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M&G Investments

The next phase for private credit markets

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Part 1: Current perspectives

The changing landscape

The resilience and adaptability of the asset class during the ongoing COVID-19 pandemic has helped to cement private credit's permanence in the minds of strategic asset allocators, with private markets proving their value to investors in balancing out the more variable and lower-returning public markets. As the focus shifts to recovery and rebuilding, the demand for private credit from investors continues. We believe the current – and evolving – market environment provides significant opportunities for private lenders to capitalise on this demand as deal pipelines build and investment opportunities proliferate across the spectrum.

The COVID-19 pandemic was a crisis like no other. Despite an outlook clouded by widespread uncertainty and hopes of an economic recovery punctuated by setbacks, investors have actively sought better risk-reward opportunities across the private credit spectrum amid better entry points arising from the dislocations that COVID-19 has triggered as well as the trends it has both accelerated and created – from e-commerce and green and clean tech to new ways of working.

The long and short of it: The resilience of private credit

Before the pandemic hit, there was already a lot of interest in private markets and large asset allocators have progressively made bigger allocations to the asset class. Private credit has arguably proved its resilience and adaptability in several ways, having emerged from the pandemic-induced disruption in pretty good shape, and this has offered comfort to cautious investors. Of course, there is no denying that the level of liquidity support provided by central banks and governments helped all credit markets – including the pockets of the market where there is secondary trading (and liquidity) including the asset-backed securities (ABS) and leveraged loan markets – rebound from the short, sharp pandemic-induced paralysis very rapidly. In turn, helping to ensure any liquidity related mark-to-market losses were short-lived.

Credit rating agencies have also scaled back their initial default predictions and the huge wave of corporate defaults that was initially foreseen by the rating agencies has not materialised. The latest forecast from S&P Global, sees the European trailing-12-month speculative-grade corporate default rate falling to 3.25% by June 2022 from 4.7% in June 2021[1], supported by an improving growth outlook and as the ratio of upgrades to downgrades points to fewer defaults in the future.

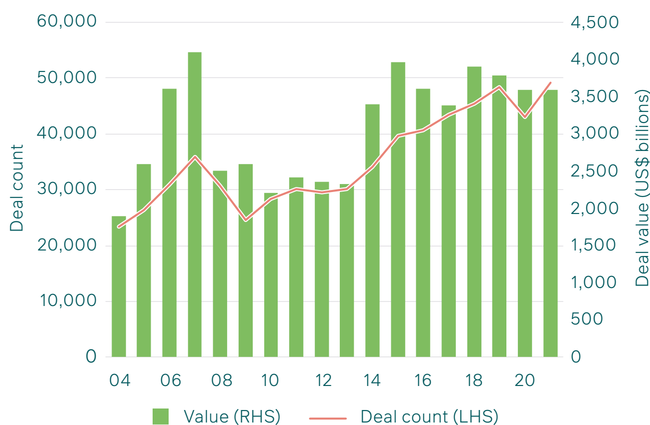
In the parts of the private credit market where there is no liquidity, pricing dynamics were not as impacted by the fluctuations in wider financial markets because the price of assets are typically model priced – those prices also usually have public market credit spreads as an input and so are not immune from mark-to-market volatility, even though they are somewhat muted. Typically the recovery of spreads within private markets lags that of the public markets; this not only provided interesting investment opportunities but the relative disconnect with public markets also helped to underscore the resilience of income-generative private assets relative to public markets as bond yields fell back to their lower bounds and equity dividends were cut or suspended.

[1]S&P Global Ratings, 'Default, Transition, and Recovery: The European Speculative-Grade Corporate Default Rate Could Fall To 3.25% By June 2022.', 24 August 2021.

Deal activity resumes

New lending activity across market sectors all but ceased for a period in the second quarter of 2020. The supply of new deals started to pick back up as market conditions normalised and primary market issuance resumed, albeit first led by higher-quality names and sectors as we saw in the leveraged loan market. Investment opportunities in corporate debt, including leveraged loans and direct lending, increased as M&A activity bounced back while fundraising has also remained significant.

Global M&A activity



Source: M&G, Bloomberg, as at 31 August 2021. Information is subject to change and is not a guarantee of future results.

Many companies were able to take advantage of improved sentiment to raise new debt, increase liquidity, and extend their maturity profile. Still-high levels of dry powder indicate a healthy appetite to put capital to work in new deals (and at higher leverage levels) – Fitch Ratings expects issuance in the second half of the year to reflect a shift toward new leveraged buyouts (LBOs), notably public-to-privates and recycled LBOs[2] – although equity sponsorship in deals has also remained high, at around 50%. In many respects, lender discipline has also been high – even in unaffected sectors, deal terms in the mid-market are said to be tougher than ever.

In real estate debt, strong underwriting worked well and credit protections proved beneficial, although few, if any, would have had included a global pandemic scenario in their 'worst-case' stress tests. In several sectors, rent collections have remained healthy while others have been affected by moratoriums on rent collections, although lenders pared back appetite and leverage at the height of the crisis, with careful stock selection remaining a key focus. The deal pipeline has continued to build and we are seeing a range of real estate financing opportunities across sectors.

Elsewhere, sectors like infrastructure debt and social housing did exactly what they said on the tin – by exhibiting the return stability that investors prize and confirming the essentiality of underlying assets. There were a few exceptions; some borrowers operating in frontline sectors including transportation were hit by operational volatility and liquidity issues, which in certain cases triggered a downward migration in ratings – although this is expected to be temporary. We are seeing more opportunities and a wider variety of deals coming to the infrastructure debt market, with more capital focused on sub-investment grade (sub-IG) markets as investors looked to meet higher risk/return hurdles with returns available in some segments of the market like utilities remaining low.

On the front foot

Private lenders proactively worked with existing borrowers to navigate a turbulent business environment, with the pandemic underscoring the strength and value of relationships and partnerships in the private world. By supporting borrowers facing short-term liquidity issues, we are able to help fundamentally good businesses stay afloat during an unprecedented period of disruption so they can remain a going concern. In doing so, we are looking to protect investments against the risk of capital loss arising from default that may have potentially otherwise occurred had we not offered support.

[2]Fitch Ratings,'European Leveraged Loan Chart Book – 1H21'.

Positioning portfolios for change

The crisis has helped to reinforce the importance of credit diversification and dynamically positioning portfolios for change – whatever shape or form 'change' may present itself over investment horizons.

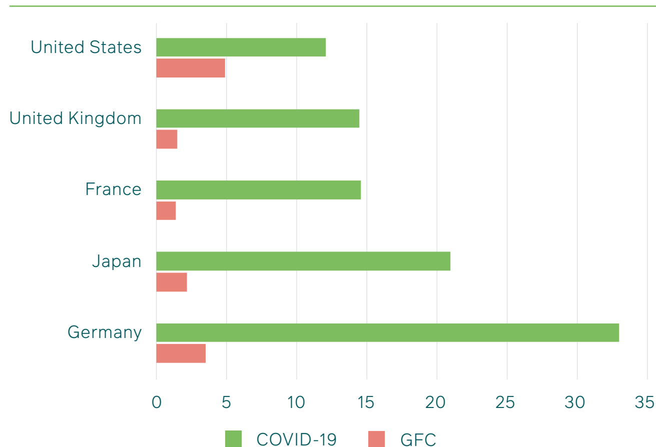
Many associate private credit financings with a long time horizon, but even when underwriting loans on a shorter time horizon of five to seven years, say, and on a senior-secured basis, it is still important to be conscious of the trends that are shaping the present and future landscape as they play out – and their potential impact on credit risk. The shift towards sustainability is firmly underway and there has been rapid acceleration in the development and adoption of new technologies across sectors over recent years. Many are also thinking about the future of business travel in the post-COVID era and the extent to which shifts in how we live, work, shop and socialise will impact those operating in certain sectors and how well-positioned they are to take advantage of secular trends.

The big picture

Unprecedented policy firepower

Bridging the liquidity needs of many corporate borrowers and individual taxpayers alike, has helped to potentially stave off bankruptcies and defaults, but turning the fiscal taps on has involved vast sums of money – to the tune of US$12.7 trillion[3]. Governments in developed economies have reportedly spent 5% of their combined GDP on stimulus payouts alone. What's more, the massive fiscal response to the crisis has been in addition to other policy measures enacted by central banks, including forcing lenders to impose moratoria on mortgage payments.

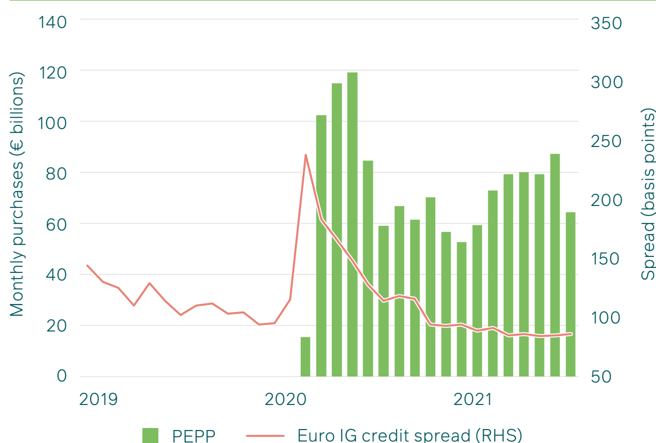
Outsized fiscal responses to this crisis, % of GDP



Source: McKinsey & Company, 'The $10 trillion rescue: How governments can deliver impact, June 2020.' Information is subject to change and is not a guarantee of future results.

