

2023 private credit outlook: all about the yield



Lushan Sun

Private Credit Research Manager
LGIM Real Assets

Executive summary:

- Overall, we believe the higher quality areas of private credit markets – investment grade (AAA to BBB-) and crossover (BB category) – can provide attractive investment opportunities given elevated yield levels.
- We prefer counter-cyclical sectors, those with good pricing power and strong structural protections which, we believe, can provide more defence against current recessionary conditions.
- By contrast, our view is that deeper sub-investment grade investment assets (such as direct lending), which have seen a surge in investor allocation over recent years, will be more challenged in a higher-rate, weaker-growth environment.



Some of our key considerations for 2023:



Yields: on the rise

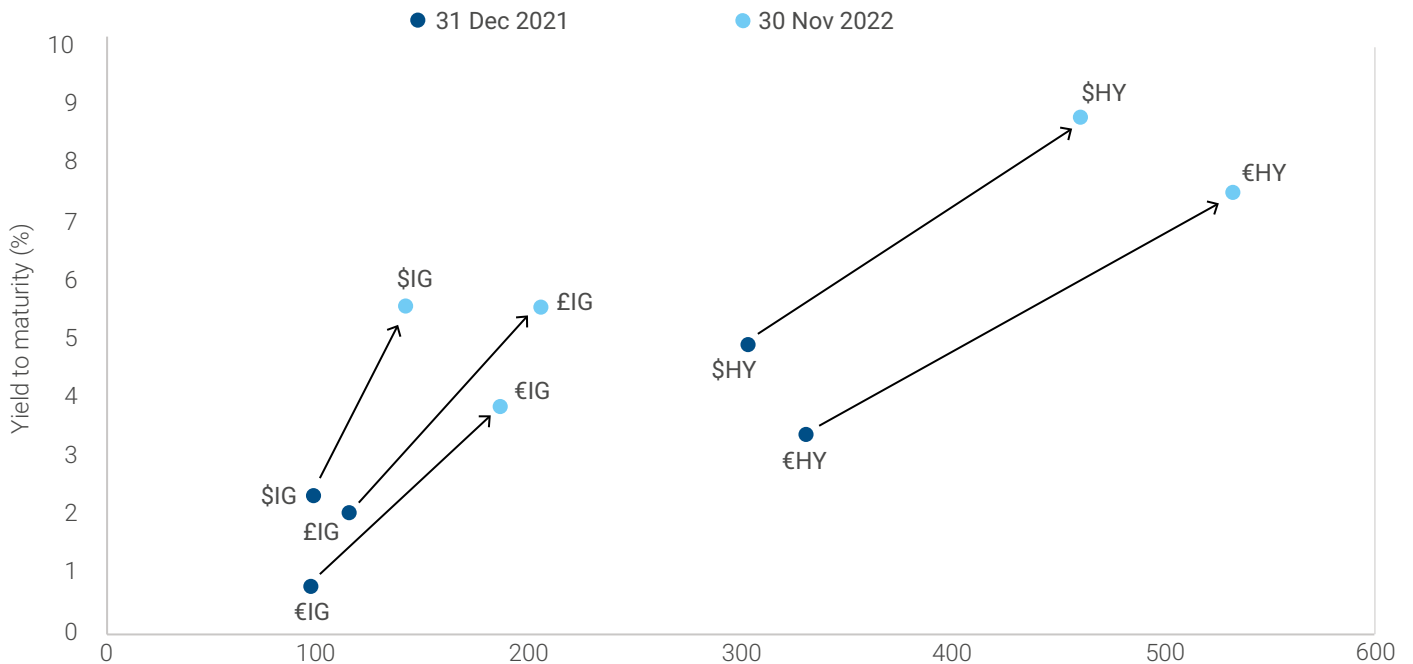
- Credit yields have moved substantially higher in 2022 to levels not seen since the GFC. Reflecting the trend in public bond markets, private credit spreads have widened.
- Together with a higher base rate this means that private credit transactions in the investment grade (IG) space have been producing yields between 5% and 8%,¹ sometimes even higher depending on asset class, duration, geography and sector.
- While it's difficult to conclude whether this is the 'new normal', it seems unlikely that yields will revert to their pre-2022 lows anytime soon.
- Based on past experience, we believe current IG spread levels provide a good buffer against potential default loss, bringing opportunities to generate good returns, while benefiting from structural protections.
- Any potential pivot in monetary policy from the US Federal Reserve – from hikes to cuts – could make fixed rate assets more attractive, in our view.



