Global Credit Market Insights

Q1 2024

Welcome to Waystone's Q1 2024 edition of our Global Credit Market Insights.

As the global Credit market continues to thrive against a backdrop of increased inflation, interest rate volatility and associated pressure on borrowers, funds need to be more resilient than ever to achieve their growth strategies.

Waystone's global team has extensive experience and specialist Credit expertise. Partnering with managers across all asset classes, we assist clients to launch, oversee and administer fund structures, both closed-end or Evergreen.

Our aim in this publication is to provide you with key news stories and topical insights from our work with investment managers within Credit and Alternatives to help you navigate market dynamics and complexities.

Credit Market News

This section provides a summary of the key news stories in the world of credit, covering Private Credit, Secondaries, and Asset-Backed Securities (ABS) including Collateralised Loan Obligations (CLOs) and Residential Mortgage-Backed Securities (RMBS).

Key themes emerging in the news segments in Q1 2024:

- Large investment banks looking to enter private markets via equity and credit
- ABS new issuance ticked up in the quarter
- Commercial Real Estate woes spill over into CLO market
- Positive development within the ELTIF regime in Ireland
- Australian managers eyeing Private Credit
- Goldman Sachs and KKR look to Private Credit in APAC
- Some reduction in wall risk given better sentiment

United States (U.S.)

U.S. banks looking for a slice of Private Credit market

According to a report by Private Equity Wire, Goldman Sachs AM is looking to increase AUM in Private Credit from $130bn to $300bn in five years. Morgan Stanley expects to increase its AUM to $50bn and JP Morgan expects to increase its exposure to $10bn in the medium-term by partnering with FS Investments and Octagon Credit Investors. Source: Private Equity Wire - read the full article here.

Nomura focuses on Private Credit market

Nomura Holdings has restructured its U.S. operation, looking to break into Private Credit markets with Asset-Based Lending (ABL), Real Estate and Infrastructure. Nomura-backed Corinthia Global Management has lifted out the Private Credit team of more than 20 people from Barings. Source: BNN Bloomberg - read the full article here.

Private Credit funds seek early stage, high growth software companies

Creative Private Credit funds are generating funding within cash burning software companies. This involves the repack of loans to non-revenue generating companies, into securitised bonds. The revenue streams of the bonds are contingent upon the future revenue streams of the companies. According to Bloomberg, the market size is already close to $1bn YTD and asset pioneers include Monroe Capital, Golub Capital and Vista Credit Partners. Source: Bloomberg - read the full article here (Private Credit Turns Cash-Burn Firms Into Billion-Dollar Bonds - subscription required).

Rise in ABS volumes in the U.S.

Bloomberg reports that up to 10 new ABS (autos, cards, equipment and SLABS) are expected to price in the 2nd week of March. U.S. ABS volumes are roughly 50% higher than at this stage last year. Source: Bloomberg - read the full article here (ABS Sales Top $112 Billion After Nine Price - subscription required).

Struggling buyout firms access Private Credit

Bloomberg report that Private Credit firms have stepped in to help with struggling buyout firms, by using cash to make preferred equity investments directly into companies. Private Credit lenders in this situation tend to be junior to existing creditors and facilities typically take on the form of payment-in-kind (PIK) in the 13-15% range. Private equity companies can now use that cash to return capital to investors – a period where distributions have plummeted amidst higher rate environment. Source: Bloomberg - read the full article here (Buyout Firms Stuck With Old Assets Tap Private Credit for Help - subscription required).

Distress in Commercial Real Estate CLOs

Commercial Real Estate CLOs are in distress given borrower strain to repay property-linked loans. Bloomberg report that the pools contain Commercial Real Estate loans viewed by Commercial Mortgage-Backed Security deals as too risky. Delinquency rates in the pools have hit as high as circa 9% (in the 60+ day delinquency bucket) in January 2024. Senior tranches remain well protected given credit enhancement, but equity tranches are in peril as loans are being restructured. To avoid a scenario where all cash is diverted to seniors (given failure of specific coverage tests), the issuers have started to repurchase defaulted loans[1] to ensure tests pass. Source: Bloomberg - read the full article here (Commercial Real Estate CLOs Near Brink as Distressed Loans Surge - subscription required).