At the same time, major central banks also resumed their quantitative easing (QE) programmes while keeping interest rates at historical lows, as policymakers pledged to do 'whatever it takes' to prop up their economies in the face of widespread disruption – with the scale and speed of the support measures helping to restore functionality in parts of the market that had effectively seized up amid fear and panic, rather than a reflection of credit risk. Although inflation concerns have reared their ugly head in recent months, public bond spreads remain tight and yields are trading near historically low levels.

ECB PEPP monthly purchases and Europe IG credit spreads



Source: M&G, Morgan Stanley, Bloomberg, ECB data, as at 31 August 2021. Information is subject to change and is not a guarantee of future results.

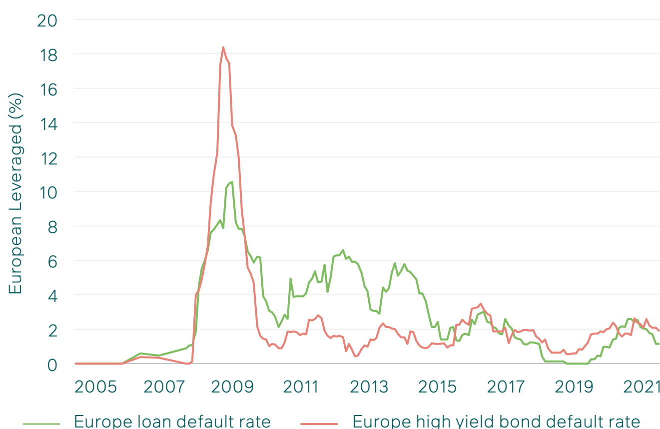
Interestingly, policymakers continue to play an outsized role, even as credit spreads have normalised. Although the ECB has announced that it has decided to move to 'a moderately lower pace' in its €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) from the €80 billion-a-month level it has run at since March.

[3]UN 'Monthly briefing on the world economic situation and prospects – No. 146, 5 February 2021'.

Cycle, interrupted

Prior to the crisis, market commentators were pre-occupied by late-cycle worries, but have the extraordinary events of 2020 and the response to them disrupted the credit cycle? Ratings agency Fitch Ratings suggests "a new credit cycle in European leveraged credit bond and loan markets reflects declining default rates and a surge in upgrades relative to downgrades.[4]" European distressed debt levels are the lowest for two decades[5], while the near-term outlook for corporate defaults offers some comfort for investors.

European leveraged loan and high yield bond annual default rates



Source: S&P LCD, S&P Ratings Direct, BofAML, as at 31 July 2021. Loan specific figures not given pre 2007 for Europe. Information is subject to change and is not a guarantee of future results.

[4]Fitch Ratings, Special report, 'European at-risk leveraged credit – June 2021', 21 June 2021.
[5]Based on the JPMorgan index of euro and sterling non-financial bonds, the proportion of bonds trading below 80 was just 0.3% at the end of May 2021.

So far, heavily indebted companies appear to have performed better than feared, having managed cash and costs well, focused on survival and tapped all available liquidity and credit support lines. Massive and continued support should therefore mean an avoidance of the dire widespread solvency situation experienced after the global financial crisis (GFC). While it is hard at this stage to see what could obviously trigger such an event en masse – perhaps barring any policy missteps – could there be reason to suspect that the 'bridging' crisis response (deployed largely in the form of debt) has merely postponed an inevitable default scenario for some highly-leveraged, struggling businesses operating in frontline sectors, with things yet to fully play out at this juncture?

The risks stemming from the consequences of heavy corporate and government debt burdens cannot be discounted. While active refinancing into historically low coupons alleviates liquidity and debt-service pressures and extends maturity headroom, a scenario in which higher interest rates is combined with higher leverage could upend current low default scenarios. Inflation could remain elevated, putting pressure on central banks to raise rates, which could make borrowers and issuers with floating-rate debt vulnerable to a jump in borrowing costs. This is a necessary consideration for debt holders too, with the majority of bank loans as well as corporate direct lending and leveraged loans tending to be floating-rate in nature.

This emphasises the need for private lenders to exercise strong underwriting rigour and risk discipline when investing, even on a senior-secured basis. Debt is an asymmetric risk, so lenders need to protect the downside through lending structures and structural protections designed to help mitigate risk in deals for lenders, and ultimately protect investors. Lenders can also arm themselves with the resources to potentially maximise recoveries in the event that an investment does not perform as expected, by having in-house restructuring resource and expertise in place to play an active role in restructurings.

Lender controls in action

We first lent to a company in 2016. In 2018, the company was sold and we again provided financing. At this stage, the company had won a large new contract which would be supportive to the business. Implementation of this contract fell behind plan and the company incurred unforeseen costs. This was exacerbated by the onset of COVID-19 and a covenant was breached.

The strong legal documentation and existence of an appropriate covenant package allowed us to engage with the investee company and the equity holder quickly. The sponsor agreed to put in additional subordinated equity to fund the short-term liquidity requirements for the company and allow the company's performance to recover. As debt providers, we were able to negotiate some additional lender-friendly changes to the loan documentation to create additional protections going forward.

Subsequently the sponsor and the lender group have agreed to target a reduction in leverage for the company. The delayed contact was implemented as expected after the delay and is delivering all key performance indicators. The business continues to trade through COVID-19, delivering month-on-month financial improvements.

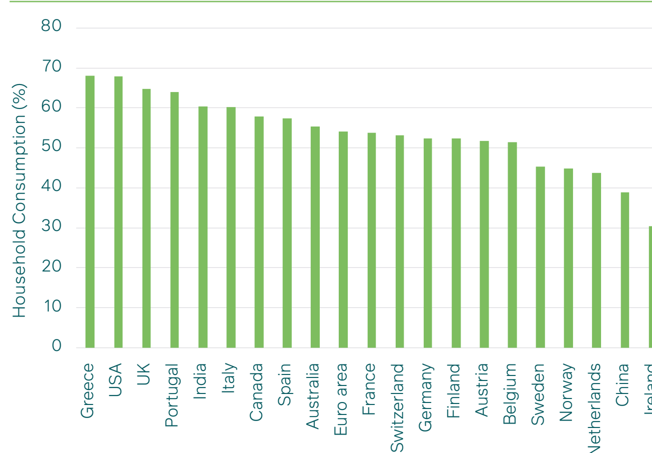
This was a fundamentally good company that had faced unforeseen issues and because of the covenants included in the loan terms, we engaged with the company to find a solution and to protect the interests of our clients. The favourable outcome was a function both of the prudent structuring and existence of expert restructuring resources.

Sustained credit performance of the consumer?

Underlying the government's outsized fiscal response has been a political necessity to protect the consumer. Developed economies are increasingly service-driven, so keeping economies growing requires the engine of economies (consumers) to be in good financial health and/or feel optimistic about their future financial prospects.

The outlook for consumer spending remains relatively uncertain going forward, while there is some apprehension about how the withdrawal of temporary state-support measures – including wage guarantees that have helped to cushion falls in household income and furlough schemes – will impact unemployment levels ahead. Nevertheless, there are several reasons to believe that even amid a devastating pandemic, many households in advanced economies are still feeling optimistic about their finances.

Household consumption as a % of GDP

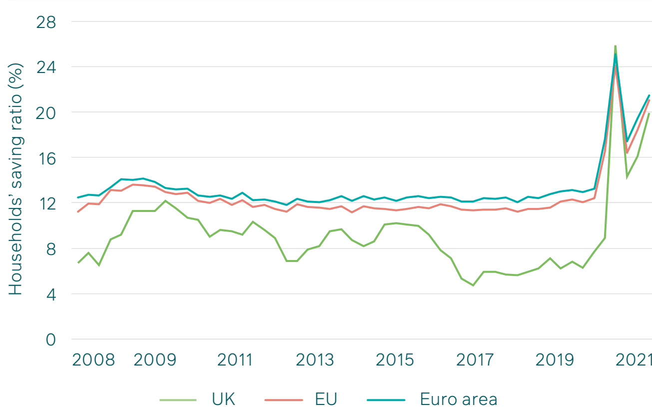


Source: M&G. Household Wealth: The World Bank 2019. Information is subject to change and is not a guarantee of future results.

Housing markets in major economies are booming, with low interest rates and high household savings driving house prices higher and mortgages rates to record lows – fuelling buyer demand. Strong housing market dynamics and rising housing prices could have many interconnected effects. Simplistically put, when house prices go up, homeowners could become better off and feel more confident about their future financial prospects, their ability to repay their debts improves and their propensity to spend more increases.