The 'cost of everything' crisis

- The earnings outlook is deteriorating in 2023 due to weaker consumer spending and higher costs of energy, labour and materials.
- As a result, borrowers in counter-cyclical sectors or those with strong pricing power are better positioned, in our view. [Our analysis shows](#) that bonds from sectors with strong pricing power have historically performed better in terms of default and mark-to-market volatility.
- We see cyclical sectors and/or those dependent on consumer discretionary spending as most affected, including sectors that are still recovering from the pandemic such as retail, travel and leisure.
- We expect to see a rise in sector and company dispersion over the next few quarters based on credit fundamentals.

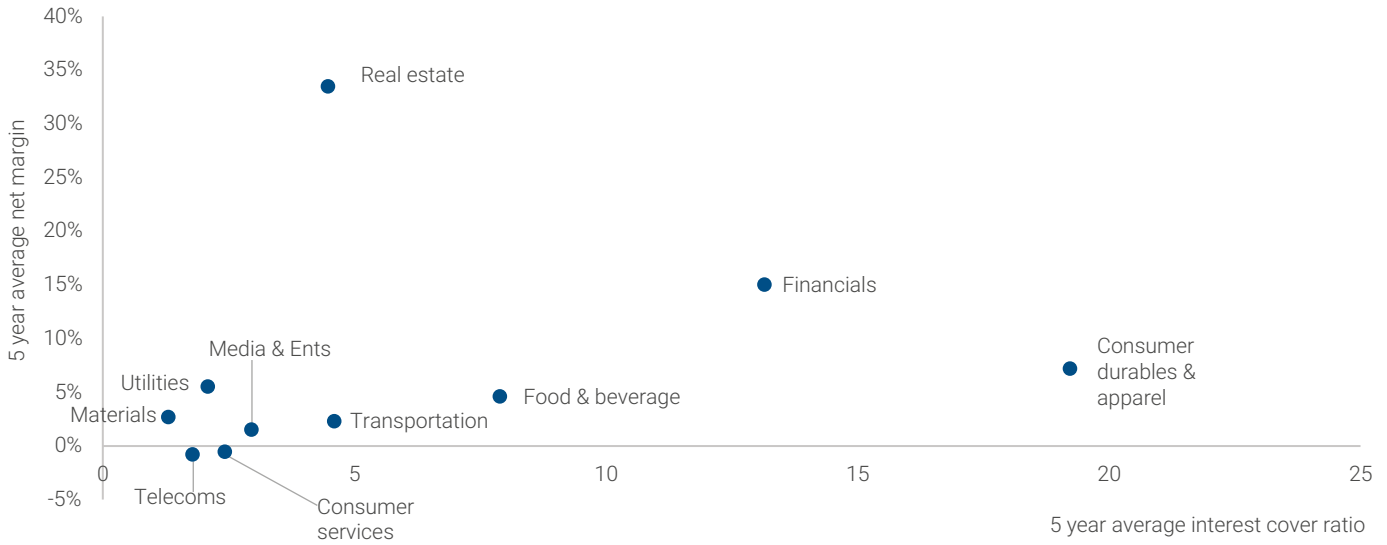
Credit yield hitting levels not seen since the Global Financial Crisis (GFC)



Source: ICE indices as at 30 November 2022.

1. Source: LGIM RA estimates as at November 2022 for illustrative purposes only, based on our experience.

Debt servicing capacity and profitability for selected corporate sectors in the UK



Source: LGIM analysis, Bloomberg, as at 31 October 2022 based on constituents of the FTSE All-Share Index.



