Structural protection in private credit

Managing default risk for investors.

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Over the last 40 years, we have experienced an enduring bond bull market and yields on fixed income assets have fallen to record lows. The compression on spreads has led to a reduction in the margin for error, magnifying the impact from any defaults. This has driven many investors to a buy and maintain approach, particularly pension schemes, for whom stable income generation is a key objective.

Managing default risk is critical for private credit, particularly since there is no public market for trading these assets. The borrowers could be unlisted entities with limited public data, which means the investment team needs to have the right skills to carry out in-depth due diligence on the borrower to determine credit risk.

However, private credit transactions typically come with valuable contractual provisions ('structural protection') that give private investors more say, especially in the context of deteriorating performance. These do not tend to be available to public corporate bond holders. This protection can take a number of different forms. Structured correctly, it ultimately gives the lender control ahead of the borrower's assets falling below the face value of the loan.

What is structural protection?

Structural protection typically falls into three main categories:

1. Seniority refers to the priority of ranking in a capital structure and determines repayment mechanisms that apply to creditors. Investors higher up the capital structure will be paid out earlier and are thus better protected from potential losses if the borrower defaults.

2. Covenants are clauses in the lending agreement that apply restrictions on a borrower to limit excess risk-taking and promote good governance behaviours. They can be both financial (e.g. cashflow or asset leverage, interest coverage ratio (interest payment relative to income), minimum asset value, etc.), and non-financial (restrictions on the amount of priority debt, restrictions on paying dividends, etc.), with the aim of ensuring borrowers meet specific requirements and/or are prohibited from certain activities. A breach of covenant could lead to earlier debt repayment or additional cash to the lender.

3. Security represents a lien (charge) over a borrower's assets. This may be over physical assets/collateral (real estate, equipment etc.), contractual cash flows (income from an asset) or equity, depending on the type of investment.

Key risk
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How does structural protection add value?

1) By controlling borrower behaviour and credit risk during the period of the loan. Covenants are particularly helpful in promoting sensible financial management of the borrower and, in general, borrowers are keen to avoid stressing the covenants in the first place, which reduces the chances of default. Ongoing monitoring of a borrower's performance against these can give early warning signs of credit deterioration and facilitate discussion between borrowers and lenders to address the problem quickly (which could result in better compensation, stricter behaviour from the borrower or additional protection for the lender if the credit risk is deemed to have increased).

2) Effective engagement between lenders and borrowers. Private credit financing can be undertaken on bilateral or syndicated bases. Notwithstanding, structural protections can promote transparent and productive dialogue. In a stress situation, the lenders can quickly work together earlier on to support the borrower's return to better 'health' and/or transition to recovery, both of which are designed to ensure the lenders' value is maintained.

3) By maximising recovery should a default occur. If an investment/ borrower fails, the recovery value will depend on various factors, including the nature of a borrower's asset base (physical assets, contractual cashflows, brand etc.), the market for those assets and, importantly, the seniority of an investor's claim on those assets. LGIM focuses on senior debt, placing us high in the capital structure and toward the front of the queue in terms of claims on assets pledged against the loan in the event of default. We estimate that structural protection could add around 25bps p.a. to yield enhancement versus public bonds.[1] Depending on the value of the cash flows and/or assets pledged, together with the compensation mechanics of the legal document (e.g., make-whole), it could even be possible to recover more than the loan balance after a default.

[1]This assumes a 15% improvement in recovery post-default for private credit.
[2]An encumbered asset test refers to the amount of assets on the borrower's balance sheet that are subject to a legal claim by the lender in the case of default. The test becomes more challenging to pass when asset values fall. A breach could represent severe consequences for the borrower, including enforced acceleration in repayment and court proceedings, and could lead to the borrower's demise.

Case study 1

LGIM provided financing for the procurement of several fleets of new electric trains. Delivery by the manufacturer was delayed significantly due to several factors including Covid-19, which impaired the borrower's ability to repay the loans (as the borrower is reliant on income from leasing the new trains to the operators). As well as the loan being senior and secured against the trains, other protection mechanisms were built in to insulate LGIM from a potential default, including:

- The loan was structured such that the manufacturer would compensate the borrower in case of significant delivery delays. In turn, LGIM set strict criteria on how the compensation could be spent, with debt servicing a top priority.