In contrast to the effects of QE, which have artificially depressed the returns on offer in many mature markets, the government resources focused on the consumer have not impacted pricing in the same way but have been supportive to the credit performance of the consumer. Consumers that have remained in full employment during the pandemic have amassed excess savings while national lockdowns reduced opportunities for discretionary spending – particularly across the hospitality, travel and retail sectors.

Household saving ratios, Euro area, EU and the UK



Source: Eurostat (online data code: NASQ_10_K, household gross saving rate (seasonally and calendar-adjusted data)), as at 28 July 2021. ONS (Series ID: DGD8, households' saving ratio % (seasonally-adjusted data)), as at 30 June 2021 (data accessed 21 September 2021). Information is subject to change and is not a guarantee of future results.

A survey conducted by the Bank of England (BoE), notes that mortgage holders were more likely to cut their spending in response to a fall in income, while those with unsecured debt were more likely to use their savings through the crisis or take on additional debt. The BoE adds that "This may reflect the fact that mortgage borrowers are concentrated in higher income brackets, and are therefore likely to have a higher share of discretionary spending, which was more restricted by lockdown measures." It could stand to reason that those consumers who are more likely to take out conventional consumer debt, like mortgages, are actually a better credit risk today than they were prior to the pandemic.

Private credit's role in financing the post-pandemic recovery

As the world grapples with the unintended economic and societal consequences of the COVID-19 pandemic, the nature of the fiscal stimulus packages and budgets announced since the onset of the crisis suggest that many governments in the developed world are heeding to the UN's universal call to action to 'build back better' – and to support a green, sustainable and fair recovery for current and future generations.

We think that private credit has an important and multi-faceted role to play in helping to finance this rebuilding to aid economic recovery in a post-pandemic world and finance many of the changes the world needs, owing to the adaptability, efficiency and wide breadth of the asset class. In our view, the opportunity set remains attractive and well-positioned in today's changed (and changing) investment landscape.

Non-bank lending 2.0

In many ways, the pandemic re-emphasised the need for alternative 'non-bank' lenders as a core part of the lending landscape in Europe.

Corporate borrowers that were able to access government liquidity schemes or those who drew-down their revolving credit facilities (RCFs) during the pandemic will ultimately need to term out this bank debt into a longer maturity profile or could require different capital solutions to potentially navigate a more challenging credit environment. Borrowers also need different capital solutions for different stages of their lifecycle. Less mature companies are sometimes less suited to traditional cashflow lending structures and require more innovative lending solutions that are better suited to the stage and nature of the business, including asset-based l ending structures. A recognisable key area of strength of private credit is an ability to meet more complex finance needs.

While this isn't 2008 again, the private debt funds that filled the gaps left by banks ten plus years ago, a cadre of closed-ended vehicles, are more numerous today and more willing to provide flexible lending capital or terms to borrowers, including providing companies with a whole financing solution, from senior loan to mezzanine. Increasingly, such 'flexible' risk capital is packaged together in a single 'unitranche' and single deals can be sizable.

These structures dominate in the UK (70%) and represented over half (56%) of the direct lending deals in Europe in the last 12 months, targeting pricing of Libor +650 basis points and above (with leverage at 5x or higher), according to the Deloitte Alternative Deal Tracker Autumn 2021. Mid-market corporate direct lending tends to involve lending to private businesses with EBITDA typically in the range of €10-40 million, according to our definition – and we focus on bilateral senior-only deals in the Libor +4-7% gap, as we think there are good opportunities to lend to good businesses and potential to generate attractive risk-adjusted returns.

There is room for both senior-only deals and the unitranche product to grow, with the popularity of unitranche key to helping the direct lending market reach critical mass.

Financing infrastructure gaps

Faced with high levels of national debt and constrained public finances – with government borrowing having risen markedly in 2020/21 to levels not seen since the second world war – policymakers are looking to private investors once again to fill funding gaps as they seek to realise their infrastructure ambitions to rebuild economies and drive long-term prosperity. There also a clear focus on steering infrastructure in the direction of energy transition and digitalisation.

The emphasis on addressing the gap in infrastructure investment is reflected in several government initiatives (on paper at least) such as the UK's 10-point plan for a green industrial revolution, the European Commission's Investment Plan for Europe and US President Joe Biden's US$1 trillion Infrastructure Bill. The UK Government's ten point plan aims to mobilise £12 billion of government investment, and potentially three times as much from the private sector, to create and support up to 250,000 green jobs, while green projects make up almost a third of the EU's €750 billion recovery fund.

There is a strong imperative to finance green projects such as offshore wind and electric transport infrastructure that can help to combat climate change, while the pandemic's effect on remote working and e-commerce has shown the need for investing in digital infrastructure, such as fibre networks or data centres. McKinsey, a consultancy, estimates spending on these must rise by 6-11% annually over the next decade to match growing usage.

Many asset owners including pension schemes and insurers have demonstrated their long-term commitment to the sector and remain keen for new opportunities to increase their exposure to infrastructure assets in search of favourable long-term outcomes, including steady cashflows and portfolio diversification, to meet pensioner and policyholder liabilities. Investors are all too aware that investment in real assets via debt or equity also could offer some protection in an inflationary environment.

Part 2: Key themes shaping the present and future

ESG and impact in private markets

Next generation capital(ism)

The next generation's capital is here, and it's more environmentally- and socially-conscious than ever before. Many believe we are going through a paradigm shift in investing, with the swing to sustainability being profound, urgent and irreversible. This is catalysed by powerful trends like decarbonisation, diversity and inclusion, and poverty alleviation, and reinforced by the pace and extent of regulatory and policy change. There is a clear regulatory imperative in Europe, in particular, as officials seek to propel sustainable business, investment and capital markets forward – and provide structure for the investment community through new rules, standards and frameworks, designed to mandate greater transparency and prevent 'greenwashing'.

There is no denying that public markets are more advanced in terms of implementation, however the momentum in ESG in the private world is just as remarkable and palpable – even though the pace of adoption and integration across sectors has not been uniform. Private lenders too, are ready to step it up a gear – recognising room for improvement in the asset class and to encourage it via engagement.

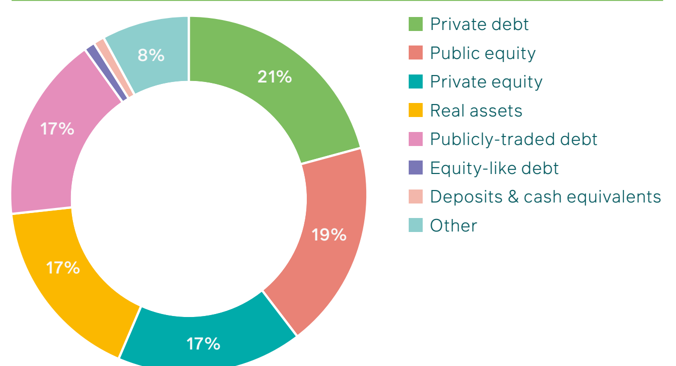
Private credit with purpose

The conversation around ESG and sustainable investment practices has shifted dramatically over recent years. Part of this is owing to increased focus from the wider investment community, led by large asset owners and managers and a growing desire to align investments with their long-term goals and social values – doubling down on sectors that are providing investable solutions that can offer tangible, real world impact.

Investors are also more engaged than ever before on the issues that matter and are paying greater attention to the dangers of unmitigated climate change.

Private assets are particularly well-suited to sustainable lending, in our view, as they can help to finance some of the solutions to the problems that the world is facing today. Private credit investments can frequently be for particular projects with a narrow and defined purpose. Similarly, facilities to finance the development of buildings with positive environmental characteristics and a social purpose are seen, including financing that facilitates increased levels and quality of housing stock for people at affordable or social rents in areas where this is low and social housing waiting lists are high.

Asset allocations by asset class (% of AUM) – impact investment



Source: GIIN, '2020 Annual Impact Investor Survey', June 2020.
Notes: % of AUM excl. outliers; n = 289; AUM = US$221 billion. 'Other' includes guarantees, mezzanine financing, and social outcomes contracts. Information is subject to change and is not a guarantee of future results.

Two sides of the same coin?

Certain private credit strategies, like infrastructure debt and social housing, provide investors with an opportunity to invest in assets that naturally benefit from the momentum in key ESG and sustainability trends, whether that's through financing the increasing need for social infrastructure assets including schools and hospitals, or energy generation, heat and mobility. Much of the early growth in renewable energy projects – like wind and solar – was financed privately and loans to finance the improvement of the environmental performance of assets such as NHS hospitals and student accommodation, including their energy and resource efficiency, have increased over the years.

Private sector operators of public infrastructure assets require a social licence to operate – to be better aligned to customer needs rather than the needs of stakeholders and to uphold the reputation they have with communities in which they operate in. The growing influence of ESG offers scope for engagement with these private sector operators to ensure their operational focus is also on maximising their social value and impact.

