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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 homogenous asset class. Investors should not confuse highly rated assets with deeper sub-investment grade assets such as direct lending which are significantly riskier.

Over recent months yields for highly rated assets have become much more attractive, in our view, and are offering a meaningful premium over public equivalents.[1]

In our view, highly rated private credit is well-positioned for recessionary conditions as it offers valuable defensive qualities including:

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

1. Source: LGIM Real Assets as at December 2022, based on transactions we observed in the market.

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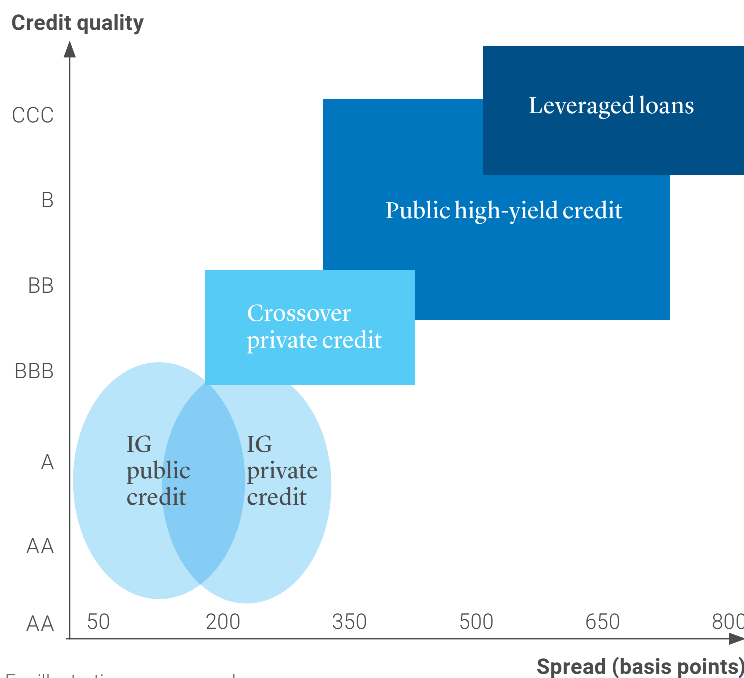
Asset class overview

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 homogenous, however, and serves different risk and return profiles.

Private credit: not a homogenous market



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Potential areas of opportunity

Corporate debt

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

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

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 have a 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 $1 trillion[2] 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, direct engagement with a borrower.

2. 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.
Estimated global market size in terms of annual new issuance	• Corporate: up to £150bn • Alternative (or structured): up to £500bn • Infrastructure: up to £200bn • Real estate: up to £750bn
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.
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 – Halma plc*

Halma is a global safety, medical and environmental technology business. Its products include fire detection and suppression, water analysis and treatment and healthcare assessment. The non-discretionary nature of Halma's offerings means that demand tends to be inelastic, and it is well positioned to manage the impact of cost inflation. The company has set a target of net-zero scope 1 and 2 emissions by 2040.

The firm is FTSE 100 listed. It is a repeat issuer in the private placement market and has no public debt. In July 2022, it raised £330 million through private placement notes in which LGIM participated. This provided our clients debt exposure to a high-quality UK company operating in a non-cyclical sector otherwise unavailable in the public market.

*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.

Why invest now?

More attractive yields

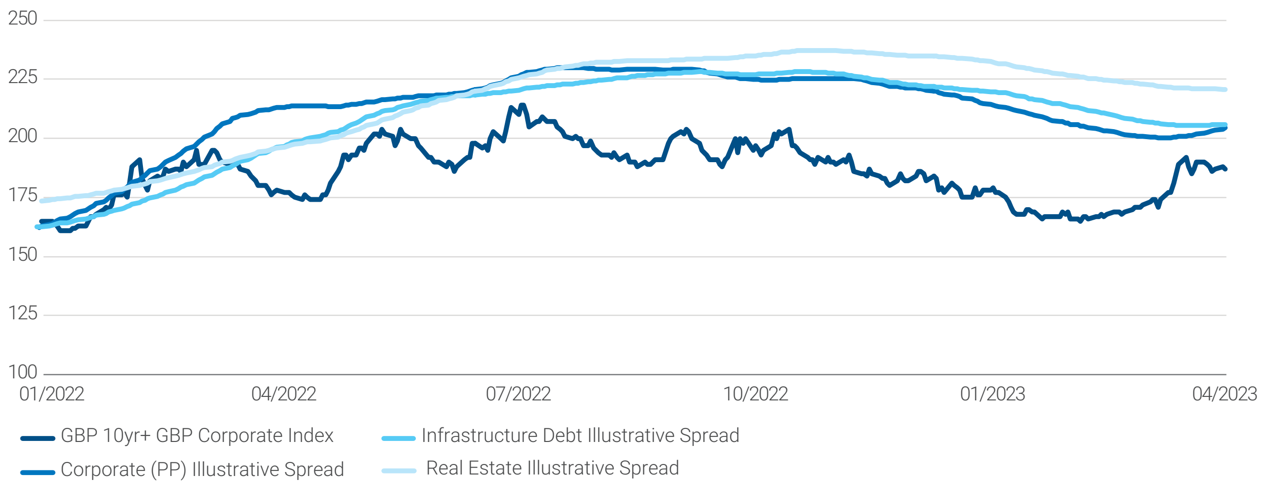
Credit yields have adjusted substantially since the beginning of 2022 and private credit is no exception. A widening in spreads, combined with a higher base rate, means that IG private credit transactions have been pricing at a yield in the range of 5-6.5%[3] and BB transactions at around 7-8%.[4] With the BofA Global Corporate Bonds Index currently yielding 5%[5], the pick-up is still material, in our view.

