2024 private credit outlook: A question of balance

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Executive summary:

- Despite the resilience that characterised 2023, we believe the lagged effects of monetary tightening in US and Europe will mean that the transition to a new equilibrium is unlikely to be seamless. We now expect several rate cuts in 2024, but given high inflation and a strong labour market, the path ahead is not straightforward.

- While debt yields are still high in a historic context, public credit spreads have tightened materially over recent weeks, especially in high yield. We believe investors should keep a strategic eye on structural trends balanced with a tactical eye on credit quality and risk-adjusted returns. Our cautious outlook means that we like resilient business models and/or conservative leverage that should allow borrowers to cope in an economic downturn.

- This pushes us to focus on the investment grade and crossover segments of the private credit markets, where we think the risk-adjusted returns are attractive. Asset selection and maintaining strong covenants are more important than ever. We still like duration, but note the window of opportunity may be closing.

- A reduction in bank lending in 2023 has encouraged more corporate borrowers into private markets and created some opportunities in alternative debt. We expect this trend to continue.

- We expect existing real estate debt assets to face sustained pressure in 2024, but the current environment is potentially creating an opportunity to provide debt funding on attractive terms, provided asset profiles and business plans support long-term performance.

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Our key considerations for 2024

1 Soft landing, disinflation, rate cuts: all at once?

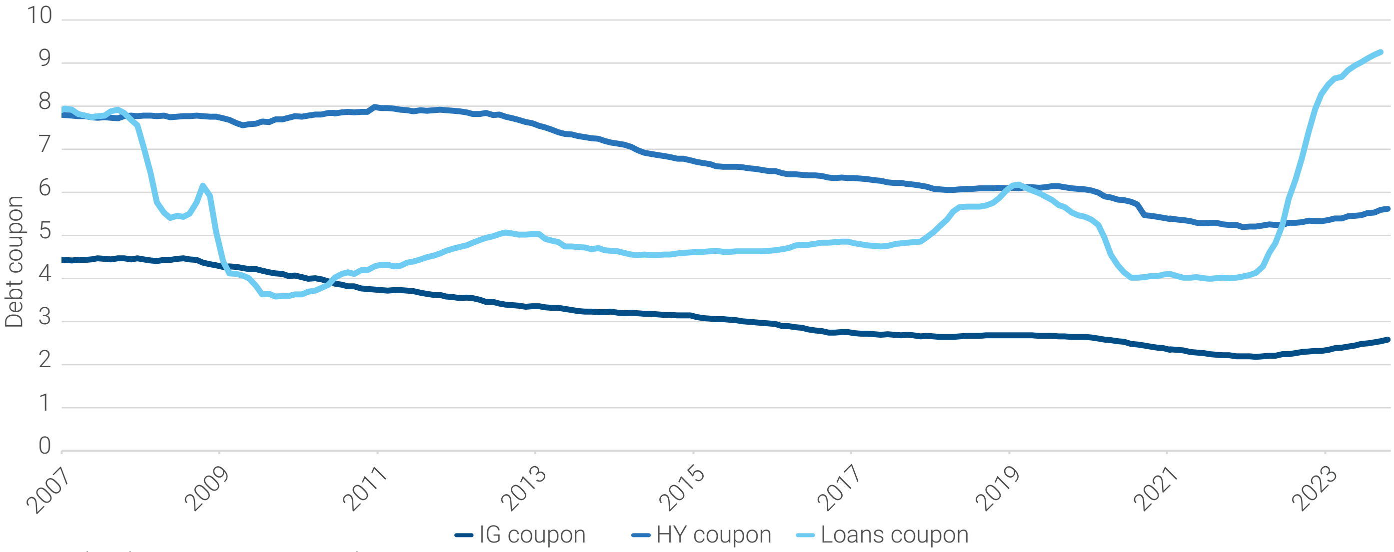
- The economy has been resilient in the face of a historic hiking cycle. Consumer savings, low debt costs and fiscal stimulus have helped the economy live with higher rates, but their effects have diminished over time and may now be beginning to reveal the transmission effect of higher interest rates to the broader economy.

