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Spotlight on private credit markets

Optimism grows, but caution is warranted

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- Private credit market activity and dealflow has picked up over recent quarters as encouraging vaccine news and optimism about the economic outlook tempered fears about the impact of second waves across much of Europe.
- We are seeing interesting opportunities arising in the more complex, newer and less competed areas of the market.
- Across private credit, an ability to differentiate and exercise a high level of selectivity will likely be important in 2021.

Overview of market conditions

The case for cautious optimism

Credit markets closed out the final quarter of 2020 on firmer footing, with positive momentum carrying over into 2021 amid encouraging vaccine news, and optimism around fresh fiscal stimulus and a stronger global economic recovery than had been previously assumed.

With hopes pinned on successful vaccine rollouts in H1 (and beyond), there is now a reasonable expectation that the global economy will grow above-trend from the second half of the year as governments look to gradually ease national lockdowns and restrictions. In recent weeks, confidence about the economic outlook together with the prospect of greater government spending (including the now-ratified US$1.9 trillion stimulus package in the US) has fuelled concerns about rising inflationary pressures. While inflation rates still remain low, these worries have led to a sell-off in global bond markets, with yields climbing back towards pre-pandemic levels.

Central bank largesse remains supportive

Activity in the asset-backed securities (ABS) and ABS-related areas of the market has continued to pick up, while the performance of the underlying collateral in ABS transactions generally remains very robust. This in part reflects the huge economic stimulus extended to companies and consumers by policymakers and the market in terms of refinancing or granting credit and loan payment extensions.

In our view, the consumer in Europe is generally in a strong position financially and while the level of unemployment will undoubtedly rise once state support measures including wage guarantees that have helped to cushion falls in household income are lifted and furlough schemes eventually run off, all indications and expectations so far are that it will be to significantly lower levels than was the case back in 2008/09 – a period which ultimately resulted in limited credit issues and impact for most European consumer ABS sectors.

Massive central bank and government support in this crisis (thus far) has effectively 'backstopped' the consumer, and this has also gone some way to support the continued strong performance in specialty finance assets (portfolios of residential mortgages and consumer loans) where prices are often linked to ABS markets. The performance of these whole loan portfolios will be impacted by actual default (and recovery) experience and cannot be sold quickly on an individual basis, although it is important to note that these are diversified pools of loan assets and loans tend to pre-pay ahead of their scheduled amortisation profile, providing liquidity for the overall investment. We also believe ensuring that the consumer remains solvent and central to the functioning of the economy will arguably be the key economic priority for governments in the post Covid-19 world.

On the corporate side, the solution to the shock of the pandemic's impact was mainly provided by debt rather than grants or equity (drawing down on all manner of available credit lines, including revolving capital facilities (RCFs), for survival and cash), on the basis of stabilising their situations. Although it is worth pointing out that the debt came largely from constructive bank and non-bank lenders, private equity (PE) owners and/or various state-support schemes – and in response to a universal health crisis. In this way, capital, the company and its stakeholders were protected.

What has been the corporate take-up for state-support schemes across Europe?

In Europe, state support came in the form of short-term loans as well as tax holidays and furlough schemes. According to S&P, Spain, Italy and France were the countries whose corporates availed themselves most of loan guarantee schemes, with corporate debt rising, on average, by 6%-12% across the three countries.

Figure 1: Loan guarantee schemes across Europe

	France	Germany	Italy	Spain	UK
Number of corporates ('000)	607.8	97.7	1,257.10	880.9	1,942.30
Requested/committed (€/£ billions)	128.7/125.0	56.2/44.6	118.4/0	0/108.0	0/65.6
Outstanding NFC debt (%)	5.7	2.5	10.1	11.9	4.9
Programme envelope (€/£ billions)	300	120	510	152	330
Envelope used (%)	42	37	23	71	20
Government guarantee (%)	70-90	80-90	90	60-80	80-100
Latest data	6 Nov 2020	19 Nov 2020	11 Nov 2020	15 Nov 2020	15 Nov 2020
Programme end date	30 Jun 2021	31 Dec 2020	31 Jan 2021	–	31 Jan 2021

Source: S&P Global Ratings, as at 20 November 2020. NFC = Non-financial corporate. Information is subject to change and not an indication of future results.

While default risk remains elevated, we think massive and continued support should mean an avoidance of the dire widespread solvency situation experienced after the global financial crisis.

Private credit market observations

Overview of market activity

While private markets tend to lag publicly-traded markets – although even the more illiquid assets are not immune to mark-to-market volatility – we have observed the positive momentum filtering through to some of the more established and mainstream areas of private credit. In the private placements market, there was a notable compression in spreads (or 'illiquidity premia') in the second half of the year, compared to the wides observed at the height of the Covid-19 uncertainty.

