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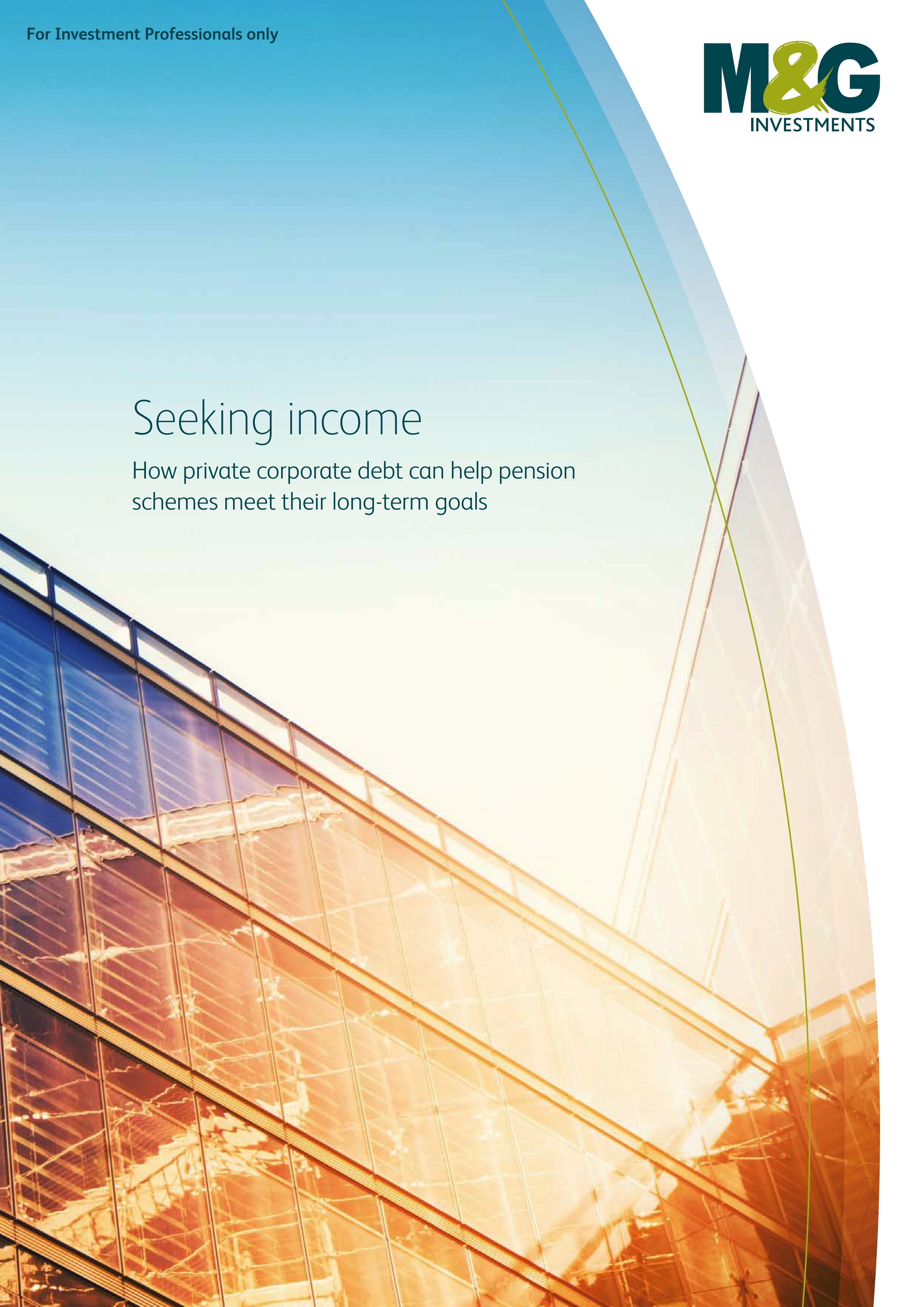


Seeking income

How private corporate debt can help pension schemes meet their long-term goals

Where can pension schemes invest to generate income?

Investing in the time of the COVID-19 'coronavirus' pandemic is unprecedented, not least for income-oriented investors.

