For Investment Professionals only

M&G INSTITUTIONAL

Spotlight on private credit markets

New opportunities emerge across the credit spectrum

August 2020

Jo Waldron, director of private credit

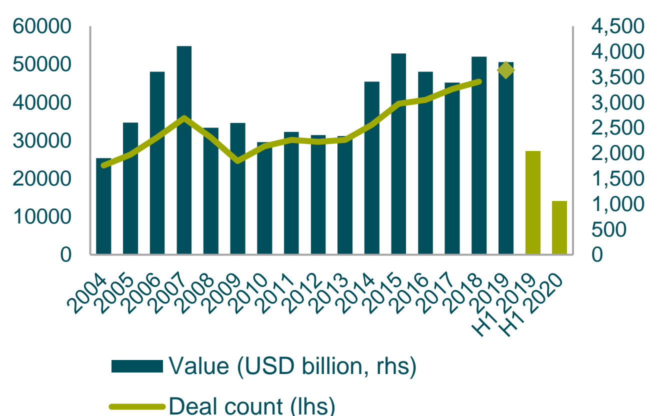
- We have seen activity in private markets picking up, with a flurry of early-stage transactions in the pipeline, that are generally reflective of a shift in bargaining power in favour of lenders
- Recent deals have offered an ability to negotiate better terms and structures than pre-crisis
- The outlook for private assets continues to be supported by technical and fundamental factors.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

Private credit: recent developments

In periods of market disruption, private market activity tends to get adversely impacted, the degree to which depends on the severity and length of time the public market disruption lasts. Private market deals tend to take a number of weeks or months to structure, and it is the ability to structure a deal to offer a premium to public markets that becomes more difficult due to fast-changing markets. For private corporate lending, the level of M&A activity is an important driver of dealflow, although there has been a recent resurgence in corporate deal-making since the start of July with deals that were put on hold a few months prior now back on track. Corporate deal-making will occur even in times of suppressed economic activity and elevated government debt.

Figure 1. Global M&A activity



Source: Bloomberg, as at 30 June 2020.

Market volatility subsided in the second quarter allowing capital markets to regain their footing after the widespread turbulence seen at the height of the COVID-19 crisis back in March and early April. As markets rebounded rapidly as unprecedented central bank intervention and government stimulus was deployed *en masse*, private market activity also cautiously restarted.

Private credit markets cautiously reopen

Activity levels have picked up both within the more liquid parts of our investable universe as well as the illiquid assets we invest in, which tend to be directly-held and bilaterally negotiated. The publicly-traded ABS market was first to reopen as conditions started to normalise but lagged the recovery in corporate bond markets, although collateralised loan obligations (CLOs) exhibited particularly strong performance in the secondary market during the second quarter following the technically-driven sell-off in March.

ABS markets: CLOs and RMBS opportunities abound

Primary market issuance in the CLO and the residential mortgage-backed securities (RMBS) sectors restarted and was met with strong

demand, however as early re-entrants back into the market, we were able to invest in a number of issues at decent spread levels while also benefiting from higher structural protections and strong credit enhancement. We took the opportunity to rotate out of US CLO holdings and into what we consider to be more resilient secondary European CLO paper, with the US corporate default-rate expected to be higher than that of Europe given the quantity of issuers already heavily indebted prior to the current crisis.

Initial issuance from the CLO and RMBS sectors was at dramatically wider spreads than those seen pre-crisis but spreads tightened relatively quickly. RMBS is the largest and one of the most liquid sectors within the ABS universe and here, high quality AAA-rated issues are almost back to pre-crisis tights in some cases.

Figure 2. Pre- and post-crisis ABS spread dynamics

Spreads (bps)	CLO		RMBS	
	AAA	**BBB**	**AAA**	**BBB**
Pre-crisis	89	315	55	170
Early deal post crisis	195	625	145	375
Recent deal	145	380	58	265

Source: M&G, as at 31 July 2020.

Illiquid and private assets: dealflow and activity picking up

We saw a number of new issues placed in the significant risk transfer (SRT) and specialty finance markets as pipelines ramped up, with the ability to negotiate stronger terms and structures than pre-crisis. Within the specialty finance market, we note a number of deals coming through that have exhibited particularly strong risk-reward profiles in the double-digit yield range.

