

E X P E R T Q & A

Media hysteria around redemption runs and AI may be overblown, but they shine a spotlight on important topics LPs should consider when investing in private debt, says Ted Denniston, co-head and senior managing director of NXT Capital



Cutting through the noise

Q It currently seems as though the travails of the private credit market are dominating the headlines, almost as much as war in Iran. Is the media overblowing the dangers, or do LPs have cause for concern?

I think it is probably a little bit of both. I do think that the media is sensationalising some of these stories. It certainly makes for good headlines, particularly in the US, given the executive order signed last year, which opens up alternative asset classes to 401(k) pension plans for the first time. I also suspect that the media frenzy that has built up

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around private debt is serving as a bit of a distraction from other things going on in the world.

Having said all that, I do think that some of the issues being raised are important. There are conversations that need to be had about the impact of retail money coming into the asset class and about the impact of artificial intelligence on the software sector, for example. These headlines are shining a spotlight on questions that LPs should be asking.

Does that mean that all software companies are fundamentally bad, which is the takeaway from a lot of these articles? Absolutely not.

Does it mean that retail investors should not be investing in private credit? Not at all. I think retail access to this asset class makes a lot of sense. But LPs need to look carefully at the GPs that they are working with to make sure that the strategy they are executing on today is the same as the strategy that built their track record. In other words, LPs need to be sure that they are getting what they signed up for.

Q As you say, there is a lot of talk about the impact of artificial intelligence on the software sector at the moment. How do you think about AI as a firm and how are you incorporating this into your underwriting?

The headlines have certainly focused on AI's impact on the software sector. We are hearing about Meta's decision to cut one in 10 jobs as a result of investment in AI, for example. The same story is playing out across other major tech companies.

Software represented less than 7 percent of our overall exposure as of the end of March, compared with some 20-25 percent in the leveraged buyout world. So, it is a relatively small piece of what we do.

That is not so much because we deemed software to be a sector to avoid, but more because we focus on EBITDA-based loans, not on annual recurring revenue, and our loans are cash pay interest rather than payment-in-kind. Software has therefore never really fitted our model all that well.

What is interesting to us, however, is the impact that AI is having on all the other sectors where we are active. It is proving to be a tailwind in certain

industries. For example, we are seeing several businesses that have been able to take significant costs out. There are companies that are definitely seeing AI-related benefits, while others are experiencing challenges. We incorporate analysis of the potential impact of AI into the underwriting process of every deal that we look at.

Q How is the retailisation trend impacting the space

where you operate? BDCs have clearly been experiencing significant redemptions. What are the implications for mid-market direct lending and what questions should LPs be asking in this regard?

Less than 1 percent of the money we manage is retail, with very limited redemption rights, so it is an incredibly small part of what we do. I think it is inevitable that there will be some



Q How is the direct lending market evolving on the global stage? Do you still believe the US is the place to be for investors?

There has been a slight contraction in terms of overall dealflow in the US. By contrast, although we are not active in other geographies, we have heard that there has been an uptick in Europe and in parts of Asia.

Nonetheless, the role of private credit in an investor's portfolio is primarily to be a stable, consistent performer and I certainly think that US direct lending continues to meet that brief. The US has the most mature private markets industry in the world. This is especially true of the private equity community. We are investing alongside private equity sponsors that have been active in the market for many years.

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impact on the wider direct lending market, however.

From an LP's perspective, the question is how retail money, and possible redemptions, will impact the ability of certain firms to be active in the market or drive a need to increase fund leverage or sell assets. BDC money typically has to be deployed quickly once raised, so those firms that have raised significant retail capital over the past few years have been very active on the new deal front.

Now that those firms may have to return some of that money due to redemption requests, there are question marks about their activity levels going forward and how they will generate the capital to satisfy the requests.

Just to reiterate, however, I do believe there is a place for retail capital in the private debt market. I just think that these products have to be structured in such a way that they don't force firms to be moving in and out of the market.

Q There are myriad other challenges impacting private credit portfolios, including tariffs, oil prices and recent instances of fraud. Is now really a good time to invest in direct lending?

We have been doing this as a team for around 25 years now, and on the basis of that experience, we believe that you should consistently be in the market. Consistency is key. I believe this isn't a market for trading – it is a market for investing.

I do think, therefore, that there are good deals to be done right now. What is important is selectivity. The focus should be on quality and not on pace of deployment. In particular, it should be important to LPs that GPs continue to focus on the same type of investments upon which they have built their track record. For us, that means a keen focus on cultivating our long-term relationships with the very best private equity firms, which are

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backing high-quality companies and putting significant money behind us in the capital structure.

Q What qualities should LPs be looking for in a private credit GP, particularly in light of some of the challenges that we have been discussing?

There is no denying that those challenges exist. The stories around First Brands and Tricolor keep coming. Then, obviously, you have all these macro concerns ranging from inflation and oil prices to AI. Against that backdrop, I believe there are two qualities that LPs should be prioritising in their due diligence of private credit managers.

The first is to ensure they are working with experienced GPs that are continuing to do what they have always done – making loans with the same type of security, which for us means first-lien senior secured loans to private equity-backed companies. What they may want to avoid, meanwhile, are firms that are drifting into new territories. Consistency is key.

The second aspect of due diligence that I think LPs should be paying close attention to is alignment of interest. A lot of firms have grown dramatically over the years and it is important that investors ensure that the GP's reward system remains aligned with their own. One tangible indicator of alignment is whether the manager retains real economic exposure alongside investors, and we do that by holding a piece of the loans we manage on our own balance sheet.

Q What impact is all the noise in the market today having on fundraising?

I do think that all the noise is making fundraising a little more challenging. Every meeting now begins with a conversation around the impact of AI on software and the impact of retail on the wider private credit market. There is a spotlight now on those issues and they need to be explained.

My experience, however, is that once investors have been walked through those topics, and once we have had the opportunity to talk about our track record and our business model, they quickly get comfortable with what we are doing. In fact, we recently completed a fundraising milestone, reflecting continued engagement from investors.

That close has involved a mix of existing investors reupping and increasing their exposure, as well as new investors that we haven't previously worked with. So, while the fundraising environment is certainly challenging, we feel like things are going pretty well. ■