

Private credit outlook



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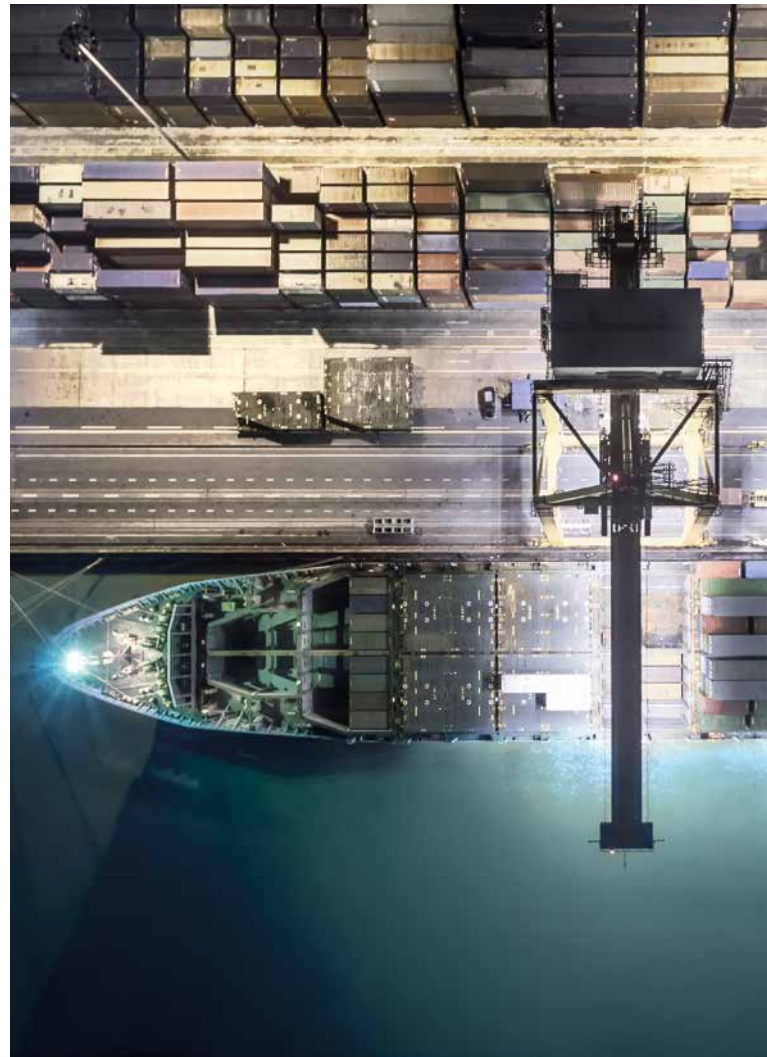
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2020 was a difficult year, for society, businesses and markets alike. The pandemic presented new and unforeseen challenges, creating periods of extreme uncertainty, and correspondingly high volatility in financial markets. As a result, governments and central banks around the world created unprecedented stimulus packages, which have effectively underwritten market spreads. This stimulus, combined with vaccination efforts, provides a much needed fundamental support, allowing countries to emerge from the pandemic, whilst providing confidence to lenders and borrowers to further promote growth and recovery.

As we look forward, we believe that 2021 has and will continue to show a clearer path to recovery ("normality"), although a number of headwinds persist, including the potential for new virus variants to emerge, the scale of the vaccine rollout, and an increasing debt burden (both sovereign and corporate). As such, positive market sentiment notwithstanding, we remain cautious and highly selective in our investments.



In private credit, we believe of the following key themes will drive investment activity in 2021:

- **Relative value:** Whilst we have seen a persistent spread tightening in public markets, this has been less pronounced in the private credit markets, creating a healthy relative value proposition;
- **Interest rates and stimulus:** Following unprecedented stimulus in 2020, market valuations have been extremely buoyant. As economies return to growth, the resultant inflation and rate moves could drive market disruptions if investors read this as a signal of withdrawal or a reduction in the need for stimulus. This could manifest in a so-called "taper tantrum", where credit spreads rise for a sustained period or in short-term spikes;

- **Continued shift in lender mix:** Banks continue to shrink their balance sheets, creating opportunities for institutional lenders to provide financing. This is particularly pronounced in the alternative debt markets;
- **Reliance on infrastructure for recovery:** The government has publicly emphasised the role of infrastructure in supporting recovery. We believe this will further stimulate opportunity, notably across renewables and digital infrastructure;
- **Covid Corporate Financing Facility (CCFF) refinancing:** A number of corporates (45 corporates, with £10.1bn nominal exposure)¹ utilised the Bank of England's COVID-19 loan scheme to provide additional liquidity and stability during the pandemic. The potential refinancing of some of these facilities may create opportunities for institutional lenders over the longer-term.

Given the nature of private markets, the pricing dynamics between each asset class and the changing lender mix, we expect to see variations in the risk/reward profiles of each asset class in 2021 and beyond. This supports our belief in a multi-asset approach to investing in private credit.



Corporate debt

The pandemic and associated disruption had an impact on corporate private debt issuance during March and April 2020 as initial lockdown measures were implemented. Despite this pause, the remainder of the year saw a steady flow of corporate issuers continuing to access the private debt market, taking advantage of historically low benchmark yields, shoring up balance sheets and bolstering liquidity.

