

Private credit 2022 market outlook



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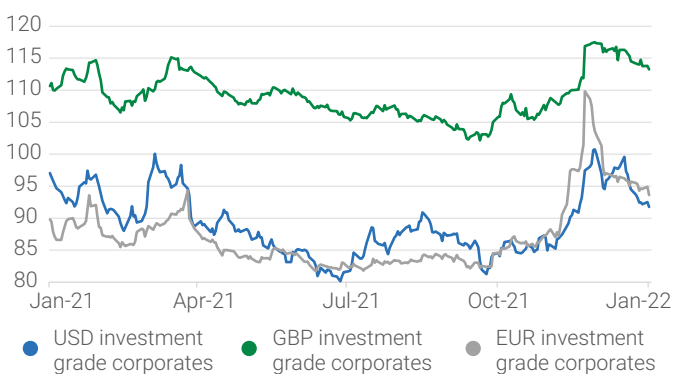


Introduction

While consensus forecasts suggest further economic recovery in 2022, we remain prepared for bumps in the road. Bond yields have been rising but public credit spreads remain very tight by historical comparisons, indicating that there is little room for further compression. The private credit market faces similar macro headwinds to public fixed income markets.

However, the additional premium versus public bonds and the availability of floating rate assets offer private credit investors a greater buffer against a rising interest rate environment.

Investment grade corporates: Jan 2021 to Jan 2022



Source: Bloomberg Barclays Indices as at 4 January 2022

Overall, we do not expect the private credit market to experience substantial spread widening or increase in defaults in 2022. We anticipate demand will remain strong yield, as investors search for higher and more resilient yield as well as diversification from other asset classes, which private credit is well-positioned to provide. There could be certain pockets of weakness due to sector-specific concerns so structural protection will continue to play an important role.



2022 themes

We believe the following key themes will drive private credit investment activity in 2022:



Emergence from the pandemic

Defaults during the pandemic have been minimised due to support from governments and lenders. Withdrawal of government support packages in the UK and US, so far, has been smooth and we are seeing an increase in business investment, which is likely to drive demand for credit.

Nevertheless, the pandemic is not over and any new virus resurgence or lockdowns could lead to heightened market volatility, as demonstrated by the Omicron variant.

There will also be significant differentiation in the pace of recovery. It is possible that more stress builds up in the higher-risk end of the market, potentially as a result of further restructuring in sectors hit hardest by the pandemic, such as retail and travel, where the true extent of long-term economic scarring is still emerging.



ESG and impact investing

The UK, EU and US have committed to invest heavily in infrastructure and decarbonisation to support the post-pandemic recovery. We believe this will drive opportunities for 2022 and beyond, notably in renewables, transportation and digital infrastructure.

Private credit investors can play a critical role in driving change:

- Investors can direct capital towards climate and social solution creators. We are exploring an increasing number of opportunities, having financed providers of healthcare for the elderly, fibre broadband and heat pumps amongst many other projects in 2021.
- In the area of transition finance, there is scope to support borrowers with their environmental and social impact objectives. We expect the pipeline of sustainability-linked loans to grow as corporates increase their efforts to deliver net zero and positive impact.



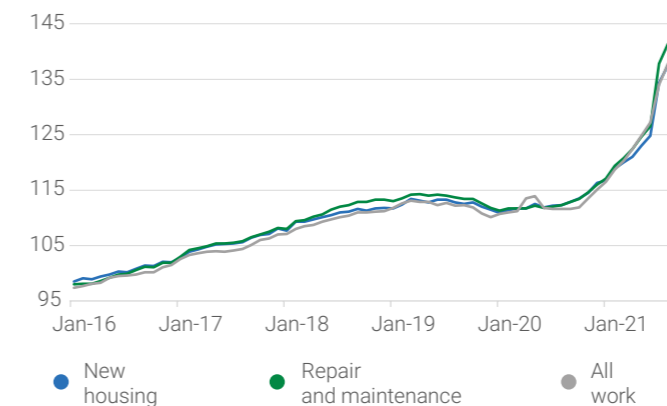
Higher rates and inflation

The extent to which the rise in inflation and rates affect credit risk will depend, amongst other things, on the extent to which borrowers can absorb higher costs or pass them onto customers (although we are mindful of affordability risk for certain sectors such as consumer discretionary and social housing).

