The Investment Podcast

Episode 32: The Investment Podcast: The state of play in European private credit
26 September 2023

[music]

Speaker 1: *The Investment Podcast*, brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

Aramide Ogunlana: Hello and welcome to Episode 32 of *The Investment Podcast*. My name is Aramide Ogunlana, I'm a senior investment specialist within the private credit group at M&G. I'm delighted to be joined here today by Fiona Hagdrup, head of Leverage Finance Investments who has over 30 years of experience in the markets and over 20 years at the firm. Hi, Fiona.

Fiona Hagdrup: Hi, Aramide.

Aramide: I'm also joined today by Michael George, a senior fund manager within the private credit group at the firm with over 20 years of investing experience and over 15 years of those at M&G. Hello.

Michael George: Hello there.

Aramide: And finally, Robert Scheer, a senior direct lending originator with almost two decades of experience in deal structuring and origination. Welcome, Robert.

Robert Scheer: Hello, Aramide.

Aramide: A lot has changed in private markets in recent years. The exponential growth of private credits in the last decade from essentially a cottage industry to 1.5 trillion market, and forecast to grow by another trillion by 2027. Fiona, in your 20 years at the firm, you've been at the forefront of this growth and rise of private credit as an asset class. Can you define exactly what this means?

Fiona: Private credit, very simply put, is a corporate subset of private debt. It doesn't include real estate debt or consumer financing, that would be caught in a wider private debt collective. Private credit is corporate lending. There can be twists and refinements. What of loans to companies with infra-like characteristics or what of asset-based lending to ring-fenced corporate assets. Simply speaking, we draw a ring around corporates when we talk private credit. Those corporates are typically owned by private equity sponsors or by their original founders or both, i.e. they are unlisted.

Now, for US investment managers, the private part of private credit often refers to the way in which corporate loans are sourced and bought, i.e. that happens directly and without any bank underwriting or involvement. This means typically that the US definition of private credit excludes leveraged loans or broadly syndicated loans, BSLs, because, in the US, BSLs are arranged and sold like high-yield bonds. They're daily traded, they're regulated, and their syndication processes and information provision are public style.

Aramide: How does this change for Europe?

Fiona: Yes, Europe is different. To exclude BSLs from private credit is overly to segregate your corporate lending options, and to cut your opportunity set in half, and to cut out the biggest and most established private companies. It thwarts gaining access to the whole range of opportunities. We think that the private, in private credit, should rather refer to the unlisted status of the investee companies and the status of the lender because all lending can be private in Europe.

Some US managers talk about private credit as some kind of privatisation of the BSL and bond market processes. They celebrate diverting companies from the visible traded world. In Europe, we think more symbiotically and we think about what investors might want from private credit, whether they're strategically or tactically allocated, whether they're held to maturity or looking for liquidity. That informs the fund type and the approach.

This is not some kind of regulatory arbitrage or a way to create false pictures of low correlation. When default risk is elevated, fundamental credit risk is heightened throughout the corporate world whether you're marking to a liquid secondary market or not. Fundamentally, in corporate lending, performance depends on the company paying you back. It's as simple as that. Your chances of that are improved hugely through a cycle, particularly by maximising selectivity and information flow.

In Europe, we resist being so rigid in defining private credit. Even BSLs are private assets here. There's access to much more information than would be available in a public bond process, upfront and through the life of the loan. The private refers, we think, to the company's unlisted status and the level of extra information that being a private lender can have, whether a company is big or small.

When you think about private credit in that holistic way, then the universe is sizable, over €800 billion in Europe alone. The point is that corporate lending doesn't warrant excessive segmentation because high selectivity and diversification paradoxically, should define any loan portfolio for best performance through a cycle.

Aramide: That's interesting, that point you mention about being holistic and the blurring of lines within private credit. Robert, what do you think this means for investors and companies?

Robert: For companies, I think it means that they don't necessarily have to decide anymore between private credit or going for a bank. We don't see private credit precluding banks, but we don't see private credit relying on banks either. If you look at the more recent market turmoil that we have experienced when banks were either unable or prohibitively expensive in underwriting transactions, private credit stepped in by taking down transactions entirely or alongside other private credit houses.

Also in normal times, I think there is definitely room for working alongside. You can think about, for instance, pre-replacing a tranche of large-size transactions with a private credit house in order to reduce market risk or you can think about mid-market deals where we often now see club deals which have historically been done by banks alone, being done in consortiums of banks and institutional investors together. We don't necessarily see a fight between banks and private credit. We do see corporation possibilities. I think for companies, that means that they will just have more optionality going forward.