- Softening inflation and the strength of the economy led to the US Federal Reserve (Fed) declaring in November 2023 that rates have peaked and are likely to come down in 2024. This drove a significant market rally in the final two months of the year.

- Despite growing positivity, we think it will remain a challenge to balance sustained GDP growth, falling inflation and rate cuts. It may not take many surprises to knock the economy off course, and as such we remain cautious.

- Credit spreads have been remarkably stable. Negative economic news may create a window for a widening of spreads that could offset any reduction in rates.

Higher debt costs have yet to be felt by the majority of corporates



Source: Bloomberg, JP Morgan as at October 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.

2 Balancing yield, risk and duration

- The flip side of higher rates is attractive debt yield. Public credit yields are currently around the 70-80th percentile versus their 20-year history. Investment grade (IG) private credit is currently yielding at around 5-8%, and sub-IG private credit around 9-13%.[1]

- However, we need to balance the returns on offer with potential risk, and given our cautious outlook, we are still wary of aggressively chasing returns. We think sub-IG private credit issuers could come under increasing pressure from weaker revenue growth and elevated funding costs.

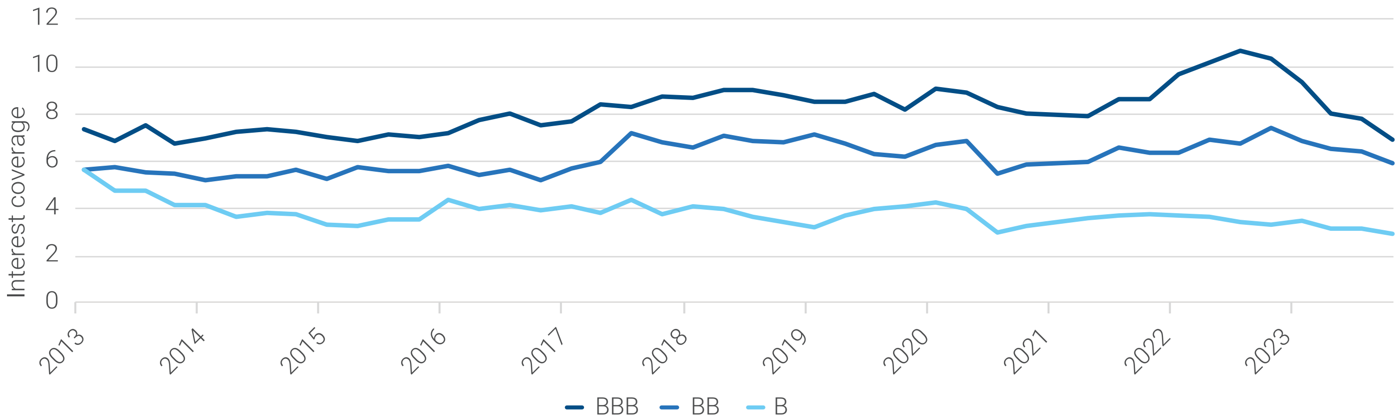
- Some borrowers over-levered when rates were near zero and are now facing unsustainable capital structures. In our view a rise in defaults, restructuring and write-downs is likely, although we don't expect a GFC-style crisis. We think newer vintages (2022 and 2023) are likely to perform better, benefitting from lower leverage and asset valuations.

3 Watch out for megatrends

- We have more conviction in highly rated private credit (i.e. IG and BB), where in our view the risk-adjusted returns on offer are compelling. Leverage is generally more conservative, the borrower base is becoming more diversified, and this part of the market has come through several economic cycles with minimal defaults.

- We think the recent steepening of the yield curve has made duration more attractive. The availability of fixed-rate debt in the highly rated space means there is a potential opportunity to lock in higher returns for a longer period. The challenge is the current scarcity of long-dated issuance, as borrowers avoid locking in higher debt costs for longer.