The world has been forced to think on its feet and adapt as the universal health crisis has unfolded in real time, dramatic fiscal and macro-prudential policy changes have been implemented, while asset prices have continued to fluctuate amid the uncertainty. How should investors with long-term horizons such as global pension schemes respond in this investment environment?

Rock-bottom interest rates have left many schemes facing the very real scenario that traditional income from bond coupons may fall short of delivering a good enough return to meet long-term pension promises. In an era of low rates, where could they look to invest in order to meet their objectives?

Private debt can offer schemes exposure to alternative and differentiated types of income-bearing assets, and can help them in their quest for diversification. Private corporate lending could be a viable option for investors seeking alternative, enhanced income from an investment portfolio. With careful sourcing and structuring of debt investments, we believe investors do not have to take on undue risk to potentially get well rewarded and improve their overall risk-adjusted return potential.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

Challenges facing income-oriented portfolios

Pension funds with current cashflow requirements depend on a steady stream of payouts, but face a number of unique challenges in their search for income against a backdrop of lower-for-longer yields and volatile investment conditions brought on by the COVID-19 pandemic.

Lower for longer.

Bonds have long been considered the mainstay of reliable income, but years of declining bond yields have made it harder for schemes to generate the levels of income/returns needed for their members from traditional investment sources. This challenge has become particularly acute over the past couple of years, as the pool of negative-yielding government and corporate debt has rapidly increased, recently hitting c.US$17 trillion – representing over a quarter of the Barclays Global Aggregate Universe. As the pool of negative-yielding debt expands, so, too, does the pool of low-yielding debt – with around 90% of the bond market reportedly trading at yields of 2% or lower.

Figure 1. Global negative-yielding debt

Source: M&G, Bloomberg BNYDMVU Index, LEGAMVU Index, as at 30 September 2020.

Investor objective: Generating income

Today's unique investment challenges:

- Investing in an era of low rates. To achieve attractive income and returns needed in a low yield environment.
- Investing in volatile markets. Finding assets that can reliably deliver income in challenging and uncertain environments.

Bond yields have largely retreated back towards their pre-COVID-19 lows, in part thanks to extensive central bank policy intervention and forward guidance on interest rates and asset purchases. Fixed income investments offering additional yield over developed market sovereign and investment grade corporate bonds may help pension schemes achieve their funding goals – although spreads on high yield corporate bonds have also tightened at the same time that default risks have increased. The crisis has also put equity income at risk despite lofty equity market valuations.

Cash (liquidity) is king.

Dividends, typically seen as a reliable source of income for many asset owners including pension schemes, have fallen considerably in recent months as companies have either cut or deferred dividend payouts to conserve cash and strengthen balance sheets given operational uncertainty in the current climate. Government and central bank support measures have helped businesses of all sizes hit hard by the severity of the crisis, but have effectively tied the hands of management looking to continue to pay out dividends to their shareholders. Major central banks and regulatory authorities have even gone to the extent of forcing banks to suspend dividend payments and share buybacks, so that banks can continue to provide finance to businesses that need it.

Forecasts for this year range anywhere between 15% to 25% being set to be wiped off global dividends, with UK and European companies estimated to be among the worst affected. According to a recent FT report, businesses in Spain, Italy, the Netherlands and the UK were more likely to cut dividends than executive pay this year.

Expanding the opportunity set

Pension schemes could have a number of different outcomes they want from their assets at any given time – the need to boost income from their assets being just one of them. Determining the right strategic asset allocation to meet a scheme's objectives depends on many variables and individual preferences, while scheme size, funding levels and time to endgame should be taken into account. The need for income is stronger than ever as many defined benefit (DB) schemes are maturing, de-risking and heading towards the end of their journey. Two-thirds of pension schemes consider themselves to be cashflow negative, according to Mercer's 2020 European Asset Allocation insights.

In a compressed return environment and with low-risk options increasingly scarce and expensive, it may become increasingly difficult to meet liabilities without allocating some assets to alternative income-bearing investments.

Alternative sources of income are mostly found in private markets, and so are better suited to those investors that can take a long-term view. Globally, pension plans have increased their allocations to private or illiquid assets in the past 10 years, but many remain underinvested or below their target allocations, given a broader preference to invest most of their assets in liquid strategies. According to the Global Pension Assets Study – 2020 from WtW's Thinking Ahead Institute, there has been an increase in allocations to private markets and other alternatives to 23%, at the expense of equities and bonds.

