Highly rated private credit – unsung heroes?

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Key messages:

As the dust begins to settle following a turbulent 2022 and the recent banking crisis, we reflect on the varying dynamics of private credit markets, their differentiation and their role in investor portfolios.

Private credit is not a homogeneous asset class. Investors should not confuse highly rated assets with deeper sub-investment grade assets such as direct lending which are, arguably, significantly riskier.

Not only have the yields for highly rated private assets become much more attractive , in our view, but they are continuing to offer a meaningful premium over public equivalents.

We believe highly rated private credit is well-positioned for recessionary conditions as it offers valuable defensive qualities for portfolios, including:

- Stability through the cycle
- Greater diversification
- Covenant protection
- Better liability matching

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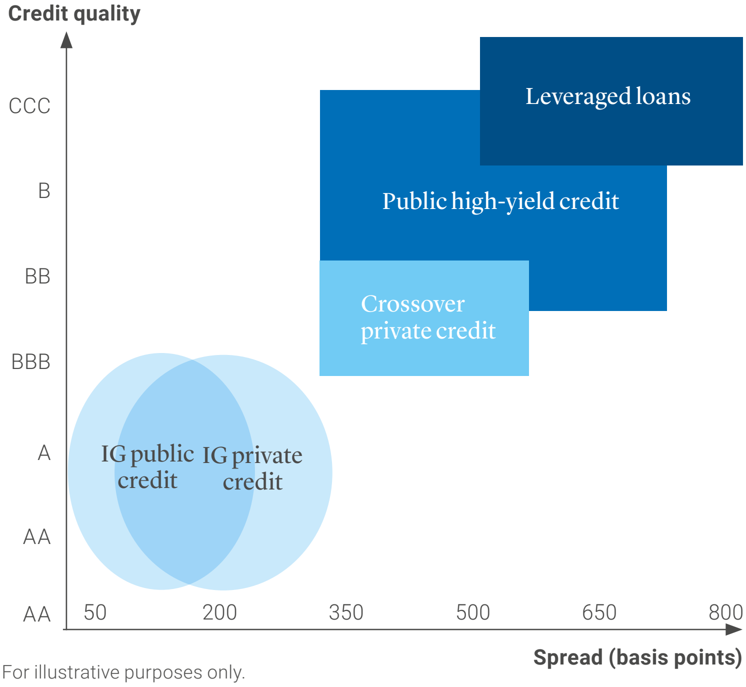
Asset class overview

References to 'private credit' often mistakenly label quite different assets under a single banner. This results in highly rated private credit, which has formed a core part of insurers' portfolios for years, being swept up with lower-rated assets that proliferated after the global financial crisis. The latter has seen a substantial increase in institutional investors' allocations over recent years in their search for yield.

The private credit market is not homogeneous, however, and serves different risk and return profiles.

Private credit: not a homogeneous market



For illustrative purposes only.

Potential areas of opportunity

Infrastructure debt

- Renewables (wind, solar & hydro)
- Digital (fibre & data centres)
- Social infrastructure
- Transport

Real estate debt

- Industrials (distribution & logistics)
- Offices in core locations
- Student accommodation and residential

Alternative debt

- Capital calls
- Supply chain financing
- Structured financing
- ESG-specific transactions, e.g., blue bonds

Corporate debt

- Traditional corporate sectors
- Utilities, housing associations
- Higher education institutions

What is highly rated private credit?

By 'highly rated' private credit, we refer specifically to investment-grade (IG) debt investments, although crossover (BB) assets can also be included. Some crossover borrowers exhibit investment grade credit metrics, strong track record and growth potential; therefore, they are high quality in the sense of being low-default risk, but they have often not achieved an IG rating due to them being smaller in size. For investors with the flexibility to invest outside IG, having some exposure to BB assets can further improve diversification and risk-adjusted returns, in our view.

For a long time, highly rated private credit has been the domain of insurance companies, particularly those from the US, who have looked to diversify their portfolios by investing globally in unlisted but high-quality assets. Over the past decade, European pension-oriented investment companies also started to build their exposure to this asset class.

'Private' does not mean a private company but is rather the nature of the investment i.e., unlisted. The investments, typically in loan or note format, span corporate, structured/ alternative, infrastructure and real estate debt markets. These markets, combined, can exceed US$1 trillion[1] of new issuance per annum.

By being unlisted and, therefore, not traded on the public market, there is a quid pro quo for investors, namely: the provision of covenants; typically a higher return than public bonds, and; often regular and direct engagement with a borrower.