We may see a rush of borrowers raising debt financing in the early part of 2022 to beat a rise in borrowing costs. Quantitative tightening could shift market dynamic more in favour of institutional investors.

We expect an increase in construction risk arising from cost inflation, supply chain disruption and labour shortages. A key area of due diligence in real estate and infrastructure will be to stress test the viability of a project to withstand input cost inflation as well as supply chain disruptions.

UK construction material costs increased by more than 20% in 2021



Source: ONS

Corporate debt

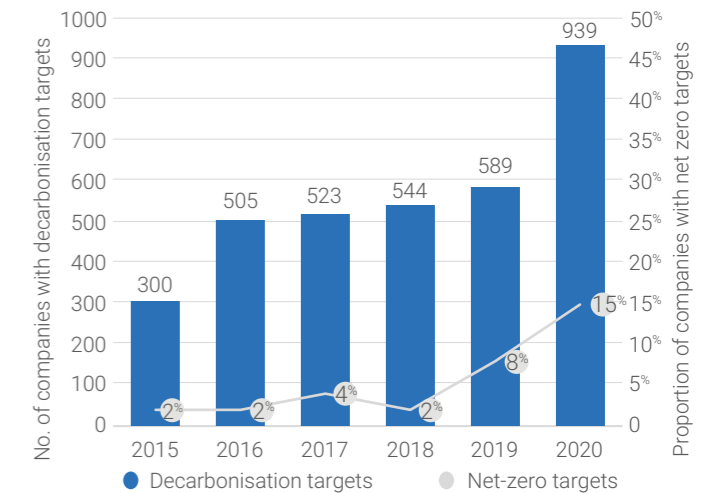
The private corporate debt market continued to see steady activity in 2021 as issuers sought to lock in low borrowing costs and bolster liquidity. Investor appetite also remained strong, particularly in sectors more insulated from the pandemic, such as consumer non-cyclicals, utilities and housing associations. The competition for assets has driven spreads lower and as a result we have been selective. We expect deal flow to improve as a clearer post-pandemic recovery and business confidence should lead to more corporates going to the debt market.

One area that has provided good value opportunities is crossover debt (in the BB rating band). This is an under-utilised part of the market since it is below investment grade but not risky enough for conventional leveraged finance strategies, which means there is less competition and more attractive pricing, in our view. The universe includes firms with strong financial profiles but which are unable to access the public debt market due to their smaller size, even though many crossover issuers are in fast-growing sectors such as healthcare and digitalisation.

They historically relied on bank facilities for funding and are increasingly turning to the private credit market to diversify liquidity sources and obtain longer-term financing.

A long-term trend that has emerged is demand for financing related to borrowers' ESG initiatives. The number of companies that have declared decarbonisation or net-zero strategies has increased substantially.

Decarbonisation and net-zero targets



Source: MSCI, based on MSCI ACWI constituents. Decarbonisation targets aim to reduce emissions but do not necessarily target net zero.

Given the magnitude of costs required to decarbonise the various sectors, we expect a strong pipeline of transition-related transactions in the coming years. In 2021, LGIM executed its first net zero-specific loan where the proceeds will be ring-fenced for the implementation of the borrower's net zero strategy. In other cases, LGIM has offered coupon reductions linked to environmental or social KPIs, for example to housing associations for improving the energy efficiency of their properties to EPC C or better. We anticipate more sustainability-linked transactions in 2022.

Real estate debt

In our view, real estate debt needs to be approached with a holistic mindset, encompassing asset sector, quality, location and lease structure, along with sponsor skills and resourcing. The market picked up significantly in 2021. According to the Bayes Business School, bank lending on commercial real estate increased by around 50% during the first half of 2021 compared to the same period in 2020. Sectors that proved most resilient, notably logistics and residential, sustained their outperformance. The shift to e-commerce continues to accelerate, creating strong demand for industrial and logistics assets, and further spread compression is anticipated.

