Creditflux

Q4 2022

Credit Rendezvous

Alan Kelly of Redding Ridge sees interesting options in secondary
European CLOs, 3

Print and sprint deals offer upside of 20% to 30%
US CLOs, 2

All-in yield and price makes high yield bonds attractive
Global high yield, 8

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Credit investors spy bright spots in gloomy outlook

Clouds are looming over financial markets as the fourth quarter begins — so investors are moving away from diversified approaches in favour of tailored investments and relative value plays

Russia has annexed parts of Ukraine and stepped-up its aggression, the US has reopened a trade war with China over microchips, the UK is routing asset managers with a self-induced gilt crisis, and Europe is readying for a winter of intense energy costs.

As a result, credit entered the quarter at record wide spreads for the year, with volatility high. A growing number of high yield companies are at near-default valuations and some IG names look like fallen angels.

But Mick Vasilache of Chenavari says the gloom of implied default rates is overdone (page 6), even though few are confident in a macro long bet. Instead, this quarter will require intensive sifting of opportunities from cyclically and thematically challenged sectors, geographies and ratings bands — credit selection will be paramount, as Sona's John Aylward points out (page 4).

Meanwhile, rates policy has brought leveraged loans and other floating rate instruments to an inflection point, as Sinjin Bowron of Beach Point Capital acknowledges (page 5). CLO managers need to explore different approaches on asset selection at a time when primary market sourcing is among the biggest challenges.

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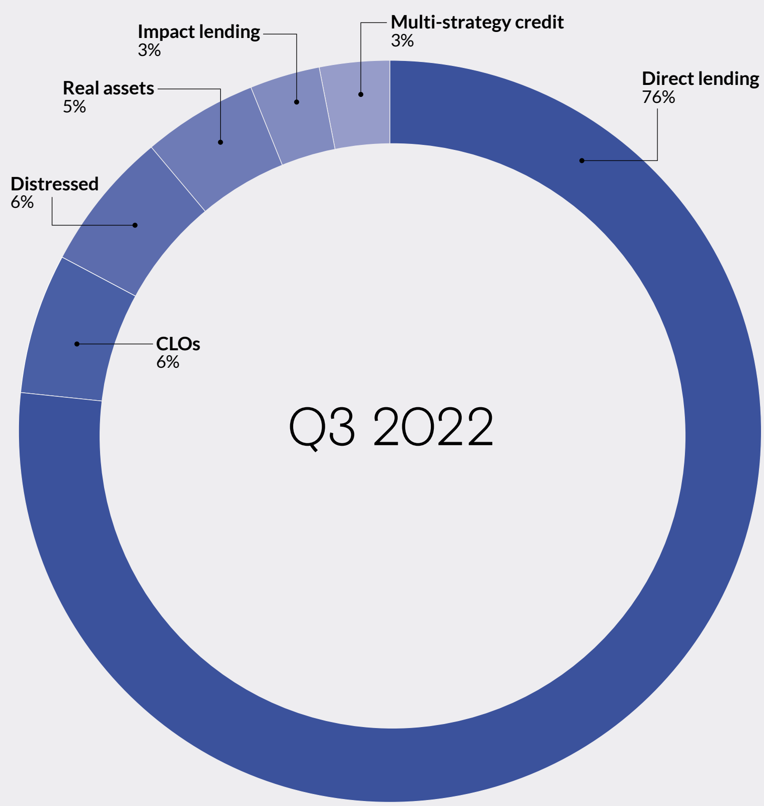
Credit funds raised by strategy

Number of funds raised globally   Source: Creditflux



Direct lending has become even more dominant, rising from an already huge 70% of fund raises to 76%, as investors seek the stability of locked up forms of credit

Source: Creditflux

Largest funds raised in Q3 2022

Fund	Manager	Category	Raised (m)	Currency	Notes
NB Private Debt Fund IV	Neuberger Berman	direct lending	8,100	USD	Final close, exceeded $5bn target. The firm focuses on performing senior secured loans to North American private equity-owned companies. The companies typically have $20 to $100 million of cash flow. Neuberger Berman Private Debt looks to invest up to $500 million per investment
Barings European Private Loan Fund III	Barings	direct lending	7,000	EUR	Final close. The vehicle is at least 50% invested
Tikehau Direct Lending IV	Tikehau	direct lending	3,300	EUR	Final close. Exceeded the previous fund, which closed at €2.1bn. Follows the firm's direct lending strategy of investing in small to medium sized companies across a range of debt instruments
KKR Asset-Based Finance Partners	KKR	direct lending	2,100	USD	Final close. The inaugural asset-based finance fund will seek investments backed by diversified pools of financial and hard assets, focusing on four sections: consumer/mortgage finance, hard assets, small-medium enterprise and contractual cash flows
BlackRock Diversified Private Debt Fund	BlackRock	direct lending	1,700	GBP	Final close. Private markets debt fund that invests across US and European direct lending, real estate debt, and the firm's global opportunistic strategy

US CLOs

New fast movers look preferable to older breeds with risky tails

Managers priced $29.7 billion of US CLOs in Q3, down 24.5% from Q2. Issuance slowed as debt spreads remained at uncomfortable wides, while loans spent the first half of the quarter moving in the opposite direction.

Loan market weakness has put pressure on CLO warehouses. Of the roughly 220 warehouses open, most have been outstanding for more than six months and are likely underwater, says Dagmara Michalczuk.

"It may take a fairly long time for the market to work out of those warehouses, and that is a technical in the market that you have to be aware of, because oversupply of paper creates widening pressure on spreads."

Print and sprint transactions — where managers issue CLOs before buying loans to fill them — have swamped the pipeline. Michalczuk says these are attractive to investors. "Following the reversal of the earlier summer rally in loans, you had the opportunity to source good quality loans at discounted prices, whereas average CLO liability costs remained range-bound," she says.

Dagmara Michalczuk

Principal and portfolio manager, Tetragon CP

Bullish

True 'print and sprint' primary CLO equity

Bearish

Seasoned double or single Bs with large tail risk

Greatest challenge

Preserving appropriate loan recoveries through this credit cycle; triple A availability and pricing

"That created a compelling return profile for the equity if you've done the liability pricing at top-tier levels and captured the full value of these meaningful periodic sell-offs."

Michalczuk says true print and sprints — where there are zero assets in the portfolio before pricing — generally have a return profile in the mid-teens to maturity, but with upside potential in the mid 20% to 30% or more, depending on how cheaply the assets are sourced and the timing of loan price recovery and early redemption.

It created a compelling return profile for the equity

Q4 is likely to extend widening across the CLO liability stack, with pressure focused on lower rating bands more reactive to the loan market, in which downgrades and defaults are likely to increase.

Issuance is likely to slow, with 2022 ending down 35% compared to 2021's total, says Michalczuk. "Our market always surprises on the upside in terms of issuance," she adds.