1. Source: LGIM estimates.

Highly rated private credit

Interest rate and inflation exposure	Typically fixed rate. Inflation-linked and floating are also available, the latter being common in alternatives. Maturities can range from <6 months (short-dated alternative debt) through to 50 years (long-dated corporate or infrastructure debt). Typical maturities for asset classes and sectors will differ e.g., real estate <=10 years, corporate 7-15 years (longer for utilities, housing and education).
Geography	Borrowers and assets are globally based, with issuance driven by UK, Europe and the US.
Global market size in terms of annual new issuance[2]	• Corporate: up to €175bn • Alternative (or structured): up to €575bn • Infrastructure: up to €225bn • Real estate: up to €850bn
Expected return	We generally expect a spread premium of 30-60 basis points (bps) over public bond equivalents. Premia will depend on credit quality, scarcity of asset, strength of covenant/security package, size of financing etc. It can also be significantly higher than this, but is investment dependent.
Liquidity	Despite these assets not being publicly traded, there is typically strong demand for them. Primary issuances continued to be oversubscribed and upsized in 2022. There is an active secondary market and insurers can accept them as part of a bulk annuity transaction.

Case study – Landsnet*

Landsnet is the sole electricity transmission system operator (TSO) in Iceland. It is a global leader in its field, transmitting electricity from almost entirely renewable sources. Iceland leads the world in sustainable, renewable energy, with close to 100% of its electricity generated from hydro and geothermal power. Landsnet plays a critical role in powering the country and supporting the country's energy intensive industries such as aluminium smelting, silicone production and data centres.

LGIM was the sole lender in a US$60m debt issuance with the proceeds used to strengthen the electricity grid around the parameter of the country. LGIM's long-standing relationship with the company allowed us to secure the full allocation for our investors, giving them exposure to a state owned, critical infrastructure asset that is highly cash generative.

*For illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio.

2. Source: LGIM estimates. As at date 22 December 2022.

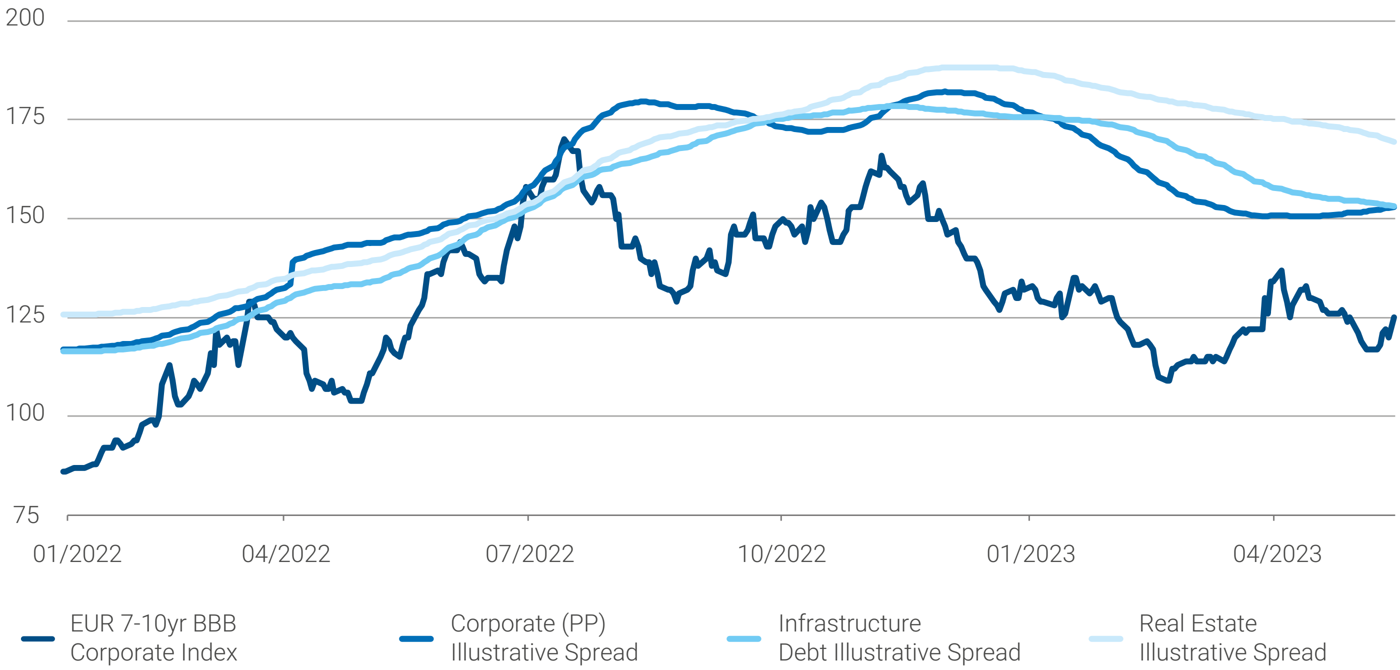
Why invest now?

