PEI Alternative Insight
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Snapshot: Z Capital talks risky credit markets

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"Z Capital chief executive Jim Zenni tells Private Equity International that both institutional and retail investors have “moved into risk areas they’re not familiar or comfortable with."

In light of Standard & Poor’s November warning about rising levels of debt used in buyouts, Z Capital president and chief executive Jim Zenni tells Private Equity International that the credit markets and low interest rates are pushing up high purchase price multiples, with signs of “significant defaults going forward.”

What impact will a Federal Reserve decision to raise interest rates have?

There’s a lot of indications from the Fed numbers that raising interest rates is a likely event. I think the problem with what all central banks, not just the Fed, have created is this environment where investors – institutional, retail – have moved into risk areas they’re not familiar or comfortable with.

What we have today is the beginnings of significant defaults going forward; significant restructurings. A lot of that is shaded or concentrated by oil and gas, and metal and mining credits. What investors are forgetting today is this kind of events, when you have commodity prices dropping 40-50 percent in a short period of times, it makes a lot of companies insolvent.

In addition to that, you’ve got the ripple effect of commodities in general decline. You’ve already seen housing values in the oil patch declining in Oklahoma, Texas, and the Balkans. We’re already starting to see it, for sure.

Where are the equity and debt markets headed?

The environment we have today is not sustainable. We’ve seen cycles in the past in the back drop of low growth. The other thing is you’ve got the stock markets, which are ultimately the price indicator for future earnings. The stock markets are saying things are not going to be as attractive as they were. Expectations are lower and lower, and lower.

I’ve been investing in leveraged deals, both equity and debt, for more than 20 years. So I’ve seen the growth of this market and syndicated loans. They have grown incredibly, especially in the last five, six, seven, eight years. Today we have high-yield bonds approaching $2 trillion. These markets were one-tenth of what they are today, 20 years ago.

How are general and limited partners responding to these challenges?

You have all this dry powder in private equity and rising interest rates, and record multiples; that’s not a good cocktail for success. There’s a resolve to lower expectations. The big PE firms have told their LPs that returns are going to come down. That’s why you see a lot of LPs moving to niche players like ourselves that are less impacted by industry dynamics in general.

You’ve seen large institutional players allocating to small niche players to recapture equity returns at high double-digit, 20-plus internal rate of returns with multiples of 2x.

I think most investors have exposure to large funds but it’s hard to find opportunities of that size to deliver those returns. Sometimes, smaller is better from a return standpoint. That’s what we adopt, frankly.

Ultimately to put those dollars to work, the goal is not to be somewhat indexed. We’ve been disciplined in the last year not to chase deals. We’ve looked at over 200 transactions, but we’ve only done a handful. In many cases it’s price, in other cases it’s the type of business, whatever it may be.

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