Even for the hard-to-abate sectors such as transportation, there is a clear need for pragmatic and responsible solutions to mitigating Co_2 emissions as they decarbonise over the next decades, including technologies such as carbon capture and storage. Private capital is well placed to help finance this. For the aviation sector, reducing carbon emissions from flights will take time and involve longer-term solutions and technologies such as sustainable aviation fuel to become commercially viable, but financing today with long-term debt can still help more challenging assets like airports to reach goals of climate neutrality. Looking to the future, there may be opportunities for more selective investments that finance the upgrading of energy-efficiency lighting at an airport versus financing a new runway, for example.

ESG in private credit – there is no one-size-fits-all approach

Private credit's emphasis on long-term credit quality lends itself well to incorporating ESG considerations in the investment process, given the fact that borrowers and lenders work very closely together. Also given the buy-and-hold nature of the asset class, lenders are encouraged to actively engage to identify and analyse how ESG factors may impact investments. This close nexus can allow meaningful dialogue with borrowers to occur on ESG issues and disclosures, giving private lenders an edge relative to public bondholders, in this respect.

Private companies do not have to comply with the same mandatory disclosures as their public peers, but we often find that the companies to which we lend are generally receptive to requests for greater ESG disclosures. Transactions are often bilateral or involve a small number of lenders so can be an important part of a borrower's total funding mix, or in cases where companies are larger and aiming for an IPO, we find they are willing to engage and demonstrate improvements over time.

Private assets can suffer from a lack of robust and consistent data, including reliable data on climate risks. The leading market providers have low coverage of these assets. This has created challenges to meet the requirements of investors who are very committed to ESG and require quantitative assessment. The challenges faced vary from formalising and validating ESG-related methodologies and processes in some of the non-corporate sectors, to bridging the evident gaps in data collection and disclosure across all sectors. So, this means encouraging borrowers and issuers to broaden their disclosures, including their future short, medium and long-term targets. Having good, sensible conversations with management about ESG matters or the impact that they are having, can mean that it's much easier to demonstrate to clients exactly where ESG and impact are coming from in their portfolios, where there may be issues and what we can do about it.

Engaging to maximise impact

A rigorous ESG engagement framework to influence decision-making and foster best practice

Source: M&G, as at September 2021. Notes: To qualify as an ESG engagement, our interaction with a company or a policymaker requires a UNPRI-aligned OBJECTIVE, ACTION and OUTCOME. In line with UNPRI best practice, an interaction with a company for data collection and/or for research purposes related to buy/sell/hold decisions are not considered to be 'ESG Engagements', but will be recorded by M&G as meetings with ESG questions or 'ESG interactions'. Information is subject to change and is not a guarantee of future results.

Going forward, we hope that sophistication will ultimately come as reporting, disclosure and benchmarking all develop for private assets, with managers also looking at big data solutions to tackle some of the problems around data availability (see 'Big data and technology').

ESG in ABS markets

ESG scorecards: Evaluating ESG considerations in ABS is both nuanced and complex because the underlying collateral is legally remote from the originating entity and because there is no management team operating an SPV. Currently, there are no third-party ESG scoring systems for ABS transactions and no real industry consensus on how to approach ESG, so we have developed our own methodology to appropriately model and score ESG risks. We believe that our recently introduced ABS ESG scorecard, is among the first of its kind in the industry. There are three elements to deriving the ESG score; the underlying collateral, the structure and the sponsor (including origination and servicing practices). ESG factors within these three pillars can then be combined to produce summary ESG scores which we use as a means to engage with sponsors to improve practice in key areas.

Engagement in action: European securitisation transactions comprise mainly asset pools that reflect lending to the real economy, including commercial and residential mortgages, auto loans, consumer loans and SME lending among other asset pools. The fallout from the COVID-19 pandemic had a direct impact on these loans as governments announced huge stimulus packages for individuals and businesses, including income support measures and payment moratoria. As significant holders of European ABS, we were able to successfully engage with the issuers of nine ABS programmes we hold to understand how payment holidays were being implemented, how vulnerable borrowers were being assessed and ensuring they were handled with due care and to seek improved noteholder disclosure. This allowed us to get better data points on the proportion of the asset pool that had taken payment holidays on their loans – the characteristics of borrowers became more prevalent in better data disclosure over time. Our own analysis suggests that UK prime borrower payment holidays peaked at c.25% of outstanding mortgages in mid-2020 and fell sharply thereafter.

Moving the dial

As well as access to borrowers, for a strong and systematic engagement programme that aims to achieve maximum effect, it's important to have sufficient resources to do the engagement (and to use these resources wisely), plus the lobbying and the risk assessment in-house, to do it both qualitatively and quantitatively. We believe it is our responsibility to address ESG issues with our investee companies/ borrowers and sponsors. Often, our engagement discussions allow us to ascertain if a borrower's ESG views are aligned with our own, and if we find that management's views are not, we are unlikely to invest.

At M&G Investments, we have been undertaking a programme of climate engagement, targeting the top 100 emitters across our portfolios. This has been co-ordinated by a dedicated climate team in conjunction with analysts that have relationships with the companies. It includes engagement in the private world.

Temperature checking net-zero targets in leveraged finance

We recently conducted an engagement with a consumer goods company to discuss the company's net-zero commitment. The company recently announced a pledge to become net zero ahead of 2050, although the company has not committed to the Science Based Target initiative (SBTi). The company is continuing to work through what it means precisely for the individual parts of the business, given it has a large manufacturing footprint (Scope 1 and 2) and is working to establish a measurement process for Scope 3 emissions. It also aiming to set interim targets during H2 2021 or 2022. While we commend the company on its net-zero commitment, we will continue to monitor progress in regard to interim targets.

The rise of sustainability–linked debt

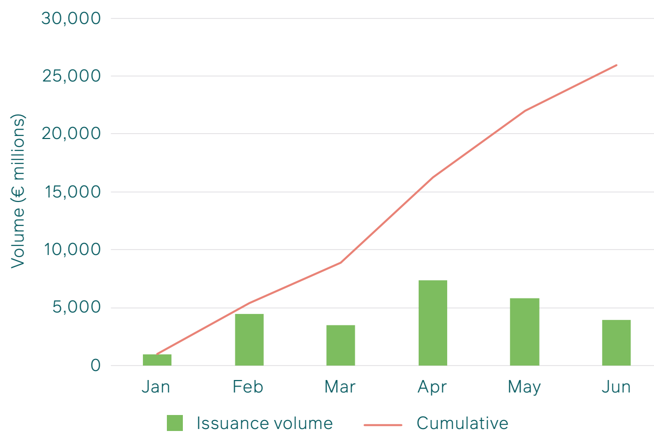
Private lenders are helping to move the dial on ESG in private markets and encourage more sustainable practices – through systematic engagement and other innovative approaches designed to provide incentives for positive change, including more financings with a sustainability link to them as we have seen in infrastructure debt deals.

Within wider fixed income markets the 'green' finance revolution appears to be firmly underway, with sustainable debt issuance continuing to set new records as sustainability becomes an increasingly critical factor for stakeholders and companies seeking to raise capital.

The issuance of ESG-labelled loans is emblematic of the way private companies are embracing change. This year, we have seen sustainability-linked loans (SLLs) – loans where margins are linked to pre-determined key performance indicators arising from sustainability performance targets that a company has set for itself – permeate the leveraged finance market. In H1 2021, SLLs across the European leveraged loan market accounted for €28 billion (c.40%) of issuance volume versus €35 billion in sustainability-linked bonds (of which c.30% for high yield issuers).

While a step in the right direction, the lender community must be assertive to ensure that hurdles set by borrowers and issuers when linking pricing to sustainability targets are meaningful and that the sustainability-linked feature is evidence of a proper framework, is relevant and is truly testing a company's ambition.

Volume of sustainability-linked loans issued in Europe in H1 2021



Source: 9fin.com, M&G, as at 30 June 2021. Information is subject to change and is not a guarantee of future results.

Sustainability in leveraged loans

For some private equity (PE) sponsors, ESG has become part of their value creation ambition which is a state of mind that pervades the companies that they own, but neither ESG risk management nor disclosure standards are uniform and often they may not be as developed as for listed companies. This is understandable when thinking about the relatively shorter history of many of them.

With a sustainable loan strategy today, we are looking to go beyond ESG integration proactively to measure and mitigate ESG risks and pursue companies exhibiting or with the intent to implement strong sustainable approaches. We're using the confidence of M&G's overall investment experience, married with our own direct history of over two decades in the loan market and quantitative tools – many of them proprietary – to rank and monitor companies in their ESG management and to scrutinise their sustainability. This is informing our investment decisions and our company engagement programme.