European bond issuer interest coverage by rating



Source: Bloomberg as at November 2023

1. Source: LGIM as at January 2024

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Corporate debt

The corporate debt market enjoyed a busy 2023, helped by borrowers looking to diversify their funding sources after the banking crisis in March. Borrowers appear to have realised that debt costs are unlikely to fall soon, so decided to get on with their refinance and investment plans – but generally focusing on shorter maturities (15 years or less). For example, we saw minimal activity from UK housing associations for the first three quarters of the year, followed by several transactions during Q4.

The European market saw a notable broadening of corporate sectors, including several sought-after names from the industrial, services, and food and beverage sectors. We see this as positive for investors looking to add defensiveness to their portfolio. The US market has been less diversified and has been dominated by utilities and infrastructure – sectors better able to pass on the higher debt costs to the consumer.

A busy pipeline led to a bifurcation in investor demand. High-quality borrowers were regularly oversubscribed, but weaker borrowers needed to offer additional incentives to get traction, for example longer maturities, higher premia, or additional ESG KPIs.

We expect 2024 to be another busy year as tight bank lending conditions are expected to remain in place for a while. This could generate potential opportunities for private credit investors, and we think issuer diversification should improve in the US once the Fed starts cutting rates. We favour counter-cyclical sectors with strong cash flow generation. Maturities are likely to remain short, which is less desirable for liability-driven investors that need duration.

Real estate debt

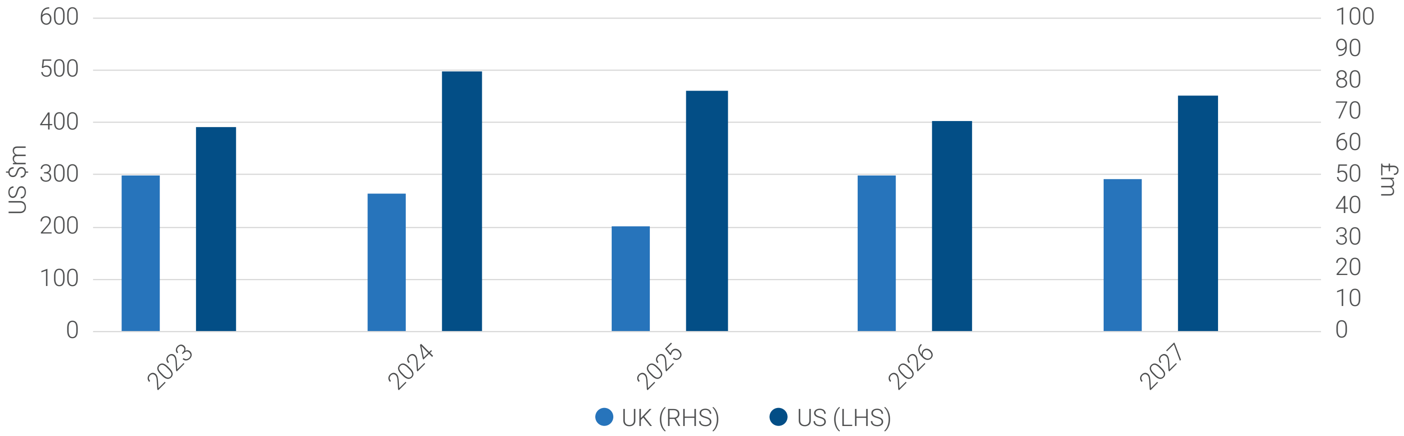
Real estate debt faced many challenges in 2023: higher interest rates, property re-pricing and the regional banking crisis. Together, these drove a significant flight to safety by lenders. The availability of finance has held up in residential, logistics and certain alternative sectors. Retail and offices are struggling (except for very high-quality assets), as are properties with poor sustainability credentials. Lender appetite is trending lower, demonstrated by smaller average loan sizes in the UK over the first half of 2023.