The regulatory capital trades we have seen recently are pricing at significantly wider levels than pre-crisis, are shorter and have thicker tranching than comparable deals transacted pre-crisis. Looking ahead, the sector is gearing up for a traditionally busy fourth quarter, and we expect there to be a number of opportunities to deploy capital.

Real estate debt transactions are starting to come to market and we are seeing several deals with better terms than pre-crisis. More generally, we are seeing sponsors looking to re-lever their core and strongly-performing assets in order to release capital to support other assets in their real estate book.

We are seeing a number of interesting direct lending deals coming through, offering around 50 basis point (bps) yield pick-up to pre-crisis levels for similar risk. Corporate mid-market direct lending deals are starting to emerge as M&A activity picks up from private equity (PE) sponsors.

Our direct lending team has also been approached on fund financing transactions where existing funds are seeking either to increase leverage to make add-on acquisitions or put in new subscription line facilities to provide immediate liquidity.

There have also been opportunities in the trade receivables sector offering better pricing terms, including one transaction providing short-term finance to an international trade finance provider. The transaction references a wide and granular portfolio of trade receivables tied to trading operations between Asia and the developed markets.

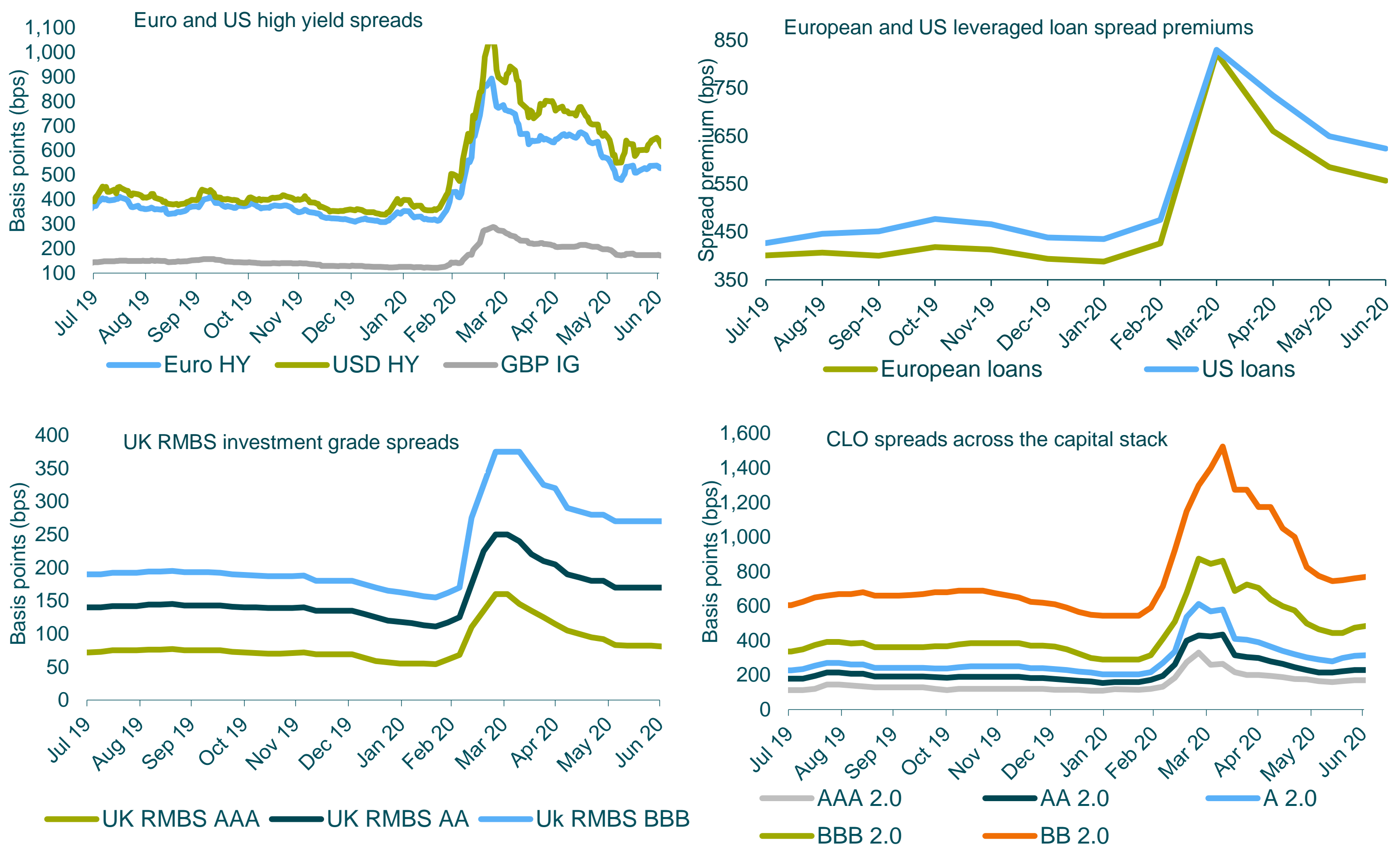
Trade receivables in action – International trade finance provider

