

Spotlight on private credit markets

Opportunities opening up across the spectrum

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- Low duration, floating rate private credit assets may gain wider appeal should inflationary pressures loom large
- Activity levels are building across the spectrum but pricing dynamics differ, requiring private lenders to make a careful assessment of relative value on an asset-by-asset basis
- Strength and diversity of pipeline could bode well for deployment opportunities in the coming quarters.

Broader market backdrop

Inflation jitters linger amid brighter prospects

Market sentiment continued to improve amid growing optimism about the outlook for the global economy, as recent data showed early indications of a pick-up in activity levels supported by a bounce-back in consumer spending. Yet for all the optimism baked into markets, is there a risk of a two-speed recovery or a widening divide between economies whose vaccination programmes are at a fairly advanced stage and starting to lift remaining restrictions having already emerged from national lockdowns, and those economies who are re-entering lockdown as they battle second, and even third, waves of the virus-outbreak amid rising cases, uncertainty linked to new variants and slower vaccine deployment?

Corporate credit and asset-backed securities (ABS) spreads have nevertheless compressed further, reflecting the upbeat tone of the market and also partly reflecting the fact that publicly-traded markets remain awash with liquidity – thanks to government and central bank crisis measures which remain in full swing – which has exacerbated the supply-demand imbalance, with high quality credits continuing to be heavily competed.

Brighter economic prospects combined with ample government spending have, however, led to heightened concerns about a resurgence in inflation after recent price data from the major economies (the US, the UK and the Eurozone, are worthy of note here) surprised to the upside, unnerving market participants.

While major central banks, led by the US Federal Reserve, have attempted to downplay the anticipated inflation spike amid the reopening of economies as largely 'transient' and idiosyncratic, markets could conceivably remain sensitive to subtle shifts in rhetoric around long-term inflation expectations.

Figure 1. Steepening US Treasury yield curve: 2s30s



Source: Bloomberg, as at 26 May 2021. Information is subject to change and not an indication of future results.

The appeal of floating-rate debt

Rising inflation and rate-hike concerns have actually proved supportive for short-dated private and illiquid credit given the typically low duration, floating rate nature of underlying assets comprising the investable universe – with this in-built protection against interest rate risk a clear advantage over publicly-traded debt, which tend to carry fixed-rate coupons and so are susceptible to changes in interest rates. Looking across the private credit spectrum, those market segments that typically pay a floating rate of interest or potentially deliver stable income streams – including the ABS and the leveraged finance markets (which offer relative liquidity as well) – have certainly attracted interest.

Even if many market participants believe that rate hikes from central banks are highly unlikely this year, more investors could continue to seek out floating-rate instruments should inflationary pressures persist as price rises threaten to erode the value of fixed rate assets.

Beyond traditional financial assets, the direct (and indirect) hedging abilities of alternative assets are therefore likely to appeal to wary investors looking to insulate their portfolios.

Private credit market activity update

While the start of the year tends to be seasonally quiet in terms of the pipeline of private assets, we have seen deal supply pick up in the second quarter – although the picture varies across sectors. By and large, activity levels in most areas of the private credit markets have been encouraging and we expect the trend to continue into the next few quarters.

Supply, demand and pricing dynamics

The quality of new supply has nevertheless been mixed in some areas – both in terms of underlying fundamentals and pricing. Demand has also remained high for certain assets and asset classes within private credit with high quality assets still widely sought-after, and also partly a reflection of the high levels of dry powder that have built up over recent years with higher levels of competition putting pressure on spreads and requiring lenders to make a careful assessment of relative value.

On balance, we are continuing to see better value, structures and terms exhibited for the risk in the more complex transactions that are coming through the mix. As private lenders who have been operating in the markets for several decades, we look for potential opportunities where we can apply our wide breadth of capabilities, resources and expertise to understand the credit, and structure the transaction accordingly to offer robust structural protections and a level of security commensurate for the risk taken.