More attractive return potential

Credit yields have adjusted substantially since beginning of 2022 and private credit is no exception. A widening in spreads, combined with a higher base rate, means that IG private credit transactions are currently pricing at a yield in the range of 5.0-6.5% and BB transactions at around 7-8%.[3] With the BofA Global Corporate Bonds Index currently yielding 5.2%,[4] the pick-up is still material, in our view. Given the level of return on offer is at its highest since the global financial crisis we believe this marks a good opportunity for investors to lock in higher returns. Interestingly, despite public credit spread contraction in recent months, private credit markets seem to have maintained good pricing discipline, which has seen resilient (and even elevated) premia.

The private credit spreads in the below chart are illustrative and aim to demonstrate general movement and levels in comparison with public bond spreads. As stated, private credit investments will be expected to generate good premia to publicly comparable bonds and, as such, crossover of spread lines does not indicate tighter pricing than publics on an individual investment basis.

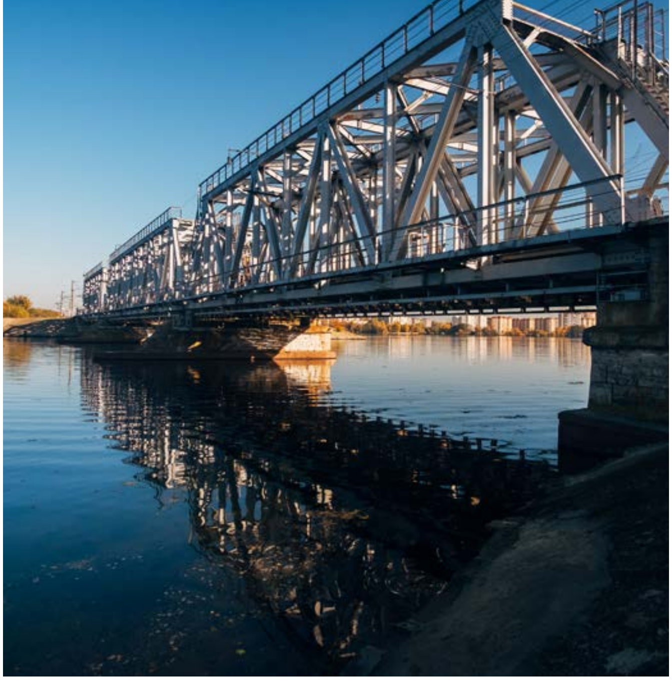
Illustrative private credit spreads vs corporate bonds (EUR)



Source: LGIM Real Assets as at May 2023, based on transactions we have observed in the market.

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.

3. Source: LGIM estimates as at June 2023.
4. Source: Bloomberg, yield to maturity as at 5 June 2023.



Stability through the cycle

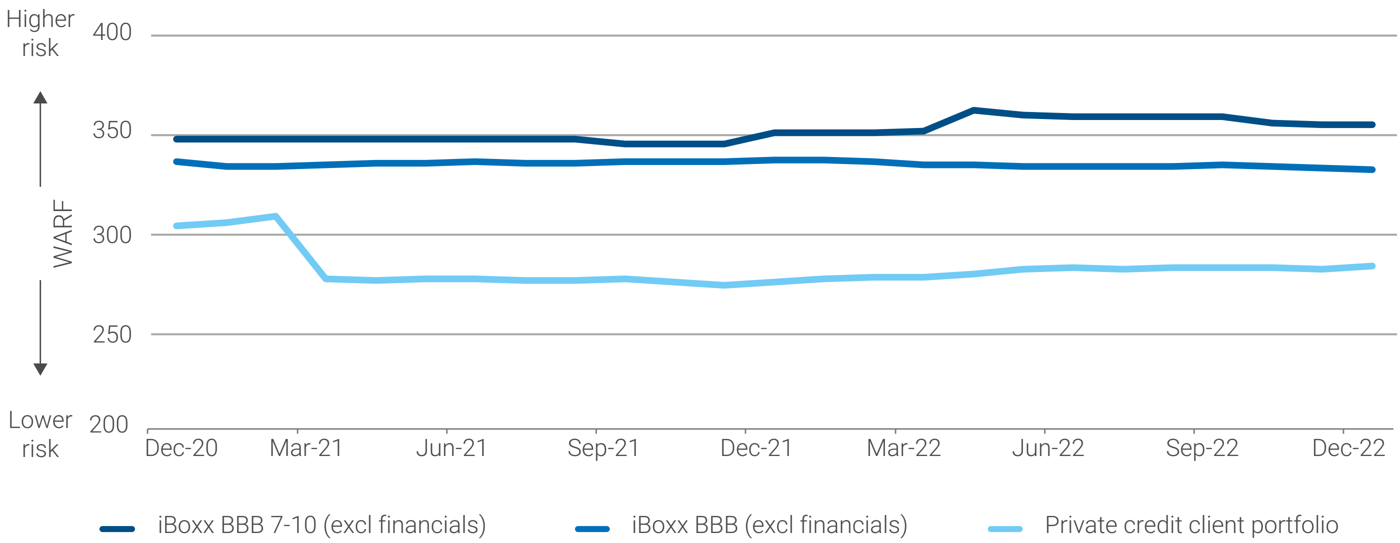
We highlighted in our 2023 private credit outlook the importance of credit quality and borrower fundamentals, as the US and Europe prepare for recession. We believe the high-quality areas of the private credit market are likely better positioned to traverse the latest cycle compared to deeper sub-investment grade assets, which may be more challenged. The recent banking crisis has reinforced this view.