Private debt: Solving for client challenges

Private debt can play a valuable role in diversifying an overall portfolio while providing an attractive source of risk-adjusted returns and long-term running income. Private corporate debt assets could also offer lower correlation to other asset classes and lower mark-to-market volatility, although investors must be able to bear some liquidity constraints.

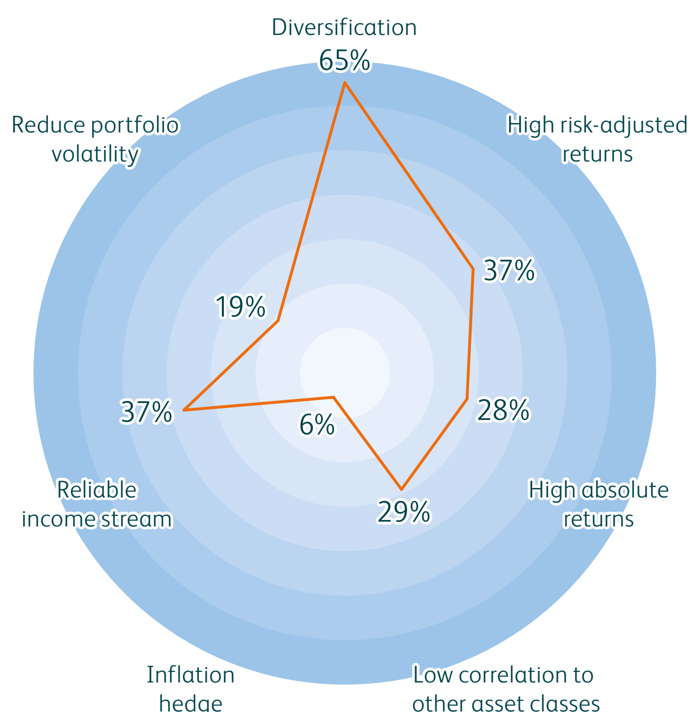
Mallowstreet private debt survey* – A UK pension scheme perspective

Key findings:

- Schemes are looking to use private debt to provide a range of outcomes: 85% of UK schemes use private debt to enhance yields and 68% use private debt for stable income. 70% use private debt for diversification.
- 90% of schemes that are less than 85% funded invest in private debt, compared to 77% of schemes with higher funding levels.
- A typical allocation varies between 1% to 10%, but allocations decrease as schemes improve their funding levels and approach their endgame.

*Key findings based on survey and interview responses from 100 leading industry professionals, conducted in late 2019.

Figure 2. Investors' motivations for investing in private debt



Source: Preqin 2020 Private Debt Report. Preqin Investor Interviews, November 2019.

Given the breadth of different options within private debt, it is important to consider what areas offer a sufficient illiquidity premium, an ability to add diversification, are adequately developed for institutional investment – and can offer a pick-up in seniority, security or spread relative to liquid public market assets. There are several types of income-bearing assets that span the private credit spectrum – on the corporate, real assets and structured finance side – which could provide stable, defensive income streams as well as those assets which offer the potential to generate reliable, high-running income.

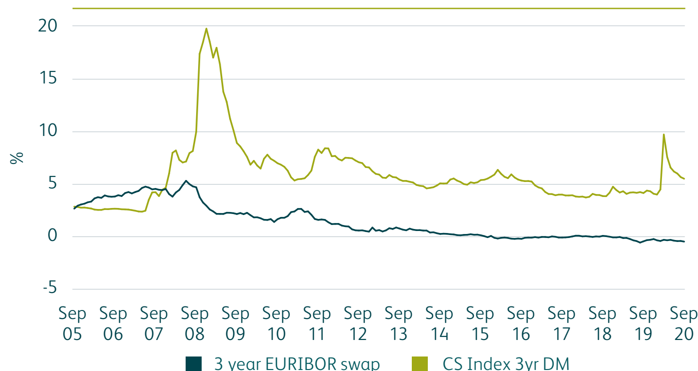
Private corporate debt could help clients meet their income needs

Private corporate debt could be an attractive option for investors seeking alternative, enhanced income from an investment portfolio. Private corporate loans provide senior, secured, floating-rate financing to companies. For larger companies, loans are syndicated and typically have secondary market liquidity, injecting some volatility but to a more muted degree than comparable bonds. For mid-market companies, often described as direct lending, loans are frequently bilateral or syndicated among only a small group of lenders (so called 'club' loans) and held until maturity. There are certain structural features that are common to most loans: security, seniority in the capital structure, floating-rate interest payments, contractual margin and amortisation, as well as close interaction between borrower and lender. This latter feature and the level of information and its frequency is a key differentiator from public markets.

