

Investment grade private credit

Fit for purpose

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Investment grade private credit: Fit for purpose

As investors in many countries wrestle with low yields and tight credit spreads in public fixed income, a popular inclination is to explore opportunities in private debt. While private debt is typically known for providing financing to smaller, potentially less creditworthy, often private equity-owned firms, the universe extends into higher quality, investment grade-rated offerings as well. Investment grade private credit (IG private credit or IG PC) has been traditionally dominated by insurance companies for regulatory reasons, but defined benefit pension plans are beginning to see its potential value as a high quality cash flow matching asset with incremental spread. Given the growing interest, in the following paper, we seek to:

- Explain the IG private credit market in more depth
- Discuss the pros and cons of investing in IG private credit
- Highlight implementation considerations and which investor types it can potentially suit

Overview

IG private credit is defined as debt issued by investment grade equivalent entities outside of public markets, either through a placement agent or on a club or direct basis. The universe includes corporate and infrastructure debt, generally fixed rate, with some managers also including specialty finance/structured credit. The investment grade slice of the private debt universe can benefit issuers who want to access capital markets quickly, while avoiding standard regulatory and reporting requirements for asset or project-specific financing. Deal structuring tends to be flexible and highly customizable, attracting a varied set of entities to the market. This can benefit investors through fostering broad issuer and sector diversification within their fixed income portfolios.

For investors, the major barrier to moving from an IG public credit mandate to IG private credit is the reduced liquidity. Underwriting these complex, customized, not as well-known deals with limited financial information is challenging in the primary market. However, the challenge is compounded if looking to transact in the secondary market where the deal may not be as fresh in investors' minds, likely limiting transactions to existing deal participants. In the absence of routine price discovery, trading can be inefficient and expensive.

Insurers, who are the dominant IG private credit investors and who are already incentivized via regulation towards a buy-and-hold approach, look for assets that can be matched to their often longer duration liabilities. For these investors, the customization, additional spread and superior covenant protection that come with IG private credit justify accepting the additional illiquidity. Defined benefit (DB) plans are another example of an investor base with similar incentives and who are beginning to take notice of the asset class.

From an asset manager perspective, a robust effort is typically difficult to justify without the aid of a large affiliate willing to invest in the resources needed to compete in this space, given the market's limited overlap with public credit and the underwriting intensity. As a result, the universe has been able to consistently provide investors with 50 to 140 basis points of excess spread¹ over a comparably rated public security with enhanced covenant protection providing further opportunities to boost total return.

Figure 1. Overview of credit markets

	Investment grade public corporate credit	Investment grade private credit	Traditional private credit
Issuers/obligors	Large corporations	Companies, governments, non-profits	Mid-market companies
Use of proceeds	General corporate purposes	Project and asset specific	Leveraged buyouts, growth capitals, etc.
Income	Fixed	Fixed	Floating
Rating	AAA–BBB	Typically A–BBB, some AA	Not rated but considered as BB+ and below
Security	Unsecured	Secured and unsecured	Secured and unsecured
Ranking	Can be subordinated	Senior	Senior and subordinated
Covenants	Limited	Maintenance/comprehensive	Maintenance/comprehensive
Tenor	5, 7, 10, 30 years	Flexible 2–30 years	Typically 3 years weighted average life
Liquidity	Liquid	Limited	Illiquid
Historical spread to comparable public credit	n/a	50 bps–140 bps	300 bps–800+ bps
Annual issuance	\$1.2T–\$1.3T	\$50B–\$75B*	~\$200B+

Source: Sun Life (as of July 29, 2020); Voya Investment Management for historical spread to comparable public credit (Data: 2001 to 2020);

Mercer for traditional private credit;

*Annual agented volume; Source: Bank of America Merrill Lynch

¹ Voya Investment Management; Data from 2001 to 2020; Average spread over the period was 75 bps.

Market make-up

The overall market size is estimated at \$1 trillion, but given the sparse liquidity in the secondary market, new investors typically rely on the primary market to build portfolios. In recent years, issuance has reached as high as \$75 billion in annual agented volume. Asset managers estimate true issuance may be around \$100 billion per annum or more if direct issuance is included.² The global IG private credit market has relatively consistent deal flow from both the US and Europe. Corporate issuance has typically tilted toward the US, while infrastructure has been more globally diversified. Ex-US issuance is generally priced in local currency, but can be issued in US dollars as well. Asset managers frequently participate across the global opportunity set, hedging currency when needed.

