April 2020

European private debt: shifting dynamics

For Investment Professionals only

Past performance is not a guide to future performance.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

Introduction

Private debt continues to attract strong demand from global investors including large pension schemes, insurance companies and other institutional investors, who have essentially gone looking for what they cannot find in public markets to meet their evolving needs and address the challenges they are facing. This being the case whether they are investing for differentiated growth and income opportunities, better downside protection or a boost to returns in times of market volatility (diversification of returns) and against a backdrop of perennially low (and even negative) rates.

As private markets in Europe continue to add flexibility, depth and sophistication, investors that are already allocating to private debt have unsurprisingly built larger and more complex portfolios over time as they have become more confident about the long-term viability of the asset class. According to data provider, Preqin, 91% of surveyed investors have indicated they intend to either maintain or increase their allocation to private debt in the long term. Those investors that have not yet allocated capital to private debt recognise how the asset class can help them meet their long-term objectives, with many showing a greater understanding and appreciation for the range of opportunities within the asset class.

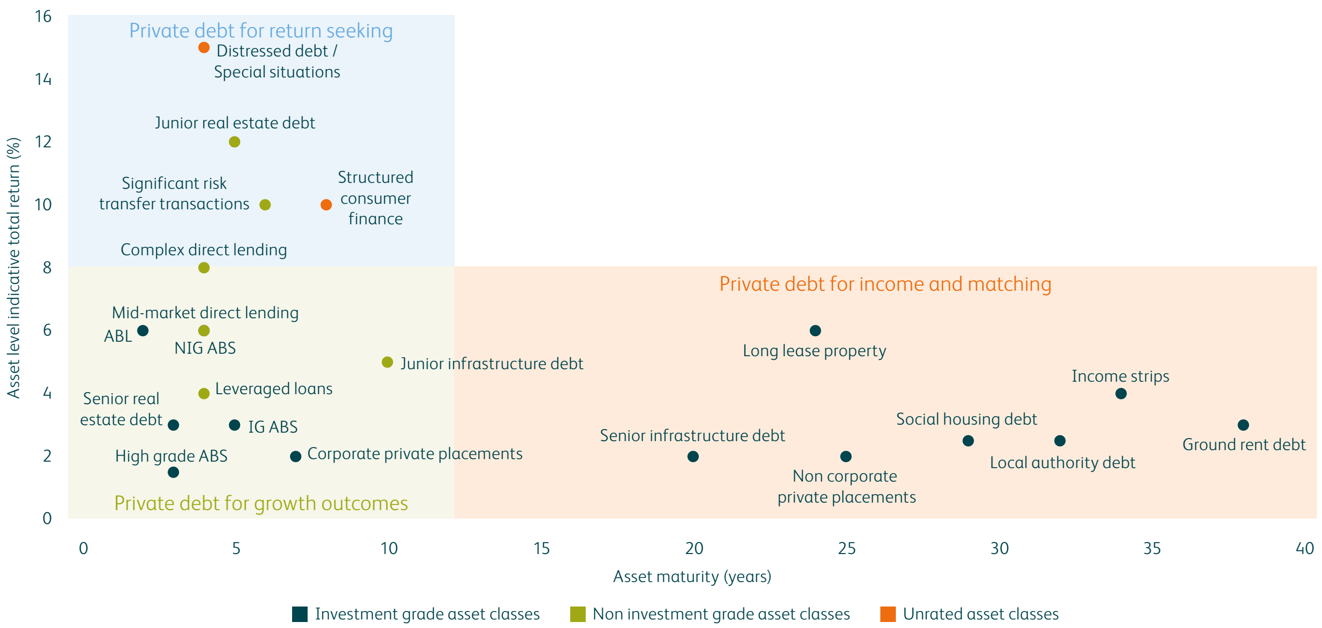
Focus on outcomes not definitions

The breadth of the private debt investment universe means that it can play a role in different parts of an investor's portfolio. For many investors, private debt is primarily an alternative to investing in fixed income.

Other investors come to the asset class with expectations of different return profiles that are more typically associated with private equity, real estate or other alternative investment strategies. The full spectrum of private debt can provide access to assets that range between everything from long term, such as 20-year financing of an offshore wind farm, or shorter investment horizons, such as leasing or supply chain finance. They can range from investment-grade-equivalent risk to higher-returning sub-investment grade opportunities, as well as being subordinated, unsecured or senior and fully secured. They can finance single assets, entire companies or even portfolios of assets.

Investors may therefore be better off looking at private debt holistically and focusing on how and where to allocate their capital to obtain the investment outcomes they need, rather than focusing too narrowly on definitions. The reason for this is: 1) value shifts over time and 2) returns decrease as asset classes become mature enough to have a separate allocation.

Figure 1. Classifying private debt assets according to outcome



Source: M&G illustrative, as at February 2020.

European private debt markets – 2019 issuance
Fortunately for investors, deal activity has remained fairly robust and there continues to be a number of interesting and unique investment opportunities coming through. We have come to expect a reasonable degree of ebb and flow in market deal flow when sourcing value opportunities from across the full breadth of the private credit spectrum for our clients, although we expect a fairly steady supply of new deals on the whole. In 2019, we estimate that the amount of private or illiquid debt issued in Europe's private markets was approximately €465 billion. This is based on our own calculations using data on annual issuance and deals where this is available from third-party sources, as well as figures derived from broker estimates (and may understate the market).

Spotlight on corporate direct lending

First, we look at the dynamics in the direct lending markets, given the ongoing popularity of the investment strategy with many institutional investors since the crisis – dry powder levels and assets under management (AUM) for direct lending in Europe far eclipse what has been raised for any other 'private debt' strategy (this excludes leveraged loans).

Deal flow and activity: general observations

The level of mergers and acquisitions (M&A) remains an important driver of deal activity in the corporate direct lending and the large-cap leveraged lending markets, respectively. Despite somewhat subdued M&A activity in Europe during 2019, it was still one of the more active post-crisis years for deal-making.

Highlights from the private credit desk: 2019 in review

We take a closer look at what was happening across Europe's private debt markets in the 12 months to end of 2019, and highlight some of the key observations or themes influencing deal activity in different parts of the market. Here we have focused on the main private or illiquid debt assets and markets that comprise our investment universe.