Leveraged loans – ability to deliver consistent income-based returns

Leveraged loans, also referred to as bank loans, are an established part of the private debt landscape, in reality occupying a position on the bridge between private debt and high yield public markets, and offering investors exposure to strong, large, sector-leading companies often with global presence (enterprise value (EV): €1 billion+). Leveraged loan returns are largely delivered from running income from floating-rate loan coupons, enhanced by the presence of zero-minimum rate-fixing floors, providing a source of extra value in the face of low or even negative rates. The effects of the pandemic on loan prices can be seen in Figure 3, whose yields are trading around 100 basis points (bps) wider compared to pre-pandemic.

Figure 3. European loan market yield versus Euribor rates

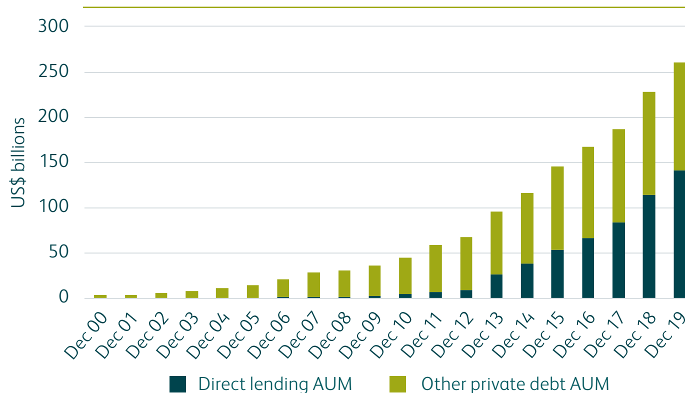


Source: M&G, Bloomberg, Credit Suisse, as at 30 September 2020.

Mid-market direct lending – potential for attractive risk-adjusted yields

Direct lending in Europe has grown exponentially in the past decade, but is a less established market compared to leveraged loans and with lower liquidity, but typically the deals have better documentation through tighter covenant packages. Mid-market corporate loans, whether structured as traditional cashflow lending or asset-based lending (ABL) transactions, have the potential to generate higher income. This is because these assets typically offer an illiquidity or 'complexity' premium to compensate for the lack of secondary trading opportunities, and involve bespoke structuring tailored to the borrower's needs.

Figure 4. The growth of European direct lending – the asset class has grown to become synonymous with private debt



Source: Preqin Pro, as at September 2020.

Borrower-led solutions for mid-market companies

Direct lending covers a broad spectrum of activity and encompasses a wide range of target returns and risk appetites through senior secured and subordinated debt and unitranche loan structures. We would define the 'mid-market' as typically floating-rate loans to private businesses with EBITDA (earnings before interest, taxes, depreciation, and amortisation) typically in the range of £10-35 million (€10-40 million), although this can be higher or lower. This is senior debt with leverage multiples (EV/EBITDA) of up to 5x – reserved only for the most exceptional businesses – lower leverage compared to unitranche direct lending, but with higher leverage levels compared to traditional (unlevered) bank lending.

In a downturn, being deeper in the capital structure (and consequently raising leverage in a financing) has the potential to amplify losses if the company is struggling. The senior secured part of the capital structure carries a significant valuation buffer, even were EV multiples to fall.

For loans to corporate borrowers with a strong asset base, these facilities tend to require bespoke structures and real-time monitoring of the underlying collateral, while management is much more hands-on and time-intensive. Leverage levels may be higher in these transactions, but lenders are protected by a dynamic borrowing base derived from the value of assets that form collateral.

Figure 5. Defining the mid-market direct lending universe

Mid-market non-sponsor backed direct lending	Mid-market sponsor backed direct lending	Mid-market asset based lending	Wholesale lending
• Directly owned and listed companies • Cashflow lending analysis • Typically lower leverage levels than sponsor backed transactions	• Providing debt finance to PE owned companies • Cashflow lending analysis	• Lending to companies with strong asset base • Analysis uses a combination of cashflow and asset valuations	• Lending to platforms, for example SME lenders • Fund financing – providing debt financing to closed-ended fund vehicles • Bespoke analysis

Source: M&G.