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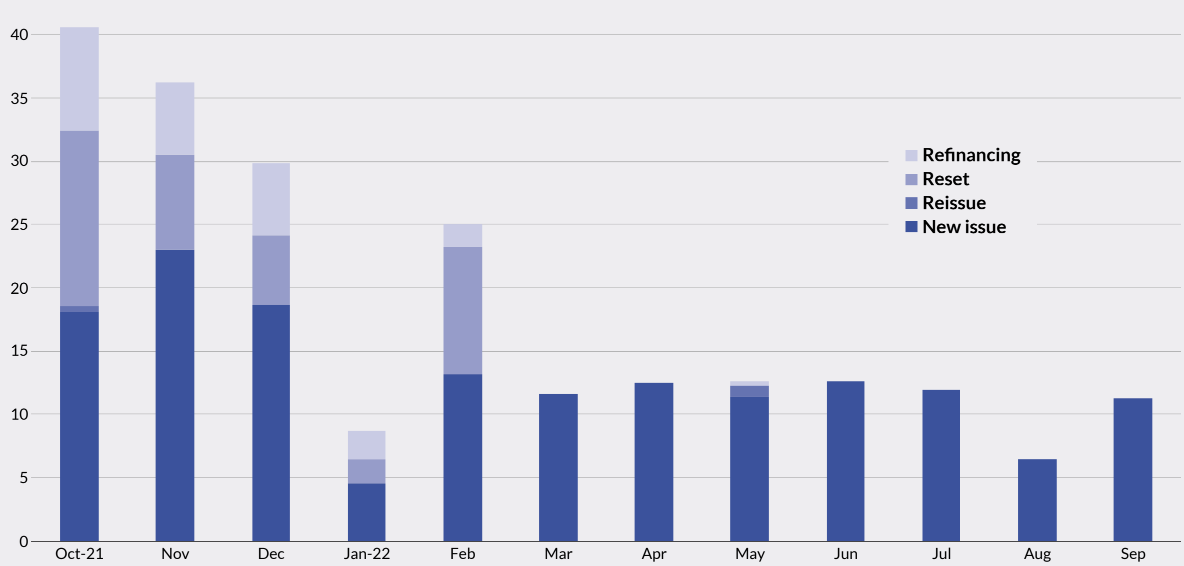
Monthly US CLO issuance ($bn)



Source: Creditflux

US CLO issuance has been more consistent than European for much of 2022, but overall volume is well below 2021, due in part to the absence of refi business since February

European CLOs

Deals have been robust but the secondary market is becoming interesting

> ## It's a question of how long it will take to put together an investor book to print a deal

European new issue CLO volume in 2022 reached just over €20 billion on 30 September, down from €25 billion over the same time period in 2021, according to *Creditflux* data. There were no resets or refinancings in the third quarter, with triple As averaging 195.83bp in 4.5-year deals.

It is unclear what new issuance can be expected in the fourth quarter, given a lack of triple A investors and new primary loan issuance.

"I've been doing CLOs for many years and one challenge has always been to expand the triple A investor base," says Alan Kelly. "Deals are getting done and there is clearly still interest out there. But it's a question of how long it will take to put together and hold an investor book to print a deal in this volatile market."

Borrowers have brought only a trickle of new loans to market, not the substantial volume required to get CLO new issues going.

In the secondary market, European CLO b-wics have been prevalent. The last week of September generated €1.5 billion, dominated by triple A and double A paper. This resulted from a sell-off in UK gilts, which drove real money investors with liability-driven investment (LDI) strategies to post additional collateral.

"The week beginning 26 September opened a great opportunity to buy higher rated CLO tranches in the secondary market at interesting entry points," Kelly says. "If I have a choice today between buying a discounted secondary piece of triple A or double A paper in the market, versus buying in primary at close to par and five or six weeks to settlement, secondary becomes a more interesting option."

Conversely, he says, new issue European CLOs since June have been robust, with extra par subordination and credit enhancement. This is a function of the underlying prices of assets, yields of loans and rating agency methodology.

European CLO triple A spreads could leak wider in Q4, based on secondary CLO volume, alongside double As and single As. One saving grace is that there may not be enough deals for investors looking to deploy in primary, meaning some pivot to secondary markets.

Among the biggest challenges in Q4 will be a lack of liquidity in the underlying loan market during earnings season.

"A CLO manager's ability to rotate and trade out of credit is limited in today's portfolio, so most deals will look pretty much the same in a few months," says Kelly. "The next quarterly earnings will start to come through and if any companies have misses — whether it's underperformance by inflation or local pressures in the company — we could see some of the collateral pool drop in price."

Kelly expects managers to undertake due diligence and manage credits, removing riskier names from portfolios. But there will be some surprises on the way, he adds.

The number of defaults looks sure to rise as the economic cycle turns. But Kelly does not expect many before the maturity walls of 2024/25 unless a liquidity event hits corporate borrowers. This is partly because of the covenant-lite nature of underlying pools.

One positive is that the CLO market has shown great resilience and creativity amid volatility.

Alan Kelly

Partner,
Redding Ridge

Bullish

Robustness of CLO structures

Bearish

New issuance volume amid lack of primary loan issuance and triple A investors

Greatest challenge

Loan market liquidity during earnings season

CLO managers issuing new deals have employed various technologies to resolve warehouses they ramped at higher prices pre-covid. This includes using senior and junior equity, delevered transactions with no single Bs, static deals or delayed draw tranches. Sources say there have been no CLO warehouse liquidations to date, as managers have worked with banks and equity investors to find solutions.

CLO managers have also had the opportunity to deploy cash to high quality credits at appetising entry levels, which helps build par and ensures the resilience of deals.

Deals performed as sources expected throughout the covid volatility that began in 2020. Some tripped tests to protect senior investors, while some equity investors and managers took the opportunity to add cash to deals to buy more collateral and delever. Recent CLO structures are also more stable, have cleaner portfolios and have greater credit enhancement than 1.0 deals.

more ≫

196bp

Average yield of triple As in 4.5-year deals in Q3

Macro credit

Europe faces a rockier and more treacherous road than the US, but this brings opportunities

There has been a growing gulf between US and European financial market performance over the past two quarters. Macroeconomic factors point to further divergence in the winter months.

Europe is in an acute crisis, with energy prices and inflation exacerbated by geopolitical turmoil. The gloomy macro backdrop, along with the rise in rates, provides plenty of volatility and dislocations. But the European market is also more fragmented and less well-researched than the US, which creates credit selection opportunities.

"The sell-off in credit has been indiscriminate," says John Aylward. "In certain cases, we feel this is warranted. For example, it's not impossible that 30% of heavy industry in Germany will have to curtail production due to energy supply issues, and default rates will no doubt increase."

But not all bonds that are trading in the 70s and 80s will have the same level of earnings volatility and cost input pressure.

"We see plenty of long opportunities in the senior double B bonds of defensive, cycle-tested companies, which will at least survive, and could even thrive, in the new regime," says Aylward. "We think that companies in technology, media and telecoms, for example, are going to withstand the cost-of-living crisis as people will continue to pay for their internet."

With double-digit yield to maturity, and additional upside from the potential to be taken out early, there are interesting opportunities on the long side. Credit selection will be paramount.

"Reflecting an asymmetric view on Europe, one can focus on the sovereign rates of the historically weakest countries in terms of geopolitical noise, budget deficits, debt/GDP, economic prospects and exposure to particular exogenous shocks," says Aylward.

In particular he points to the Italian political noise around Draghi's resignation and snap elections; the rising cost of debt as ECB hikes disproportionately impact Italy and Greece; and the end of the ECB's asset purchase programmes, which will impact periphery corporates disproportionately.

