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The Role of Secure Income Assets Post-COVID-19

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The impact of the global pandemic is expected to influence the world around us, long after its eradication.

We have previously commented on the potential changes to industry precipitated by the crisis. Obvious primary effects could include the way in which we shop, travel, socialise and work. There may also be secondary and tertiary effects that will become clearer over time. A trend that we see accelerating is the disintermediation of banks and companies seeking access to broader sources of funding as a result. In our view, this is where secure income assets[1] can play a crucial role.

A brief history of private markets

Traditionally, banks have been one of the primary sources of funding for all manner of borrowers. In the early to mid-90s, a relatively small number of European borrowers began to take advantage of private institutional investment markets. By utilising the availability of longer-term capital from the likes of US insurance companies, they were able to better match their liabilities with income. In effect, this 'private placement' market, which had been providing capital to US borrowers for half a century, was now expanding internationally.

Over the course of the next decade, these private markets expanded significantly. However, a real step change in borrowing behaviour followed the financial crisis, when the willingness and ability of banks to lend, particularly to small and medium sized entities, declined. We observed a sizeable increase in issuance across sectors that had only sporadically accessed institutional money in the past – for example, housing associations and universities – and an increase in financings undertaken with more modestly sized companies that would not be able to access the public bond markets. We have also seen an increase in pension fund money stepping in to bolster available capital across sectors.

To place the markets in context, estimated direct GBP investment volumes across private markets are as follows:

Asset Class	Approximate average GBP issuance (p.a.)
Real Estate Debt	£40bn
Infrastructure Debt	£40bn
Corporate and Alternative Debt	£35bn
Total	**£115bn**

Source: LGIM internal data, August 2020

1. 'Secure income assets' ("SIA") identify cashflow outcomes from illiquid private asset classes, where the income stream often benefits from a range of contractual protections that enhance asset owners rights to maintain expected cashflows (for example, covenant protections, specific security or ring-fenced collateral). The contractual protections of a particular asset will depend on these terms and the financial strength of the counterparty. SIAs are held with the aim of producing a predictable income stream - this income stream is not guaranteed and there is no underwriting of income.

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Private capital to play a more meaningful role

In our view, COVID-19 may provide the catalyst for a further step change in private funding.

With various parts of the economy grinding to an abrupt halt, the ability of companies to manage their liquidity – to pay workers and suppliers, for example – has been stretched. This is different to the bank-led global financial crisis and is causing borrowers to review their sources of funding to ensure they have access to more diversified sources of liquidity. Going forward, using banks to provide short-term liquidity facilities and institutional investors for longer-term debt may strike a better balance for borrowers to manage economic cycles and bouts of market instability.

Indeed, as a large institutional lender, we believe part of our role is to help navigate through periods of uncertainty by providing core, more permanent debt. This implicitly helps companies steer through tougher periods while using more traditional sources of funding, such as banks, for shorter term liquidity. In our view, it also helps support the growth and development of sustainable businesses.

We believe Defined benefit ('DB') pension schemes also have an increasing role to play here. These patient pools of capital marry well with companies seeking long-term funding, many of whom are engaged in revitalising the UK economy by investing in new infrastructure projects, helping to refinance upcoming debt maturities or providing additional debt funding where needed. Pension capital could ultimately drive a return to growth through investing in these secure income type assets, whilst also offering the potential benefit of helping schemes achieve required funding levels without taking excess risk.

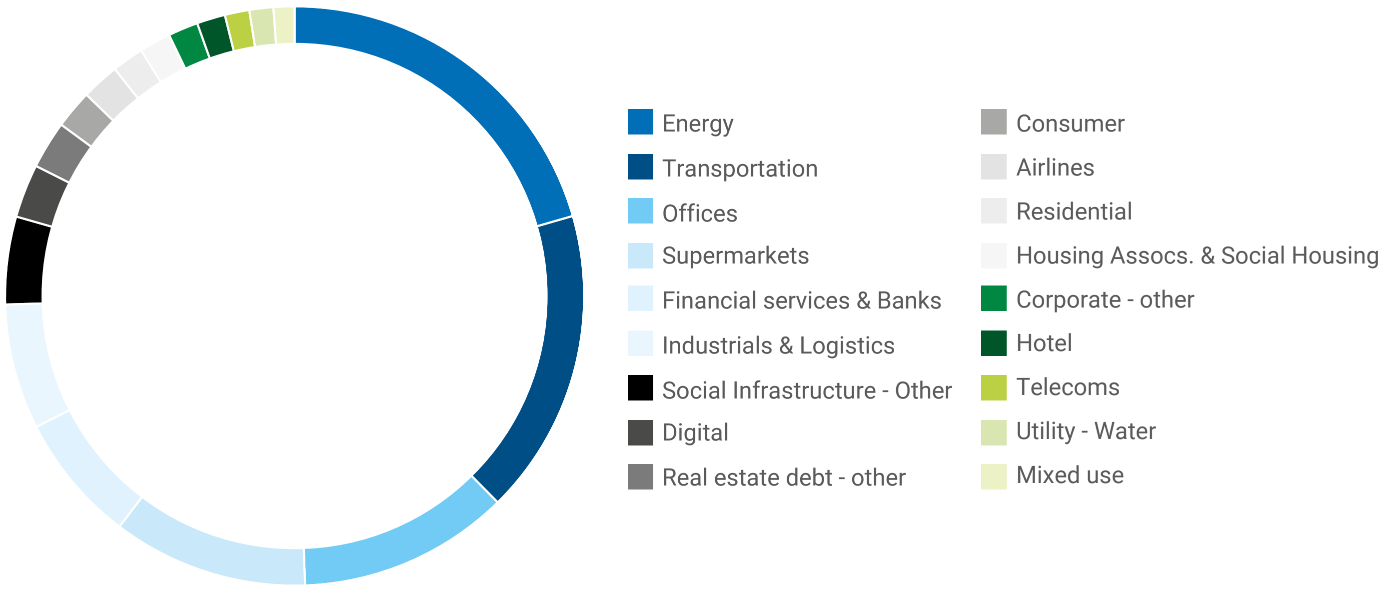
There is a wide range of borrowers who are now looking to the private market for capital. We believe the majority of these require between £100m and £300m of debt finance, which is generally regarded as too small for public markets. We also see opportunities in more nascent sectors such as digital infrastructure and those in the crossover space, where access to other capital sources has become more challenged. Figure 1 (below) gives an overview of the diversity in sectors we have witnessed in the private markets so far this year, demonstrating the increasing breadth of secure income assets.

Conclusion

Over the past three decades we have witnessed a necessary and positive escalation of funding source diversification in the UK, enhancing the opportunity for borrowers and lenders. We believe this will continue to accelerate. For the private credit markets, this fundamental evolution can offer investors the opportunity not only to access a much greater range of investment opportunities, but also to help shape the world around us, particularly in the context of ESG-focused investment.

In our view, providing financing for high quality assets across the UK such as social housing developments, renewable projects, logistic centres, offices in core locations and manufacturing businesses, among many others, is likely to align with many DB pension schemes' objectives. It has the potential to increase certainty of a scheme's returns, to generate cash flows to pay pensions, and to reduce overall funding level volatility while also supporting the broader market recovery.

Figure 1: Sector breakdown of all deals seen across sterling secure income assets year-to-date



Source: LGIM Real Assets, 28th August 2020. Chart represents all private credit deals seen by LGIM's private credit investment team year-to-date. It does not reflect assets transacted on by LGIM during the period.

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