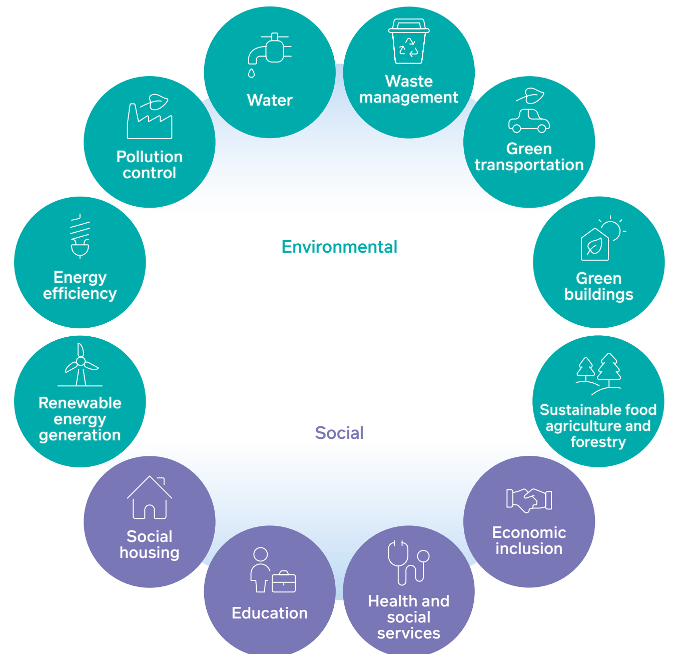
We engage bilaterally with our investee companies on relevant and material issues regularly but we recognise that improving sustainability is a collaborative effort so we also actively engage on key sustainability themes, debates and initiatives with like-minded institutional investors in the wider market.

Targeting real-world impact

Private credit is particularly well-suited to impact investing due to the fact that financing is made to discrete projects (to construct a wind farm or a hospital, for instance) or smaller companies that allow for the more precise targeting of impact capital. The core focus tends to be on privately-negotiating transactions, analysing and managing risk through close relationships with borrowers to protect the value of investments for underlying investors, as well as an ability to offer bespoke lending structures to fit the nature and stage of the investment opportunity. The breadth and esoteric nature of the private credit universe offers investors access to a diverse array of suitable assets with the potential to generate intentional and measurable impact alongside a financial return.

Private loans can take many forms, including project or development finance to fund the construction of a new offshore wind farm that generates clean, renewable electricity to help to reduce harmful Co_2 emissions, loans to housing associations to help them build new affordable housing developments that seek to provide a better quality of life and increased opportunities for low-income families, or debt issued to finance the construction of new mental healthcare facilities offering specialist inpatient care to people in underserved communities.

Defining the impact investment universe



Source: M&G. Information is subject to change and is not a guarantee of future results.

Moreover, we think there could be huge opportunities for investors to target real-world impact as calls to action on climate change and wider sustainability issues intensify. For example, waste generation and waste management are rapidly growing global challenges that are closely linked to other environmental concerns including resource depletion and climate change – and we have seen a number of deals coming through focused on these themes. There is recognition that modern waste-to-energy (WtE) facilities, which power and heat homes from waste generated by society, can help the transition to a more resource-efficient and circular economy, and support broader net-zero ambitions.

Part 2: Key themes shaping the present and future

Big data and technology

Deepening the capabilities of data analytics

Data is at the heart of investment and analysis across all asset classes. Technology and big data are increasingly important from the perspective both of analysing risk and provision of information to stakeholders. Ever greater emphasis is being placed on continually improving data and information flow – particularly when it comes to meeting investors' and regulators' expectations and obligations on ESG. It can pay to be forward-thinking when it comes to deepening the capabilities of data analytics in private credit.

Private lenders are dealing with often complex investments, and lack of third-party views or information to invest. Investment is resource-intensive, from origination, due diligence and credit underwriting through to portfolio construction and ongoing monitoring of investments. Assets may come with substantial amounts of underlying data which can conceal important insights into the risk of an investment.

Yet, the build-out of innovative technological solutions and sophisticated data analytic tools that extend beyond the capabilities of off-the-shelf software is turning some of these challenges into opportunities to gain greater insight. Embracing the use of big data and technological-enabled solutions throughout the lending process, could help to change things for the better and potentially enable better outcomes for clients over the long term.

Rising to the ESG data challenge

When it comes to data availability and disclosure requirements on the private side, there are still challenges to overcome in providing tangible evidence and data that prove the sustainability of business or asset operations – from corporate to real assets lending.

Public companies have an obligation to produce a certain amount of data (part and parcel of being a listed entity) and are rated by third-party data providers such as MSCI, while initiatives such as the Climate Disclosure Project (CDP) – for strengthening assurance of ESG data disclosure in corporate reporting – along with regulations, like the Corporate Sustainability Reporting Directive and the Non-Financial Reporting Directive, are helping to up the ante on climate disclosure. Conversely, corporate borrowers and issuers on the private side are often smaller in scale and resource, so are not as far along the disclosure journey as large corporates that access the capital markets.

Therefore the private world offers greater potential for influence in promoting sustainable practices and pushing for greater ESG disclosures. Some borrowers are already on the front-foot in terms of providing more ESG information such as on diversity and inclusion, climate and sustainability-related metrics, and of higher quality, without prompt from lenders – some PE sponsors have fully embraced ESG over recent years and long advocated good disclosure across all ESG areas when it comes to their portfolio companies. In infrastructure debt, lenders are able to get access to data at the sponsor-level, even for small businesses, or request information from other counterparties. Infrastructure borrowers who are regulated entities also have an obligation to their regulators to be transparent on their ESG credentials and increasingly need to evidence how they are delivering broader societal benefits.

We are also seeing progress in the social housing sector, a sector recognised for providing evident societal benefits, with many providers including housing associations lagging behind when it comes to broader ESG data disclosure, for example on energy efficiency. The Sustainability Reporting Standard for Social Housing (SRS) is a voluntary reporting framework which was launched in November 2020 by the ESG Social Housing Working Group, a collaboration of housing associations, banks, investors, service providers and impact investing organisations. As a member of the Working Group, which was set up in 2019 to address the lack of transparency and consistency in ESG reporting, we have been an early proponent of improving ESG disclosure and standards in the social housing sector. The Standard covers 12 themes and 48 criteria across ESG considerations such as affordability, fire safety and net-zero carbon emissions.

In the leveraged loan market, we have had ongoing involvement in industry working groups, including most recently involvement with shaping new guidance around the Sustainability-Linked Loans (SLL) product – in light of the surge of SLL issuance in the European leveraged finance market this year – with the release of the Sustainability Linked Loan Principles (SLLP) in May, which were originally developed by LMA in conjunction with the LSTA and APLMA in 2019.

We are also among investors endorsing a new initiative, the Private Markets Pilot, which is aimed at addressing the growing number of high carbon-emitting companies being delisted. The new disclosure framework calls for more than 1,000 private companies from emerging and developed markets to provide environmental data through the CDP platform, to address a gap in transparency with their listed peers. The pilot is set to include the development of the first ever standardised environmental platform dedicated to private assets, which will allow investors to compare the environmental performance of private companies.

Carbonator – generating carbon proxies for private assets

Obligations to report climate data in line with Task Force on Climate-Related Financial Disclosures (TCFD) are coming for asset owners and asset managers alike. Good-quality emissions and intensity data for private assets simply doesn't exist for the vast majority of private assets, so it's important to start somewhere. This is why we have developed a proprietary tool to rise to the challenge of the ESG data and disclosure gap in private assets. Carbonator is a tool that seeks to approximate carbon emissions data across our private credit portfolios. Each asset class requires a different methodology. For example, for corporate exposures Carbonator utilises machine learning techniques to look for patterns across publicly-available data input based on what is most relevant for the company, such as scale of operations, sector/industry, geographical spread or reach. Other technology tools such as internet data scraping, can help to further enhance data collection from public sources like corporate financial accounts.

The objective? Doing this better enables us to unleash our superpower as private lenders: Engagement. Carbonator generates approximated data points, for investments where carbon data is either unavailable or has not been disclosed, which we can put forward to borrowers, originators and issuers as a starting point for discussion and encouragement to get them to disclose a more accurate number. Innovative technology tools like Carbonator can therefore help to enhance a sustained and systematic engagement programme and help better manage and monitor ESG risk over the lending relationship.

The methodology and approach to generate carbon proxy data for a corporate borrower differs from the appropriate methodology for securitisations referencing an underlying pool of mortgages or loans or for real assets – which can be too bespoke to compare in the same way or there may not be obvious public asset comparators. In these cases, engaging with originators/issuers to get this information may be possible but utilising underlying loan tapes such as the carbon emissions data for Auto ABS, allows us to create proxies across our portfolios. For assets with property backing data, such as location and property type, can be used to create estimates for even the most granular portfolios.

Applying Carbonator technology to our entire range of private credit assets brings unique challenges, but we are constantly looking to refine our methodologies as we gather a greater wealth of data and analysis, and the quality of input naturally increases.

Speed matters

An ability to construct proprietary systems to enable fingertip access to information and use of data mining techniques could allow managers to draw conclusions quicker – increasing speed to market. When the European ABS markets saw volatility spike in March 2020, we were able to quickly assess exposures to frontline sectors and industries and run additional stress-testing across portfolios and underlying collateral pools of CLOs, RMBS etc. ABS by its very nature deals with a lot of data, much of it standardised unlike other parts of the private credit market, and we have built proprietary databases to capture this data and stress test the data for monitoring and portfolio management purposes.