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John Aylward

Founder and chief investment officer, Sona Asset Management

Bullish

Long opportunities in senior double B bonds of defensive, cycle-tested companies in resilient sectors (for example, TMT)

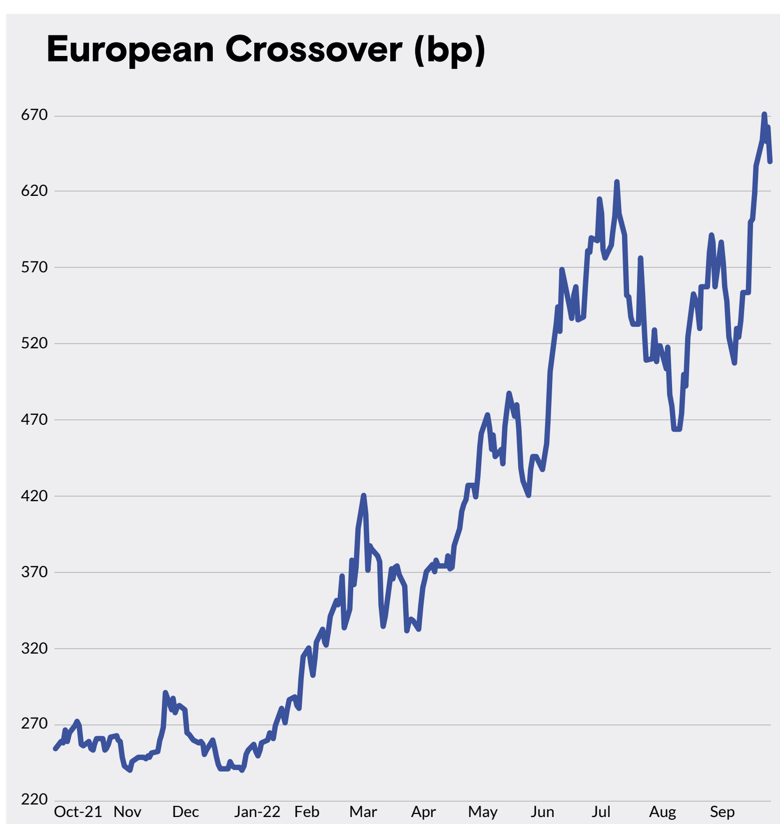
Bearish

Cyclically and thematically challenged European credit and peripherals

Greatest challenge

Knowing the difference between the two — credit selection will be paramount

We see long opportunities in the senior double B bonds of defensive, cycle-tested companies

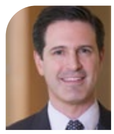


Source: iTraxx Xover from IHS Markit

European credit has underperformed US, with spreads testing levels reached in the March 2020 covid sell-off

US loans

Lenders are approaching inflection point as borrower costs mount



Sinjin Bowron

Portfolio manager, Beach Point Capital

Bullish

Valuations provide a great entry point into the asset class

Bearish

Companies that don't have pricing power are suffering from inflationary pressures and have no way to fix that, particularly if they have near-term maturities

Greatest challenge

Transition from rising rates being a benefit to being a headwind

Loans look fairly cheap, but spreads and valuations will be dictated by the rate of policy change

The leveraged loan market has been on a wild ride since this year's second quarter. The average bid rose from around 92 cents at the start of July to over 95 by mid-August, before the trend reversed and loans ended last quarter almost exactly where they started.

Investors flooded into loans in the early months of 2022. But in Q4 lenders fear the asset class is approaching an inflection point, where the benefit of higher coupon payments is negated by borrowers struggling to service their debt costs.

Beach Point's Sinjin Bowron says the market is driven by Federal Reserve policy. "You have a downdraft on the technical demand for loans, as well as some concern over the fundamentals of floating rate issuers," he says. "The asset class is at a crossroads but is still performing among the better of all the risk assets out there."

The discount margin to maturity of the loan asset class is around 600bp, says Bowron. Loans' yield-to-maturity is hovering around the 10% area.

"Loans look fairly cheap to us, but spreads and valuations are going to be dictated by the rate of policy change," he says. "Spreads have the possibility to move wider, because the Fed continues to make clear on a daily basis that they're not done raising rates in an aggressive fashion to combat inflation."

With the LBO pipeline effectively frozen, there has been little primary issuance in the loan market, and that situation is likely to continue toward the end of 2022. Defaults are expected to increase, but investors sense the rate is likely to look benign by historical standards. Issuers are coming off two years of balance sheet repair and have healthy interest coverage ratios.

Bowron says recent inflation data has looked optimistic, which is a positive signal for the outcome of future US Federal Reserve meetings.

"There are components of inflation that have a high probability of coming down over the near term, which should alleviate the tension that monetary policy is facing between the economy and inflation," he says. "With any potential inflection point in monetary policy, we think loans will perform quite well."

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Source: CDX NA HY from IHS Markit

High yield bonds have underperformed loans for much of 2022 with CDS trading in between. Some predict convergence between the three as rates (and spreads) continue to rise

European loans

Buying engine will have another chance to show it is built for volatility

Mick Vasilache

Portfolio manager, Chenavari

Bullish

Higher coupons/spreads on existing loans as issuers refinance

Bearish

CLO arbitrage

Greatest challenge

Downgrade risks

European loan investors had to navigate volatile markets in the third quarter amid the Ukraine-Russia war, cost of living crisis, energy supply problems and inflation. But the good news, says Mick Vasilache, is that CLOs are designed to cope with volatility — and the economic outlook will be less gloomy than the market has priced in.

"What the various market indices seem to imply — with iTraxx Crossover reaching 700bp and the S&P ELLI loan index at 90 cents — is a level of default and distress that is significantly higher than what we think will happen in our portfolios over the next several quarters," says Vasilache.

"There is a disconnect between fundamentals — which in some sectors are deteriorating — and levels of stress implied by market indices. Clearly, some sectors are being challenged and some are already going through an earnings downturn, but a 6-7% default rate per year for five years seems like a big gap."

Downgrade risk is one of the biggest challenges for loan investors going into Q4, although rating agencies are taking time to review and downgrade individual names. This contrasts with 2020, when they were quick to downgrade entire sectors.

Chenavari priced its first CLO of the year (and eighth overall) in March. Vasilache says the firm went effective earlier than usual over the summer because it had achieved ramping objectives and wanted to mitigate downgrade risk.

Over Q4, CLO managers must stay mindful of defaults and triple C buckets. If exceeded, these could threaten equity payments and sub management fees.

Europe's new issue loan pipeline remains thin as issuers and private equity sponsors come to terms with the higher interest rate environment. But there has been a trickle of new deals and add-ons to existing deals. Companies with good credit fundamentals created a buying opportunity for CLOs, Vasilache says, with issuers offering higher yields.

"For example, House of HR is a company we have been lenders to for a long time. We were in the existing deal, then the company changed hands. The first lien loan coupon was 375bp. It's now 575bp, we got repaid at par on the old loan and the new loan in OID was 94. Such a trade is quite attractive, particularly if you have existing CLOs where the cost of debt is reasonable."

> **There is a disconnect between fundamentals and levels of stress implied by market indices**

The European leveraged loan index rallied at the start of September, largely driven by technical factors. Six new issues priced, but by September-end the index plummeted to below 90 after the UK's mini-budget panic.

