Rising interest rates and inflation: What should private debt investors expect?

Five key questions for Sandrine Richard, Head of Private Debt at Generali Investments Partners

Sandrine Richard, Head of Private Debt at Generali Investments Partners, discusses the impact of rising interest rates and inflation on private debt investments as well as the approach to this increasingly important asset class at Generali Investments Partners.

1. You specialise in the selection and the management of private debt. What are your assets under management and in which segments do you operate?

At Generali Investments Partners S.p.A. Società di gestione del risparmio ("GIP"), we manage around €12 billion of invested private debt and €19 billion of committed capital. This committed capital has three main segments: 50% of the amount allocated is invested in corporate private debt with or without sponsors; 25% is in infrastructure debt, and the rest is split between real estate and other categories.[1]

In terms of corporate private debt, we have two main strategies. The first is a fund of funds offering that focuses on best-in-class global asset managers[2] and includes direct lending, asset based lending and special situations strategies. The second is currently being launched and focuses on direct corporate private debt, with the financing strategies in senior debt, unitranche and mezzanine debt to support small and medium-sized European companies who wish to commit to ESG objectives. In terms of indirect lending, we have a team of eight and we are setting up a direct lending team across France, Italy, Germany and Spain. Our aim at GIP is to bring together an investment team of around twenty employees.

2. What is the impact of rising interest rates and inflation on private debt?

We have indeed seen an increase in margin rates over the past few weeks of around 100 basis points on the unitranche, but we believe this re-pricing is approaching a plateau because Euribor rates are also rising. A rise in the Euribor combined with an increase in margin rates is too expensive for issuers, who could therefore postpone projects.

Regarding the unitranche, it is interesting to note that several lenders can now intervene on this type of instrument, which was not the case until recently. A form of syndication is being set up as before with the banks. Private debt funds have grown significantly in terms of outstanding debt, so they can acquire unitranche debt and then distribute it among several lenders. This type of strategy makes it possible to support companies during a more difficult economic climate, while still maintaining adequate diversification.

The other important change to note is that the unitranche no longer systematically excludes banks. Banks can intervene in order to supplement the financing. We also notice that some banks set up their own unitranche debt funds in order to support their clients.

In terms of inflation, since the return on private debt is often composed of floating rates, the duration risk linked to rising rates is lower for private debt investors compared to those invested in fixed rate debt.

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3. Do you expect a recession? What are the consequences for private debt in terms of default rates?

There is no doubt that the economic environment is deteriorating globally. All companies will be impacted at different levels by an increase in default rates, decreases in turnover growth, the reduction of profitability and cash generation, etc. Venture capital funds, which are typically leading indicators of the economic situation, are calling for more adequate cash positions in portfolio companies, closer to 18 months or even 24 months, instead of 12 months previously.

4. Are you avoiding certain sectors in your portfolios or strengthening due diligence in light of rising recession risk?

At GIP, our investment decisions are made over a long period of time and after extensive due diligence, with a slower pace of deployment compared to listed investments, so the current macroeconomic uncertainty has not led us to significantly modify our processes or portfolio compositions. We are however increasing our dialogue with the asset managers in which we invest in order to really understand how they're reacting and adapting to macroeconomic conditions.

5. Are investors arbitrating in favour of liquid fixed rate debt?

We are convinced of the benefits of private debt with floating rates, but from a tactical point of view arbitrages could be interesting at the moment in favour of fixed rates. Sovereign debt is looking more attractive now than it has in a long time. But ultimately we believe that senior secured floating rate private debt provides diversification, a natural hedge against inflation, more lender-friendly documentation, defensiveness, and low volatility to long-term portfolios, so having the right mix of private and public assets exposure is crucial.

FOOTNOTES:

1 Source: Generali Investments Partners as of 30 June 2022

2 Based on the manager's view

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