Private credit – from niche to mainstream?

For more than a decade, both corporate and consumer borrowers benefited from low interest rates and a very low cost of capital. As the global economic backdrop continues to adjust to the activity of central banks and the uncertain geopolitical backdrop, investors are seeking ways to ensure that their portfolios are adequately positioned in order to meet their long-term risk and performance goals, write **Jo Waldron and Karen Lam at M&G Investments.**

Whilst historically seen as a niche asset class, investor appetite for private credit assets has grown considerably as investors seek to gain access to the asset class's diversification benefits. As we navigate markets with our investors, we believe there are three key aspects which make the asset class attractive.

The search for yield is not over

The global search for yield has seen investors consistently increasing their allocations to private and alternative credit. Today's private credit investors remain well-compensated for taking illiquidity (read: complexity) risk and capital remains patient, but the investing backdrop is pushing alternative motivations for investing in private credit up the priority list. The broad spectrum of private credit, ranging from private corporate lending to consumer finance, real assets lending and structured credit tend to have very different underlying risks and performance drivers, which may provide opportunities for investors seeking a secure income stream.

The asset class is inherently less sensitive to the movements of global markets than traditional asset classes – most assets are model-priced helping to reduce mark-to-market volatility and are typically held until maturity. Return generation from the asset class is not contingent on long-term macroeconomic dynamics, given the prevalence of cashflow-generative assets delivering income-driven returns rather than returns predicated on market gain.

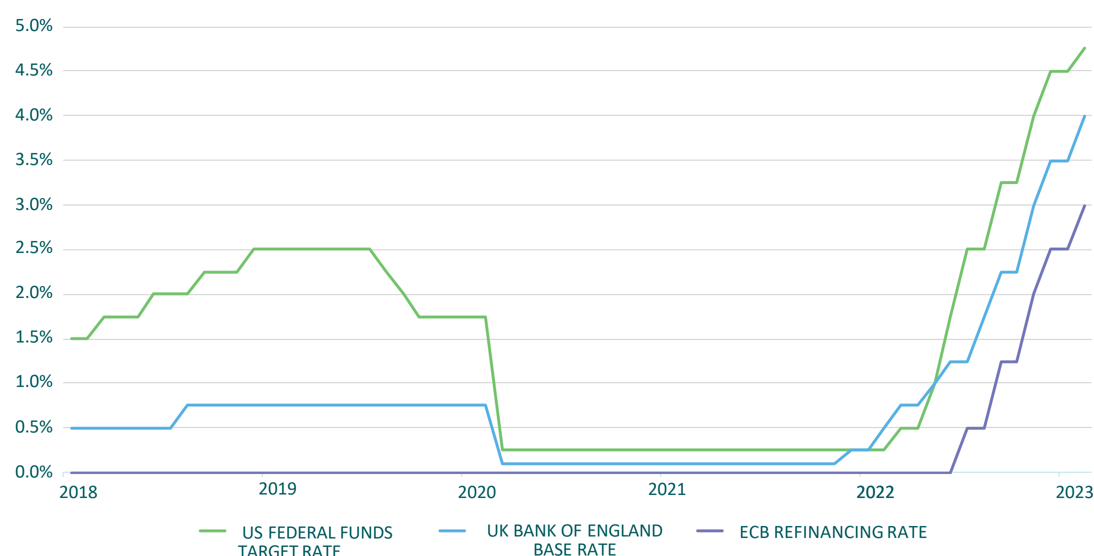
Weighing up the risks and opportunities ahead

Credit fundamentals generally remain strong, although companies are entering a more complicated refinancing environment. Corporate borrowers and issuers with floating-rate debt may be vulnerable to a jump in borrowing costs given expectations for rising interest rates in developed economies. Private lenders (and sponsors) have also proved supportive through periods of disruption of the recent crisis, helping fundamentally-solid corporate borrowers ride out short-term issues – to ensure the credit remains a going-concern and to protect the value of the debt (and equity) through the life of the investment.

Under the current interest rate environment, the floating-rate nature of the asset class can be particularly attractive for income-seeking investors by offering income that rises as interest rates go up.

Beyond floating rate coupons, there are certain structural features that are common to most private corporate loans, including security, seniority in the capital structure, contractual margin, as well as close interaction between borrower and lender. Loan contracts also come with financial covenants which help to mitigate against downside risks and help to retain value in an investment in the event of default.

Moving on from the era of ultra-low rates



Source: RefiniEv Datastream, February 2023. Past performance is not a guide to future performance.

Sustainability and impact investing

By definition, the buy and hold nature or private credit investing requires effective stewardship in order to protect and enhance value over time. The close, often bilateral relationship with borrowers provides investors with a significant opportunity to influence and engage with regards to ESG issues.

The momentum behind sustainable and impact investing shows no sign of abating, driven by pressure from regulators and consumers alike. Given events of the past couple of years, investors have become more aware and engaged with many of the global challenges that we all face, and are becoming more focused on the non-financial outcomes of their investments. There has been a clear trend towards sustainable investment approaches, with investors looking to put their money to work in strategies that address key social and environmental challenges, including reducing carbon emissions, improving healthcare and alleviating poverty.

Impact investing is an obvious and meaningful way to address these challenges, directing capital towards borrowers that actively seek to provide solutions. In this way, impact investors aim to support, encourage and fund such companies and organisations, with the intention of meeting that dual objective of generating measurable, material positive impacts, alongside competitive financial returns.

Private credit also involves lending to smaller companies that are more likely to be focused in a narrower range of business activities than public markets, which also contributes to the great number of pure-play impact investment opportunities in private markets. Given the increasing focus on directing investment into sectors poised to benefit from the transition to a low carbon future, we believe that this will be an important area of long-term value creation, from both a financial and also societal perspective.

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