Private credit: Can it survive a 'higher-for-longer' environment?

Lushan Sun
Private Credit Research Manager

A year on from the inflation genie being released from the bottle, inflation is still nowhere near its long-term target level.

As a result, central banks have so far remained committed to their inflation-fighting mandate at the expense of economic growth.

Against this background, we examine the impact of a 'higher-for-longer' environment on private credit. Active selection and borrower engagement will become increasingly important, in our view, as credit risk typically trends upwards in a recession.

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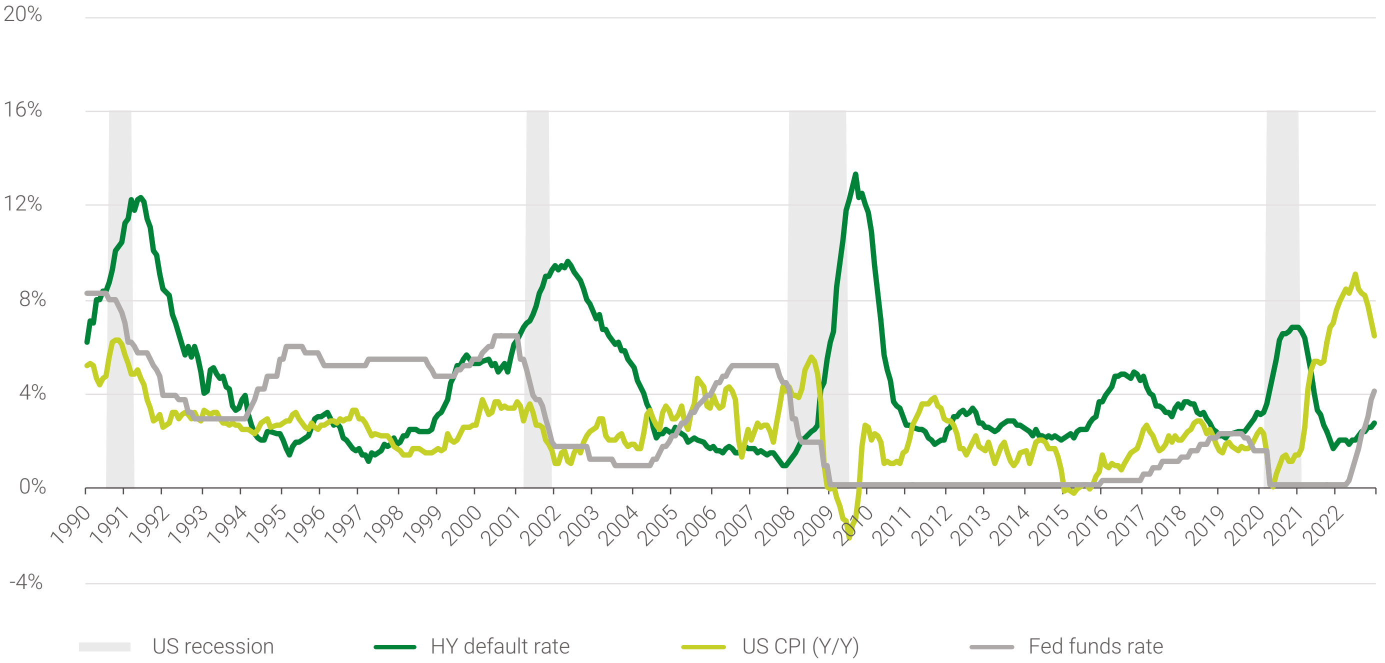
Default risk ultimately determined by credit quality

Investment grade (IG) debt has historically performed strongly – the IG corporate bond market has had almost zero credit loss over the last 40 years. Indeed, the highest annual IG credit loss was 0.4% in 2008.[1]

Although there is no comprehensive database on IG private credit, the Society of Actuaries in the US published a study covering private placement bonds between 2003 and 2015, which found that on average the annual credit loss over the period was limited to just 0.11%.[2]

High-yield (HY) defaults, by contrast, have been much higher. Apart from the COVID pandemic, defaults have typically peaked after a period of higher inflation, rate hikes and recessions. Sub-IG high yield has a relatively limited track record, since it grew significantly after the global financial crisis. Restrictive rates, weaker earnings and higher costs will put pressure on these borrowers, and a rise in defaults in a 'higher-for-longer' environment, similar to public high yield bonds, is likely.