2021 was another strong year for the residential sector in terms of performance and capital commitments. Momentum is expected to continue through 2022 and 2023. We remain positive on the fundamentals of this sector given the trend in urbanisation and demographic changes.



The end of Covid-19 restrictions in July 2021 in the UK led to people returning to the big cities, resulting in a rise in demand for rented accommodation.

At the other end of the spectrum, investment sentiment stabilised in the sectors most impacted by Covid-19, such as retail and leisure; however, the recovery is still very vulnerable to new virus resurgences. The retail sector is further challenged by the ongoing growth in e-commerce (retail warehouse fared better compared to high street and shopping centres). Market activity is slowly recovering but we remain cautious.

The office sector experienced a relatively quiet year but should pick up in 2022 as more people return to the office, and once Asian buyers (traditionally a core investor base for prime assets) can travel internationally. We believe that changes in working practices will result in a polarisation of the sector, with demand remaining strong for high quality assets in prime locations with good environmental credentials. The second-tier market is likely to face greater challenges due to weaker location, ageing stock, and fewer new developments. As such, we continue to focus on best-in-class modern and green office assets in good locations, and let to high-quality tenants.



Infrastructure debt

Infrastructure came under the spotlight in 2021 as a result of the energy price crisis, the "build back better" narrative and the net-zero agenda. We have seen an increase in activities as sponsors became comfortable raising capital in a more stable market environment. The energy sector had a very busy year, with spreads grinding tighter. Another sector experiencing similarly strong demand is digital infrastructure, given the continuation of virtual working.

The level of competition for good assets is expected to remain strong as more investors enter the market, including large private equity houses. Given the heavy competition and downward pressure on spreads, we will remain selective and continue to seek better value for our investors.

The sectors most impacted by Covid-19, notably transportation and student accommodation, are in recovery mode. The exception is airports, where passenger numbers are still hampered by travel restrictions. While we are positive on the long-term growth prospects of air travel, we are cognisant of the ongoing level of uncertainty and the decarbonisation challenges facing the aviation sector.

Looking ahead, we expect private capital to play a key role in providing development finance for planned infrastructure investments, given the constrained public finances. This should generate a healthy pipeline of opportunities over the next few years in areas such as low carbon energy, transportation and digital infrastructure.

Alternative debt

The breadth of opportunities and the niche and often complex nature of alternative debt transactions meant that we did not see the same extent of spread compression here as in other parts of the private credit market. Bank retrenchment means that the alternative debt market has become a rich source of attractively priced opportunities for investors with the right capabilities across securitised credit, derivative strategies and short-dated financing including trade financing and capital call facilities¹ (CCFs).

Bank retrenchment is ongoing in non-core lending activities that either do not generate substantial new revenue or are capital intensive. Areas such as swaps-related transactions and supply chain financing could create interesting alternative private credit opportunities for non-bank investors.

We saw significant growth in CCF, which benefited from the record amount of private equity 'dry powder' that is gradually being deployed.



In 2021, LGIM supported several capital call facilities for high calibre funds with strong ESG policies, and we expect the trend to continue.

Alternative debt is well-positioned for a rising rate environment, since a large part of the universe is made up of short-dated assets. It is a market that is constantly evolving and we are exploring new niche areas such as lease monetisation.

2022: prepare for the unexpected

The breadth of opportunities means that private credit is well-positioned to take advantage of the post-pandemic recovery and to access sectors aligned with 'mega-trends' and government policies. Demand for financing is expected to remain high, as corporates increase business investment and governments in the US, UK and EU roll out their ambitious infrastructure plans. However, there is no historical parallel to the environment we are in today, and the road ahead is unlikely to be smooth. Challenges such as inflation pressures and potential central bank policy errors could present risks as well as opportunities. We remain selective and agile in our approach, focusing on stress-testing our investments for a variety of outcomes.

¹ Capital call facilities are senior short-dated loans (typically 12 months) to private market investment funds that are secured against their legally binding investor (Limited Partners or LPs) commitments as well as any fund assets. This helps the funds smooth their drawdown profile for LPs as well as providing bridge financing for any acquisitions.



Contact us

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