Higher for longer?

- The consensus is that policy rates in US and Europe are likely to peak in mid-2023 before falling in late 2023 or 2024, as inflation is currently forecast to normalise rapidly over the next 12-18 months.
- However, history suggests that once inflation hits very high levels (>8% p.a.) it tends to be sticky over several years, so we need to be prepared for a ‘higher for longer’ scenario and consider implications for borrowers.
- The rise in funding costs will expose borrowers’ ability to service debt and refinance at a time when earnings are being challenged. [Structural protection](#) will prove its worth in a time of rising credit risk.
- Deeper sub-IG borrowers, with more exposure to floating rate debt and less financial flexibility to manage/absorb costs, will likely come under greater pressure, in our view.



4 Energy security and transition

- The war in Ukraine has led to a rethink in Europe on how to balance net-zero goals with a new imperative for energy security. We believe that there will be no long-term energy security without decarbonisation.
- Decarbonising the energy system is going to require a significant injection of capital into infrastructure, associated supply chains and technologies that mitigate the intermittent nature of renewables (when the wind doesn’t blow, or the sun doesn’t shine).
- Significant investments are also needed to support the broader transition to net zero for real estate, transportation and corporate sectors.

Corporate debt

The corporate debt market has remained open and competitive² despite volatility in the public bond market, which has led to more borrowers approaching the private market for debt financing. In 2022, we saw a wider range of borrowers across different sectors including FTSE 100 and 250 companies, as well as ongoing activity from the usual sources such as housing associations and universities. This has been positive for portfolio diversification, and we expect the trend to continue in 2023.

Anecdotal evidence suggests that the pipeline has been busy despite some initial reluctance from borrowers to raise finance at current yield levels. Investor demand remains strong particularly from dollar-based investors. Despite that, our observation is that the market has shifted in favour of the lenders. Pricing has become less aggressive, and borrowers appear more willing to accept more restrictive covenant requirements.

Against the recessionary backdrop, we prefer counter-cyclical sectors and will continue to focus on revenue resilience, cost management and long-term sustainability.

Real estate debt

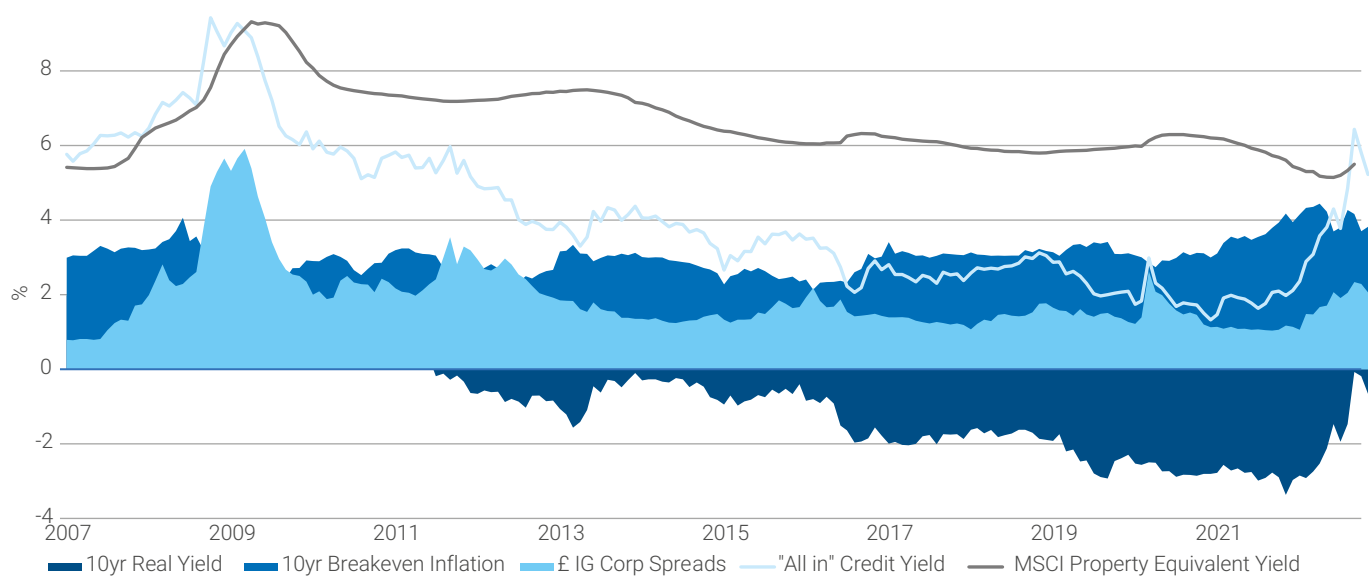
After years of strong growth, the real estate market underwent a valuation correction in the second half of 2022 as property yields started to catch up with rising bond yields.