Vasilache believes the index will be "range bound for the rest of the year" on lower-than-average liquidity. He says he follows index changes to see where he can build a new portfolio, and as an overall indicator of market sentiment.

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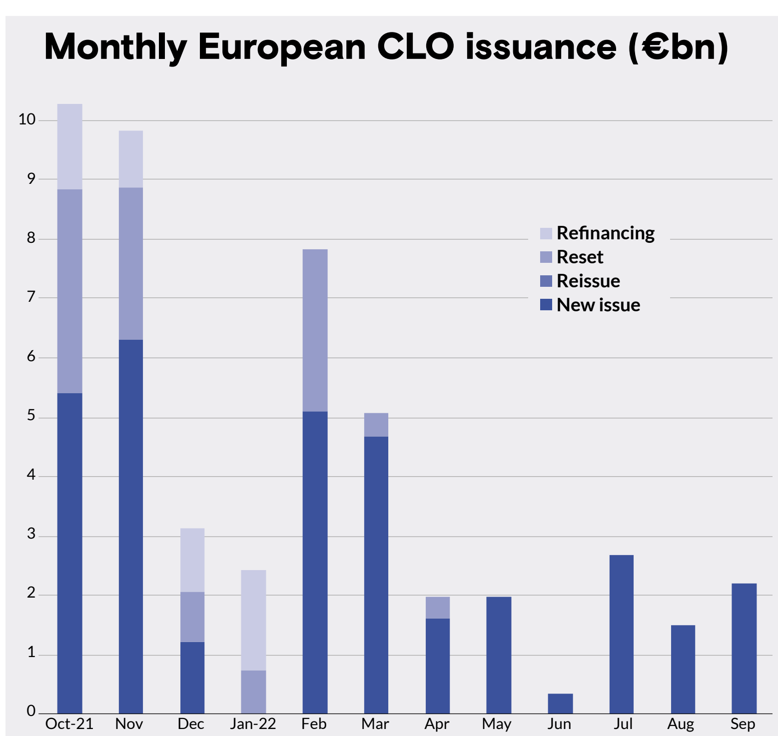

Source: Creditflux

The European CLO new issuance pipeline has tentatively returned. There are wide variations of pricing and structure because the loan market is volatile and has generated sparse primary business. CLO refinancing remains absent

Investment grade

IG takes a hit, but that only makes the entry-point more enticing

Investment grade credit has taken a hammering, particularly towards the end of the third quarter, as outflows from European funds peaked at just over $6 billion-equivalent in the last week of September, according EPFR Global data. About $7.9 billion left US IG funds, sources say.

Globally the prospects in IG credit had been improving, with the CDX IG index rallying from 100.5bp on 1 July to 73.75bp in mid-August. But gains for long investors unravelled as the index leapt to 107.75bp by quarter-end. As spreads widened, debt issuers were reluctant to enter the primary market and September bond volume reached a meagre three deals and $1.7 billion in the US.

"The key question on our minds is what level of tightened financial conditions are required to deliver a recession of sufficient length and depth to address what has proven to be persistent and systematically underestimated inflation," says Alexandra Wilson-Elizondo.

She says GSAM is defensively postured, but ensuing volatility has "created opportunities to play both defence and offense".

Looking across markets, Wilson-Elizondo says she is starting to prefer some credit risk over equities. "Some high-quality credit now yields nearly as much as the S&P index, implying relative attractiveness compared to equity dividend yields. That said, credit selection and curve positioning will be paramount to any fixed income positioning."

This is an outlook with which asset manager CQS agrees. A post by the firm highlighted US equity risk premia is in its first percentile (since 2011), while credit is in its 68th percentile.

"IG and HY yields are now attractive relative to equities on a risk-adjusted basis, providing a level of income that should help dampen market volatility," wrote CQS senior portfolio manager Darren Toner.

Wilson-Elizondo says yields are attractive, even though credit spreads appear tight. Her default outlook is benign and she says IG credit has been resilient, given economic indicators. But she is less comfortable with high yield, preferring an underweight allocation to the asset class because of credit issues regarding triple C-rated companies.

Many other asset managers are similarly positioned, with Neuberger Berman recently stating its view on IG credit had improved. "Wider spreads appear to compensate for increased risks from higher interest rates and economic softening," said the firm in a fixed income outlook.

Given interest rate increases globally, floating rate debt might be regarded as an obvious safe haven. But Wilson-Elizondo warns against piling in. The energy sector looks a better bet, she says.

"One of the most challenging aspects of the first part of this year was that there were no clear safe-havens with the rates sell-off," she says. "We looked to address what asset classes would perform as safe havens in this environment. Energy, for example, was an asset class outside the traditional 60/40 models, but we were able to quickly identify it as a safe haven that would replace the historical volatility dampening component of the model."

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Alexandra Wilson-Elizondo

Head of multi-asset funds, Goldman Sachs AM

Bullish

Parts of credit look preferable to equity due to low refinancing needs, no structural sector issues, and potential to achieve equity-like returns. Short-duration IG looks attractive

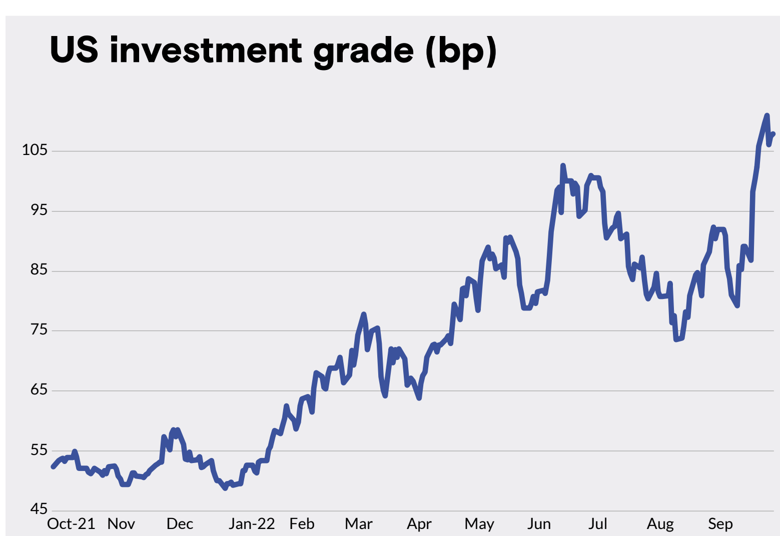
Bearish

Floating-rate debt. Loans are less liquid than bonds, and the many loan-only capital structures and under-followed names make trading and allocating challenging

Greatest challenge

Diminishing liquidity, especially as dealers shore up risk-weighted assets for year-end, will make it challenging to price risk assets

Credit selection and curve positioning will be paramount in fixed income



Source: CDX NA IG from IHS Markit

Investors are increasingly differentiating the US from other worse performing global markets. Even so, there has still been a doubling of US investment grade index spreads

High yield

Income and capital appreciation opportunities are returning

After a difficult 2022, investors say they are optimistic about global high yield bonds. The global HY market has not had two consecutive years of negative returns since the inception of the ICE BofA Global High Yield Index in 1998. Also, strong returns have often followed a negative year due to cheapened valuations and the power of high coupons.