[1] In 2022 Bloomberg report that the repurchase amount was circa $0.5bn, however in 2023, the number had risen to $1.3bn.

Europe

ELTIF 2.0 authorisation process in Ireland

The Irish Regulator, the Central Bank of Ireland (CBI), updated its Alternative Investment Funds (AIFs) Rulebook to include its framework for authorised European Long Term Investment Funds (ELTIFs) to be established in Ireland. The regime facilitates the launch of alternative investment funds, with a focus on raising capital in Europe for longer-term assets. Guidance for the authorisation process of AIFs and Retail Investor Alternative Investment Funds (RIAIFs) are available here on the CBI's website here.

ABS news

Green Storm 2024 (Prime Dutch RMBS) and Sunrise 2024 Italian STS ABS both expected to price mid-March. Saecure 22 STS ABS (€600 issuance) priced at +40bps. Source: Bloomberg - read the full article here (Europe ABS Pipeline - subscription required).

Asia Pacific (APAC)

Private Credit in Australia

The credit crunch in Australia paves the way for Private Credit. Industry misconduct among major Australian banks has left them risk averse, especially non-performing portions of banks' books to hit AUD1.8bn as reported by Bloomberg. Private Credit funds are now stepping into the residential space (e.g. Apollo Global Management), an area that Australian banks have shied away from. Bloomberg report that one of the key risks associated with this trade is the contractor selection. Spiralling costs have caused the bankruptcy of many Australian contractors. Source: Bloomberg - read the full article here (Australia's Housing Crunch Lures More Private Credit Lenders - subscription required).

Goldman Sachs enters the APAC Private Credit market

Goldman Sachs has established a key relationship with Mubadala Investment Company to enter the APAC Private Credit market, signing a $1bn management account. Private Credit is a focus within APAC but it is expected that India will be the largest part of the investment strategy. Source: Markets Media - read the full article here.

High quality undervalued assets in APAC driving interest

KKR sees Asia as an attractive investment opportunity given financing opportunities and high-quality undervalued assets in APAC. Given the recent tightening in lending practices, defaults have been removed, thus leaving high-quality assets, which are undervalued relative to U.S. and European alternatives. This shift in focus may be further accentuated by existing High-Yield bonds maturing (56% in Asia maturing in three years) in the short to medium term. Source: Bloomberg - read the full article here.

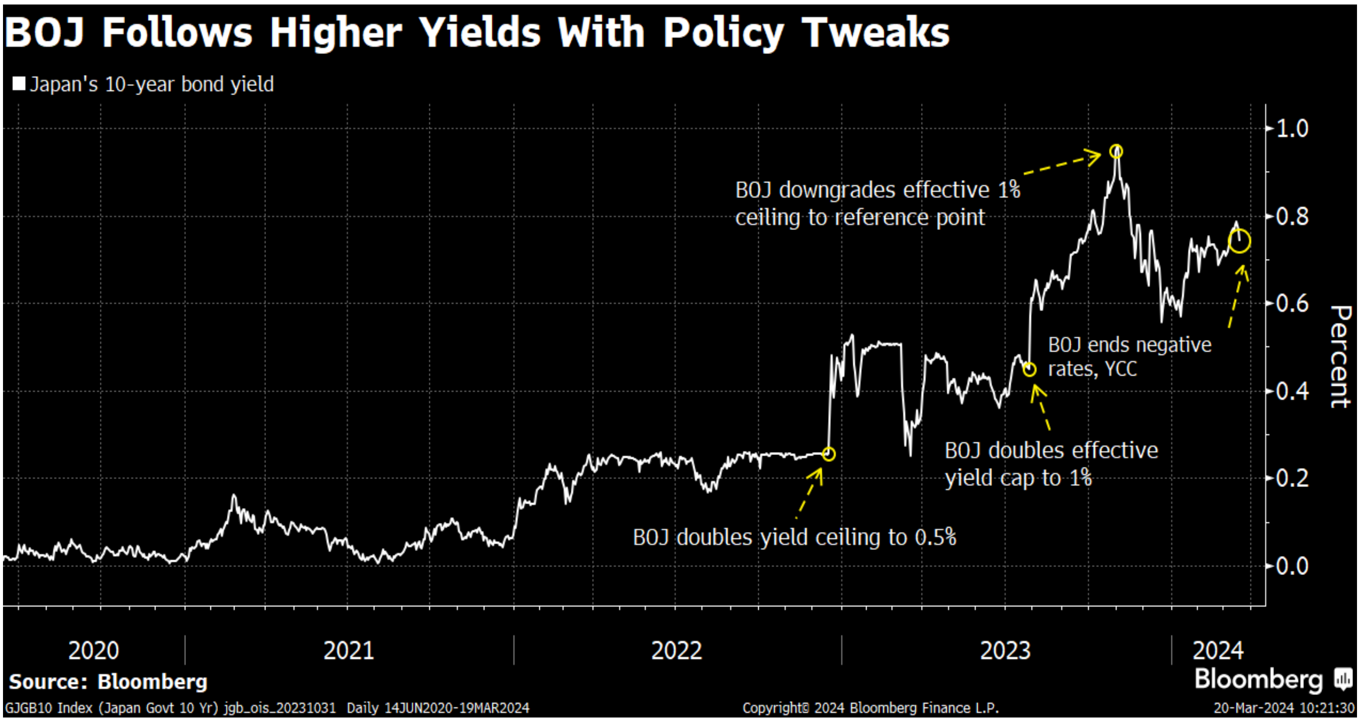
Australian pension funds shift focus to Private Credit

