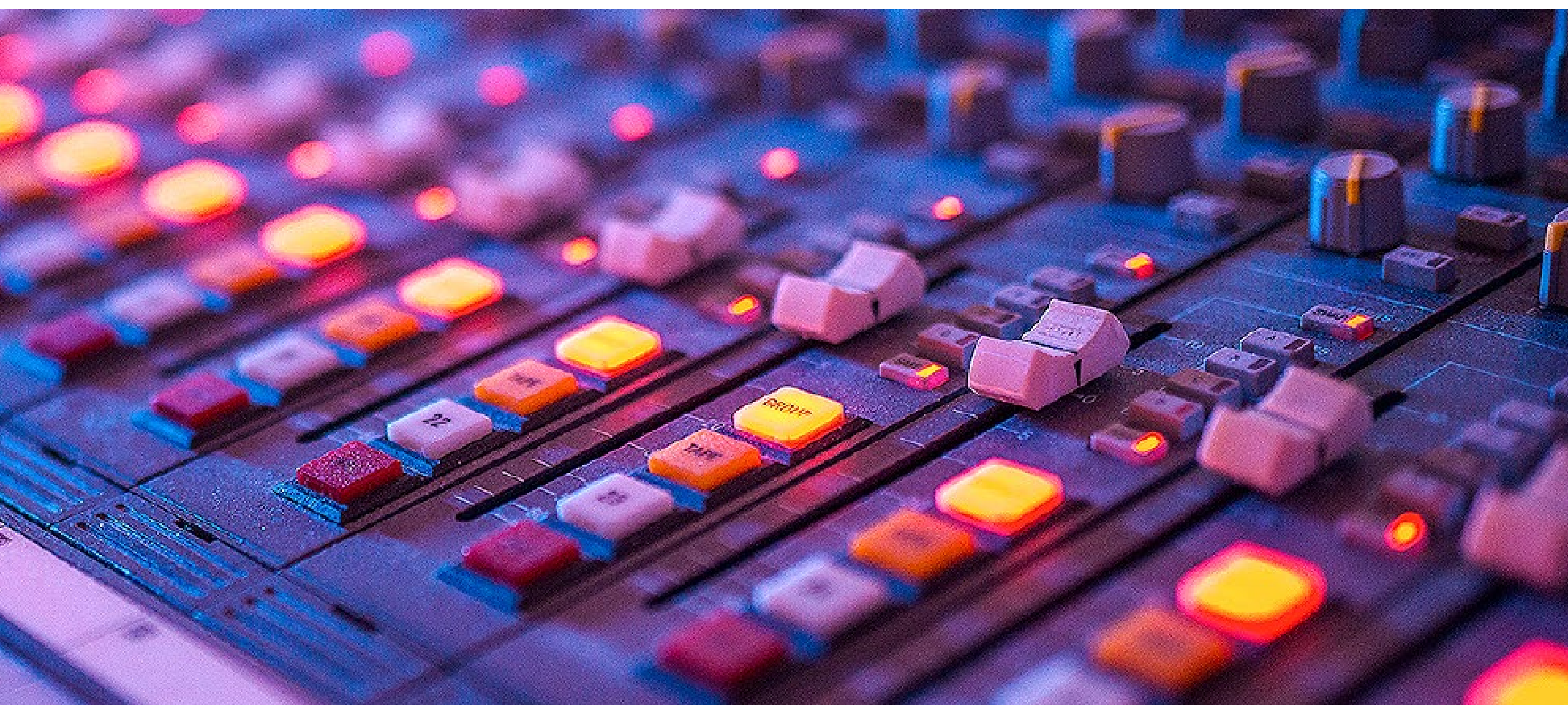
Private credit: A diverse and versatile toolkit for investor

M&G Investments



For over a decade, both corporate and consumer borrowers benefited from low-interest rates and a very low cost of capital – but this is changing as global economies continue to adjust to central bank interest rate hikes and an uncertain geopolitical backdrop. Private credit proved its resilience and adaptability through the current cyclical downturn, and demand for the asset class continues. Given the current macroeconomic backdrop, private credit may be well-placed to help investors steer through the myriad challenges ahead.

Some three years on from the onset of the COVID-19 pandemic, market participants have found themselves contending with higher interest rates than they've seen in over a decade and a challenged economic environment. Although inflation has eased since its recent double digit peaks, the risk of elevated inflation in Europe remains for this year. Indeed, despite troubles in the banking sector, in March the European Central Bank announced it would hike its main interest rate above the 3% mark for the first time since 2008[1], signalling that inflation remains a high priority on its agenda.