It is worth remembering that private debt is made up of multiple discrete markets, each with their own nuances and supply-demand dynamics, so we would caution against inferring anything about one part of the market based on the observations of another.

Mid-market direct lending

What has the supply of deals looked like? Direct lending markets got off to a relatively slower start in 2019, but deal activity soon picked up again. The Deloitte Alternative Lender Tracker Autumn 2019 shows that the number of direct lending deals in Europe declined by 4% on an LTM basis to June 2019, while capital deployment (H1-19: €22.6 billion) remained in lockstep with fundraising.

Key observations

Traditional cashflow lending remains crowded: The dynamics in the UK market meant that the deals that did come through during the first half of the year saw fierce competition, particularly for the best credits, which squeezed pricing tighter and drove down spreads. Direct lending remains in high demand, with global dry powder levels still above US$100 billion (at $52 billion for Europe) at the start of March 2020, according to Preqin.

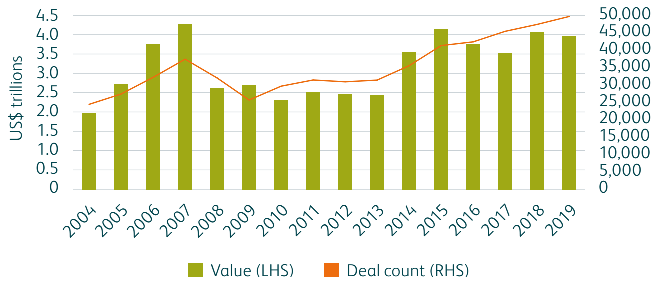
Pushback on deal terms: Covenants remain an important protection in first-lien loans, but so-called 'covenant-loose' loans are gaining ground in some parts of the middle market – symptomatic of a competitive, borrower-friendly environment and as sponsors use precedents from the large-cap market on smaller credits. Encouragingly, this is only being seen in better quality deals and lenders are pushing back on attempts to reduce or relax covenant packages.

Growing diversity of deal structures: We are finding opportunities to originate short dated (typically 2-4 years) asset-based loans, including invoice financing and trade receivables. These are more complex credits requiring bespoke structures and real-time monitoring of the underlying collateral, but offer the lender greater control and downside protection given the security and high quality collateral backing the loan.

Private equity outlook: sponsor-backed deals

The volume of global M&A in 2019 broadly kept pace with the levels seen in the previous five years, at $3.8 trillion versus $3.9 trillion in 2018, but there were some clear differences between regions. Activity in the US was up six per cent from a year ago, while Europe was down some 25%.

Figure 2. Global M&A annual volumes and number of transactions



Source: Bloomberg, as at 31 December 2019.

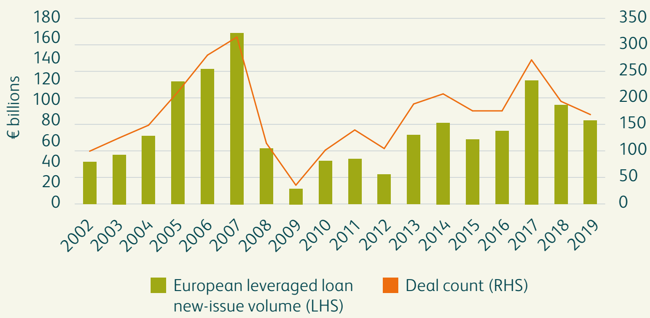
At the start of 2020, private equity sponsors had access to $2.5 trillion of dry powder, but the year got off to a challenging start with January said to be the quietest month for takeovers since April 2013, according to an FT report citing Refinitiv data. This was before fears about the Covid-19 coronavirus pandemic started to dominate the headlines and drive volatility in markets – the overall value of deals in Q1-20 reportedly fell 28% versus a year ago, led by the US with European volumes conversely 51% higher in the period.[1] Unsurprisingly deal-making becomes more challenging in such an environment as volatility and uncertainty affects valuations across myriad of industries.

[1] Source: Financial Times "Dealmaking grinds to a halt on coronavirus impact", 31 March 2020.

Leveraged loans

What has the supply of deals looked like? New loan issuance totalled €81 billion (in gross terms) split roughly evenly across the four quarters, and down 15% from 2018 levels, thanks to somewhat subdued M&A in Europe. Although more than half of new loan supply arose from sponsor-backed M&A activities (2018: 70%) mainly LBOs, with take-private deals also proving popular. Refinancings accounted for a third of total issuance compared to 20% in 2018.

Figure 3. Annual European leveraged loan new issue volume



Source: S&P LCD, as at 31 December 2019.

Key observations

Loan spreads remained in medium-term range: New-issue loan spreads fell slightly in 2019, but remained in their post-crisis range of +350-450bps – remarkable resilience in the context of public credit, indicating a yield to maturity, in euro terms, of c.4%. While acknowledging the recent widening in spreads, we expect new-issue loan pricing to remain in this range over the medium term.

Supply met with solid demand: New CLO issuance was up to €29.8 billion in 2019 from €27.3 billion in 2018 creating a new post-crisis record while inflows from institutional investors, both in Europe and Asia, continued steadily.

Loan fundamentals supportive: Leverage levels were broadly similar to 2018 (first lien: 4.8x), though EBITDA adjustments (add-back flexibility) can flatter the picture, meaning that investor vigilance remains crucial. Valuation multiples and interest coverage ratios are at all-time highs, and sponsors are maintaining sizeable (40-50%) equity levels. Higher equity cheques have been a consistent feature of European buyouts since the financial crisis and offer important downside protection.

We would define the 'mid-market' as typically floating-rate loans to private businesses with EBITDA ranging from £10 million to £35 million (also can be higher or lower). Our focus is on senior lending with leverage multiples (EV/EBITDA) of up to 5x reserved only for the most exceptional businesses – on average, the mid-market direct lending deals we do are below this. We also require a sizeable equity contribution of around 50% in the borrower's capital structure. Otherwise, we require strong asset backing for asset-based lending (ABL) structures within the direct lending sphere, where leverage levels may be higher but lenders are protected by borrowing base rests and the value of assets.

Direct lending covers a broad spectrum of activity and encompasses a wide range of target returns and risk appetites through senior secured and subordinated debt, and unitranche loan structures (senior-only deals, with pricing Libor/Euribor +650bps or above, as classified by Deloitte[2]). In the 12 months to the end of H1 2019, unitranche structures represented 59% of UK transactions and 49% of European transactions, while senior debt tranches made up 28% of transactions in the UK and 30% of transactions in the rest of Europe.