Stella Ma says valuations have become more attractive in terms of bonds' all-in yield and price. "The yield to worst on developed market high yield has risen to nearly 10%, above the last 20-year average of 7.7%," says Ma. "Before this, there had been three periods when developed market HY bond yields went to 10% or above since the global financial crisis: the Eurozone debt crisis in 2011, the commodity price crisis in 2016 and the pandemic shock in 2020."

A lot of downside risk is priced in, says Ma. "Historically, at a starting yield level of 9% and above, 12-month forward-looking returns tend to be strong due to the power of carry and price appreciation potential."

But earnings and balance sheets could deteriorate for issuers operating in highly cyclical industries such as retail, chemical and auto. Those without free cash flow will be further squeezed by higher funding costs. Ma prefers the double B and select single B parts of high yield markets over triple Cs.

Stella Ma

Portfolio manager, high yield bonds, Vontobel

Bullish

Attractive valuation for developed market HY. Possible strong 12-month forward-looking returns

Bearish

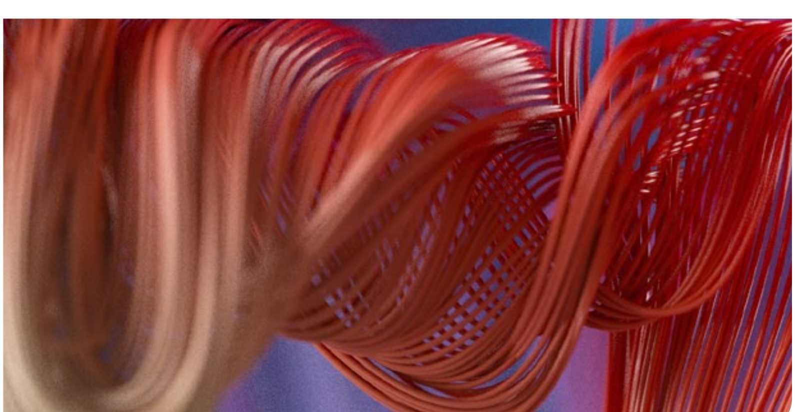
Likely deterioration of earnings and balance sheets for issuers operating in highly cyclical industries

Greatest challenge

Market liquidity expected to deteriorate further

High yield defaults are at 1.3% in the US and 0.3% in Europe over the past 12 months. These figures are below the historical average 4% (US) and 3% (Europe). Default rates are expected to rise from today's low levels but remain below the worst levels of previous cycles. European and US high yield CDS indices have priced in about 40% and 35% of cumulative defaults over five years, respectively.

"The last time we reached a 35% cumulative five-year default rate was during the period of the global financial crisis," says Ma. "We don't expect high yield bond default rates to get anywhere close to that level over a five-year horizon because macroeconomic fundamentals and private sector balance sheets today are in much better shape than in 2008."



We don't expect high yield bond default rates to get close to 35%

The quality of the high yield bond universe has improved over the past decade, adds Ma. Large capital structure fallen angels have entered and weaker credits have left in the default cycles of 2016 and 2020.

Spreads will likely remain volatile until inflation abates. But Ma believes HY bonds offer decent risk/reward for investors with a medium to long term horizon. They must closely watch Q4 corporate earnings season to assess the impact of inflation and tightening financial conditions.

"Judging from the recent flow data, investors are sitting on significant amounts of cash," says Ma. "If the earnings season turns out to be more benign than expected, the high yield bond market may see a rally into year-end given the conservative positioning from the investor base and cheapening valuations."

Conversely, if earnings turn out worse than expected and inflation stays sticky, there is scope for further spread widening. Market liquidity has been challenging all year due to relentless volatility and low risk appetite from dealers.

"We expect market liquidity to deteriorate further as we head into year-end, which can cause meaningful dislocations," adds Ma. "High yield bond prices will not only be driven by fundamentals but also market positioning. Popular short positions can see big squeezes higher and vice versa. The low liquidity environment is always a challenge to navigate, but at the same time it provides opportunities as prices deviate from fundamentals."

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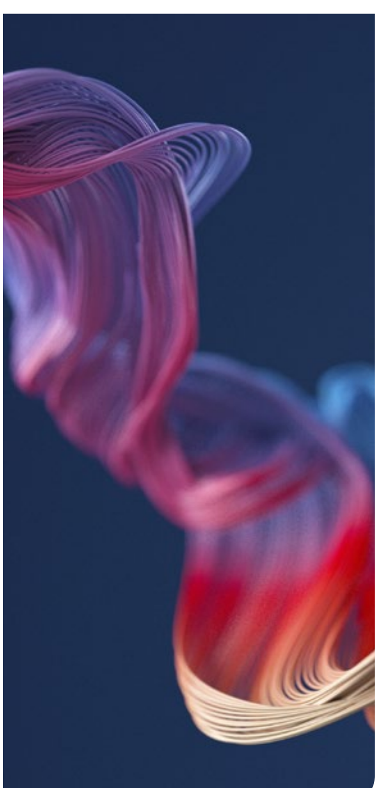
Distressed

The pipeline is burgeoning, but separating fundamentals from macroeconomics is hard

With many volatility drivers liable to disrupt financial markets, distressed investment strategies look more dependent than ever on mitigating macroeconomic uncertainty. What remains is a narrow range of sectors and geographies, but with plenty of situations to choose from.

"We haven't even seen the start of a true recession yet," says Amyn Pesnani. "But it's hard to see how we avoid a downturn, so it's right to stay cautious. What we are bullish on is the pipeline of opportunities falling within our remit."

TDO's focus is going long on northern and western European corporate borrowers in the industrials, business services, consumer and healthcare sectors, through investments with a three- to five-year horizon. The strategy does not seek exposure to real estate or financials, while also avoiding sectors such as retail and energy.



Amyn Pesnani

Head, Triton Debt Opportunities, Triton Partners

Bullish

Our pipeline for the future, but particularly the travel sector given pent up demand from covid-19, especially as China reopens

Bearish

Consumer, construction-related

Greatest challenge

Picking right/best placed companies amid greater macroeconomic uncertainty

"We are looking opportunistically for fundamentally good businesses," says Pesnani. "They might be having a hard time but are in industries we view as structurally sound. We want to be aligned with similar investors and conduct the same deep situational analysis we have always done, rather than trying to time the market cycle or predict energy prices — both of which are highly uncertain."

Downside analysis is more important than ever. But, as Pesnani points out, the maturity wall next year may not be as bad as some anticipate. "There will be a lot of amend and extends, albeit with sponsors having to provide incremental money to creditors."

Travel-related investments look attractive, especially through illiquid credit and assets — including physical ownership of aircraft. Triton sees the reopening of the Chinese economy from covid-19 — whether in 2023 or 2024 — being a big driver of this sector's rejuvenation.

European energy price fluctuation remains a major source of uncertainty for industrials. And with consumers getting squeezed by rising costs, both these sectors will have winners and losers. But Triton is keen to avoid anything construction related, since mortgage markets coming under pressure and the buy-to-let model no longer working are big risks to prices and pipeline.

There will be a lot of amend and extends, albeit with sponsors having to provide incremental money to creditors

In this context, Andrew Wilkinson, co-head of London restructuring practice, Weil, Gotshal & Manges, says the UK faces unprecedented levels of corporate distress versus the rest of Europe, according to Weil's European Distress Index.