Lenders have so far been supportive, with sponsors injecting capital in many cases. However, there are signs that, with the market not yet recovered, some lenders would like to reach a resolution soon. 2024 also marks the point when loans taken out in 2019 – the valuation peak for most sectors – will reach the end of the typical five-year maturity. Refinancing these loans could be more challenging than earlier vintages due to lower equity buffers. We may see more lenders enforcing or encouraging sales in 2024 which could accelerate price discovery and help the market bottom out.

Despite the challenging backdrop, our opinion is that the current environment offers potential opportunities for investors to provide financing on attractive terms. Yields are high, loan-to-value is lower (to support interest coverage), and there is less bank competition. That said, macroeconomic uncertainties demand a careful assessment of cashflow risk and ESG-related capex needs.

We favour sectors supported by demand-supply mismatch and long-term structural trends, such as residential, student accommodation, industrials and data centres.

Refinancing wall over the next five years



Source: MSCI, Bayes Business School, December 2023

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Infrastructure debt

Relative to other sectors, infrastructure debt activity was more subdued for much of 2023. Infrastructure equity pricing has been slow to adjust to the higher rate environment which makes the economics of project financing more difficult. Transactions generally focused on corporate refinancing deals, particularly in Europe.

Lower pipeline volume means that investor demand remained strong, with some deals over-subscribed by multiple times. The transportation, energy, and digital sectors dominated issuance. P3-related activity in the US and Canada has increased, with recent deals including toll roads, education, healthcare and rail.

We expect infrastructure debt to perform well in 2024, with high pricing power offering potential downside protection in a recessionary environment. Activity increased in the last four months of 2023, as sponsors learnt to live with a high-for-longer environment, and we expect it to recover further once the prospect of rate cuts becomes more evident.

Pricing has become in our view more attractive, but tighter overall than other private credit asset classes as asset fundamentals remained resilient. We are seeing relatively higher premia in crossover-rated assets, where competition is less given limited bank participation.

Alternative debt

Alternative debt saw another year of strong pipeline and richly priced opportunities. Retrenchment by the banking sector and the upswing in funding costs encouraged borrowers to shift towards the institutional market. A growing imbalance between supply and demand has emerged, pushing spreads c.100-150bps wider over the year, with transactions focused on short-dated opportunities. Long-dated swap repacks have been less active, with rising rates improving the mark-to-market value of the swaps on the banks' balance sheet.

Demand for fund finance solutions from private market general partners (GPs) has been strong, but it is important to take the broader context into account – among other issues, the M&A environment remains subdued, fundraising remains weak, and valuation re-pricing is lagging. We advocate a cautious and selective approach to assessing GP credit risk, avoiding exposure to higher-risk sectors and diversifying into other asset classes like private credit and infrastructure.

Debt-for-nature swaps proliferated in 2023, with the $1.6bn Ecuador deal the biggest. This is an area where we expect strong growth in the coming years.[2] While debt-for-nature swaps alone are no panacea, we expect them to play an increasingly important role in helping to support developing economies and potentially providing investors with ESG-aligned high credit quality opportunities.

2. Source: www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support

Where next for investors?

2023 was a good year for private credit, driven by high yields, economic strength and borrowers' desire to reduce reliance on bank lending. At the time of writing, the key uncertainty is the timing and depth of a recession.

This is a double-edged sword. Stronger growth is supportive of fundamentals, but is likely to keep rates higher for longer, so not helpful for refinancing. A deep recession would reduce the cost of debt but would damage consumer demand and broader market stability. Geopolitical tensions add further complications to the mix, as does AI. We believe this represents an enormous opportunity in some sectors, while other borrowers risk being left behind if they are either disrupted by the technology, or fail to leverage it to its full potential.

Despite increased investor optimism around a soft landing, we believe there are still too many uncertainties and prefer a more risk-focused approach. We view the risk-adjusted returns in investment grade and crossover private credit as attractive, and so is duration. In terms of sector exposures, we lean towards needs-based assets, borrowers with resilient business models and/or long-term structural shifts, which we believe are better able to cope with recession or a higher rates environment.

Despite increased investor optimism around a soft landing, we believe there are still too many uncertainties to ramp up risk at this stage.

Contact us

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Key risks

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