[2] Deloitte Alternative Lender Tracker Autumn 2019.

With more capital to deploy than ever before, thanks to years of successful fundraising, direct lenders have continued to scale up the size spectrum beyond their traditional mid-market focus in search of opportunities.

Talking points: Scaling up – Direct lenders show up in the syndicated loan market

Direct lenders have continued to target bigger business that would traditionally have turned to a syndicate of banks for underwriting. Increasingly, that has meant buying second lien tranches of LBOs where the senior debt has been broadly syndicated, or targeting transactions involving businesses in tricky cyclical sectors – capitalising on the lukewarm reception from public markets after several large deals proved difficult in 2019.

While the instances of direct lenders showing up in these sorts of transactions, and encroaching on traditional lender-held territory, still remains few and far between, there has been a gradual increase in deals requiring much larger debt facilities more generally, with some funds with considerable amounts of capital to deploy seen to be writing much bigger cheques for individual transactions – over the £1 billion mark.

Real estate debt

What has the supply of deals looked like? There continued to be a strong level of deal flow in the market, as borrowers looked to refinance around €150-200 billion of debt secured against European commercial real estate, according to CBRE's estimates.

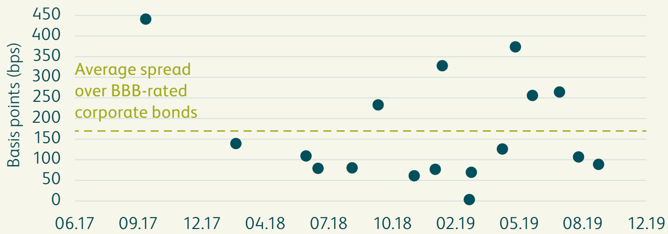
Key observations

Demand picture remained strong: Prior to Covid-19, it was anticipated that investor demand for (commercial) real estate debt would remain strong as many investors are attracted by the ability of the asset class to provide them with a diversified, steady income stream derived from rental income, and significant downside protection in the event of a decline in real estate values, as well as additional returns over public comparators.

According to investment consultancy bfinance, 2019 was the first ever year in which searches conducted by investors for real asset debt (real estate debt and infrastructure debt) outweighed, in dollar terms, searches for corporate private debt.

Healthy fundamentals for office and industrial sectors: In continental Europe, the picture was much the same as the UK, with office and industrial sectors performing strongly in 2019 and direct equity investors still seeking exposure to these sectors, and often applying leverage. Even prior to the Covid-19 pandemic, the retail sector was suffering from oversupply of space caused by high levels of development in the run up to the global financial crisis and by growing internet penetration, most notably in the UK.

Figure 4. Real estate debt gross discount margin over corporate bonds (BBB-rated investments)



Source: M&G, Bloomberg, BBB-rated 3-5 year corporate bond spreads. Please note that spreads are provided on the day of deal funding and are provided at 3M Libor/Euribor rate. Average spread between BBB and senior DM is not capital weighted.

Seeking the right balance: the benefits of breadth and scale

Pipelines in some of the smaller, less-explored corners of private debt have steadily built over the last few years in particular, but deal supply tends to be more difficult to anticipate and is not usually in large volumes, so transactions are executed on more of an opportunistic basis compared to the larger, better-established parts of the market. Investing in alternative opportunities can create scope to diversify private debt portfolios and exploit the 'complexity' premiums on offer (see 'Finding (relative) value in complexity').

As complex investments often trade at lower frequencies, it is harder to build meaningful scale, at least to begin with. Simplicity, in terms of plain 'vanilla' lending, is good as it allows you, as a manager, to get scale so you can put a decent amount of your client's capital to work and relatively quickly too. Speed of deployment is often cited as a key concern for investors in private markets, so it can be beneficial to have strong access to larger, developed sectors including the leveraged loan market.

Mallowstreet Private Debt Research

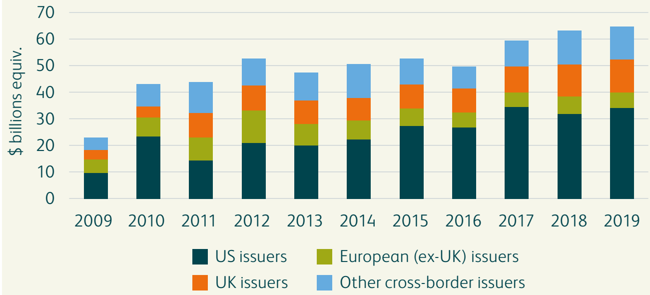
M&G recently collaborated with the Research and Insights arm of mallowstreet, an online community within the pensions industry, to survey and interview 100 leading institutional pension professionals in the UK in Q4-19 to understand their needs and challenges in private debt investing today. The survey highlighted that consultants are more worried than pension schemes about capital being deployed too slowly – 58% of advisors name the speed of capital deployment as one of their top three main concerns, but only 28% of the pension schemes interviewed are concerned about this.

The survey also revealed schemes' views on liquidity. Among schemes over £3 billion in size, 64% say they prefer to invest mainly in illiquid assets due to the additional returns and ability to match specific outcomes they can provide. Almost three quarters of schemes that are less than 85% funded are also willing to invest in illiquid assets, compared to less than half of better-funded schemes.

Private placements

What has the supply of deals looked like? Total issuance in the US private placements (USPP) market in 2019 was US$64.9 billion equivalent (c.€57.8 billion[3]) versus $63.3 billion (c.€56.3 billion[3]) in 2018 (although these figures are derived from broker estimates and believed to understate the market).

Figure 5. USPP annual issuance – issuers by geography



Source: M&G, as at 31 December 2019.

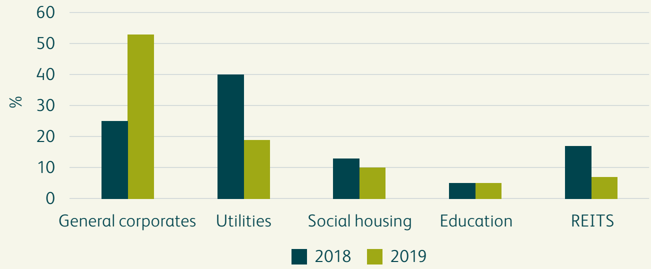
In 2019, gross new issue volume for Corporate Schuldschein loans, a predominantly German market, was €26.5 billion (2018: €24 billion). Volumes in the Euro PP, a predominantly French market, were tracking at c.€3 billion as of end Q3-19, a good 25% lower than the volumes seen in the same YTD period in 2018 thanks to bumper issuance in Q3-18.