Beyond income potential

In addition to the income-producing attributes of different types of private corporate loan assets, they share a number of common characteristics that can fit the requirements of institutional investors. Similar to high yield bonds, leveraged loans and direct lending are sub-investment grade or are considered to be comparable to rated sub-IG credit risk in the case of direct lending – these deals tend to be unrated so 'rated' credit risk is illustrative as albeit typically only leveraged loans will be rated by rating agencies. We have an internal credit ratings process for assigning an equivalent rating for our loans. In the case of leveraged loans and direct lending, loans are typically senior in the capital structure so lenders are first in line to get paid in the event of a default. The level of equity commitment in leveraged loan and (sponsor-backed) direct lending deals also tends to be high, around 50%, providing a sizeable buffer for senior lenders. Although in our experience, the equity cushion in direct lending deals is usually over 50%. The following table offers an overview of the characteristics of European leveraged loans and (mid-market) direct lending and how they could compare to public high yield bonds, respectively, based on data where it is available.

Figure 6. How European leveraged loans and (mid-market) direct lending compare to high yield bonds

	Private leveraged loan market	Private mid-market direct lending	Public high yield bond market
Coupon structure	Floating (Libor/Euribor plus a spread)	Floating (Libor/Euribor plus a spread)	Fixed
Prepayment option	Yes	Often yes	No
Portability	No	No	Often yes
Liquidity	Lower to moderate	Lower	Moderate
Market volatility	Lower to moderate	Lower	Higher
Average indicative rating	B	M&G internal rating: B-BB	BB-
Average EBITDA	€250-1 billion (av. €750 million)	€10-40 million	N/A
Typical target return	3.5%-5.5%	Senior debt: 4%-7%	4%-4.5%
Typical leverage at issue	5.5x (total) 4.8x (first lien)	Senior debt: 4x	5-7x
Typical equity cushion	52%	>50%	N/A
Annual default rate	2.6%	N/A	1.7%
Recovery experience	70%*	Higher (typically secured)	43%*
Market size	€303.5 billion**	Est. €120 billion	€324.5 billion***

Source: M&G, S&P LCD European Leveraged Loan Index (S&P ELLI), Bloomberg, ICE BofA Euro Non-Financial High Yield Constrained Index (HEAD), as at 30 September 2020.
*Moody's Investors Service 'Corporate Default and Recovery Rates – 1920-2019'. Average annual recovery rate for period from 1983 to 2019.
**Based on the market valuation of the Credit Suisse Western European Leveraged Loan Index (CS WELLI), which represents some of the institutional subset – although the market is at least 30% larger, in our view.
***Public high yield bond market size based on Q943 custom Euro Non-Financial High Yield Constrained Index (2% issuer cap, ex EME).

Information on the private mid-market direct lending universe, by its definition, tends to stay private. As mentioned previously, based on our experience we would define the 'mid-market' as typically floating-rate loans to private businesses with EBITDA typically in the range of €10-40 million, with an average internal rating of between B to BB, as shown in the table above.

Moreover, each type of asset offers a range of benefits that extend beyond their income generating potential. Here we consider what other advantages different private corporate lending assets could bring to an income-oriented portfolio.

Beyond income potential – benefits of investing in leveraged loans and mid-market loans

Leveraged loans

Volume and ability to build allocations

- Access to larger, developed sectors within private debt like leveraged loans can help to build strategic exposure to the asset class, so managers can put a decent amount of capital to work and relatively quickly too.

Diversification potential

- Loan market is comprised of large and high-quality businesses with strong market positions and cashflow-positive borrowers.
- Exposure across a range of sectors and geographies (albeit limited exposure to the energy and retail sectors) and little crossover between loan and high yield bond issuers in Europe.

(Relative) liquidity

- An active secondary market for large-cap loans offers liquidity and can provide options (and ability to exit) in a variety of scenarios, including loan restructurings.

