RBC Global Asset Management

Not the same old private credit opportunities

Markets are changing, and so is what investors want.

BlueBay Senior Portfolio Manager, Mihai Florian, and Portfolio Manager, Duncan Farley, recently sat down with Institutional Investor to share insights into private credit opportunities and how they've evolved over time.

Private equity and private credit have dominated the conversation around where institutional investors are targeting their assets in recent years, but of late intriguing opportunities have begun to surface in distressed credit and emerging markets credit – in part because they aren't the same old same old.

"Funds have been focused on private credit for some time now, and frankly that's been a good investment," says Duncan Farley, Portfolio Manager, Leveraged Finance, RBC BlueBay Asset Management. "The first ones launched have done very well, and there's a feel-good factor around that. Based on what we hear from clients, some are still happy to have that exposure – but more and more of them are suddenly suggesting they might want to increase their distressed exposure. Two years ago – even a year ago – they wouldn't have been saying that."

In Europe, for example, there are currently just under 1,500 high-yield bond issues out there, not including levered loans. Just shy of 650 of those are already trading below .90 cents.

"There's already stress in the European high yield market. Investors – including our firm – are looking for stressed opportunities, and they have a lot more to consider today," says Farley. "We're not quite into what I might call a distress cycle – and no one really wants to be. That depends on whether today's markets and global economies end up experiencing a hard or soft landing.

An evolving opportunity

Farley and the team are predominantly focused on stressed and distressed opportunities in the public and the private markets, and he is careful to distinguish between liquid and illiquid "because not everything private is necessarily illiquid, and illiquid has been hard to come by in distressed more recently," he says.

Over the last 10 years or so it hasn't been a deep market in the U.S. or Europe. As a result, distressed funds (or credit opportunity funds, among several other handles) have been more focused on the public markets.

"Given the price action that we've seen in those public markets for high yield or levered loans, it's time to take a breath," says Farley. "Many debt instruments are trading in the 80s, and that doesn't strike us as an irresistible opportunity – whereas for the past 10 years, if you bought bonds and loans in the 80s you've ridden a nice wave. The current market requires a more nuanced and sophisticated view. By and large, tread carefully. At the same time, we are starting to see the opportunity set emerge for private markets and distressed, but it's still early days."

Cycle-proofing emerging markets

This has been a year of transition to what may be a new post-Covid normal, and in emerging market private credit that means (among many things) being prepared for whatever hand investors are dealt.

"We have a variety of sleeves in our emerging market strategies," says Mihai Florian, Senior Portfolio Manager, RBC BlueBay Asset Management. "From secondaries to new money to stressed and more, the sleeves are there to ensure no matter where we are in a cycle we have a sleeve for the current market conditions."

Florian has observed sources of opportunity result from the market dislocations of the past two years. For starters, more blue-chip corporates are willing to pay extra for accessing international markets.

"In that context, we're seeing more new money opportunities from corporates that would not normally look at private credit in normal market conditions," he says, "and we also expect the stress bucket to keep us busy farther down the line. Regardless of where the market could go on the EM side, we have various pockets that can help us shape a view."

In addition, Florian sees opportunity for more than just the yield hunting institutional investors have done in EMs in recent years.

"Recently senior private credit strategies were barely producing low single-digit yield in developed markets," he says. "At the moment, investors are being a bit more selective. At the same time, they have an appetite and the assets to allocate, and realize if they deploy capital now they can lock in a much better opportunity, both from a risk and return perspective. The market is definitely in flux, but ultimately see interest and value in our strategy."

Identifying risk

Managing risk is vital to the opportunity in emerging market credit, and step one in mitigation is identification. Florian keeps an eye on three main areas of risk. Two are fairly commonly cited – legal risk and reputational risk. But neither is the leading reason EM companies experience fiscal challenges.

"The number one reason local corporates experience financial difficulties is FX," he says. "We all know that emerging markets currencies typically go through devaluation periods, and it ultimately affects the performance of the local companies. It's a risk you have to live with and mitigate for in EMs. That's why we focus only on hard currency instruments. The underlying loans are actually dollars or euros."

In fact, Florian and his team go an extra step by focusing on borrowers with hard currency revenues.

"It would surprise a lot of investors to learn how large a portion of revenue for some local corporates is hard currency because as borrowers they've been living with FX devaluation for decades," he says. "It can be export lead or even internal local business. Infrastructure and ports, for example, have hard currency revenues."

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