[3] Converted using USD/EUR exchange rate of 0.8902 as at 31 December 2019.

Key observations

Strong flexibility underpins issuance: While some PP issuers can, and also do, issue uncovenanted EMTNs, the PP market is regarded as a market with lower execution risk. There has been a good mix of issues coming to traditional PP markets.

Figure 6. Private placements – UK issuers by sector



Source: M&G, as at 31 December 2019.

Financial covenants remain a key feature of the PP market: Private placements continue to offer strong structural protections including financial covenants that provide additional safeguards for investors, and remain a key differentiator between privately-placed debt and public corporate bonds.

In search of relative value – flexibility and selectivity

The growth in capital allocated to private debt has undoubtedly contributed to pricing competition, creating unhelpful incentives in some parts of the market. The asset class continues to present a variety of options, many attractively priced, although investing in private debt arguably calls for having access to a wider range of opportunities than ever before.

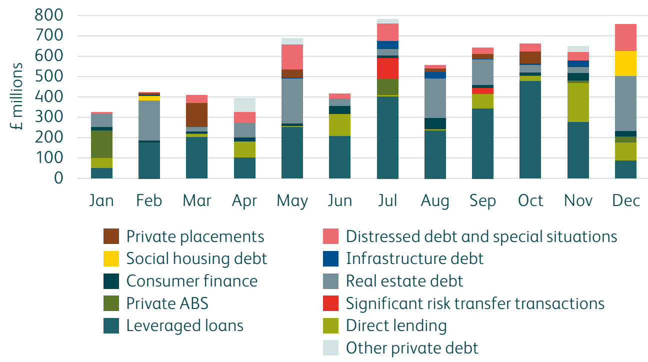
Many investors want to invest in certain popular trades and strategies, but they want to do so at a yield that may no longer exist in Europe, so having the flexibility to be able to look across the full spectrum and select the transactions that bring diversification to your portfolio and also the best relative value can be beneficial.

You have to look across the entire market to see what is available at any one time, what the demand is like, what the pricing is like and whether the deal offers adequate compensation for the risk taken, or whether a more attractive way of accessing this risk is available in the public markets without assuming the illiquidity risk (and where daily-dealing opportunities are readily available).

Spotlight on private debt origination in 2019

Our proprietary deal data tracks the private debt transactions we have made on an ongoing basis, as well as logging the transactions that have come through the desks, which we have declined to invest. According to our calculations, a total of £6.7 billion (c.€7.9 billion[4]) in private debt assets were originated in primary markets in 2019. Figure 7 represents the £6.7 billion that we have invested over 2019 and also reflects that we declined, on average, c.80% of the deals we saw.

Figure 7. Private debt originated deals in 2019



Source: M&G, as at 31 December 2019.

[4] Converted using GBP/EUR exchange rate of 1.179 as at 31 December 2019.

Significant risk transfer transactions (SRT)

What has the supply of deals looked like? In 2019, there was approximately €9 billion of new issuance placed in the SRT market by 20 issuers (2018: €7.5 billion placed by 19 issuers). For 2020, prior to Covid-19 we were already seeing a strong pipeline in the market, with over 50 potential SRT issuance scheduled for the year across different asset types and issuers. We have seen both conventional (first-loss risk position) trades and also mezzanine trades coming through the pipeline.

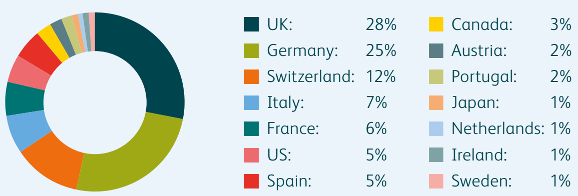
Key observations

Issuance dominated by Western European banks: Countries such as Germany, UK and Switzerland have made up the bulk of new SRT issuance to date (65% in 2019) due to broad support local banks have received from local regulators who have got comfortable with these transactions. The US has comprised only a small proportion of total issuance in the market (5% in 2019), but we expect US banks will accelerate their issuance activity going forward.

Growing diversity of opportunities: Corporate loans are expected to remain a core part of the SRT market, but investors are increasingly able to gain exposure to different asset types, sectors and regions, including social housing, trade finance, subscription finance, commercial real estate and emerging markets.

Technology to model and analyse large datasets: The benefits of using proprietary securitisation technology to systematically model and analyse these types of transactions and assess loan quality are widely recognised. This technology is also being used and adapted for a broader set of assets.

Figure 8. Number of SRT transactions by originator country[5]



Source: Citi January 2020. [5]Synthetic Transfer only, does not include cash SRT.

Key observations

- **Executed transactions higher in second half of the year:** Of the deals we transacted on in 2019, there was a clear increase in traded volume in the second half of the year relative to the first half.
- **Diversity of private debt assets:** We invested in a broad array of asset types that span the entire opportunity set of Europe's private credit markets.
- **High degree of selectivity:** We continued to exercise a high degree of selectivity over which investments we included in our clients' portfolios. For 2019, we invested in c.20% of all the private debt deals we reviewed over the course of the year meaning that our rejection rate was c.80% (based on the total amount of rejected deals).

Investing in private debt: key themes shaping the opportunity set

We are often asked how we are able to find great deals and can capitalise on the best opportunities available in private debt markets. The answer to this depends on having several key (and assumed) factors in place, including (but not limited to) the following: 1) Good access to assets and information within the lending markets; 2) Direct relationships with our borrowers and an open dialogue with our investors; 3) A strong network of industry contacts; 4) The required technology to manage risk and investment decisions, and; 5) The capacity to generate your own deal flow.

In an environment of change, the key points of differentiation for lenders will gradually evolve – shifting greater focus on flexibility, speed of delivery and decision-making along with an ability to offer tailor-made financing solutions.

