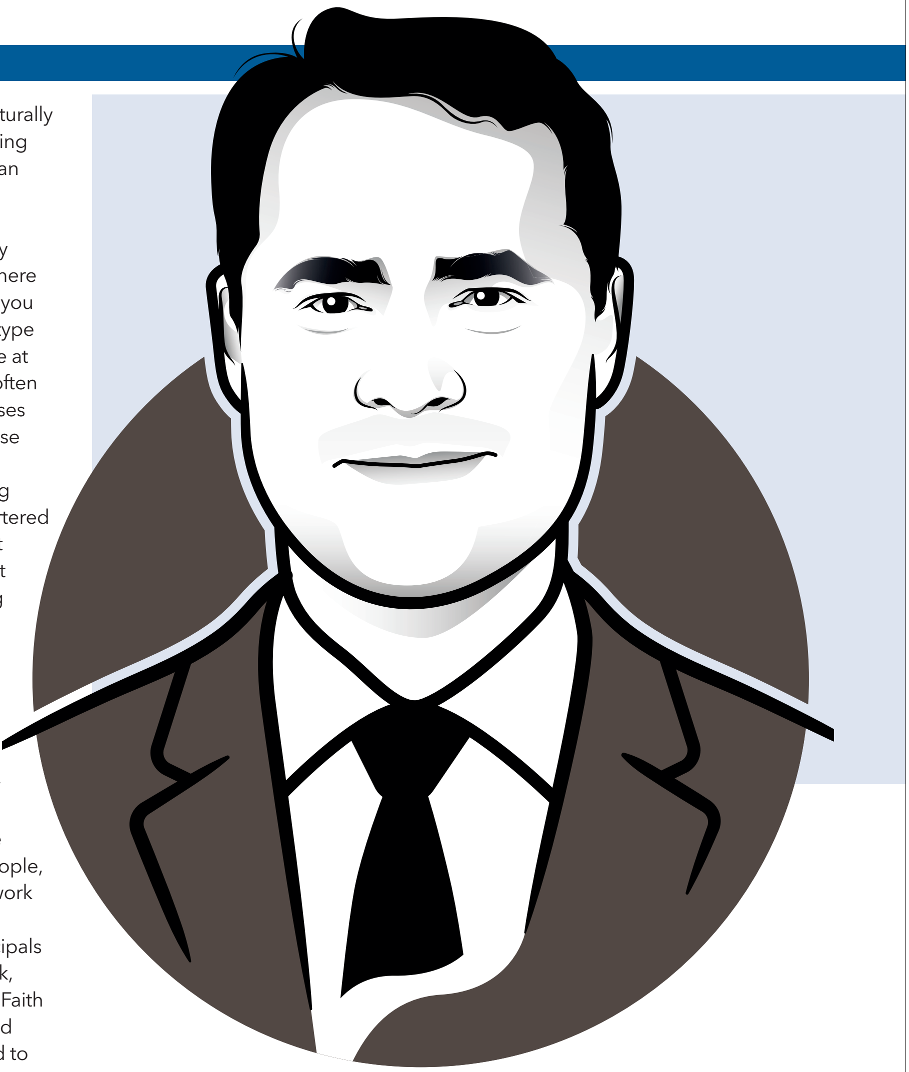

Strategy HPS 'built to navigate complexity'

'It could be structurally complex – layering new debt onto an existing capital structure – or it could be a really complicated business where there are not many comparators, so you can't just say, 'This is a certain type of business which has leverage at x so we'll leverage it at x.' We often have to dig deep into businesses on first principles. We love those transactions."

Michael Patterson, governing partner of New York-headquartered fund manager HPS Investment Partners and head of the direct lending platform, is describing the complexity that he maintains lies at the heart of HPS's approach, ***writes Andy Thomson.***

"We're built to be able to navigate that complexity. But we do ask ourselves, is it really complexity or is it just more work? If it is, you've limited the competition because most people, given the choice, will do less work rather than more."

