IPM monthly blog

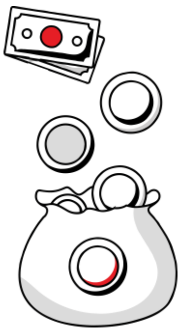
Our monthly insights into private markets – **July 2023**

Real estate

Liquidity at lowest point in a decade

- Global commercial real estate investment volumes in 2Q23 fell to ca. USD 75 billion, a level not seen since the years preceding the global financial crisis.
- The all-in cost of debt remains well above property income yields in most markets, significantly reducing the buyer pool. This is particularly true in larger size bands.
- Although real estate yields continue to edge out, the spreads between corporate and government bonds are narrow on a historical basis. This limits the attractiveness of real estate to multi-asset investors.
- For the buyers who are active in the market, there is a vast polarization in sector preferences. Offices, particularly in the US, are challenged by the structural implications of increased home working reducing demand, and the very high capex costs required to upgrade sustainability credentials.
- More niche sectors demonstrating strong supply-demand credentials still have liquidity. These include life sciences, cold storage, self-storage, data centers and most residential segments.
- Investors are preferring to pay higher prices for assets with a strong outlook on rental growth, rather than secure assets at a significant discount where the occupational outlook is challenging. This is a trend we expect to continue in 2H23.

Private credit



The evolving collateralized loan obligations opportunity set

While equity and bond markets have experienced a sustained rally in 1H, structured credit markets, particularly CLOs, have lagged the broader recovery this year. CLOs are currently trading at historically wide spreads (both on a relative and absolute basis) and elevated yields. In addition, the debt tranches have a reasonable amount of credit enhancement, which should provide sufficient protection to absorb losses in most scenarios.

Market recap

- Broadly, investor sentiment on the space remains negative as market concern around deteriorating corporate credit fundamentals have leaked from leveraged loan to CLO markets. This has resulted in a significant decline in investor demand and challenging technicals, particularly for mezzanine tranches.

- Across the capital stack, CLO spreads remain quite wide, both on a historical absolute basis as well as relative to other corporate credit assets. For instance, investment grade and high yield corporate credit spreads are at 130bps and 405bps, respectively. This reflects historical spread percentiles of 39% and 35%, respectively. In comparison, CLO BBB and BB spreads are currently at 527bps and 986bps, respectively. These figures reflect the 89th and 91st percentiles historically. CLO AAA tranches also offer a reasonable yield profile given spreads are currently 197 bps.

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- As a result of the elevated spreads on CLO debt, new CLO issuance and securitization activity has also slowed materially as rising funding costs have eroded the CLO arbitrage. This has resulted in it not being economical for existing CLOs to refinance or reset their liabilities, and fewer new CLOs being created. Historically, CLO managers have represented 60% of loan purchases; however, approximately 40% of CLOs are scheduled to exit their investment periods by the end of 2023 due to the current liability costs. This could have material implications for the syndicated loan markets and cause an overall decline in demand for loans.

- Supply of new loans remains constrained, as underwriting standards have tightened, and potential borrowers are deterred by current rates. Dispersion remains elevated as rising rates and a slowing economy begin to result in varied outcomes for companies. Despite deteriorating leveraged loan fundamentals and default rates ticking up to 2.9%, this lack of supply could serve as a partial offset to the decline in demand from CLOs.

- The rise in interest rates has acted as a double-edged sword. While the increase in the base rate results in higher cash flows for loan and CLO debt investors, it has compressed interest coverage ratios and will likely lead to a more challenging environment, particularly for the underlying levered borrowers.

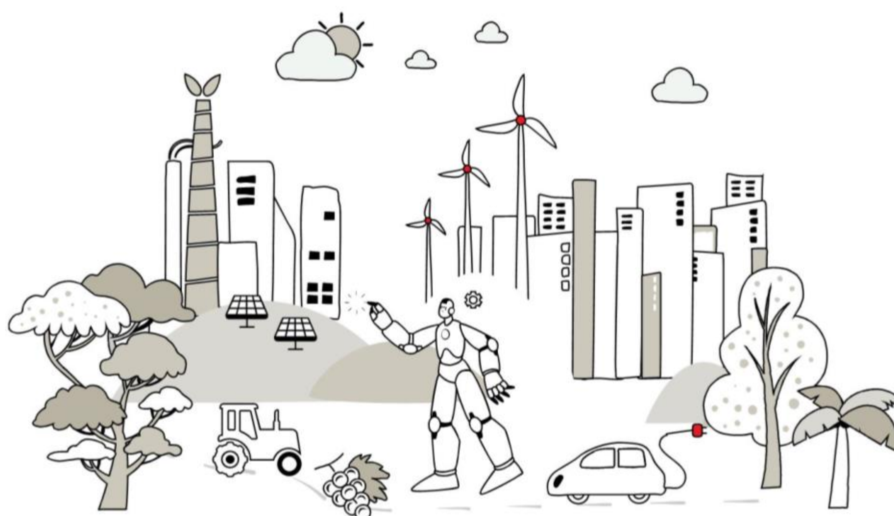
Opportunity set

- In the above detailed market environment, CLO BBB and BB tranches appear to offer attractive risk / reward, both on a relative value and absolute basis. BBB and BB tranches remain historically wide, and offer additional yield relative to corporate credit, with yields typically ranging from 12-15%. The outlook for CLO equity is less certain as these assets trade at elevated yields but are more sensitive to an increase in downgrades and default rates.

- CLOs' structural protections also provide additional principal protection in the form of OC requirements, CCC exposure limits, and subordination / equity cushion. With active management, CLOs have historically experienced lower default rates than leveraged loans.

- Continued dispersion among leveraged issuers have also resulted in a strong environment for fundamental credit selection, which may potentially allow CLO managers to add value through credit selection, pull-to-par opportunities or secondary trading.

- With the natural buyer of loans likely sidelined as CLOs exit their investment period and overall slowed new issuance, private credit managers may also have the opportunity to step into the market and provide private off market credit solutions to would-be leveraged loan issuers. Private credit lenders have been taking share from the syndicated loan market and this trend will likely continue, offering a compelling market opportunity for private credit strategies.



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