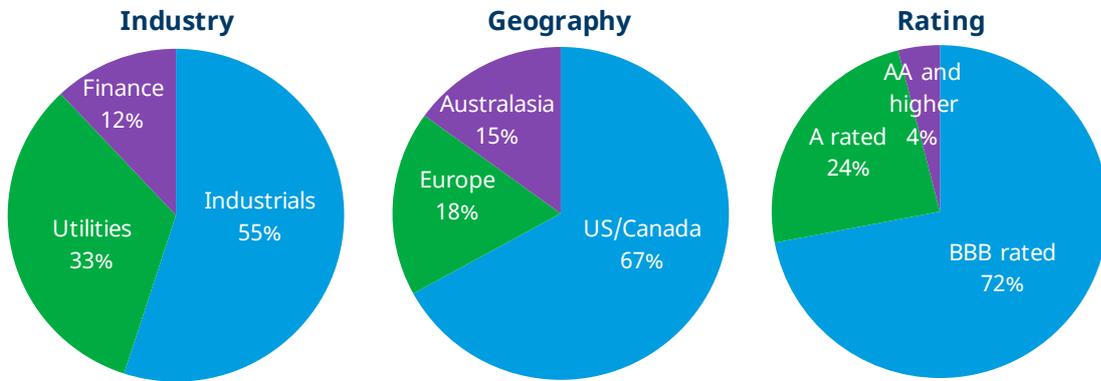
It is important to note that IG private credit in Europe may not always share the same characteristics as in the US. For example, the European private placement market tends to have a broader investor base than the US, which is heavily concentrated with insurance companies. While European investors still view the asset class as a higher yielding, cash flow matching asset, broader participation has pressured spreads and covenants more than what has generally been observed in the US. However, this behavior ebbs and flows, making it important to find an asset manager with strong cross-border expertise. Additionally, issuance in Europe is also slightly more ESG-friendly as renewable energy projects are more prevalent due to broad government and public support.

On a sector basis, traditional corporate private placements comprise the bulk of the IG private credit market, however infrastructure debt is also a significant part of the market. Compared to IG private credit, infrastructure debt can be more underwriting intensive with less investor competition, potentially offering wider spreads than private corporates. Collateral can be higher quality in nature, being secured by essential assets or cash flows (toll roads, oil refineries, renewable energy projects, etc.). Infrastructure debt has greater global diversity, a longer duration profile and provides cash flow with amortizing debt.

Private asset-backed securities, esoteric structured credit, and real assets will occasionally also reside within IG private credit platforms. Private structured credit has a steady, reliable deal flow with ample supply, contrasting with other more competitive private credit sectors. In particular, this sub-sector provides higher quality and shorter duration securities with enhanced yield, which can prove to be a valuable outlet when technicals squeeze spreads on more traditional corporate issuance.

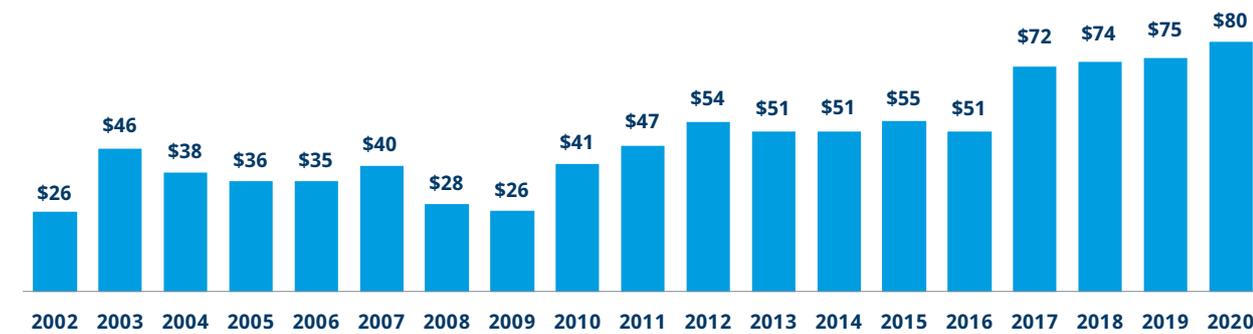
² Estimated true issuance based on a series of meetings with Investment Grade Private Credit managers and a review of their presentations.

Figure 2. Market breakdown



Source: Voya Investment Management, Bank of America Merrill Lynch, as of December 31, 2020

Figure 3. Annual agented issuance in the private credit market, billions



Source: Voya Investment Management, Bank of America Merrill Lynch, as of December 31, 2020

Why consider investing?