Activity levels in many private credit markets have unsurprisingly picked up over recent quarters as public markets bounced back, adding to the robust and growing pipeline of opportunities we are seeing across the asset universe. In the wholesale lending space, there have been several fund financing transaction opportunities, where existing funds are seeking either to increase leverage to make add-on acquisitions or put in new subscription lines and NAV facilities to provide immediate liquidity. In terms of the corporate mid-market direct lending deals we have seen coming to the market, these deals have attracted a lot of interest from direct lending funds eager to deploy into opportunities following the pandemic-induced pause in supply, but have consequently demonstrated little in terms of value in our view. Looking ahead, we think this dynamic could change amid better supply prospects.

However, we are seeing interesting opportunities surfacing in areas that are more complex, newer and less competed, including private securitisation warehouse facilities, receivables financing and significant risk transfer (SRT) transactions.

Observations from APAC and US origination teams

From our Asian origination team, we are seeing a number of attractively priced consumer and mortgage loan warehousing transactions in the market, as well as several asset-backed and receivables financing opportunities. In the US, our deal desk has seen a number of interesting risk-reward opportunities emerge, including opportunities to enter into existing warehouse facilities in mezzanine (subordinated) tranches of private ABS transactions. One example was a platform lender originating and servicing home improvement loans to prime US consumers, looking for non-bank funding to diversify their funding away from bank forward-flow arrangements. 'Prime' consumers, in this respect, are considered to be borrowers with average FICO scores in the higher 700s out of a 300 to 850 range, categorising them as 'Very Good' credits[1].

Diverse range of SRT opportunities

We witnessed good dealflow coming through in the regulatory capital trades or SRT market amid a traditionally busy fourth quarter period, offering exposure to a diverse range of reference assets ranging from SME (corporate) loans, capital call facilities through to agricultural loans or social housing loans. We have seen both conventional (first-loss risk position) trades and also mezzanine trades coming through the pipeline. As the sector matures, we anticipate opportunities to invest in transactions with an increasingly diverse range of underlying collateral types, sectors and regions offering differentiated risk-reward exposures to investors.

[1] The FICO score scale ranges from 300 to 850, with scores above 660 generally considered to be a prime credit score.

SRT in action: Portfolio of agricultural loans from a UK bank

Opportunity: To finance a transaction referencing a highly granular, and geographically-diverse portfolio of mortgage loans made to farms and rural businesses, secured on a first-charge basis on land, homes and other farm assets.

Exposure to a low leveraged sector where its participants generally have a higher propensity to repay debts. The UK agricultural industry has exhibited lower default rates and exceptionally low losses given default to date. The sector's historical zero loss track record (since 2001) is further supported by the significant government sponsorship that the sector benefits from.

Strong selection criteria in place to reduce concentrations to weaker credits and limit total exposures, such as loan-to-value (LTV) ceilings. Quality of security together with low LTV ratios (average: 39%) across the loan portfolio offers comfort.

'Skin in the game' as issuing bank expected to retain at least a 5% economic interest in the securitisation.

Source: M&G, as at February 2021.

Outlook for 2021

Looking ahead to the rest of 2021, so far the markets have been willing to look through the near-term weakness thanks to the positive vaccine news and supportive stimulus measures. Nevertheless, there are numerous risks ahead, including policy mis-steps and rising (and mutating) virus infections, so renewed market volatility is possible from here. 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 during periods of market volatility. Across private credit, an ability to differentiate and exercise a high level of conservatism in selection will likely be important in 2021.

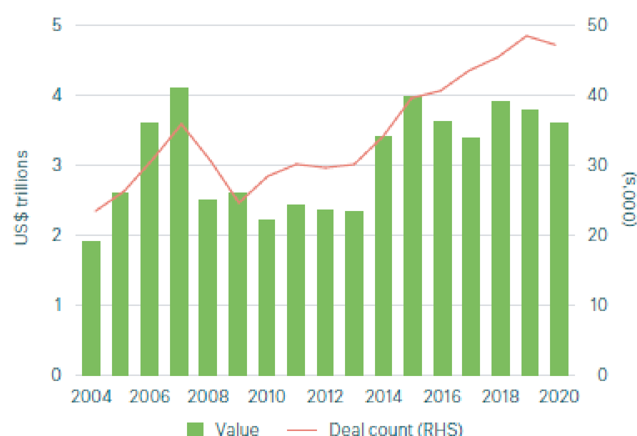
We think an increasingly global originating capability remains key to capturing opportunities across the full breadth of the private markets spectrum. Our Asian origination team, in particular, continues to see robust dealflow in many areas, including consumer, SME and mortgage loan warehousing transactions, as well as secured transactions in real estate, telecoms infrastructure and receivables financing.