The picture varies significantly across sectors. Impacts upon the most exposed sectors were immediate and profound, and issuance in these sectors was and will probably remain very limited. Where borrowers could raise debt, investors remained cautious, which caused spreads to widen significantly. In sectors more insulated from the effects of the pandemic, such as consumer non-cyclicals, utilities, housing associations and logistics, the effect upon spreads was less pronounced. In some cases, spread levels have already returned to pre-pandemic levels. Whilst public markets have been accommodating to borrowers, they continue to value the diversity and consistency of the private debt market. This is particularly valuable in times of volatility or stress.

Traditionally, one key differentiator of the private debt market is the longer maturities available to borrowers. Understanding how the pandemic will impact a borrower over time is a key part of current due diligence. It also reinforces the need to create appropriate structural protection both to enhance borrower engagement and mitigate unforeseen downside risks for the lender.

Longer-term trends are not yet clear but private corporate debt has experienced strong growth in recent years. This has been driven by a secular shift, with pressure on banks forcing them to rationalise lending and seek greater returns from borrowers, leading more of them to contemplate private institutional debt. We believe it will continue to be a significant funding source for borrowers going forward.

¹Bank of England, 10 March 2021



Infrastructure debt

Despite a strong start to 2020, the infrastructure debt market was also impacted by COVID-19. Transaction volumes slowed in the second and third quarter as borrowers and lenders focused on asset management necessitated by short-term COVID-19 related issues. Investors were required to consider their medium to long-term view on assets, including those that have historically been seen in extremely attractive sectors, such as capital city airports.

Where deal activity did continue, it generally required lenders to take a view on the timeliness of the resolution of COVID-19 related issues, or a willingness to embrace short-term rating instability. Generally, this was not something we felt was appropriate for our existing client base. A broader recovery in deal activity occurred in the fourth quarter, with strong demand for the best assets. This equated to a focus on certain sectors, such as digital and renewables, which both proved to be resilient in a COVID-19 context and benefit from strong forward fundamentals. However, heavy competition put pressure on spreads, requiring careful consideration of the relative value in each transaction.

As we look forward in 2021 we must continue to be vigilant about COVID-19 and its consequences for assets. Our short-term pipeline will still focus on more resilient sectors, but we look to access less competitive parts of these to preserve value. Over the medium term, governments across developed markets remain focused on infrastructure spending. For example, in the UK we have seen the launch of the Scottish National Investment Bank and the announcement of a National Infrastructure Bank by the UK Government to support economic recovery and transition to net zero carbon emissions. These initiatives should provide for a strong pipeline of transactions over the coming years.

Real estate debt

The onset of COVID-19 threw property valuations into turmoil, leading to the implementation of material uncertainty clauses, gating of property funds, retrenchment of overseas investors and, essentially, the real estate market hitting the pause button. Activity did pick up in the second half of 2020, but investors were still cautious, causing a flight to quality. Our core focus remained consistent with careful sponsor selection and prudent transactional structures secured upon collateral with strong property fundamentals.

The sectors most challenged by COVID-19 last year included leisure, retail, hospitality, student accommodation and serviced offices. In 2021, we remain highly cautious about these sectors. The pandemic has accelerated some of the longer term structural challenges faced by the retail sector and, in the short term, the leisure and hospitality sectors are still the most vulnerable to lockdown restrictions and the uncertain path to recovery.

During 2020, the institutional private rented sector (“PRS”) continued to display defensive characteristics and received record levels of capital commitments. We believe PRS should continue to perform well, owing to its favourable supply and demand dynamics. Similarly, we remain positive regarding the industrial and logistics sector, with take-up for 2021 expected to exceed the five-year average, driven by the accelerated rise of ecommerce.

The office sector, which has increasingly come under the microscope due to the significant increase in remote working, is likely to cause vacancy rates to edge higher in the second half of 2021 as more ‘grey space’ comes to the market. However, we believe in the long-term importance of the office and the critical functions it provides for businesses. As such, we believe a strong opportunity remains for best-in-class modern office assets in good locations and let to high-quality tenants.



Alternative debt

Alternative credit covers a broad spectrum from trade and asset-backed finance through to government-supported opportunities, with many varied areas in between. Whilst not immune to the impact of COVID-19, the breadth of these transactions in 2020 meant we were able to continue to find deals that met our risk and return parameters.

Classic private ABS (asset-backed securities) covering RMBS (residential mortgage-backed securities), autos and consumer finance continue to perform well but offer sporadic value and hence have not been a focus for us. Within asset finance, aviation assets all experienced varying degrees of stress. However, all but the weakest credits continue to perform, reflecting the extraordinary government support provided. Export Credit Agency (“ECA”) and government-backed loans were the driving force of new issuance volumes. Many of these opportunities failed to meet LGIM’s ESG requirements but we did commit on behalf of our clients to finance electric car development with a large automotive OEM (original equipment manufacturer) under an ECA loan structure.

The other key theme from 2020 which continues into 2021 is an acceleration of bank retrenchment from wide areas of traditional lending. This includes everything from medium to longer-dated corporate loans and derivatives exposure, to short-dated financing such as trade finance and capital call facilities. All continue to prove resilient and often offer a more senior position in the capital structure of the borrower.



This retrenchment has created a wealth of opportunities for institutional investors willing to take the time to understand and structure opportunities as banks struggle with the capital implications of long-dated assets or single-issuer risk limits. LGIM committed to financing long-dated derivatives with a UK port operator, the first institutional investor to do so, and we continue to add to derivative opportunities in the UK water sector. In addition, we have created a platform to enable investment in fund subscription line facilities. Aside from these broad areas, niche opportunities in supporting the green agenda continue to arise, such as financing the rollout of heat pumps and the retro-fit of other energy-saving solutions, both of which we have supported through investments.

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