This experience in working with large datasets has enabled us to apply securitisation techniques to private pools of assets and to asset classes where we have the institutional knowledge, but which are relatively new to ABS markets and techniques, such as social housing and agricultural loans. Having a large database to capture data allows us to analyse and value private opportunities such as ABS warehouses, and also helped us to identify the full opportunity in consumer finance as it was emerging as a sector in its own right.

Heightening analysis possibilities in consumer finance

The ability to access, format and process large quantities of data provides a valuable advantage when evaluating purchases of residential mortgages and consumer loan portfolios. Extensive, granular, loan-by-loan, historical data from the originator is made available to the buyers of these loan portfolios. When combined with historical data from third-party originators and the European Data Warehouse, this can help to facilitate the manager's underwriting, stress-testing and portfolio selection and pricing. The outputs are used in negotiations to determine which portions of portfolios to include and exclude, and the appropriate price to pay.

The absolute quantum of data required to perform this analysis is far beyond the capacity of off-the-shelf spreadsheet and database programmes, and proprietary Python-based databases and systems must be built to first store the data before analysing it. To stress test a recent purchase of auto loans, over five billion data points sourced from historical ABS transactions and the seller of the loan book were analysed. We used this to generate likely loan default probability and loss risks over the lifetime of the loans, which enabled us to determine the appropriate purchase price to assume these risks and generate the desired level of return. This type of analysis can be extended to different factors of interest when analysing loan portfolios, such as the impact of prepayments, credit quality of borrowers, or loan to value.

The future is digital

Looking ahead, there are multiple possibilities for big data and sophisticated technology solutions to be applied in other areas of private credit investing.

Tokenisation of private and illiquid assets

Private assets, by their very construct, are often bespoke in nature, sometimes esoteric and can be wildly different to one another. The side effect of having a private asset where the structure and credit specifics are not available and transparent to all, is illiquidity – with closed-ended fund structures prevalent in private credit. This is a feature of private assets that affects fund structure, market participants and indeed returns since it generates an information asymmetry. As private assets are not normally liquid and not as transparent as public assets, they are inherently more difficult to invest in. Public assets have transferability because they are listed on an exchange and can therefore be traded between market participants in different-sized units. However, the cost of listing issues of debt or equity is high and so only the largest companies can create public securities. Liquidity also relies on having a functioning secondary market with decent two-way flow.

The advent of blockchain technology has facilitated what is known as 'Tokenisation' – which is the ability to convert an illiquid asset into a digital, and transferable product or security. The FCA considers security tokens to be securities and so rather than the provenance of a private asset and its investors logged on paper, the assets – whether buildings or private loans – get digitalised into blockchain and managed on a distributed ledger. This is the same technology used for Central Bank Digital Currencies – a growing area of interest that is being studied by central banks worldwide. This common execution framework potentially separates tokenisation from the many tech innovations that preceded it and have faded from memory and relevance.

The technology permits hitherto illiquid assets to be fractionalised and transferred – in a way that becomes relatively simple, cheap, and quick to do – potentially opening up access for a much broader set of investors. Many attractive private asset investment opportunities which may suit investors' requirements are many hundreds of millions in size and can't easily be split. These become open only to a handful of potential buyers and the ability to divide these assets democratises access to these assets to a wider array of potential owners. The concept of liquidity could eventually follow in the same way that it does when standardising how equities or government bonds are traded.

Tradability does not in itself change the liquidity of a private asset – the information asymmetry means that potential buyers may find it hard to understand what an asset is and what its risks are, and so are unwilling buyers – but it is potentially a step in the right direction to the democratisation of private and illiquid assets.

Blockchain, explained

Blockchain is a specific type of database or used as a ledger for transactions based on distributed ledger technology (DLT), a digital system that differs from a typical database in the way it stores information. Blockchain is used in a decentralised way so that data is not controlled by a single administrator or group and all users collectively retain control – and is considered to be a single source of truth. Once data is entered in a decentralised blockchain, it cannot be changed.

While blockchain is most commonly associated with cryptocurrencies, in areas where there is a need for high data security and data sharing such as secure sharing of medical data and musical royalty tracking, blockchain technology is also used.

New frontiers

A healthy appetite for innovation

Established managers that have developed the breadth of capabilities, expertise and resources have been able to respond to investor appetite for new sources of alpha by unlocking opportunities in new markets and unconventional asset classes not previously considered under the private credit label. Expanding access to more unconventional asset classes and opportunities in the pursuit of super-normal returns and enhanced diversification possibilities, is also helping to challenge traditional, tightly-held definitions of private credit and allow investors to embrace more holistic investment approaches focused on meeting target outcomes.

Moreover, we think that private lenders with the depth of capability, and perhaps more importantly, the appetite to come up with new, innovative investment ideas – together with sufficient origination capacity and reach – are integral to private credit's ongoing evolution and widening appeal among different types of investors and borrowers alike.

Borrower-led financings

Companies are opting to stay private for longer periods of time compared to a decade ago before going public – European IPOs dropped by a third to an eight-year low in 2020 – instead spending their fastest-growing years under private ownership and tapping into big pools of private growth capital in order to build to sufficient size and scale for an IPO or other forms of listing/exit. This could potentially mean more, and more varied, investment opportunities for private and alternative lenders.

Consequently, having the capabilities and flexibility of mandates to provide different types of capital to borrowers as and when it is needed, can help private lenders to forge virtuous lending partnerships over time. 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, while lenders with the depth of capability are able to offer and structure loans with significant in-built hard asset protection for underlying investors.

For asset managers with a broad private credit offering, a relationship with a company through its lifecycle could go from a very small direct lending club loan through a buy and build growth phase that sees a company become a large-cap, PE-owned entity that may also issue public bonds and may ultimately list on the stock exchange. Constructive managers that have the breadth and scale in both public and private markets could feasibly feature at every stage along the way with a borrower.

Targeting a range of investor objectives

For prudently-regulated investors such as insurers, private credit has proved quite attractive as they have recognised how the asset class can help them balance a range of liability requirements with higher return objectives than traditional debt over the long term. The advent of Solvency II in Europe and other capital-based regulatory regimes has incentivised insurers to invest in certain assets that attract a lower risk weighting and thus a lower capital charge relative to other asset classes, including private equity. To meet this demand, there have been a number of 'Solvency II-friendly' assets coming to the market, for example, unrated debt in general and also with investment grade (IG)-equivalent 'qualifying infrastructure' debt attracting lower capital charges under the Solvency II regime.

Across the private credit spectrum, we are seeing a healthy pipeline of deals and a wider variety of deals coming to the market, going for different types of investors. Many investors will have very different requirements from their investment portfolios. In private markets, you have a large number of asset classes that you can put into various different strategies or treat as 'building blocks' to construct bespoke portfolios, each doing different things and selected on that basis. For example, if you are looking at infrastructure debt or long lease property, then quite often they will have an explicit inflation component – so you may get 20 years of inflation linkage and that could be very interesting for certain pension schemes looking to generate the cashflows to pay pensions into the future. Or you may be looking at something that is more shorter-dated, like consumer finance, where you may be getting a significantly higher risk-adjusted return over the next seven or eight years. Again, that could be interesting to a whole different set of investors, from high net worth investors and into different sorts of institutional investors seeking to boost portfolio returns.

Playing to your strengths

Private credit's investable universe has become much broader and more diverse as a result of continued innovation within the asset class. While some alternative providers of capital have played to their strengths to build reputation among the borrower community and establish their presence in certain verticals and jurisdictions, others have looked to balance this with a healthy appetite for innovation.

Taking tried and tested techniques of working in partnership with borrowers to new sectors and markets, as well as new parts of the globe is helping to create differentiated sources of alpha and beta for underlying investors and build a strong origination pipeline. For example, securitisation structures and techniques are being applied across multiple sectors and a wider set of private asset types, leading to more tranching within the different verticals to appeal to different investor bases and target different risk/return objectives.

Spotlight on Asia origination

Private assets are ever-evolving and we have looked to establish origination presence in more regions globally, such as Asia-Pacific and the US, to expand the range of asset opportunities and enable a more diverse and broad investment universe in which to put into various different strategies to achieve greater portfolio diversification potential for investors. 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.

This year, our Asia-Pacific origination team has consistently observed good dealflow in many areas, but particularly on the structured finance side – with many of the opportunities often transactions that are secured on loan portfolios or real estate assets – a theme that the team believe will have further room to run.

Innovation mindset

There is no shortage of assets requiring private credit financing solutions, in our view. Even so, an ability to come up with new ideas and create new market opportunities that can scale is equally important to ensure that the asset class can continue to meet the evolving and changing needs of different investors over the long term, and as parts of the market mature and become more commoditised over time.

To do this successfully, we believe having a first mover mindset to overcome high barriers to market entry is one thing, but also the in-house resources, expertise, sourcing and relationship networks – and the margins – to be able to try new things is important. Private lenders also often require sufficient origination capacity and reach to generate the dealflow across the full spectrum of private credit in order to have the flexibility to seek out the best available opportunities, and remain highly selective when adding deals to portfolios.