Aramide: Michael, did you have a view on that?

Michael: Well, Aramide, for investors all the things that define mid-cap lending, the diversification, the income generation, the higher yield are today just as true for large-cap lending. The yield gap between large and small company loans have narrowed since the general sell-off in 2022. Directly originated loans have their advantages, of course, certainty of execution being one thing, tighter documentation, and on average lower leverage as another.

The trade-off between broadly syndicated loans and narrowly syndicated loans, NSL or direct lending, is that the documentation versus liquidity, the broader syndication, the looser covenants, but the greater the secondary markets, meaning a chance to change a portfolio's tilt through a cycle. We think that a well-diversified corporate portfolio has a place for both large and mid-cap companies broadly and narrowly syndicated, liquid and illiquid intermediated by banks or directly sourced.

Aramide: When people refer to direct lending, they often mean the mid-cap space. Robert, in Europe, this hasn't really been through a proper default cycle yet. What's the outlook from here?

Robert: Yes, you're right. I think these days people finally realise that mid-market lending is not risk-free although certain people might have thought otherwise over the past couple of years. I think it's more of a return to normality, right. Yes, there is an increase of stress in the mid-market, but nothing which hasn't been experienced before. There are no public figures, to be honest. It's a pretty private market, of course. The market is less transparent than the upper end of the market.

You also have to consider that not all market participants are happily talking about the stress they are experiencing in their portfolios. From bilateral conversations, from reports about lenders taking the keys of companies, and last but not least, by speaking to lawyers and restructuring firms which are all flat-out busy, you can obviously infer that there is an increased level of stress in the market.

Interestingly, it's not only in those sectors that have been the centre of attention over the past year, I'm thinking about consumer-related businesses, but we're seeing stress more broadly across sectors and also across sectors that have been, in the past, very popular choices.

Aramide: Why do you think there's broad-based stress across these sectors, even the favoured industries that people typically focus on?

Robert: I think there are multiple reasons, but think about companies that have undergone a very aggressive M&A strategy in the past, and that, paired with loose documentation can lead to fairly high debt piles. Then look at the base rates, how they have developed coming from basically zero and to the 3% to 4% area, that's obviously a big drain on cash flow. If the latter doesn't live up to expectations because synergies are not materialising to the extent they were planned or because you have inflationary pressure on your cost base, that obviously creates problems. Coming back to your initial question, there is definitely stress in the system and we do think it will become slightly worse before getting better against the macro backdrop that we have at the moment. By the way, that's also the view that is shared by the large rating agencies.

Aramide: That seems like a pretty broad-base bleak picture. Is it really that black and white?

Robert: Well, maybe I'm wearing my credit hat here. I think it's not the easiest of times. I think we all have to admit that, but I think by no means I'm suggesting or we are suggesting that private credit is not an attractive asset class. I think it just tells you two things. Firstly, manager selection is key. You need to have a manager who has long-term experience. You need to have a manager who has encountered higher default cycles in the past, and a manager that has embarked on conservative underwriting standards and, importantly also, the ability to perform proper credit analysis. Not just buying the market, but credit by credit performing proper analysis.

To be fair, there's obviously a couple of players out there who have grown very quickly, and maybe where the analyst's capabilities have not caught up with the growth they have experienced.

Last, but not least, it favours those houses that do have in-house restructuring capabilities. You have a dedicated set of people who are experienced with issues like that, an independent view. Last, but not least, it also allows the origination teams to remain focused on what they actually have been hired for, i.e. sourcing opportunities for the investors.

The second point I want to make, and that touches on what Fiona has already alluded on before, I think there are different strategies within private credit. There are riskier strategies, there are less risky strategies. Take the uni-tranche for example. It's a blend of a senior and a second lien, at the end of the day. You sometimes have a first-out piece ranking ahead of you, whereas pure senior lending doesn't have that, and by nature should then have a lower default rate and a higher recovery.

I'm not suggesting that you should refrain from one or the other, or that one is better than the other, but it just shows you that not all strategies should be thrown in the same basket.

Fiona: It's true. But I observe, though, the vast majority of the companies across the spectrum are performing rising rates notwithstanding, floating rate loans notwithstanding, they can service their debt and they have their refinancing in hand. Again, we have to differentiate between the US and Europe because the inherent liquidity of companies on average is simply higher, several turns of interest coverage ratio higher for European companies.