Patterson is one of five principals at HPS alongside Scott Kapnick, Scot French, Purnima Puri and Faith Rosenfeld. The firm was formed in 2007, when Patterson joined to establish the European business before heading back to the US two years later. It was originally known as Highbridge Principal Strategies and part of the Highbridge Capital Management unit within JPMorgan Asset Management. Its principals and employees bought it out in 2016. It has been known since then by its abbreviated form, 'HPS'.

Complexity is a further differentiator from scale, which is frequently cited by the larger private debt fund managers these days given the increasing ability for them to replace parts of the capital markets. Make no mistake, though: HPS certainly has scale, too. Patterson points out that the firm recently passed the $100 billion threshold in terms of assets under management. Ranked third in the latest version of the PDI 100 – our ranking of the asset class's top fundraisers over a trailing five-year period – HPS's most recent fundraise, for its Strategic Investment Partners V fund, pulled in $12 billion at final close in March this year.

In an unusual twist, Patterson says that while the firm's reputation was built around its ability to do difficult deals, it has responded to investor demand for more plain vanilla-

Buildings won't necessarily crumble

Building products is the example Michael Patterson gives of the type of sector often shunned by private equity and debt investors but which – when applying conservative levels of leverage – might just be a viable option.

"Most direct lenders will just say no because it's building products, but if you're thoughtful about it and you lend at 2.5 turns of leverage and it's being bought at 8x, maybe that works," says Patterson.

"I'd be willing to bet it's not going to be worse for building products than in 2008 and, if you run a 2008 analysis based on moderate leverage, it might not look too bad – and no one else will look at it. There's generally always an attachment point that works."

Unfavoured sectors is one theme HPS is looking at. Another is layering new debt into an existing capital structure.

"The weakness in public credit documentation that has been injected over the last decade gives new lenders tons of opportunity to do something creative, and frankly often pretty safely," says Patterson. "So we think that's a big opportunity and really plays to our strengths from a structuring perspective. There have only been one or two so far, but I think there are going to be many more of those."

> "Europe should be wide of the US rather than tight to the US so we were very selective in Europe in 2022"

type direct lending in recent years. "We started with the 'off the run' complicated deals and then some of our investors said, 'We like your process, we've been invested with you for a long time, will you do the straightforward deals too?' So it's not that we don't have a presence in that market, but it came a decade after our original business."

Caution over Europe

In terms of geographic approach, Patterson says around 75 percent of HPS's capital is typically deployed in the US, around 20 percent in Europe and up to 5 percent in Australia/New Zealand and parts of developed Asia. Given the complexities in Europe – and HPS's experience in complex situations – it seems surprising on the face of it that Patterson has viewed Europe as relatively unattractive.

He explains why: "We think the average deal in Europe in the second half of 2022 was done at 25 basis points inside the average US deal. Now that doesn't control for industry and other factors, but that number is still very odd to me. You're paying a lot more in an energy crisis and with more exposure to foreign exchange risk, which I think CFOs have become unsophisticated about over the last decade. If anything, it should be the reverse in my view: Europe should be wide of the US rather than tight to the US, so we were very selective in Europe in 2022. As market volatility continues, we expect there to be interesting pockets of opportunity in 2023."

In Australia, meanwhile, HPS has been seeing opportunity to "add an ounce of creativity and get paid meaningfully more" than the banks, according to Patterson. That "ounce of creativity", Patterson adds, could be something as simple as allowing borrowers' proceeds from asset sales to buy another asset rather than be forced to use the proceeds to help repay the loan. It's the kind of flexibility that's common in markets like the US and UK, but not in Australia where the conservative approach of the big four banks has dominated the lending scene.

In the Asia-Pacific region, Patterson says HPS has been cautious as it's "awash with capital" and unitranches are "hard to blend to an interesting level because options for senior lending are so cheap and aggressive".

However, he adds: "I do think over the next five to 10 years there's something there. There's always been an Asian special sits market that's periodically interesting but if we're talking about true private credit, I would bet that it gains some traction."

Looking at the market in general, while Patterson notes that there are currently big premia on straightforward, senior secured loans he does think there's something of a swing back to complexity. "It feels like there's a lot of complicated situations out there, so I think it's about to get super interesting in that space," he notes. ■