Opening up access to new markets

The emergence of a specialty finance sector in Europe has opened up an opportunity for investors to gain exposure to a large, mature and resilient asset class – consumer finance – offering myriad of potential benefits, including diversification and higher risk-adjusted returns. Only a few years ago, the opportunity was largely inaccessible to institutional investors. However, regulatory capital constraints placed on retail banks has left them with little choice but to find efficient ways in which to free-up capital on their balance sheets, to do more lending, and meet higher capital and leverage ratios imposed by the regulators. One avenue has been for banks to embark on whole loan asset sales, including residential mortgages and other consumer loans, to trusted, non-bank partners. There has also been an emergence of non-bank lending platforms in certain lending segments, including specialist mortgage lending, that require financing and this is providing another source of transaction activity.

Patient and long-term institutional capital can be viewed as an advantage by sellers of these assets. These transactions work best when the buyer and seller are looking to build a symbiotic long-term relationship, such that the time, cost and effort of the diligence is worth it for both parties. Our scale and presence in the market has enabled deep originator and lender relationships, which offer counterparties confidence in our ability to execute and are critical to achieving target return objectives, in our view.

Part 3: Looking ahead

What's next for private credit markets?

The story (so far) – moving to the mainstream

Private credit offers investors a diverse and dynamic allocation opportunity over the longer term. Its growth story in the years since the GFC has been well-told through the lens of direct lending – with the European market growing from practically nothing to $157 billion in assets under management (AUM) in the decade to 2020. Interest in other prominent parts of private credit has also steadily grown over the same timeframe as markets became widely investable – strategic allocations to growth-orientated fixed income continue to see appetite from investors, with private debt seeing a 5% increase in investors reporting an allocation to the asset class from 2019 to 2020, according to Mercer's European Asset Allocation Insights 2020. Long-duration assets such as infrastructure debt and social housing debt have also been used by asset owners to match long-dated liabilities.

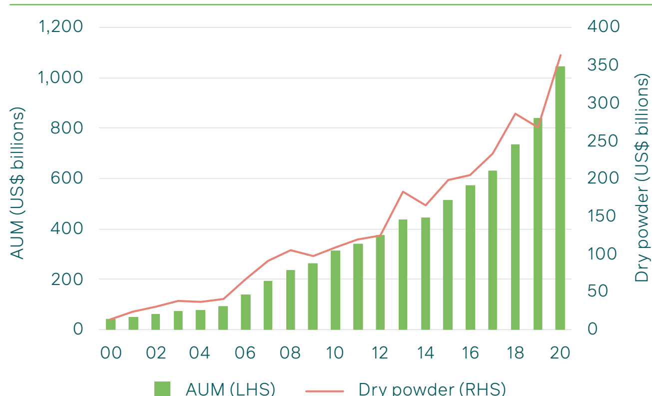
The varying sectors within private credit are at different stages of maturity, although one constant has been the growth in new markets which has led to more choice for investors to diversify and generate strong risk-adjusted investment returns for their portfolios, and has helped to promote more efficient capital markets.

Looking ahead, the direction of travel seems clear as private credit moves into the mainstream. The past two decades have been no short of transformational and the next decade promises to be just as (r)evolutionary. Given the key, multi-year themes helping to shape private credit, we think this could usher in a new era for the asset class.

The age of private markets – a new chapter of growth?

All signs indicate further growth in allocations as investors make private assets a more strategic and critical part of their portfolios. Preqin, the alternative data provider, has forecasted private debt AUM to reach $1.4 trillion by 2025, increasing at a compound annual growth rate (CAGR) of 11.4% – the second highest of any alternative asset class, after private equity – having surpassed the $1 trillion threshold this year. Dry powder levels — the amount raised for private debt strategies but not invested – has also increased exponentially in recent years, reaching $386 billion in October 2021 according to Preqin Pro figures. Preqin attributes the rise in dry powder to a combination of reduced M&A and abundant liquidity in other debt pools slowing deployment rates in 2020.

Growth of private debt AUM and dry powder, 2000-2020

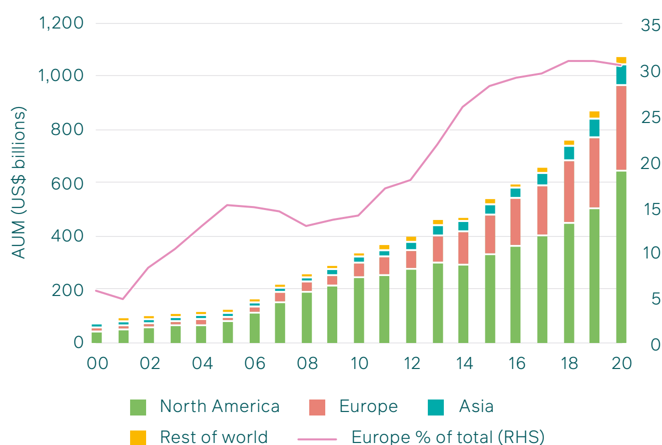


Source: Preqin Pro, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

Is Europe aiming for the stars (and stripes)?

As it stands today, the US is, by far, the largest and most developed private credit market globally, followed by Europe, and while private credit is less developed in Asia, it has continued to show promising growth. Since this is largely due to the differences in banking sector dominance across regions, there is good reason to think Europe's private credit markets are following in the footsteps of the US – although there is still some way to go.

Private debt AUM by geographic focus, 2000-2020



Source: Preqin Pro, as at 31 December 2020. Information is subject to change and is not a guarantee of future results.

The growth and development of the mature leveraged loan market in Europe over the past two decades offers a potentially interesting case study. The simplistic conclusion would be that the European loan market has finally become an incarnation of the US one. After all, bank disintermediation has taken place almost wholesale in the European loan market as it has done in the US, with the banks – in the sub investment-grade sphere anyway – having almost fully retrenched. Attracted by the significantly higher returns on offer, institutional investors have steadily taken advantage of the financing opportunities as banks pulled back – over three-quarters of the leveraged finance market is currently held by non-bank investors. But the reality is more nuanced and the relationship between company, relationship bank and institutional investor is more symbiotic these days.

Europe's investor split is, however, subtly different to that of the US. The US market is larger, more liquid and arguably more public and 'bond-like' in nature – with the European market having no Retail investor presence, unlike the US, with loans being ineligible assets for UCITS funds.

When a private market becomes big enough and liquid enough, is there greater symbiosis between public and private assets? In Europe, the crossover between the loan and high yield bond market has tended to be limited given dominance from PE-owned issuers in Europe, meaning companies offer no other investment opportunities in any public forum (debt, equity). Although for some big deals, PE sponsors are coming to both the leveraged finance market and the bond market for debt funding.

Capitulation in bank lending capital

In the long run, we see an acceleration of European bank deleveraging, potentially catalysed by greater M&A activity and further consolidation in the banking sector. Multi-year banking and financial regulatory reform looks set to further diminish the lending capital available to borrowers from this traditional source, resulting in greater opportunities for alternative sources of capital.

In the corporate direct lending markets, we see further capitulation in banks which are becoming a less and less relevant part of the lending landscape for mid-market companies. Looking ahead, we think scale could become increasingly important in corporate direct lending deals, with non-bank lenders operating in the upper end of the mid-market willing to lend £250-600 million debt financing at a time, and with record levels of dry powder ready to deploy. Unitranche club loans are also increasingly common and so-called 'blockbuster' deals are getting bigger – this year saw the largest unitranche on record hit the market, a US$2.6 billion of debt financing to help finance PE firm Thoma Bravo's buyout of Stamps.com.

We think there are huge opportunities for alternative lenders in the commercial real estate lending market, given the growing gap between the financing capacity of traditional bank lenders since the GFC, and the demand for new commercial real estate loans. Outside the US, real estate debt finance is primarily a bank-led market so there is plenty of scope for a more diversified lender base to develop in Europe over the next decade with the presence of non-bank lenders including debt funds in the sector only expected to grow from here – borrowers are attracted by the relationship-based nature of private lending transactions.

While this doesn't remove the role of banks in the sector, asset managers and their clients, including pension schemes and insurers, are natural long-term holders of real estate loans given the long-dated nature of their liabilities and investment horizons – so we think more of an even 50/50 split between banks and non-bank lending activity in Europe is possible. This is quite significant considering non-bank lending activity in the sector was near-negligible only 10 years ago.

Lending without banks

Larger sponsor-backed LBOs or take-privates require significant debt financing to get deals over the line, even if sponsors are able to front up a sizeable equity contribution. Banks used to finance this sort of thing, but not anymore.

Higher-leveraged deals, at more than 8x for example, simply fall outside of the appetite and risk tolerance of most underwriting banks and their regulators. Nevertheless, there is a growing cohort of sizable private debt funds more than willing to step into the void left by banks, underscoring the growing firepower of some non-bank lenders and their readiness to provide whole financing solutions – from senior loan to mezzanine.