We continue to emphasise some of the broad themes that we believe are key to investing in private debt and can help lenders access and align opportunities that can deliver differentiated income and matching, growth and return outcomes for investors, respectively. We also talk about some themes influencing the asset class that are multi-year in nature, since they are being driven by structural drivers that are expected to persist and evolve over time. This year could bring some of these themes into even sharper focus.

Finding (relative) value in complexity

There is often good relative value to be found in niche or complex areas of private debt. These types of opportunities are less likely to be favoured, at least initially, by other investors and therefore opportunities are less-competed (and more illiquid) – and can offer a return premium. Alternatively, areas where the traditional buying base has disappeared, can be a good source of additional return especially in the early stages. There are certain types of financings that are more likely to be passed up today by traditional bank lenders, for example – those that are deemed to be more administratively complex or have requirements that tend to fall outside of banks' parameters, are more capital-intensive or simply do not meet their internal risk limits.

Certain deal types are inherently complex for a variety of reasons. The borrower's business model may be sufficiently complex to require additional due diligence or the transaction needs to be structured according to a bespoke set of requirements and hence differs from 'off-the-shelf' deals or plain vanilla structures.

Consumer finance: consumer and residential mortgage loans

What has the supply of deals looked like? Along with banks, non-bank financial platforms specialising in originating consumer loans and mortgages have been a growing source of deal flow. We have successfully executed bulk asset purchases and have aggregated loans via forward-flow partnerships.

A steady state annual opportunity set of even 5% of the market size of €7 trillion implies an annual addressable market size of €350 billion for portfolio acquisitions.

Key observations

Attractive pricing, attractive loan assets: Returns on consumer loan assets remain attractive, while losses and financing costs remain low, enabling stable 8%+ net IRRs on investments.

Limited competition: There are a limited number of suitable partners or 'buyers' able to participate in such transactions in Europe, which helps us secure access to deals at attractive risk-return levels, often bilaterally as well.

New investment themes: We see opportunities in certain types of re-performing loans, and also with captive auto finance providers.

Growth in market set to continue: As banks continue to address their balance sheet challenges, transactions involving pools of performing loans are increasing in volume terms. The aggregate amount of capital that has been raised for investment in SRT and for whole loan asset sales to date is a fraction of the total projected capital needs of banks.

You have to be willing to head into areas where others fear to tread, willing to lend in situations where you are secured against a business asset or assets – including inventory, accounts receivable or plant and machinery, which are harder to value, and credit is less well-understood – and be willing to put in the extra work required to structure these deals.

Developing new and innovative financing solutions

The array of potential borrowers and issuers coming to the private markets for debt financing now includes plenty of growing companies that require innovative financing solutions. Lenders that have the strength in origination to be able to offer all types of financing options, from the shortest to longest maturities, senior to junior debt structures and work within multiple currencies, can be invaluable to borrowers throughout the lending lifecycle and changing circumstances.

Investment example: Life insurance receivables

Investment overview: We initially provided a four-year €25 million loan with a coupon of 6% to an established pan-European life insurer that distributes policies through third-party brokers. The transaction was rated BB+ by M&G analysts. As is common for the industry, broker commissions are paid up-front, creating a working capital need. We provide finance for these commissions, secured against all policy-related cashflows.

Strong security controls: Transaction offers security over collection account, while financial covenant ensures debt is over-collateralised. Guarantee from parent company.

Complexity premium: Transaction involved a complicated corporate and security structure. Unusual asset class which requires broad and deep knowledge base utilising a range of analysts to evaluate fully.

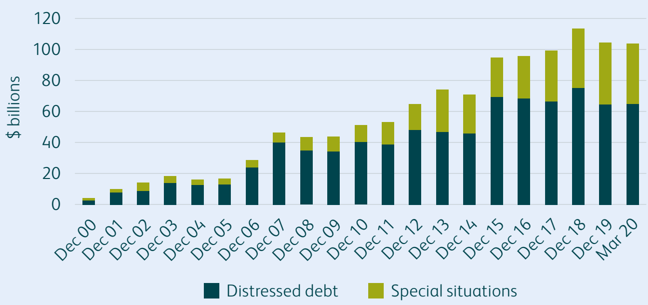
Distressed debt and special situations

What has the supply of deals looked like? 2019 marked a return to more stable market conditions in Europe, following a few bearish weeks at the end of 2018. We continued to see the effect of this 'wobble' on a number of names we liked. Consequently, there were a few more distressed opportunities compared to recent years, but deal flow remained in short supply compared with the dry powder available for distressed investments.

Key observations

Distressed debt funds have plenty of firepower: There is still plenty of capital waiting to be deployed in both distressed debt and special situations opportunities, albeit dry powder for distressed debt strategies decreased slightly during 2019.

Figure 9. Global dry powder – distressed debt and special situations



Source: Preqin Pro, as at March 2020.

Special situations financing proving attractive: The three main categories of special situation financings that we have been looking at include, but are not limited to: 1) 'Real assets', such as development land in Spain; 2) Innovative financing 'platforms', including a UK consumer lending (ethical lending) platform and a UK real estate development finance one; and 3) 'Opportunistic' financings which are more 'one-off' in nature, such as providing finance to a specialist US auto manufacturer that urgently needed a cash injection to satisfy its working capital needs against a very strong, growing order book. For 2020, we are seeing a strong pipeline of deals coming through.

(Still) late in the cycle: 2019 was not without periods of market volatility but the fourth quarter saw economic and political concerns dissipate and progress towards a US-China trade deal was made, just as a decisive result in the UK elections inspired confidence in a clearer position on Brexit. While a turn in the credit cycle may not be imminent, signs of more difficult market conditions are beginning to appear, even before we factor in the potential full impact of the Covid-19 coronavirus pandemic.

To complement our approach to sourcing transactions in attractive sub-sets of the market, we can offer bespoke capital structures or tailor-made financing solutions to a diverse pool of borrowers that others are unable to provide, and that can better match the needs of the borrower (and interests of the lender) compared to broader capital markets. This can create a virtuous circle as lenders can find themselves first in line for repeat financing arrangements or be given exclusivity on a deal.

Casting a wider net: positioning for the next phase of market growth

We find ourselves not only looking to avoid the popular, overly-competed trades and proactively exploring new and innovative ways to drive value for our investors, but actively building our expertise and resources in other areas of the lending market to position for the next iterations of market development.