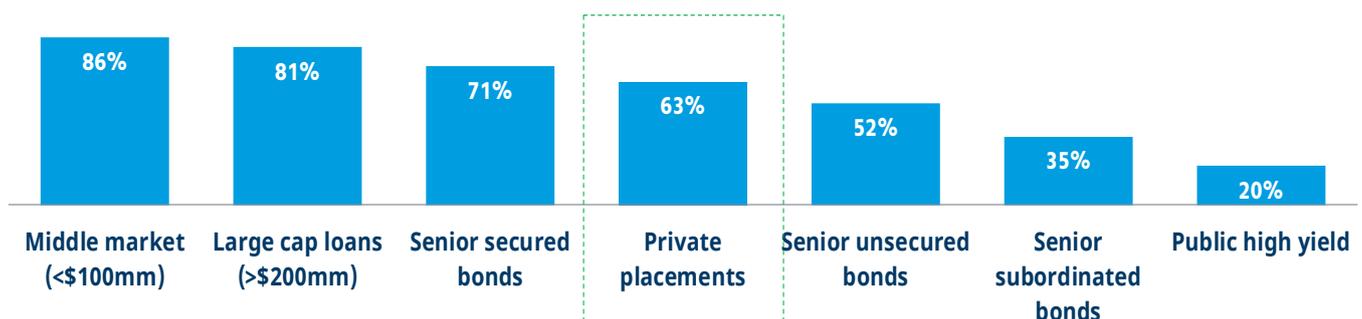
IG private credit can achieve modestly higher returns over a comparable public portfolio without compromising on credit quality or structure. This value proposition may look attractive to many investors in the current yield starved environment, at least in developed markets. However, the catch is that investors need to exercise patience and commit to the universe for the long haul. Given the universe’s patchy and competitive primary market and illiquid secondary market, time is needed to build a robust portfolio and wind down existing allocations.

Pros:

- Enhanced yield
 - Historically, IG private credit has offered a yield premium over the public market, while avoiding higher defaults and credit losses. Note: fees for an IG private credit mandate can be 10-15 basis points higher than a comparable public credit mandate, which partially reduces the yield advantage.

- Barriers to entry
 - Given the limited overlap with public fixed income, managers cannot rely on their existing public credit platform and are required to make a significant investment in resources to adequately cover the universe. Additionally, issuers tap this market to customize deal terms that would not be available in public markets. The customized nature of each deal adds an extra layer of complexity. Illiquidity, complexity and specialized resources needed to navigate the universe ultimately drive the higher premium over public issuance.
- Diversification
 - By some estimates, only 20% of corporate private issuers overlap with public fixed income, thus enhancing diversification within portfolios. Corporate issuers also tend to be smaller in size and regionally focused. The opportunity set is also globally expansive with frequent deal flow within the US, Europe, Australia, Asia and Canada. Infrastructure and private asset-backed securities provide further diversification beyond minimizing corporate issuer overlap, by allowing various duration profiles and cash flows via amortizing debt.
- Covenants
 - IG private credit covenants are highly structured and have not followed the covenant-lite trends seen in public issuance. With limited deal participants and a thin secondary market, covenants are investors' primary lever to restructure and modify deals to help ensure proper compensation or protection if performance is unsatisfactory. In addition to incremental income, the covenant structures have led to fewer defaults and superior recoveries over public bonds, further improving private credit's relative performance (see figure 4).

Figure 4. Recovery rates by asset class



Source: Voya Investment Management, Bank of America Merrill Lynch, Society of Actuaries, 2003-2015 Credit Risk Loss Experience Study: Private Placement Bonds

Cons:

- Costly liquidity:
 - The same forces that enhance yields in private credit through an illiquidity premium also can detract if an investor is forced to raise capital over a short period or unwind an allocation. To consistently help achieve an excess spread, investors should have a long-term strategic mindset and view a mandate within the context of the illiquid allocation of their portfolio. This can alter the tradeoff conversation from an "excess yield over comparable public bonds" to "excess yield over other illiquid opportunities" where IG private credit may not look as compelling as a higher risk private debt fund.
- Capacity:
 - Investors' insatiable demand for yield has created an environment where technical factors can heavily favor the issuer. Annual issuance (up to \$100 billion per annum) has steadily increased to take advantage of this pressure, but demand remains well in excess of supply. The relatively small and competitive primary market, along with the thinly traded secondary market, creates a slow ramp up for new mandates. For example, it is not uncommon to take a year or more to fully invest a new segregated account.
- Competing affiliate demand:
 - Given that most investment teams' genesis has been to supply their affiliated parent company with private placements, the affiliate's portfolio could crowd out third-party investors during attractive periods. Allocation policies should be seriously scrutinized, especially when assets under management heavily favors the affiliate. A large affiliate does provide many advantages: a stable asset base, alignment of interests on shared exposures, and the ability to invest in the resources needed to find incremental yield. However, unfavorable allocation policies could dilute this beneficial impact for third-party portfolios.