"Against a backdrop of 40-year highs in inflation, tightening monetary policy and forecasts of recession, the UK is now facing its highest levels of distress since August 2020," he says. "Alarmingly, consumer confidence has also hit rock bottom — surpassing lows from both the pandemic and the global financial crisis."

Wilkinson places this in stark contrast with France, where corporate distress is below long-term averages. "France has acted quickly to cap energy price rises to 5% compared to the previous year — compared to in the UK, where energy bills are likely to double despite the price cap."

Although it may seem counterintuitive in the context of the energy crisis, infrastructure, utilities and power companies have improved their balance sheets, Wilkinson adds. These companies have been able to offload price increases to consumers and businesses, resulting in improved profits, valuations and market fundamentals.

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Structured credit

Opportunities abound if investors fly solo and dare to be different

ABS markets have been battered in the 2022 sell-off, but the diversity of assets falling under the acronym means investors can find pockets of opportunity, says Frank LaTorraca.

He characterises the investment universe in two segments. “First is esoteric ABS, where you have transactions that are typically using a homogeneous non-traditional collateral pool, like operating assets. The second is structured corporates, which typically use a single asset with payments coming from an investment grade-rated payor.”

Within the esoteric ABS sector, LaTorraca says he particularly likes pooled commercial aircraft-backed securitisations. These should follow an A/B note format, both of which are investment grade, and the underlying should be attractive in terms of aircraft type, age or use.

For structured corporate investments, LaTorraca says an example is net lease-backed securitisation. This is also in an A/B format, based on a pool of single tenant commercial property, with diversified underlying retail or commercial businesses. Attractive features include geography, credit enhancement features such as interest reserves, and strong debt service coverage.

He is more bearish on construction projects around commercial real estate. “We see those in the form of credit tenant leases or ground lease transactions,” he says. “We have a similar view of the limited-service hospitality and unsecured consumer sectors.”

One challenge facing today’s market is deal access and demand from insurance company balance sheets, LaTorraca adds.

“We believe Neuberger Berman is in a unique position as a pure play asset manager to have these strong sourcing capabilities where we don’t have to serve our own insurance balance sheet in potential competition with our third-party clients.”

more ≫

Frank LaTorraca

Head, private placements insurance solutions, Neuberger Berman

Bullish

Pooled commercial aircraft-backed securitisation, net lease-backed securitisation

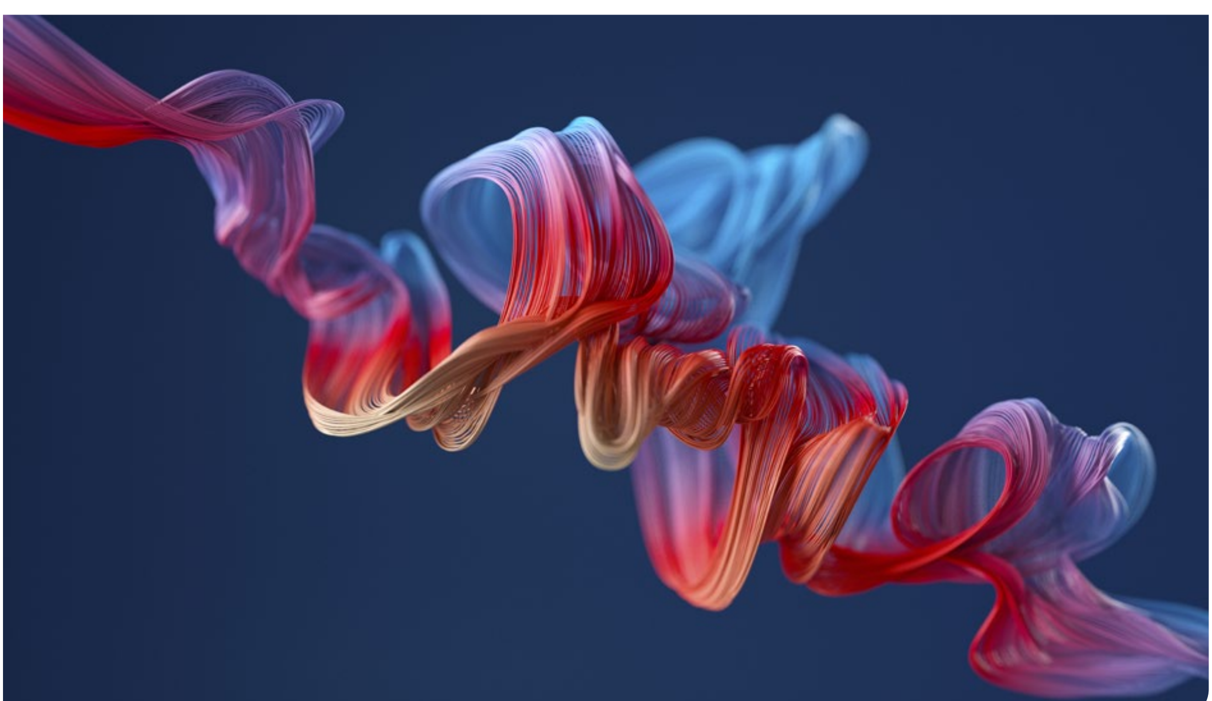
Bearish

Construction projects around commercial real estate

Greatest challenge

Deal access and demand from insurance company balance sheets

The diversity of assets falling under ABS means investors can find pockets of opportunity



US direct lending

Fundamental value and realistic projections are replacing available capital as dominant drivers

Direct lending portfolio companies face much the same headwinds impacting other businesses across the economy: debt service costs are rising at the same time as wage and input inflation surges. Yet the product continues to draw high interest from investors, leading to an expanded footprint for private credit within the investment universe.

Tightening financial conditions have changed the way investors think about pricing private credit deals, says Milwood Hobbs.

"The private markets are beginning to reprice risk based on credit fundamentals, expected cash flows and valuations based on reasonable financial projections, as opposed to the last few years, in which the price of risk was determined by the availability of capital," Hobbs says.

"Legacy investments are not appropriately priced based on risk, and private credit could experience a dislocation as markets adjust to rising rates, inflation and increased volatility — both of which could impact traditionally beneficial, high-growth sectors, like technology and business services."

As private credit grew and became institutionalised, direct lenders have faced a growing list of questions regarding their role in the financial universe, says Hobbs.

"As the asset class grows, what is the right role in the leveraged finance ecosystem? Is it replacing traditional bank capital? How do you provide incremental value to private equity firms and corporate borrowers?"