Structured finance markets remain active

The growing pipeline of deals is translating to potential opportunities across the investable asset universe, particularly on the public ABS side with a number of deals we are seeing offering exposure to a diverse range of reference assets from consumer loans, credit cards, UK and European logistics to commercial mortgage-backed securities (CMBS) and UK buy-to-let residential mortgage-backed securities (RMBS). The positive sentiment observed in the ABS markets more broadly also reflects the robust performance in the underlying collateral and the subdued levels of defaults in the sector.

Our Asia-Pacific origination team has consistently observed good dealflow on the structured finance side – a theme that the team believe has further room to run.

There have been several potential opportunities to enter into warehouse facilities in senior and mezzanine (subordinated) tranches of private ABS transactions, one recent example being a warehouse transaction supporting the origination of personal loans to consumers in New Zealand via a technology-enabled platform. These are loans taken out by consumers that would be used for a number of purposes including home improvements or for debt consolidation, with the platform known for its responsible lending approach which is underpinned by its ‘big data’ driven underwriting processes.

Similarly we continue to witness a number of transactions coming through in areas like significant risk transfer (SRT) transactions and specialty finance assets (portfolios of residential mortgages and consumer loans) where prices are often linked to ABS markets.

Turning to the directly-held and bilaterally negotiated parts of the investable universe, which have also benefited from an noticeable increase in activity levels in recent months.

We have observed some sectors continuing to recover lost ground after last year’s Covid-related sell-off, albeit still essentially lagging the broader recovery in public credit markets. The commercial mortgages sector has been one sector, for instance, that has benefited from asset stabilisation and enhanced market liquidity after the onset of the Covid-19 crisis created short-term uncertainty around underlying asset valuations.

Direct lending dealflow bounces back

We have been observing a growing number of corporate mid-market direct lending and asset based lending (ABL) transactions coming through. One recent example was a transaction to fund dividend and shareholder reorganisation for a seller and servicer of IT infrastructure. We are often able to differentiate ourselves from other lenders in this space, given our ability to offer borrowers tailored lending solutions, including hybrid cashflow and ABL structures.

The revival in corporate mid-market direct lending dealflow should be noted following a period of more limited supply in 2020. The Deloitte Alternative Lender Deal Tracker Spring 2021, which covers data for the second half of 2020, showed a 52% increase in direct lending dealflow in Europe in the second half of 2020 compared to the first half of the year albeit the deal count was one quarter lower in percentage terms than the same period in 2019. Deloitte added that the number of European direct lending deals was the highest ever recorded Q4 level¹.

¹ Deloitte Alternative Lender Deal Tracker Spring 2021.

The pick-up in direct lending deal supply comes against a backdrop of fervent global dealmaking activity and as debt-laden corporates look to term-out their liabilities. The value of deals globally reportedly hit US\$1.3 trillion in the first three months of the year marking the strongest start to M&A activity in four decades, with US-based deals up by 160% versus a year ago, according to an FT article citing data from Refinitiv².

Infrastructure debt interest remains high

Interest remains high in the sub-investment grade (sub-IG) infrastructure sector. Notable transactions in the infrastructure debt market in recent months include traditional Holdco financings for traditional investment-grade (IG) infrastructure assets, together with senior debt in newer sectors such as digital infrastructure and troubled sectors such as parts of the transportation sector. In each case, there has been a sense of market correction in pricing, with assets that would previously have been too expensive for consideration in multi-asset private credit strategies becoming affordable. This dynamic has been helped by two factors – a reduced appetite of the banking market for lower credit risks, and a smaller number of institutional investors willing to look at this space.

In digital infrastructure markets, there have been deals with wider pricing in both primary and secondary markets, with some banks seeking to recycle capital away from a sector which has seen a flurry of deals but not broad syndication. This has driven a more sensible discussion on pricing in particular. In transportation, we are again seeing transactions in both primary and secondary markets which offer value, in our view. While the pricing of debt for the major airports has rebounded well in the public markets, smaller regional or niche airports have had a lesser following, allowing for more sensible pricing discussions on secondary transactions. For primary transportation transactions, alongside the pricing, there is a keenness on the part of the borrowers to maintain flexibility to refinance once their sector recovers. There is a short-term window to achieve better pricing but that will close in due course.