As well as greater financing flexibility and greater certainty that a deal will get done, there are obvious synergies between private equity and private credit. There are also no roadshows and no public ratings, unlike with the leveraged loan and high yield bond markets.

Risk-sharing opportunities

The regulatory environment has seen banks withdrawing from certain market segments or lending niches while more stringent regulation of their capital bases have kept banks from originating opportunities outside of their risk tolerances and leverage thresholds, pushing them further into IG segments – and opening up opportunities for non-bank lenders in other areas. Capital-strapped banks have also looked to offload loans and other asset exposures from their balance sheets from time to time, including infrastructure debt assets.

Equally, this is leading to opportunities for alternative providers of capital to position as asset acquirers of performing whole loan portfolios, including residential mortgages and consumer loans – long-term secured forms of finance that arguably sit better off of a bank's balance sheet spawning a growing consumer finance investment opportunity for institutional clients who can provide the financing to allow these lenders to grow their market share. Although non-bank lenders are stepping into some of the gaps left by banks focusing their lending activities, European banks today still are the dominant originators of consumer debt. Providing overdrafts and RCFs for SMEs are also activities best performed by banks.

For loan asset types such as SME loans – which, due to their nature, banks cannot sell for practical or reputational reasons – banks have increasingly engaged in significant risk transfer (SRT) transactions by selling the first-loss risk position to third-party investors. This sector has been steadily growing across the past decade and we expect to see further growth in SRT opportunities ahead, across geographies as well as sectors and industries.

Funding fintech platforms

Similarly, we think fintech funding by institutional capital looks set to accelerate. Fintechs including specialist lending platforms are making inroads in certain lending segments, including SME lending alongside private debt and direct lending funds, and are helping to transform the lending landscape.

For example, platforms have started to pop up in the specialist buy-to-let and specialist mortgage lending segment – a sector once occupied by retail banks prior to the GFC, but have since stepped away – and have attracted funding from institutional investors, including M&G. These mortgage products are often securitised in order to provide more efficient funding. There are also multiple fintech providers offering unsecured personal loans to customers.

Expanding definitions

It's also worth pointing to the growth of PE funds, which is leading to opportunities in real estate debt and infrastructure debt respectively, above and beyond inherent corporate direct lending and leveraged finance opportunities that tend to be created as a result of PE deals. For private equity, a key element in boosting returns is debt. PE sponsors, who have seen equity returns compress over time, have been looking to put more debt into their portfolios to optimise financing structures to reduce debt servicing costs and bolster their own returns. PE funds are also helping to expand the definition of real asset classes, like infrastructure and real estate, in the debt markets by expanding into newer sectors such as digital infrastructure and communication.

The real estate investment universe (debt and equity) is much bigger than it once was, with 'alternative' sectors such as the private rented sector (PRS), student accommodation and even logistics considered to be mainstream these days. As such there is a wall of unrestricted capital seeking yield-enhancing opportunities that is waiting to be deployed. Looking ahead, as opportunities proliferate across the spectrum there could be a trend towards investors looking for more specialist mandates to access different parts of the lending market, for example development finance.

In a different sense, providers of equity capital are helping to open up opportunities for investors to gain access to the social and affordable housing sector and benefit from exposure to inflation-linked rental income and house price inflation. Housing associations form the largest not-for-profit grouping in the UK, working closely with both private and public organisations. Over the years, housing associations have accumulated higher amounts of debt as they have needed to borrow debt capital to finance their capital expenditure programmes, to supplement shrinking grants received from governments.

However, to meet social housing needs in England over the next decade, it is estimated that the sector will require an average of £14.6 billion in capital grant from the government each year[6]. In addition to debt financings, one model that has emerged to help finance the funding gap faced by providers of social and affordable housing is for-profit Shared Ownership vehicles providing equity to finance the provision of new homes, with these regulated vehicles also qualifying for government grants. We think that Shared Ownership models are here to stay and could play a bigger role in financing the provision of social housing in the coming years.

[6]National Housing Federation, 'Capital grant required to meet social housing need in England 2021-2031'.

Policymaker push

Policymakers are going some way to encourage the development of private credit in Europe, with recognition that non-bank lending plays a valuable role connecting capital markets with the real economy – many have already pointed to the crucial role that private credit could play in the rebuilding of economies, particularly having demonstrated its adaptability during 2020. From a financial stability standpoint, policymakers are acutely aware that provision of credit by banks to corporate borrowers is risk capital from customer deposits. Given this, is it any surprise that policymakers have been open to removing existing barriers to investment and enabling greater investor access to long-term assets?

The UK Government recently called on pension schemes and other asset owners to support the economic recovery by investing a greater proportion of their funds into UK long-term assets like infrastructure projects, and other long-term growth prospects like tech start-ups – typically backed by venture capital and increasingly being snapped up by PE buyout firms. This is just one instance of policymakers looking to push long-dated liabilities into long-dated assets with the promise of long-dated income streams in return – it is clear that debt-laden governments recognise a potential alignment of long term, non-bank private capital in financing the long-term changes needed to move to a greener and more sustainable economy.

An important investment trend is the democratisation of private assets, given the appetite from a wider set of investors for access to private market opportunities. To support this, there is a clear need for innovation in funding and regulatory models. The UK Government is supporting the creation of the Long Term Asset Fund (LTAF) that would allow retail investors to diversify beyond traditional listed asset classes like equities and bonds. This is similar to the goal of the European long-term investment fund (Eltif) that launched in 2015, albeit a closed-ended structure and largely restricted to European investments. The idea is that by adjusting fund structures, and making them more flexible, to allow the holding of long-term private assets, the defined contribution (DC) savers of the future can participate in the rebuilding and reshaping of economies.

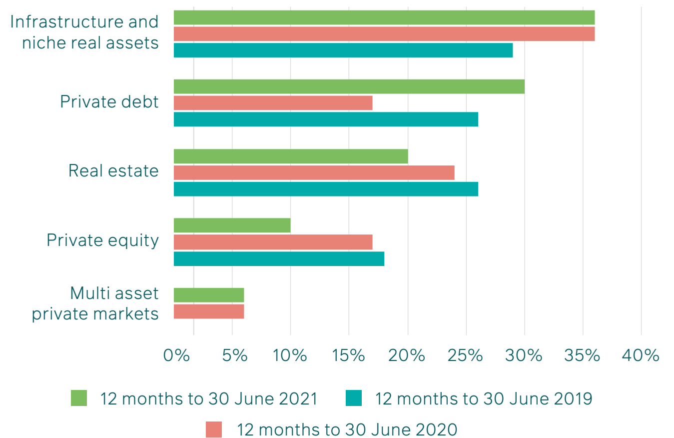
There are many things that the regulators and various governments would also like to do because there is an understanding that because an asset is private, because it is illiquid, that doesn't necessarily mean that it is not suitable for pension schemes. In other words, pensions function as long-term retirement savings vehicles which means they have a natural alignment with long-term investment assets. Assets such as long-term infrastructure, are therefore potentially highly suitable for an individual's private pension scheme – if they are not going to be able to touch that for the next 20 or 30 years, then having something with a very long-timescale works quite well.

Meeting the demands of investors

According to Preqin's Global Private Debt Report 2021, nearly half of investors surveyed expect to commit more capital to the asset class in the next 12 months, while a further 40% are looking to maintain allocations. Only 14% of investors surveyed planned to reduce their allocation to private debt in the next 12 months. Private debt now constitutes 30% of all new private markets search activity in the trailing 12 months to 30 June 2021 – the highest it's been in three years, as stated by investment consultancy, bfinance in its 'Manager Intelligence and Market Trends, August 2021' paper. The consultancy adds that the "...search figures actually understate the importance of private debt activity since we've also seen a pick-up in real estate and infrastructure debt searches that are captured in these specific categories."

Looking ahead to the next five to ten years, we think managers that have an incumbency advantage in private credit today could be well-placed to deliver desired outcomes from the asset class as investors' needs and objectives evolve. Relatedly, having deep networks across all areas of private credit can help to facilitate access to compelling opportunities alongside strong origination capacity and reach. An ability to embrace innovation together with a first-mover mindset to not only come up with new ideas, but also make them viable with an ability to scale, will be crucially important in expanding opportunity sets, in our view.

Private markets manager searches – year-on-year (%)



Source: bfinance 'Manager Intelligence and Market Trends, August 2021'. Notes: 'Private debt' excludes real estate and infrastructure debt; includes trade finance and leasing strategies. These figures only represent projects initiated during the specified period and do not include pre-existing client engagements that continued during the year. Information is subject to change and is not a guarantee of future results.

We think the trend towards greater capital concentration in the private credit industry will only gather pace as investors seek to simplify their roster of external managers in favour of longer, strategic partnerships over time. Having a wide breadth of capabilities can help to meet the demand of investors looking for a smaller number of managers or multi-strategy debt solutions, while managers that are able to offer the full rostrum of private debt and have capabilities in both private and public markets could stand to potentially benefit from this trend.

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