Mid-market direct lending

Potential to dampen portfolio volatility

- Assets tend to be model priced so mark-to-market volatility is reduced.
- Mid-market loans are conservatively structured and involve bespoke negotiations with borrowers on terms and structural features.
- A diversified direct lending portfolio may be less sensitive to economic cycles than public debt markets.

Enhanced downside protection

- Mid-market loans generally have tighter covenant packages – all assets senior secured with maintenance covenants.
- Like large-cap loans, interest coverage ratios remain comfortably high and typical equity cushion in deals is >50%.

Security and lender controls

- ABL deals tend to be more defensive from a loss-given default perspective and have a lower probability of capital impairment.
- These facilities offer the lender greater control and downside protection given the security and high quality collateral backing the loan.

Engagement potential for private lenders

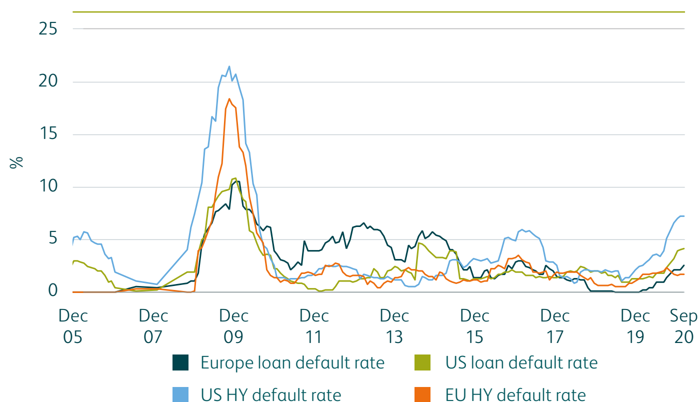
While it is important to recognise that lenders tend to have limited influence over the (design, management and implementation of) ESG policies of portfolio companies, relative to shareholders and equity owners, they have an advantage over public bondholders in engagement. The very nature of private lending means a direct relationship with a borrower exists, and frequent interaction between lender and borrower facilitates lobbying to a greater extent than is the case between bondholder and issuer. This creates the opportunity to call for greater disclosure on ESG issues and to mitigate risk.

An all-weather strategy?

Private corporate debt is a strategy with proven risk-return and resilience through crises and over decades, and does not need a V-shaped economic recovery to be a successful strategy. Rather it needs survivorship and debt service capacity on the part of the corporate borrower. Of course, lenders that focus on the quality of credit underwriting and proactive risk management and mitigation can help to build greater resilience into portfolios. With careful sourcing and structuring of senior debt investments, we believe you do not have to take on undue risk to potentially get well rewarded in today's environment.

Default outlook: The economic aftershock of the pandemic has yet to be fully felt on balance sheets and it is still early days in what could be a protracted restructuring cycle. Many companies have been bolstered by government support measures, drawing down on available credit facilities during the period of disruption to operations and revenues at the height of national lockdowns, or have looked to secure additional covenant headroom. Defaults are rising, albeit from a very low base prior to COVID-19, but market observers do not expect them to reach the levels seen in the global financial crisis (GFC).

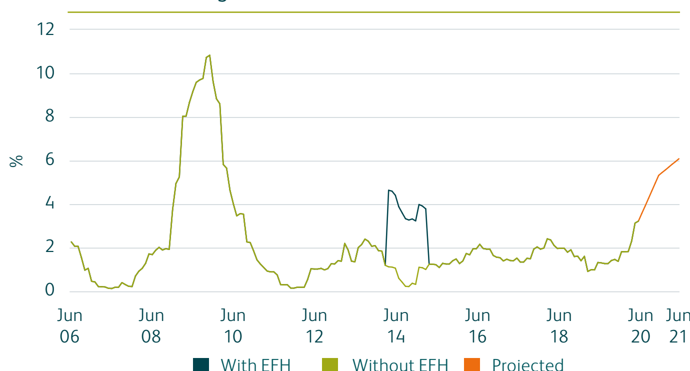
Figure 7. US and European sub-investment grade annual default rates



Source: S&P LCD, S&P Ratings Direct, BofAML as at 30 September 2020. Loan specific figures not given pre 2007 for Europe and pre 2005 for US.