High-yield (HY) default cycles since 1990 have been closely sync'ed with inflation, rates and recession



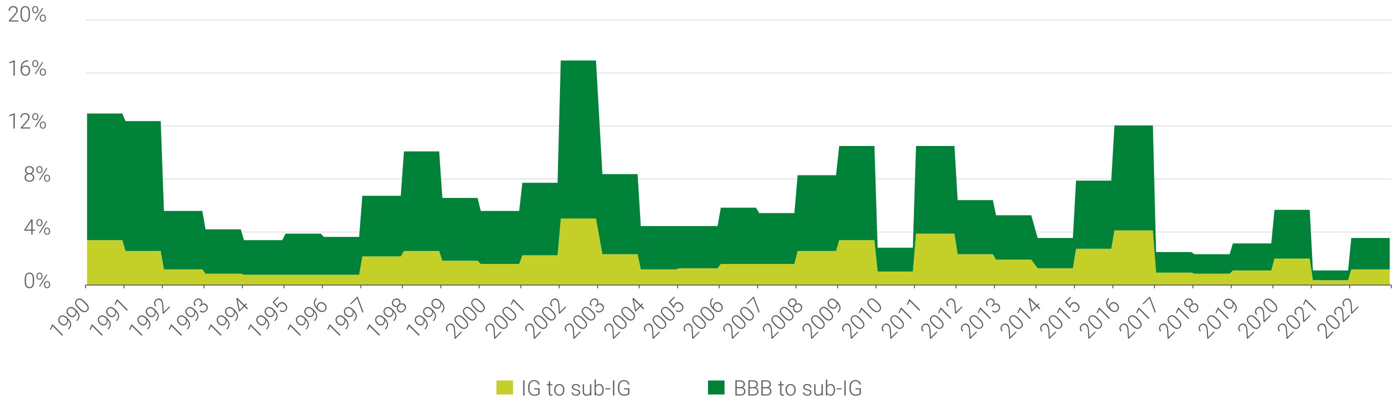
Source: Moody's as at December 2022.

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

1. Source: Moody's
2. Source: Society of Actuaries (latest research available)

Downgrade is a more significant risk for investment grade, in our view, especially from IG to sub-IG which can be problematic for investors with rating constraints.

Downgrade risk is the main concern for investment-grade credit during times of stress



Source: Moody's as at March 2023.

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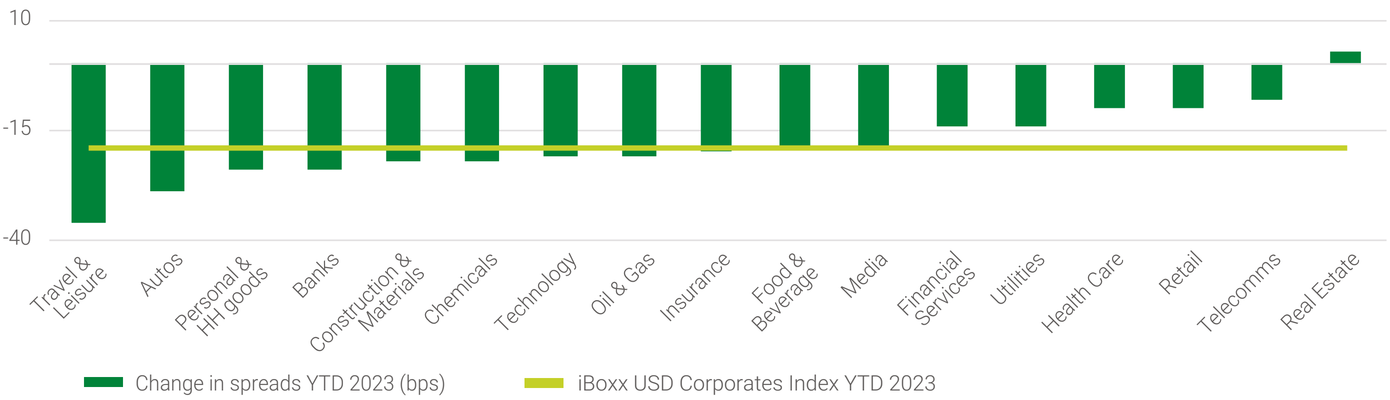
The analysis supports our preference to remain focused on private credit in the current environment. The data suggest that IG private credit should be able to navigate the current cycle although the downgrade risk is likely to increase. The high yield default rate is already on the rise in 2023 and that's before Europe and the US enter a potential recession. This leads us to place more caution on sub-IG private credit, which is exposed to the double whammy of rising debt costs (due to floating rate debt) and weak economic growth.

