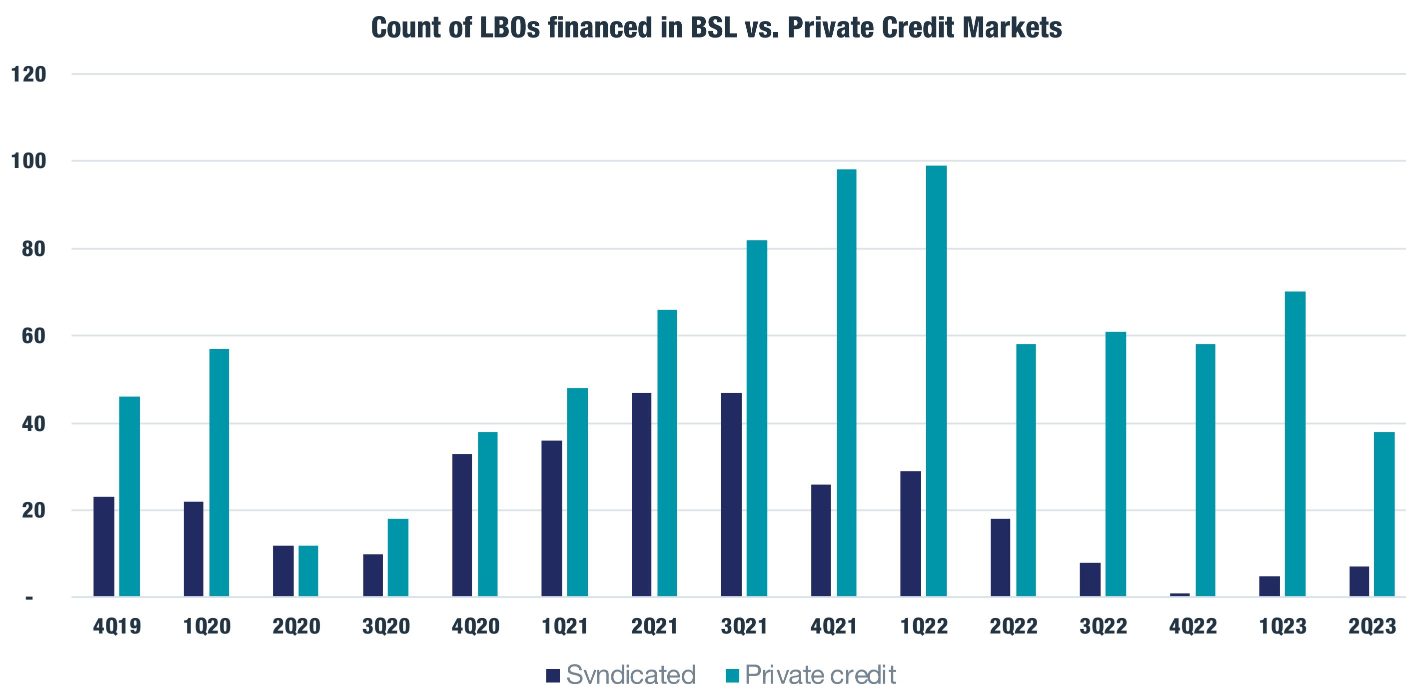
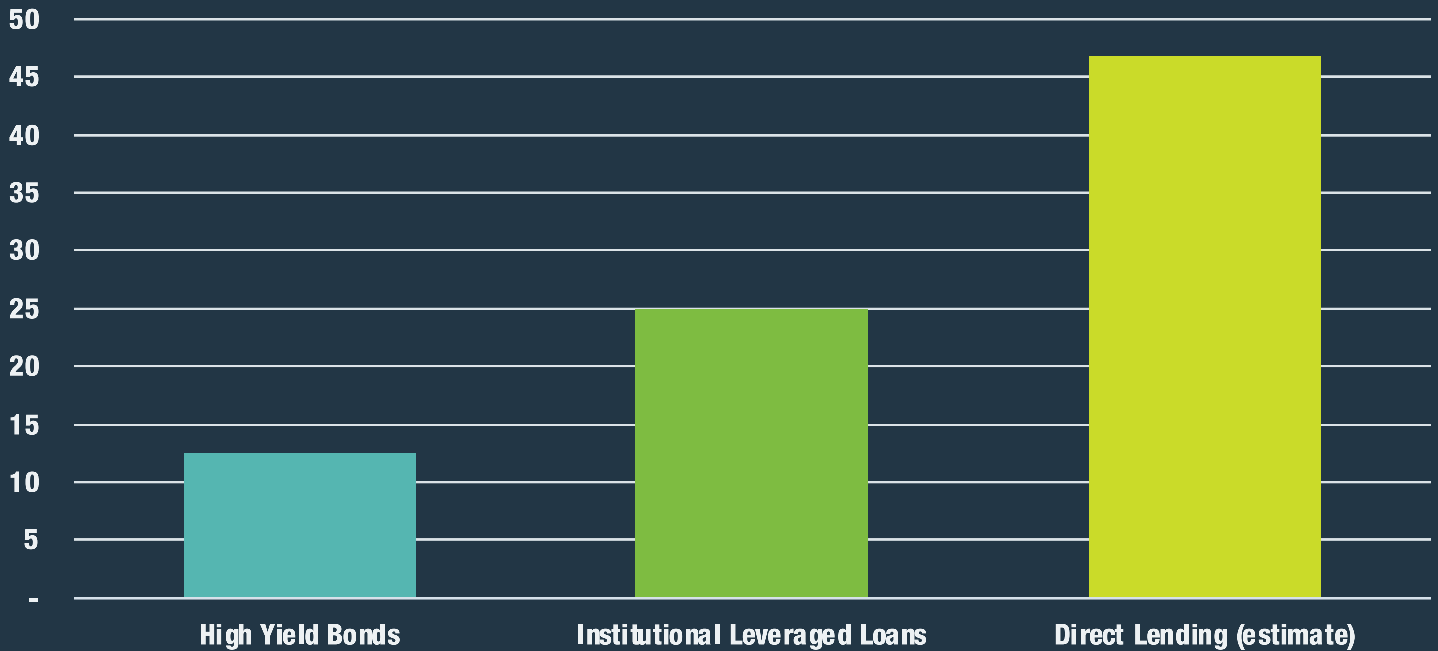