Traditionally banks have been in the 'moving' business and investors have been in the 'storage' business, he adds. "As some direct lenders shift to the 'moving' business, how will LPs adjust to expect more potential volatility in their returns?"

more ≫

Milwood Hobbs Jr

Head of North American sourcing and origination, Oaktree Capital Mgmt

Bullish

Risk is being repriced on credit fundamentals, rather than the availability of capital

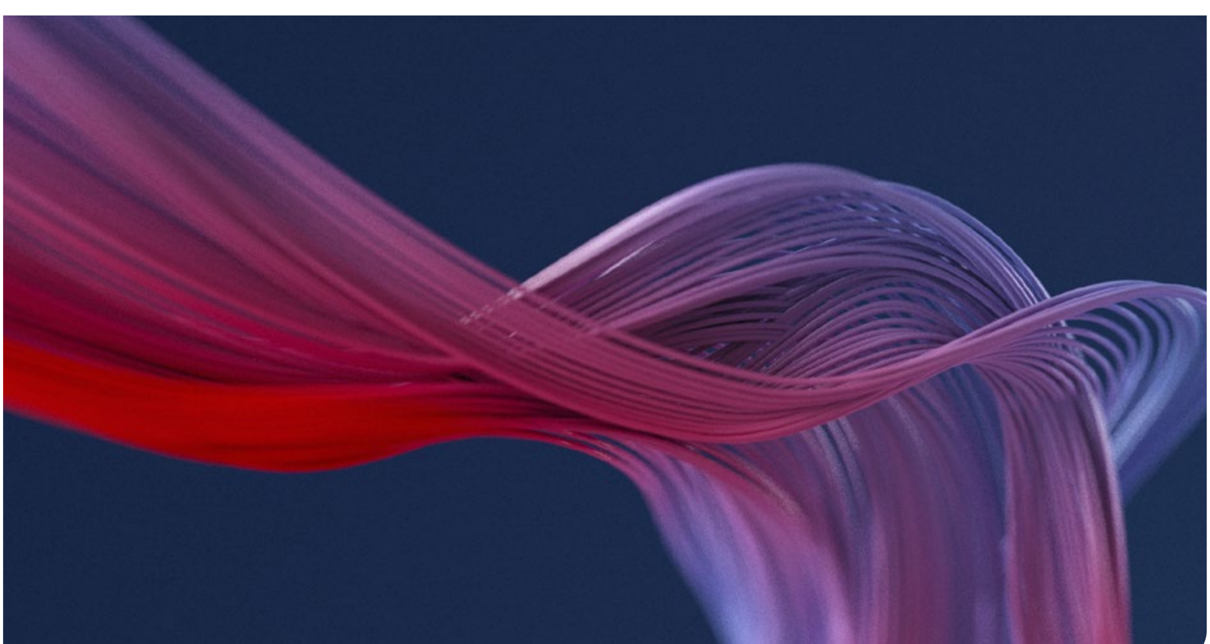
Bearish

Legacy investments are not appropriately priced

Biggest challenge

Finding the right role for private credit in the leveraged finance ecosystem

Private credit may face a dislocation as markets adjust to rising rates, inflation and volatility



European direct lending

It is time to reassess portfolios amid greater volatility and higher rates

The third quarter accelerated some risks but also increased opportunities for European direct lending managers. Increasing dislocation and volatility in public markets meant private credit lenders could capture attractive relative value through strong execution and continued deal flow. This resulted in attractive pricing and strong lender terms during the quarter.

According to David Ross, excess returns compensate for a potentially elevated loss environment over the next two to three years. Forward rates are difficult to predict but suggest the UK and Eurozone could experience interest rates over the next three years that are 300bp or more above those of the last three years. The market is also expecting transaction spreads to widen by 50bp or more.

"Historically, direct lending has had 50-70bp of losses, so the incremental return in today's market offers significantly enhanced yield, even after you include elevated estimated loss assumptions," says Ross.

Direct lenders must be transparent with investors on loss-adjusted return expectations, he adds. As well as higher rates and inflation, the broader volatility and macro risk will create heightened challenges for specific borrowers.

Lower consumer demand could also start to challenge the capital structure of some businesses. Direct lenders will examine how rising rates and lower margins impact their portfolios and reassess whether each business has a truly consistent underlying customer demand in a softening market.

"Private equity sponsors and management are working much harder to pass price increases through to customers, to reconsider cost structure adjustments and pivot businesses into areas of more stable demand," Ross says. Instead of a great increase in credit risk, he expects to work with management teams to stabilise and grow companies the next six-to-twelve months.

more ≫

David Ross

Managing director, Northleaf Capital Partners

Bullish

Credit returns

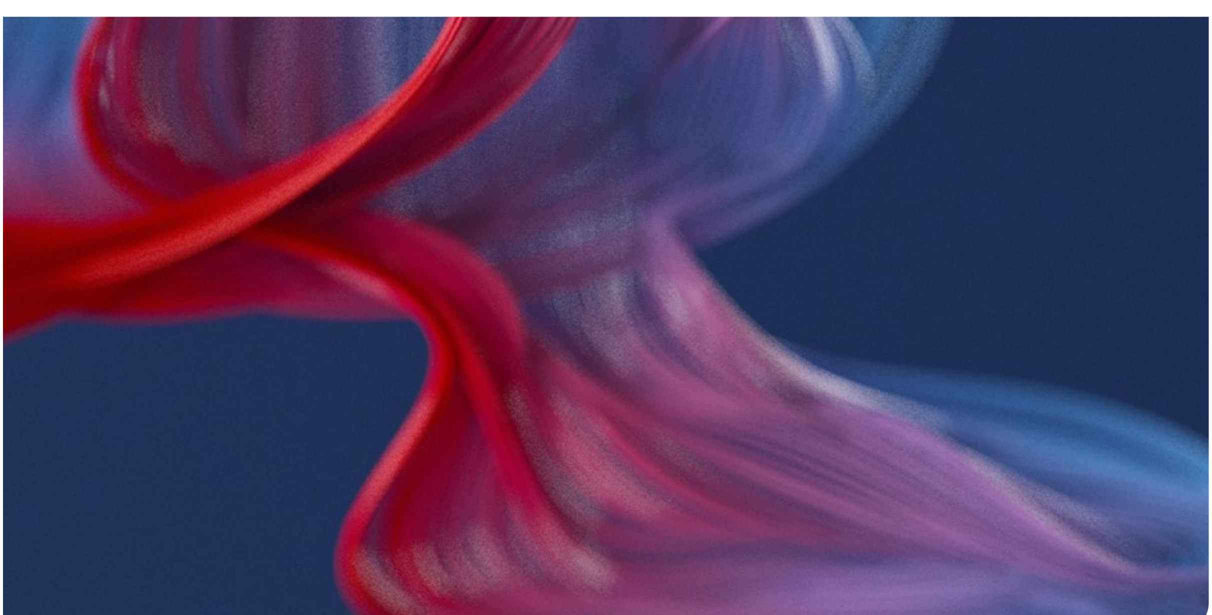
Bearish

Consumer demand

Greatest challenge

Valuation re-calibration as era of government-supported demand ends and market seeks to assess risk of inflation and de-globalisation

The incremental return in today's market offers significantly enhanced yield



Emerging markets

Negatives appear priced in, but IG could be vulnerable

Emerging market credit has had a particularly difficult year, having lost around 20%, sources say (while US high yield is down about 15%). But such has been the drop, it seems the only way is up.

"It's been such a tough year and it's hard to see valuations getting much worse, especially in EM HY, even taking into account geopolitical tensions rising, rates volatility and energy price hikes," says Nick Smallwood.

He says that new issuance is down about 50% this year but, putting that in context, US high yield issuance has slumped by 75% in 2022. Another point of difference between emerging and developed markets is dispersion. Whereas US high yield has outperformed investment grade this year (owing to the latter's sensitivity to interest rates), the reverse is true in emerging markets.

"Emerging market high yield has been hit for six," says Smallwood, noting that emerging market IG has been viewed as a safe haven and has held up reasonably well. The sell-off in high yield paper has been indiscriminate, he says.

