Spotlight on private credit markets

Thriving amid the uncertainty

Jo Waldron, Director of Private Credit
Karen Lam, Director, Private Credit
December 2021

The demand for private credit from borrowers remains high, as demonstrated by the level of deal activity we have been seeing across multiple sectors of the market. Investors also continue to look to the potential benefits offered by short-dated private credit assets, given broad-based uncertainty about the macroeconomic backdrop and the outlook for monetary policy from here.

Broader market backdrop

For many developed economies, activity levels have picked up and growth prospects have improved this year. The nascent recovery from the pandemic-induced disruption has been fuelled by higher consumer spending and excess demand for goods – and increasingly services – as restrictions have been lifted and vaccines rolled-out across the adult population. During the past few months, several headwinds including rising infection rates, rising energy costs, global supply chain imbalances and labour shortages, have nevertheless emerged and threatened to curtail this renewed growth momentum.

Inflation looms large

While most market observers expect these Covid-related headwinds to dissipate in 2022, uncertainty clouds the economic outlook particularly given concern about the emerging coronavirus variant, Omicron. Investors have also had to contend with nagging concerns about inflation, with differing views on the transitory nature of current inflation among market participants as well as risks of entrenched inflationary expectations leaving several possible scenarios on the table. In the UK, headline inflation printed at an almost decade-high in October and US consumer prices rose at their fastest pace in 30 years, while forward inflation expectations have spiked, especially in the UK – piling pressure on major central banks to raise short-term rates ahead of schedule.

Central banks have already started to signal their plans to wind down their asset purchase programmes, but have resisted raising rates so far. Nevertheless, markets are dialling up their bets that the Bank of England (despite standing pat in November) and the US Federal Reserve will seek to tighten monetary policy in the next year. While Eurozone consumer prices have also accelerated (hitting a record high in November), the ECB has pressed back against market expectations that rate increases could begin as early as the second half of 2022.

The quandary facing monetary and fiscal policymakers is acute. In most developed markets, the yield on 10 year government bonds remains well below the rate of inflation. At the same time as real yields are low and in negative territory, debt-to-GDP ratios are also running at post-war highs.

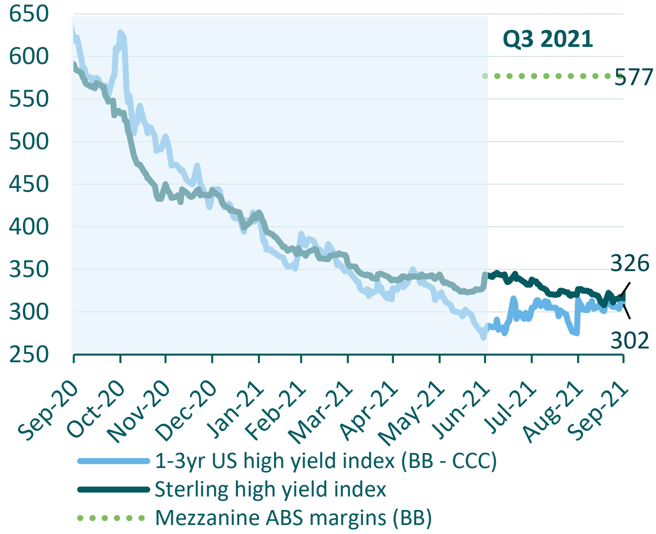
Private credit – providing secure income sources

In the current low-yield environment, investors have found income generation from traditional fixed income assets harder to come by. For some, this has incentivised them to look further down the credit spectrum for yield, while also in the knowledge that assets carrying fixed-rate coupons could see their value erode in a rising rate environment – especially those with lower spread profiles. It's perhaps no surprise that broader inflationary concerns have been supportive of short-dated private and illiquid credit. The investable universe comprises largely of floating-rate loans and instruments linked to a short-term reference rate, often with clearly-defined cashflow profiles and in-built investor protections such as financial covenants. Prudent investors may look to further mitigate the risk in their portfolios by diversifying into other private and alternative assets, including real assets investments, that have historically tended to stay ahead of longer-term inflation.

Structured finance – eyeing a yield pick-up

Investors have been finding opportunities to pick up additional yield in the floating-rate European asset-backed securities (ABS) market, given their positive carry characteristics with lower asset volatility than public market equivalents – generated from simply collecting the coupons of the assets until maturity. While we have observed spread compression across the ABS markets, which in turn has bolstered underlying asset valuations, we believe there could still be room for further compression ahead – barring any unexpected shocks.

Figure 1 Comparison of private mezzanine ABS spreads to US & UK high yield option-adjusted spreads (basis points)



Source: ICE BofA Sterling High Yield Index (HL00). ICE BofA Euro 1-3yr US High Yield Constrained Index (H1AC). Mezzanine ABS margins: The source of the information is based on M&G experience trading in the market. Information is subject to change and is not a guarantee of future results.