Sectoral dispersion in this cycle

We believe that borrowers with strong pricing power and/or a higher proportion of fixed costs should be less sensitive to inflation and have the potential to outperform in this stage of the current cycle. We are conscious that the environment we have now is somewhat unique due to the lingering effects of the pandemic. Accumulated savings, supply chain issues and pent-up demand for retail and services mean that the pricing power of more cyclical sectors has held up better.

We analysed movements in credit spreads across sectors since the start of 2022 and compared spread levels against historical averages, to see whether the current market perception of credit risk is a good reflection of the impact of higher for longer inflation on different sectors. Here are our findings:

USD investment grade credit spread movement year-to-date by sector



Source: Bloomberg, LGIM as at 16 August 2023.

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3. Source: Sub-IG borrowers have significant exposure to floating rate debt from leveraged loans and private credit.

In 2022, spreads widened across all sectors but with significant dispersion. Defensive, counter-cyclical sectors such as healthcare and food held up well during the initial period of high inflation as expected. Service sectors, which are traditionally more cyclical, benefited from post-COVID pent-up demand. Growth and interest rate sensitive sectors saw larger spread widening, including utilities and real estate.

Real estate has historically been considered a good inflation hedge, as rental growth is commonly linked to inflation (subject to a cap). However, it is currently facing a confluence of challenges – the structural shift to remote working and e-commerce, a challenging refinancing environment, and weaker economic growth which impacts occupier demand.

Public credit spread movements so far in 2023 have been driven more by idiosyncratic issues (e.g., the banking crisis) rather than inflation or recession risk. This has supported the year-to-date public credit performance of cyclical sectors such as autos. In our view, current public spread levels poorly reflect the impact an inflation-driven recession would have on the different sectors. When compared against historical averages, we think public credit spreads (except financials) appear tight.

USD spreads versus their five-year averages

Sector	Current spread	5-year average	Percentile
Financials	166	162	54%
Banks	161	154	56%
Financial services	161	167	45%
Insurance	178	184	45%
Non-financials	136	176	15%
Basic materials	175	214	22%
Consumer goods	122	173	11%
Consumer services	139	175	18%
Healthcare	115	151	14%
Industrials	126	166	15%
Oil & gas	155	208	18%
Telecommunications	151	194	11%
Utilities	155	183	24%

Source: Markit, LGIM as at 31 July 2023.

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"Growth and interest rate sensitive sectors saw larger spread widening, including utilities and real estate."

Typically, the public credit market trends ahead of the private credit market, but this time the reverse seems true as we are already seeing evidence of growing differentiation in recent private credit transactions, with investors becoming more cautious in light of the macroeconomic uncertainty. Issuers sensitive to higher rates and inflation are needing to offer better spreads to attract investors, but more defensive issuers are still commanding strong interest. This has led to growing divergence in private credit spreads this year, and we expect the 'strong versus weak' story to continue to play out in the private credit market (and eventually extend to the public credit market).