To put this in context, we looked at our experience during the pandemic. In general, the portfolio rating was highly stable with no income interruption or loss, and no requirement to actively manage out of assets. This is illustrated in the below chart where we have compared the WARF (weighted average risk factor) of one of our funds against its public index comparator over the past two years. The portfolio yields c.50bps higher than the index and has achieved a slightly higher credit quality (closer to BBB+ compared to BBB for the index) and excellent rating stability.

Additional diversification

Investors can access investment opportunities that are not available on the public market, in particular infrastructure and alternatives. Assets such as lending on renewables and supply chain finance also cannot be easily proxied by public assets. Within the corporate debt space, we are seeing an uptick of borrowers who prefer the flexibility and stability of the private market - this includes large public companies which target specific maturities, cashflow structures, or simply do not wish to meet the more stringent requirements of issuing bonds in the public market.

WARF comparison: LGIM client portfolio vs public index comparator



Source: LGIM, Moody's and Bloomberg. For reference, the WARF ratings for BBB+/BBB/BBB- are 260, 360 and 610.

The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Stronger protection

Private credit transactions typically come with documentation protections not available to public bond holders. These are designed to control borrower behaviour and credit risk, promote effective engagement and maximise recovery in the event of a default. In the current environment, we believe these protections are especially valuable.

Protection is typically achieved through seniority in the capital structure, covenants on key financial metrics such as leverage and debt service (or interest) cover and, depending on asset class, may include security over assets and/or cashflows. As a result, investors can be more certain that the borrowers intend to live within certain performance parameters, which reduces the likelihood of downgrades and default.

ESG considerations, engagement and impact

The direct and flexible structure of private credit transactions can be highly effective in integrating environmental, social and governance (ESG) considerations into the investment process and encouraging borrowers to adopt a more sustainable business strategy. We proactively work with borrowers to incorporate sustainability-linked provisions and increasingly offer a pricing benefit if they agree to meet certain ESG targets e.g., reducing carbon footprint.

A significant and increasing proportion of private transactions are focused on decarbonisation, positive social impact and biodiversity efforts. In recent years we have participated in the financing of (among others):

- Manufacture of new fleets of electric trains in London
- Retrofitting for a number of UK housing associations to boost energy efficiency and reduce bills for tenants
- Marine conservation in Belize with credit risk insured by a highly rated US government body

The private nature of the investments, coupled with the requirement for borrowers to report and measure financial and covenant performance, provides lenders with the context for more transparent dialogue. This leads to a higher level of engagement. It is common for private credit lenders to meet with management regularly, outside normal investor communication cycles.

Case study – Sustainability linked blue bonds

In 2021, LGIM made its first commitment to a blue bond, supporting marine conservation in Belize. The government of Belize worked in partnership with The Nature Conservancy to restructure its external public debt, thereby significantly reducing the country's existing debt service costs, while also securing funding for marine conservation activities.

A proportion of the proceeds and interest payments of the loan will go towards protecting essential coastlines of Belize, which accommodate a rich biodiverse barrier reef – the second largest in the world and a UNESCO recognised world heritage site. The reef is also a key driver of Belize tourism, essential for the economy.

Belize is targeting eight key milestones in relation to the marine conservation, including expanding biodiversity protection zones. In the event it does not achieve these milestones; it will need to make increased payments to the conservation funding.

In summary

It is important not to confuse highly-rated private credit with its deeper sub-investment grade siblings. The former has been generating stable returns and diversification for institutional investors for decades. Current returns, combined with robust protections, make highly-rated private credit a compelling universe of investment opportunity in general, but especially so in today's environment, in our view.

This asset class is also playing an increasingly significant role in providing the capital required to accelerate progress in the net-zero transition, as well as socio-economic regeneration and environmental protection.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

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