Private credit: looking forward and looking back

The higher yielding parts of the private credit market are possibly facing their first recession. We caught up with Lushan Sun, Private Credit Research Manager at Legal & General Investment Management (LGIM), to find out what headwinds and opportunities she sees.

By *Harry Geels*

How has private credit as an asset class fared in the first half of the year?
'Let's start with the question how we define private credit. In its simplest terms, it is a loan between a borrower and a lender that is not publicly traded. It can be bilateral between one borrower and one lender, or a syndicated loan with multiple lenders – although there will typically be fewer lenders in private markets than in public markets.

Lenders in private markets generally have much more direct access to borrowers' senior management teams. There can also be more flexible terms, especially with regard to ESG requirements. Default rates in private credit markets are expected to be lower than those in public markets, since many loans are secured against tangible assets.

Turning to the markets, conditions for credit have been very challenging since the onset of the war in Ukraine. There has been a lot of volatility in the broader market, but private credit has proven quite resilient. As central banks have hiked rates in response to the present bout of inflation, yields in private credit have moved much higher. They have reached levels we haven't seen previously, making the asset class in our view quite attractive.

In the public credit markets, we haven't seen much divergence in spreads between different sectors, which is peculiar given that many analysts are forecasting a recession. In the private credit markets, we have noticed greater spread divergence between cyclical and defensive issuers. Defensive sectors are still witnessing a lot of demand, with oversubscription on new issues and tighter spreads.

We are seeing more and more borrowers diversifying their borrowing needs. In the past, it was primarily banks and public markets, but today private markets are becoming more professional, driven by bank retrenchment, at least in the smaller and mid-market areas. Also, general market volatility has made issuing public debt more challenging. Negotiating power has gradually shifted from borrowers to lenders, which is positive for private credit.

In general, we are observing loans' maturities becoming shorter this year, because borrowers don't want to lock in the current high rates for a long time.'

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Is there a more general trend from public to private markets?
'It is widely known that fixed income investors have gravitated towards private credit during recent years, in search of yield in the low-rate environment that followed the global financial crisis (GFC).

ILLUSTRATION: SHUTTERSTOCK

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I would like to make a distinction between private credit in investment grade and its high yield counterpart. The former has been around for decades, with a strong track record through different economic cycles, with insurance companies the main investors. In a recent publication, I called this market ‘the unsung hero’, given its resilience across economic cycles and that it is relatively unknown to institutional investors.

High yield private credit has only recently started to grow, with the emergence of direct lending, mezzanine financing, and junior loans. People tend to label these as ‘the private credit market’, but in my opinion it’s more nuanced, because investment grade private credit is a large market and has a much longer history. This myopic view of the private markets, especially assuming it consists solely of high yield issuers, has been fostered by benign conditions and the fast growth of high yield from the GFC to last year. So yes, we have seen the private markets grow, but mostly in the higher yielding segments.’

Given current market stress, what catches your eye?

‘Real estate debt is an interesting space at the moment. We have seen significant real estate equity valuation corrections this year, first in Europe and then in the US.

The biggest challenge for real estate debt borrowers is massively higher (re)financing costs. Lenders and borrowers are working closely to find the best solutions: it’s not in lenders’ interests to allow a default and take the assets, so we have seen banks extending current loans for one or two years to get borrowers through these challenging times. Borrowers are in general willing to inject more capital, because there is still a lot of equity left to protect.

We don’t expect a crisis like in 2008, because leverage levels are much better now: around 60%, compared to 80% then. However, there are situations where solutions cannot be found, especially if the lenders are smaller US banks that have come under pressure as a result of higher rates and deposit flight. This means some increase in forced sales is possible.

At the same time, real estate credit markets currently offer investors a window to provide financing at what we believe are attractive yields. We are witnessing a lot of refinancing activity in sectors that are quite resilient, such as industrials, logistics, residential, and student accommodation, and leverage levels are trending lower.’

Will there be a recession in the US and Europe, and if so, where do you expect the strongest headwinds?

‘Recession is still LGIM’s base case. We believe the lagged effects of the significant rate rises have still to manifest themselves. However, it remains to be seen how deep the recession will be. If one arrives, whatever it looks like, there isn’t much scope for central banks to lower rates, given still-high levels of inflation.

But our take is that private credit markets have already priced in recession risk to a larger extent than the public markets. In other words, if the recession arrives, we would expect more volatility in public than in private markets. Given the potential macro headwinds, in our view investment grade private credit could potentially offer a good haven over the long-term, as previous down cycles have suggested.

On the other hand, high yield private credit markets will be facing their first serious downturn, and performance will depend on individual borrower’s ability to cope with financial stress. But this part of the private credit market has re-priced significantly and is currently offering yields from high single digits to mid-teens, depending on level of risk and position on the capital stack.’ ■

Key Risk Warnings

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SUMMARY

Private credit has proven quite resilient despite volatility in the broader market.

Private credit markets have greater spread divergence between cyclical and defensive issuers.

Private credit markets are growing, but mostly in the higher yielding segments.

Real estate debt offers plenty of opportunities.

High yield private credit markets may face their first serious downturn due to the expected recession.

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