Private credit can act as a tactical tool to gain exposure to different assets but also allocation can be specifically tailored for a changing macro backdrop

Many corporate and consumer borrowers entered this inflationary period in fairly decent shape at a fundamental level, although we remain mindful that with a return to more normal base rates away from zero levels, the higher interest obligations could trigger a wave of defaults in weaker companies. Indeed, these shifting macroeconomic and market conditions highlight the importance of remaining forward looking, continually reassessing the evolving nature of risk factors, and most importantly taking a prudent approach to credit selection.

As markets continue to adapt to this new complex phase, the demand for duration and real income hedges through floating rate instruments like private credit has increased. This in combination with the current dislocation provides significant opportunities for private lenders to capitalise on this demand, providing a credible solution as deal pipelines build and investment opportunities proliferate across the spectrum.

Slicing the private credit pie

Source: M&G, as as April 2023.

A differentiated and diverse toolkit

Although historically seen as a niche asset class, the global search for yield has seen investors consistently increasing their allocations to private credit and alternatives. According to data from Preqin, assets under management in private debt grew from just under $500 billion in 2013 to $1.2 trillion by 2021 and are expected to double once more to $2.3 trillion by 2027[2]. The complexity return premium is not the only driver of this, increasingly investors are also allocating on the basis of diversification and yield stability. We believe private credit is a versatile toolset for investors in various environments, whether challenging or a bull run, offering exposure to differentiated groups of income-bearing assets which can help investors in their quest to achieve their efficient frontier portfolio.

There are many ways to slice the private credit pie given the diversity of the underlying asset classes. One such method is liquidity, where there are broadly two distinct buckets: Liquid private debt (including Senior loans and ABS) and Illiquid private debt (such as Direct lending and Infrastructure debt).

Liquid private debt can offer downside protection afforded by security against assets and seniority in the capital structure. In the Illiquid corporate private debt space although there is lower liquidity, investors don't necessarily need to reach to the most junior end of spectrum for the best opportunities. The senior end still offers an attractive illiquidity premium whilst benefitting from the presence of maintenance covenants.

The broad spectrum of private credit, ranging from private corporate lending to consumer finance, real assets lending and structured credit have very different underlying risks and performance drivers. This provides opportunities for investors seeking a secure income stream at different stages of the cycle. With careful sourcing and structuring of debt instruments, investors do not have to take on undue risk to get well rewarded and improve their overall risk-adjusted return potential. Having the right private credit expertise is crucial in balancing quick deployment in liquid assets such as loans and ABS which are daily tradeable, with long term allocations to more illiquid assets such as direct lending or infrastructure debt, which require deep sourcing channels and relationships.

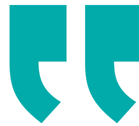
Robust and adaptable

Global growth forecasts generally converge around a deceleration of growth in 2023, in fact the IMF expects a 3% growth rate over the next five years, the weakest pace in over three decades[3]. It is clear credit markets are experiencing one of their most challenging periods since the GFC, and there is scope for more volatility ahead. Nevertheless, the resilience and adaptability of the asset class through the various crises of the past three years – notably COVID, the Russia/Ukraine war, and the run on the banks – have helped cement private credit as a core allocation in the minds of strategic asset allocators. The universe proved its value to investors in balancing out the more volatile mark-to-market driven public assets classes which experienced some double-digit drawdowns.

A factor of this volatility dampening is the prevalence of cashflow-generative assets delivering income-driven returns rather than returns predicated on market gain ergo price volatility. Return generation from private credit is not contingent on short-term macroeconomic dynamics. Another factor contributing to the lower volatility than its public market counterparts is that most private credit assets are typically held until maturity and benefit from sticky capital and a largely institutional investor base, reducing the spectre of forced liquidations.

Although companies are entering a more complicated refinancing environment, credit fundamentals remain generally resilient. Corporate borrowers and issuers with floating-rate debt may be vulnerable to a jump in borrowing costs given the higher base rate environment. However, this is a sophisticated universe and many of these companies have proactively put in place hedging mechanisms and successfully refinanced shorter term liabilities, so are prepared for the near-term higher funding costs.

That being said, credit ratings agencies have warned that persistent or intensified cost pressures and supply chain issues could challenge the cashflows of those with weak pricing-power, particularly if demand softens. Investors should therefore continue to take a forward assessment of corporate balance sheets and business plans, including sensitivity analysis as tail risks have fattened.