The highest-returning assets take time to source. This is because certain types of opportunities are not ready-made. In some cases, they can take years of hard work to come to fruition and rely on a strong origination capability to gain footholds in new markets, sectors or jurisdictions that were previously inaccessible to non-bank lenders.

Regulation and the retrenchment of the banking sector has been a crucial driver underpinning the growth of Europe's private credit markets. Given the long-term structural shifts in the European banking landscape, many European banks

Investment example: The Microfinance Enhancement Facility

Investment overview: We provided US$90 million in senior debt financing to the Microfinance Enhancement Facility (MEF), a $690 million global microfinance debt fund set up in 2009 to offer a reliable and stable source of finance to microfinance institutions in a wide range of developing countries.

Providing finance at scale: Innovation played a key part in this investment, as the transaction structure allows M&G to provide finance at scale to borrowers in developing countries by applying our ABS expertise to a diversified pool of loans. The transaction provides a significant level of credit enhancement for senior noteholders given significant equity capital commitments in the fund's capital structure from reputed government and quasi-government counterparties. Given this strong equity sponsorship, the deal was rated AA by M&G analysts.

Infrastructure debt

What has the supply of deals looked like? In 2019, the total amount of infrastructure debt issued in private markets was in the region of £84 billion (c.€99 billion[6]) in value terms from 370 issues.

In the UK project finance market, deal flow was mainly in the renewable energy sector (wind and solar), rolling stock and student accommodation sectors although overall refinancing of existing assets outweighed greenfield deals. For euro-denominated assets, there was a better balance between greenfield and brownfield project financings. In both currencies there was a steady flow of corporate (as opposed to project finance) transactions as well, across sectors. If you look at the deals we invested in last year, these were tailored to differing client needs, with a wide range of ratings (AA to B), maturities (5 to 30+ years) and interest bases (fixed, index-linked and floating rates).

Key observations

Patient and selective investment: With significant liquidity in the market especially for BBB credits, core infrastructure continues to be priced tightly, requiring a selective and disciplined approach to find investments that offer suitable risk-adjusted returns. It is possible to earn superior returns from more complex transactions which are executed away from the general market.

An active syndication market: The infrastructure debt secondary loan market continues to develop, with most of the sales stemming from banks' loan books rather than primary syndication. Banks faced with stringent regulatory capital requirements are looking for ways to release capital from their balance sheets, and are selling existing portfolios of loans (with specific tranches carved out for institutional investors) in decent size.

The search for yield: Infrastructure investors continue to move into new sectors, with the definition of 'infrastructure' stretched further each year. Some have also returned to invest in European jurisdictions which had been shunned for a number of years following previous negative experiences, as these offered wider spreads as a consequence. The premium for investing in these countries narrowed rapidly through 2019.

[6] Converted using GBP/EUR exchange rate of 1.179 as at 31 December 2019.

have focused on reducing the asset size of their balance sheet to meet the regulatory capital requirements set out by the regulators. The need for 'capital relief' is certainly being reflected in the types of opportunities banks are bringing to the capital markets and to institutional investors. With consumer finance and SRT set to become increasingly important non-bank markets in Europe, non-corporate private lending could well be the next phase of market growth.

Further expansion in the private debt opportunity set means that institutional investors can gain access to differentiated exposures that promote greater diversification in a portfolio.

Investment example:
Forward-flow Irish mortgage transaction

The Irish mortgage market is dominated by a small number of banks. We formed an exclusive forward-flow partnership with Finance Ireland (FI) – Ireland's largest non-bank lender – to originate residential mortgages.

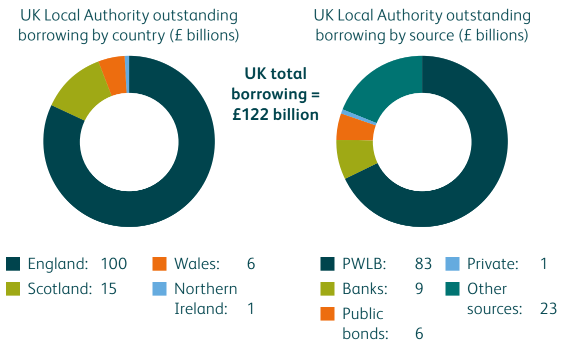
We first partnered with FI to acquire an originated mortgage book (€245 million) from a competitor in October 2018. FI simultaneously acquired the competitor's origination platform.

Initially financed through bank warehouse facility, and in July 2019, c. €290 million of the mortgages were securitised via an oversubscribed RMBS transaction – boosting IRR expectations to 27%.

Local government sector – opening up to private lenders?

We see an opportunity for private lenders to step in and provide long-term finance to local government authorities in the UK in increasing volume. To date, individual local authorities have been able to meet the majority of their financing needs and fund new projects by tapping the loan facility provided by the Public Works Loan Board (PWLB), a statutory body of the UK Government. The PWLB is the source of 68% (£83 billion) of UK Local Authorities outstanding borrowing, with a further 10% (£12 billion) emanating from local government sources.

Figure 10. Local Authority outstanding borrowing

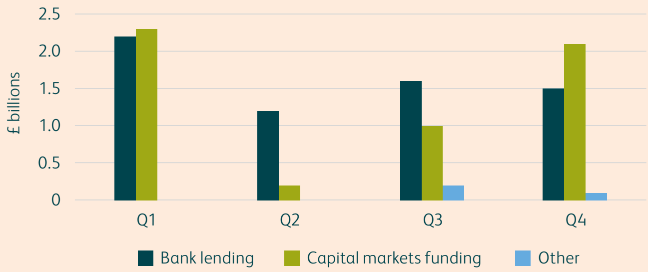


Source: UK Government, as at 31 December 2019.
Local government finance tables (Borrowing and investment):
https://www.gov.uk/government/statistical-data-sets/live-tables-on-local-government-finance#borrowing-and-investment

Social housing

What has the supply of deals looked like? There was a steady stream of social housing transactions throughout the year. A total of £12.4 billion of new social housing finance facilities, including refinancing, was agreed in 2019. Capital market funding accounted for 47% of new funding in 2019, with bank lending contributing 52%. Figure 11 below shows the amount of new issuance by funding source for each quarter.