Our views on the fundamentals of real estate debt have not materially changed. Leverage for senior loans (measured in loan-to-value) has fallen from 70-80% pre-GFC to 50-60% today.³ Demand for assets in industrials, student accommodation and residential sectors remains healthy and occupier performance has been stable during 2022. Debate about the future of offices is ongoing. Our preference is to lend against high-quality, well-located buildings that have strong green credentials.

The rise in yield means that maintaining a prudent interest cover ratio (ICR) is now the critical challenge. The relative short maturity of real estate debt – typically five years – means that a significant chunk of outstanding debt needs to be refinanced every year. Significant equity injections are expected at the next refinancing in order to meet lenders’ ICR requirements. Not all borrowers would have sufficient capital and this, in our view, could throw up opportunities for debt investors to step in and provide financing at attractive yields.

Despite a slowdown in activity in 2023 we believe lenders will likely benefit from improved return prospects. The key is to structure transactions prudently to allow for risks stemming from higher-than-expected interest rates or a further downturn in the property market.

Playing catch-up: Corporate bond yields and property yields



Source: Bloomberg, MSCI, as at 30 November 2022.
 2. Based on the degree of oversubscription in the new issuance market.
 3. Source: Bayes Business School, 2022.

Infrastructure debt

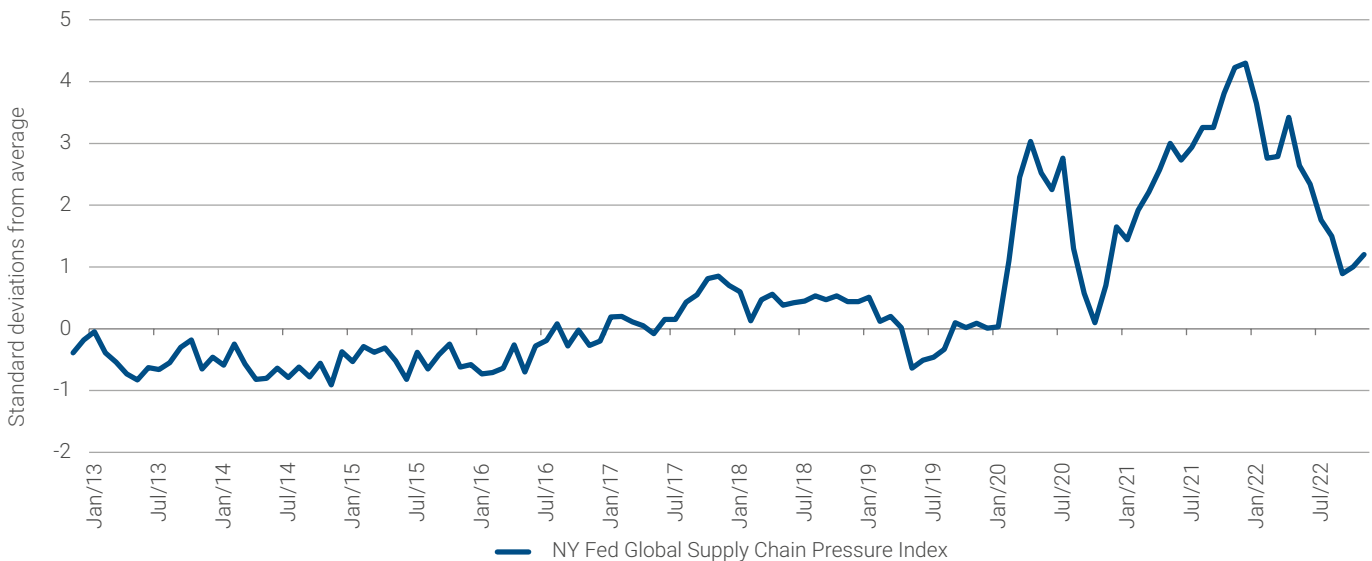
Infrastructure debt experienced a smaller adjustment than other asset classes in 2022. Based on current observations, we believe renewables (and the energy sector in general), digital assets and essential economic infrastructure continue to attract a high level of investor demand. As a result, based on the transactions we have seen this year, asset valuations have yet to experience a significant drawdown and debt spreads only modestly widened in the IG space over 2022.

