

Press Release

## Credit Market Update: A Renaissance Period for Credit Investing

**David Allen, Managing Partner and Chief Investment Officer, AlbaCore Capital Group**

**London 2 March 2023-** The conditions present in today's market are highly favourable for lenders and compare well to any period since the financial crisis, perhaps longer. This is due to the sustained disruption to capital markets and an elevated rate environment.

Higher coupons and yields, lender-friendly terms, and a less dire economic outlook than originally feared put credit in a position to generate equity-like returns over the coming years. In market conditions like the present, lenders have historically been able to extract higher premiums at more stringent terms, with investment opportunities pricing senior secured risk at or above 10 percent yields. This is near or above long-term equity returns without stretching for subordination or distressed situations.

In recent months, economic conditions have appeared to be improving, or are at least better than was feared heading into this period. Higher energy storage levels in Europe, China's reversal of COVID policies and more resilient consumer spending despite higher prices has blunted recessionary fears. Capital flows to high yield are returning, but we are still a long way from normalisation. Perhaps instead, we are entering a new normal of an era where rates aren't pegged at zero and borrowers' (equity) and lenders' (credit) are more equally matched.

While it's positive to see better economic data, we believe rates and yields will remain elevated – higher than two percent - across developed markets for the next several years. However, higher rates are a double-edged sword, as companies and individuals adjust their expenditures to accommodate for a higher cost of capital. Elevated interest expenses, especially for companies already stretched thin, will likely lead to higher levels of default in the coming years. Going forward, credit selection is critical and will require a deep understanding of deal structures, company, sector, regional fundamentals and sponsor behaviour/incentives to avoid pitfalls as companies fail or are no longer supported by sponsors. There is ample opportunity, but many situations will require experience with complexity, and a flexible approach to capital solutions.

### Capital Market Activity

Capital markets activity is generally the lifeblood of credit investing opportunities. 2022's absence of activity leaves a hole in the market, but also creates opportunities for investors to facilitate creative solutions for companies to address financing needs in 2023 and beyond.

Leveraged credit primary issuance was down nearly 70 percent year-over-year in 2022, reflecting a market that has not yet adjusted to higher financing costs. European loan issuance in 2022 was the lowest in ten years, and high yield the lowest since 2009. This year is off to a slow start so far, with ~€10bn in bonds and loans. European LBO activity also slumped in 2022, and as a result, the forward pipeline for issuance is relatively light, meaning that refinancing activity, sponsor-to-sponsor transactions and smaller M&A activity are likely to be the dominant themes for 2023.

2021's record issuance levels and elevated levels during 2018-2020 has meant 2022's dearth of activity does not leave an immediate technical threat on the horizon. The "maturity wall" does not really start to become sizeable until 2026, with a notionally manageable ~€50bn to refinance in the next two years. We also expect higher quality companies to be pro-active in addressing some amount of 2024 and 2025 maturities this year. With LBO activity largely on pause due to higher financing costs, **the 2023-2025 maturity universe represents the bulk of our current efforts and will remain an area of significant focus for this year.**

In addressing upcoming maturities, we expect companies to utilize **a mix of public and private market solutions** to address their upcoming maturity needs. Our flexible mandate is well suited to this, and we are involved in several situations where there is an opportunity to meet a short-term need for the company (refinance or extend maturities) with an attractive return.

Companies unwilling to test public markets to refinance looming maturities have several options:

- **Switch to private markets:** Many borrowers are considering private lending options to replace previously public financing.
- **Negotiate with existing lenders (Amend & Extend):** We are seeing a significant uptick in A&E, both in loans and bonds.
- **Amend & extend with sponsor support:** Sponsors willing to put new money into companies, either via equity, or structured junior financing alongside higher coupons/margin terms for extending maturities by two to three years.
- **Let the company go (Default):** Sponsors can also face difficult portfolio decisions and must choose whether to provide further support to existing holdings, relinquish ownership to lenders, or try to finagle something in between.

### **Default Outlook**

Default rates have been slowly creeping higher over the course of 2022, after resuming post-GFC lows in the wake of the brief COVID spike. Agency forecasts have also been steadily rising as well, with Moody's<sup>1</sup> 12-month baseline June 2022 forecast for Europe at 3.2% and US at 4.2% respectively rising to 4.2% and 5.9% respectively in the past six months.

The process of managing an investment through a bankruptcy process, distressed exchange or even a complicated amend & extend is time consuming and requires expertise. As a result, many initial holders of securities (CLOs, long-only funds, ETFs) often exit investments at this point.

Our view is that not all defaults are bad, especially if your investments were made at levels where a company's liabilities are valued at a substantial discount to par, and a lower EV as a result. While we don't typically enter investments (opportunistic or otherwise) with the intention of taking over companies, we often focus our opportunistic investments on discounted secondary positions, especially during periods of dislocation like 2020 and 2022. Most of these investments are made with the expectation that a market

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<sup>1</sup> Source: Moody's as of 31 January 2023.

recovery will create a pull-to-par scenario. However, there can be benefits to entering an investment on the verge of a financial restructuring where value is still in flux between original holders of risk, and potential new investors in the business.

We believe AlbaCore is well positioned for this environment, in part because the vast majority of our capital is not constrained by time/flows (closed-end funds), so we can be more patient in extracting value from these investments. Our team also has decades of experience and increasing familiarity with restructuring situations around Europe. The restructuring environment of the past 24 months has been largely cooperative and reasonable between parties, though as sponsors are forced to choose between saving investments and letting companies go, this process is likely to become more time consuming and difficult to navigate.

We believe the outlook for recoveries will be more challenging in the next two years, yet it will largely be driven by specific circumstances. For these reasons, we remain focused on senior secured opportunities, with a bias towards issuers, jurisdictions and sponsors who we have a deeper familiarity with.

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**David Allen is the Managing Partner and Chief Investment Officer at AlbaCore Capital Group.**



Mr. Allen has nearly 30 years of financial services and investment experience, with a focus on the High Yield and Leveraged Finance Markets.

Prior to founding AlbaCore Capital Group, Mr. Allen managed Canada Pension Plan Investment Board's European Principal Credit Fund and was a member of the Investment Committee. Mr. Allen was also a Partner, Investment Committee member and Senior Portfolio Manager at GoldenTree Asset Management, where he established and ran the firm's European presence. Mr. Allen spent a decade with Morgan Stanley in New York and Hong Kong, working across M&A and investment banking before specializing as a High Yield media analyst.

Mr. Allen graduated from the University of California, Berkeley, where he earned a Bachelor of Arts in Economics and was an all-conference rower.

**About AlbaCore Capital Group**

AlbaCore Capital Group is one of Europe's leading specialist credit investors focusing on public and private corporate credit markets. The senior investment team have been investing with this hybrid strategy for over a decade. Founded in 2016, AlbaCore has invested over ~\$23bn<sup>2</sup> for global pension funds, sovereign wealth funds, consultants, insurance companies, family offices and endowments.

AlbaCore is focused on consistently outperforming the market in the long term while protecting investor capital. The credit selection process is based on fundamental research with a focus on capital preservation, ESG factors and risk-adjusted returns.

Headquartered in London with offices in New York and Dublin, AlbaCore has a partnership approach with values at the center of the AlbaCore community.

[www.AlbaCoreCapitalGroup.com](http://www.AlbaCoreCapitalGroup.com)

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<sup>2</sup> Invested capital is the sum of all 'buy' trades for all AlbaCore mandates since inception to 30 September 2022 and includes recycled capital and co-investment.