Spotlight on private credit markets

Adjusting, adapting and responding

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- Private markets re-open following a period of relative stability and reduced volatility in publicly-traded markets
- We are seeing interesting and varied investment opportunities emerge, but selectivity remains key to operating in this new deal environment
- The pipeline of private and illiquid debt assets continues to steadily build into year end.

Overview of current market conditions

While the current crisis conspires to create an environment of uncertainty and reduce visibility in the short term, markets are arguably exhibiting more stability than expected – adjusting to the new reality despite evolving newsflow, with many economies in the UK and across Europe entering into second nationwide lockdowns in recent weeks. More recently, market sentiment has been buoyed by hopes that a potential vaccine solution may see an end to the virus-outbreak sooner rather than later. A return to 'normal' nevertheless seems some way off, and depends on how quickly a vaccine could be rolled out and the extent to which further lockdown measures may be needed (or not needed) in the future, notwithstanding the ongoing economic fallout.

Improving ABS market dynamics

Asset-backed securities (ABS) and ABS-related assets have continued to perform well. The latter part of the third quarter brought with it the welcome return of primary ABS issuance in Europe following the traditional summer lull, with mezzanine ABS continuing to tighten after rebounding in the second quarter. The collaterised loan obligations (CLO) market, in particular, is exhibiting greater stability with CLO fundamentals improving as the rate of loan downgrades continued to slow.

More broadly, there appears to have been more of a rational repricing of credit risk across the board to reflect a weaker growth environment, but perhaps a less severe prognosis than originally thought back in the spring.

Given the pace and scale of the immediate monetary and fiscal response to the COVID-19 crisis, default rate expectations have subsequently been revised lower after credit ratings agencies were quick to downgrade externally rated companies in the earlier stages of the pandemic. Stimulus measures have helped to reduce the imminent capital needs of many businesses, while sponsors and lenders took immediate action to ensure liquidity, including drawing down on available credit facilities, and ensuring that businesses remain a going concern.

Although given the differentiation in risk across the board – between the more 'COVID-impacted' and the more 'COVID-resilient' businesses – selectivity still remains key when investing in the current climate.

Beyond the corporate landscape, we have been encouraged by further signs of a recovery in European property and consumer credit markets, and also by the improving trend in borrower payment holidays from the latest bank results and securitisation data.

While the full extent of the impact from further lockdown measures and increases in unemployment is not yet known, there has not been signs of substantial credit deterioration in mortgage and consumer loan portfolios to date, which has supported the recent strong performance in specialty finance assets we have seen.

Quiet summer gives way to busy Q4 for many private credit markets

Unlike the more liquid parts of the investable universe, including the European ABS market, activity in the private credit markets has been fairly limited in response to the COVID-19 induced disruption.

However, there has been renewed interest to get deals done and enter into negotiations on new investments as private markets re-open following a period of relative stability and reduced volatility in publicly-traded markets. We think this bodes well for the pipeline of private assets heading into year end.

For instance, we are seeing increased private market activity across multiple real estate financing segments, including real estate debt, commercial mortgage-backed securities (CMBS) and portfolios of residential mortgage loans. Outside of the UK and Europe, we are starting to see a number of interesting opportunities emerge in Asia and Australia, including regulatory capital trades, and consumer and residential mortgage transactions.

Real estate debt markets – pockets of value

In this new deal environment, we are seeing a number of real estate debt transactions offering significantly more attractive risk-adjusted returns across both the UK and Europe relative to pre-pandemic times. While the COVID-19 pandemic has led to significant and ongoing disruption for certain sectors, with ‘bricks-and-mortar’ retail and hotels feeling the immediate impact of lockdown measures, other sectors such as logistics and industrial warehouses have thrived with the latter benefiting from the accelerated structural shift to e-commerce seen prior to the pandemic.

Additionally, we believe alternative real estate debt sectors such as data centres and biotechnology/science parks continue to offer compelling opportunities as they come to the forefront of investors’ minds in the current climate, and given the almost overnight shift to remote, digital working models.

Even in sectors of the real estate debt financing market that have been more impacted as a result of the pandemic and would therefore warrant a more cautious approach, attractive opportunities can still be found in our view. Although investors need to remain selective, for example good quality offices with long-leases to high quality tenants.

CMBS markets reopen

The CMBS markets have been quiet since the volatility in March as the pandemic put investors in panic mode, but have started to reopen once again as market sentiment improves. The CMBS segment follows in the footsteps of the residential mortgage-backed securities (RMBS) and CLO segments, which were among the first ABS markets to reopen in the second quarter.

Asia’s growing pipeline

We have also been seeing a number of opportunities in Asia and Australia to refinance or enter into existing warehouse facilities in mezzanine tranches of private ABS transactions for various underlying collateral types, including auto loans, consumer credit and residential mortgages.

Banks seek risk-sharing transactions

Looking to other sectors, the traditionally busy fourth quarter for regulatory capital trades is in full swing. The regulatory capital trades, or significant risk transfer (SRT) trades as they are also referred to, we have recently seen in the market are offering significant value compared to pre-pandemic times in our view, and offer investors exposure to a core and performing part of banks’ lending book. Banks remain keen to undertake such transactions, whether in the form of SRT trades or through whole loan asset sales (specialty finance), to improve their regulatory capital position and avoid having to raise potentially dilutive equity capital – and are willing to pay a premium to access these markets.

Corporate direct lending – rotating into better value opportunities

In the direct lending sector, after initially seeing a flurry of attractive, early stage, corporate direct lending transactions post the ‘wides’ of the crisis, the risk-return profile of most of these transactions became less favourable as competition for trades increased. While the supply of traditional cashflow lending opportunities has been limited and highly competed, we are seeing more opportunities in asset-based lending structures, loans to corporate borrowers with a strong asset base, which may become a growing area of focus over the coming months.

Corporate direct lending in action: Medical services and software company

Opportunity: To refinance the debt of a UK-based medical affairs solutions company which assists global pharmaceutical clients with data-driven marketing strategies for new drug compounds.

High customer retention rate owing to long-standing relationships with clients who are among the largest and most sophisticated in the global pharmaceutical industry. There is a strong revenue profile associated with drug compounds that the company markets on behalf of their clients, which have long lifecycles, so 'off-patent' compounds still generate revenues beyond expiry of the patent as they ultimately still need to be marketed.

High barriers to entry given the high level of medical expertise required to operate in the medical affairs software market, the need to build long-term, trusted relationships with customers and restricted supplier lists.

Significant equity cushion of around 68%, offering a sizeable buffer to senior lenders.

Momentum building into year end

After a quiet summer, the pipeline of private or illiquid debt assets is now steadily building as dealflow and activity in private markets improves heading into year end. While we have seen an increase in competition for certain assets and structures in recent months, we are seeing a number of interesting transactions coming through in other parts of the private credit markets, not only in terms of improved pricing but lending terms and covenant protections are more attractive than pre-COVID times, further pointing to a shift in bargaining power in favour of lenders, in our view.

One area where we see renewed potential in the new deal environment is the real estate financing sector, although selectivity is key. The pipeline of potential transactions from our Asian origination team continues to grow, presenting potential opportunities to deploy capital in these areas over the coming months.

We continue to assess potential investments on an asset-by-asset basis, looking for interesting and attractive entry points across the private credit asset classes we invest in and rotating into value opportunities as they present themselves. By being alive to both the risks and opportunities that a fast, and evolving situation can bring in the short term, lenders can seek to ensure the best possible outcomes for underlying investors.