Australian pension funds are shifting risk focus to Private Credit as bonds are not offering enough yield; for example, CBUS and Hostplus are looking to ramp up their Private Credit exposure rapidly, according to Bloomberg. Australia's largest pension provider, AustralianSuper, has partnered with Churchill AM Private Credit specialists. Source: Bloomberg - read the full article here (Private Credit Is Next Big Wager for Australia Pension Funds - subscription required).

Japanese investors back in for bonds

Japan moves its key policy rate to near-zero (0% to +0.1% range) as inflation ticked up to its 2% monetary target, up from minus 0.1%. The Japanese inflation rate was no doubt positively impacted by global inflation (such as from supply chain issues after Covid and the Ukraine war). Given the uptick in yields (see Chart 1 below), the move will no doubt entice investors into Japanese bonds and may have a longer-term impact, given the nature of the regime shift from the Bank of Japan. Source: Bloomberg - read the full article here (Pimco Says BOJ Rate Hike Has Put Japanese Bonds Back on the Map - subscription required).

Chart 1: Bloomberg Analysis of the 10-Year Japanese Bond Yield



Source: Bloomberg

Global

Wall risk evaporation

Raised by investment and bond managers in 2023, wall risk is a series of bond maturity falling on a similar maturity date. Bloomberg report that this pressure has been substantially reduced as companies are looking to tap a buoyant bond market to lock in more favourable coupons and push out maturity dates. Coupons have been reduced on the back of lower interest rates from the FED, ECB, MPC and better overall market sentiment. Source: Bloomberg - read the full article here (Bond Rush Is Breaking Down a Maturity Wall That Everyone Feared - subscription required).

PIK structure used by Russell Investments

Similarly to the wall risk evaporation, Russell Investments have tapped the leveraged loan market but used a PIK structure to push out debt maturities. The manager has used an amend and extend (push out maturity of existing debt for additional margin) offering to the tune of $1.2bn and increased pricing by +500bps over SOFR. Source: Bloomberg - read the full article here (Bond Rush Is Breaking Down a Maturity Wall That Everyone Feared - subscription required).

Effect of Cayman Islands' removal from EU AML List on CLOs

The Cayman Islands has been removed from the EU AML List, meaning CLOs can be domiciled in the territory when setting up new CLO vehicles. Source: Bloomberg - read the full article here (CLOs Can Return to Cayman After Change by EU: Structured Weekly - subscription required).

Fund Investment Manager Perspectives

This section focuses on insights drawn from Waystone's regular interaction with investment managers globally. Managers have reported a strong functioning primary and secondary credit markets. Borrower performance has also improved and the expectation among credit managers is for borrowers to be better positioned if inflation and interest rate risk subside (as is expected).