We have seen a number of mezzanine (subordinated) tranches of private ABS transactions offering a sizeable pick-up compared to high yield indices as well as public mezzanine ABS. These are typically privately-structured forward funding facilities, lending against collateral including US home improvement loans and US credit card receivables. The complexity in the structuring and bespoke documentation written into these transactions can also help to mitigate downside risk, and this is unique to these private transactions.

Private credit markets activity update

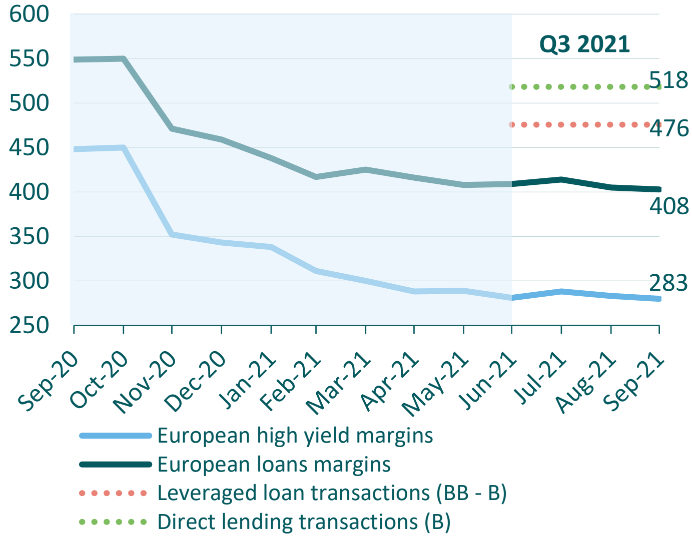
We have been encouraged by the level of deal activity during the third quarter and into the early part of the fourth quarter, with strong dealflow seen across multiple sectors of the private credit markets as borrower appetite remains high.

Leveraged loans – identifying relative value opportunities

Looking at the broader market, while some sectors have become increasingly expensive due to excess liquidity chasing yield further down the credit spectrum, others are offering attractive relative value, in our view, when compared to public market equivalents. We took advantage of a window of opportunity to make a strategic allocation to European leveraged loans, amid better spread levels versus high yield indices. We have also been encouraged by the strength of loan issuance in Europe – which is on track for a new post-global financial crisis high. New loan issuance this year has been skewed towards funding new M&A activity as private equity (PE) sponsors looked to deploy significant amounts of dry powder, as well as new issuers to the market, leading to greater investor choice and wider pricing for the second half of the year.

The observable relative value opportunity in loans is in addition to the well-understood benefits of high running income potential and low duration thanks to their floating-rate coupon, as well as secondary trading opportunities in the senior-secured loan market. In turn, an active secondary loan market with decent two-way flow offers relative liquidity compared with other parts of the private credit universe – and allows us the flexibility to rotate into other private and illiquid opportunities, as and when attractive value emerges.

Figure 2 Corporate debt spreads – leveraged loans and direct lending deals have offered a premium (basis points)



Source: Credit Suisse Western European Leveraged Loan Index (CS WELLI) 3-year discount margin. ICE BofA European High Yield Index (H0A0). Leveraged loan and direct lending margins: The source of the information is based on M&G experience trading in the market. Information is subject to change and is not a guarantee of future results.

Equally, on an opportunistic basis, we have observed a number of single B (internally-rated by our credit analysis team, with ratings calculated using proprietary ratings methodology and fundamental credit research and analysis), high conviction loan trades coming through the secondary market, trading at a moderate discount to par value. The discount margin level on these loans reflect market concerns regarding the high level of leverage which has impacted short term loan pricing for these category and sector-leading credits, therefore presenting an attractive entry point, in our view. Depending on how relative value evolves in the loan market from here we are open to considering additional opportunities, although we remain highly selective – only considering potential opportunities with risk-return profiles that adequately compensate for the risk taken and not at the expense of fundamental credit quality.

Mid-market corporate lending – strength of dealflow

Our direct lending team has seen a good range of mid-market corporate direct lending deals coming to the market over the past couple of months and through much of 2021, including a financing facility involving a sponsor-backed best-in-class business, lending to a New Zealand-based agricultural business and financing for a UK real estate investment trust. In aggregate, spreads offered on the mid-market corporate direct lending transactions we are seeing in the market remain attractive.

Direct lending in action: Financing facility supporting sponsor-backed buyout

Opportunity: To participate in a financing facility to support a PE sponsor acquire a 'best-in-class' business that offers high quality products to wholesale customers and to retail customers through its own portfolio of sites.

Differentiated business model where we view its wholesale manufacturing facility as being a key source of competitive advantage. There are also identifiable strong barriers to entry via its vertically-integrated operating model.

'Best-in-class' business which has delivered strong organic growth across like-for-like sales and rollout of new stores, delivering strong year-on-year revenue and EBITDA growth since inception.

The business was impacted by Covid-related site closures in 2020, but adjusted quickly in response to increased off-site consumer demand, demonstrating the resilience of its business model. It also benefited from significant government support during the period of operational disruption.

In-built investor protections resulting from a senior-secured debt structure and loan documentation, with maintenance financial covenants (applying to gross leverage levels) in place through the life of the loan.