Stability through the cycle

We highlighted in our 2023 private credit outlook the importance of credit quality and borrower fundamentals as US and Europe prepare for a recession in 2023. We believe the high-quality areas of the private credit market are 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 our view.

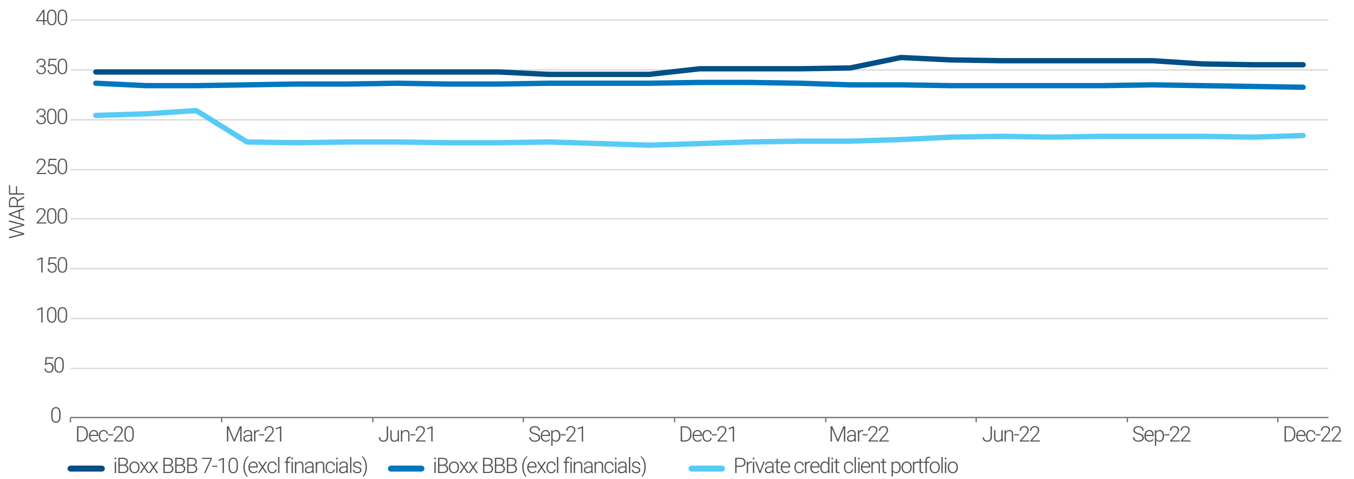
To put this in context, we looked at our experience during the pandemic. In general, the portfolio rating was highly stable with no income interruption or loss, and no requirement to actively manage out of assets. This is illustrated in the below chart where we have compared the WARF (weighted average risk factor) of one of our UK pension clients against its public index comparator. 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 over the last two years.

Illustrative private credit spreads vs corporate bonds



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

Illustrative private credit weighted average risk rating (WARF) vs corporate bonds



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

3. Source: LGIM estimates as at March 2023.
4. Source: LGIM estimates as at March 2023.
5. Source: Bloomberg as at 18 April 2023.

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.

Additional diversification

Investors can access 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 FTSE 100 and 250 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.

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 could be especially valuable.

They are typically achieved by high seniority, 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 much more certain that the borrowers intend to live within certain performance parameters, which should reduce the likelihood of downgrades and default.

Better liability matching

UK defined benefit (DB) pension schemes in general experienced a significant improvement in their funding levels in 2022. Volatility in the gilt market also highlighted the risks of over-reliance on leveraged liability driven investments (LDI).

Regulatory reform opening up opportunities

In the UK, we are currently awaiting updates on the Solvency 2 reforms. Proposed changes include greater flexibility with respect to repayment and construction, together with lower capital requirement jumps between investment- and sub-investment grade assets. Although the proposed changes are not directly relevant to non-insurance investors, if implemented there could be a substantive increase in the universe of investment opportunity, notably in infrastructure (and potentially real estate) debt, which may benefit all investors.

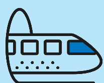
As a result, DB schemes have been reducing leverage in their LDI portfolios, as such they need to increase the contribution from physical assets to the overall hedge. With less leverage, the physical assets also need to generate sufficient returns to support the long-term objective.

The flexible nature of high-quality private credit assets means that DB schemes can build a portfolio tailored to their cashflow profile, and at the same time aim to take advantage of the additional yield on offer. Maturities range from less than 6 month to 50 years, compared to very specific issuance maturities in the corporate bond market. Loans can be structured as bullet or amortising, and some come with inflation linkage.

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.

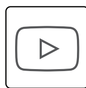
Belize is targeting eight key milestones in relation to the marine conservation, including expanding biodiversity protection zones. In the event that it does not achieve these milestones, it will need to make increased payments to the conservation funding.

In summary

It is important not to mix highly rated private credit with its riskier, deeper sub-investment grade siblings. The former has been generating stable returns and diversification for institutional investors for decades. Current yields, combined with robust protections, make highly rated private credit a compelling opportunity in today's environment, in our view. This asset class is also playing an increasingly significant role in providing capital to potentially 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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