Global perspectives

Secondary loans

U.S. managers are seeing value in B-rated names. Performance has been the best since 2009 for some managers, a combination of improved marks pulling to par (rate expectations) and better credit performance of borrowers through inflation. Managers are also seeing an uptick in refinancing activity as borrowers are looking to exploit better market sentiment and to refinance ahead of 2025 maturity dates.

In Europe, there is a slightly different tilt as managers factored in geopolitical risk when making new investment decisions. Managers were happy to hold onto cash and ride the positive momentum for the existing book, rather than deploying when they believe company/bond valuations were inflated on a risk-adjusted return basis.

CLOs

Spreads: Moving from Q4 2023 into Q1 2024, managers reported arbitrage opportunities in lower-rated but quality names. Some tightening in BB-rated CLOs that have lagged the rally. Market has ground tighter in Q4 and in Q1 and the strategy is now to deploy capital or revenues from CLOs. Managers are still seeing value in Europe relative to the U.S. and CLOs are still offering up to 200bps pick up on mezz paper in high yield bonds. There has been considerable uptick in demand for CLO product and AAA-investors stepping back into the market as new issuance within +120 to +130bps range for senior paper.

Risks: Collateral pools expected to improve as rates trend lower in expectation of moves by the U.S. Federal Reserve and the European Central Bank. Borrowers have taken pain and are well placed to shift into more stable environment from interest coverage perspective. Investors are still earning strong coupons for collateral that is improving.

United Kingdom (UK) RMBS

Very competitive opening to the year with senior spreads of new issuance inside the +100bps area for prime RMBS paper. Warehouse facilities are now looking at floors in new issuance given expectation of lower rates to come.

U.S. Private Credit

Private Credit spreads and activity

Managers are also seeing similar refinance uptick in secondary market, as borrowers are looking to exploit better market sentiment. Healthcare continues to feel pain as it recovers from wage inflation hike. The inability to pass-through price hikes may result in some restructuring of specific names. We are seeing some shift in focus in terms of adding risk in Q4 and in Q1 2024. As discussed previously in this article, an abatement in rates and inflation will have a positive impact on the earnings capacity of borrowers, boosting interest coverage and credit risk profile. The expectation is for investment managers to work through existing Watchlist names with a limited amount of new entrants to the Watchlist as a result.

Private Credit managers are reporting that investors are much more engaged, given a swift uptick in momentum in the space. This is partially explained by difficulties in raising capital on the private equity side. Larger investment managers still have large volumes to deploy in Q1 and Q2 2024. With spread contraction in liquid markets, this has a kick-on effect on spreads in Private Credit and in terms of leverage facilities used by managers. Refinancings are still extremely low but managers see some opportunistic refinancings as the market begins to reprice Fed moves.

UK Real Estate

ESG impact in the UK

There has been divergence in UK Real Estate Office market, with strong demand for EPC rated “B” and above with highest spec but in smaller size (hybrid working model). This effect is exacerbated by the maturing of long-lease contracts in 2024, as many of the existing buildings do not meet the criteria for lessors. Buildings not meeting the standard will require large investment to bring up to specification. Values of properties in this bracket have suffered large write-downs, often below replacement cost.

Featured Article

Perennial Private Credit Market Booms: Is it Ready for Evergreen?

Authors:  Austin Brady and  Daniel Forbes

Private Credit experienced a remarkable evolution during the pandemic and has continued to thrive despite increased in inflation, interest rates and associated pressure on borrowers. Compared to high yield bonds, Private Credit still offers considerable pick-up[2], more diversification and lower market volatility. But how can this evolution marry together with the Evergreen fund structure?

The evolution of the Private Credit Evergreen fund structure

Private Credit is an asset class of credit where borrower lending solutions are completed off-market (unlisted or non-publicly traded), offered by non-bank lenders. As the name suggests, the Private Credit market is illiquid in nature and often viewed as opaque in terms of asset valuation. Evergreen funds are open-ended fund structures with no fixed end date, that offer investors considerable liquidity in terms of fund subscriptions and redemptions.

According to Pitchbook, the global Private Credit industry has expanded from a $280bn industry in 2007 to $1.5tn in 2022[3] and in its Future of Alternatives 2028 report, Preqin estimates that the industry will almost double by 2028 to reach approximately $3tn. While much of the growth has come from the US market, changes to the Alternative Investment Fund Manager Directive II (aka AIFMD II) promotes non-bank loan origination in which has led to more market participants. However, this is just one part of the evolution that has attracted global investor interest, including in the APAC region[4].