Chart 1: Source of LBO Debt Financing
Source: PitchBook LCD | * Geography: US | * As of June 30, 2023
Note: Private credit count is based on transactions coveered by LCD News.

Chart 2: 1H 2023 M&A Financing ($)



Note: The total M&A financing for the first half of '23 is roughly $85B. We believe healthcare makes up roughly the same percentage of this financing as its share of GDP (~20% or $17B YTD).

Source: PitchBook LCD | * Geography: US
* As of June 30, 2023
Note: Direct lending analysis is based on transactions coveered by LCD News.

Why Private Credit is Attractive in 2023 and Beyond

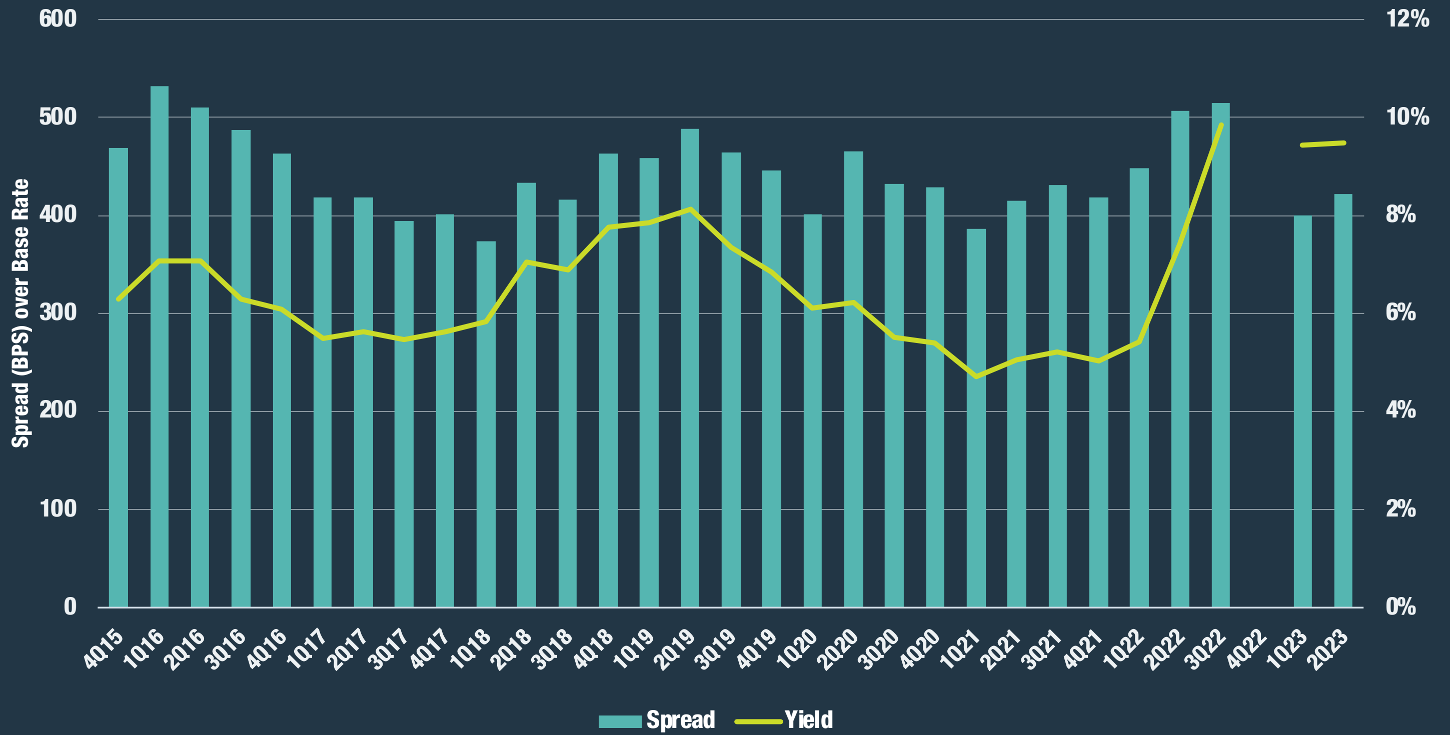
Increased Yield with Decreased Risk Measures Due to Decreased Competition from Banks: Private credit has historically offered higher potential returns compared to traditional fixed-income investments. This yield premium is a result of the illiquidity and complexity associated with private credit, which can be effectively managed by experienced private credit firms. In addition to high yields, private credit has historically maintained lower loss ratios than high-yield fixed income instruments.

In 2023, the average direct loan is yielding ~300 basis points more than large leveraged loan indexes. At the same time, aggregate leverage levels in new deals is down, suggesting improved credit quality[2]. This increase in yield combined with lower leverage levels in 2023 is a product of continued credit tightening by traditional banks and a need for tailored debt solutions and certainty of execution from borrowers.

Large Funding Gap Left by Banks: With banks still subject to stringent regulatory capital requirements, there is a significant funding gap for middle market and lower middle market companies. Private credit firms can fill this gap by providing direct loans to these businesses. In the wake of the pandemic, many middle market companies are looking to accelerate growth both organically and through M&A. This creates a strong demand for flexible, bespoke financing solutions that private credit firms are well-positioned to provide.

