

Private debt market impacts on borrower negotiations and what it could mean in capital markets

Eric Smith, CEO and Managing Partner at Locust Point, examines what opportunities exist for lenders amid market headwinds

What sources of debt capital are available for mid-market companies?

Over the near term, the majority of corporate borrowers will experience difficulties in refinancing existing debt. We may witness a significant increase in loan amendments and maturity extensions as banks seek to navigate through the challenging environment. The notion of "Survive to 2025" is becoming a reality.

Borrowers have very few options given the seizure of capital markets. Banks' balance sheets are full, and with no liquidity available in the market, borrowers can't refinance their loans, forcing banks to extend maturities. Furthermore, bank regulators are increasing capital requirements, which is reducing liquidity further. In prior credit cycles, as banks pulled back, non-banks would step in providing much-needed liquidity. However, this time, many of them, especially those employing a levered strategy, are also out of the market due to borrowing base issues related to rising interest rates. In addition, many institutional investors and insurance companies are dealing with their own liquidity issues, which has created an illiquidity credit loop with seemingly no clear exit. Breaking this loop will only happen when the Federal Reserve (Fed) begins to cut rates. Until then, most companies are left with few good options. If they can secure debt, it will be at much higher rates and lower leverage. In most cases, their only real option is to work with their existing lenders to re-margin and extend loans.

How are terms and conditions changing? Can lenders get more security in transactions?

I believe we're nearing the bottom of the current credit cycle as liquidity becomes scarcer. Consequently, credit terms have undergone significant changes. This presents one of the best opportunities for credit in over a decade. Currently, we're observing the lowest debt multiples and leverage combined with the highest yields, and the tightest loan covenants since the Global Financial Crisis (GFC).

Due to the limited market liquidity, weaker deals that may have been feasible when capital was abundant aren't even making it to market. Only the strongest deals are being considered, and even these occasionally encounter



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challenges when securing financing. As we move towards year-end, things are likely to become even tighter. Banks will need to review their loan portfolios in preparation for audit season, potentially leading to additional write-downs and further reduction of liquidity in the market.

What are the advantages of sector specialization for you as a lender? What are the advantages for investors?

Looking ahead, I anticipate that many institutional investors will explore specialized credit sectors offering lower correlations with the broader economy, diversifying their portfolios beyond corporate credit and generalist strategies. This exploration comes amid an ongoing debate regarding the potential for a recessionary hard landing in the US, driven by conflicting economic data which I believe will persist until clearer economic indicators emerge. I think institutional investors should start to think outside the box and focus on sector specific strategies that display limited correlation to economic cycles. One sector that I find particularly interesting is seniors housing, where a specialized asset manager can deliver substantial value. From my perspective, the seniors housing sector offers institutional investors attractive risk-adjusted returns over a multi decade period. Since seniors housing is a needs-based sector, it has historically exhibited resilience during economic downturns and a lack of correlation with the broader economy. I believe institutional investors should consider it as a hedge in their larger credit portfolio.

Are there any sub-segments you are targeting at the moment? For example, companies in need of refinancing.

Continuing our focus on senior housing, there's a strong case for new development in this sector. In the past five years, the number of new construction projects for seniors housing has fallen significantly due to factors like COVID-19, inflation, and high interest rates. Industry experts suggest that we should be aiming to build approximately 54,000 units per year until 2025, and then see a substantial increase to 95,000 units per year from 2025 to 2030. However, the average number of new units under construction over the past five years is an estimated 28,000 units and is declining.

Recent data from National Investment Center (NIC), the trade association for seniors housing, indicates that occupancy rates in primary markets rose to 84.4% in the third quarter of 2023.¹ It's important to note that the time between applying for building permits to admitting the first resident typically ranges from 24 to 36 months. As a result, we shouldn't expect new supply to enter the market anytime soon. This juxtaposed against the demographic tailwinds, will create an imbalance in supply and demand leading to high occupancies, strong financial performance in the asset class, and a multitude of investment opportunities, especially in credit.

¹ <https://www.nic.org/news-press/senior-housing-occupancy-rate-increases-for-ninth-consecutive-quarter/>

Eric Smith serves as the Chief Executive Officer and co-founder of **Locust Point Capital**, a credit-focused alternative asset manager established in 2016, exclusively specializing in the U.S. Seniors Housing sector. In his role, Mr. Smith is responsible for shaping the firm's core investment philosophy. With over two decades of experience in structured finance, he has dedicated the past 25 years to originating, underwriting, and overseeing investments in the long-term care, seniors housing, and healthcare services sectors. Over the course of his career, Mr. Smith has actively participated in more than 500 transactions, representing a combined transaction value of approximately \$7 billion in senior debt, mezzanine, and equity investments.