Pricing moves have been less accentuated in Euro-denominated transactions, especially in crossover credits where institutional investors are more likely to view a senior credit in the BB rating range while banks use the historically low loss-given default experience of infrastructure debt to justify pricing more commensurate with an IG rating.

In such an environment, lenders need to be able to make a careful assessment of the relative value presented by each potential investment opportunity in the sector. By utilising our fundamental credit analysis and resource we can sort the good, quality businesses (with a reason to exist) – which have temporarily dipped into sub-IG territory as a result of the pandemic and offer an opportunity to invest at a good price – from those lower-rated businesses which may, in our view, offer less compelling risk/reward or terms. Equally, having the flexibility and ability to invest in solid sub-IG businesses requiring finance can also be an advantage when selecting assets from across the spectrum.

Looking ahead

After a few quarters of subdued private market activity due to disruption related to the Covid crisis, the pipeline of private assets is growing once again. We are encouraged by the strength of the pipeline coming from our Asia-Pacific origination team, and on the structured finance side in particular, with many of the opportunities we have observed often transactions that are secured on loan portfolios or real estate assets.

In terms of the UK and the rest of Europe, we are continuing to see interesting opportunities arising in many areas across the private credit spectrum, including the real estate debt markets which are generally offering improved terms and pricing compared to pre-pandemic levels. Nevertheless, we believe it is better to remain cautious in this market, and only consider potential investments which we believe offer strong long-term value.

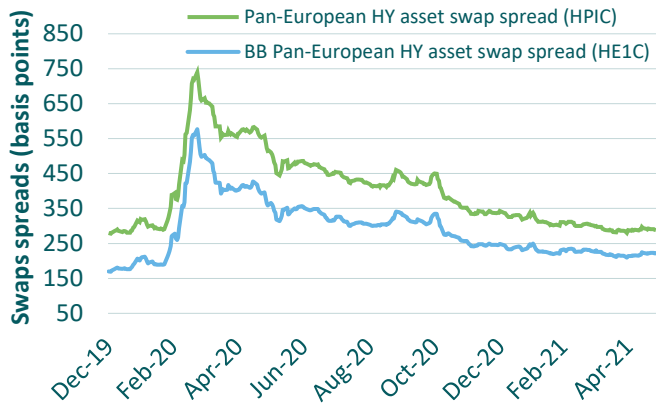
Pipelines in other sectors, including SRT transactions, are showing clear and sustained momentum and we expect there to be a number of potential opportunities to deploy capital ahead, with mezzanine tranches offering a particularly interesting opportunity, in our view.

Eyeing an illiquidity premium

Despite the uptick in bond yields this year, widely-traded credit spreads have tightened considerably since the peak of the crisis and relative to private and illiquid credit markets. In the current low interest rate environment, private credit assets could potentially provide investors with higher risk-adjusted returns and diversification, often with greater lender controls – and offer good relative value versus public comparators, in our view.

² Financial Times, “Spac boom fuels strongest start for global mergers and acquisitions since 1980”, 31 March 2021.

Figure 2. European high yield asset swap spreads



Source: Bloomberg, as at 26 May 2021. Pan-European high yield swap spreads represented by the ICE BofA Merrill Lynch European Currency Non-Financial High Yield 2% Constrained Index (Ref. HPIC), BB component of Pan-European high yield swap spreads represented by the ICE BofA Merrill Lynch BB Euro High Yield Non-Financial Constrained Index (Ref. HPIC). Information is subject to change and not an indication of future results.

Notwithstanding eventual corrective central bank action, we believe yields for private credit assets should stay within a fairly steady range (even if spreads oscillate). The ability to capture an illiquidity premium with limited interest rate risk therefore goes some way to ensure ongoing demand for private credit assets from investors as they continue to allocate more to the asset class.

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Key risks associated with this strategy:

Credit risk: The strategy may be exposed to the possibility that a debtor will not meet their repayment obligations.

Liquidity risk: Where market conditions make it hard to sell the strategy's investments at a fair price to meet redemptions, we may suspend dealing in the strategy.

Prepayment risk: Loans may be prepaid by issuers at short notice, as a result it may be difficult for the strategy to locate and reinvest capital at an attractive price or at all, which may affect the strategy adversely.



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