Direct Control and Flexibility: Private credit allows lenders to negotiate terms directly with borrowers, providing greater control and flexibility in structuring deals. Deep access to company records received by private lenders enables stronger due diligence and documentation than may be the case in public markets[3]. This can lead to better risk management and alignment of interests between the lender and borrower.

Chart 3: 1H 2023 M&A Financing ($)



Note: Note, as assets such as treasury bonds have seen an increase in yields, pricing on direct loans has seen a commensurate uptick. Note average LBO financing yields of ~10% materially outpace the 10-year treasury yield of 4.9% at the time this paper was written.

Source: PitchBook LCD | * Geography: US
* As of June 27, 2023
Note: There were not enought observations in Q4 2022 to provide meaningful averages.

Why Private Credit is Attractive in 2023 and Beyond (continued)

Value Proposition of Private Credit: Much of the growth in demand for private credit solutions has been driven by the unique value proposition that private lenders can offer borrowers. Private lenders are becoming preferred financing partners due to their sophistication, flexibility, certainty of execution, and the critical support they can offer to borrowers in challenging environments[4].

Lower Correlation to Public Markets: Private credit investments have a lower correlation to public markets, offering potential for portfolio diversification and risk mitigation.

Benefits of Sector Specialization

Deep Sector Knowledge: Specialization allows a fund to develop deep knowledge of a particular sector. This can include understanding industry trends, regulatory changes, competitive dynamics, and key risk factors. This deep knowledge can lead to better investment decisions and risk management.