Aramide: It seems that the chopping and changing in interest rates this year has brought a lot of uncertainty, which has put a blocker on M&A. Michael, does that mean we're in for a period of lean issuance?

Michael: Well, it's of course no surprise that M&A is the real engine of activity and without that, then activity reduces for all. That's not unique to the private credit market, of course, that's all parts of that too including private equity. Over the last 18 months, we've seen activity slow more in the broadly syndicated loan market with some of that slack being picked up by the private credit direct lending market overall.

In totality, issuance has been sluggish, but what we are seeing is green shoots coming through for the remainder of the year, evidenced by our conversations with private equity sponsors, advisors, and underwriting banks.

Aramide: What does that mean for sourcing investments? Does that make it difficult from here on?

Michael: In terms of finding investments, whilst this episode is different in characteristics to what we've seen historically, the challenges it brings to the lending market are not. The core thesis of asymmetric investing is one of basic credit fundamentals. Now is certainly not the time to be chasing transactions, relaxing credits or documentational standards. This can only be achieved by having a well-resourced and experienced team that have worked through many cycles, ones that have deep relationships to ensure investors' capital is used for the right opportunities.

Having strong origination capabilities will differentiate those that can be selective versus those under pressure to deploy capital or less attractive opportunities. Ultimately, there will be a distinction between those that have historically just focused on sourcing rather than on robust selection. You can no longer have just one of these capabilities, especially now when lending into this kind of environment. Activity will, of course, ebb and flow over time. What is clear is that both markets are forecast to grow from here. Having capital, flexible capital to deploy in both markets will be beneficial.

Aramide: That's a great point you make about activity ebbing and flowing. I think often private credit is seen as a strategic allocation. Are there tactical opportunities as well given this ebb and flow?

Michael: Absolutely. The events of the last year have resulted in a repricing of risk assets and private credit markets are currently offering unusually higher potential returns combined with defensive characteristics of low duration and security. Wider market volatility and ongoing higher levels of uncertainty on issues such as terminal rates, inflation, geopolitics and economic growth forecasts over the past year have highlighted the defensive characteristics of floating rate private credit, whilst also providing a compelling investment opportunity given the widening in spreads.

Unlike fixed-rate asset classes which were double hits on duration and credits, the price we've seen in the more liquid parts of the private credit spectrum were driven by credit spread widening only. The senior secured nature defensive sector positioning, shorter life, and floating rate characteristics of much of this asset class has helped insulate against the duration drag of the year.

Private credit also enables investors to diversify further accessing companies and opportunities not present in public markets. This is an addition to, not a neither/nor decision to lend to good quality companies on favourable terms. In addition, the asset class exhibits less volatility than wider public markets acting as a ballast for investor portfolios. In more volatile times, increasingly issuers will take to private markets to provide capital solutions.

Companies and issuers will want surety of financing, which at times public markets cannot provide. That is valuable, value for both the borrowers and crucially for the lenders, which should be able to extract better terms and would've been available under wider, more syndicated public markets. It's for all of these reasons that we've seen such investor interest, both from institutional and wholesale investor basis, and indeed why we're seeing the democratisation of private credit unfold currently.

Fiona: Europe definitely has room to democratise, doesn't it, Michael? It has no business development companies for one thing, for example, which is a common means for US wholesale investors to gain exposure to private credit. It's dominated by locked-in, long-dated partnership structures. Now, I think the regulators get that, they're facilitating finding another way, which is why we've also seen the creation of long-term investment funds like ELTIFs and LTAFs if you read up on your acronyms.

I think they understand that investors need to be able to change their allocations to restore numerator/denominator balance and have some access to liquidity at times. All of this is possible in private credit.

Aramide: Well, we've certainly discussed a lot today on the podcast regarding the state of play in private credit markets. Fiona, thank you so much for your time.

Fiona: Thank you.

Aramide: Michael, likewise. Thank you for those insights.

Michael: Pleasure to be here.

Aramide: Thank you, Robert, as well for joining us today.

Robert: It was my pleasure. Thank you.

[music]

Aramide: I'm afraid that's all we have time for today. To our listeners, we hope our conversation sheds some interesting light on the state of play in the private credit markets. If you have any questions or comments, please do reach out to us. Don't forget to subscribe to our podcast for more insights on the latest trends in the world of investments. Thank you for listening. We'll see you next time.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

[music]

[00:19:41] [END OF AUDIO]