Credit ratings agencies were quick to downgrade companies in earlier stages of the pandemic, but default forecasts tend to overestimate actual defaults and are already being revised lower – Moody's predicts that the high yield bond default rate in Europe could hit 8% in Q1-2021, then fall to 6.2% in Q2. An LCD Default Survey, based on responses from loan portfolio managers, expects the trailing 12-month leveraged loan default rate (for global loans) to climb to 5.2% by year-end, edging to 6.1% in June 2021, on average.

Figure 8. Lagging 12-month leveraged loan default rate – forecasts through June 2021



Source: LCD, an offering of S&P Global Market Intelligence. Survey forecasts as at June 2020.

To date, pan-Euro high yield bond default rates have not reached a quarter of the peak seen in the GFC[1], and it is a similar picture for European leveraged loans, with current default rates some way below the 11% seen at the height of the financial crisis.

The US corporate default rate is expected to be higher than that of Europe given the quantity of issuers already heavily indebted prior to the current crisis, and given higher exposure to cyclical sectors such as oil and gas.

The need for dedicated in-house analysts and specialists is integral to the management of distressed situations, to help mitigate the risk of default losses and expected recoveries in the event of a default or restructuring.

Headwinds as a result of the COVID-19 pandemic have also put even greater emphasis on credit selection, focusing on companies with balance sheets that are able to withstand a challenging environment such as companies with strong cashflow or those operating in more defensive industries and sectors.

Private equity owners have huge cash reserves – c.US$2 trillion-equivalent of 'dry powder'— ready to support companies with cash injections and liquidity management, and have been on hand to provide direct and operational advice to their portfolio companies during the current crisis. With or without additional support from sponsors, the senior-secured nature of private corporate lending can help to mitigate against the risk of capital impairment and ensure income streams from investments remain resilient in more challenging environments. It is equally important for lenders to hold firm on attempts by borrowers to push on leverage levels and other terms.

Demand has continued to outstrip supply in the direct lending market with dealflow down 29% in Europe in the first half of 2020 compared to the same period in 2019, according to the Deloitte Alternative Lender Deal Tracker Autumn 2020. Our rejection rate in 2020 for direct lending deals has hit 98% and is 61% for European leveraged loans, although we expect better risk-reward opportunities ahead and as direct lending dealflow picks up. A short-term impact of COVID-19 has been that companies have borrowed against revolving credit facilities (RCFs) to shore up liquidity and may need to term out debt, creating opportunities for private lenders.

[1] Based on ICE BofA indices (Ref. HEOO + HLOO).

Building strategic allocations

In an environment of lower-for-longer rates and uncertainty about the prospects for the global economy, asset owners are facing a number of challenges in their search for reliable and consistent income/returns to meet liabilities. We believe building strategic exposure to private corporate debt could help to boost income at a time when it is most needed, and help investors in their quest for diversification.

Private debt strategies can be used to enhance or diversify traditional allocations to fixed income. Private corporate debt can serve as a complement to (largely unsecured) public corporate debt while potentially offering a sizeable pick-up in risk-adjusted return with typically lower correlation and volatility. Our diversified and dynamic investment approach allows us to find the best-available opportunities across the private corporate credit spectrum, and gives us the flexibility to dial up or down exposures.

What to look for in a private corporate debt manager

We believe that employing a conservative, defensive bias focused on building resilient loan portfolios could help to deliver high absolute returns and could help to minimise default loss. It is this approach that gives us greater certainty over ongoing income delivery.

M&G and private corporate debt

M&G have been long standing investors in private corporate debt. We began investing in private corporate debt in 1997 in order to source assets offering attractive return profiles and diversification from traditional corporate credit.

We were among the first non-bank European investors in leveraged loans and private placements, and were the first investment manager to launch an institutional direct lending strategy in the UK, in 2009.

We have over €14 billion of private corporate debt assets under management as at 30 June 2020*. Using our scale, together with our strong origination capability and depth of expertise, in turn enables good access to assets and an ability to source investment opportunities from across the spectrum on a relative value basis.

Private corporate lending is an asset class with proven risk-return through crises and over decades. In terms of the direct lending deals we have invested in to date, we have had no defaults, and the average default rate for our European loan strategy is comparatively low, at 1.4%, below the average default rate for the S&P ELLI, at 3.5%**.

*Figure converted using a GBP/EUR rate of 1.096.
**Source: M&G, as at 30 June 2020.

M&G INVESTMENTS

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