- The borrower paid half of the procurement costs upfront (financed by LGIM). The manufacturer provided a letter of credit from a bank with a strong credit rating, which means in the event of no delivery, the borrower would be able to recoup the down payment from the bank and use it to repay the loan from LGIM.

Case study 2

LGIM held private placement debt in a UK retail property company. One of the covenants included an encumbered asset test,[2] which the borrower was going to breach in 2020 as a result of combination of lockdowns and falling retail property values. The borrower approached LGIM and the other private placement lenders for a covenant amendment. Due to LGIM's expertise in retail real estate, we led a coordinated negotiation between the lenders and borrower, ending in additional protections in exchange for a loosening in the encumbered asset test covenant. These improvements were not granted to other creditors, including banks and corporate bond holders. The most valuable addition was a requirement for the borrower to offer full pre-payment of the loan upon any significant equity raising or asset disposal, both of which the borrower carried out several months later. LGIM decided to accept early repayment in full, ensuring no losses as a result of the exposure to the troubled borrower.

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Looking ahead

Market uncertainty is likely to persist for the foreseeable future, driven by the ongoing Covid-19 pandemic, the timing and materiality of central bank tapering, concerns over inflation, and geopolitical tensions, amongst other factors. We believe retaining robust structural protection is therefore critical in ensuring cashflow certainty during times of market turbulence.

ESG considerations are also important in private credit, particularly given the long-term and illiquid nature of the loans. The direct and flexible structure of private credit transactions can be highly effective in facilitating ESG integration into the investment process and potentially encouraging borrowers to adopt a more sustainable business strategy.

1. Engagement. The private nature of the investments, coupled with the need 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.

2. Sustainability-linked terms. We proactively work with borrowers to incorporate sustainability-linked provisions. For example, in a recent social housing transaction, we asked the borrower to ringfence the proceeds for energy efficiency improvement and socially positive initiatives. We also increasingly offer borrowers a pricing benefit if they agree to meet certain ESG targets, e.g. carbon footprint reduction.

What about illiquidity?

For many institutional investors, retaining a good degree of liquidity in a portfolio is a key objective. This is one of the main factors why the allocation to private credit significantly lags behind its more liquid corporate bond counterparts, despite the yield premium and structural protection benefits of the former.

Although it is difficult to assess the relative importance of structural protection versus liquidity, we offer the following observations as food for thought:

- **It is important to maintain an appropriate level of liquidity** so investors can meet their obligations, especially those seeking to insure their liabilities in the short to medium term.

- **Nevertheless, liquidity comes at a cost (in terms of the illiquidity premium)** and having too much liquidity could dampen returns and thus the ability to reach long-term investment objectives. Investors are unlikely ever to liquidate their entire portfolio (with the possible exception of a bulk annuity transaction for pension schemes).

- **The main purposes of a strategic allocation to credit are to harvest the credit premium and benefit from income generation.** This is particularly true for buy and maintain mandates, where the assets are expected to be held to maturity and the turnover is generally kept low. Although corporate bonds can be traded on a daily basis, their liquidity would only be expected to be utilised when other better sources of liquidity had been exhausted.

- **It is also worth noting that the transaction cost of trading corporate bonds remains high** (c.1% for a round-trip) and the market experienced a severe liquidity crunch during the Covid-19 pandemic. However, despite the apparent illiquidity, there is an active secondary private credit market, and high-quality assets can be sold quickly.

- **As such, it is worth considering whether a higher degree of illiquidity can be tolerated within a credit portfolio.** In our view, private credit exemplifies the buy and maintain investment style and fits well as part of a broader allocation. The higher cashflow predictability created by structural protection even during challenging market conditions could be very valuable to income-focused investors.

Conclusion

Structural protection can be a key return driver in private credit, using mechanisms unavailable in the public market. Given the level of ongoing market uncertainty, we believe investors should consider looking to improve the resilience of their credit portfolio by seeking such protections. One approach could be to incorporate private credit into a broader buy and maintain credit allocation, for example as part of a long-term de-risking plan. Holistic liquidity analysis can help investors understand their reliance on credit assets for liquidity and determine their tolerance for private credit within the portfolio.

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