Reputation and Relationships: A fund that specializes in a particular sector can build a strong reputation and relationships within that sector. This can lead to better deal flow, as companies and intermediaries are more likely to approach a fund that is known to understand and invest in their sector.

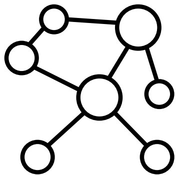
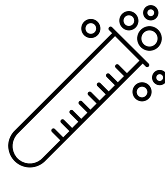
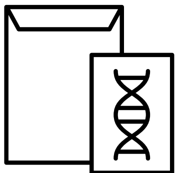
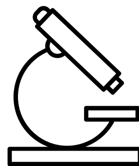
Efficient Due Diligence: With a deep understanding of a sector, a fund can conduct due diligence more efficiently. It can quickly assess the potential risks and opportunities of a deal, which can be a competitive advantage in a fast-moving market.

Benefits of Sector Specialization

Tailored Financing Solutions: A specialized fund can tailor its financing solutions to meet the specific needs of companies in its sector. This can make the fund's offerings more attractive to potential borrowers, leading to better investment opportunities.

Risk Diversification: While it may seem counterintuitive, sector specialization can actually contribute to risk diversification. By deeply understanding a sector, a fund can identify and invest in a diverse range of companies within that sector, spreading risk across different sub-sectors, business models, and geographies.

Performance and Returns: All of the above can contribute to better performance and returns. A fund that understands its sector deeply, has strong deal flow, can conduct efficient due diligence, offers tailored financing solutions, and manages risk effectively, is likely to deliver strong returns to its investors.

Benefits of Healthcare Focus

Steady, Growing Demand: Healthcare spending in the U.S. accounted for 17.7% of the Gross Domestic Product (GDP) and is expected to grow at an average annual rate of 5.4% for 2019-28, reaching $6.2 trillion by 2028[5]. This growth is driven by the aging of the U.S. population and other macro dynamics[5]. Healthcare is a necessity, not a luxury. Regardless of economic conditions, people still need medical attention, prescription drugs, and other health-related services. This constant demand provides a steady revenue stream for healthcare companies, making them reliable borrowers.

Resilience During Economic Downturns: As mentioned earlier, the healthcare sector is often considered defensive, meaning it tends to be more resilient during economic downturns. This resilience can reduce the risk of loan defaults compared to sectors that are more sensitive to economic conditions.

Government Support and Insurance Coverage: Healthcare costs are heavily subsidized by the government or covered by insurance. This can provide a reliable source of income for healthcare providers, enhancing their ability to service debt obligations.

Long-term Growth Prospects: Aging populations in many developed countries and increasing healthcare needs in developing countries suggest strong long-term growth prospects for the healthcare sector. This growth can enhance the financial strength of healthcare companies, making them attractive borrowers.

Innovation and Technological Advancements: The healthcare sector is characterized by continuous innovation, which can lead to new revenue streams and increased profitability for healthcare companies. Lenders who understand the sector and can accurately assess the potential of new developments may find attractive lending opportunities.

Conclusion

The private credit space presents compelling opportunities for private credit investors, offering the potential for higher returns, portfolio diversification, and direct control over investments. The healthcare subsect of private credit allows investors to take advantage of these opportunities in a growing, resilient space. These opportunities come with their own set of challenges and risks, necessitating a rigorous approach to due diligence, deal structuring, and portfolio management that we believe are best managed by a team dedicated solely to the healthcare space.

End Notes:

1 "The New Kings of Wall Street Aren't Banks. Private Funds Fuel Corporate America." – The Wall Street Journal (October 8, 2023)

2 "Can private credit continue to perform" — J.P. Morgan Private Bank

3 "Why Private Credit" — Stellus Capital Management, LLC

4 Understanding-Private-Credit-Educational-Paper-2022 — Goldman Sachs Asset Management

5 FoxWayne Enterprises Acquisition Corp. | 10-K (March 29, 2021)

About Solgen Capital

Solgen is a sector focused private credit fund manager investing in growing lower middle-market healthcare companies. Solgen provides flexible credit-oriented capital solutions to profitable companies with established operating histories and EBITDA of >$2 million. Solgen seeks to preserve investor capital through rigorous debt underwriting while offering appreciation through contractual debt income, equity features and active board participation.

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