The central question is whether the effect of higher bond yields will eventually extend to the core infrastructure sector, resulting in a pricing correction and higher spreads. For now, we are seeing better pricing in crossover (BB) assets and pockets of value in IG, for example renewables in Europe. At the same time, we are expanding our universe to search for new growth areas such as battery storage and carbon capture.

Energy dominated the agenda in 2022 and is likely to do the same in 2023, given that the war in Ukraine has put the need for energy security into sharper focus. Longer term, the current situation is likely to accelerate clean energy deployment. According to the REPowerEU Plan, the EU set out more ambitious transition targets in its immediate response to the energy crisis by raising the share of renewables in the energy mix to 45% by 2030. Similarly, the Inflation Reduction Act in the US aims to spur investments in clean energy.

In our view, this represents a real opportunity for institutional investors to provide much-needed capital. While investors will need to carefully assess the economics of new developments, given rising capex costs and windfall taxes in Europe, the renewed focus from governments has provided a structural tailwind in our view, and conditions for private investors could become more favourable.

Supply chain pressures are easing



Source: Federal Reserve Bank of New York as at July 2022.

4. Source: Prequin as at September 2022.

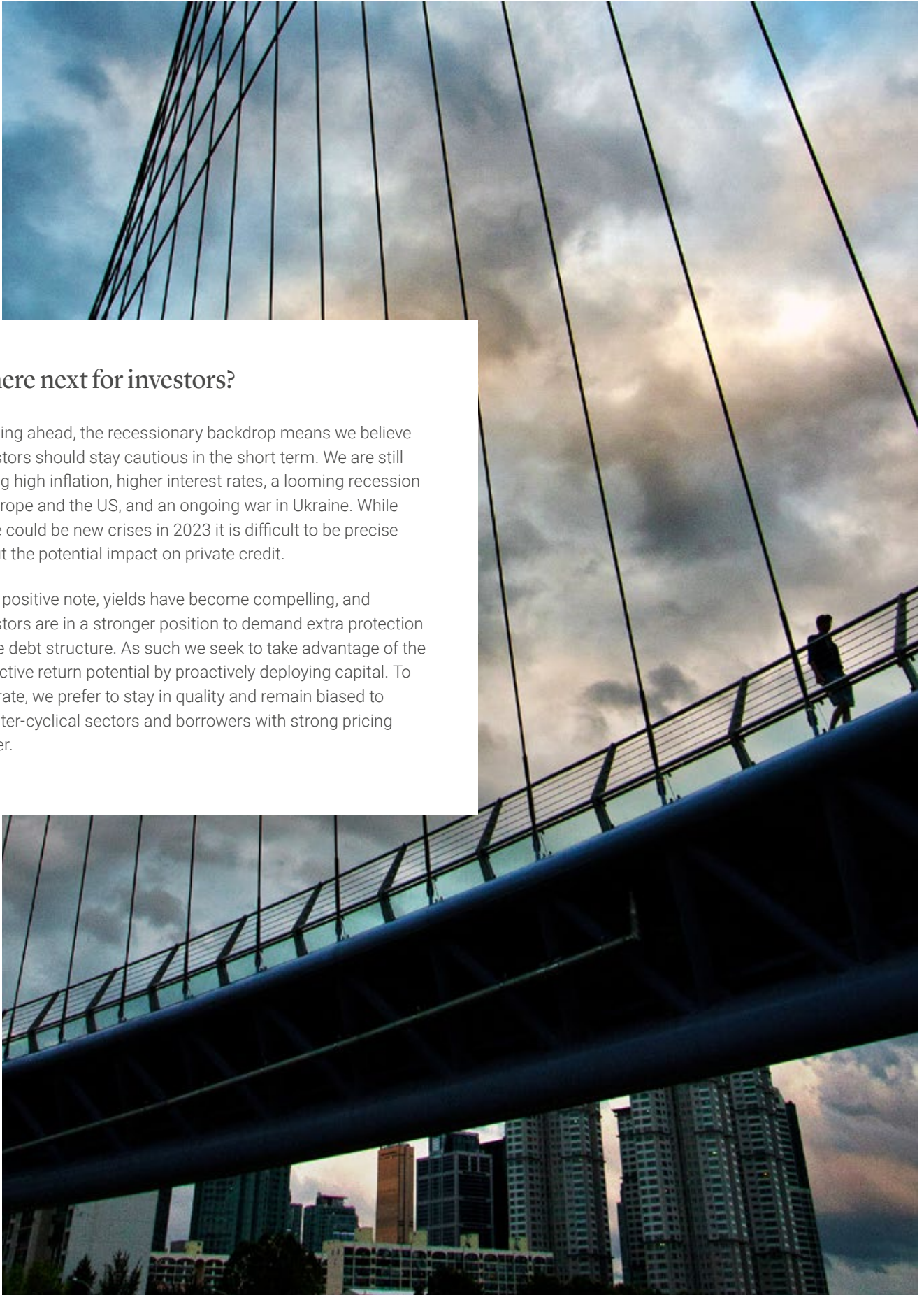
Alternative debt

2022 was a busy year for alternative debt and we expect pipeline growth to continue into 2023. We believe, bank entrenchment, driven by a combination of regulatory pressure and balance sheet de-risking, has given other less encumbered investors access to richly priced short- and long-dated opportunities.