Figure 11. Amount of new social housing debt issued in 2019

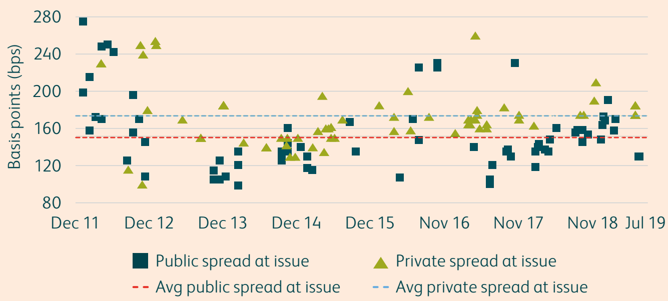


Source: Regulator of Social Housing quarterly surveys, as at 31 December 2019.

Key observations

Private deals offer favourable spreads: The average spread obtained at issue for private social housing transactions has exceeded the average spread of public social housing issues – the difference in the average spreads at issue being 24bps over the period shown in the chart below.

Figure 12. Average spreads at issue – private and public social housing deals



Source: M&G, as at 31 July 2019.

However, the surprise 100 basis points hike in the rate charged by the PWLB for new loan advances (typically Gilts plus a margin) announced in October 2019 effectively penalises local authorities borrowing from the PWLB to fund infrastructure projects, (social) housebuilding and regeneration schemes, and opens up the sector to other lenders willing to lend at cheaper rates than the PWLB – depending on the perceived credit quality of the local authority. At M&G, we have been active in this sector for a number of years and have done £824 million of private or illiquid lending deals with local authorities in the UK to date.

Furthermore, debt-like lease income strips from local authorities are becoming a growing part of the market, with the funding typically being used to regenerate town centres and local high streets.

Relationships matter

Much has been made of the competition between banks and non-bank lenders in the years following the crisis, but often non-bank lenders lend alongside banks through co-lending agreements or buy assets from the banks themselves. We have long-preferred such models of collaboration, working with banks (and others) rather than against them, forming strong partnerships in areas like direct lending, private placements, infrastructure debt and leveraged finance. Our bank (and, equally, our non-bank) partners can often be instrumental in introducing us to new opportunities, and it is important to have a broad set of relationships for sourcing assets.

In transactions involving consumer and residential mortgage loans, because of the extensive commercial and legal due diligence needed to acquire these loan assets from retail banks, we are looking to build symbiotic long-term relationships with banks, who are selling these assets for regulatory capital reasons, such that the time, cost and effort of the diligence is worth it for both parties. Being one of the few operators in the market for SRT transactions (or 'capital relief trades'), banks want to engage with known and trusted investors to whom they are willing to provide large volumes of confidential data.

Multi-year themes

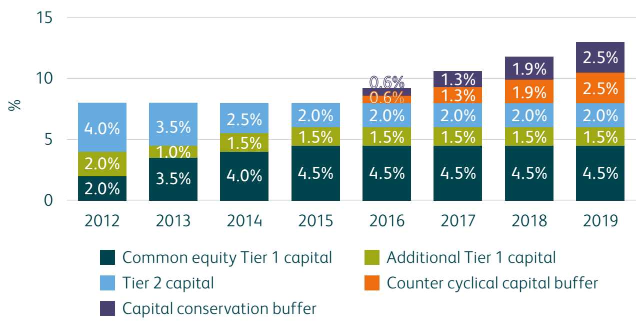
The regulatory landscape

The landscape of private debt in Europe is ever-shifting thanks to several multi-year themes that are continuing to shape the growth, development and evolution of the asset class. Regulation being an important theme; not least because policymakers and regulators in Europe are quite keen to see a far deeper and more structurally robust set of markets, but also given the fact that changes in financial regulation are providing more varied opportunities for institutional investors and borrowers alike.

Banks in Europe have been severely challenged since the financial crisis on several fronts due to increased capital requirements from the various Basel Capital Accords, very low interest rates, increased regulatory costs and higher technology spending to compete with the emergence of fintech and digital-first challenger banks – all the while being unable to generate sufficient earnings to balance these requirements.

Given the sheer scale of the regulatory burden on banks, the regulatory authorities have agreed that the reforms will be phased-in gradually. Banks are currently implementing Basel III, while also incorporating the IFRS 9 accounting standards. Updated rules, dubbed 'Basel IV', due to be implemented from 2022 will see a phased-in capping of the benefit of using internal risk models, while full recognition of IFRS 9 is set to take effect from 2023. Even though it may be too early to see the impacts in business models or pricing, the European Banking Authority (EBA) conservatively estimates that capital demand for EU banks will increase by around 24% under Basel III alone. The EBA also estimates that introduction of credit impairment provisions under IFRS 9 will on average reduce Tier 1 ratio by 79bps.

Figure 13. Basel III: Capital requirement increase



Source: European Commission, "New proposals on capital requirements", July 2011.

This means that even in the absence of announcing new regulation, banks are still facing a mammoth task over the next few years to meet the stringent and binding standards that have been agreed to date.

Talking points: Libor transition

With good progress made in 2019, we can expect the rhetoric and action on the global London Interbank Offered Rate (Libor) transition to ramp up in 2020, with more financial regulator-driven milestones being set. In sterling, there is a 2021 deadline for the cessation of Libor. While Euro-denominated loans are less affected (Euribor being reformulated but not eradicated), most loans are multi-currency, meaning that there will be individual documentation amendments needed for thousands of contracts, in all likelihood.

ESG considerations and impact investing

Incoming regulation looks set to drive important and wide-reaching changes over the coming years. As part of the EU's Action Plan, asset managers are expected to comply with the Disclosures Regulation which requires the disclosure of new policies relating to integration of sustainability within firm, and external impact of firm's investing on sustainability. The Framework Regulation establishes a taxonomy for determining whether an economic activity is environmentally sustainable. Both are due to come into force in 2021.

What gained significant traction in 2019 was the attempt by institutional investors to improve the integration of ESG risk assessment into their credit analysis, including greater engagement with borrowers and private equity owners. This is a welcome development that could contribute to enhanced disclosure even if it is acknowledged that privately-owned companies lag their large, listed peers in terms of publicly-available and consistent ESG data. Private lenders are nevertheless in a strong position to engage with borrowers throughout the investment process – the direct contractual, and often bilateral, nature of a private loan creates relatively frequent interaction between the parties that permits typically greater engagement than in the bond market.