Implementation

Implementing an investment grade private credit allocation can be challenging for several reasons, but the main impediment is the need to build a portfolio in the primary market. This leaves investors beholden to the pace of issuance. Additionally, while over time, issuance comes from a variety of industries and geographies, during any given period it can be more concentrated. This could limit a portfolio's broader diversification if investors try to scale an allocation too fast. As a result, segregated portfolios can take 6 to 18 months (or more) to ramp up and be fully invested, while the manager remains selective and builds sector diversification. Pooled vehicles are less common, but do exist. These vehicles aid in accessibility, however, cash and public bonds are held to manage client liquidity which dilutes the portfolio's overall spread advantage.

Investment considerations

- Separately managed accounts typically have \$200m minimums
- Select pooled vehicles are available – five or fewer options
- Fees are generally around 30 bps

It is also worth noting that valuations in IG private credit can lag public markets, potentially introducing unwanted short-term tracking error. The COVID-19 induced volatility during 2020 was a glaring yet exceptional example of lagging private to public credit spreads. However, this is generally viewed as a short-term phenomenon and likely to correct over a full market cycle.

Investor Considerations

Life insurers have traditionally been the dominant players in the IG private credit market. Other rating-constrained investors like property and casualty insurers and health insurers are also frequent participants, utilizing allocations within liability hedging and surplus portfolios. Allocating to IG private credit has historically been an efficient means for these insurers to enhance yield without taking additional credit risk or incurring greater risk-based capital charges or greater solvency requirements. Insurers tend to prefer separately managed accounts (SMAs) as they allow them to enhance customization and hold the assets on Schedule D of their balance sheet, which has more favorable capital treatment versus a pooled fund. For a funding source, asset owners typically give a manager a public core or credit allocation to be drawn down over time and invested in private credit as opportunities arise.

Insurance implementation considerations

- SMAs are capital efficient in light of regulatory requirements (RBC and Solvency II)
- Longer ramp period but enhances customization and ability to match liabilities

DB pension plans have recently emerged as a new client type in IG private credit as spreads in public markets have compressed. The incremental yield and diversification benefits to public bonds and the ability to construct a diverse maturity and cash flow profile with call protection to align with liabilities has attracted them to start exploring the space. Pension plans have tended to

use IG private credit to replace or supplement public long credit exposure or blend long with intermediate credit to help achieve liability matching duration.

DB plans tend to access IG private credit through a pooled vehicle to mitigate ramp periods and provide some additional liquidity through the fund structure (i.e., by funding withdrawals through income, proceeds from new investors, and a liquidity bucket within the fund). Accessibility and liquidity are beneficial, but come at the expense of a lower spread premium.

If a DB plan is looking to wind down its IG private credit allocation as the plan approaches termination, a pension risk transfer (PRT) is a possible route to liquidate a portion of the portfolio. Life insurers have a steady appetite for IG private credit, however, they tend to be picky in the credits they are willing to accept and can sometimes be punitive in determining the fair value of a third-party portfolio. Additionally, insurers would also need to re-register each security in order to hold it on their balance sheet, potentially limiting the number of willing parties. The transfer can be a considerable effort for both parties and is typically undertaken by insurers seeking to accelerate a ramp-up. If a DB plan pursued this path, they would likely still need to wind down a portion of the portfolio via the secondary market that the insurer was not willing to accept.

DB implementation considerations

- Pooled vehicles improve accessibility by minimizing ramp period and creating structural liquidity
- However, cash and public bond allocations can weight down a fund's yield differential
- As plans approach termination, PRTs are an option to wind down a portion of an IG PC portfolio

Conclusion

Investment grade private credit is most suitable for ratings or regulatory-constrained investors seeking modestly higher yielding, longer duration investments. Liquidity at the security level can be problematic; however, several managers offer pooled vehicles that allow investors better accessibility and liquidity at the expense of a slightly lower spread premium. Regardless of how the universe is accessed, investors should have a long-term, buy-and-hold mindset to maximize the benefits of the asset class. IG private credit has typically been best suited for insurers within their liability hedging and surplus portfolios. However, DB asset owners have also started utilizing it more frequently for liability-hedging reasons as a substitute for public long credit. Total return-orientated, or less constrained investors, may be better served by maximizing both yield and illiquidity premium by dipping down further in credit quality or utilizing a true private debt drawdown structure.



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