Equity sponsor providing a significant cash equity cushion supporting the buyout of the business. The PE sponsor has experience in this sector and will work with the management team to enhance the operational efficiency of existing sites and sensibly scale-up its portfolio.

Source: M&G, as at November 2021.

Infrastructure debt – finding fundamental value

Interest remains high in the infrastructure sector, with debt financing opportunities ranging across a number of markets. One sector where we are identifying select opportunities for senior debt financings of infrastructure assets is the airport sector.

In focus: Debt financing for aviation infrastructure
The aviation sector has undoubtedly faced some significant headwinds due to Covid-related disruption to the travel and leisure industry, but there is evidence of recovery in air travel with passenger numbers beginning to improve. While there remains a degree of uncertainty in the short term, we believe the pricing we are seeing in the market for fundamentally good airport assets in the long run compensates for the risk being taken, offering a clear premium against public comparators (equivalent public bonds of similar tenor issued by the same borrowers) to compensate for the illiquidity.

Potential risks to the downside could emanate from a meaningful decline in passenger numbers due to government intervention to curtail carbon emissions or due to lifestyle choices leading to a reduction in air travel. However, given the short tenor of the loan facilities we viewed this risk to be low during the holding period. In terms of assessing environmental, social and governance (ESG) factors, many airports are also taking action to reduce their own emissions – having high levels of accreditation under the Airport Carbon Accreditation, a global carbon management certification for airports. We are also seeing financings with a sustainability link to them, with one of the opportunities including a sustainability key performance indicator (KPI) which would mean the issuer would have to pay a penalty for not meeting the terms indicated by the KPI.

Speciality finance – diversification opportunities

In the specialty finance sector, there have been several warehouse financing opportunities including a junior pre-securitisation warehouse finance for a European lending platform, as well as a refinancing opportunity of an existing mezzanine warehouse financing to a US credit card platform financing credit card receivables. The latter opportunity was particularly interesting, in our view. The platform has a very experienced management team, loan servicer and has developed a proprietary platform that can select the most suitable expected risk-adjusted return from the target consumer group, which are non-prime consumers or categorised as "Fair Credits". There are also multiple layers of credit protection built into the transaction, including a comprehensive set of borrowing base controls, with strict portfolio concentration limits and eligibility criteria in place to maintain portfolio quality.

Outlook

Private market activity that had halted as Covid-19 emerged, restarted and has continued to strengthen through the course of the year. Looking ahead, how will private credit markets fare into year-end and beyond amid uncertainty about the broader economic backdrop and the outlook for monetary policy? What can we expect in terms of deal activity across the private credit markets in the coming months?

We think short dated private and illiquid credit remains well positioned in all market environments, delivering potentially higher risk-adjusted returns with lower asset value volatility than public equivalents for equivalent credit risk. In higher inflationary environments, the floating-rate structure of loans and instruments largely comprising the investable universe limits the effect of inflation and rising rates. Investors of floating-rate debt may therefore benefit from rates trending higher.

Deal pipelines are shaping up

On the private corporate lending side, we are seeing several opportunities coming through, potentially boding well for additional capital deployment levels in the months ahead. Deals involving funding for a specialist component manufacturer or a private placement deal with a UK-based wealth manager looking to refinance existing notes at better pricing levels and no change in credit quality, are just some of the examples we are seeing in the market.

Equally, the strength of dealflow in asset based lending (ABL) remains encouraging. Mid-market businesses are recognising that by putting particular assets to use, such as property, inventory, receivables, machinery or equipment they can get secured asset-based financing at a more attractive rate. For private lenders, these investments can also offer a good level of return for the level of risk, being fully supported by collateral in a variety of forms.

Pipelines in other sectors, including significant risk transfer (SRT) transactions, are showing good momentum in what is a traditionally busy fourth quarter period for the sector – potentially offering opportunities to deploy capital ahead.

Focus on global origination

Throughout 2021, we have continued to establish and build-out our origination capability globally, including in Asia-Pacific and the US, as well as increasing our origination presence in Europe, which is helping to expand the investable universe of private and illiquid assets and enabling us to build increasingly diverse deal pipelines and portfolios. We think building out origination capabilities in regional markets, like Asia-Pacific, puts us closer to the management of the companies we are lending to, originators we can partner with and extend and deepen relationships with banks in the region.

A number of potential opportunities have come through our global deal channels. This year, our Asia-Pacific origination team has consistently observed good dealflow in many areas; recent examples of the type of dealflow we are seeing in the market include an Australian real estate commercial mortgage transaction, involving lending against a building with very high environmentally-sustainable or 'green' credentials, as well as a transaction involving debt financing to an Indian-based financing platform. The team is seeing numerous potential transactions on the structured finance side – typically transactions that are secured on loan portfolios or real estate assets – a theme that the team believe will have further room to run.

Equally encouraging, we are seeing a good flow of ESG and sustainable lending opportunities, partially reflecting the synergies from the growing origination capability across our Private & Alternative Assets business.

www.mandg.com/institutional

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.

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.

M&G Investments