The short-term nature of some of the assets (typically three months for supply chain financing and up to 12 months for capital-call facilities) means they give investors more flexibility when it comes to managing liquidity needs and minimising cash drag.

The ongoing supply chain disruption has led to greater demand for supply chain financing. As companies moved from ‘just in time’ to ‘just in case’, they sought to build up their inventory and in turn increased their requirement for bridging financing. While the expectation is that disruptions will normalise over 2023, we believe the shift in the way companies manage their supply chains (and thus demand for supply chain financing) is probably here to stay.

Private equity firms have been busy deploying capital in 2022⁴ which has supported demand for capital-call facilities. While we believe heightened recession risk could lead to a slowdown in M&A transactions in 2023, new fund launches in real estate and infrastructure should help diversify exposure to funds and managers.



Where next for investors?

Looking ahead, the recessionary backdrop means we believe investors should stay cautious in the short term. We are still facing high inflation, higher interest rates, a looming recession in Europe and the US, and an ongoing war in Ukraine. While there could be new crises in 2023 it is difficult to be precise about the potential impact on private credit.

On a positive note, yields have become compelling, and investors are in a stronger position to demand extra protection in the debt structure. As such we seek to take advantage of the attractive return potential by proactively deploying capital. To reiterate, we prefer to stay in quality and remain biased to counter-cyclical sectors and borrowers with strong pricing power.

Contact us

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