Demand for debt financing for real estate transactions also appears to be increasing. Given the defensive nature of real estate debt in this more volatile market environment, we continue to see attractive opportunities emerging in this sector, however we prefer to remain cautious in our approach, and only consider investments which we believe are supported by strong long-term fundamentals.

If the early 2021 M&A pipeline is anything to go by, is M&A back in full swing?

M&A activity tends to lead new loan issuance (usually with a 6-to-12 month lag). M&A volume ended 2020 at US$3.6 trillion, only 5% down from 2019, making for encouraging 2021 loan issuance prospects given its back-ended nature.

Figure 2: Global M&A annual volume and number of transactions



Source: Bloomberg, as at 31 December 2020. Information is subject to change and not an indication of future results.

Our Leveraged Finance team anticipates a busy period of opportunistic take-privates, bolt-on acquisitions and secondary buyouts ahead to create subsequent loan issuance of size this year. There is US$1.6 trillion in unspent private equity capital – so sponsors will not be shy about getting back to work and a renewed appetite for deal-making is expected.

We think the resumption in M&A activity is also likely to lead to a pick-up in the supply of corporate mid-market lending deals too. Equally, companies that were able to access government liquidity schemes or those who drew-down their RCFs during the pandemic will ultimately need to term out short-term (bank) debt and loans into a longer maturity profile or will require different capital solutions amid a more challenging credit environment.

While we believe such a backdrop could create more opportunities for non-bank lenders in Europe ahead, lenders need to focus on the quality of credit underwriting, structuring and ongoing monitoring of investments to help mitigate against risks that could result in capital impairment or loss, including credit risk, default risk and liquidity risk, to ensure each investment offers sufficient compensation for the risks taken.

In focus: ESG in private credit

2021 also looks set to be a big year for environmental, social and governance (ESG) and climate-change action thanks largely to incoming regulation for investors and cohesive lobbying pressure – particularly for carbon target-setting and quantifiable emissions disclosure – including in the private corporate world.

Private credit's emphasis on long-term credit quality lends well to incorporating ESG considerations, especially since debt is an asymmetric asset class. When conducting due diligence on a potential investment, our analysts assess the materiality of ESG risks and opportunities, and where these are financially material, integrate such factors into their financial analysis.

Specifically for private assets, it is not possible to apply a one-size-fits-all approach to analysing ESG given the unique attributes and risks (which can be idiosyncratic in nature) of the diverse range of sub-asset classes and assets that comprise the investable universe. There may be certain ESG risk factors and thematic issues that have greater applicability to some areas of private credit but not others, for instance what ESG metrics may be financially material for a long-dated private infrastructure debt asset may not be for a pool of residential mortgages. The impacts of certain ESG and ESG-related risks may also change over different time horizons, what may be identified as a immaterial issue at time of investment may develop to become financially material in five or 20 years' time, so ongoing monitoring and active engagement with issuers and borrowers is crucial to managing ESG risks over the life of the investment.

One of the benefits of being an active, private markets investor is the ability to directly engage with borrowers, issuers and PE sponsors to build trusted and long-term working relationships. As private lenders have a closer nexus with companies than bond investors, this also improves their opportunities to engage on ESG-related matters. The nature of the transactions we participate in usually means that we engage with borrowers over a period of many months, and any information that is shared between both parties is private and does not have to be disclosed publicly.

Assessing all of the relevant ESG factors affecting our investments, and engaging with management teams where a material ESG risk develops, we believe can safeguard and enhance the value of our investments, and ensure they can deliver the best possible risk-adjusted returns for clients.

ESG engagement in action: Ensuring access to financing for SMEs amid the pandemic

Borrower overview: UK-based technology-based lender focused on short-term loans (stock finance and invoice advancement) for smaller businesses.

Engagement objective: To ensure that existing clients have required access to financing given uncertainty amid the Covid-19 pandemic.

Actions taken:

We engaged with the borrower at the onset of the pandemic in March 2020 to discuss what actions to take in the face of an expected increase in loan delinquencies from SMEs due to lockdowns and other government-imposed restrictions.

We agreed with the company that they would take a series of measures to provide SME customers with support to help their businesses remain a going-concern through the crisis period – without triggering a default on their loans. These measures also sought to ensure fair and equitable treatment of customers.

Measures included payment holidays, capitalisations, lowering monthly payments, wind-down solutions for customers unable to make their monthly payments.

Outcome: We believe these measures helped to provide a social benefit by allowing SMEs to access the finance needed to remain operational and protect employment. Taking these measures was also the best way to protect the value of our investment, in our view.

Source: M&G, as at February 2021.

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