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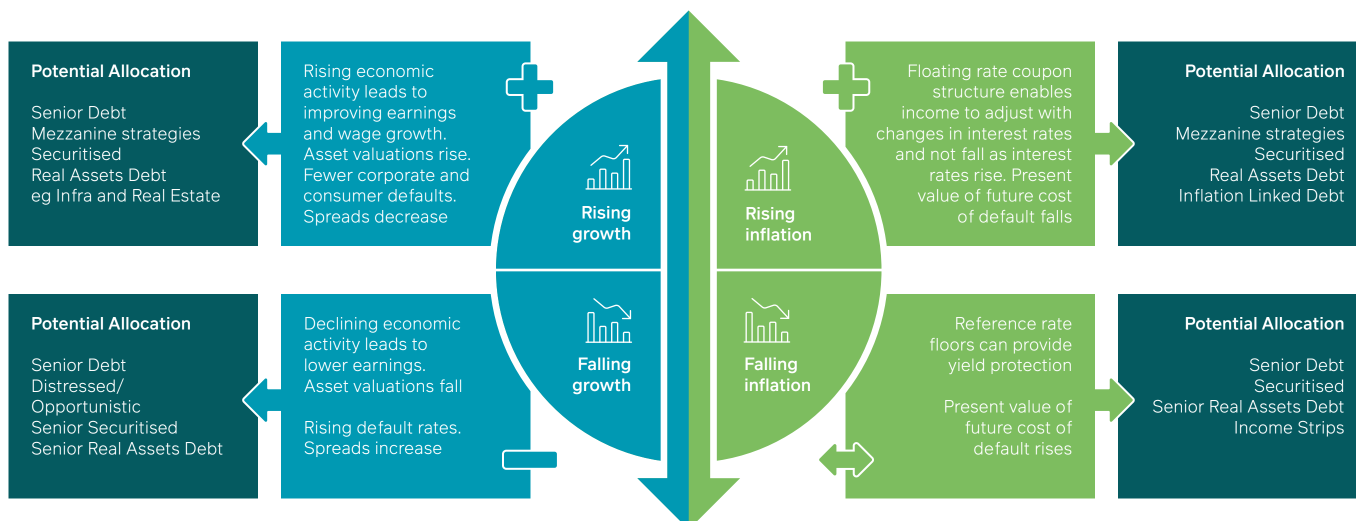
As well as exercising the necessary underwriting rigour and strong risk discipline when investing across private credit in all market environments, private lenders need to ensure downside protections are in place in the event an investment does not perform as expected. There are certain structural features that are common to most private corporate debt facilities, including security, seniority in the capital structure, contractual margin, as well as close interaction between borrower and lender. Furthermore, many contracts come with financial covenants which help to mitigate downside risks by limiting the borrower's ability to take on excessive risk and in turn minimise value leakage in the event of default.

In addition, private lenders (and sponsors) have proved supportive through periods of disruption, helping fundamentally-solid corporate borrowers ride out short-term issues – to ensure the credit remains a going-concern and to protect the value of the debt (and equity) through the life of the investment. That sponsors now have significant skin in the game promotes better alignment with lenders' interests than what historically had occurred prior to the GFC.

Ultimately, careful credit selection is crucial to sustainable value creation when lending to companies which, in the private lending space, tend to be sub-investment grade.

Asset allocation can be specifically tailored for macro backdrop for "an all-weather portfolio"



Multiple access points

Private and alternative credit markets are not a single marketplace but rather a series of different asset classes with different types of risks and different access points. These range from relatively small to large – including leveraged loans which are on a par in size with the developed high yield market – and indeed value between them can wax and wane over time. The companies which encompass this universe are similarly diverse, ranging from mega-cap household names to more esoteric offerings.

This means private credit can act as a tactical tool to gain exposure to different assets but also allocation can be specifically tailored for a changing macro backdrop in an "all-weather portfolio" in areas such as Senior debt, Mezzanine, Inflation-linked debt, Securitised debt and Real assets lending. These are asset classes that could be better positioned to weather volatile and inflationary periods given their historic close positive correlation to inflation. In contrast to traditional fixed income, private credit assets typically carry limited duration risk. During a period of higher inflation, private credit's floating rate coupon structure enables income to adjust with changes in interest rates and not fall in real terms as rates climb.

It is worth noting that like most asset classes, a combination of high economic growth and low inflation is fundamentally more favourable. In the growth stage of the cycle where economic activity leads to improving earnings and wage growth – and therefore fewer corporate and consumer defaults, ceteris paribus – asset valuations should rise. Overall, we believe private credit can be blended in a simple structure with no need for complex derivatives to offer a secure income for investors through the different stages of an economic cycle.

Flexibility is key

Although inflationary and recessionary concerns may continue to drive investor sentiment, the ultimate path to recovery is uncertain. In our opinion, the dislocation and dispersion across credit markets does provide an attractive entry point for investors looking for experienced deployers of flexible, patient, and long-term private capital. However, balancing this with the flexibility to go where the best relative value lies within private credit and adjust exposures can be hugely helpful during times of higher uncertainty. We believe being as selective and diverse as possible can help to build these robust "all weather" portfolios with the ultimate goal of stable secure income. □

[1] European Central Bank, "Key ECB interest rates", (ecb.europa.eu), 16 March 2023.
[2] Preqin, "Global report 2023: Private debt", (preqin.com), January 2023.
[3] IMF, "The path to growth", April 2023.

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