Private credit investing: Whatever the weather?

M&G Investments

December 2022

Private credit is an asset class which refers to lending to private companies (ie those not listed on the stockmarket). It comprises potentially higher-returning, but equally, potentially riskier, more complex opportunities where your money is locked in for a period and cannot easily be withdrawn. A range of potential risk/return profiles are available across this asset class, which is not traded on public markets.

A new reality – a rising interest rate environment.

For more than a decade, both corporate and consumer borrowers benefited from low interest rates. Now things are changing as central banks raise interest rates to control runaway inflation. And although many corporate and consumer borrowers have entered this inflationary period in pretty good shape, in some cases higher interest obligations may trigger a higher rate of defaults on loans. This puts the spotlight on the importance of lenders taking a prudent approach when underwriting credit risk in this environment.

Stagflation (a damaging combination of lack of economic growth and rising prices) and worries about a recession continue to drive market sentiment and macroeconomic uncertainty is already leading to a much wider range of risk/return possibilities across public credit markets (bonds which can be bought and sold on publicly accessible markets – for example, a new bond issue from a major retailer). This can lead to opportunities for investors and also for borrowers looking for providers of flexible, patient long-term capital.

In the current inflationary, rising interest rate environment, private credit appears to be relatively well-positioned to navigate the challenges ahead in our opinion. Private credit is not bought and sold on the open market. Unlike a publicly traded bond, which has an offering document, or prospectus, outlining the terms on which the bond is issued, private credit is a transaction between two or more parties, where the terms of the loan are negotiated, and a contract drawn up between the parties. One example would be a fixed-term loan to a major retailer which is facing liquidity challenges.

The evolving macro, fiscal, (geo)political landscape.

Up, up and away? – Following the pandemic, inflation concerns have come back to bite as prices climb to multi-decade highs. Supply-chain problems, conflict in Ukraine, surging energy and commodity prices and a slow initial response from global central banks have allowed inflationary pressure to intensify. As a result, businesses are facing rising input costs and households are reporting an increase in their cost of living as higher energy, food and fuel prices are passed on.

Growth and inflation: A short-term trade-off? – Inflation impacts all aspects of the economy, eroding purchasing power. This means central banks must act now to ward off the threat of stagflation or worse, an outright recession. Together with wariness over the path of energy prices and labour and supply shortages, uncertainty clouds the longer-term outlook for inflation and growth – and the shape of the response from policymakers.

Policy quandary

Whatever it takes? – The sheer extent of the pandemic-era firepower – mainly in the form of bond purchases and low interest rates -- deployed, both in scale and scope, shielded businesses from insolvencies and supported household consumption. However, government and central bank coffers were put under strain. Central banks became buyers of last resort as well as lenders of last resort, with a notable presence in bond markets. Now that inflation is rising, quantitative easing (QE) – where the central bank purchases securities to reduce interest rates and increase money supply in the hope that this will encourage lending and investment - is ending. Its opposite, quantitative tightening (QT) – where the central bank sells its government bonds, leading to a surplus in the markets that depresses bond prices and pushes yields, which move in the opposite direction, higher -- is beginning.

Don’t fight the Fed? – While arguably slow off the mark, central banks, led by the US Federal Reserve (Fed), are raising interest rates decisively in their efforts to tame inflation. Central banks are also concerned about the spillover effects from wage increases. They are faced with a careful balancing act of seeking to restore price stability without triggering a recession and without increasing unemployment rates too much.

Private credit amid changing conditions

Private credit offers investors exposure to alternative and differentiated assets and could generate a range of outcomes, such as enhancing risk-adjusted returns, generating potentially reliable income streams or acting as a diversification tool. This means the asset class could potentially play a variety of roles in an investor’s broader portfolio.

In our opinion, today private credit investors remain well-compensated for taking illiquidity risk (ie, not being able to sell on the investment quickly). The new realities of higher inflation, rising interest rates and uncertainty about the global economic outlook could push motivations for investing in private credit up the priority list.

Private credit is a broad and versatile asset class that spans a wide range of investment opportunities across the spectrum of risk/reward profiles. The investable universe is made up of a range of assets;

- Corporate - Leveraged loans
  Leveraged loans are normally used to finance mergers and acquisitions of privately owned businesses (companies not listed on public stock exchanges). Loan terms are negotiated individually between the borrower and lender. Usually, the process is led by a bank, which may fund the loan with capital provided by a group of investors.

- Real assets – Real estate debt or commercial mortgage loans
  Real estate debt (or ‘commercial mortgage loans’) consists of loans made to commercial property owners to finance the purchase or redevelopment of real estate. This real estate may comprise offices, hotels or retail properties, which the borrower rents out to tenants. Loans are secured against the physical real estate.

- Consumer and structured debt
  Structured credit involves packaging together similar types of debts and selling off the ensuing cashflow. Financial assets such as loans and mortgages are pooled together into a product, which is backed by those assets; it is this product that is sold.

Investing in these types of asset could help investors be less exposed to inflation risk and access investments which are not directly influenced by central bank policies. As private market assets tend to have very different underlying risk and performance drivers, they offer the potential to diversify away from corporate risk and towards investments where public market equivalents don’t exist.

Private assets are less liquid than instruments listed on public markets, which can be bought and sold more easily. Because of this, this asset class is inherently less sensitive to the movement of global markets than traditional asset classes, but the downside is that investors must lock in their money for longer. Investors risk not being able to access their money right away should they wish to get out of their investment ahead of time, as they would have to wait until a private buyer is found. The costs of selling the asset could also be higher than that of assets listed on the public markets, depending on factors such as the state of the asset, its location, or more generally, market conditions.

Whatever the weather

The search for ‘all weather’ asset classes that can reliably deliver income and returns in an inflationary environment of higher interest rates and protect capital in more challenging market conditions is perennial. In our view, the dynamic and diversified private credit asset universe could offer relative resilience compared to traditional asset allocations.

Higher interest rates should increase the appeal of an asset class which is less sensitive to interest rate rises and where the returns can be linked to current prices. Many private credit assets, in contrast to most traditional (public) fixed income assets, have a coupon (regular interest payment) which adjusts with changes in interest rates and therefore does not fall as interest rates rise.

Unlike publicly traded markets, private lenders can benefit from having their money locked in for a fixed period as well as being in a pool with a largely institutional investor base, which means forced liquidations are less likely. Crucially, private

lenders have levers at their disposal -- clauses within the initial contract - to help to ensure that investors remain compensated for the risks taken when investing in the asset class.

A glossary of financial terms used within this document can be accessed here; **Financial Investment Glossary | M&G Investments UK (mandg.com)**

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