Opportunity: Structured as a private securitised facility providing finance to a trade finance provider, secured by a portfolio of trade receivables.

Well diversified portfolio of receivables in terms of both geography and industry, with a significant proportion supplied by investment grade names.

Strong security package including an 85% loan to value; strong covenants that are applied if payments are delayed or missed; conservative advanced rate to ensure that total loan availability is controlled. Also includes a comprehensive set of borrowing base controls, with portfolio concentration limits and daily testing on eligibility criteria to capture non-compliance.

Figure 3. Market snapshot: a tale of two quarters?



Source: ICE BofA Euro Non-Financial High Yield Constrained Index (HEAD), ICE BofA US High Yield Index (H0A0), ICE BofA Sterling Corporate Index (UC00), JPM 1.0 CLO spread data, City Velocity 2.0 CLO spread data, as at June 2020.

With greater insight into the state of various credit markets, we can better contextualise the reaction and dynamics of the private credit markets over recent months. Markets have bounced back but not retraced all of the losses seen during the first quarter. Typically the recovery of spreads back to 'normal' within private markets lags that of the public markets and provides interesting investment opportunities.

While the majority of the private credit assets we invest in are model priced, those prices also usually have public market credit spreads as an input and so are not immune from mark-to-market volatility even though they are somewhat muted. ABS assets are typically priced by the market or by brokers, so even illiquid assets tend to be affected by technically-driven market moves, which have been driven by supply-demand factors rather than any weakening of the underlying credit quality.

While the major economies fell into recession in the second quarter, many companies have been bolstered by government support measures, drawing down on available credit facilities during the period of disruption to operations and revenues, and staving off default as national lockdowns have eased and economies have started to reopen. The economic aftershock of the pandemic has yet to be fully felt on balance sheets and it is still early days in the restructuring cycle. Defaults are rising but are not expected to reach the levels seen in the global financial crisis.

High yield bond markets serve as an input into many of the model priced private assets. We have seen US high yield spreads tighten by approximately 100bps during the second quarter, reversing much of the spread widening observed in the first quarter. Technical factors remain supportive despite a deluge of new-issue activity, as supply has been met with continued inflows from retail investors, and the start of the US Federal Reserve's ETF-buying programme.

Leveraged loans typically serve as a proxy to direct lending, although we see much less mark-to-market volatility here as many of the assets we hold in the sector on behalf of our multi-asset private credit strategies do not have spread inputs to pricing. The European Leveraged Loan Index showed what appears to be a quicker-than-expected resumption of business in June, coming

after better-than-expected liquidity and operating performance for some issuers in May.

There have been almost no defaults in loans and very few in high yield markets so far, and the default rate this year is now expected to be lower than initially feared by the credit rating agencies. This is partly justified by evidence of fiscal support made available to issuers including support from PE sponsors (utilising the US$2.7 trillion of dry powder at their disposal). However, we continue to see bifurcation in loan prices, particularly for issuers that entered the crisis with an over-levered capital structure.

What is the outlook for private assets?

The outlook for private assets continues to be supported by a number of technical and fundamental factors. Strong demand for yield is likely to persist given 'lower for longer' rates, underpinning investor flows into private credit asset classes offering good risk-reward balance and downside protection.

More broadly, we believe certain asset classes present interesting entry points, either wider spreads compensate for the low-rate environment at comparable risk to pre-crisis or where we are able to construct portfolios to deliver similar returns to pre-crisis with lower risk characteristics. We continue to take a flexible approach to portfolio construction, ensuring diversified exposure to private credit and evaluating investments on an asset-by-asset basis.