US private placement spreads range wider

10 years	High IG (AA/A)	Low IG (BBB)
Jul-23	120-200bps	225-260bps
Jan-23	150-175bps	200-225bps

Source: Private Placement Monitor. Note that private placements predominantly capture corporate private debt transactions and only represent a part of the overall private credit market. We have also seen range widening in real estate debt and alternative debt in 2023 but there is not a comprehensive database capturing all the private credit transactions.

Index-linked private debt coupons

Inflation-linked coupons tend to be found in infrastructure debt and are not common in corporate or real estate debt. They are generally unavailable in the corporate bond market.

Within infrastructure debt, the availability of index-linked issuances is higher in sectors where there is a clear correlation between revenue and inflation. Renewable energy is a good example. In Europe, renewable projects have been able to access government schemes such as Contract for Difference (CfD) whereby the government guarantees long-term income to the power generator with annual uplifts linked to inflation. We have also seen index-linked debt in social infrastructure and utilities.

Availability of index-linked debt issuance by sector

Sector	Amount of index-linked issuance	Comment
Transport	Low	Generally fixed rate except availability-based assets with index-linked revenue streams on a contracted basis.
Digital	Low	Earlier stage businesses.
Renewables	Medium	The maturation of the sector means we see fewer government schemes with embedded inflation linkage and more power purchase agreements (PPAs) and exposure to merchant pricing. This has led to reduced issuance of index-linked debt.
Social	Medium-high	Availability-based assets, student accommodation and social housing where revenue is expected to be correlated with inflation.
Utilities	High	The returns that utility companies are permitted to earn are typically linked to inflation.

Source: LGIM Real Assets 2023

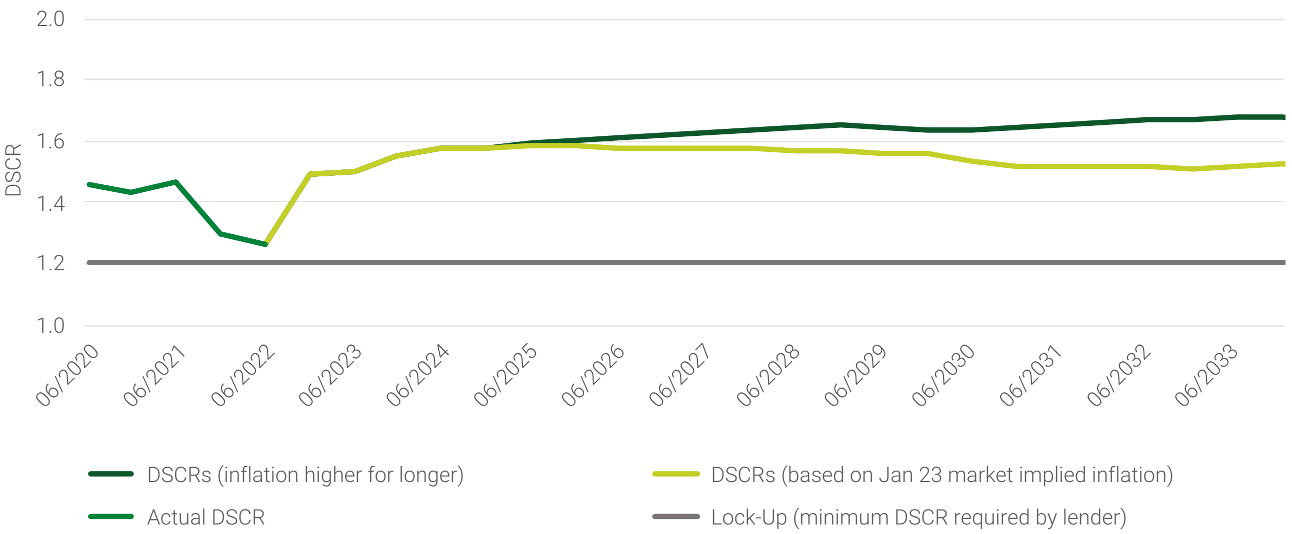
A statement we often see is that infrastructure debt provides a hedge against inflation. As we have already shown, this is true for certain sectors. Investors seeking to maximise explicit inflation protection may therefore need to be selective in their portfolio construction to get the right exposures.