The other part of the story is the shift in strategy and behaviour of fund managers, particularly in challenging situations. There has been less emphasis on “taking the keys” and more focus on working with borrowers and thereby holding the assets for a long period of time. This shift further aligns the Private Credit asset class with the Evergreen fund.

Taking the example of a Private Equity fund: by pooling investments, Evergreen funds can invest in a variety of private companies, thereby offering diversification for investors. Extending this concept, the Private Credit fund can be replicated within an Evergreen structure. Instead of acquiring stakes in companies, the Private Credit fund provides financing directly to companies and receives regular interest payments in return. This is an important consideration as the revenue earned from interest within a high-rate environment, along with maturities, refinancings and sales, enable managers to reinvest into new Private Credit opportunities on an ongoing basis.

Benefits of a Private Credit Evergreen fund structure

More Flexibility and Greater Liquidity

The Evergreen fund is a flexible investment vehicle with the structure underpinned by lower minimum subscriptions (circa $25k versus $5m for closed-ended) and greater liquidity[5] for investors. This is because Evergreen funds continually add capital (with no lock up), resulting in a wider pool of investors subscribing to the fund. This also provides managers with greater scope and ease to rebalance asset portfolios. With the growth of the Private Credit market in the U.S. and the EU, more participants are gravitating to the space. Speed, therefore, is crucial when closing deals. Evergreen funds offer a more flexible liquidity profile, where capital is readily available and can be deployed immediately. This gives managers comfort to close deals more opportunistically. By offering perpetuity-like investment opportunities or early withdrawals to LP's, access to the asset class is offered to investors seeking more liquidity. In 2023, elevated rates and associated borrowing costs side-lined many investors as liquidity became their primary concern. The Evergreen structure may help alleviate this risk.

Less Set-Up Fees and No Closing Period

The perennial deal flow cycle, as mentioned above, results in the need for the open-ended fund structure. The alternative is to have a closed-ended structure that winds-down or harvests after 5-7 years. During the harvesting period, a new fund will launch, often replicating the same Private Credit strategy as the legacy fund and targeting the same investor pool. The Evergreen structure can save fund managers additional costs in terms of setting up further funds. In addition, as many managers faced funds closures during times of distress (in the aftermath of the Global Pandemic), challenging positions needed to be sold (or more creative solutions deployed) to return capital to investors. The Evergreen structure helps alleviate this liquidation as investors are protected by the flexibility of timing regardless of credit-cycle stage.

Is the future Evergreen?

Overall, Private Credit is well-suited for the Evergreen fund, especially within the more evolved Private Credit market. While the Evergreen structure many benefits, particularly in terms of liquidity, traditional Private Credit funds continue to offer investors closed-ended structures. Through our experience working with credit fund managers worldwide, we have seen considerable flexibility from fund managers offering bespoke closed-ended structures in parallel with Evergreen structures to meet investor demand or requirements throughout the credit cycle. The market can comfortably accommodate both structures and ultimately provide investors with greater choice.

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[2] The U.S. Federal Reserve indicates pick up range is typically between 200bps and 400bps relative to comparable asset classes, depending on seniority.
[3] The Fed estimates that the figure is now (as of February) $1.7tn versus HY bond market of $1.3bn.
[4] For e.g. Marketsmedia reported that Golman Sachs and Mubadala IC (as a co-investment strategy) have a $1bn account to invest within PC in the region – specific focus on India.
[5] Increased liquidity is crucial for investors, especially as volatility increases or with a shift to a risk-off environment.

Waystone is a leading provider of institutional governance, administration, risk and compliance services to the asset management industry, with 1,700 people across 25 locations. Partnering with institutional investors, investment funds and asset managers, Waystone builds, supports and protects investment structures and strategies worldwide. With over 20 years' experience and a comprehensive range of specialist services to its name, Waystone provides its clients with the guidance and tools to allow them to focus on managing their investment goals with confidence.

If you would like to discuss in more detail any of the topics shared in this publication or would like to sign-up to receive our communications, please contact your usual Waystone representative directly or reach us via the below.

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