The growing focus on ESG from investors is certainly helping to drive interest in certain asset types, including infrastructure debt, social and affordable housing, and green buildings. In a broader context, green and sustainable-related issuance could become more of a feature of the market going forward. Even if it does not, we expect the emphasis from lenders to be on pushing for greater ESG risk disclosure, including the impact of climate-change and the state of cyber health, and wider integration of ESG factors into investment analysis and decision-making processes.

Positive impact through private debt: For those investors looking to generate real world impact from their investments, the case for using private debt to build impact investment portfolios has gained ground over recent years. Private debt impact strategies target a broad range of opportunities by providing direct private loans to companies, projects and organisations operating in a number of sectors, so are able to offer investors attractive returns and diversification, while generating a positive environmental or social impact.

The influence of investors

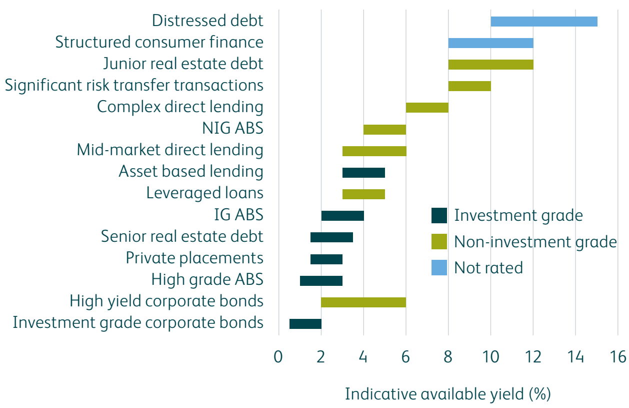
The investor base for private credit remains predominantly institutional. While wholesale investor participation is still relatively limited outside of the US, this appears to be changing as the industry rapidly evolves to create a broader range of strategies, formats and vehicles, designed to attract a wider set of investors. The influence of different investor types, subject to changing regulation, is likely to continue to have a significant bearing on the development of the asset class in several areas such as risk management and due diligence processes, monitoring and reporting requirements.

Investments that benefit from reduced capital charges under the Solvency II regime, including private placements, real estate debt, specially-created tranches of infrastructure debt and matching-adjustment-eligible assets, continue to attract strong interest from insurers. Managers are already working closely with insurance clients to ensure that the data and reporting meet the requirements of the regulatory authorities under the standard model.

Focus on spreads: Why the (il)liquidity premium is in the eye of the beholder

Liquidity preferences will be different for each investor, but for the average pension scheme, most pension payments are due relatively far in the future. We have seen clients coming to us with the realisation that they do not want to pay for all the liquidity they have in their portfolios. Institutional investors are already aware that investment into private assets can offer the potential for greater security and covenants than publicly-listed assets, but the flow of capital into private markets ultimately relies on the belief that they will outperform public markets.

Figure 14. Indicative returns available from private debt and alternative assets



Source: M&G, as at 31 December 2019. Returns are indicative and gross of fees.

Three things investors should understand about harnessing an illiquidity premium:

1. **The illiquidity premium is not constant:** Investors may command a higher premium for investing in less familiar assets or in areas where there are high operational barriers to entry. This premium may normalise over time as markets become more commoditised and greater investor interest causes pricing advantages to ebb away. The complex or illiquid nature of an asset does not guarantee that an investor will earn a premium.
2. **Measurement is not an exact science:** Quantifying an illiquidity or complexity premium for private assets can present its own challenges as it depends on what you measure it against. For many private debt assets, a comparable or similarly-rated public asset may not always exist and for other assets, there may be several comparators.
3. **Be realistic about what is achievable:** It is important to determine how much of a premium is on offer at any given time to ensure that they are sufficiently rewarded, and be realistic about what is achievable in the investment grade space.

Looking ahead: What to watch (out for)

The factors supporting the growth of private credit look set to fuel further expansion of the asset class over the coming years as new and exciting opportunities develop across the investment spectrum. Although with market dynamics changing, competitive pressures shifting and wider market concerns looming large in investors' minds, there will be risks to be managed and mitigated where possible.

Corrections and disruptions can occur at any point of the credit cycle and can adversely affect borrowers. Corporate borrowers have been increasingly keen in recent years to give themselves flexibility to cope with shocks beyond the normal course of business. The outbreak of Covid-19 'coronavirus' certainly would qualify. The full impact of the pandemic is largely unknown at time of writing while governments and policymakers alike implement their containment action plans and take measure of the problem at large, and it may be several months yet before the full effects are known and quantified.

In terms of bespoke private debt assets, the pervading uncertainty has also impacted deal flow and broader activity. This is largely unsurprising, and is common in periods of market disruption, given the reduced appetite from borrowers who are reluctant to pay higher margins for financings at periods of uncertainty. When markets stabilise we anticipate that there will be a pent up supply of deals needing to be done which could offer interesting opportunities for private (non-bank) lenders.

Long term matters – Being prepared for all scenarios

The virus-outbreak has undoubtedly caused fear and panic in global financial markets and a consequence of this is volatility. Private debt portfolios are designed to purchase assets which are illiquid in normal markets (with the exception of leveraged loans which have an active secondary market), the intention is to hold assets to maturity. Many in the industry would argue that private credit is less exposed from a fundamental perspective to any protracted downturn and deal structures are robust enough to withstand a more challenging environment. By being alive to both the risks and opportunities that such a fast-moving situation can bring in the short term, lenders can ensure the best possible outcomes over the long term for their clients.

Applying strict underwriting discipline

While it is possible to hedge some of the risks taken, it is not possible to hedge all risks associated with an investment. Financial covenants are typically a feature of private debt assets, which will allow a lender to engage with the investee company and its owners should performance start to deteriorate. Covenants do not offer one-size-fits-all protection against capital loss, so careful lending practices, including a high level of selectivity over which assets make it into a portfolio, rigorous due diligence and ongoing vigilance and monitoring of existing assets become ever more important for investors. Managers need to focus on strong underwriting and loan structuring to ensure that the investment appropriately reflects and compensates for the risks involved.

Focusing on high quality assets

There is perhaps greater importance on investment selection within and across sub-asset classes. If this is done correctly then credit risk in portfolios should be kept to a minimum. So expected credit losses, rating downgrades and defaults remain low. The key thing is not to be a forced buyer – either of the debt of weaker companies that might not fare well in a downturn or of strong companies whose access to borrowing means there is not an appropriate risk compensation for lenders.

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