"Nigeria has done well as it is an oil exporter, while other sub-Saharan African countries do not benefit from oil price appreciation," says Smallwood. "Despite that key difference, single B-rated sovereign bonds in this region have sold off similarly. We've spent a lot of time analysing bonds that we view as having sold off unjustifiably."

Although emerging market corporate fundamentals are strong, investors will be looking at fund flows and how this impacts Latin America. "The outlook is unclear, because talk of a US recession is getting louder and that draws the question: will money move out of Latin America and into US high yield?" says Smallwood.

Many funds have allocated to Latin America because of the obvious issues in China, Russia, Ukraine and Turkey. "The good news here is that most funds now allocated to Latin America are EM dedicated, which reduced the risk of leakage into US HY," says Smallwood.

more ≫

Emerging market high yield has been hit for six

Nick Smallwood

Emerging market debt — financials strategist, M&G Investments

Bullish

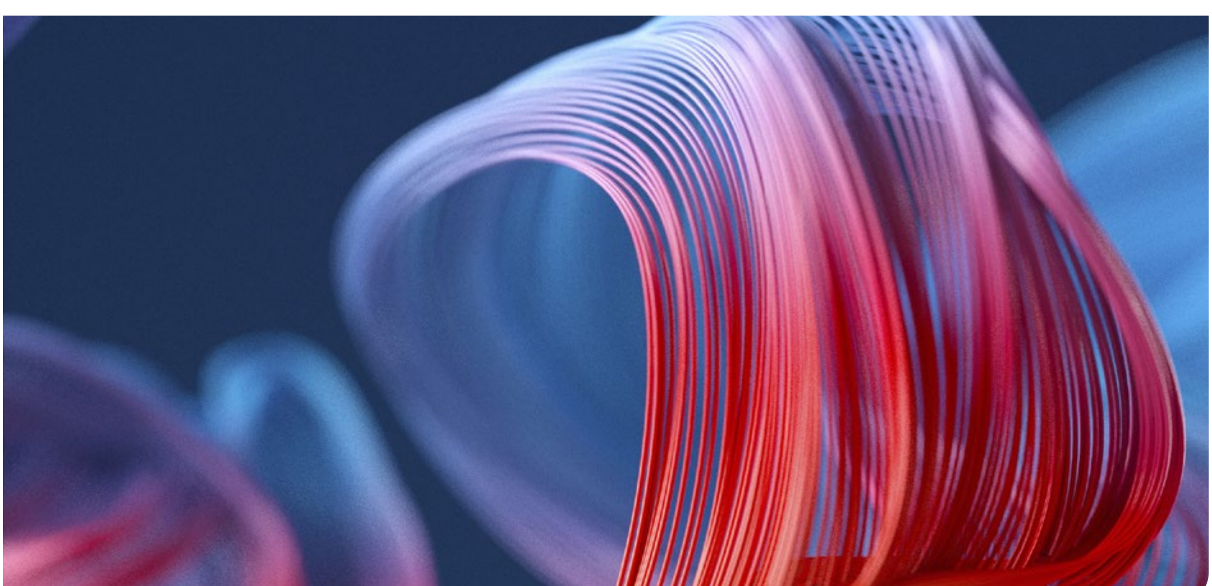
Fundamentals are strong; selected corporates in Indonesia, Thailand and Uzbekistan; and in Peru and Colombia where negatives are fully priced in

Bearish

Refi risks for weaker corporates if market closure persists; highly levered HY companies that do not benefit from commodity prices

Greatest challenge

Executing trades given rates instability and illiquidity in credit



Real assets

The UK is not going back to the 1970s — but investors will have to be selective

A recurring theme has been banks pulling back from real estate lending, but an overlooked aspect is how this could affect asset managers that were reliant on banks for loan-in-loan funding, and are having their credit lines pulled.

"That will, in our view, present opportunities for alternative lenders with levered capital to take advantage of rising returns and reducing risk in a market where the fund gap is ever widening," says Natalie Howard.

She also says lenders affiliated to a real estate equity platform have an advantage. "Where valuations do fall, we expect opportunities [for these lenders] to present themselves as assets are refinanced, providing senior secured financing where others are unable, in preferential terms."

Schroders does not believe the UK real estate market is set to experience a 1970s-style boom-bust-boom cycle. But the firm sees secondary shops and shopping centres, dedicated conference hotels and offices in secondary locations as vulnerable.

"We do not favour any building with poor energy efficiency and general lack of higher-rated tenant amenities," wrote the firm in a blog in August. On the flip side, the firm advocated bulky goods retail parks, because these "generally enjoy steady demand from discounters like Aldi, B&M and Lidl, as well as mid-market retailers such as M&S and Next".

In the US, Oaktree Capital Management wrote in a recent post that multi-family and industrial real estate sectors have been resilient in 2022. Multi-family generally has short average lease terms (roughly one year), and this is beneficial during periods of high inflation, because property owners can adjust the rental rates they pay.

Natalie Howard

Head of real estate debt, Schroders

Bullish

Opportunities in real estate debt as liquidity in the market reduces with banks further retrenching, which will also affect asset managers reliant on banks for financing

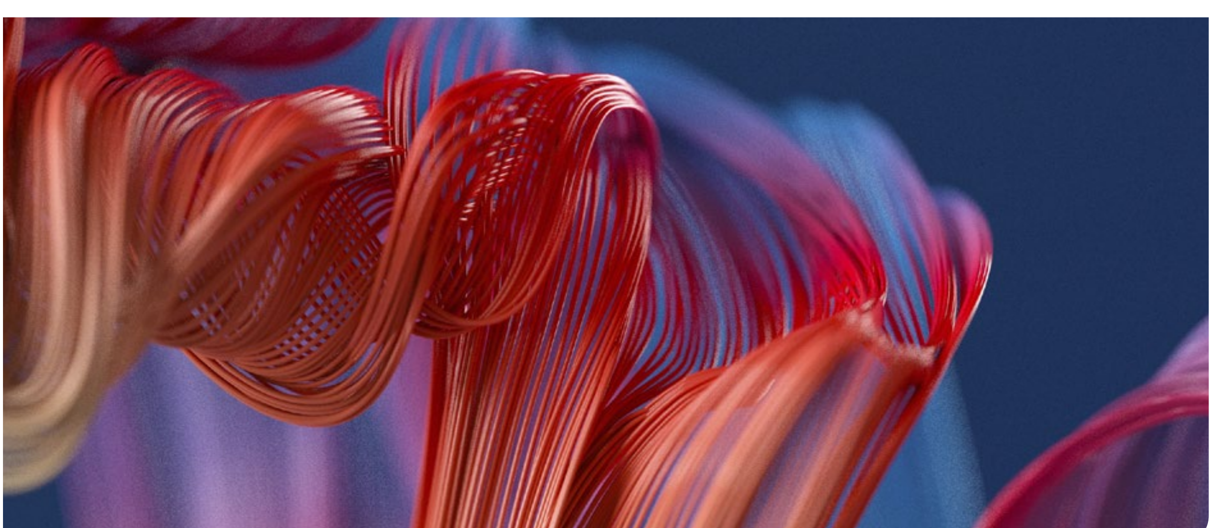
Bearish

Asset classes and transactions without full suites of covenants

Greatest challenge

Staying close to investors on deal-flow, given the general slowdown in investor commitments

Alternative lenders with levered capital will be able to take advantage of rising returns



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