Origination is key

We have seen activity in private markets pick up over recent weeks, with a flurry of early-stage transactions in the pipeline, that are generally reflective of a shift in bargaining power in favour of lenders. We are seeing a decent pipeline of assets from our origination team covering Asia and Australia and would expect there to be a number of investment opportunities coming through in the months ahead.

www.mandg.com/institutions

Please note that this website has not been reviewed by the SFC and will contain information about funds that are not registered with the SFC.

For Investment Professionals / Sophisticated Investors / Qualified Investors / Institutional Investors only. This guide reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. Past performance is not a guide to future performance. The distribution of this guide does not constitute an offer or solicitation. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information given in this document has been obtained from, or based upon, sources believed by us to be reliable and accurate although M&G does not accept liability for the accuracy of the contents. **Notice to investors in the United States.** This document is for informational purposes only and is not an offer to sell or purchase interests in any M&G fund. Shares in M&G funds have not been and will not be registered under the United States Securities Act of 1933, as amended, or registered or qualified under the securities laws of any state of the United States and may not be offered, sold, transferred or delivered, directly or indirectly, to any investors within the United States or to, or for the account of, US Persons, except in certain limited circumstances pursuant to a transaction exempt from such registration or qualification requirements. The funds will not be registered under the United States Investment Company Act of 1940, as amended. Any offer to sell or purchase of any interest in an M&G fund must be made pursuant to local laws of the relevant jurisdiction in which such interests are offered. M&G plc, a company incorporated in England and Wales, is the direct parent company of The Prudential Assurance Company. The Prudential Assurance Company is not affiliated in any manner with Prudential Financial, Inc, a company whose principal place of business is in the United States of America or Prudential plc, an international group incorporated in the United Kingdom. **Notice to investors in Canada.** These materials are not, and under no circumstances are to be construed as, an advertisement or a public offering of any securities or a solicitation of any offer to buy securities in Canada or any province or territory thereof. These materials are not, and under no circumstances are they to be construed as, a prospectus, an offering memorandum, an advertisement or a public offering of any securities in Canada or any province or territory thereof. Upon receipt of these materials, each Canadian recipient will be deemed to have represented to M&G Investment Management Limited, that the investor is a "permitted client" as such term is defined in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. **Notice to investors in Australia.** M&G Investment Management Limited (MAGIM) and M&G Alternatives Investment Management Limited (MAGAIM) have received notification from the Australian Securities & Investments Commission that they can rely on the ASIC Class Order [CO 03/1099] exemption and are therefore permitted to market their investment strategies (including the offering and provision of discretionary investment management services) to wholesale clients in Australia without the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth). MAGIM and MAGAIM are authorised and regulated by the Financial Conduct Authority under laws of the United Kingdom, which differ from Australian laws. **Notice to investors in the Netherlands.** This document does not constitute investment advice or an offer to invest or to provide discretionary investment management services. **Notice to investors in Singapore.** In Singapore, this financial promotion is issued by M&G Real Estate Asia Pte. Ltd. (Co. Reg. No. 200610218G) and/or M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), both regulated by the Monetary Authority of Singapore. All forms of investments carry risks. Such investments may not be suitable for everyone. The information contained herein is provided for information purposes only and does not constitute an offer of, or solicitation for, a purchase or sale of any investment product or class of investment products, and should not be relied upon as financial advice. **Notice to investors in Hong Kong.** For Professional Investors only. Not for onward distribution. No other persons should rely on any information contained within. In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited. Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Hong Kong. This financial promotion is issued by M&G Investment Management Limited, registered in England and Wales under number 936683, registered office 10 Fenchurch Avenue, London EC3M 5AG. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. M&G Real Estate Limited is registered in England and Wales under number 3852763 and is not authorised or regulated by the Financial Conduct Authority. M&G Real Estate Limited forms part of the M&G Group of companies.

M&G Investments Japan. Financial Instruments Business Operator; Registration Number with the Director-General of Kanto Local Finance Bureau (FIF) No. 2942. Member of Japan Investment Advisors Association (JIAA).

M&G Investments Japan provides agency and intermediary services for execution of discretionary investment management agreements and/or investment advisory agreements between investment managers registered in Japan and its offshore affiliated companies. For details of the agreements such as specific fees, etc., related to the agency and intermediary services, please refer to the relevant agreement. This material is not intended for solicitation of the said agency and intermediary services and/or solicitation of an offer to buy interests of the funds offered/to be offered by its offshore affiliated companies.. **AUG 20 / 470705**

M&G INVESTMENTS