A large proportion of the private credit market is floating rate (primarily in the sub-investment grade space and in alternative debt). This gives rise to an implicit link to inflation, as tighter monetary policy increases coupons. While floating rate coupons can potentially help to maintain real returns, affordability of higher debt cost becomes increasingly challenging especially for high-yield borrowers who are not prepared for a double-digit financing environment.

Inflation can be good for debt coverage in certain cases

The main cashflow-related risk metrics private credit investors monitor are interest coverage ratio (ICR) and debt service coverage ratio (DSCR). ICR is commonly used in corporate and real estate debt. DSCR, which includes total debt servicing (interest and principal) in the calculation, tends to be used for project finance / infrastructure debt where amortisation is more common.

Higher inflation can improve these metrics where revenue is strongly linked to inflation. These include renewable energy, social infrastructure and utilities. For illustration, we modelled the DSCR of a UK offshore wind farm asset under a higher inflation scenario (CPI = 5% p.a. from 2023 to 2030 versus c.3% p.a. market implied CPI). The analysis suggests a c.10% improvement in DSCR in the higher inflation scenario.



Asset type	UK offshore wind farm
Revenue	Inflation-linked – benefits from annual CPI uplifts from the CfD scheme
Operating and maintenance costs	Long-term fixed cost contract with the providers
Debt	A mixture of fixed rate and CPI-linked
Overall impact of inflation on DSCR	Positive

Source: LGIM Real Assets as at December 2022

For illustrative purposes only. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Prepare for the unexpected

Historical data show that when inflation exceeds 8% p.a. it tends to be sticky over several years. The current market pricing assumes inflation falling back towards central bank target over the next one to two years. However, if history repeats itself, investors might need to be prepared for more extreme scenarios.

An example is government intervention. Sectors with regulated index-linked revenue tend to be sheltered in a moderate inflation scenario. However, when inflation was running at above 10% in 2022[4], governments introduced caps to protect the consumer. For example, energy price caps or subsidies were introduced across Europe last year. In the UK, housing associations were required to limit the 2023 rental increase at 7% instead of the official CPI+1% (which would have been 11.1%).[5]

Price caps could become more permanent in a stagflation scenario. While we believe this may be politically popular, would be damaging to the long-term financial feasibility of these sectors, some of which are highly leveraged with thin margins.

Lastly, the impact of the unprecedented pace of interest rate hikes is beginning to feed through the economy, with cracks already showing in the banking sector. Central banks so far have stuck to their inflation-fighting mandate. We believe the risk of overtightening will put borrowers with floating rate loans or urgent refinancing needs under greater pressure, potentially generating more financial market stress in the direct lending and real estate debt markets.

Favouring high-quality assets

Private credit has fared reasonably well so far in this inflation cycle, but stubborn inflation means we see more challenging times ahead. Corporate earnings and margins are expected to deteriorate, and real estate debt faces a challenging refinancing environment. Infrastructure assets have been supported by their essential nature and, in some cases, index-linked revenues.

Our preferences continue to be high-quality assets and defensive, counter-cyclical borrowers. Our belief stems from their expected resilience in a stagflation environment, from a proven track record in previous cycles and from low exposure to floating rate debt costs.

"Price caps could become more permanent in a stagflation scenario."

4. Source: Office for National Statistics
5. Source: HM Government, rent capped at 7% from April 2023.

Contact us

For further information about LGIM Real Assets, please visit lgim.com/realassets or email contactrealassets@lgim.com

Key risks

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